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IRS issues new regulations for partnership withholdings



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On May 13, the Internal Revenue Service issued final and temporary regulations regarding U.S. partnerships (all references to partnership herein are meant to include multiple-member limited liability companies (LLCs) that are treated as partnerships for federal tax purposes).

The regulations apply to a U.S. partnership's obligation to withhold tax under Internal Revenue Code § 1446 on "effectively connected income" allocable to foreign partners.

The new regulations finalize regulations proposed on Sept. 3, 2003, and are intended to simplify partnership withholding on a foreign partner's share of a U.S. partnership's effectively connected income under Code § 1446.

The final and temporary regulations are applicable to partnership taxable years beginning after May 18. However, a partnership may elect to apply the final regulations to partnership taxable years beginning after Dec. 31, 2004. In addition, a partnership may elect to apply the temporary regulations to partnership taxable years beginning after 2004, if it also elects to apply the final regulations to partnership taxable years beginning after 2004.

Generally, a foreign person (including individuals and corporations) who is engaged in a U.S. trade or business is subject to U.S. tax on income that is effectively connected with such U.S. trade or business. A foreign person who is a partner in a U.S. partnership that is engaged in a U.S. trade or business is considered to be engaged in a U.S. business and is taxable at graduated rates on its share of partnership income.

Pursuant to Code § 1446, a U.S. part-

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nership that has effectively connected taxable income that is allocable under Code § 704 (relating to a partner's distributive share of partnership income) to a foreign partner, must pay a withholding tax to the IRS at the highest tax rate applicable to such foreign partner. The tax is at the highest marginal rate of tax applicable to corporations or individuals (both rates are currently 35 percent), and the foreign partner is generally allowed a credit for the tax paid on its behalf by the partnership.

This article will highlight some of the significant provisions of the new regulations, including guidance on: (1) the determination of the domestic or foreign status of partners, (2) tiered partnership structures, (3) the calculation of the withholding tax and (4) the application of interest, penalties and additions to the tax when a withholding agent fails to comply with the regulations.

Determining status of partner

Since a partnership must only withhold on a foreign partner's share of effectively connected taxable income, it must determine whether the partner is U.S. or foreign. Prior to the issuance of the new regulations, the process to certify foreign status was not consistent with the withholding rules for passive income (i.e., interest, dividends, etc.) applicable to foreign persons under Code § 1441 and § 1442.

The final regulations allow a U.S. partnership to accept any form that constitutes acceptable documentation of status for purposes of Code § 1441. Such forms include: W-9 (Request for Taxpayer Identification Number and Certification), W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding), W-8IMY (Certificate of Foreign Intermedi-

ary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding), 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), W-8EXP (Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding), or a substitute form that is consistent with the regulations under Code § 1441.

There are, however, two notable differences between the rules under Code §§ 1441/1442 and 1446. For purposes of Code § 1446, a U.S. grantor trust with a foreign grantor will be treated as a foreign partner, rather than a U.S. partner, and a foreign simple trust will be treated as an entity, rather than as a flow-through entity. Thus, a U.S. grantor trust with a foreign grantor will provide Form W-8 for Code § 1446 purposes and Form W-9 for Code §§ 1441/1442 purposes. A foreign simple trust is permitted to provide a Form W-8 on its own behalf to the partnership to establish its foreign status, but for Code § 1441 purposes, the payor of income is required to look through a foreign simple trust and consider the documentation of the beneficiary of such trust.

Tiered partnership structures

In general, if a U.S. partnership is a partner in another U.S. partnership, the upper-tier U.S. partnership is responsible for the § 1446 withholding tax. Under the new regulations, if the partnerships agree, the upper-tier partnership may pass along documentation about its partners to the lower-tier partnership, and the lower-tier partnership will take over any necessary Code § 1446 withholding with respect to the foreign partners of the upper-tier partnership.

The final regulations require a partner-

ship to look through any of its partners that is a foreign partnership to the extent that such foreign partnership has provided appropriate documentation, including the Form W-8IMY and documentation establishing the status of its partners. If an upper-tier foreign partnership provides a lower-tier U.S. partnership with a Form W-9 on behalf of one of the partners of the upper-tier partnership, but fails to adequately document the status of its other partners, the lower-tier partnership must look through the upper-tier partnership to the extent of the U.S. partner's interest and not withhold § 1446 tax on the U.S. partner's allocable share of income.

Calculation of withholding tax

The final regulations also provide guidance in calculating the amount of the Code § 1446 withholding. The IRS recognized that overwithholding may occur because a partnership may be required to pay Code § 1446 withholding in excess of a foreign partner's actual tax liability. The new regulations allow a U.S. partnership to consider the relevant type of income or gain allocable to a foreign partner during the taxable year when computing its Code § 1446 withholding obligation. Thus, a partnership may generally apply a reduced rate of tax (15 percent) to effectively connected income consisting of long-term capital gain allocable to a non-corporate partner. However, a partnership may not use the lower rate of tax if such partner has not adequately documented its status to the partnership.

The temporary regulations also allow a U.S. partnership in certain circumstances to consider a foreign partner's deductions and losses that are reasonably expected to be available to reduce the partner's U.S. income tax liability on its allocable share

of U.S. business income or gain from the partnership in the tax year. Under the new temporary regulations, certain foreign partners may certify that they have deductions and losses that will reduce their tax liability on their allocable share of the partnership's effectively connected income. However, the partnership may be liable for the tax if the partner's certification turns out to be incorrect.

Additions to tax, interest and penalties

The final regulations also clarify the rules relating to the imposition of additional tax, interest and penalties for a partnership's underpayment of Code § 1446 withholding tax. Under the new regulations, a partnership may be responsible for additions to tax, interest and penalties on its failure to make installment payments even when the partnership is deemed to have paid all Code § 1446 tax due with respect to a foreign partner as of the close of its taxable year with respect to a foreign partner who fully paid its U.S. income tax.

Conclusion

These new regulations should be welcome guidance for many foreign investors in U.S. partnerships. Notably, foreign individual partners may now benefit from the lower capital gain rate (15 percent) when the Code § 1446 tax is computed. Foreign partners may also take into account certain deductions and losses from outside the partnership and reduce the withholding tax required to be paid by the partnership. These new regulations thus provide foreign investors relief from overwithholding.

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