REPORT #598

TAX SECTION

New York State Bar Association

Report on Section 1446

by the Committee on U.S. Activities of Foreign Taxpayers

December 21, 1988

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December 23, 1988

Section 1446 of the Internal Revenue Code

Dear Commissioner Gibbs:

I enclose our Report on Section 1446, which has been prepared in anticipation of the issuance of regulations or other administrative guidance with respect to the amendment to that section made by the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"). The report was written by Franklin L. Green with comments from Cynthia G. Beerbower, William L. Burke, Robert Cassanos, Arthur A. Feder, Gordon H. Henderson, Philip T. Kaplan, Bruce Kayle, Stephen L. Millman, Michael L. Schler, Charles M. Morgan 111, Shirley Staples, William H. Weigel and Harry E. White, Jr.

We anticipate that the Section 1446 regulations under TAMRA will be based substantially upon Revenue Procedure 88-21, 1988-15 I.R.B. 13, which administratively allowed partnerships to elect withholding procedures similar to those now provided by TAMRA. In addition to a number of specific comments about the Revenue Procedure and other matters, the following general suggestions are made by the Report:

(1) the new mandatory procedures should be made as workable as possible;

(2) clear safe harbor protection should be made available to withholding agents in all circumstances to allow them readily to avoid liabilities imposed with respect to under withholding;

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(3) consideration should be given to allowing, at least in some circumstances, partnerships the option of electing to withhold on distributions (as permitted prior to TAMRA) rather than to make the estimated-tax type of payment provided by TAMRA; and

(4) the rules with respect to tiered partnerships should be clarified.

The Tax Section of the New York State Bar Association hopes that this report will be useful to you in preparing regulations on Section 1446.

Sincerely

Herbert L. camp

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Tax Report #598

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Section 1446

by the Committee on U.S. Activities of Foreign Taxpayers

December 21, 1988

NEW YORK STATE BAR ASSOCIATION

TAX SECTION[1]

Report on Section 1446 of the Internal Revenue Code

December 21, 1988

Section 1446 of the Internal Revenue Code of 1986 (the “Code”), which was enacted as part of the Tax Reform Act of 1986, imposed an obligation on partnerships with effectively connected income to withhold United States tax with respect to distributions to foreign partners. The Technical and Miscellaneous Revenue Act of 1988, (“TAMRA”), which was executed by President Reagan on November 10, 1988, repealed the 1986 provision (“Old Section 1446”) and replaced it with a new provision (“Section 1446”). Under the new Section 1446, withholding is not required with respect to distributions, but a partnership is required to make payments in the nature of estimated tax payments on behalf of its foreign partners with respect to their respective shares of its effectively connected income (“Estimated Payments”).

[1] The principal draftsman of this report was Franklin L. Green. Helpful comments were received from Cynthia G. Beerbower, William L. Burke, Robert Cassanos, Arthur A. Feder, Gordon D. Henderson, Philip T. Kaplan, Bruce Kayle, Stephen L. Millman, Michael L. Schler, Charles M. Morgan III, Shirley Staples, William H. Weigel and Harry E. White, Jr.

Section 1446(f) of the Code directs the issuance of “regulations as may be necessary to carry out the purposes” of Section 1446. We anticipate that these regulations will be based substantially upon Revenue Procedure 88-21, 1988-15 I.R.B. 13 (the “Revenue procedure”), which is the only administrative guidance published to date and which was issued on March 31, 1988 with respect to Old Section 1446. As a matter of administrative discretion, the Revenue Procedure authorized a partnership (other than a publicly traded partnership) to elect not to withhold on distributions as required by Old Section 1446, but instead to make Estimated Payments pursuant to a system like the one now established by Section 1446.

We are issuing this report to express our views concerning the provisions of the Revenue Procedure which we believe will be the foundation for the forthcoming regulations under Section 1446 and to make various related comments.

General Comments

We urge that the Estimated Payment procedures of the Revenue Procedure be refined, especially because under Section 1446, Estimated Payments are no longer elective but instead are required of all partnerships, including publicly traded partnerships. We are concerned that the Revenue Procedure created vicarious liabilities for withholding agents without providing sufficient safe harbor protection. Moreover, we believe the procedures under the Revenue Procedure were overly complex in several respects and were unnecessarily potentially disruptive of the relationships among partners and between partnerships and their creditors. In addition, we believe that more guidance is required than was provided by the Revenue Procedure with respect to a number of matters including the rules governing tiered partnerships.

Finally, we suggest that consideration be given to providing in the regulations that at least in some circumstances a partnership may elect to withhold on distributions (“Distribution Withholding”) rather than to make Estimated Payments. Although generally less precise, Distribution Withholding is simpler and would allow partnerships to avoid the potential complexity and commercial disruption that can arise under an Estimated Payment regime. In addition, existing partnerships may be subject to contractual limitations which restrict their ability to comply with the requirements for making Estimated Payments under Section 1446 and to deal appropriately with all their partners in view of those requirements. Distribution Withholding may be particularly appropriate for publicly traded partnerships in order to accommodate the securities industry's use of nominees, as well as for other partnerships with a large number of partners and for partnerships in which no foreign person has a substantial interest.

Statutory Background

Old Section 1446 addressed the concern that foreign partners of partnerships have failed to file required returns and to pay United States income tax with respect to the partnerships' effectively connected income. S. Rep. No. 99-313, 99th Cong., 2d Sess. 414 (1986).[2] As a means of collecting this tax, Old Section 1446 required partnerships to withhold from distributions to foreign partners.[3]

Effective for taxable years of partnerships beginning after December 31, 1987,[4] TAMRA entirely changed Section 1446 from a provision which imposes withholding on distributions to a provision which establishes a system of Estimated Payments. The reason given for this change is a concern that in its initial form, Section 1446 may have frequently resulted in over withholding. S. Rep. No. 100-445, 100th Cong., 2d Sess. 304 (1988).[5]

[2] As indicated in the Report of the Senate Finance Committee, a withholding regime was imposed because it was believed that generally the Internal Revenue Service would “find it nearly impossible to locate . . . and collect .the tax” from non-compliant foreign partners. In the Committee's view partnership investments “ordinarily do not represent the type of substantial and continuing U.S. presence that justifies the absence of a withholding requirement.” Id.

[3] Attached as Appendix 1 is a summary of Old Section 1446.

[4] Under TAMRA, Old Section 1446 in effect was repealed ab initio and does not apply to any periods. See TAMRA, § 1012(S)(1)(D).

[5] The reason for adoption of a new Section 1446 was given as follows in the Report: “Because [Old Section 1446] has the potential to impose a withholding tax on distributions that include little, or in some cases no, income that would be subject to U.S. tax, a provision that accomplishes the objectives of the [1986] Act more accurately and that results in less over withholding is more appropriate.” Id.

Section 1446(a)(1) provides that, if a partnership has “effectively connected taxable income” which is allocable to a foreign partner, the partnership must pay a withholding tax as prescribed in regulations. Under Section 1446(b) the amount payable is equal to the “applicable percentage” of the effectively connected taxable income of the partnership allocable under section 704 of the Code to the foreign partner; the “applicable percentage” is the highest rate of tax under Section l of the Code in the case of income allocable to non-corporate partners, and the highest rate of tax under Section 11(b) of the Code in the case of corporate partners, “Effectively connected taxable income” is defined by Section 1446(c) to mean taxable income of the partnership effectively connected, or treated as effectively connected, with the conduct of a United States trade or business, computed with the following adjustments: Section 703(a)(1) of the Code does not apply; a deduction for oil and gas depletion is allowed and determined without regard to Sections 613 and 613A of the Code; and no income or deduction is taken into account to the extent included in the distributive share of a partner who is not a foreign partner. A “foreign partner” is defined in Section 1446(e) as any partner who is not a United States person.

Under Section 1446(d)(1), each foreign partner is allowed a credit under Section 33 for its share of withholding tax paid by the partnership under Section 1446(a), for the partner's taxable year in which or with which the partnership taxable year (for which such tax was paid) ends. Under Section 1446(d)(2), an amount equal to that credit is treated as distributed to the partner on the last day of the partnership's taxable year (for which the tax was paid).

Section 1446(f) directs the Treasury to prescribe “necessary” regulations, including regulations providing for the application of Section 1446 in the case of publicly traded partnerships.

Discussion

A. Estimated Payments

We assume that the Estimated Payment system of the Revenue Procedure will be the starting point for providing rules under the new statute. Accordingly, we believe it would be helpful for us to comment upon those provisions of the Revenue Procedure that relate to making Estimated Payments.

Section 3.[6] Requirement of Withholding

Section 3 authorized an election (described in section 8) under which a partnership, instead of withholding from distributions, would make quarterly Estimated Payments on behalf of its foreign partners with respect to their shares of the effectively connected income of the partnership (the “ECI Election”). Section 12 provided that the ECI Election was not available for publicly traded partnerships. Under Section 1446, however, Estimated Payments are no longer elective but must be made by all partnerships including publicly traded partnerships. Accordingly, a more workable' Estimated Payment system should be an especially important goal in adapting the procedures of the Revenue Procedure to formulate guidelines under TAMRA.

[6] All section references hereinafter other than to Section 1446 of the Code are to the Revenue Procedure unless otherwise indicated.

Section 3 does not address the special circumstances of trading partnerships. Pursuant to Sections 1.864- 2(c)(2)(ii) and 1.864-2(d)(2)(ii) of the Income Tax Regulations, foreign partners of some partnerships which effect certain transactions in the United States in stocks and securities or commodities are not thereby considered to be engaged in a trade or business in the United States. See LTR 8750049 (September 15, 1987) (applying Section 1.864-2(c)2)(ii) to a tiered partnership structure, but specifically expressing no opinion as to withholding obligations under Old Section 1446). It would be helpful if guidance were issued as to whether withholding is required with respect to these partners. As a policy matter, it would seem appropriate to exempt these partners from withholding.

Section 5. Determination of Whether a Partner Is a Foreign Person

Section 5 provided rules for a partnership to determine the foreign or domestic status of its partners -- a determination that is also required under TAMRA. Under Section 5.02, the partnership generally could rely on a certification of non-foreign status from a partner but only if the partnership “does not have actual knowledge that the certification is false."[7] No guidance was given with respect to the circumstances under which that knowledge was to be attributed to the partnership from its partners. We have several suggestions regarding the clarification of those circumstances.

It seems appropriate not to attribute to the partnership the knowledge of limited partners if, as under Section 4, the general partners (but not the limited partners) are to have joint and several liability as withholding agents. Moreover, if the knowledge of limited partners were attributable

[7] This language does not appear in Sections 1.1441-1 and 1. 1441-3(f) of the Income Tax Regulations, which require domestic partnerships to withhold tax on United States source fixed or determinable annual or periodical income included in the distributive share of a foreign partner. Rather, under the general standard of Section 1.144l-5(a) of the Regulations, partnerships can rely on a written statement by an individual that he is a citizen of the United States or by a partnership or corporation that it is not a foreign partnership or corporation. The only reference in the Section 1441 Regulations to the knowledge of the withholding agent does not relate directly to the knowledge of a partnership with respect to its partners; it concerns acceptance of a statement of exemption from withholding on compensation for personal services under a tax treaty pursuant to Section 1.1441-4(b)(2). There is apparently no authority as to how this knowledge standard should be applied. *See also* Prop. Treas. Reg. § 1.1441-6(e)(1)(6) (permitting withholding agent to rely on Certificate of Residence as evidence that beneficial owner meets residence requirements to secure certain treaty benefits, unless withholding agent has "reason to know" beneficial owner is not entitled to such benefit); Prop. Treas. Reg. § 1.1441-3(c)(6)(iii) (permitting withholding agent, unless he has "reason to believe to the contrary," to rely on statement of person entitled to accrued original issue discount as to amount subject to withholding or the amount of tax required to be withheld); and Treas. Reg. § 35a.9999-5 for several examples of payments not subject to information reporting or backup withholding unless an issuer or its agent has "actual knowledge" that a payee is not a U.S. person.

to the partnership, the general partners, in an effort to protect themselves against liability, regularly would have to poll all the limited partners as to their knowledge of any partner claiming foreign status - a cumbersome, and in the case of public limited partnerships, unworkable procedure.[8] Similarly, there also may be circumstances involving partnerships with a large number of general partners where it would be appropriate to take into account only the knowledge of the managing general partners.

Finally, guidance is needed as to the circumstances under which a general partner, itself, is attributed with the knowledge of its employees and officers so that it is deemed to have the knowledge which in turn is attributed to the partnership. Presumably, the same rule should apply here as applies wherever an employer is to be held responsible for the acts of its officers and employees in withholding situations.

We also have two specific drafting points. Section 5.022(a) indicated that a partnership generally could

[8] The legislative history of TAMRA recognizes that for publicly traded partnerships “special rules may be necessary in identifying . . . partners as U.S. or foreign.” S. Rep. No. 100-445, 100th Cong., 2d Sess. 305 (1988).

rely on a partner's certification of non-foreign status until “the end of the third year after the taxable year of the partnership during which the certification was obtained.” It is not clear whether the end of such third year referred to the third anniversary of the last day of that taxable year of the partnership (which we recommend) or the December 31st of the year in which that third anniversary falls. It is also not clear whether the parenthetical clause in the last sentence of section 5.026 modified the term “partnership” or the term “partner” in that sentence.

Section 8. Election by Partnership to Make Quarterly Payments of Tax on the Basis of Foreign Partner's Effectively Connected Income Attributable to the Partnership

(a) Background

Section 8 set forth the procedures of the Estimated Payment system of the ECI Election. Two general concepts are relevant to the consideration of any Estimated Payment system, including the regime imposed by TAMRA.

First, an Estimated Payment system inherently has the potential for disrupting the commercial arrangements among partners and between the partnership and third parties. Where tax is withheld from actual distributions, the relationships among partners or between the partnership and its creditors is unaffected. However, where, as is the case with an Estimated Payment system, there is no actual distribution but tax payments nevertheless are required to be paid to the Internal Revenue Service (the “Service”) by a partnership on behalf of some of its partners and not others (“Preferential Payments”), there is substantial potential for business upset.[9]

Whenever Preferential Payments are required with respect to a foreign partner, the foreign partner is benefitted because it can either apply the payments against its United States income tax liability or, if appropriate, obtain a tax refund. Generally, domestic partners would have to receive comparable “make-up” distributions from the partnership in order to be made whole. Failure to make immediate “make-up” distributions obviously would be unfair to domestic partners. Moreover, that failure could inadvertently change the ongoing allocations of partnership items where the allocations are made in accordance with capital accounts and where an existing partnership agreement does not contemplate preferential distributions. On the other hand, “make-up” distributions may not be authorized under a partnership agreement, may impose liquidity problems on the partnership and may be violative of various contractual obligations of the partnership under its debt, lease or other agreements. Indeed, making Estimated Payments may be violative of the terms of such agreements restricting distributions to partners.

[9] Allowing partnerships to avoid the problems involved in making Preferential Payments is a primary reason for our view that, despite adoption of TAMRA, consideration should be given to allowing partnerships, at least under certain circumstances, the option of electing to withhold from distributions instead of making Estimated Payments.

There is no facile means for dealing with these practical problems, especially in the case of existing partnerships. A partnership might seek to be reimbursed by a foreign partner for the Estimated Payment made on its behalf, However, the foreign partner with or without reason may choose to refuse to make the payment -- for example, if the partner has effectively connected losses from other United States activities and will not itself owe tax or estimated tax for the year. In addition, the partnership might attempt to treat the Estimated Payment as a loan to the foreign partner on which interest could be charged and might attempt to collect this deemed loan by offsetting it against future amounts to be distributed to the partner. However, the partnership's rights to create a deemed loan and to offset it against distributions (especially if the foreign partner in the interim has transferred its partnership interest to a third party) are problematic as a legal matter in the absence (as heretofore has been typical) of specific authorization in the partnership agreement. In any event, this proposed solution does not address the problem of contractual restrictions in debt or lease instruments on a partnership's right to make distributions or even loans to its partners. Furthermore, any solution is likely to be cumbersome and burdensome, especially for any partnership with numerous foreign partners.

Thus, an Estimated Payment system raises practical problems of partner and creditor relationships. These problems will be exacerbated if the partnership is required to make numerous Preferential Payments in differing amounts for different foreign partners at differing times during the year. The problems will be made more acute if, in the absence of clear safe harbors, the partnership is forced to protect itself against liability by taking so conservative a view of all issues that over withholding is the result.

Second, Section 1446 now applies estimated tax procedures in a withholding context. However, the estimated tax system of the Code relates to the payment by a taxpayer of its own tax liabilities, whereas the withholding system deals with the payment of tax on behalf of a third party. We believe that certain concepts and approaches justified in applying the estimated tax provisions of the Code may be inappropriate in creating, vicarious liabilities and obligations for withholding agents. In particular, we believe a partnership should be given as clear a path as possible to follow to avoid the imposition of penalties and should never be left without a safe harbor.

(b) Comments

Against this background we have the following specific comments, which we believe will be directly relevant to future guidelines under TAMRA:

(1) Penalties

Under the estimated tax system, generally a taxpayer is not subjected to penalty if it makes estimated payments of at least 90% of the tax for the year as reported on its income tax return. Sections 6654(d)(1) and 6655(d) of the Code. Thus, no estimated tax penalty arises if on audit the taxpayer's tax liability for the year is increased -- the estimated tax system is a collection, not an enforcement, regime. Section 8.04 generally applied certain of the safe harbors and other rules of the estimated tax system to the ECI Election; accordingly, no liability to the withholding agent should have resulted under Section 8 if on audit the effectively connected income of the partnership were increased. We suggest that the TAMRA guidelines more clearly address this issue and state explicitly that no penalties will arise as the result of audit changes in the computation of effectively connected income (either from an increase in the total income of the partnership or from an increase in the portion of its income which is effectively connected). Obviously, the withholding agent should be subject, where otherwise applicable, to negligence or other enforcement penalties, if its reporting of the amount of its effectively connected income is made without a reasonable basis.

(2) ECI Election Procedures

The procedures in our view unduly sacrificed workability (and perhaps even precision) to the concept that an Estimated Payment should be made for each partner at the same time that the partner is required to make its own estimated tax payment.

Basically, Section 8 required that with respect to each foreign partner the partnership had to make equal' quarterly payments of amounts computed at the partner's highest possible tax rate of the amount of tax that the partner would owe with respect to his share of the partnership's effectively connected income for the partnership year ending in or with the partner's taxable year (the “Quarterly Payments”). Generally, the partnership was required to make these payments by the due dates of the partner's estimated tax payments. Thus, if foreign corporation FP, which utilized a calendar year, was a partner in Partnership P, which utilizes a June 30 year, P would have to make Quarterly Payments on behalf of FP on April 15, June 15, September 15 and December 15 with respect to P's year ending June 30.

The following example illustrates the complications inherent in this system when foreign partners and the partnership have different taxable years. Assume Partnership P, which utilizes a June 30 taxable year, has a number of United States partners but only two foreign partners -- X Corp., which utilizes a calendar taxable year, and Y Corp., which notifies P that it utilizes a May 31 taxable year. On these facts, Partnership P would have to make the following Quarterly Payments during its taxable year ending June 30, 1993:

Due Date of Payment	Foreign Partner	Taxable Year of Partnership to which Payment Relates	Partnership Taxable Year on which Safe Harbor Computation is Base[10]	Taxable Year of the Partner for which it gets Withholdinq Credit
9/15/92	X	6/30/92	6/30/91	12/31/92
9/15/92	Y	6/30/92	6/30/91	5/31/93
11/15/92	Y	6/30/92	6/30/92	5/31/93
12/15/92	X	6/30/92	6/30/92	12/31/92
2/15/93	Y	6/30/92	6/30/92	5/31/93
4/15/93	X	6/30/93	6/30/92	12/31/93
5/15/93	Y	6/30/92	6/30/92	5/31/93
6/15/93	X	6/30/93	6/30/92	12/31/93

Thus, with just two foreign partners, P would be faced with the following tasks under the system of the Revenue Procedure during the period of only one of its taxable years.

(a) It would have to meet seven different deadlines for making Quarterly Payments;

[10] The applicability of the safe harbor rule is discussed below. Some of these years would be different if the partnership seeks an extension to file its return for its taxable year ending June 30,1992. See the last sentence of Section 8.042 and Section 1.6031(b)-1T(b) of the Income Tax Regulations.

(b) It would have to determine the shares of its partners in the effectively connected income of the Partnership with respect to two of the Partnership's taxable years (or as many as three of its taxable years if Y were to qualify for the safe harbor rule and X were not); and

(c) It would have to determine the maximum corporate tax rates for three different taxable years.[11]

Moreover, as discussed above, the Quarterly Payments would be Preferential Payments for which domestic partners (and indeed other foreign partners) would have to be compensated. Under the regime of Section 8 involving multiple payments in differing amounts, the difficulties of implementing a make-up system would be compounded.

(3) Proposed Alternative

We wish to propose the following alternative to the procedures of Section 8 in connection with the implementation of TAMRA:

(a) Estimated Payments should not be scheduled in accordance with the due dates for estimated tax payments by particular partners. Rather, the only relevant period should

[11] Although not clear, it appears Section 8.025 required Quarterly Payments to be computed with reference to the tax rate in effect for the taxable year of the partner, not the partnership.

be the taxable year of the partnership itself. Any payments made with respect to that year should be applied to the tax liabilities of the partners for their taxable years in which or with which the partnership's taxable year ends. This proposal could result in payments being made at somewhat different times than under the Revenue Procedure. We do not believe this timing difference is material in terms of use-of-money and in any event is justified by the resulting enhancement of the workability of the system.

(b) Estimated Payments should be made quarterly on the basis of the partnership's taxable year, As well as being provided quarterly, information regarding the payments should be included with the information provided to the Internal Revenue Service and the foreign partners with the Schedule K-l's to the partnership's return.[12] A safe harbor annualization rule created specially for Section 1446 (the "Special Annualization Rule") should be made available. Under the Special Annualization Rule, the safe harbor would be based on the partnership's effectively connected income for the

[12] Presumably partnerships are required as a practical matter to report foreign partners' distributive shares of effectively connected income on Schedule K-l to the return as a separately stated Section 702(a)(8) item of income; there is, however, apparently no explicit regulatory mandate on this point. See W. McKee, W. Nelson, R. Whitmire, Federal Taxation of Partnerships and Partners 19.08(2)(d)(1977).

taxable year to which the Estimated Payments relate rather than the prior year. This proposal would be more workable and precise, particularly in dealing with short taxable years of the partnership as well as with partners whose interests in the partnership change during the partnership's taxable year -- two subjects that were not addressed directly in Section 8.

(c) The tax rates to be employed in computing the Estimated Payments should be the maximum rates possibly applicable to a corporate or non-corporate partner, as the case may be, with the same taxable year as the partnership.

(d) The credit for partnership withholding for the taxable year of the partnership should be applied to reduce the amount of estimated tax to be paid by the partner with respect to its taxable year (the “Credit Year”) in which or with which the partnership's year ends. In the same manner as the credit for wage withholding under Section 6654(g) of the Code, the credit for the total amount of Estimated Payments paid by the partnership with respect to the partner for the partnership's year should be allocated equally among the partner's estimated tax payment dates for the Credit Year. . This approach would allow the partner the credit in a simple and fair manner.

(4) Safe Harbors

Under TAMRA, there is a critical need to have a clear safe harbor in computing Estimated Payments. In our view, the safe harbor rules of Section 8.042 were too cryptic and ambiguous to provide sufficient guidance. Most fundamentally, the Revenue Procedure appears to have failed to provide what may well be the most useful of the safe harbor concepts -- annualization.

The Revenue Procedure does not appear to have incorporated the annualization rules of Sections 6654(d)(2) and 6655(e)(2) of the Code, whereby a taxpayer generally can base its estimated tax payments on the results to date of the current year. Our proposed Special Annualization Rule, based on the results of the partnership prior to each of its Estimated Payment dates, should be the same for all partners whether corporate or noncorporate. In our view, this annualization would result in accurate and timely withholding and would provide a reliable and workable safe harbor. Furthermore, we believe this rule would allow partnerships to deal readily with changes in partnership interests and short partnership years. In addition, especially in view of the vicarious nature of the partnership's liability, we recommend that for a partnership utilizing the Special Annualization Rule, penalties be limited to cases where there is no substantial authority within the meaning of Section 6661 of the Code for the positions taken by the partnership in annualizing its income.

For some partnerships, safe harbors based on the prior year's results of the partnership might be easier to apply; accordingly, consideration should be given to retaining that safe harbor as well as the Special Annualization Rule. We note, however, that payments based on a prior year's results obviously can result in substantial over withholding or under withholding.

In addition, we suggest the following comments on the Revenue Procedure be considered in implementing safe harbor rules under TAMRA:

(a) The references in Section 8.042 to Section 6655(i)(2) and Section 6655(i) of the Code were mistakes (presumably the references should have been to Section 6655(g)(2) and 6655(g)) and made the rules with respect to large corporations speculative. In any event, we question the fairness of limiting a partnership's opportunity to rely on safe harbor rules with respect to those partners whose interests are substantial enough for them to be classified as large corporations.

(b) It should be made more explicit that no penalty would be imposed if a partnership makes quarterly payments meeting the 90%-of-current-income standard of Sections 6654(d)(1)(A) and 6655(d)(1)(B)(i) of the Code as applied to the effectively connected income of the partnership.

(c) It is not clear to what extent, if any, the 100%-of-prior-year's income standard of Sections 6654(d)(1)(B) and 6655(d)(1)(B)(ii) of the Code would apply if (i) the partnership's prior year were a short year, (ii) the partner's interest were different from what it was for the prior year of the partnership, or (iii) the partnership had terminated pursuant to the change of ownership rules of Section 708(b)(1)(B) of the Code.

(d) In general, additional examples illustrating the detailed application of the safe harbor rules would be most helpful.

(5) Calendar Year Presumption

Under Section 8.031, the partnership was directed to assume that a partner had a calendar taxable year unless otherwise notified by the partner. Section 8.031 did not give guidance as to what would constitute notice for this purpose or as to the circumstances under which the partnership could rely on the notice. More importantly, it was unclear whether the partnership had a duty to request its partners to specify their taxable years. In this regard, we note the necessity of the partnership to pay heed to the actual taxable years of its partners in order to apply the rules of Section 706(b) in making the ongoing determination of its own taxable year.[13]

The calendar year presumption/of Section 8.031 may have been intended to have the substantive effect of simplifying the application of the rules of Section 8. If so, we suggest that for the reasons discussed above, it would be preferable to have Estimated Payments made with regard to the taxable year of partnership and without regard to the taxable years of particular partners.

(6) Liquidity

Section 8.01 noted the need for the partnership to retain cash to fund its payment obligations under an ECI Election (the elective Estimated Payment regime under the Revenue Procedure). For the reasons discussed above regarding “make-up” payments to domestic partners, the need for cash to make

[13] We also note that item 5(b)of the report, required by Section 9.03 to be filed by the withholding agent withthe Internal Revenue Service and the foreign partner requested the taxable year of the partner. It is likely that a partner would notify the partnership if the taxable year listed for the partner on this form were erroneous.

Estimated Payments may be only the tip of the liquidity iceberg for a partnership.

Section 10. Crediting of Withheld Amounts or Quarterly Payments

Consistent with Section 1446 and with our proposal for changing the procedures for Estimated Payments, in the new guidelines it should be made clear that the credit is to be applied against the partner's tax liability for its taxable year in or with which the partnership's year ends.

Section 12. Publicly Traded Partnerships

Section 12 provided that the ECI Election procedures of Section 8 were not available for publicly traded partnerships. However, TAMRA imposes an Estimated Payment system on all partnerships, and new Section 1446(f) of the Code specifically directs the issuance of regulations for the application of Section 1446 in the case of publicly traded partnerships.

Section 12 allowed publicly traded partnerships to designate nominees as withholding agents in accordance with the provisions of section 1.1445-8T of the Income Tax Regulations. The effect of Section 12 was to permit partnership interests to be held through a central security depository (“Depository”) which acted as nominee for a brokerage house (“Broker”), which in turn held the partnership interest as nominee for a foreign partner. Under the procedures of section 1.1445-8T of the Regulations, a publicly traded partnership subject to the Distribution Withholding system of Old Section 1446 could have made a distribution with respect to the partnership interests registered in the name of the Depository without any withholding, the Depository could have forwarded those distributions to the various Brokers for which it acted also without any withholding, and the Brokers would have been required to make the required withholding ("Nominee Withholding"). Without the Nominee Withholding procedures of section 1.1445-8T, it would not have been possible for a Depository to be a registered owner of a partnership unit since a Depository treats all securities (including partnership interests) bearing the same CUSIP number as fungible and, thus, cannot withhold, or receive amounts net of withholding, with respect to only some of its partnership units.

Under the Estimated Payment system of Section 1446, it would be difficult, if not impossible, to implement the procedures of Section 1.1445-8T to allow a Depository to be a registered owner of a partnership unit. Since neither the partnership nor the Depository knows the identity of the beneficial owner of the partnership interest under the Nominee Withholding System, it would be necessary for the Estimated Payments (which as described above are Preferential Payments) and make-up distributions to be made by the Broker. As a practical matter, the funding of these amounts would have to come from the partnership. Furthermore, in view of the requirement of uniformity with respect to the flow of funds through the Depository, the partnership would be required to distribute for each Estimated Payment date with respect to each of its partnership units the maximum possible amount due as an Estimated Payment. Thus, the partnership could face a cash drain (especially if our suggestions with respect to Section 8 are not adopted) if a Depository were utilized.

The immobilization of securities through Depositories has made it possible for the securities industry to handle a volume of transactions far in excess of what was feasible in the past.. The Estimated Payment regime is inconsistent with the fungibility concept, a fundamental premise of the immobilization system. Thus, as a policy matter, it may well be advisable for the approach of Section 12 to be continued under TAMRA -- that is, to continue to give publicly traded partnerships, as discussed below, a right to elect Distribution Withholding pursuant to the procedures of section 1.1445-8T of the Regulations.

Section 13. Tiered Partnerships

Section 13 set forth rules to govern the situation of tiered partnerships, a matter of continuing relevance under TAMRA. Where a partnership (“P”), which conducts a trade or business in the United States, has a partner (“FP”), which is a foreign partnership, FP is itself subject to the rules of Section 1446 in respect of each of its own foreign partners (“FPFP”). Similarly, the rules also apply to FPFP if it is a foreign partnership with its own foreign partners.

Without any substantial elaboration, Section 13 provided a general rule that P had to withhold or make Quarterly Payments with respect to FP, which in turn FP could use as a credit against its own obligations to withhold or to make Quarterly Payments. Section 13 failed to give any detailed explanation or examples of how this complex regime was supposed to operate. The only guidance, which is itself cryptic, was buried in the form of attachment set forth in Section 9.03 (items 5(e) through (j) and 6(g) through (1)). This lack of guidance is troublesome because as noted in the legislative history to TAMRA, administrative rules are required in the context of tiered partnerships to avoid "the imposition of more tax than will be properly due." S. Rep, No, 100-445, 100th Cong., 2d Sess. 305 (1988).

We note the following areas where elaboration would be helpful in the new guidelines.[14]

(1) Although Section 13 (as applied by the form under Section 9.03) contemplated a credit to FPFP against its tax liabilities to the extent of the FP's withholding or Quarterly Payment obligation with respect to FPFP, there was no procedure contemplated for seeking a refund of any excess paid by P over the amount owed by FP. This excess could arise in a number of ways -- for example, simply because P is required to make Quarterly Payments with respect to FP at 34% (see Section 8.025) but FP is required to make such payments only at 28% because FPFP is an individual. We suggest that it be made clear who is entitled to the refund and what procedures should be followed to claim it.[15] Presumably, the refund should go to the ultimate tax paying partner.

[14] In Announcement 88-57, 1988-15 I.R.B. 46, the Service has indicated that it is considering issuing additional rules regarding tiered partnerships.

[15] Under Section 1446(d)(2) of the Code, the Estimated Payment would be treated as having been distributed on the last day of the taxable year to FP by P.

(2) Similarly, there is no procedure provided for crediting or refunding amounts paid by P which are allocable to partners of FP who are domestic rather than foreign.

(3) Consideration should be given to the effect of changes in ownership of FPFP's interest. The following is an example of a situation where guidance is needed. Assume P makes an Estimated Payment with respect to FP. Assume further that for the year of the Estimated Payment by P, FP has no net effectively connected income and, thus, is not required to make Estimated Payments for that year. What are the consequences (in terms of credits and refunds) if during that year, FPFP transfers its interest in FP to another person?

As a final comment, our concerns, which are discussed above, about the complexities under the Quarterly Payment system of Section 8 (with payments geared to the taxable years of the partners rather than of the partnership) are compounded in the context of tiered partnerships.

B. Distribution Withholding

As discussed above, TAMRA substituted an Estimated Payment system for Distribution Withholding. This legislation was enacted after the Revenue Procedure had authorized administratively an elective Estimated Payment system for partnerships (other than publicly traded partnerships) notwithstanding the requirements of Old Section 1446 for Distribution Withholding. For a number of reasons (some of which are discussed above), we suggest that consideration now be given to granting administratively to partnerships a right to elect at least in some circumstances Distribution Withholding, notwithstanding the requirements of Section 1446 for Estimated Payments.[16]

An Estimated Payment system, especially as implemented by the Revenue Procedure, is complex and potentially costly to comply with. Moreover, it entails (i) the problems of partner and creditor relationships that arise from a system of Preferential Payments and (ii) the lack of uniformity that creates difficulties for the securities industry with respect to publicly traded interests.

The legislative history of TAMRA as it relates to Section 1446 is sparse; as noted above, the stated reason for the amendment was the desire for a provision that would be more accurate[17] and would less likely result m over withholding. This legislative history would not seem to prohibit an exercise of administrative discretion to grant partnerships the choice of a simpler, albeit generally less accurate, system of Distribution Withholding. If there is a concern (which is not mentioned in the legislative history) that Distribution Withholding is more susceptible to manipulation,[18] the election could be limited to circumstances where the need for simplicity may be great

[16] We believe that as was the case with respect to the granting of the right to make an ECI Election by the Revenue Procedure, there probably is sufficient statutory authority for the regulatory creation of an elective Distribution Withholding system under TAMRA. If there is a concern about a lack of authority, consideration should be given to seeking a technical amendment to Section 1446.

[17] An Estimated Payment system with safe harbors based on results in prior years also may result in inaccurate payments.

[18] Since a foreign partner is currently taxable in any event on the effectively connected income of a partnership, this manipulation would result in the non-payment of tax only in the case of a non-compliant taxpayer.

(for example, where the partnership is publicly traded or otherwise has a large number of partners) or where the possibility of manipulation is slight (for example, a partnership in which foreign partners in the aggregate own less than 20% and no one foreign partner owns more than 2%). Similarly, it may be particularly appropriate (and should not present any material risk of manipulation) to allow the election in the case of a partnership which is required by its partnership agreement to distribute its income on a relatively current basis to its partners.

On the possibility that Distribution Withholding may be allowed at least in some instances in the future, we believe it would be helpful for us to comment on the provisions of the Revenue Procedure relating to that subject.

Section 4. Withholding Agent

Under the Distribution Withholding scheme of the Revenue Procedure, general partners had to act at the peril of deficiencies, interest and penalties in determining how much to withhold. This peril would have been very real with respect to determining the “effectively connected percentage” of the -partnership -- that is, the percentage of a distribution which was subject to withholding. Under Old Section 1446 and the Revenue Procedure, the “effectively connected percentage” was determined by reference to the effectively connected proportion of the partnership's gross -income for the prior three years. This determination required resolutions of questions of fact and law with respect to the nature and timing of income -- issues that often cannot be resolved with assurance. In our view, because of the types of judgments involved, the risk of challenge on audit would typically have been greater than that run by withholding agents with respect to payments of passive income.

If a Distribution Withholding system is allowed as an alternative under the new statute, we suggest that some reasonable degree of protection be provided to withholding agents -- for example, by eliminating the risk of under withholding liability where the withholding agent has taken a position for which there is substantial authority within the meaning of Section 6661 of the Code. We are concerned that without this protection withholding agents would have to over withhold in order to protect themselves.

Alternatively, since the Distribution Withholding would be elective, it might be determined that in the interest of simplicity (a primary reason for allowing the election in the first place), the full amount of all distributions should be subject to withholding – in other words, the “effectively connected percentage'“ would always be 100%.

Section 6. Section 1446 Distributions

Section 6, consistent with Old Section 1446, provided that distributions were subject to withholding without regard to the amount of the current or accumulated net income of the partnership.[19] (The effectively connected concept was taken into account in the withholding system under Old Section 1446 only with regard to the gross income ratio that determined the “effectively connected percentage”.)

We have a number of comments regarding the rules of Section 6. However, most of these comments relate to issues that as a practical matter would probably not arise if an election for Distribution Withholding is made available only to partnerships with many partners or partnerships in which the interests of foreigners are not substantial.

(a) Amount of Constructive Distributions

The blunt approach of Section 6 was required by Old Section 1446 and had the advantage of relative simplicity and ease of application and enforcement. However, we believe that in its treatment of so-called constructive distributions, Section 6 departed from the statute and created the potential for hardship and commercial disruption. In particular, we are concerned by the rule of Section 6.01(c) that for withholding purposes the assumption of liabilities of foreign partners and the receipt of property from foreign partners subject to liabilities were treated under all circumstances as' constructive partnership distributions in the full amount of such liabilities.

[19] As noted above, this lack of relationship with the resulting possibility of over withholding is the reason that - has been given for the TAMRA's change of Section 1446 to require an Estimated Payment system. S. Rep. No. 100-445, 100th Cong., 2d Sess. 304 (1988).

Section 6 did not offset against this constructive distribution the fair market value of any assets contributed to the partnership in conjunction with the transfer of the liabilities to the partnership.

Thus, for example, if a foreign partner FP were to transfer an operating business consisting of assets with an aggregate fair market value of $1,600,000 and liabilities of $1,200,000 to partnership P, FP would have been treated as receiving a constructive distribution of $1,200,000 from P for withholding purposes. Under Section 6, P would have been required to withhold $300,000 (20% of the sum of $1,200,000 and a gross-up amount of $300,000).

Obviously, the naked transfer of liabilities to a partnership is the economic equivalent of a distribution and should be subject to Distribution Withholding. However, when assets are transferred in conjunction with the transfer of liabilities to a partnership, it is artificial to split the transaction into two segregated segments and to focus- solely on the debt transfer as a distribution. We propose that netting should be allowed and a distribution should be found only to the extent of any net withdrawal from the partnership -- that is, any excess of liabilities over fair market value of assets transferred.[20] In our view, the effects of' segregation are simply too disruptive and unfair and the potential abuses of netting are far too tenuous to justify the approach of Section 6.

Our proposal for netting is further supported by practical considerations which justify applying the concept of constructive distributions as narrowly as possible. Distribution Withholding with respect to a constructive, as contrasted to an actual, distribution, results in Preferential Payments and the problems attendant thereto, discussed above.

In any event, if it were concluded that allowing Distribution Withholding can be justified as an administrative matter only if the constructive distribution rules of Section 6 are retained, we believe it is more important for the election to be provided than for the constructive distribution rules to be changed.

(b) Other Matters

We have considered whether the up-front withholding required by Section 6 on the transfer of liabilities to a partnership is appropriate even with regard to the amount by which transferred liabilities exceed the fair market value of transferred assets. On analysis, we believe this aspect of Section 6 is justified as the most feasible approach to a difficult problem. Without up-front withholding it would be necessary to identify some other event as the equivalent

[20] Consistent with our views set forth below regarding up-front withholding, our proposal looks to the net withdrawal of value from the partnership without regard to the basis of the contributed property or the contributing partner's percentage interest in the liabilities of the partnership.

of a distribution -- for example, the payment of the liability by the partnership or any other decrease in the foreign partner's share of the partnership's liabilities within the purview of Section 752(b) of the Code. We believe that upfront withholding is by far the easiest rule to apply and enforce. Concomitantly, we also believe that the rule of Section 6 should be clarified to provide explicitly that deemed distributions pursuant to Section 752(b) of the Code are not otherwise subject to withholding.

In addition, we suggest that the rules be clarified to exclude from the withholding requirements constructive distributions arising from the termination of a partnership pursuant to the 50%-change-of-interest rule of Section 708(b)(1)(B) of the Code. Consistent with this proposal, the gross income history, of the terminated partnership should be taken into account in determining the “effectively connected percentage” of the reconstituted partnership pursuant to Section 7.

Finally, Section 6.01(b) provided that the fair market value of any property distributed in kind constituted a distribution (to the extent of 125% of that value to reflect the gross-up for tax) without reduction for the amount of any liabilities to which the property was subject. We believe this omission may have been an oversight; in any event, in our view it is unfair and should not be adopted in the new guidelines. Moreover, failure to take liabilities into account creates potential liquidity problems for the partnership. For example, assume partnership P distributes property worth $2,000,000 and subject to liabilities of $1,500,000 to foreign partner FP -- under Section 6.01(b), FP was required to withhold $500,000 (20% of the sum of $2,000,000 plus $500,000).

Section 7. Effectively Connected Percentage

Under Old Section 1446, withholding was required with respect to the “effectively connected percentage” of each distribution (which was deemed to have been 100% if it would otherwise be at least 80%). Our discussion of Section 4 sets forth several comments on this subject.

Consistent with Old Section 1446(b)(2), Section 7 provided that the determination of the effectively connected percentage was made by reference to the gross income of the partnership during a measuring period. Old Section 1446(b)(2) provided that the measuring period was comprised of the three taxable years of the partnership preceding the taxable year of a distribution. Without statutory authorization, Section 7.03 excluded from the measuring period any portion thereof during which the partnership did not conduct a trade or business in the United States. This exclusion could have dramatically and inappropriately increased the effectively connected percentage and would appear to have excluded not only (1) periods before a partnership first engages in business in the United States but also (2) periods after the partnership has left the United States. To illustrate with an extreme example, if partnership P were to be engaged in a United States activity which produced 80% of its gross income in year 1 but were to conduct no activities in the United States in years 2 and 3 even though it had very substantial activities elsewhere in those later two years, its effectively connected percentage with respect to year 4 would have been 100%. The same result would have arisen if P's only United States activities were in year 3.

Moreover, although Section 7.03 was somewhat ambiguous in this regard, it seems to have provided that if a partnership were to conduct activities in the United States for only a few months in the three-year period prior to the year of distribution, then only its income for those few months would have determined its effectively connected percentage.

To repeat, however, the availability of an election of a Distribution Withholding system with a 100% effectively connected percentage is better than having no opportunity to make such an election. Stated alternatively, we believe some partnerships would find the simplicity and workability of Distribution Withholding so attractive that they would elect that alternative even if it were likely to result in over withholding.

Conclusion

The guidelines under TAMRA with regard to Estimated Payments should be made clearer and more practicable than the procedures under the Revenue Procedure. In addition, despite enactment of TAMRA, consideration should be given to continuing the approach of the Revenue Procedure in allowing partnerships at least in some circumstances two alternatives for satisfying their obligations under Section 1446.

Appendix 1

Summary of Old Section 1446

Under the general rule of Old Section 1446(a), if a domestic or foreign partnership had income which was effectively connected, or treated as effectively connected, with the conduct of a United States trade or business, partnership withholding was required at 20% of any amount distributed to a partner who was not a United States person.

Old Section 1446(b)(1) provided that if the “effectively connected percentage” was less than 80%, then withholding was required only with respect to that percentage of any distribution. Old Section 1446(b)(2) defined “effectively connected percentage” to mean the effectively connected portion of the gross income of the partnership for the three taxable years preceding the taxable years of the distribution.

Under the heading of “Exceptions,” Old Section 1446(c) set out three possible limitations to the general withholding requirement of Old Section 1446(a). First, Old Section 1446(c)(1) provided that Old Section 1446(a) was inapplicable where 30% withholding applied (or would have applied in the absence of applicable treaty provisions) with respect to distributions attributable to dividends, interest and other amounts governed by sections 1441 and 1442 of the Code. Second, Old Section 1446(c)(2) provided that withholding was not required (except as provided in regulations) to any partnership if “substantially” all its income from United States sources and all its income which was effectively connected was “properly allocated” to United States persons The Joint Committee Staff Report indicated that the reference to “substantially all” was not intended to exempt minority holders from withholding where straight allocations were employed; rather the exemption was limited to partnerships which specially allocate U.S. items to U.S. partners and foreign items to foreign partners. Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 100th Cong., 1st Sess. 1056 (1987). Third, Old Section 1446(c)(3) provided that under regulations, proper adjustments should be made in the withholding obligations under Old Section 1446(c) to take account of FIRPTA withholding under Section 1445 of the Code.

Finally, under Old Section 1446(d), the Treasury was directed to prescribe “necessary or appropriate” regulations. The Conference Committee Report anticipated that these regulations would specify the proper withholding agent in the case of tiers of partnerships and would set out the withholding requirements for a partnership that had effectively connected income for the first time. H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess. II-654 (1986).