DO THE FINAL AND TEMPORARY REGS ON WITHHOLDING TAX FOR PARTNERSHIPS WITH FOREIGN PARTNERS REALLY EASE BURDENS?*

By Alexander F. Peter

Alexander F. Peter is a German attorney (Rechtsanwalt), a certified tax adviser (Steuerberater), and is admitted to the New York Bar and to the U.S. Tax Court in Washington. He earned his Ph.D. in law at the Rheinische Friedrich-Wilhelms University, Bonn, Germany in 1998 and his LLM in taxation in 2005 from Georgetown University Law Center, Washington. He is with Norton Rose in Frankfurt, Germany.

Peter believes that the newly promulgated final and temporary regulations on the obligation of a partnership to withhold tax on some income of foreign partners under section 1446 will have a substantial effect on foreign investment in the United States. This article highlights the administrative burdens of the new withholding regime and suggests possible ways to minimize those burdens.

Table of Contents

I. Introduction ............................................ 1173
II. Taxation of P'ships With Foreign Connections ....................... 1174
   A. In General ..................................... 1174
   B. Withholding on Partnership Income .... 1174
III. The Configuration of the Withholding Tax ............................. 1175
   A. Determination of the Foreign Partner .. 1175
   B. Determination of ECTI .......................... 1177
   C. Administrative Burdens ...................... 1181
IV. Conclusion ............................................. 1184

I. Introduction

On May 13, 2005, the IRS and Treasury promulgated final and temporary regulations under section 1446 on the obligation of a partnership to withhold tax on income that is effectively connected with a U.S. trade or business (ECTI) and allocable to a foreign partner under section 704. The regulations amend previously issued (in September 2003) proposed regulations. A couple of authors have already commented on those proposed rules, and this article does not undertake a detailed review of all provisions of the new rules. Rather, it will focus on the administrative demands of the final and temporary regs that were either changed from the proposed regs and revenue procedures or were not properly addressed by the IRS and should be tackled in additional amended final regulations.

1If the partnership’s income that is allocable to a foreign partner is not ECTI, that income often will be subject to withholding under section 1441. See Paul D. Carman, “Foreign Partners, Doing Business, FIRPTA Withholding, and the Section 1446 Proposed Regulations,” 31 Real Est. Tax’n 62 (2004).


4By and large, this article will not discuss the rules for publicly traded and tiered partnerships, now in Treas reg. sections 1.1446-4 and 1.1446-5. For issues not discussed in this article, see “Attorney Seeks Withholding Relief for Chapter 11 Partnerships,” Doc 2004-5912, 2004 TNT 57-33; “Florida Bar Addresses Proposed Foreign Partner Withholding Regs,” Doc 2004-8499, 2004 TNT 77-45, for a clearer specification of the period during which interest and penalties accrue and for a treatment of distributions under section 731 as advances; “Gas Firm Comments on Proposed Partnership Withholding Regs,” Doc 2003-21411, 2003 TNT 195-18, for implementing a mechanism whereby the burden of the collection of withholding and the remittance of the funds can be transferred to the paying agent (that is, the transfer agent or the broker); “ABA Comments on Proposed Foreign Partner Withholding Regs,” Doc 2004-3262, 2004 TNT 33-16, for the possibility to treat any obligation by the foreign partner to return any overwithheld tax as reducing the amount of any distribution to the foreign partner.

II. Taxation of P’ships With Foreign Connections

A. In General

Nonresident foreign persons are taxable on all of their U.S.-source income at the usual individual (section 1) or corporate rates (section 11) if the income is from a U.S. trade or business and effectively connected.\(^7\)

That determination is made at the partnership level. Therefore, if a foreign person is a partner in a partnership that is engaged in a U.S. trade or business, the foreign person is also treated as engaged in a U.S. trade or business.\(^8\) However, a domestic or foreign partnership’s activities that do not rise to the level of engagement in a U.S. trade or business can be requalified if a partner fulfilling that requirement acts as an agent for the partnership and not on his own behalf.\(^9\)

The nonresident foreign person can be so ensnared in section 875 that his participation in the partnership is treated as an engagement in a U.S. trade or business.

U.S. trade or business is not defined in the code and is only partially defined in the regulations. Section 864(b) provides that any performance of services in the United States generally will be treated as a U.S. trade or business. Section 864(b)(2), however, excludes the trading in securities or commodities from creating a U.S. trade or business\(^10\) if trading is conducted through a resident broker retained by a foreign person. For any other activities not described in section 864 and its regulations, the determination as to whether a person is engaged in a U.S. trade or business will be based on the facts and circumstances in each case.\(^11\) In general, that element will be found to exist if there are regular, continuous, and considerable business activities in the United States; isolated or sporadic transactions will usually not be construed as the conduct of a trade or business.\(^12\)

The effective connection of the income with a U.S. trade or business is then to be ascertained and is determined depending on the income derived.\(^13\)

Nonresident foreign persons with income that is not ECTI are generally taxed only in the United States if the income belongs to one of the items mentioned in section 861,\(^14\) was allocated by regulations to sources within the United States (section 863), or is sourced by comparison and analogy with classes of income specified within the statutes,\(^15\) which the IRS also referred to as the “general principles of law.” Sections 871(a), 881(a)(1), and 1441(b) designate part of that income as determined, annual, or periodic (FDAP) income from U.S. sources.\(^16\) It is subject to a flat tax of 30 percent on the gross amount of the income received and collected by withholding,\(^17\) meaning the payer of the item has to pay the tax on behalf of the actual receiver of the payment unless an exception (for example, sections 871(h), 881(c), or a tax treaty) applies. Net capital gains that do not fall within FDAP income are not U.S. real property gains under sections 861(a)(5) or 897 and are not exempt from ECTI if the nonresident alien is not present in the United States for at least 183 days during the tax year.\(^18\)

If the income is not sourced within the United States, it is sourced outside the United States.\(^19\) In that case and if the exemption of section 871(a)(2) applies or if the income is not ECTI, the income is not taxable for a nonresident alien. Only U.S. citizens are taxable on their worldwide income.\(^20\)

B. Withholding on Partnership Income

Generally, resident and nonresident taxpayers have to pay their expected (estimated) tax liability for the fiscal year in advance installments (section 6654 for individuals and section 6655 for corporations). However, two very different withholding tax schemes are applied to foreign persons in a partnership, based on whether or not the income is ECTI.

If a nonresident taxpayer is a partner in a partnership with revenues that are not ECTI, the partnership assumes that duty by withholding tax\(^21\) on the individual taxpayer’s share of FDAP income from U.S. sources under

---

\(^{14}\)Id.

\(^{15}\)Sections 871(a), 1441(b), and 881(a)(1).

\(^{16}\)See, e.g., Bank of America v. United States, 680 F.2d 142, 147 (Ct. Cl. 1982); citing Howkins v. Commissioner, 49 T.C. 689 (1968).


\(^{18}\)Section 861(a). FDAP income includes interest, dividends, rents, salaries, wages, premiums, annuities, compensation, renumeration, and emoluments.

\(^{19}\)Sections 871(a) and 881(a).

\(^{20}\)Sections 1441 and 1442.

\(^{21}\)Section 871(a)(2).

\(^{22}\)Section 862.


\(^{24}\)If the tax withheld does not cover the complete tax liability of the taxpayer, he is still obliged to pay estimated taxes in the amount of the underpayment; see sections 6654 (b) and 6655(b).
section 1441 and Treas. reg. section 1441-5(b)(2)(i)(A); on the nonresident corporations’ share under section 1442 and Treas. reg. section 1442-1; and on the tax-exempt organizations’ share under section 1443 and Treas. reg. section 1443-1(a). Withholding on dispositions of U.S. real property interests by partnerships generally is governed by section 1445(a) and (e). However, partnership income of foreign nonresident partners ECTI is subject to withholding tax under section 1446.25

Since its enactment in 198626 and until 2003, no regulations were issued under section 1446.27 Treasury promulgated a series of revenue procedures28 providing guidance as to Treasury’s interpretation of section 1446.

III. The Configuration of the Withholding Tax

The crucial question is, when a partner is qualified as foreign, how is the ECTI calculated and allocated to that partner, and what consequences does that have for the reporting, filing, and payment requirements with the IRS?

A. Determination of the Foreign Partner

1. Rev. Proc. 89-31 and 88-21. Under section 1446(e), a foreign partner is any partner that is not a “United States Person.” That leads to the definitions in section 7701. By applying section 7701(a)(30), a foreign partner is any partner that is either a nonresident alien individual, foreign partnership, foreign corporation, or any foreign trust or estate. Special care must be taken when considering individuals, trusts, and estates.29

To determine if a person is a foreign partner under Rev. Procs. 89-31 and 88-21, the partnership needed to obtain an informal certification with some required information from a partner that he or she is not a foreign partner.30 However, the claim of an exemption from withholding under sections 1441 and 1442 by making the election under sections 871(d) or 882(d)31 and therefore filing the old Form 4224 has several consequences: It leads to the inclusion of that partner's income into his allocable share of ECTI for section 1446 purposes and therefore to the establishment of his status as a foreign partner.32

A mistake in qualifying the partner as foreign can have far-reaching consequences for the partnership. Under section 1461, the partnership is liable to Treasury for the withholding tax. Because there are no restrictions in the wording of that provision about the extent of the liability, a strict liability for any wrongful act of omission to pay withholding taxes could be operative.33

The IRS, however, granted partnerships a relief from any liability for nonwithholding if the partnership does not have “actual knowledge that the certificate is false” and relied “in good faith upon a certification.”34 While section 5.02(6) of Rev. Proc. 89-31 did not contain any explicit provison regarding a limitation of the partnership’s liability if it relied on one of the above-mentioned forms, section 5.02(7) clarified that the good-faith exception in that case also applies. However, there was no guidance as to the particular circumstances that would trigger the exception from liability.

To determine whether a person is a foreign partner, both Rev. Procs. 88-21 (section 5.03) and Rev. Proc. 89-31 (section 5.03) provided that the partnership could also rely on — not further designate — “other means” instead of a certification. However, in that case, the IRS would not grant any relief from the strict liability in section 1461 for a wrongful act of omission of withholding. The revenue procedures both stated that an erroneous determination triggers the full liability under section 1461. Section 4.02 of both revenue procedures additionally pointed to possible criminal and civil penalties. The civil penalties imposed by section 6672 on the responsible persons at the withholding agent (the partnership) or in

---

25See also section 8.05(1) of Rev. Proc. 88-21, 1988-1 C.B. 777 (obsoleted by Rev. Proc. 89-31); section 7.02(1) of Rev. Proc. 89-31, 1989-1 C.B. 895; and prop. Treas. reg. section 1.14466-3(c)(1) which explicitly state that tax on FDAP income subject to tax only under section 871(a) or section 881 is collected by section 871(d) and Treas. reg. section 1.1446-2; section 7.02(2) of Rev. Proc. 89-31, 1989-31, 1989-1 C.B. 895; and prop. Treas. reg. section 1.1446-3(c)(2). Prop. Treas. reg. section 1.1446-3(c)(3) now also gives priority to section 1446 in a conflict with withholding under section 1443. For examples as to the general (not completely up-to-date) interplay of sections 1441, 1442, and 1446, see Daniel B. Lee, supra note 3, at 39.

26See P.L. 99-514.


29See Lee, supra note 3, at 39.

---

30Sections 5.02(1), (2), and 5.04 of Rev. Proc. 89-31 as well as sections 5.02(1), (2), and 5.04 of Rev. Proc. 88-21. Publicly traded partnerships and partnerships with more than 200 partners could instead rely on the information included in a Form 1001, W-8, or W-9. Sections 5.02(7) and (6) of Rev. Proc. 89-31.

31Sections 871(d) and 882(d) relate to the treatment of real property income as effectively connected income.

32See section 6.01 of Rev. Proc. 89-31. That the foreign partner has established his foreign status with the filing of Form 4224 results only indirectly from the revenue procedures since it is not mentioned under section 5.01 of Rev. Proc. 89-31 that deals with the certification procedure of the qualification as foreign partner. See also the preamble to the final regs, T.D. 9200.

33See also section 4.02 of Rev. Proc. 89-31 and section 4.02 of Rev. Proc. 88-21.

34Section 5.02(2) of Rev. Proc. 89-31 and section 5.02(2) of Rev. Proc. 88-21.
a corporation as general partners are equal to the amount that should have been withheld.

2. The proposed Treasury reg. The proposed regulations generally followed the requirements of Rev. Proc. 89-31 but also gave further direction while keeping a few questions still unresolved.

One modification was the change from a separate certification of nonforeign status to general conformity with the paperwork requirements under section 1441 regulations. The practical effect of the change was that for the partnerships that are required to withhold under both sections 1441 and 1446, only one set of forms from each partner would be required, thus reducing recordkeeping and eliminating inconsistent documentation. Under prop. Treas. reg. section 1.1446-1(c)(2)(i), a partnership should obtain either a Form W-8BEN, “Certificate of Foreign Status of Beneficial Owner for U.S. Tax Withholding” or W-8IMY, “Certificate of Foreign Intermediary, Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding,” from each of its foreign partners, or Form W-9, “Request for Taxpayer Identification Number and Certification” from each of its domestic partners.

However, the proposed regs did not explicitly recognize the qualification of a partner as foreign if he files the Form W-8ECI (the former 4224 document) required for the withholding regime under section 1441.

Furthermore, the requirement to receive those forms was amplified: If a partnership did not receive a valid Form W-8BEN, W-8IMY, or W-9 from a partner, it was explicitly presumed that the partner was a foreign person and the partnership had to withhold and pay withholding tax under section 1446 on ECTI allocable to that partner.

The presumption did not apply if the partnership could correctly determine by other means the nonforeign status of a partner. Although not expressly stated, that implied that in case of an incorrect determination the (strict) liability of section 1461 and all other consequences like the civil penalty of section 6672 was operative.

However, the good-faith exception in the revenue procedures when relying on the informal certificates was aggravated if the partnership was now confiding on the above-mentioned official forms. While under section 5.02(2) of both revenue procedures only actual knowledge excluded a good-faith reliance, now the partnership’s liability under section 1461 (and all other consequences) already kicked in if it had “reason to know” that the forms contained incorrect or unreliable information and it did not withhold any tax.

A definition of that expression was contained in prop. Treas. reg. section 1.1446-1(c)(2)(ii), which referred to Treas. reg. sections 1.1441-4(b)(viii) and 1.1441-7(b)(2). Under those latter provisions, a partnership had reason to know that information on a withholding certificate or statement is incorrect or unreliable if its knowledge of relevant facts or statements contained on the form or other documentation is such that a reasonably prudent person in the position of the withholding agent would question the claims made. Although the reader might object and argue that the definition needs case law to determine the “reasonably prudent person standard” in the relevant constellation, the regulation clarifies that all circumstances (“other documentation”) — and not only (suspicious) mistakes on the official forms — could cast doubt on the credibility of the papers presented.

Prop. Treas. reg. section 1.1446-1(c)(2)(iii) gives some further guidance by reference to Treas. reg. section 31.3406(h)-3(e). Under that provision, a payer cannot “reasonably” rely on the validity of the certificate if it does not contain the name and taxpayer identification number of the payee, is not signed and dated by the payee, does not contain the statement, when required, that the payee is not subject to withholding because of notified payee underreporting, or if the payee has deleted provisions by which the payee certifies or affirms the correctness of the statements contained on the form.

3. The final Treasury reg. The new final regulations strengthen the general conformity with the paperwork requirements under the section 1441 regs, which were partly brought in line already in the proposed regs.

Besides the forms mentioned in the proposed regs (Forms W-8BEN, W-8IMY, and W-9), the final regs now explicitly recognize the following forms to establish the characterization of the partner as foreign, namely Form W-8ECI, “Certificate of Foreign Person’s Claim for Exemption From Withholding on Income Effectively Connected With the Conduct of a Trade or Business in the United States,” and Form W-8EXP, “Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding.”

Also, the final regulations now provide guidance on which persons have to produce which official forms; for example, the W-9 certificate must be provided by a U.S. person who is a partner in the partnership to show that he is not a foreign person and therefore no withholding tax is due.

The question whether informal certificates can serve as other means to rebut the presumption that a partner is

35See Treas. reg. sections 1.1441-1(d), (e), and -5(c) to determine the status (domestic or (beneficial) foreign) and the tax classification (corporate or noncorporate) of its partners.

36See also note 32 supra.

37Supra note 3, at 40.

38See also note 32 supra.

39Prop. Treas. reg. section 1446-1(c)(3).

40Carman, supra note 1, at 65 n.27 pointing out that the proposed regs do not seem to contemplate substitute forms as the informal certification in the revenue procedures anymore. Treas. reg. section 1.1446-1(c)(2)(iii) only refers to Treas. reg. section 31.3406(h)-3(h) but not to substitute forms in Treas. reg. section 31.3406(h)-3(c) even though the reg relates to the validity of both Forms W-9 and substitute certificates. Furthermore, the substitute form rules of Treas. reg. section 1.1441-1(e)(4)(vi) do not appear to be incorporated in the proposed regulations that are otherwise trying to correspond to those rules. The question remains, then, of what other means are left to rebut that presumption.

41See prop. Treas. reg. section 1.1446-1(c)(4).

42See Treas. reg. section 1446-1(c)(2)(i). For a discussion of that form, see also the preamble of the final regs, T.D. 9200.

43Treas. reg. section 1446-1(c)(2)(ii).
foreign if he does not provide a commensurate official certificate is now answered in the affirmative because the possibility of substituting its own form for the official Form W-8 is explicitly left to the partnership.

The reasonably prudent person standard for questioning suspicious or fraudulent certificates remain essentially unchanged but is more clearly structured by adding some subheadings.

What would happen if no determination of the partner’s status were performed and not even informal certificates were produced or requested because the section 1446 regulations are relatively unknown to many taxpayers? Commentators remarked that although the regulations do not address that situation, the good-faith reliance standard should apply analogously to “still get it right.”

B. Determination of ECTI

1. Determination of ECTI under the revenue procedures and regs.

a. In general. The first version of section 1446 did not offer any further definition of and guidance on ECTI and how it should be calculated but connected it to an actual distribution to a partner. Against the wording of that version of the code, section 8 of Rev. Proc. 88-21, however, offered the opportunity for a partnership to make an election and pay the withholding tax not on actual distributions but on ECTI attributable to the foreign partner. That last procedure worked less like a normal withholding procedure and more like those procedures that would be followed by corporations and individuals under sections 6654 and 6655 when they make their quarterly estimated tax payments.

By contrast, the current version of section 1446, introduced roughly two years later, expressly delinked the withholding tax from distributions to avoid the criticized overwithholding and focused on the allocable share of the partner’s ECTI. A share of the partnership’s ECTI is not allocable to a foreign partner if those amounts are exempt from U.S. tax for that partner by operation of a treaty or reciprocal agreement or by a provision of the code.

b. Tax-exempt income not allocable to a foreign partner. However, the revenue procedures and proposed regs did not give any guidance for determining when a foreign partner will be exempt from the partnership’s taxable income. That left partnerships in the position of having to make complex legal and factual determinations at their own risk.

There were three alternatives:

• the partnership, although engaged in a trade or business in the United States, may not have a permanent establishment (PE) in the United States, and a partner resident in a treaty country may therefore be entitled to an exemption;
• the foreign partner is a foreign government entitled to an exemption under section 892 for its investment and commercial activities; or
• the foreign partner is a foreign organization that is described in section 501(d) to the extent that the amounts are not income includable under section 512 in computing the organization’s unrelated business taxable income.

Regarding the first alternative, article 7, subsection 1 and article 14, subsection 1 of the U.S. model tax treaty provide for the competence of the United States to tax business or service income to the extent the taxpayer has a PE in the United States. A PE for treaty purposes (see article 5, subsection 1) means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Because partnerships (at least in older treaties) are not treaty beneficiaries, the question arises when a partner has a PE in the United States. Because section 875 provides that if a partnership is engaged in a trade or business within the United States, its partners are also treated as being so engaged. Case law and the IRS holds that the ownership of a partnership interest constitutes a PE if the partnership itself carries on its business through those means.

Thus, only in rare cases, when the partnership has no PE in the United States, the United States has no general right to tax the income derived from a business in this country and the partnership is therefore not obligated to withhold tax on the share of the nonresident foreign partner’s taxable income.

44See supra note 39.
45Treas. reg. section 1446-1(c)(5).
46See Treas. reg. section 1.1446-1(c)(iii) and (iv).
48P.L. 99-514 (Oct. 22, 1986): “(a) General Rule. — Except as provided in this section, if a partnership has any income, gain, or loss which is effectively connected with a trade or business within the United States, any person described in section 1441(a) shall be required to deduct and withhold a tax equal to 20 percent of any amount distributed to a partner which is not a United States person.” See also Allen and Renfroe, supra note 25, at 425; and Gartner and Scheine, supra note 28.
49P.L. 99-514 (Oct. 22, 1986); see also Allen and Renfroe, supra note 25, at 425.
50P.L. 100-647 (Nov. 10, 1988).
51See Appel and Karlin, “Regulations Proposed,” supra note 3, at 65. Overwithholding was not eliminated by this change in the law as the following explanations show.

52See section III.A.1 supra.
55“California ITC Submits Paper on Overwithholding on Foreign Partners and Shareholders,” Doc 96-13802, 96 TNT 97-49; mentions only the first two alternatives.
Nevertheless, in the two other alternatives (foreign governments and charitable organizations), the United States waived its right to tax income of those entities. Unlike Treas. reg. section 1.1441-8, the revenue procedures, Treas. reg. section 1.1441-9, and the proposed regs did not take those cases into account at all. Treas. reg. section 1.1446-1(c)(2)(ii)(G) and Treas. reg. section 1.1446-3(c)(3) now distinguish between those two constellations and require the withholding of tax on ECTI allocable to a foreign government and to a foreign section 501(c) organization to the extent the income is includable under sections 512 or 513.

The income of the partnership for those purposes was computed with the following adjustments:

- no items are separately stated under section 703(a)(1);
- the amount of any deduction for depletion for oil and gas is determined without regard to sections 613 and 613A;
- no items are taken into account to the extent that they are allocated to U.S. persons; and
- a partnership does not take into account net operating loss carryovers and charitable contributions.

The computation of ECTI includes partnership income subject to a partner’s election under sections 871(d) or 882(d), and income from the disposition of U.S. real property interests.

Although principally following Rev. Proc. 89-31, the proposed and final regs expanded the list of disallowed deductions to calculate the partnership income for purposes of section 1446 specified in the previous Rev. Proc. 89-31.

2. Proposals for amendments of the regs. As there was already no doubt under old Rev. Proc. 89-31 that its application led to significant overwithholding of tax in comparison to the tax due of a foreign partner, the proposed regs (and partially the final regs) under section 1446 establish even further a tax refund rather than a withholding tax system not favorable from a fairness and administrative point of view. That adversely affects the cash flow of the partnership.

Hence, there are several proposals to fix this “congenital defect” of section 1446.

- Because section 1446(b)(2)(A) refers for determination on the applicable tax rate to the foreign partner’s allocable share of ECTI only to the “highest rate in section 1,” regulations could split the rate in the highest rate applicable to ordinary income or short-term capital gain under section 1(a)-(g), and in the highest rate applicable to capital gain under section 1(h), in each case corresponding to the foreign partner’s allocable share.

- When a partnership has gain that would be subject to sections 1445(e)(1) and 1446, namely from the disposition of U.S. real property interests, section 58See Treas. reg. section 1.1446-2(b)(3). For further explanations and examples that delineate the overwithholding resulting from those provisions, see Lipton and Mossina, supra note 3, at 337; and Florida Bar, supra note 4. But see Appel and Karlin, “At Long Last,” supra note 47.

60Overwithholding is caused by, among other things, the application of the highest tax rate for calculating the withholding amount without taking into consideration any deductions a partner may be entitled. See “California Firm Says Withholding on Effectively Connected Partnership Income Should Be Restricted to Amounts Allocated and Distributed,” Doc 88-4272, 88 TNT 94-49; “IPA Wants Rev. Proc. 90-31 Amended to Provide That No U.S. Withholding From Foreign Partners Occurs When No U.S. Tax Is Owed,” Doc 89-5303, 89 TNT 136-26; California ITC, supra note 55. That is also recognized by the IRS. See the preamble to the proposed regs, 68 Fed. Reg. 52465.

61Appel and Karlin, “Regulations Proposed,” supra note 3, at 67. See also House of Representatives Ways and Means Committee Report, H.R. Rep. No. 795 110th Cong., 2d Sess. 289, 291 (July 26, 1988): “Further, the bill provides the Secretary the authority to prescribe regulations necessary to carry out the purposes of the provision. For example, special rules may be necessary in identifying a publicly traded partnership’s partners as U.S. or foreign. In addition, rules may be necessary in the case of tiered partnerships to prevent the imposition of more tax than will be properly due.”

62Willock, supra note 28, at 240; Ken Milani and Marianne C. Deda, “Cash Flow Implications for Partnerships With Nonresident Alien Partners,” 14 J. Int’l Tax’n 26 (June 2004); California ITC, supra note 55.

63See the overview from Appel and Karlin, “Regulations Proposed,” supra note 3, at 68.

64Ernst & Young Comments on Proposed Foreign Partner Withholding Regs,” Doc 2004-12015, 2004 TNT 112-43; ABA Comments, supra note 4.
1445 should control because it has a well-developed mechanism for avoiding overwithholding.

- The IRS should permit a foreign partner to certify an amount of deductions that are available to offset partnership income if the deductions derive from current or prior-year activities of the partnership and are consistent with the partnership’s allocation of deductions to the partner, including a withholding certificate procedure modeled on the procedures under section 1445.

- No withholding tax should be imposed for income derived from the cancellation of indebtedness (CODI) when no cash or other property is received by the partnership as in Treas. reg. section 1.1445-2, which gives a relief in similar circumstances.

- The IRS should develop criteria (for example, with a substantial presence of assets in the United States) by which a foreign partner could apply for a certificate of “good driver status.” That partner would then be allowed to certify to a partnership the availability of losses and deductions, including losses and deductions that are not related to the partnership, such as losses and deductions from other partnerships or from activities directly carried on by the foreign partner in the United States.

3. Authority to issue regs to mitigate overwithholding.

The question is whether those kinds of relief are supported by sufficient authority in section 1446. Section 1446(f) reads as follows:

(i) The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section, including —

(1) regulations providing for the application of this section in the case of publicly traded partnerships, and

(2) regulations providing —

(A) that, for purposes of section 6655, the withholding tax imposed under this section shall be treated as a tax imposed by section 11 and any partnership required to pay such tax shall be treated as a corporation, and

(B) appropriate adjustments in applying section 6655 with respect to such withholding tax.

If one considers the statement of the House Ways and Means Committee giving the IRS authority to issue rules that may be necessary to prevent a higher imposition of tax than it is properly due, it can be argued that the section has to be interpreted as not restrictive; the reference to publicly traded partnerships and the interaction of section 1446 with section 6655 is meant only to describe some of the required regulations that carry out the purposes of the section.

That point of view is evident in the Senate Finance Committee report that explains the wording of the previous (never adopted) version of section 1446, that did not include any authority for the secretary to issue regulations:

The Secretary may by regulations provide for exceptions to this withholding requirement in cases where withholding is not necessary to ensure compliance with U.S. tax law.

Moreover, authors in the professional literature and in letters to the IRS underscored that the proposed changes to avoid overwithholding would also still comply with the congressional intent.

Congress became concerned that foreign partners who were mere passive investors in a U.S. partnership — particularly those holding interests in publicly traded partnerships essentially as a portfolio investment — would escape U.S. taxation. In the context of the introduction of section 1446, the Finance Committee reasoned:

These types of partnership investments ordinarily do not represent the type of substantial and continuing U.S. presence that justifies the absence of a withholding requirement. The committee does not believe that a partnership’s conduct of a U.S. trade or business provides any assurance that its foreign partners will comply with U.S. tax law. In these cases, the investors are required to file U.S. tax returns.

---

65ABA Comments, supra note 4. The rule that section 1445 trumps the withholding mechanism of section 1446 remains unchanged; see prop. Treas. reg. section 1.1446-3(c)(2) final Treas. reg. section 1.1446-3(c)(2)(i), and the preamble to the final regs (T.D. 9200).


68See Chicago Bar Comments supra note 67; “Bankers’ Group Comments on Proposed Foreign Partner Withholding Regs,” Doc 2004-4399, 2004 TNT 42-35; California ITC, supra note 55; Ernst & Young, supra note 64; ABA Comments, supra note 4.

69See supra note 61.


72The wording of the adopted previous version of section 1446(d) (P.L. 99-514) (99th Cong. 2d Sess., Oct. 22, 1986) reads in the relevant part as follows: “(d) Regulations — The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section.”


returns and pay U.S. tax, but if they fail to do so the IRS is likely to find it nearly impossible to locate them and collect the tax. Therefore, the committee believes that all effectively connected income earned by foreign persons through U.S. partnerships should be subject to U.S. withholding tax to ensure collection of such persons’ U.S. Tax liability.

Therefore, if a foreign partner of a U.S. partnership has filed a U.S. income tax return under penalties of perjury calculating its section 1 and section 11 tax on its effectively connected partnership income (in the same manner as its counterpart U.S. partners) and has paid that U.S. income tax liability, there is no need for withholding in accordance with the intent of Congress.75

The IRS has argued that section 1446 does not contain provisions for reducing or eliminating the general withholding obligation like the provision in section 1445(c).76 That opinion is provided by the wording of section 1445(c), which explicitly allows commensurate regulations.

(c) Limitations on amount required to be withheld. —

(1) Cannot exceed transferor’s maximum tax liability. —

(A) In general. — The amount required to be withheld under this section with respect to any disposition shall not exceed the amount (if any) determined under subparagraph (B) as the transferor’s maximum tax liability.

(B) Request. — At the request of the transferor or transferee, the Secretary shall determine, with respect to any disposition, the transferor’s maximum tax liability.

(C) Refund of excess amounts withheld. — Subject to such terms and conditions as the Secretary may by regulations prescribe, a transferee may seek and obtain a refund of any amounts withheld under this section in excess of the transferor’s maximum tax liability.

(2) Authority of secretary to prescribe reduced amount. — At the request of the transferor or transferee, the Secretary may prescribe a reduced amount to be withheld under this section if the Secretary determines that to substitute such reduced amount will not jeopardize the collection of the tax imposed by section 871(b)(1) or 882(a)(1).

(3) Procedural rules. —

(A) Regulations. — Requests for —

(i) qualifying statements under subsection (b)(4),

(ii) determinations of transferor’s maximum tax liability under paragraph (1), and

(iii) reductions under paragraph (2) in the amount required to be withheld, shall be made at the time and manner, and shall include such information, as the Secretary shall prescribe by regulations.

(B) Requests to be handled within 90 days. — The Secretary shall take action with respect to any request described in subparagraph (A) within 90 days after the Secretary receives the request.

Insofar as Karlin77 claims that there is a clear precedent for a regulatory withholding procedure in Treas. reg. section 1441-4(b)(3), which provides with no statutory authorization in section 1441 for the IRS to enter into agreements to exempt wholly or partially from withholding compensation for personal services, that seems to be a bit far-fetched. Section 1441(c)(4) authorizes the Secretary in cases of compensation for personal services to prescribe regulations so that those services “may be exempted from deduction and withholding under subsection (a).” That is a broad mandate to set up a procedure for an exemption from withholding; it does not require a unilateral exemption procedure at all.

However, the IRS itself does not seem completely convinced of its own opinion. Policy reasons are obviously the decisive factor. In the preamble to the proposed regs, the IRS also states that other suggestions for a mitigation of overwithholding have not been adopted in the regs because of concerns that affect the administrability of those approaches.78

That allegation is challenged by arguing that the procedures in sections 1441 and 1445 give sufficient examples for a safe certification and notice procedure; apart from that, in some cases, a posting of security or other credit support could resolve the doubts of the IRS.79 And if there are still administrability issues remaining, those concerns should be clearly aired and tried to get resolved in cooperation with tax advisers.80

4. The temporary regulations. In conjunction with the final regulations, Treasury issued temporary Treas. reg. section 1.1446-6T.81 The provision addresses only some issues in the area of overwithholding but does not eliminate it in many instances.

• The overwithholding through the application of the highest applicable tax attributable to the foreign partner’s share of ECTI as long as it is ordinary income82 and the precedence of section 1445 over

75Preamble to the proposed regs, 68 Fed. Reg. 52465.

76Preamble to the proposed regs, 68 Fed. Reg. 52465.

77California ITC, supra note 55.

78Preamble to the proposed regs, 68 Fed. Reg. 52465.

79Bankers’ Group, supra note 68.

80ABA Comments, supra note 4.


82However, if the allocable income of ECTI is long-term capital gain, Treas. reg. section 1.1446-3(a)(2)(ii) now permits (unlike Treas. reg. section 1.1446-3(a)(2)) the partnership to consider preferential rates for capital gain, uncaptured section 1250 gain, and so forth provided the foreign partner has (Footnote continued on next page.)
section 1446 was deliberately not tackled by Treas. reg. section 1.1446-6T.\textsuperscript{94}

- For losses and deductions attributable to the foreign partner, Treas. reg. section 1.1446-6T (the so-called good driver rule) permits the partnership to take those items into consideration in calculating the withholding tax applicable to its share of ECTI. The foreign partner, however, must navigate numerous rules to demonstrate a history of compliance with U.S. income tax law,\textsuperscript{85} including timely submission to the partnership of a loss certificate setting forth the deductions and losses available to the foreign partner and representing that the partner timely filed U.S. income tax returns for the preceding four tax years and timely paid all taxes shown therein.\textsuperscript{86} The complicated loss certification procedure does not cover anticipated losses or deductions for the current year.\textsuperscript{87} Charitable and certain other deductions are completely left out.\textsuperscript{88} In any event, those items can reduce the partner’s share of ECTI by no more than 90 percent.\textsuperscript{89}

- No exception for withholding for tax attributable to CODI was considered by the new regulations. According to the IRS, the purpose of the section 1446 is to collect taxes that foreign persons may not otherwise pay, regardless of the liquidity of the withholding agent; further, unlike section 1441, section 1446 does not require that a partnership have control, receipt, custody, disposal, or payment over the income that is subject to withholding.\textsuperscript{90} The general loss certification regime in Treas. reg. section 1.1446-6T is therefore sufficient to protect partners and partnerships from unfair results in connection with tax on CODI.\textsuperscript{91}

C. Administrative Burdens

1. Calculation of the withholding tax, reporting, and filing requirements. Under both Rev. Proc. 89-31 and the regs, a partnership is required to make quarterly installment payments of the withholding tax imposed by section 1446 based on the amount of the partnership’s effectively connected taxable income allocable to foreign partners, without regard to any distributions made during the tax year.\textsuperscript{92} In determining the amount of that installment payment,\textsuperscript{93} the partnership has two options. First, it may compute the amount of the withholding tax based on the safe harbor rule of section 6655(d)(1)(B) with modifications of the prior-year safe harbor rule.\textsuperscript{94} Alternatively, it may use one of several annualization methods following the regulations under section 6655(e).\textsuperscript{95} If any of the installment is underpaid, the partnership will become subject to an addition to tax determined under section 6655, which generally determines the amount of addition to tax payable by corporations when any underpayment of the actual tax liability occurs, as well as other applicable interest and penalties.

Also, there are additional complicated and extensive reporting requirements that amount more to a documentation odyssey than to an easement of the compliance burdens.\textsuperscript{96}

Section 1446(a) expressly leaves the time and manner of the withholding tax to regulations prescribed by the IRS. While both revenue procedures (section 8 of Rev. Proc. 89-31 and section 9 of Rev. Proc. 88-21) only partially stipulated that the relevant information has to be delivered to the IRS,\textsuperscript{97} as some forms were not yet drafted, the proposed regs now provide for comprehensive formal reporting duties.

Under Treas. reg. section 1.1446-3(d)(1)(i) and (ii), the quarterly payments on the withholding tax must be made simultaneously with the filing of Form 8813 (“Partnership Withholding Tax Payment Voucher (Section 1446)”) before the 16th day of the 4th, 6th, 9th, and 12th months of the partnership’s tax year. Although each foreign partner must be informed about those payments on his behalf by the partnership, no specific form is provided documentation in (for example, Form W-8BEN) in accordance with Treas. reg. section 1.1446-1. See also the preamble to the final regs T.D. 9200.\textsuperscript{98}

\textsuperscript{92}Treas. reg. section 1.1446-3(d)(1)(i) and (ii); prop. Treas. reg. section 1.1446-3(a)(1) and (b)(1); section 7.01(1) of Rev. Proc. 89-31.

\textsuperscript{93}See, for a calculation example, Appel and Karlin, “At Long Last,” supra note 47.

\textsuperscript{94}Treas. reg. section 1.1446-3(b)(1) and (3); prop. Treas. reg. section 1.1446-3(b)(1) and (3). See also section 7.01(2)(ii) of Rev. Proc. 89-31 (some deviations in the concrete calculation of the installments). The safe harbor rule is fulfilled and no addition to tax (penalty) is levied if the amount of the current and prior installments during the tax year equals 25 percent of the section 1446 withholding tax that would be payable on the amount of the partnership’s ECTI allocable to foreign partners for the prior year; the prior tax year consisted of 12 months; the partnership timely files an information return under section 6031 for the prior year; and the amount of ECTI for the prior year is not less than 50 percent of the ECTI shown on the annual return of section 1446 withholding that must be filed for the current year.\textsuperscript{95}Treas. reg. section 1.1446-3(a)(2); prop. Treas. reg. section 1.1446-3(a)(2).\textsuperscript{96}See also section 7.01(2)(ii) of Rev. Proc. 89-31.


\textsuperscript{98}Lipton and Mossina, supra note 3. The new documentation requirements of Treas. reg. section 1.1446-6T that are not dealt with herein have those burdens complicated even more.

\textsuperscript{99}See also Scheine, supra note 28; Plutte, supra note 28.
required. Final Treas. reg. section 1.1446-3(d)(1)(ii), however, does provide for some significant changes: The notification of the foreign partner has to be made within 10 days of the installment payment due date, or, if paid later, the date that installment payment is made. Furthermore, the final regs relax that information obligation by making the regulations more complicated and adding two subsections: Treas. reg. section 1.1446-3(d)(1)(i)(A) and (B) allow the partnership to refrain from apprising the foreign partner if:

• the partnership’s agent is the same agent responsible for the foreign partner’s U.S. tax obligations; or
• the partnership has at least 500 partners and the foreign partner’s ECTI is less than $1,000.

Treas. reg. section 1.1446-3(d)(1)(iii) provides for the filing of two additional forms: When the partnership’s tax year closes, a partnership with foreign partners must report on Form 8804 (“Annual Return for Partnership Withholding Tax (Section 1446)”) its total tax liability under section 1446 for the tax year. The partnership must also show on Form 8805 (“Foreign Partner’s Information Statement of Section 1446 Withholding Tax”) the amount of effectively connected taxable income and the tax payments allocable to each partner for the partnership’s tax year, file it with the IRS and hand a copy to each partner affected; he then can claim a tax credit under sections 33 and 1446(d), on its federal income tax return in the amount shown on the form as paid on the partner’s behalf.101

Finally, every partnership (section 761(a)), either domestic (section 6031(a), Treas. reg. section 1.6031(a)-1(a)(1)) or foreign (in this case, only if the foreign partnership has ECTI)102 must file a return103 on Form 1065. Each partner has to be furnished a copy of the return.105

Furthermore, a foreign nonresident taxpayer who wants to claim a refund for overwithheld tax (for instance, by providing proof for deductions), will have to do that on a regular income tax return.106 U.S. citizens and residents are obliged to file a regular income tax return under section 6012(a).107

Moreover, for each of the partnership’s tax years, any U.S. person that holds a controlling 50 percent interest at any time during a partnership’s particular tax year must generally complete and file Form 8865 (“Return of U.S. Persons With Respect to Certain Foreign Partnerships”) as an information return.108 If that foreign partnership is controlled at any point during the partnership’s tax year by U.S. persons each owning more than 10 percent, any U.S. person participating in the partnership owning at least 10 percent must file a Form 8865 as well.109 Those reporting obligations have increased the costs for U.S. investors in foreign partnerships.110

2. State tax law requirements. Compliance issues are exacerbated if one takes into account the state level. With the dramatic rise in the use of multistate passthrough entities over the past decade, states have faced a growing challenge (and temptation) to collect tax from nonresident owners of entities that operate within their boundaries.111 Initially, many states did not tax out-of-state partners of multijurisdictional partnerships and joint ventures. During the last period of economic downturn, 301.6011-3(d)(4) defines the term “partnership return” as “a form in Series 1065 (including Form 1065, ‘U.S. Partnership Return of Income,’ and Form 1065, ‘U.S. Return of Income for Electing Large Partnerships’), along with the corresponding Schedules K-1 and all other related forms and schedules that are required to be attached to the Series 1065 form.” Treas. reg. section 1.6031-1(a)(1) (introduced by T.D. 6364, Feb. 13, 1959, and with further amendments in force until T.D. 8841) still explicitly provides that the partnership “shall make a return for each taxable year on Form 1065.”

Section 6031(b).


Treas. reg. section 1.6012-1(I).

Treas. reg. sections 1.6038(a)(1), (2); Treas. reg. section 1.6038-3(a)(1).

Treas. reg. section 1.6038(a)(1) and (2) and Treas. reg. section 1.6038-3(a)(2). See also section 6038B (filing requirements for a U.S. person transferring property to a foreign partnership); section 6038A (persons acquiring, disposing of, or substantially altering their interests in a foreign partnership). See also Philip F. Postlewaite and John S. Pennell, “Investing in Foreign Partnerships More Costly Under New Reporting Proposed Regulations,” 90 J. Tax’n 114 (1999); Michael Hirschfeld, “Foreign Partnerships: New and Expansive Reporting Requirements,” 1 Bus. Entities 40 (January/February 1999). For section 6046A (returns by U.S. persons acquiring, disposing, or changing his or her interest in partnership interests), see Daniel L. Hess, “U.S. Return Filing Rules for Foreign Partnerships,” 71 J. Int’l Tax’n 419, 422 (1996); and for the relation between the three provisions, see Hess, supra note 103.

Postlewaite and Pennell, supra note 109, at 117.


1182 TAX NOTES, November 28, 2005

100Forms 8804 and 8805 must be filed before the 16th day of the 4th month following the close of the partnership’s tax year. See Appel and Karlin, “At Long Last,” supra note 47, at 36 (regarding the issues arising out of the regulations under section 1446(d)).


104Treas. reg. section 1.1446-3(d)(1)(iii). Although Treas. reg. section 1.6031(a)-1(a)(2) for domestic partnerships and Treas. reg. section 1.6031(a)-1(b)(1) for foreign partnerships with ECTI refer to Treas. reg. section 1.6031(a)-1(a)(2), wherein the “partnership return must contain the information required by the prescribed form” and although section 1.6031(a)-1(e)(1) states that the “return of a partnership must be filed with the service center prescribed in the relevant IRS revenue procedure, publication, form or instructions to the form (see section 601.6011(d)(2))” those provisions (introduced by T.D. 8841, Nov. 10, 1999) do not provide anything else for any specific form the partnership has to use for its return. Only Treas. reg. section 1.6031(a)-1(a)(2), wherein the “partnership return must contain the information required by the prescribed form.”

Footnote continued in next column.)
However, many states seized the opportunity to increase revenues or to capture lost revenue by asserting jurisdiction over out-of-state partners and owners of other pass-through entities doing business in their states.\footnote{Faranak Naghavi, Bruce P. Ely, and Rebecca Bertothy, “Compliance Challenges Faced by Pass-Through Entities and Tax Administrators: The Search for Uniformity Continues,” 5 Bus. Entities 14 (May/June 2003). See also Allan Karnes, “State Tax Withholding on Nonresident Partners’ Shares of Partnership Income,” 13 J. P’ship Tax’n 46 (1996), and Peter A. Lowy and Juan F. Vasquez Jr., “When Is It Unconstitutional for States to Tax Nonresident Members of Limited Liability Companies?” State Tax Notes, May 19, 2003, p. 633, each discussing constitutional questions regarding the taxation of nonresident partners by state tax legislation.}

To simplify the return procedures, composite or group returns were invented. Those returns allow a pass-through entity to file state income tax returns and pay state taxes on behalf of its partners (depending on the state, either nonresident or resident partners, or both); by allowing that filing, states reduce their administrative costs and burdens because the state receives one partnership composite return as opposed to multiple nonresident individual returns, some of which may show a miniscule amount of income.\footnote{Naghavi et al., supra note 112, at 16.} Also, nonresident partners that have no other connection with the state in which the pass-through entity files a return are relieved of the duty of filing a tax return in a state in which they otherwise would not have had to file a return but for the presence in the state of the pass-through entity.\footnote{Patrick H. Smith and Scott A. Salmon, “States Seek to Reach Income of Owners of Pass-Through Entities,” 15 J. Multistate Tax’n 14, 21 (March/April 2005); Naghavi et al., supra note 112, at 16.}

Composite returns originated as informal agreements between multistate partnerships, S corporations, or business trusts and various state revenue departments.\footnote{Bruce P. Ely, “Nonresident LLC Members’ Income Tax Obligations — The Extra Burden of Inconsistent Treatment,” 2 J. Ltd. Liab. Co. 103 (Winter 1996); Naghavi et al., supra note 112, at 16.} In June 1989 the American Bar Association promulgated the Model S Corporation Income Tax Act (MoSCITA) to provide uniform state income tax treatment for S corporations and their shareholders. Section 1007(b) of MoSCITA provides that states “shall permit S Corporations to file composite returns and to make composite payments of tax on behalf of some or all of its nonresident shareholders.”\footnote{See “Report of the Subcommittee on State Taxation of S Corporations: Model S Corporation Income Tax Act and Commentary,” 42 Tax Law. 1001 (1989).} The commentary to that provision reads as follows:

Because composite filing benefits the state at least as much as it benefits taxpayers, the state is not permitted to impose additional conditions upon this privilege (e.g., to require that a nonresident included in a composite return have no other in-state income or to require that all nonresidents be included in a composite return).\footnote{Id.}

However, the methods of calculating the income tax and filing returns for partnerships were still as different as the geographical dimensions of the states. Three years after promulgation of the MoSCITA, the Multistate Tax Commission therefore introduced an extensive proposed uniformity rule concerning so-called composite return reporting options for nonresident partners of partnerships.\footnote{See, e.g., Scott D. Smith, “The Multistate Tax Commission’s ‘Working Draft’ of a Proposed Model Rule for a Partnership Composite Tax Return Applicable to Multijurisdictional Partnerships,” State Tax Notes, Nov. 30, 1992, p. 810; see also Ely, supra note 115, at 108; Naghavi et al., supra note 112, at 24.} While there was little activity associated with the proposal during the 1990s, 2001 saw a renewed interest in establishing a uniformity provision addressing the taxation of nonresident owners of partnerships and other pass-through entities.\footnote{See http://www.mtc.gov/UNIFORM/Pass-throughEntityMemberReportingOptions-12-18-03.pdf.} In January 2003 the MTC published “Recommendation Concerning Enactment of a Uniformity Provision on Reporting Options for Non-Resident Members of Pass-Through Entities,” which was adopted on December 18, 2003,\footnote{Unfortunately, the version of January 10, 2003 — along with some comments from tax practitioners — has been withdrawn from the Web site.} with only minor changes in comparison to the discussion basis on January 10, 2003,\footnote{See http://www.cpa2biz.com/ResourceCenters/Tax/State+and+Local/MTC_comment.htm. See Naghavi et al., supra note (Footnote continued on next page.)} but left only a fragment of what was suggested in the 1990s. The current adopted version expressly provides in section 3 (C)(3) that:

the pass-through entity is not required to withhold tax for a nonresident member if . . . the member elects to have the tax due paid as part of a composite return filed by the pass-through entity under section 2.

Section 2 reads as follows:

A. A pass-through entity may file a composite income tax return on behalf of electing nonresident members reporting and paying income tax at the highest marginal rate provided in [state tax rate provision] on the members’ pro rata or distributive shares of income of the pass-through entity from doing business in, or deriving income from sources within, this State.

B. A nonresident member whose only source of income within a state is from one or more pass-through entities may elect to be included in a composite return filed pursuant to this section.

C. A nonresident member that has been included in a composite return may file an individual income tax return and shall receive credit for tax paid on the member’s behalf by the pass-through entity.

Although the American Institute of Certified Public Accountants requested that the use of the highest tax rate without allowance for exemptions, deductions, and NOLs should be optional rather than mandatory,\footnote{See http://www.cpa2biz.com/ResourceCenters/Tax/State+and+Local/MTC_comment.htm. See Naghavi et al., supra note (Footnote continued on next page.)} the
MTC did not follow that demand. That is a major deviation from the MTC’s proposal in 1992 when the tax base constituted the “aggregate net amount of the partnership’s partners’ aggregate net distributive shares.”123 That, unfortunately, now corresponds to the situation in some other states.124 It is no wonder that state tax procedures will not be more lenient if the IRS applies a strict withholding regime that does not allow composite returns.125

Some states, however,126 follow a different approach. Section 48-7-129(b)(1), (e)(1)(A) of the Georgia state code allows the filing of composite returns, substituting withholding taxes and offering nonresident partners the opportunity to be taxed only on their allocable net income. Under Georgia reg. section 560-7-.34(3)(c) there are three options to compute the tax on Form IT-CR:127

• The tax is computed by multiplying the member’s income from the entity’s business done in Georgia by the applicable tax rate. The “applicable tax rate” is the rate from the tax rate schedule that applies to each individual member.

• The tax is computed by determining Georgia taxable income and calculating the tax due on the member’s share of the Georgia income. Under this option, the member may take the standard deduction and a personal exemption and credit for dependents, however, these adjustments must be apportioned so that adjustments are allowed only to the extent that they apply to Georgia income.

• The tax is computed for the member making adjustments to income based on allowable itemized deductions and personal exemptions and credit for dependents. The member’s income and adjustments must be calculated based on the ratio of the member’s Georgia income to the member’s total income.

That composite return would make the demanded waiver of withholding for partners with good driver status128 redundant. The question whether refunds of excessive withholding taxes should be paid to the partners (see prop. Treas. reg. section 1.1446-3(d)(2)(iv) or the partnership129 will then also be of lesser importance. The quarterly notifications to perhaps thousands of partners, now required by prop. Treas. reg. section 1.1446-3(d)(1)(i), could be abolished.130 Finally, if the resident partners were also included on such a return, the complicated determination process of foreign resident partners would be dispensable, as all partners would be taxed on their actual allocable income.

3. Authority to introduce composite returns on the federal level. The question is whether the introduction of a composite return on the federal level would be possible without amending the code.

Section 6011(a) provides that any person required by the underlying regulations must file a return. Under Treas. reg. section 31.6011(a)-8 the commissioner may authorize the use, at the option of the employer, of a composite return in lieu of any form specified in that part for use by an employer, subject to appropriate other requirements. The existence of composite returns is therefore not unknown to the regs.

Section 6031(a) and (e) explicitly gives the Treasury secretary the authority to prescribe the forms and regulations for the filing of partnership returns. The introduction of a composite return is therefore buttressed by the wording of the code.

As already mentioned, it was the intent of Congress that the secretary provide for exceptions from withholding when it is not necessary to ensure compliance with U.S. tax law.131 The implementation of a composite return would be conducive to that goal.

Besides, the introduction of composite return filing would ease the administrative burdens for the tax authorities, because tax collection would be simpler and the costly refund procedure could be practically discontinued.

IV. Conclusion

The current partnership withholding rules fall short in easing burdens for foreign partners. Neither do they significantly reduce the amount of overwithholding in many instances nor the massive paperwork involved in the withholding procedure of section 1446. That the withholding provisions of sections 1441 and 1446 are not

112, at 27, for a further discussion of issues discussed in the MTC’s hearing. However, Michigan, for example, although withholding on “income available for distribution,” each member’s share of that income is determined on the basis of net profits of the flow-through entity. Thus, the term “withholding” is really a misnomer because the flow-through entity, allowed to file a composite return, is not withholding or remitting tax advance payments on an actual distribution but is paying an estimated tax on potentially taxable income that might not be distributed; see June Summers Haas, “Michigan’s New Withholding Requirements for Flow-Through Entities,” State Tax Notes, May 3, 2004, p. 376.

123 See MTC Working Draft, supra note 118, at 812.

124 See Smith and McLoughlin, supra note 111, at 34 for examples for many states.

125 Gina M. Biondo et al., “U.S. Reporting Requirements for Offshore Partnerships Under Section 6031 and Related Provisions,” 17 J. Tax’n Investments 173, 185, point out that although state and local tax authorities are in no way required to follow federal rules, they (frequently) look to the IRS and its regulations to set the foundation for their taxation terms and concepts.

126 Smith and McLoughlin, supra note 111, at 34. Georgia and South Carolina explicitly allow itemized deductions and personal exemptions.


128 California ITC, supra note 55; ABA Comments, supra note 4. Those waivers are available under state law for the taxation of nonresident partners too, see Naghavi et al., supra note 112 at 14, and Carolyn Joy Lee and Joseph Lipari, “Recent Developments in New York State and Local Taxation,” State Tax Notes, Dec. 15, 2003, p. 954.


131 See supra note 61.
coordinated carries on in the underlying regulations and even complicates the whole procedure of withholding. It creates artificial tax-motivated structures in which foreign investors form U.S. corporations to act as domestic partners in U.S. partnerships in which they invest in debt instruments with equity kickers qualifying as interest, or directly in U.S. assets with payments to U.S. joint ventures structures as management fees with profit-related bonuses.\textsuperscript{132} It constitutes a significant impediment for investments from abroad, especially because other major European jurisdictions do not have a withholding tax for partnerships engaged in a trade or business in the relevant country. Further improvements of the withholding rules are necessary. They would protect the collection regime against criticisms that the excessive withholding is discriminatory against the double tax treaty partners of the United States and is not in line with the commensurate double tax treaty antidiscriminatory provisions.\textsuperscript{133}

\textsuperscript{132}Appel and Karlin, “Uncle Sam,” supra note 81.