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Report No. 1504
December 9, 2024

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Deputy Assistant Secretary (Tax Policy)
Department of the Treasury
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The Honorable Daniel I. Werfel
Commissioner
Internal Revenue Service
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The Honorable Marjorie A. Rollinson
Chief Counsel
Internal Revenue Service
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Washington, DC 20224

Re: NYSBA Tax Section Report No. 1504 - Report on Treatment of Foreign Partnerships under Section 1445

Dear Mses. Aron-Dine and Rollinson, and Mr. Werfel:

Please see attached Report No. 1504 of the Tax Section of the New York State Bar Association, which discusses treatment of foreign partnerships under Section 1445 of the Internal Revenue Code of 1986, as amended.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Jiyeon Lee-Lim
Chair

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**Report No. 1504**

# NEW YORK STATE BAR ASSOCIATION TAX SECTION

## REPORT ON

## TREATMENT OF FOREIGN PARTNERSHIPS UNDER SECTION 1445

**December 9, 2024**

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## REPORT ON TREATMENT OF FOREIGN PARTNERSHIPS UNDER SECTION 1445[1]

This report ("**Report**") of the New York State Bar Association Tax Section discusses the treatment of foreign partnerships under Section 1445.[2] Specifically, we recommend adoption of a look-through rule for foreign partnerships in determining Section 1445 withholding liability, modeled after the Section 1446(f) framework, under which foreign partnerships may certify the exempt status of their partners or a more accurate computation of the "maximum tax liability" associated with the transfer. Such a change would harmonize Section 1445 with other withholding regimes that currently apply an aggregate theory of partnerships and would obviate the need for onerous pre-clearance procedures in many otherwise non-abusive circumstances. As an alternative, we recommend a modification and tightening of the FIRPTA pre-clearance procedures in these circumstances in a manner that promotes more certainty and administrability for taxpayers.

This Report is organized into three parts. Part I provides a summary of the applicable statutory and regulatory provisions and a general overview of the treatment of foreign partnerships under Section 1445, as well as a brief history of the applicable rules. Part II discusses why foreign partnerships are utilized in practice by both domestic and foreign partners. Part III discusses other withholding rules that currently apply look-through treatment to foreign partnerships, in contrast to the provisions applicable to Section 1445. Part IV sets forth our principal recommendations.

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[1] The principal authors of this Report are Marcy Geller, Jonathan Talansky, Andrew Todd, Michael Stephenson and Kevin Hilton. This Report reflects comments and contributions from Kim Blanchard, Josiah Child, Samuel Duncan, Steven Gilbert, Stephen Giordano, Jiyeon Lee-Lim, William McRae, Jason Narducci, Amanda Nussbaum, Arvind Ravichandran, Jason Sacks, Mike Schler, Vikram Sharma and Libin Zhang. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the New York State Bar Association Executive Committee or the House of Delegates.

[2] Unless otherwise indicated, all "**Section**" references are to the Internal Revenue Code of 1986, as amended as of the date hereof (the "**Code**"), and all "**Treas. Reg. §**" and "**Regulations**" references are to the Treasury Regulations promulgated thereunder.

## I. Introduction, Brief History and Summary of Current Law

### a. Withholding Under Section 1445

The provisions enacted as part of the Foreign Investment in Real Property Tax Act of 1980 ("**FIRPTA**") and the Tax Reform Act of 1984 impose certain withholding obligations when U.S. real property is sold, exchanged or disposed of by a foreign person, which includes a foreign partnership. In particular, Section 1445 imposes a 15% withholding tax on transferees on the gross amount realized with respect to a transferor's disposition of a U.S. real property interest ("**USRPI**") if the transferor is a foreign person.[3] Section 1445 imposes a withholding obligation but is not in and of itself the provision which imposes the substantive tax otherwise due under the FIRPTA provisions of Section 897; thus, amounts withheld and remitted to the Internal Revenue Service ("**IRS**") may be different than (and are credited against) the transferor's actual tax liability. Foreign partnerships[4] subject to withholding under Section 1445(a) can credit such withheld amounts against their other Section 1446(a) withholding tax liability only to the extent such amount is allocable to foreign partners and such partnership may not have any such actual tax liability.[5]

The Section 1445 withholding regime was first enacted in section 129(a) of the Tax Reform Act of 1984.[6] Originally, the contemplated enforcement mechanism for collection of tax due under FIRPTA was an information reporting disclosure regime under Section 6039C and related regulations (which were not finalized and were ultimately withdrawn).[7] The basic Section 1445 regulations were promulgated between 1986 and 1990,[8] thus predating by several years the applicable withholding rules under Sections 1441, 1442 and 1446 described in this

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[3] Section 1445(a); *See* Section 897(c)(1) (A USRPI is an interest in real property within the U.S. or an interest in a domestic corporation, unless it is established that the domestic corporation was not a U.S. real property holding corporation during the specified look-back period).

[4] Under Section 7701, the definition of "person" includes a partnership, the definition of "foreign" means a corporation or partnership which is not domestic, and the definition of "domestic" means created or organized under the law of the U.S. or any state unless, in the case of a partnership, the Secretary provides otherwise by regulations. Section 1445 defines a foreign person as any person other than a U.S. person and a QFPF (defined below). A foreign person includes a nonresident alien individual, foreign corporation, foreign partnership, foreign trust, or foreign estate.

[5] Treas. Reg. § 1.1446-3(c)(2)(ii).

[6] Pub. L. No. 98-369, 98 Stat. 494 (1984). Originally, Section 1445 imposed a 10% withholding tax which was later raised to 15% in 2015. *See* Pub. L. No. 114-113, § 324(a) (2015).

[7] T.D. 7832, 47 Fed. Reg. 41,532 (Sept. 21, 1982); T.D. 8000, 49 Fed. Reg. 50,667 (Dec. 31, 1984).

[8] T.D. 8114, 51 Fed. Reg. 46,651 (Dec. 24, 1986); T.D. 8321, 55 Fed. Reg. 50,552 (Dec. 7, 1990).

Report.[9] The Section 1445 framework has been subsequently amended by updated regulations (including, for example, the recent regulatory project addressing treatment of qualified foreign pension funds and other "withholding qualified holders"[10]), but at no point has Treasury reconsidered the entity treatment of foreign partnerships for purposes of Section 1445 withholding.[11]

Under current law, a transferee is not generally permitted to look-through a foreign partnership to the partnership's underlying partners for purposes of determining whether withholding is required under Section 1445. Instead, Section 1445 withholding is determined at the entity level, and foreign partnerships are subject to withholding under Section 1445 regardless of the foreign, domestic, taxable or tax-exempt status of the partners. Such treatment leads to overwithholding for foreign partnerships who have U.S. partners or partners who are eligible for certain FIRPTA exemptions, such as foreign governments eligible for exemption under Section 892 ("**Foreign Governments**") and "qualified foreign pension funds" eligible for exemption under Section 897(l) ("**QFPFs**").[12] If two or more persons are joint transferees of a USRPI, each transferee has a duty to withhold, and that obligation is fulfilled with respect to each such person if any one of them properly withholds.[13] The FIRPTA rules stand alone as the only area where foreign partnerships are subject to withholding on an entity theory, as described more fully herein.

The operation of the withholding rules under Section 1445 operate to essentially presume that all partners in foreign partnerships are taxable foreign persons.[14] When these foreign partnerships have exempt partners who seek to attain the benefit of their tax exemptions, such partners must directly file a U.S. tax return and claim a refund from the IRS. This process can be

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[9] Discussed *infra* at Section III.
[10] As defined in Treas. Reg. § 1.1445-1(g)(11).
[11] T.D. 9971, 87 Fed. Reg. 80,042 (Dec. 29, 2022). Additionally, the Section 1445 Regulations do not account for certain FIRPTA amendments, including the creation of the QFPF regime described below. *See* Treas. Reg. § 1.1445-3(d)(2).
[12] In the context of QFPFs, this overwithholding issue no longer exists for foreign partnerships that are wholly owned by one or more QFPFs. *See* Treas. Reg. § 1.897(l)-1; T.D. 9971, 87 Fed. Reg. 80,042 (Dec. 29, 2022) ("The Treasury Department and the IRS agree that a foreign partnership that is held *entirely* by qualified holders should not be subject to withholding under section 1445 because the ultimate owners should qualify in full for the exemption under section 897(l).") (emphasis added). Consequently, as applied to QFPFs, this Report addresses foreign partnerships owned partly, but not wholly, by QFPFs.
[13] Treas. Reg. § 1.1445-1(b)(1).
[14] Treas. Reg. § 1.1445-1(a).

costly and time consuming, especially when the partner has no other procedural contact with the IRS. Additionally, certain categories of exempt investors such as Foreign Government and QFPF investors may have non-tax reasons why they would prefer not to file U.S. tax returns, including political and confidentiality considerations.

Foreign partnerships will not only face these potential overwithholding issues in the context of direct dispositions of USRPIs. Certain distributions from real estate investment trusts ("**REITs**") are accorded similar treatment under FIRPTA, as are non-dividend distributions from U.S. real property holding corporations ("**USRPHCs**") under Section 301(c).[15] These distributions are common, and current law gives rise to inappropriate overwithholding results and administrative burdens of applying for a credit due to such overwithholding when foreign partnerships invest in U.S. real estate.

Domestic partnerships are themselves withholding agents under Section 1445 and are obligated to withhold under Section 1445(e)(1) at the highest applicable rate under Section 11(b) on dispositions of USRPIs, with respect to the gain attributed to the foreign partners who are not eligible for exemption from FIRPTA.[16] Importantly, these special withholding rules in Section 1445(e)(1) do not apply to dispositions of USRPIs by foreign partnerships,[17] but only to dispositions of USRPIs by domestic partnerships, and certain other transactions.

In contrast to domestic partnerships, foreign partnerships are treated as foreign persons for purposes of Section 1445, requiring the transferee of a USRPI from a foreign partnership to withhold under the general rule in Section 1445(a).[18] Furthermore, because Section 1445 requires withholding equal to 15% of the amount realized (as opposed to the gain) in the sale or disposition, the resultant overwithholding can be substantial in the absence of an application for a withholding certificate using IRS Form 8288-B. For the same reasons noted above, foreign partners are sensitive about obtaining withholding certificates and thus are typically subjected to overwithholding.

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[15] A USRPHC means any corporation if the fair market value of its USRPI equals or exceeds 50% of the fair market value of its (i) USRPIs, (ii) interests in real property located outside the U.S., and (iii) any other assets which are used or held for use in a trade or business. Section 897(c)(2).
[16] Section 1445(e)(1).
[17] Section 1445(e).
[18] Section 1445(e); Section 1445(f)(3).

### b. Treatment of Foreign Partnerships under Substantive FIRPTA Provisions

Although this Report focuses on the treatment of foreign partnerships for purposes of FIRPTA's procedural withholding rules, it is important to consider the way in which foreign partnerships are characterized under certain substantive FIRPTA provisions.

#### 1. QFPF Exemption

Section 897(a) generally applies to the gain or loss of "a nonresident alien individual or a foreign corporation." In addition, section 897(h)(1) applies to any distribution by a qualified investment entity ("**QIE**") to a nonresident alien individual or a foreign corporation (or other QIE). Section 897(l) provides that a QFPF shall not be treated as a nonresident alien individual or a foreign corporation for FIRPTA purposes, and an entity all the interests of which are held by a QFPF is treated as a QFPF.[19] Thus, under the statute, when a QFPF disposes of a USRPI, Section 897(a) does not apply to any gain or loss from the disposition because Section 897(l) treats the QFPF as neither a nonresident alien individual nor a foreign corporation. The same is true when a foreign partnership consisting solely of QFPF partners disposes of a USRPI (as long as the partnership certifies its status as a withholding qualified holder). In a 2019 report, we requested that Treasury and the IRS adopt a general look-through rule for QFPFs when the seller is a foreign partnership.[20] Treasury and the IRS declined to adopt a broad look-through rule, instead only allowing look-through treatment where the entity is 100% owned by a QFPF.

#### 2. DCREIT Exemption

The recently finalized Regulations addressing "domestically controlled REITs" ("**DCREITs**") provide for look-through treatment of foreign partnerships. A REIT or other QIE is domestically controlled when less than 50 percent in value of the stock was held directly or indirectly by foreign persons during the relevant testing period. The Regulations employ a look-through approach for foreign partnerships to determine whether a REIT or other QIE is

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[19] Section 897(l)(1) (For purposes of this section, a qualified foreign pension fund shall not be treated as a nonresident alien individual or a foreign corporation. For purposes of the preceding sentence, an entity all the interests of which are held by a qualified foreign pension fund shall be treated as such a fund).

[20] New York State Bar Association Tax Section Report No. 1421, "Report No. 1421 – Report on Proposed Regulations relating to Section 897(l) (Exception for Interests Held by Foreign Pension Funds)" (September 4, 2019), Section III(1)(b)(v)(3).

domestically controlled. Specifically, attribution rules are applied to "look-through persons," (e.g., a non-publicly traded partnership) whereas no attribution rules are applied to "non-look-through persons" (e.g., an individual or a QFPF).[21] Under this look-through approach, the REIT or other QIE stock is imputed to the look-through person's owners on a pro-rata basis based on their proportionate interests in the look-through person.

#### 3. Publicly Traded Exception

One area where foreign partnerships are not treated on a look-through basis and where cumbersome pre-transaction planning is often required, is the publicly traded exception under Section 897(c)(3). Under that provision, "[i]f any class of stock of a corporation is regularly traded on an established securities market, stock of such class shall be treated as a [USRPI] only in the case of a person who, [during the relevant period], held more than 5 percent [of the fair market value] of such class of stock."[22] Treas. Reg. §1.897-1(c)(2)(iii) looks solely to "beneficial ownership" of USRPHC stock; however, General Legal Advice Memorandum 2023-003 applied the 5% standard at the foreign partnership level on an entity basis, without the ability to look through the foreign partnership.[23] The IRS stated that because a partnership is a "person," the 5% rule should apply at the partnership level.[24]

### c. Relief for Overwithholding

The Code provides for alternatives to relieve foreign partnerships from overwithholding under Section 1445. Partnerships may also structure transactions in a manner that permits some form of look-through treatment under Section 1445. This section describes these approaches in more detail and highlights their imperfections.

#### 1. Applying for a Withholding Certificate

In certain cases, Treas. Reg. § 1.1445-3 allows a transferor or transferee to reduce withholding by obtaining a withholding certificate from the IRS.[25] The transferor or transferee

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[21] Treas. Reg. § 1.897-1(c)(3)(ii)(B); Treas. Reg. § 1.897-1(c)(3)(ii)(C).
[22] In the case of a publicly traded REIT, the ownership threshold is increased to 10%. Section 897(k).
[23] AM 2023-003.
[24] *See* Section 7701(a)(1) which defines a partnership as a "person" who purposes of Section 897(c)(3).
[25] Section 1445(b)(2); Treas. Reg. § 1.1445-3(a).

must apply for the withholding certificate, using IRS Forms 8288 and 8288-B, before or on the date of closing.[26] A transferor applying for a withholding certificate must provide the transferee with written notice of such application on or before the closing date.[27] The application must include all information necessary for the IRS to confirm the taxpayer's determination of its maximum tax liability on the disposition of the relevant USRPI.[28]

The IRS "ordinarily will act upon an application" within 90 days of receiving complete information, but sometimes requires substantial additional time for complex cases.[29] If additional time is required, the IRS will notify the taxpayer by the 45th day following receipt of all information required to make a determination.[30] If a withholding certificate is approved by the IRS prior to closing, the transferee can rely on the withholding certificate and can reduce the amount of withholding to the extent the partners in the foreign partnership would have otherwise been subject to withholding if they had sold the USRPI directly.[31] If an application for a withholding certificate is submitted or outstanding on the closing date of a transfer, the applicable withholding is not required to be paid over to the IRS until 20 days following the date that the IRS mails the ultimate notice of denial or withholding certificate to the withholding agent.[32] In these circumstances, however, buyers and sellers will be required to negotiate contractual provisions (such as escrows) that account for various eventualities.

While this process is designed to provide both the transferee and the IRS with certainty regarding the proper amount of FIRPTA withholding that is required, it can be time-consuming and burdensome, and in practice it does not always operate as intended. Forms 8288 and 8288-B are often complex for parties to complete. Further, the 90-day window could be a hindrance for commercial transactions as some parties may not have sufficient time to wait for the certificate. It is not always practicable to file for a withholding certificate by the date of a disposition and withhold necessary amounts until such certificate is obtained. Additionally, our understanding is that in many cases, the IRS is unable to comply with the 90-day and 45-day timelines, introducing an additional element of uncertainty in transactions where a withholding certificate is

[26] Instructions to Form 8288-B, rev. February 2016.
[27] *Id.*
[28] *See* Instructions to Form 8288-B, rev. February 2016.
[29] Rev. Proc. 2000-35; Treas. Reg. § 1.1445-3(a), (c).
[30] *Id.*
[31] Treas. Reg. § 1.1445-2(d)(7).
[32] Treas. Reg. § 1.1445-3(a), (c); Treas. Reg. § 1.1445-1(c)(2); Instructions to Form 8288-B, rev. February 2016.

sought. In fact, we understand that delays of twelve to fifteen months or more are not uncommon, and we have received reports of 2023 withholding certificate requests still being processed as of October 2024. As a result, practitioners typically are loathe to rely on these procedures, due to the potential delays and uncertainty associated with the process. Further complexities arise in the context of transactions involving post-closing purchase price adjustments, earnouts and other similar arrangements.

Foreign partnerships can apply for a blanket withholding certificate on any other basis not specifically enumerated in Rev. Proc. 2000-35.[33] These "category 6" applications allow the IRS to issue withholding certificates under Section 1445 on terms or conditions not available under the standard FIRPTA clearance procedures. Since these "category 6" applications provide a "nonconforming type of security" for the tax liability, to qualify for a "category 6" certificate, the application must contain a memorandum of law and facts establishing that the proposed security is valid and enforceable and that it adequately protects the government's interest.[34] These blanket withholding certificates are not a practical solution because they can take a significant amount of time to obtain and typically only apply beginning on the date of issuance with no retroactive effect to the date of application.

### 2. In-Kind Distribution of USRPIs

It is theoretically possible to mitigate the problem of FIRPTA overwithholding by structuring the transaction so that the partners of the foreign partnership, rather than the partnership itself, dispose of the USRPI. For example, the foreign partnership could distribute out the USRPI in-kind to partners, and the partners would then be free to dispose of their distributed portion of the USRPI. Assuming that the partners in the foreign partnership are U.S. persons or otherwise exempt from FIRPTA withholding, neither the distribution itself nor the partners' ultimate dispositions of the USRPI should trigger substantive FIRPTA withholding obligations.[35] If some partners were subject to FIRPTA withholding due to their status, the

[33] Rev. Proc. 2000-35, Section 4.03(6) ("To facilitate the processing of applications for withholding certificates, this revenue procedure divides all applications into six basic categories as follows … 6. Applications for withholding certificates on any other basis.")
[34] Rev. Proc. 2000-35, Section 4.10.
[35] Section 731; Treas. Reg. § 1.1445-11T(c).

withholding should apply only to their portion, and would not result in overwithholding with respect to other partners.

Structuring the disposition of a USRPI as a multi-step distribution followed by ultimate disposition introduces very substantial legal and economic complexity. It would typically require negotiation and legal authorization from many additional parties, including each of the partners and possibly lenders. It would also shift much of the tax compliance burden from the partnership level to the partner level and could contribute to withholding foot-faults at the partner level. In some circumstances, this approach would result in (otherwise inapplicable) transfer taxes under state tax law. Finally, structuring dispositions in this way may be flatly prohibited by the governing documents of the partnership, largely due to the added complexity and commercial unattractiveness of receiving a portion of an asset rather than cash. These added legal, economic, and administrative complexities are precisely the things that partners hope to avoid by organizing and conducting business in partnership form, so it is unlikely to be a useful tool in a large majority of circumstances.

### 3. Investing Through a Lower Tier U.S. Partnership

If partners hold a FIRPTA interest through a foreign partnership which owns one or more USRPIs through a lower tier U.S. partnership, Section 1445 does not apply to a direct disposition of the USRPI by the domestic partnership. Additionally, not only will the transferor be exempt from Section 1445 withholding vis-à-vis the transferee, but the domestic partnership will be able to look through the foreign partnership under Treas. Reg. § 1.1446-5(c) by reason of the coordination of Section 1445 and Section 1446 withholding, which is described more fully below. Structuring investments in this manner can entail additional administrative burden, as it requires the formation of the lower tier partnership, the filing of a U.S. tax return and the need to include another partner and may be restricted by lenders or regulatory authorities. These requirements may serve to defeat the original purposes for why a foreign partnership would be used in this context.

## II. The Use of Foreign Partnerships

Foreign partnerships are often useful vehicles for aggregating capital for investment. Their use is typically driven by a host of commercial and non-tax legal reasons. Investments in U.S. real estate by asset managers and other financial sponsors often feature significant institutional capital, including Foreign Governments and QFPFs. These investors will often participate through pooled investment vehicles, most of which are taxed as partnerships for U.S. federal income tax purposes. Due to greater familiarity with local (non-U.S.) jurisdictions and corporate law, it is not uncommon for these special purpose entities to be organized outside of the United States. Where U.S. investors participate in these structures as well, they may prefer to invest through these same vehicles.

A foreign partnership organized in a specific jurisdiction may be preferred to a U.S. partnership because it enables or eases compliance with regulatory regimes. For example, any manager operating a fund over a threshold level of assets under management[36] where (1) the fund is marketed to European Union investors, (2) the fund is seated in the European Union, or (3) the manager is seated in the European Union, is generally subject to country-level regulation which implements the Alternative Investment Fund Managers Directive (AIFMD).[37] The AIFMD generally aims to limit systemic risk and protect investors through certain supervision, reporting, transparency, governance, and marketing requirements applicable to alternative investment fund managers (AIFMs).[38] AIFMs complying with these requirements may obtain a "passport" which allows marketing to professional investors both within and outside the AIFM's home state.[39] As a result, many fund managers marketing to European Union investors choose to organize a controlled partnership in a European Union jurisdiction, such as Luxembourg, or enter into an agreement with a third-party AIFM situated in a European Union member state allowing usage of their passport for certain purposes. In contrast, if a U.S. partnership is used, sponsors are limited in their ability to conduct offerings to European investors.

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[36] This amount is generally 100 million euros for funds utilizing leverage, and 500 million euros for funds not utilizing leverage. Directive 2011/61/EU of the European Parliament and of the Council of the European Union of 8 June 2011, Article 3.
[37] *Id.* at Article 1.
[38] *Id.* at Article 1.
[39] *Id.* at Article 35.

A traditional use of a foreign partnership that was tax-driven was the use of these entities to avoid Subpart F issues that resulted from using a domestic partnership. The 2022 Regulations under Section 958 have mostly eliminated these issues, as they now generally treat domestic partnerships as aggregates for purposes of determining income inclusions under Section 951.[40] However, there are still unanswered questions under Sections 751 and 1248 which may result in the residual use of foreign partnerships in these circumstances.[41] This is because Treasury has explicitly stated that the aggregate treatment does not apply for purposes of Section 1248, thus encouraging the use of foreign partnerships for non-U.S. investments.[42]

The distinction between domestic and foreign partnerships in the withholding area seems sensible at first blush. Specifically, the IRS can easily proceed against a domestic partnership for failure to withhold, and therefore it is not necessary to impose on such a partnership the potentially onerous task of providing its partners' tax forms. On the other hand, a foreign partnership is typically more difficult for the IRS to reach. However, when one considers that the definitions are based entirely on the place of organization of the partnership, the lines become a bit more blurry.[43] A domestic partnership doesn't lose its status as such where all its partners are foreign persons, and conversely a foreign partnership may have predominantly U.S. resident partners. Forming a partnership under U.S. law versus foreign law often does not have significant income tax ramifications due to pass-through treatment, 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. This is likely the reason why the treatment of partnerships under U.S. federal income tax law (with some exceptions) does not typically depend on the residence of jurisdiction of the partnership.[44] In a prior NYSBA report, we recommended a

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[40] Treas. Reg. § 1.958-1(d).

[41] There are anomalous tax results created by Treasury's application of Sections 751(c) and 1248(g)(2)(B) when a partner sells an interest in a partnership where the partnership owns stock of a controlled foreign corporation ("**CFC**"). Neither Treasury nor the IRS has issued formal guidance on the application of Sections 751(c) and 1248(g)(2)(B) to sales of partnership interests, but it appears that Treasury has taken the position that the sale of an interest in a partnership that owns a CFC should be treated as the sale of a noncapital asset (to the extent of untaxed earnings and profits under Section 1248) and produce ordinary income under Section 751(c). *See* T.D. 9345; *See also* T.D. 9644. However, if the partner sold the CFC directly, then Section 1248 would apply, and the gain would be eligible for preferential tax treatment.

[42] Preamble to REG-101828-19, 84 F.R. at 29119.

[43] Treas. Reg. § 301.7701-5.

[44] By contrast, domestic corporations are subject to full corporate taxation under Sections 11 and 55, while foreign corporations are only subject to U.S. entity-level income tax on taxable income effectively connected with the

general presumption that a partnership's residence should be irrelevant and should not have substantive tax impact, unless the underlying policies of the provision mandate otherwise.[45]

Partnerships are taxed in the United States on a flow-through basis (regardless of residence), and the choice of residence is both entirely elective and, as described above, often driven by bona fide non-tax considerations. Since our prior aforementioned report, regulatory regimes have become more elaborate and complex, and we would expect that foreign partnerships will continue to figure prominently in inbound investment structures. Consequently, harmonizing the treatment of these partnerships under Section 1445 with their treatment under other regimes will promote more certainty and administrability.[46]

## III. Look-Through Rules in Other Withholding Contexts

There are several other withholding regimes that currently allow foreign partnerships to avoid the overwithholding issues described above. These rules generally treat foreign partnerships as aggregates, or alternatively, allow the foreign partnerships to assume withholding responsibility themselves. This section will briefly summarize these rules, which will provide a contrast to the treatment of foreign partnerships under Section 1445. The inability under current tax law to look-through a foreign partnership to the underlying owners in the Section 1445 context is inconsistent with the look-through approaches taken in other sections of the Code.

Under Section 7701, a foreign partnership is a foreign person.[47] In promulgating the rules described in this section, the Treasury and IRS were not overly restrained by the "foreign person" definitions and were able to permit look-through treatment of foreign partnerships. There does not seem to be a discernible reason why these principles cannot be implemented in the Section 1445 context as well.

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conduct of a US trade or business pursuant to Section 882 (and otherwise on US-source income on a 30% gross withholding basis under Section 881). However, much like partnerships, corporations are subject to a place of organization rule under Section 7701(a)(4).

[45] New York State Bar Association Tax Section Report No. 1124, "Report on Differences in Tax Treatment of Domestic and Foreign Partnerships" (January 3, 2007) (the "**2007 Report**"), Section III.

[46] *See* 2007 Report, Section II.

[47] Section 7701(a)(1); Section 7701(a)(5).

### a. Sections 1441 and 1442: FDAP

For withholding on payments of dividends and interest or other fixed, determinable, annual or periodical ("**FDAP**") income under Sections 1441 and 1442, look-through treatment is applied to foreign partnerships and the determination is made at the partner level.[48] By contrast, a domestic partnership is treated as the payee on an entity theory because the U.S. partnership is itself a withholding agent under Section 1441.[49] The FDAP withholding scheme is implemented by directing the applicable withholding agent or payor to treat the partners of a recipient nonwithholding foreign partnership as the "payee" for purposes of withholding.[50]

This look-through approach requires that the withholding agent be able to "reliably associate" a partner's distributive share of the payment with a withholding certificate provided by the beneficial owner.[51] This "association" is achieved through the provision of a W-8IMY together with an attached schedule setting forth the allocation of the associated income. A foreign partnership typically provides an IRS Form W-8IMY attaching a statement allocating the payment to its partners and providing the withholding certificates of its partners. This treatment applies to tiered partnership structures with look-through treatment applied to the underlying partners of higher-tier partnerships.[52] If a portion of the payment cannot be reliably associated with documentation from a partner, such amounts are presumed to be made to a foreign payee.[53]

Most categories of interest are exempt from FDAP withholding under the portfolio interest exemption.[54] If a foreign lender owns (directly or by attribution) 10% or more of the voting stock of the U.S. borrower, the portfolio interest exemption will not apply.[55] If the lender is a partnership, the determination of whether the foreign lender owns 10% or more of the voting

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[48] Treas. Reg. § 1.1441-5(b)(1); Treas. Reg. § 1.1441-5(c).
[49] Treas. Reg. § 1.1441-5(b)(1); Treas. Reg. § 1.1441-5(b)(2). *See* 61 Fed. Reg. 17614, 17627 (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").
[50] Treas. Reg. § 1.1441-5(c)(1).
[51] Treas. Reg. § 1.1441-5(c)(1).
[52] Treas. Reg. § 1.1441-5(c)(1)(i)(D).
[53] Treas. Reg. § 1.1441-5(d)(3).
[54] Section 871(h); Section 881(c).
[55] Section 871(h)(3)(A); Section 881(c)(3)(B).

stock is made at the partner level.[56] The partner level test of Treas. Reg. § 1.871-14(g)(3) is applied without distinction between a domestic and a foreign partnership.[57]

An ordinary REIT dividend is subject to the FDAP rules described above. Consequently, where a REIT makes a dividend distribution to a foreign partnership shareholder, withholding can be reduced on a look-through basis. On the other hand, and illustrating the discontinuity highlighted in this Report, where the REIT distribution is attributable to the sale of a USRPI, no mitigation is permitted. This is because such a distribution is subject to FIRPTA and Section 1445 by reason of Section 897(h)(1).[58]

#### b. Treas. Reg. § 1.1441-5(c)(2): Withholding Foreign Partnerships

A foreign partnership may itself be treated as the FDAP payee if it assumes primary withholding responsibility by entering into a contractual agreement with the IRS to be a withholding foreign partnership.[59] The withholding foreign partnership will provide a certificate (W-8IMY without underlying tax forms) to the withholding agent and will receive payments free of withholding. Where a foreign partnership assumes this responsibility, it avoids withholding on payments it receives and instead administers withholding as if it were a domestic entity, in a manner consistent with the withholding agreement procedures described above. The IRS has a greater ability to collect from a withholding foreign partnership in the event of a failure to withhold due to the contractual withholding agreement between the foreign withholding partnership and the IRS. Importantly, "withholding foreign partnership" status is limited to FDAP withholding and is not available under FIRPTA or other withholding regimes.

#### c. Section 1446: ECI

Foreign partnerships generally receive look-through treatment for purposes of withholding on effectively connected income ("**ECI**") under Section 1446, including Section 1446(f).[60] A partnership, whether domestic or foreign, must withhold on ECI that is allocable to

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[56] Treas. Reg. § 1.871-14(g)(3)(i).
[57] Treas. Reg. § 1.871-14(g)(3).
[58] The same result applies to a non-dividend distribution by a USRPHC to a foreign partnership shareholder.
[59] Treas. Reg. § 1.441-5(c)(2).
[60] Treas. Reg. § 1.1446-5(c).

a foreign partner.[61] The Regulations set forth a process whereby a partnership first determines whether it has any foreign partners, and then whether it has ECI allocable to a foreign partner.[62] Finally, the partnership computes the applicable withholding tax, pays such withholding tax to the IRS and reports the income and tax in accordance with the form requirements.[63] A foreign partnership provides the withholding agent with a Form W-8ECI (omitting partner information) and then withholds on foreign partners' distributive shares in the same manner as domestic partnerships. Foreign partnerships are entrusted with the responsibility of ensuring withholding compliance despite the lack of a withholding agreement. A foreign partnership that is subject to withholding under Section 1445(a) during its taxable year may credit the amount withheld under Section 1445(a) against its Section 1446 tax liability for that taxable year only to the extent such amount is allocable to foreign partners.[64]

#### d. Treas. Reg. § 1.1446-5: Tiered Partnerships

When a domestic partnership realizes ECI and has a partner that is a foreign partnership, the lower tier domestic partnership is allowed to look-through the upper tier foreign partnership via Form W-8IMY (and accompanying tax forms) for withholding purposes.[65] The calculation of the amount of the Section 1446 withholding is determined by looking through to any losses, credits or deductions of the underlying partners.[66] If the underlying partners are U.S. persons or are exempt from FIRPTA, a domestic partnership could reduce its Section 1446 withholding in proportion to the amounts attributable to those partners. This treatment applies to FIRPTA ECI as well due to the coordination rules between 1445 and 1446, so a lower tier domestic partnership can look through an upper tier foreign partnership for FIRPTA withholding.[67] More specifically, where a domestic partnership disposes of a USRPI, it may collect a W-8IMY from its upper tier foreign partnership, together with a withholding statement, and reduce the

[61] Section 1446(a); Treas. Reg. § 1.1446-1(a).
[62] Treas. Reg. § 1.1446-1(b).
[63] *Id.*
[64] Treas. Reg. § 1.1446-3(c)(2)(ii).
[65] Treas. Reg. § 1.1446-5(c).
[66] Treas. Reg. § 1.1446-5, -6.
[67] Treas. Reg. § 1.1446-3(c)(2).

withholding obligation.[68] The above rules effectively allow an upper tier foreign partnership to achieve the same treatment as if it had realized the ECI directly.

#### e. Section 1446(f): ECI from Sales of Partnership Interests

Section 1446(f)(1) generally requires the transferee of a partnership interest to withhold a tax equal to 10% of the amount realized by the transferor when the disposition results in gain that is treated as effectively connected with the conduct of a U.S. trade or business under Section 864(c)(8). Under Section 1446(f), foreign partnerships are treated as aggregates for withholding purposes on sales of interests in lower tier partnerships that result in or are deemed to result in ECI. A foreign partnership is entitled to look through treatment even if it has not entered into a withholding agreement with the IRS and has no continuing contacts with the U.S. after the sale. More specifically, the Section 1446(f) Regulations prescribe certain procedures that allow a transferee to reduce the withholding otherwise required. A foreign partnership may utilize a "modified amount realized" approach, pursuant to which the transferee may look through the foreign partnership, and compute the amount required to be withheld based on the domiciliary status of the partners.[69] Where a foreign partnership sells an interest in a lower tier partnership that implicates Section 864(c)(8), the foreign partnership can certify to the buyer via a Form W-8IMY (along with Forms W-8 or W-9, as applicable) providing the percentage of gain allocable to each partner and whether each partner is a U.S. or foreign partner.[70] Under the "modified amount realized" approach, the buyer proportionately reduces the amount realized for the percentage of gain allocable to domestic partners and in turn reduces the amount withheld. Alternatively, a transferee may rely on a certification of a foreign transferor as to the transferor's "maximum tax liability."[71] Under this procedure, a foreign transferor determines its liability based on its "effectively connected gain" multiplied by the "applicable percentage."[72] The certification of maximum tax liability must include (i) a statement that the transferor is a foreign person, partnership, corporation or trust, (ii) the transferor's adjusted basis, (iii) the transferor's

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[68] *See* Form W-8IMY, Part VIII, Line 21(b).
[69] Treas. Reg. § 1.1446(f)-2(c)(2)(iv).
[70] *Id.*; IRS Form W-8IMY, Part VIII, Lines 21c and d.
[71] Treas. Reg. § 1.1446(f)-2(c)(4).
[72] The "effectively connected gain" is the amount of outside ordinary gain and outside capital gain that would be recognized and treated as effectively connected gain under Treas. Reg. §1.864(c)(8)-1(b) on the determination date. Treas. Reg. § 1.1446(f)-2(c)(4)(iii)(E).

amount realized, (iv) whether the transferor remains a partner immediately after the transfer, (v) the effectively connected gain, and (vi) the transferor's maximum tax liability.[73] Additionally, the certification of maximum tax liability must include representations from the transferor that it provided the transferee a copy of the "partnership statement," on which the effectively connected gain was based.[74]

## IV. Recommendations

### a. Allow Transferees to Look Through to Underlying Partners for FIRPTA Withholding

As we stated in a prior report, "Section 1445 is the most draconian withholding regime for foreign partnerships."[75] This is due to the fact that a foreign partnership generally cannot avoid withholding where it disposes of a USRPI, irrespective of the composition of its partners. It is difficult to discern a policy reason for distinguishing domestic and foreign partnerships for FIRPTA withholding purposes. As enumerated above, aggregate treatment of foreign partnerships is found in other withholding regimes, including the Section 1446(f) rules enacted in 2020, and we believe Section 1445 withholding can be modeled after the "modified amount realized" and/or the "maximum tax liability" framework.

We believe that application of these principles to Section 1445 is appropriate and would represent an improvement to the FIRPTA withholding landscape. Furthermore, the existing rules already contain mechanisms that can be utilized to implement such treatment. We recommend that the withholding regime under Section 1445 be updated to allow for transferees to look through non-U.S. partnerships to determine how to withhold appropriately on a transfer.[76] In 2005, when the Regulations under Section 1446 were amended, they were conformed to Section

[73] Treas. Reg. § 1.1446(f)-2(c)(4)(iii)(A-F).
[74] Treas. Reg. § 1.1446(f)-2(c)(4)(iii)(G-H). The "partnership statement" is a statement provided from the transferee to the transferor that includes the partnership's name, address, and TIN, and the transferor's "aggregate deemed sale effectively connected ordinary gain" and the transferor's "aggregate deemed sale effectively connected capital gain," each within the meaning of Treas. Reg. § 1.864(c)(8)-1(c)(3)(ii). Treas. Reg. § 1.1446(f)-2(c)(4)(iv).
[75] 2007 Report, Section IV(B)(1)(c).
[76] We also considered, but chose not to recommend, allowing non-U.S. partnerships to assume withholding foreign partnership responsibility.

1441.[77] In the 2007 Report, we recommended that the Section 1445 withholding tax regime be conformed to Sections 1441 and 1446 to allow a foreign partnership to be permitted to demonstrate that it has U.S. partners under the Section 1441 standards and thereby reduce the amount of required withholding.[78] Our present recommendation maintains that the Section 1445 rule should be similarly conformed.

Specifically, the "modified amount realized" and "maximum tax liability" approaches utilized by the Section 1446(f) Regulations should be adopted and applied for purposes of Section 1445 withholding for foreign partnerships. As discussed above, both Section 1441 and Section 1446(f) apply aggregate treatment to foreign partnerships, and similar policy concerns underlie both withholding regimes. In the years since the Section 1445 rules were enacted, QFPF status was created and Form W-8EXP was updated, and the recommendations in this report would facilitate these exemptions. As applied to FIRPTA, the approach of the Section 1446(f) Regulations would allow foreign partnerships to reduce the amount of withholding required under Section 1445 by demonstrating the percentage of FIRPTA gain allocable to its U.S. and exempt partners or by computing a redetermined amount of effectively connected gain. Adopting these procedures, which are already utilized in the Section 1446(f) Regulations, will reduce transaction costs and further promote sound tax administration.

**b. 90-Day Review Period and Escrow Release**

We acknowledge that the "maximum tax liability" determination is more complex than the "modified amount realized" approach, and therefore if the IRS and Treasury believe it is not workable to permit a transferee to independently rely on the transferor's computation, a foreign partnership could be required to furnish the relevant information that the partnership provides to the withholding agent to the IRS. In these circumstances, the transferee can maintain an escrow of the withheld amounts in order to provide the IRS adequate time to review the forms.

Precedent for such a procedure already exists under the Section 1441 withholding rules. For example, Form 8233[79] is provided first to the withholding agent, and if the withholding agent

[77] *See* TD 9200 (May 13, 2005) ("Treasury and the IRS believe that the documentation requirements of Sections 1441 and 1446 should be coordinated where feasible").
[78] 2007 Report, Section IV(B)(2)(c).
[79] Form 8233 is used by non-resident alien individuals to claim exemption from withholding on compensation for personal services because of an income tax treaty or the personal exemption amount.

accepts the information as true and correct, then the withholding agent must sign and provide the form to the IRS within five days of acceptance.[80] If the IRS does not object within ten days, then the IRS is deemed not to reject the form.[81]

As discussed above, the Regulations governing FIRPTA pre-clearance certificates provide that the IRS "will act upon an application for a withholding certificate not later than the 90th day after it is received."[82] In the case of the "maximum tax liability" method (and, if the IRS so prefers, the "modified amount realized" method as well), the IRS should consider adopting the 90-day period as a more firm standard, which hopefully provides sufficient time to review the accuracy of the withholding certificates. Under such approach, should the IRS fail to act on the application for a withholding certificate within such period, the withholding agent or escrow agent would be permitted to release all amounts withheld on the 91st day after the application for the withholding certificate was filed. The foreign partnership transferor would remain liable in the event the IRS ultimately determined that the withheld amounts were insufficient to cover the Section 1445 liability.

Accordingly, we recommend that in the event the IRS and Treasury have concerns regarding the adoption of the Section 1446(f) approach in the context of the Section 1445 withholding rules, the IRS and Treasury consider combining such alternative with the prescribed IRS review period of 90 days currently found in the Regulations.

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[80] Treas. Reg. § 1.1441-4(b)(2)(v).
[81] Treas. Reg. § 1.1441-4(b)(2)(i).
[82] Treas. Reg. § 1.1445-3(a).