New York State Bar Association
Tax Section

Report on Differences in Tax Treatment of Domestic and Foreign Partnerships

January 3, 2007

Report No. 1124

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This report sets forth the views of the New York State Bar Association Tax Section on the appropriateness of provisions in existing law that treat domestic and foreign partnerships differently for federal income tax purposes.[1] The report addresses the definition of what constitutes a domestic as opposed to a foreign partnership,[2] situations in which the tax liability of partners or persons dealing with partnerships is affected by whether a partnership is domestic or foreign, and differences in the application of withholding and other administrative provisions to domestic and foreign partnerships.

Part I of the report discusses the definitional distinction between domestic and foreign partnerships under current law and describes in a general manner the circumstances in which the distinction makes a difference for tax purposes. Part II sets forth our general recommended approach as to when, if at all, domestic and foreign partnerships should be treated differently. Part III sets forth our views on specific provisions of current law that treat domestic and foreign partnerships differently for purposes of determining the tax liability of partners or persons dealing with partnerships. Part IV sets forth our views on specific areas in which domestic and foreign partnerships are treated differently for purposes of income tax withholding

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1. This report was prepared by an ad hoc committee of the New York State Bar Association Tax Section, chaired by Andrew H. Braiterman, whose members are Kimberly S. Blanchard, Stephen B. Land, Carlyn S. McCaffrey, David S. Miller, Joel Scharfstein, and David H. Schnabel. Substantial assistance was provided by Diane Beleckas and Meredith Stead. Helpful comments were provided by William B. Brannan, Patrick C. Gallagher, Edward E. Gonzalez, Michael L. Schler, David R. Sicular, and Willard B. Taylor.

2. References in this report to "partnerships" are to entities treated as partnerships for federal tax purposes, regardless of their legal form under state or foreign law.

and other administrative provisions. To the extent that we suggest changes from current law, we have indicated whether we believe that such changes can be accomplished through regulations or whether legislative changes are needed.

I. Background

A. Definitions of Domestic and Foreign Partnerships

Pursuant to Section 7701(a)(4) of the Internal Revenue Code of 1986, as amended (the "Code"),[3] a partnership is "domestic" if it is "created or organized in the United States or under the law of the United States or of any State unless . . . the Secretary provides otherwise by regulations." Section 7701(a)(5) provides that a partnership is "foreign" if it is not domestic. Treas. Reg. § 301.7701-5(a) essentially repeats these definitions. To date, the Treasury Department has not exercised its authority to issue regulations providing exceptions to the general definition of domestic partnership.[4]

As discussed in more detail below,[5] Treas. Reg. § 1.861-2(a)(2) provides a separate definition whereby a partnership is treated as a resident partnership if it is "engaged in

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3. Except where otherwise indicated, Section references herein are to Sections of the Code.

4. The words "unless . . . the Secretary provides otherwise by regulations" were added to Section 7701(a)(4) by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1151(a). Congress anticipated that the general rule for classifying partnerships as domestic or foreign would continue to be based upon the place where the partnership was created or organized (or the laws under which it was created or organized), that the regulations would create a different classification "only in unusual cases," and that such a recharacterization would be based on "material factors" such as the residence of the partners, the extent to which the partnership was engaged in business in the United States, or the extent to which the partnership earned U.S.-source income. Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997 (Blue Book), JCS-23-97 (Dec. 17, 1997), at 317.

5. Part III. E, *infra*.

trade or business in the United States." This definition applies solely for purposes of determining the source of interest paid by a partnership.[6]

Because the status of a partnership as domestic or foreign is based solely upon the law under which it is organized (absent the exercise of regulatory authority under Section 7701(a)(4)), such characterization is essentially elective in most cases.[7] Organizing a partnership under foreign rather than domestic law typically does not have substantial non-tax consequences and, as long as the partnership is transparent under foreign tax law or is organized in a tax haven, need not have significant foreign tax consequences.[8] The elective nature of domestic versus foreign status is enhanced by the ability to form disregarded entities under the check-the-box rules. For example, a business whose owners desire tax treatment as a foreign partnership but prefer to present themselves for non-tax purposes as doing business through a U.S. entity can be organized as a foreign partnership that conducts its operations through a wholly-owned domestic limited liability company. From a U.S. tax standpoint, the income of the limited liability company is deemed to be earned by the foreign partnership. Moreover, depending upon the

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6. Treas. Reg. § 301.7701-5 previously included a similar residence definition. This definition was repealed (and not replaced) in 2004. T.D. 9153 (Aug. 11, 2004). The stated reason for the repeal was that the definitions involving residence (resident foreign corporation, nonresident foreign corporation, resident partnership and nonresident partnership) had "become obsolete due to statutory changes since the final regulations were published in 1960."

7. In the case of a contractual arrangement that is treated as a partnership for federal income tax purposes, determination of whether the deemed partnership is domestic or foreign is potentially less clear. Relevant criteria could include the contractual choice of law provisions (which may lead to further complications if there are multiple agreements) or the location or locations where negotiations take place.

8. Possible tax consequences under laws of jurisdictions other than the United States or the country of organization may also have to be considered. For example, where the partnership invests or does business in a third country, the availability of treaty benefits may be affected.

specific circumstances and foreign tax laws, the owners may be able to benefit from treatment of the limited liability company as a non-transparent entity for foreign tax purposes.

B. Differences in Tax Treatment between Domestic and Foreign Partnerships

The federal income tax treatment of partnerships and their partners is for the most part unaffected by the status of the partnership as domestic or foreign. A U.S. partner is subject to tax on a current basis on its share of the partnership's income, regardless of the partnership's nationality.[9] A foreign partner is subject to tax on a net income basis on its share of the partnership's income that is effectively connected with the conduct of a U.S. trade or business ("ECI"), on a gross income basis on its share of U.S.-source fixed or determinable annual or periodical gains, profits and income ("FDAP") that is not ECI, and, in the case of a nonresident alien individual, on certain U.S.-source capital gains. Again, the nationality of the partnership is irrelevant, at least as a matter of domestic law.[10]

There are, however, exceptions to the general principle that a partnership's nationality does not matter. As discussed in Part III of this report, there are a number of situations in which a partnership's nationality or residence affects its partners' tax liabilities or, in the case of interest paid by a partnership, the tax liability of the partnership's lenders. These situations occur where a partnership is viewed on an entity as opposed to an aggregate basis and the treatment of an item of income or loss (for example, its source) is dependent upon a

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9. This report refers to a partnership's status as domestic or foreign as its "nationality."

10. In some cases, foreign partnerships that are taxed on a residence basis by their home countries may be entitled to treaty benefits that would not be available to domestic partnerships and their foreign partners. Issues regarding partnerships and treaty benefits are beyond the scope of this report.

taxpayer's nationality or residence rather than solely upon the location of income-generating activity.

As discussed in Part IV, there are also situations in which a partnership's nationality does not affect anyone's ultimate tax liability but does have administrative significance with respect to reporting and withholding tax requirements.

II. Recommended General Approach

We believe that whether the nationality of a partnership should affect the tax liability of its partners or its lenders should be determined based upon an examination of the policies behind the relevant statutory provision, giving appropriate consideration to administrability. As a general matter, however, our view is that the nationality of a partnership should not have any substantive tax impact absent a compelling reason for differential treatment of domestic and foreign partnerships.

The primary argument in favor of our recommended presumption that a partnership's nationality should be irrelevant is that partnerships are pass-through entities and a partner's obligation to pay U.S. federal income tax on its share of partnership income is unaffected by the status of the partnership as domestic or foreign. In light of this general statutory scheme, determining the amount, source, or character of particular items of income by reference to the partnership's nationality is inherently aberrational.[11] It is also difficult to see why tax liability should be different for operations conducted through a partnership as opposed to a disregarded entity or other branch. Furthermore, to the extent that the nationality of a

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11. In contrast, domestic and foreign corporations are subject to fundamentally different taxation regimes, as a result of which other nationality-based distinctions with respect to specific items of income are not unexpected.

partnership does affect its partners' tax liability, the essentially elective nature of whether to form a partnership under domestic or foreign law provides the potential for manipulation by taxpayers. Conversely, such distinctions pose a potential trap for the unwary where the taxpayer does not anticipate them at the time of partnership formation or there was an overriding non-tax or foreign tax motivation for choosing the jurisdiction of organization.

Congress recognized the appropriateness of essentially similar treatment of domestic and foreign partnerships when it repealed Section 1491 of the Code as part of the Taxpayer Relief Act of 1997.[12] Section 1491 imposed a 35% excise tax on gain realized on transfers of property by U.S. persons to foreign partnerships where gain would otherwise qualify for nonrecognition treatment, despite the fact that the U.S. transferor would continue to be subject to U.S. tax on its share of the foreign partnership's income. Section 1491 was replaced by Sections 367(d)(3) and 721(c), which give the Secretary regulatory authority to address shifting of income or gain to foreign persons through transfers to domestic or foreign partnerships.[13] These new provisions appropriately focus on whether income or gain escapes the U.S. tax net as opposed to the nationality of the partnership.

In contrast, providing different withholding tax regimes and other administrative rules is as a general matter less troublesome, as long as the parties' ultimate tax liabilities are unaffected. As a practical matter, domestic partnerships are more likely than foreign partnerships to have U.S. partners and/or U.S. business operations. It makes sense to differentiate between domestic and foreign partnerships for administrative and withholding

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12. Pub. L. No. 105-34.

13. This regulatory authority has not been exercised, presumably in large part because Section 704(c) generally is adequate to prevent shifting of income or gain.

purposes to the extent that the partnership's nationality has a likely correlation to the amount of income that will be subject to U.S. tax and the Internal Revenue Service's ability to collect amounts due from the ultimate taxpayers. A partnership's nationality is often an imperfect but nonetheless useful proxy for these purposes. Differential treatment may ease taxpayers' compliance burdens and increase the government's ability to enforce the law. In such cases, thought should be given to the appropriate criteria for classifying a partnership as domestic or foreign, balancing enforcement considerations with ease of compliance for partnerships and other persons who have dealings with partnerships.

III. Current Law Provisions Affecting Substantive Tax Liability Based upon Nationality of Partnership

We have identified a number of provisions in which the status of a partnership as domestic or foreign affects the substantive tax liability of partners or taxpayers dealing with partnerships. The operation of these provisions under current law and our recommendations for change (if any) are discussed below.

A. Treatment of Partnerships as Shareholders for Purposes of Subpart F

1. Current Law

Section 957(a) of the Code provides that a foreign corporation is a controlled foreign corporation ("CFC") if more than 50% of the total voting power or value of the outstanding stock of the corporation is owned (taking into account constructive ownership rules) by "United States shareholders." Pursuant to Section 951(b), a "United States shareholder" is a United States person that owns (taking into account constructive ownership rules) at least 10% of the total voting power of the corporation's stock. Section 951(a) requires a United States shareholder to include in income its share of a CFC's subpart F income and earnings invested in U.S. property under Section 956 of the Code.

A domestic partnership is a United States person; a foreign partnership is not. In effect, a domestic partnership is treated on an entity basis while a foreign partnership is treated on an aggregate basis for purposes of these rules. This results in subpart F being applied very differently to U.S. taxpayers who own interests in foreign corporations through domestic partnerships as opposed to foreign partnerships. A domestic partnership that owns 10% or more by vote of the stock of a foreign corporation is treated as a United States shareholder, regardless of how widely ultimate beneficial ownership is diffused among the partners or even how much (if any) of the interests in the partnership are owned by U.S. taxpayers. If, for example, a domestic partnership is the sole shareholder of a foreign corporation, the foreign corporation is a CFC and all of its U.S. partners – no matter how small their partnership interests – are required to include a share of the subpart F income generated by the foreign corporation. By contrast, where a foreign partnership owns shares in a foreign corporation, United States shareholder status is determined at the partner level on a look-through basis. Under Section 958(a)(2), stock owned by a foreign partnership is considered as being owned proportionately by its partners. The application of this look-through rule in cases where partners have differing interests in profits and capital, non-pro rata interests in income, or differing voting or control rights is in many cases unclear. For example, it is not clear whether the voting power of all the stock owned by a foreign partnership is attributed to a U.S.-resident general partner who has a small economic interest but has sole control over the partnership's investment and voting decisions.

The consequences of treating a domestic partnership as an entity for purposes of the subpart F rules can often be avoided through structuring of partnership vehicles. For example, private equity funds are often organized as partnerships under foreign law, or

alternatively parallel foreign partnerships are created in order to avoid United States shareholder status.

Conversely, there are situations in which taxpayers can use the partnership rules to their advantage in order to achieve United States shareholder or CFC status. For example, a U.S. corporation and a foreign corporation that jointly own another foreign corporation as a 50/50 joint venture can own the joint venture corporation through a domestic partnership holding vehicle in order to cause the joint venture corporation to be a CFC and thereby enable the U.S. corporation to benefit from the more liberal look-through rules under Section 904 of the Code applicable to CFCs as compared to non-controlled Section 902 corporations.[14] This result would not apply if a foreign partnership were used or if the parties owned stock in the joint venture corporation directly without an intervening partnership. The partnership anti-abuse regulations expressly endorse this type of planning as consistent with the intent of subchapter K.[15] Similarly, U.S. partners with small economic interests in a domestic partnership may be better off if their share of income from the partnership's stock investments is subject to the CFC regime rather than the passive foreign investment company ("PFIC") rules.

2. Recommended Approach

We do not see any persuasive policy reasons for treating domestic and foreign partnerships differently for purposes of the United States shareholder and CFC definitions. The

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14. These distinctions were reduced by the enactment of Section 904(d)(4) in 1997, effective for tax years beginning after December 31, 2002, which provides look-through treatment for dividends (but not for interest and royalties) received from noncontrolled Section 902 corporations. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1105(b).

15. Treas. Reg. § 1.701-2(d), *Example 3*.

nationality of the partnership is in our view irrelevant to arguments in favor of entity or aggregate treatment of partnerships for this purpose.

We believe that subpart F is intended to apply only to U.S. taxpayers with substantial interests in foreign corporations. Accordingly, the application of subpart F should be based upon the extent of the ownership of the actual taxpayers -- *i.e.*, the partners as opposed to the partnership -- and the look-through rule currently applicable to foreign partnerships should be applied to all partnerships. This would be consistent with recently proposed regulations that would apply the rule excluding 10% shareholders from the portfolio interest exemption at the partner rather than the partnership level in the case of interest received by a partnership.[16] We believe that our suggested approach would require amendments to Section 958 of the Code.[17]

Admittedly, there are objections that can be raised to applying the subpart F rules at the partner level. The concentration of corporate control where a partnership owns a major stake in a CFC, even in the case of a widely held partnership, arguably supports entity level treatment. However, we think that it is inappropriate to provide for entity level treatment where the partnership is predominantly owned by foreign partners. Conditioning entity treatment upon some minimum level of ownership of the partnership by U.S. partners would have the potential for anomalous results insofar as a change in ownership of the partnership would result in changes

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16. Prop. Treas. Reg. § 1.871-14(g).

17. Although it has been suggested that the Treasury Department has regulatory authority to treat domestic partnerships on an aggregate basis for purposes of U.S. shareholder determinations under subpart F, we do not believe that this would be consistent with the plain language of the statute. It can be argued that Section 7701(a)(4) gives the government authority to treat an otherwise domestic partnership as a foreign person for this purpose, although it is unclear that Congress intended such authority to encompass treating a partnership as foreign only for purposes of certain Code provisions. The more plausible reading of Section 7701(a)(4) is as a grant of authority to treat a domestic partnership as foreign for all purposes of the Code, if it possesses sufficient foreign attributes, such as place of management or control and where its operations are actually carried on.

to the tax treatment of the original U.S. partners if the ownership change resulted in the foreign corporation becoming or ceasing to be a CFC.[18] In addition, entity level treatment for domestic partnerships has the advantage of simplicity, because it avoids the necessity to apply the look-through rules that apply to foreign partnerships (but we note that if simplicity concerns were paramount, the Code would not look through foreign partnerships but would treat a foreign partnership as an entity as well, producing anomalous results in many cases). We also acknowledge that partner level determinations are inconsistent with the general rule that income earned through a partnership is determined in the first instance at the partnership level. Treating some partners (but not others) as earning subpart F income and excluding subsequent dividends allocable to such partners as previously taxed income under Section 959 can produce complexity from a reporting standpoint. However, this potential already exists for foreign partnerships.

On balance, notwithstanding the arguments in favor of entity treatment noted above, our view is that aggregate treatment is more appropriate than entity level treatment regardless of the nationality of the partnership. The IRS should provide guidance on the application of the look-through rules applicable to foreign partnerships and, if our recommendation is adopted, to domestic partnerships.

B. Application of Corporate Inversion Rules to Partnerships

1. Current Law

Section 7874 of the Code provides rules intended to combat potential abuses involving "expatriated entities" and their foreign acquirers. In general, an expatriated entity is a

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18. Although U.S. persons who directly own stock in a foreign corporation can be affected by transactions in the corporation's stock involving other shareholders, this is only an issue for 10% shareholders.

domestic corporation substantially all the properties of which are acquired (or a domestic partnership substantially all the properties constituting a trade or business of which are acquired) directly or indirectly by a foreign corporation in a transaction which results in the owners of the domestic entity owning at least 60% by vote or value of the stock of the acquiring foreign corporation by reason of their interests in the domestic entity. Section 7874(a)(1) of the Code provides that the taxable income of the expatriated entity shall in no event be less than its "inversion gain." Inversion gain is defined as income or gain recognized by reason of the transfer or license of property by the expatriated entity as part of the expatriation transaction or, in the case of a transfer or license to a related foreign person, within the following ten years. If the owners of the domestic entity receive an 80% or greater interest in the acquiring foreign corporation, Section 7874(b) provides that the acquiring foreign corporation is treated as a domestic corporation.

Section 7874 has implications for partnerships in two different situations. First, the Treasury Department has exercised its authority under Section 7874(g) to issue regulations necessary to prevent the avoidance of the purposes of Section 7874 through the use of pass-through or other noncorporate entities. Temp. Treas. Reg. § 1.7874-2T(e)(1) provides that a "publicly traded foreign partnership" is treated as a foreign corporation for purposes of Section 7874. Temp. Treas. Reg. § 1.7874-2T(e)(2) defines a "publicly traded foreign corporation" as a foreign partnership that would be treated as a corporation pursuant to the Section 7704 publicly traded partnership rule, but for the application of Section 7704(c)[19] at any

19. Section 7704(c) generally excludes partnerships with predominantly passive income from the application of the publicly traded partnership rules.

time during the two-year period following the foreign partnership making an acquisition otherwise described in Section 7874. As a result, unless one of the exceptions to Section 7874 applies, the foreign partnership is treated as a domestic corporation for all tax purposes if the former owners of the domestic entity acquire 80% or more of the interest in the foreign partnership. If the 60% threshold is met but the 80% threshold is not, the domestic entity is subject to the Section 7874 rules on inversion gain but the foreign partnership is otherwise treated as a foreign partnership. These rules have no application to an acquisition by a domestic partnership.

Second, Section 7874 can apply to an acquisition by a foreign corporation (or, in the circumstances described above, a foreign partnership) of substantially all of the properties constituting a trade or business of a domestic partnership, regardless of whether such business is conducted in whole or in part within the United States and regardless of whether any of the partners is a U.S. person. By contrast, Section 7874 does not apply to an acquisition of properties of a foreign partnership, regardless of the location of its activities or the identity of its partners.

2. Recommended Approach

We do not think that there is any policy reason for distinguishing between domestic and foreign partnerships for purposes of Section 7874. In the case of an acquisition by a publicly traded partnership, we do not see why a foreign partnership poses any greater policy concerns that justify treating the partnership as a domestic corporation pursuant to Temp. Treas. Reg. § 1.7874-2T(e) than does a domestic partnership. For the reasons set forth in an earlier

report which we submitted prior to issuance of the temporary regulations,[20] we do not believe that treating partnerships as corporations pursuant to Section 7874 is appropriate. However, if our recommended approach discussed above of treating all partnerships, both domestic and foreign, on an aggregate basis for purposes of the CFC rules is not adopted, the Treasury Department and the IRS could take the view that it is appropriate to address potential abuses by recharacterizing foreign, but not domestic, partnerships as corporations on the theory that the CFC rules are adequate to deal with acquisitions by domestic partnerships.

Similarly, to the extent that it is appropriate to treat the acquisition by a foreign corporation of substantially all the properties of a trade or business of a partnership as an inversion transaction under Section 7874, the nationality of the partnership has no readily apparent relevance. The location of the partnership's activities and the identity of the partners are more germane to the policies underlying Section 7874. The current rules potentially encourage well-advised taxpayers forming new partnerships to avoid possible future application of the inversion rules by using foreign partnerships, even if all the partners are initially U.S. persons and all the partnership's activities are initially conducted in the United States. Applying Section 7874 to acquisitions of trades or businesses of foreign partnerships would require a statutory change.

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20. NYSBA Tax Section Report on Temporary Treasury Regulations Section 1.7874-IT (Report No. 1107, Mar. 22, 2006).

C. Loans by Controlled Foreign Corporations to Partnerships

1. Current Law

Current law provides substantially different consequences under Section 956 for a loan by a CFC to a partnership depending upon whether the partnership is domestic or foreign.

Section 956 treats domestic partnership borrowers on an entity basis. Because a domestic partnership is a U.S. person, the Code clearly requires treatment of a loan by a CFC to a "related" domestic partnership as an investment in U.S. property, subject to certain exceptions, regardless of whether any or all of the partners is a U.S. person or whether the loan proceeds are invested by the partnership in the United States.[21]

There are no clear statutory rules applying Section 956 to loans by CFCs to foreign partnerships. A loan to a foreign partnership, even where the partners are United States shareholders of the CFC and/or the foreign partnership is engaged in a U.S. trade or business, can only be treated as an investment in U.S. property if the partnership is viewed as an aggregate of its partners. In the notice of proposed rulemaking with respect to regulations applying Section 954(i) to partnerships, the Internal Revenue Service and Treasury Department solicited comments regarding the application of Section 956 to loans by CFCs to foreign partnerships.[22] In response to this request, the NYSBA Tax Section submitted a report recommending that a loan to a foreign partnership generally should be treated as an investment in U.S. property only

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21. Section 956(c)(1)(C) provides that an obligation of a U.S. person is U.S. property. Section 956(c)(2)(M) provides an exception for a loan to a domestic partnership that is not a United States shareholder of the CFC (within the meaning of Section 951(b)) and does not have as a partner the CFC or a related person (within the meaning of Section 954(d)(3)). Section 956(c)(2) also includes certain narrower exceptions that potentially apply to obligations of U.S. partnerships and other U.S. persons.

22. REG-106418-05, 71 Fed. Reg. 2496 (Jan. 17, 2006).

in certain circumstances involving investments of the proceeds by the partnership in U.S. property or distributions of proceeds by the partnership to U.S. partners.[23]

2. Recommended Approach

The Internal Revenue Service and Treasury Department, in their request for comments on the application of Section 956 to loans to foreign partnerships, indicated a particular interest in "the consistent application of Section 956 to foreign partnerships, domestic partnerships, foreign branches, and disregarded entities of U.S. shareholders." We do not see any policy reason for treating loans by CFCs to partnerships differently based upon the nationality of the partnership. The purposes of Section 956 are better served by rules that focus on the identity of the partners and the use of the proceeds.

Attaining consistency between loans to domestic and foreign partnerships will require changes to the entity approach embodied in Section 956 as currently in effect. Section 956 in its current form tends to be overinclusive in treating loans to domestic partnerships as investments in U.S. property (*e.g.*, where all the partners are foreign corporations) and underinclusive with respect to loans to foreign partnerships (because treatment as an investment in U.S. property generally requires exercise of the Secretary's authority to issue anti-abuse regulations). The substantive content of appropriate rules is beyond the scope of this report.

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23. NYSBA Tax Section, Report on the Application of Section 956 to Partnership Transactions (Report No. 1114, June 30, 2006).

D. Source of Notional Principal Contract Income

1. Current Law

Treas. Reg. § 1.863-7 provides rules for determining the source of income from notional principal contracts. The source of notional principal contract income is determined by reference to the residence of the taxpayer as determined under Section 988(a)(3)(B)(i),[24] subject to exceptions for notional principal contract income attributable to a foreign qualified business unit ("QBU") of a U.S. resident, which generally is treated as foreign source,[25] and notional principal contract income that is ECI of a foreign person, which is treated as U.S.-source.[26] In the case of a partnership, although Section 988(a)(3)(B)(i) provides that a domestic partnership is a U.S. resident and a foreign partnership is a foreign resident, it is unclear whether the "taxpayer" referred to in Treas. Reg. § 1.863-7(b)(1) is the partnership or the partner.

2. Recommended Approach

We believe that the residence sourcing rule for notional principal contracts should be applied at the partner level rather than at the partnership level, regardless of the nationality of the partnership. One of the principal benefits of residence-based sourcing for notional principal contract income is to eliminate issues as to whether and to what extent notional principal contract income earned by foreign persons is FDAP subject to U.S. withholding tax. Outside the partnership context, notional principal contract income of a foreign taxpayer is either ECI, which is taxed by the United States on a net income basis, or foreign source non-ECI, which is not

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24. Treas. Reg. § 1.863-7(b)(1).

25. Treas. Reg. § 1.863-7(b)(2).

26. Treas. Reg. § 1.863-7(b)(3).

taxed by the United States at all. Determining residence at the partnership level would lead to the anomalous situation where a foreign partner in a domestic partnership could have domestic source notional principal contract income that is not ECI and therefore potentially subject to taxation on a gross income basis. Our recommendation is consistent with the source rules for gain and loss on sale of personal property,[27] as well as the recently finalized regulations addressing income from space and ocean activities[28] and communications income.[29]

E. Source of Interest Paid by Partnerships

1. Current Law

Prior to enactment of the American Jobs Creation Act of 2004 (the "AJCA"),[30] the source of interest paid by a partnership was not affected by whether the partnership was domestic or foreign. Subject to exceptions for deposit interest paid by foreign branches, the source of interest paid by a partnership depended solely on whether the partnership was a "resident" of the United States.[31] Pursuant to Treas. Reg. § 1.861-2(a)(2), a domestic or foreign partnership is treated as a resident of the United States for purposes of Section 861 of the Code if (and only if) it is engaged in a trade or business in the United States at any time during its taxable year.

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27. Under the general rule of Section 865(a), which is subject to numerous exceptions, gain or loss from the sale of personal property is determined by reference to residence. Section 865(i)(5) provides that, in the case of a partnership, except as otherwise provided in regulations, which to date have not been promulgated, Section 865 is applied at the partner level.

28. Treas. Reg. § 1.863-8(e).

29. Treas. Reg. § 1.863-9(i).

30. Pub. L. No. 108-357.

31. The exception under Section 861(a)(1)(A), treating interest paid by resident alien individuals and domestic corporations as foreign-source if an 80% foreign business requirement is met, does not apply to partnerships.

The AJCA added Section 861(a)(1)(C) to the Code. Section 861(a)(1)(C) provides that interest paid by a U.S.-resident foreign partnership is U.S.-source only if (i) the partnership is not predominantly engaged in the active conduct of a trade or business outside the United States or (ii) the interest is paid by a U.S. trade or business of the partnership under principles similar to the branch interest rules of Section 884(f) or is allocable to ECI. The prior rule, which treats all interest paid by a partnership as U.S.-source if the partnership is engaged in any U.S. trade or business, remains in effect for domestic partnerships.

The source of interest paid by a partnership has no effect on the tax liability of the partners as such, although it can affect the partnership's withholding obligations and therefore gross-up or other indemnity obligations under credit agreements. The source of interest income can be relevant to foreign lenders who are not entitled to benefit from the exemption for portfolio interest (*e.g.*, foreign lenders who are 10% shareholders or banks not entitled to exemption under a treaty). In the case of U.S. lenders, the source of interest income affects foreign tax credit limitations.

2. Recommended Approach

As a theoretical matter, interest paid by a partnership probably should be treated as U.S.-source if and only if it reduces income of the partners that is subject to U.S. tax, either because the partner is a U.S. person or because the income is ECI allocable to a foreign partner. Determining source of interest on an aggregate rather than an entity basis, however, likely would entail insurmountable practical difficulties. In the case of a partnership that has both U.S. and foreign partners, a payment of interest could be partially U.S. and partially foreign source, with the mix changing based upon changes in ownership of the partnership. In many cases, it may be very difficult for the partnership and its lenders to make the appropriate source determinations in an accurate and timely fashion.

We do not believe, however, that determining the source of interest paid by a partnership should depend upon whether the partnership is domestic or foreign. The rules enacted by the AJCA for payments of interest by foreign partnerships, which focus on the activities of the partnership, strike a reasonable balance among competing considerations and should be made applicable to all partnerships.

We recognize that the current rules applicable to domestic partnerships, which treat all interest paid as U.S.-source if the partnership is engaged in a U.S. trade or business, have the advantage of simplicity. However, our proposal would preserve this result in the case of a typical domestic partnership that conducts all its activities in the United States.

There are several respects in which it would be helpful to clarify the current rules. At least based upon a literal reading of Treas. Reg. § 1.861-2(a)(2), it appears that a partnership (such as an investment partnership) that is not engaged in a trade or business anywhere in the world is not a resident partnership, with the result that any interest paid by such a partnership is foreign source. It would be more sensible to provide that the source of interest payments by such a partnership is determined by reference to the location of its principal office or possibly its nationality or the residence of its partners.

The IRS should also clarify that the "predominantly engaged in the active conduct of a trade or business outside the United States" test of Section 861(a)(1)(C) is applied by aggregating all active business activities outside the United States. Guidance should also be provided concerning how to apply the test where a partnerships carries on investment or other non-business activities. To the extent that such activities are not taken into account in determining whether a partnership is U.S.-resident, there is no apparent reason for taking them into account for purposes of the "predominantly engaged" test. While we believe that the

purpose of the "predominantly engaged" rule might best be served by excluding such non-business activities, we recognize that the more natural reading of the language employed by Congress is that such activities are taken into account.

F. Deductibility of Payments to Related Partnerships

1. Current Law

Section 267(a)(3) generally requires a taxpayer to use the cash method of accounting with respect to interest and other amounts owed to a foreign person that is related to the taxpayer within the meaning of Section 267(b). Section 163(e)(3) provides a similar rule for original issue discount. There is an exception for income that is taxable to the related foreign person as ECI.[32]

Treas. Reg. § 1.267(b)-1(b) provides that a transaction between a partnership and a person other than a partner is treated for purposes of Section 267 as occurring between the partners (based upon their relative interests in the partnership) and such other person. However, this regulation predates the addition of Section 267(b)(10), which treats commonly owned partnerships and corporations as related persons, and the extent (if any) of its continuing validity is unclear. Thus, it appears that Section 267(a)(3) and 163(e)(3) may not apply where the related payee is a U.S. partnership with foreign partners but may apply to the entire payment where the related payee is a foreign partnership some or all of the partners of which are U.S. persons.

2. Recommended Approach

The applicability of Sections 267(a)(3) and 163(e)(3) should not depend on whether a related partnership payee is domestic or foreign. We recommend a two-step approach

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32. Treas. Reg. § 1.267(a)-3(c); Treas. Reg. § 1.163-12(b).

in which, consistent with Section 267(b)(10), the relatedness of the payee is determined by treating the partnership as an entity, and the applicability of the deferral rule is then determined by reference to the partners' U.S. or foreign status on a look-through basis. For example, if a 35% interest in a domestic or foreign partnership that is related to the payor is owned by foreign persons whose share of the partnership's income is not ECI, then 35% of the payor's deduction should be subject to the deferral rule, regardless of whether the foreign partners are related to the payor. We also believe that it is appropriate to apply Section 267(a)(3) and 163(e)(3) to payments to an unrelated partnership that are allocable to a foreign partner that is a related person with respect to the payor.

G. QEF Elections for PFICs with Partnerships as Shareholders

1. Current Law

Under current law, the method of making a qualified electing fund ("QEF") election under Section 1295 of the Code with respect to stock in a PFIC owned by a partnership differs depending upon whether the partnership is domestic or foreign. As under subpart F, a domestic partnership with holdings in a PFIC is treated on an entity basis while a foreign partnership is treated on an aggregate basis. In the case of a domestic partnership, the QEF election must be made at the partnership level,[33] while partners in a foreign partnership must make the election at the partner level.[34]

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33. Treas. Reg. § 1.1295-1(d)(2)(i)(A).

34. Treas. Reg. § 1.1295-1(d)(2)(i)(B).

2. Recommended Approach

To the extent that it is appropriate to mandate that QEF elections be made at either the partner or the partnership level (as opposed to giving partners and partnerships a choice as to the level at which the election is made), the current rules providing for partnership level elections for domestic partnerships and partner level elections for foreign partnerships operate in a reasonable manner. Making PFIC-related elections and other determinations at the partnership level is probably simpler in terms of ease of compliance for the partners. However, mandating partnership level elections for foreign partnerships often would not be workable as a practical matter, since foreign partnerships, which in many cases do not have to file U.S. tax returns, are less likely than domestic partnerships to be attuned to U.S. tax planning concepts. The distinction is based on the empirical likelihood that domestic partnerships will be managed by U.S. persons and foreign partnerships by foreign persons, as opposed to any inherent difference between domestic and foreign partnerships.

We think, however, that in many cases the different treatment of domestic and foreign partnerships for purposes of QEF elections does not serve the purpose of the PFIC and QEF rules. We believe that it would be preferable to allow the election to be made at either the partner or the partnership level, regardless of the nationality of the partnership. The requirement to elect at the individual level can be cumbersome for a foreign partnership with U.S. partners, many of whom own small interests. Conversely, there is no policy reason why the failure of a domestic partnership to make the election should preclude the partners from doing so. Our recommendation would not require a statutory change, but could instead be effected by amending the regulations. We acknowledge that our recommended approach would not allow a partner to override a partnership's QEF election. Because making the election is in most cases more favorable than not making the election, we do not think that this is a major concern.

H. Treatment of Partnerships under the Stapled Stock Rules

1. Current Law

Section 269B provides that if a foreign corporation and a domestic corporation are "stapled entities," the foreign corporation is treated as a domestic corporation and therefore is subject to U.S. tax on its worldwide income. A group of two or more entities are stapled entities if more than 50% in value of the beneficial ownership in each of such entities consists of "stapled interests." "Stapled interests" are two or more interests that are, or must be, transferred together because of form of ownership, transfer restrictions, or other terms or conditions. The stapled stock rules do not apply if it can be established to the satisfaction of the Secretary that both the domestic corporation and the foreign corporation are foreign-owned. A corporation is foreign-owned if less than 50% of (1) the total combined voting power of all classes of stock entitled to vote, and (2) the total value of the stock of the corporations, is held directly (or indirectly) by U.S. persons.[35] In determining ownership, a domestic partnership is treated as a U.S. person, while a foreign partnership is subject to look-through treatment.[36] Thus even if none of the partners of a domestic partnership is a U.S. person, the partnership is a U.S. owner for purposes of the ownership rules.

2. Recommended Approach

We believe that the fundamental purpose of the foreign ownership exception to the stapled stock rules is to limit their application to stapled corporations owned by U.S. taxpayers. Accordingly, it is appropriate to make the foreign ownership determination at the

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35. Section 269B(e); Treas. Reg. § 1.269B-1(a)(2).

36. Section 269B(e)(2), cross-referencing Sections 7701(a)(30) (domestic partner is a U.S. person) and 958(a)(2) (stock owned by a foreign partnership is considered as being owned proportionately by its partners).

partner rather than the partnership level, regardless of whether the partnership is domestic or foreign. Any concerns that the government may have as a result of difficulty in determining the identity and status of the partners is alleviated by the fact that the taxpayer bears the burden of proof in establishing foreign ownership. Our suggested change would require a statutory amendment.

IV. Current Withholding and Other Administrative Provisions

A. Return Filing Requirements under Section 6031

1. Current Law

A domestic partnership must file an annual partnership return, unless (i) it has no income, deductions or credits for the taxable year[37] or (ii) it has previously elected to be excluded from the application of subchapter K.[38] A foreign partnership is not required to file a partnership return if it does not have any gross income that is (or is treated) as ECI and does not have any U.S.-source income.[39] In addition, a foreign partnership that has no ECI is not required to file a partnership return if (i) it has no U.S. partners at any time during the taxable year[40] or (ii) it has U.S. partners but its U.S.-source income is less than $20,000 and at no time during the taxable year do its U.S. partners have a 1% or greater interest in any item of partnership income, gain, loss, deduction or credit.[41] A foreign partnership that has U.S partners but no ECI has

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37. Treas. Reg. § 1.6031(a)-1(a).

38. *Id.*

39. Treas. Reg. § 1.6031(a)-1(b)(1)(i).

40. Treas. Reg. § 1.6031(a)-1(b)(3)(ii).

41. Treas. Reg. § 1.6031(a)-1(b)(2).

modified filing obligations with respect to its non-U.S. partners. A foreign partnership that is not otherwise required to file a return may be required to file a limited purpose return in order to make certain partnership level elections.[42]

2. Recommended Approach

The current rules, which do not extend to domestic partnerships the limited exemptions from return filing requirements available to foreign partnerships, appear reasonable to us. In theory, domestic partnerships with no U.S.-source income or U.S. partners could be exempted from return filing requirements. However, providing an exemption for domestic partnership with non-ECI U.S.-source income would be inconsistent with the operation of the rules under Sections 1441, 1445, and 1446, discussed below, which requires domestic partnerships to act as withholding agents for U.S.-source income allocable to its foreign partners.

B. Withholding Taxes

1. Current Law

The withholding rules under Sections 1441, 1445, and 1446 make several important distinctions between domestic and foreign partnerships.

(a) Section 1441 Withholding

In order to avoid withholding under Section 1441 on payments of FDAP received by a domestic partnership, the domestic partnership need only provide the payor with a single IRS Form W-9 that includes the partnership's taxpayer identification number.[43] The domestic

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42. Treas. Reg. § 1.6031(a)-1(b)(5).

43. Treas. Reg. § 1.1441-5(b)(1). If the withholding agent knows or has reason to know that an IRS Form W-9 is incorrect, it must withhold, but if the Form W-9 is in fact correct, there is no duty to withhold. *See* Treas. Reg. § 1.1441-1(d)(2), referencing Treas. Reg. § 31.3406(h)-3(e) (a payor is not liable for any tax imposed if

(Footnote continued on next page)

partnership is then required to act as withholding agent with respect to amounts allocable to its foreign partners, if any.[44] In contrast, to avoid withholding under Section 1441 on payments to a foreign partnership, the foreign partnership must either provide the payor with IRS forms from each of its partners (in addition to an IRS Form W-8IMY from the partnership itself) or become a withholding foreign partnership.[45] A foreign partnership can become a "withholding foreign partnership" by entering into an agreement with the IRS.[46] Payments to a withholding foreign partnership are not subject to withholding; instead, the partnership acts as withholding agent with respect to income allocable to its foreign partners in the same manner as a domestic partnership.

The lax requirements under Section 1441 (and, as discussed below, Sections 1445 and 1446) with respect to payments to domestic partnerships are based on an implicit assumption that the IRS may proceed directly against a domestic partnership (or its partners) for failure to withhold, and on the significant administrative burden that would be imposed on domestic partnerships generally were they all required to submit their partners' IRS forms to each payor.[47] However, because the definition of a domestic partnership is based solely upon the place of

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circumstances establish that the payor reasonably relied on a Form W-9; listed reasonableness factors all relate to the facial validity of the document, not the knowledge of the payor).

44. Treas. Reg. § 1.1441-5(b)(2)(A).

45. Treas. Reg. § 1.1441-5(c)(1) (to determine amounts to be withheld on payments to foreign partnerships, withholding agents must look through partnerships to their partners to determine who are the actual payees).

46. Treas. Reg. § 1.1441-5(c)(2)(ii). The IRS has provided detailed procedures for entering into withholding foreign partnership agreements, requiring submission of detailed information regarding the partnership's partners and its activities. Rev. Proc. 2003-64, as modified by Rev. Proc. 2005-77.

47. 61 Fed. Reg. 17614 (April 22, 1996) ("[P]ayments to domestic partnerships would not require withholding, even if the partners were foreign persons. A domestic partnership is the withholding agent for [each] item of income included in the distributive share of a partner that is a foreign person.").

organization,[48] a partnership may qualify as a domestic partnership even if it has no U.S. partners or assets. Thus, foreigners that use a domestic partnership as an investment vehicle can cause the partnership to take aggressive withholding tax positions and make distributions to the foreign partners without withholding (or simply fail to withhold tax that clearly is required to be withheld). In such a case, the IRS would have little ability to enforce the tax. In fact, a U.S. person that makes a payment to a domestic partnership is under no legal obligation to withhold even if the U.S. person knows that the domestic partnership will not fulfill its withholding tax obligations.[49]

Moreover, a payor is required to treat a partnership that fails to provide any forms as a domestic partnership for purposes of Section 1441, but then the partnership is subject to backup withholding under Section 3406.[50] This default rule maximized withholding when the regulations were promulgated in 1997 because, at that time, the backup withholding rate of 31% exceeded the withholding rate of 30%. However, the backup withholding rate is currently

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48. Treas. Reg. § 301.7701-5.

49. *See* Treas. Reg. § 1.1441-7 (provisions relating to liability of withholding agents are framed in terms of the reliability of documentary evidence, not assurance of actual withholding). *Compare* Treas. Reg. § 1.1441-1(b)(2)(ii) ("A withholding agent making a payment to a U.S. person . . . who has actual knowledge that the U.S. person receives the payment as an agent of a foreign person must treat the payment as made to the foreign person. However, the withholding agent may treat the payment as made to the U.S. person if the U.S. person is a financial institution and the withholding agent has no reason to believe that the financial institution will not comply with its obligation to withhold.").

50. Treas. Reg. § 1.1441-5(d)(2). Treas. Reg. § 1.1441-1(b)(3)(ii) provides presumptions regarding entity classification in the absence of valid documentation. Once an entity is determined to be a partnership for purposes of Section 1441 withholding, the entity is subject to Treas. Reg. § 1.1441-5(d)(2), which provides presumptions for determination of partnership status as U.S. or foreign in the absence of documentation. Treas. Reg. § 1.1441-1(b)(3)(i) states that if presumptions lead to the determination that an entity is a "U.S. person" for purposes of Section 1441, then the withholding regime under chapter 24 of the Code, and in particular, Section 3406, applies. Section 3406(a) generally imposes "backup withholding" on payments to a domestic partnership that does not provide an IRS Form W-9. It requires a payor to withhold at a rate equal to the fourth lowest tax bracket under Section 1(c).

28%.[51] As a result, a foreign person can effectively reduce the withholding rate on U.S.-source FDAP simply by investing through a partnership that declines to provide any U.S. tax form.

(b) Section 1446 Withholding

The withholding regime under Section 1446 applicable to ECI allocable to foreign partners is similar: To avoid withholding under Section 1446 on income allocable to an upper-tier domestic partnership that is a partner in a lower-tier partnership engaged in a U.S. trade or business (an "ETB partnership"), the upper-tier domestic partnership need only provide the lower-tier ETB partnership with a single IRS Form W-9; the upper-tier partnership is then required to withhold under Section 1446 with respect to its foreign partners.[52] In contrast, to avoid withholding under Section 1446 on income allocable to an upper-tier foreign partnership that is a partner in a lower-tier ETB partnership, the upper-tier foreign partnership must either provide the lower-tier partnership with IRS forms from each of its partners establishing that they are U.S. persons (in addition to an IRS Form W-8IMY from the partnership itself) or the foreign partnership must have entered into an agreement with the IRS to become a withholding foreign partnership.[53]

The distinction between upper-tier domestic and foreign partnerships under Section 1446 is most acute if the lower-tier ETB partnership recognizes cancellation of indebtedness income. In this case, the lower-tier ETB partnership with foreign partnership

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51. T.D. 8734 (Oct. 6, 1997); Section 1(c).

52. Treas. Reg. § 1.1446-5(a) (a lower-tier partnership need not withhold on payments to a domestic partnership holding a direct interest in such lower-tier partnership). Treas. Reg. § 1.1441-5(b) indicates that the only requirement for determining domestic status for a partnership is receipt of a valid Form W-9.

53. Treas. Reg. § 1.1446-5(c)(2) (applying Section 1441 standard of reasonable reliance on documentation for determination of partner status as foreign and domestic).

partners is required to remit tax on the foreign partners' distributive share of the cancellation of indebtedness income, even though cancellation of indebtedness income generally does not generate cash for distribution to the partners.[54] As a result, the partnership (and, by extension, the other partners) must bear the cost of the withholding absent reimbursement from the foreign partners.[55] However, an ETB partnership with only domestic partners (including domestic partnerships) is not required to withhold in respect of cancellation of indebtedness income. Accordingly, this rule encourages an ETB partnership to insist that its foreign partners invest through domestic partnerships in order to protect the domestic partners from potential liability.

Similarly, where it is unclear whether income of a lower-tier partnership is ECI, the lower-tier partnership has a strong incentive to take conservative positions rather than face the risk of being forced to pay its partners' tax liability after income has been distributed without withholding. This provides an incentive for foreign investors to use their own domestic partnerships as holding vehicles for their investments in ETB partnerships.

(c) Section 1445 Withholding

Section 1445 is the most draconian withholding regime for foreign partnerships. A foreign partnership that sells a U.S. real property interest is always subject to withholding equal to 10% of the purchase price, and is not permitted to reduce withholding by demonstrating that some or all of its partners are U.S. persons. Similarly, in the case of a sale of stock of a

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54. Other forms of non-cash income pose similar issues.

55. *See* 68 Fed. Reg. 52,466 (Sept. 3, 2003), corrected at 68 Fed. Reg. 62,553 (Nov. 5, 2003) (recognizing difficulties caused by the application of cancellation of indebtedness income at the partner level rather than at the partnership level but choosing not to amend existing regulations but rather only to seek comments on the issue); NYSBA Tax Section, Report on Final and Temporary Section 1446 Regulations (Report No. 1103, Feb. 2, 2006), at 7-15.

publicly traded United States real property holding corporation, a foreign partnership that is a 5% shareholder is subject to withholding even if none of its partners is a 5% shareholder. By contrast, a domestic partnership that sells a U.S. real property interest and delivers a "nonforeign affidavit" is not subject to withholding, even if some or all of its partners are foreign.[56] The amount that the domestic partnership is then required to withhold is limited to 35% of the gain allocable to its foreign partners,[57] which in many cases is less than 10% of the proceeds. Moreover, as we discussed in our prior report on the Section 1446 regulations, domestic ETB partnerships with partners that are foreign partnerships which sell U.S. real property interests may be subject to Section 1446 withholding tax in excess of the substantive tax liability of their foreign partners.[58]

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56. The domestic partnership, in turn, may obtain a withholding certificate from its foreign partners that reduces or eliminates the Section 1445 withholding based upon a statement to the effect that the foreigner's maximum tax liability is less than the withholding otherwise required, or based on an agreement to post adequate security for the partnership. *See* Treas. Reg. § 1.1445-6 and Rev. Proc. 2000-35, 2000-2 C.B. 211.

    In this respect, Section 1445 is more generous than Section 1446 because Section 1446 does not permit a foreign partner in a partnership that is engaged in a trade or business in the United States to demonstrate that its taxable income will be less than the amount withheld. In finalizing the Section 1446 regulations, the Treasury and the IRS decided not to institute a similar withholding certificate regime for Section 1446 purposes. T.D. 9200. Although Temp. Treas. Reg. § 1.1446-6T permits partnerships to reduce Section 1446 withholding with respect to certain foreign partners who certify that they have available loss carryovers from prior years, the partnership generally remains liable for the Section 1446 tax if the certificate is inaccurate.

57. Section 1445(e)(1). For amounts paid after May 28, 2003, the IRS may, by regulation, reduce the amount to 15%. After December 31, 2008, the amount may be reduced by regulation to 20%. Pub. L. No. 108-27, §§ 301, 303.

58. NYSBA Tax Section, Report on Final and Temporary Section 1446 Regulations (Report No. 1103, Feb. 2, 2006), at 16. Withholding under both 1445(e)(1) and 1446 may be required if a domestic partnership allocates gain treated as "deemed ECTI" under Section 897 to a foreign partner. The Treasury and IRS have resolved the issue in the 1446 regulations by applying only Section 1446 if both are technically applicable. Treas. Reg. § 1.1446-3(c)(2)(i). This "trumping rule" is based on Section 897 applying to all dispositions by domestic partnerships of U.S. real property interests and the primacy of Section 1446 over Section 1445.

    Section 1445 contains a withholding certificate regime to allow taxpayers to reduce or eliminate required withholding amounts by showing that the taxpayer's maximum tax liability is less than the imposed withholding

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2. Recommended Approach

(a) Payments to Domestic Partnerships under Sections 1441, 1445 and 1446

As discussed above, no withholding is required under Sections 1441, 1445 or 1446 on a payment to a domestic partnership that provides a correct and complete IRS Form W-9, even if the withholding agent knows or has reason to know that the domestic partnership will not satisfy its withholding tax obligations. This rule has the tremendous benefit of being clear, bright and simple to apply. However, it does permit foreigners to take aggressive positions or violate the law, and deny the IRS recourse.[59] We are not aware of domestic partnerships being used by foreigners to violate a known withholding tax obligation. However, U.S. partnerships are used by foreigners to avoid possible withholding by U.S. payors where (i) the parties reasonably believe that a particular instrument constitutes indebtedness qualifying for the portfolio interest exemption (as opposed to dividends subject to withholding) for federal income tax purposes, but this treatment is not entirely clear, (ii) the payor is a lower-tier partnership and the foreigners reasonably believe that the partnership is not engaged in a trade or business in the United States or that certain of its income is not ECI, but that conclusion is not entirely clear, (iii) the parties reasonably believe that property is not a United States real property interest, but

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amount or by posting adequate security for any assessed tax. Section 1446 does not contain such a provision. Thus, as a result of the "trumping rule," a domestic partnership's disposition of U.S. real property interests is subject to full withholding under Section 1446, even if withholding certificates would have caused zero tax liability to be assessed under Section 1445.

59. The fact that a partnership is organized under domestic law does not necessarily give the IRS the ability as a practical matter to enforce the partnership's obligation to withhold taxes in respect of its members if the partnership's assets are held offshore. Although domestic limited liability companies and limited partnerships generally are required to appoint agents for service of process, collectibility is not ensured. General partnerships in many states do not have to file certificates of organization with state authorities.

that conclusion is not free from doubt, or (iv) the parties reasonably believe that a credit derivative is a notional principal contract or an option for federal income tax purposes, but that conclusion is not free from doubt.[60] If the IRS and Treasury are concerned about these situations (and we do not think that they should be) or believe that domestic partnerships are otherwise being used to avoid withholding tax liability, there are four different approaches that could be adopted:

(1) Redefine the residence of partnerships for purposes of withholding. Under one approach, the definition of domestic partnership could be narrowed for withholding tax purposes. For example, a domestic partnership without meaningful U.S. assets or partners could be treated as a foreign partnership for withholding tax purposes. We do not recommend this approach. Statistically speaking, most partnerships organized under U.S. law have all U.S. partners, conduct business in the United States and have assets here. Determining the residence of a partnership by reference to the jurisdiction in which it is organized provides a simple bright-line rule that is administrable and most often corresponds to reality. A different residence test for purposes of withholding likely will increase compliance costs without clear benefits.[61]

(2) Impose the requirements applicable to foreign partnerships on domestic partnerships (*i.e.*, require domestic partnerships to provide IRS forms from their partners). Under a second approach, domestic partnerships could be required to offer documentary proof of residence for each of their partners and payors would be required to withhold on payments

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60. *See* Notice 2004-52, 2004-32 I.R.B. 168.

61. For example, the definition of a domestic partnership could be narrowed by requiring that the partnership or the tax matters partner have a U.S. office. Although this theoretically could help to ensure compliance, it is unlikely to be effective in stopping taxpayers who are intent on evasion.

allocable to foreign partners. We do not recommend this approach. As mentioned above, most domestic partnerships have all U.S. partners, and have their assets and business here, and therefore do not present abuse potential. Requiring that domestic partnerships deliver IRS forms for each partner to payors would tremendously increase compliance costs.

(3) Require that a domestic partnership identify a U.S. individual or corporation to serve as a responsible person to ensure that the partnership satisfies its withholding tax responsibilities. Under a third approach, an individual or corporation subject to the jurisdiction of the U.S. courts would assume responsibility for the partnership's withholding taxes. This approach would fundamentally change the withholding tax regime and dramatically increase personal liability. Because there is no demonstrated abuse, and a less drastic approach exists (see below), we do not recommend it.

(4) Require a U.S. payor to a domestic partnership to withhold if the payor "has reason to believe that the payee will not comply with its obligations to withhold."[62] Under a fourth approach, withholding agents could be required to satisfy a higher standard.[63] This approach might help address extreme abuse, but will create uncertainty. If this approach were adopted, we strongly recommend that the regulations make clear that a withholding agent does not know or have reason to know that a domestic partnership will fail to comply with its withholding obligations if a reasonable basis exists not to withhold, even if foreigners are

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62. *Cf.* Treas. Reg. § 1.1441-1(b)(2)(ii).

63. 61 Fed. Reg. 17614 ("A system that reduces withholding at source permits an investor to receive its full income without the administrative costs and delays that can occur when applying for a refund of withheld taxes. This advantage, however, is necessarily accompanied by the need to rely, in part, on withholding agents. Withholding agents perform an important compliance function.").

investing through a domestic partnership that is used to avoid potential withholding liability for a payor.

(b) Payments to Foreign Partnerships under Section 1441

The current rules applying Section 1441 to payments to foreign partnerships pose substantial compliance difficulties. If the foreign partnership is not a withholding foreign partnership, the amount required to be withheld must be determined at the time of payment, which in many cases is prior to the time at which partners' allocable shares of partnership income can be determined (*e.g.*, if the partnership agreement provides for tiered allocations or a carried interest for the general partner). This results in a significant potential for underwithholding or overwithholding. A foreign partnership can avoid these problems by becoming a withholding foreign partnership, in which case it (in the same manner as a domestic partnership) can defer paying withholding tax with respect to undistributed U.S.-source FDAP until the end of the year. However, very few foreign partnerships have the necessary expertise and organizational infrastructure to become withholding foreign partnerships.

We recommend that a foreign partnership be given the option to be treated in the same manner as a domestic partnership or a withholding foreign partnership by electing to appoint an intermediary to receive payments of FDAP and comply with the withholding rules on its behalf. The intermediary could be a U.S. financial institution or a foreign financial institution (or foreign branch of a U.S. financial institution) that has become a "qualified intermediary" for

purposes of Section 1441 by entering into a withholding agreement with the IRS.[64] No withholding would be required on payments to the intermediary.

Intermediaries likely would be better equipped than foreign partnerships to comply with the withholding rules. The suggested regime would benefit both taxpayers and the government by facilitating more accurate withholding.

(c) Section 1445

As discussed above, foreign partnerships are treated as foreign persons for purposes of Section 1445, and are not permitted to certify the portion of the proceeds from a sale of a United States real property interest that is attributable to their U.S. partners.[65] We recommend that the Section 1445 withholding tax regime be conformed to Sections 1441 and 1446 and that a foreign partnership be permitted to demonstrate that it has U.S. partners under the Section 1441 standards and thereby reduce the amount of required withholding. Similarly, a foreign partnership that is a more than 5% shareholder in a United States real property holding company should be permitted to certify the extent to which its partners do not exceed the 5% threshold and avoid withholding to that extent. The tax policies underlying Sections 1441, 1446 and 1445 are identical and last year, when Treasury and the IRS revised the Section 1446 regulations, they conformed the Section 1446 regime to Section 1441.[66]

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64. The definition of "qualified intermediary" is set forth in Treas. Reg. § 1.1441-1(e)(5)(ii).

65. Treas. Reg. § 1.1445-2(b)(2)(i) (a foreign partnership is a "foreign person"). The Section 1445 regime was promulgated 20 years ago and has not been revised since. T.D. 8113 (Dec. 18, 1986).

66. *See* T.D. 9200 (May 13, 2005) ("Treasury and the IRS believe that the documentation requirements of Sections 1441 and 1446 should be coordinated where feasible.").

(d) Interaction between Withholding and Backup Withholding Rules

As discussed above, because the withholding tax regulations assume that an entity is a domestic partnership in the absence of documentation and the backup withholding rate is currently 28% (*i.e.*, less than the 30% withholding tax rate), foreigners can avoid 2% tax by simply declining to provide any form. We recommend that the withholding regime be revised so that, in the absence of any documentation, withholding applies at the greater of the withholding rate and the backup withholding rate. Moreover, if the regulations under Section 1441 are revised to require a U.S. withholding agent to withhold if the payor has reason to believe that a domestic partnership payee will not comply with its obligations to withhold, then the U.S. payor's obligation to withhold should be at the 30% rate.

C. Determination of Partnership Taxable Year

1. Current Law

Under Section 706(b) of the Code, the taxable year of a partnership generally is determined by reference to the taxable years of its partners.[67] Under Treas. Reg. § 1.706-1(b)(6), in determining the taxable year of a partnership under Section 706(b), the interest held by a foreign partner is disregarded unless that partner was allocated gross income of the partnership that was ECI during the partnership's immediately preceding taxable year.[68] An exception to

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67. The taxable year is (i) the "majority in interest" taxable year, (ii) if there is no majority in interest taxable year, the taxable year of all the "principal partners" in the partnership and (iii) if there is no such taxable year, the calendar year except as otherwise provided in regulations. The majority in interest taxable year is the taxable year of partners having an aggregate greater than 50% interest in profits and capital. A partner is a principal partner if it has an interest of 5% or more in profits or capital.

68. The foreign partner's interest will be taken into account only if taxation of the ECI allocated to the foreign partner is not precluded by application of a U.S income tax treaty. If the foreign partner was not a partner during the immediately preceding year, the foreign partner's interest will be disregarded unless the partnership reasonably believes that such partner will be allocated ECI during the year. Note that the regulations also

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this rule is provided for cases where each partner that is not a disregarded foreign partner holds less than 10% of the interests and the "regarded" partners, in the aggregate, hold less than 20% of the interests.[69] For purposes of applying Section 706(b), a foreign partner is any person that is not a U.S. person within the meaning of Section 7701(a)(30), except that a controlled foreign corporation (within the meaning of Section 957(a)) is not treated as a foreign partner.[70]

Under these rules, in determining the taxable year of a partnership that is not engaged in a U.S. trade or business, and that has another partnership (an upper-tier partnership) as one of its partners, the upper-tier partnership generally will be disregarded if it is foreign (even if all of its partners are U.S. persons and therefore subject to tax on their indirect allocable share of the lower-tier partnership's income) and will be taken into account if it is domestic (even if all of its partners are foreign).[71]

2. Recommended Approach

Given the purpose of the current rules, which is to disregard partners that are not subject to U.S. taxation on the income of the partnership, the theoretically correct rule would be to look through upper-tier partnerships to their partners (domestic or foreign). However, this

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exclude from consideration the interests of tax-exempt partners that are not subject to tax on any income from the partnership (i.e., because the partnership has no unrelated business taxable income). Treas. Reg. § 1.706-1(b)(5).

69. Treas. Reg. § 1.706-1(b)(6)(iii).

70. Treas. Reg. § 1.706-1(b)(6)(ii). A foreign personal holding company within the meaning of now-repealed Section 552 was also not treated as a foreign partner.

71. The preamble to the proposed regulations (Jan. 17, 2001) states that the mechanical rules of Section 706(b) and the proposed regulations are subject to the anti-abuse rule of Treas. Reg. § 1.702-1 and illustrates a tiered partnership arrangement to which the anti-abuse rule might apply.

may impose too great an administrative burden on many partnerships. We recommend, however, that a partnership have the right (but not the obligation) to look through tiers of partnerships for purposes of applying Section 706 provided that it does so consistently and looks through all upper-tier partnerships in the chain. It would also be appropriate to provide an anti-abuse rule to prevent U.S. persons from using foreign partnerships as vehicles for investment in lower-tier partnerships in order to manipulate the taxable year rules and defer income inclusions, although we believe that such situations are highly unusual if not non-existent.

D. Eligibility of Partnerships to be Tax Matters Partners of Lower-Tier Partnerships

1. Current Law

Treas. Reg. § 301.6231(a)(7)-1(b)(2) provides that if there is a U.S. person that is eligible to be designated as the tax matters partner ("TMP") of a partnership, then a partner that is not a U.S. person cannot be designated as the TMP. Because the Section 7701(a)(30) definition of U.S. person applies, a domestic partnership can be a TMP of a lower-tier partnership even if all its partners are foreign persons, while a foreign partnership cannot be a TMP even if all its partners are U.S. persons (assuming that there is an eligible partner of the lower-tier partnership that is a U.S. person).

2. Recommended Approach

We believe that as a general matter the current rules work appropriately for purposes of determining a partnership's eligibility to be a TMP. The IRS should not be required to ascertain whether a foreign partnership has U.S. partners in order to be eligible to serve as a TMP. However, we are recommending changing the regulations so that a domestic partnership with no U.S. partners is not eligible for designation as a TMP. The partners in such a partnership may not be subject to U.S. tax on the income of the lower tier partnership and thus should not

represent the partnership in IRS and judicial proceedings. If such a partnership is improperly designated as a TMP, however, the IRS should be allowed to treat it as the TMP.