IRS Issues Final Regulations on Withholding Requirements for Partnerships with Foreign Partners

BY ANDREW M. SHORT AND MATTHEW G. BRIGHAM

On April 28, 2008, the Treasury Department and the Internal Revenue Service (the "IRS") issued final regulations (the "final regulations") regarding when a partnership may take partner level deductions and losses into account in determining the partnership’s obligation to pay a withholding tax based on the foreign partner's allocable share of the partnership’s effectively connected taxable income. The final regulations replace temporary regulations that were published on May 18, 2005 (the "temporary regulations").

Internal Revenue Code (the "Code") Section 1446 requires a partnership to pay a withholding tax (the "Section 1446 tax") on a foreign partner’s allocable share of the partnership’s effectively connected taxable income ("ECTI"). Procedurally, the partnership makes quarterly payments of Section 1446 tax based on the estimated amount of effectively connected taxable income. The partnership must also file a year-end annual return on Form 8804, "Annual Return for Partnership Withholding Tax (Section 1446)" and pay any additional amounts with respect to the Section 1446 tax. If a partnership fails to pay all or any portion of a quarterly installment, the partnership is liable for an addition to tax under Code Section 6655. The partnership is also liable for the Section 1446 tax and is subject to interest and penalties for failure to file an annual return and pay the Section 1446 tax.

Under the final regulations, foreign partners can under certain circumstances certify as to partner level deductions and losses that may be available to reduce the partnership’s tax liability. The certification is made using Form 8804-C, "Certificate of Partner-Level Items to Reduce Section 1446 Withholding." A partnership that reasonably relies on the certificate remains fully liable for the Section 1446 tax, interest and penalties if the certificate turns out to be defective, but is not liable for any addition to tax on quarterly installments under Code Section 6655. The partnership may be liable for other penalties.

To be eligible to provide a certificate to the partnership, the final regulations generally require a foreign partner to have (i) timely filed a U.S. income tax return for each of its preceding three taxable years; (ii) timely filed a U.S. income tax return for the taxable year to which the certificate applies; and (iii) timely paid all taxes due on these returns. The three-year period is a compromise between the four-year period in the temporary regulations and a two-year period suggested by...
commentators. An important change from the temporary regulations requires that these returns must include income or gain effectively connected with a U.S. trade or business or deductions or losses properly allocated and apportioned to such activities.

Any certified losses and deductions must be allocable to the partner’s gross income which is effectively connected with the partner’s trade or business in the United States. The final regulations follow the temporary regulations in allowing a foreign partner to only certify losses and deductions arising in a prior taxable year and not allowing a foreign partner to certify charitable contributions, regardless of what year they are made. The IRS and the Treasury Department rejected commentators’ suggestions that would permit foreign partners to certify current year deductions or charitable contributions.

One exception to the no-offset rule for current year deductions is made for state and local taxes. Unlike the temporary regulations, the final regulations allow a partnership to reduce a foreign partner’s ECTI by ninety percent of the partner’s allocable share of current year state and local taxes with respect to ECTI that have been withheld and paid over to state and local tax authorities by the partnership. In determining their Section 1446 tax liability, partnerships should be sure to always include these eligible state and local tax deductions as they are available outside of the certification procedure.

The final regulations require a foreign partner to identify any certified deductions and losses that are subject to special limitations at the partner level and provide information to the partnership that will allow the partnership to take into account the special limitations. This requirement was not part of the temporary regulations. This additional information will prevent a foreign partner from certifying a passive activity loss to the partnership where the partnership conducts an activity in which the foreign partner materially participates.

Following the temporary regulations, the final regulations cap a partnership’s use of a foreign partner’s net operating loss deduction at ninety percent of the foreign partner’s allocable share of ECTI reduced by all other certified deductions and losses and state and local taxes. Additionally, this limit must be applied on a cumulative basis for each installment period. These limits will remain in effect only as long as the alternative minimum tax ninety percent limitation is also still in effect.

Trusts and estates are ineligible to certify deductions and losses to a partnership. The IRS and Treasury Department believe that, because trusts and estates are not always pure conduits for tax purposes, it is difficult for a partnership to determine who – the trust, estate or beneficiary – will pay tax on the ECTI allocated to the trust or estate. Additionally, the IRS and Treasury Department believe that a decedent’s filing history may have limited relevance in predicting the estate’s likely compliance.

The final regulations also clarify procedures for an upper-tier partnership to certify to a lower-tier partnership to avoid double-counting of the available partner level loss and deduction.

It remains to be seen whether the final regulations will have any significant practical relevance. A partnership and its general partner receive limited protection if they withhold based on a foreign partner’s certificate even if the partnership acts reasonably and the certificate is not facially defective. The certification procedure may be most beneficial to closely held partnerships or family partnerships where the risk of defective certificates is limited. Larger partnerships and investment funds may be less willing to accept certificates due to the amount of potential exposure to penalties caused by multiple foreign partners. Although many investment funds currently have provisions in their partnership agreements allowing them to withhold from partners an amount required to satisfy withholding tax obligations, this may
not be enough to protect the fund if it accepts a certificate. An investment fund that agrees to the certification procedure will want to ensure that it will have the ability to withhold or call capital from the certificate provider to protect the fund and its other investors in case of a defective certificate.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

New York
Andrew M. Short 212-318-6018 andrewshort@paulhastings.com
Joseph P. Opich 212-318-6596 josehopich@paulhastings.com
Matthew G. Brigham 212-318-6678 matthewbrigham@paulhastings.com

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