International Taxation

IRS Issues New Partnership Withholding Rules

*By Eva Farkas-DiNardo, Sam Kaywood and Kevin Rowe**

The IRS issued final and temporary regulations ("the New Regulations") concerning the withholding obligations of a partnership under Code Sec. 1446 as to U.S. business income allocable to a foreign partner.[1] The New Regulations change many provisions under the previous regime that tended to result in over-withholding. These regulations are generally effective for partnership tax years beginning after May 18, 2005, but partnerships may elect to apply them to partnership tax years beginning after December 31, 2004.

Background

In general, foreign persons that are engaged in a U.S. trade or business are subject to U.S. federal income tax on net income that is effectively connected with the trade or business. If an income tax treaty applies, the U.S. business income is taxed only if the business is conducted through a "permanent establishment" located in the United States. Foreign persons without a U.S. trade or business are only subject to 30 percent (or lower treaty rate) withholding tax on certain types of U.S. source fixed and determinable annual and periodic income.

Under Code Sec. 875, a foreign partner in a partnership that is engaged in a U.S. trade or business is treated as engaged in a U.S. trade or business. If the foreign partner is eligible for the benefits of a U.S. income tax treaty, the permanent establishment standard applies. This attribution of U.S. trade or business nexus to foreign partners applies without regard to the size of the foreign partner's interest in the partnership and whether or not the foreign partner actively participates in the business of the partnership.

The Tax Reform Act of 1986, as amended by the Technical and Miscellaneous Revenue Act of 1988, added Code Sec. 1446. Code Sec. 1446 would require partnerships to withhold federal income tax

Sam K. Kaywood, Jr., is a Partner at the firm of Alston & Bird LLP and practices in Alston's Atlanta Office. **Kevin Rowe,** Counsel at Alston & Bird, and **Eva Farkas-DiNardo,** Associate at Alston & Bird, practice in New York office. All are members of the firm's International Tax Group.

at the highest applicable ordinary income rates on effectively connected taxable income ("ECTI") that is allocable to foreign partners. The partner may credit the withheld tax on its U.S. tax return. If the withheld tax exceeds the partner's final U.S. tax on ECTI, the excess will be refunded to the partner. Until the issuance of proposed regulations on September 3, 2003, the principal source of guidance under Code Sec. 1446 was Rev. Proc. 89-31,[2] which, among other things, precluded the partnership from taking into account the lower rates on capital gains and net operating losses attributable to partnership losses previously allocated to the foreign partners.

New Rates for Withholding Tax

The New Regulations permit the partnership to determine the amount of the withheld tax using lower capital gains rates on long-term capital gain allocable to a noncorporate partner (assuming the partner has adequately established its noncorporate status). For ordinary income, the New Regulations retain the rule (based on the plain language of the statute) requiring the tax to be determined using the highest applicable rate under Code Secs. 1 and 11.

> The New Regulations permit the partnership to determine the amount of the withheld tax using lower capital gains rates on long-term capital gain allocable to a non-corporate partner.

Loss Certification Procedure

The New Regulations include temporary and proposed regulations that attempt to address the potential problem of over-withholding under Code Sec. 1446 attributable to the failure to take partner losses into account in calculating the amount of the tax required to be withheld. The New Regulations permit the partnership, in certain circumstances, to consider a foreign partner's deductions and losses that are reasonably expected to reduce the partner's U.S. income tax liability for the tax year. Foreign partners using the procedure must navigate numerous rules designed to demonstrate a history of compliance with U.S. income tax law.

In addition, certain deductions, including charitable contributions, are not taken into account, and no more than 90 percent of the partner's share of ECTI can be offset by net operating losses. A foreign partner must submit the loss certificate to the partnership at least 30 days before the due date of the first withholding tax installment for the tax year showing deductions and losses that are available to the foreign partner. A separate certificate is required for each year.

The foreign partner must be able to represent that it timely filed (or will timely file) U.S. federal income tax returns for each of the four preceding tax years and for the tax year to which the certificate relates. The foreign partner must also represent that it has timely paid (or will timely pay) all tax shown on U.S. income tax returns it has filed (or will file). A partner may satisfy this rule by reference to compliance in tax years that predate the effective date of the New Regulations.

All deductions and losses set forth on the certificate must generally be reflected on the partner's U.S. income tax return for a preceding tax year. The loss certification procedure does not cover anticipated losses or deductions for the current year. If a foreign partner determines that any part of the certificate is incorrect, the certificate must be corrected within 10 days of the determination.

If a foreign partner who is an individual certifies to the partnership that the partnership investment is the only activity that will give rise to ECTI (or loss), the partnership is not required to withhold tax on the partner's distributive share of ECTI unless the amount of tax due with respect to the partner is at least $1,000. A foreign partner making such a certification must meet the general requirements outlined above for certifying losses (*e.g.*, the partner has timely filed or will timely file U.S. income tax return for the preceding four years).

Other Provisions

Under prior law, there was concern whether the payment of withheld tax to the IRS under Code Sec. 1446(f) constituted a distribution to the foreign partner at the time of payment (quarterly during the partnership tax year) that could produce gain recognition by a partner if the deemed distribution exceeded the partner's basis in its partnership interest at such time. The New Regulations specify

Continued on page 34

affecting the sales value. If it affects the sales value, Customs informs the importer making the declaration and the importer has two weeks to respond.
- Customs makes no change if a party proves that the sales value of its transaction is very close to the value of comparable sales, and the transaction took place on the same day or very close dates.

Transfer pricing issues between related-party transactions are covered in relation with sales value under the 4458th Customs Law. However, this coverage is indirect and very limited in nature.

Conclusion

Articles 15–17 of the corporate tax law have fundamentals of transfer pricing, including related-party transactions, use of comparables and arm's-length principle. However, Articles 15–17 are not sufficient to serve the purpose of an inclusive transfer pricing regulation, given more complex needs of Turkey in both domestic and international transfer pricing issues.

As its economy develops, Turkey is also putting effort to achieve compatibility with the EU. Given Turkey's dynamics, in order to act in accordance with the member countries of both OECD and EU, it will be necessary for Turkey to review and modify the tax codes. Specifically, in regard to transfer pricing, it is essential for Turkey to develop complete and attuned regulations. A transfer pricing guide and tax agreement model prepared by the OECD will possibly be used as a reference in constructing a complete transfer pricing regulation and a guideline in Turkey.

Endnotes

* The author expresses her thanks to Robert Feinschreiber for his comments.

1. TÜM VERGI KANUNLARI I, at 1-184, Mali Hukuk Burosu, Olus Yayincilik A.S., 13th Edition, August 2004.
2. Kapusuzo lu, T., VERGISEL YÖNDEN TRANSFER FIYATLANDIRMASI, at 292, Olus Yayincilik A.S., Istanbul 2003.
3. *Id.*, at 252–54.
4. *Supra* note 1, at 207–09.
5. *Supra* note 1, at 209.
6. Gül H. Gökhan, *Transfer Fiyatlamasi ve Türk Vergi Sistemi Yönünden De erlendirilmesi*, Yüksek Lisans Tezi Sosyal Bilimler Enstitüsü Maliye Ana Bilim Dalı, Gazi Üniversitesi. 2002.
7. *Supra* note 1, at 209–10.
8. *Supra* note 2, at 244–47.
9. *www.danistay.gov.tr.*
10. *Supra* note 8, at 247–65.
11. Dani tay Vergi Dava Daireleri Genel Kurulu Kararı E: 1995/415 ve 17/1/1997 gün ve K: 1997/6.
12. *Supra* note 1, at 503–26.
13. *www.maliye.gov.tr.*
14. *Cifte Vergilendirmeyi Onlemede Uluslararası Vergi Anlasmaları ve Turkiye Uygulaması*, I. Uzun, Yuksek Lisans Tezi, Sosyal Bilimler Enstitüsü Maliye Bilim Dali, Dokuz Eylul Universitesi 1999.
15. Kapusuzo lu, T., *Vergisel Yönden Transfer Fiyatlandırması*, at 265–79, Olus Yayincilik A.S., Istanbul 2003.
16. *4458 Sayılı Gümrük Kanunu, www.haser.com/kanun/gumrukkanunu.html.*

Int'l Taxation

Continued from page 6

that the deemed distribution is an advance or drawing against the partner's distributive share of partnership income subject to Reg. §1.731-1(a)(1)(ii), which defers determination of whether the distribution results in gain to the distributee-partner until the last day of the partnership's tax year.

The New Regulations permit the partnership to withhold tax by looking through upper-tier partnerships, as long as it receives proper documentation from the upper tier partnerships that identifies the ultimate partners. The New Regulations did not follow the many recommendations calling for a broad exception to withholding for tax attributable to cancellation of debt income ("CODI"). Among other things, it had been argued that withholding by a partnership in a chapter 11 bankruptcy proceeding might constitute preferential treatment of partners at the expense of creditors. The IRS stated that the general loss certification regime discussed above is sufficient to protect partners and partnerships from unfair results in connection with tax on CODI. The New Regulations retain the rule that provides that the general withholding regime of Code Sec. 1446 trumps FIRPTA real estate withholding under Code Sec. 1445. Some of the difficulties associated with this rule, however, may be eased by the loss certification regime.

Planning Considerations

Partnerships and foreign partners that are subject to Code Sec. 1446 should determine whether the New Regulations reduce required withholding, and whether they should elect to apply the New Regulations to their current tax year). Although the loss certification regime is cumbersome and not as generous as it might appear at first glance, it should reduce the withholding tax bur-