Foreign Partner Withholding Under IRC Sec. 1446

Statement of the problem

There's a pervasive belief among tax professionals that Internal Revenue Code ("IRC") section 1446 applies anytime a nonresident alien receives income from a domestic partnership. That belief is incorrect. The purpose of this presentation is to analyze sec. 1446 and discuss its proper application. (*Note:* Red letter is used for emphasis.)

Section 1446 of the Internal Revenue Code

Sec. 1446 is entitled, **"Withholding of tax on foreign partners' share of effectively connected income."** The title references withholding on the partnership's "effectively connected income" allocable to the foreign partner—not domestic sourced income characterized as "effectively connected income" pursuant to sec. 864(c)(3) by the foreign partner after having received it from the partnership. The general rule under sec. 1446 reads as follows:

> ***(a) General rule***
>
> *If—*
>
> ***(1)*** *a partnership has effectively connected taxable income for any taxable year, and*
>
> ***(2)*** *any portion of such income is allocable under section 704 to a foreign partner, such partnership shall pay a withholding tax under this section at such time and in such manner as the Secretary shall by regulations prescribe.*
>
> *26 U.S.C. § 1446(a)*

To reiterate, sec. 1446 applies to a "partnership [that] has effectively connected taxable income" allocable to a foreign partner—not domestic income received by the foreign partner and subsequently characterized as effectively connected income pursuant to sec. 864.[1]

Partnerships and partners

The IRC defines a partnership and partner as follows:

> ***(2) Partnership and partner***
>
> *The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.*
>
> *26 U.S.C. § 7701(a)(2)*

[1] An exception to this occurs through a nonresident alien election to treat real property income as income connected with United States business pursuant to sec. 871(d) and its implementing regulation, 26 C.F.R. § 1.871-10. *See* p. 7.

For tax purposes, partnerships can be depicted as an aggregate of partners, or as an entity apart from the aggregate of its partners. The following regulatory example addresses the difference.

> ***(e) Abuse of entity treatment -***
>
> ***(1) General rule.*** *The Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder.*
>
> ***(2) Clearly contemplated entity treatment.*** *Paragraph (e)(1) of this section does not apply to the extent that –*
>
> *(i) A provision of the Internal Revenue Code or the regulations promulgated thereunder prescribes the treatment of a partnership as an entity, in whole or in part, and*
>
> *(ii) That treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.*

26 C.F.R. § 1.701-2(e)

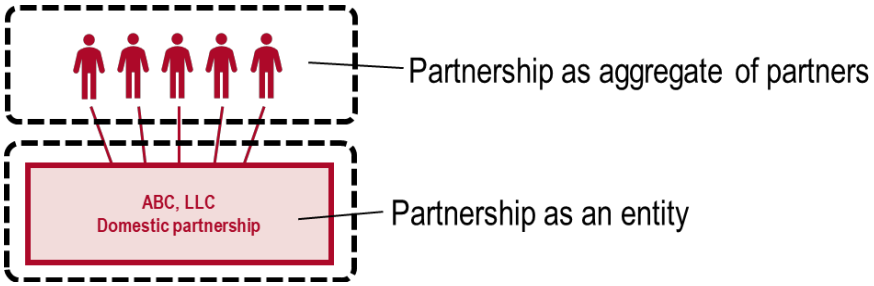

Figure 1. **Partnership depictions – partners in aggregate or as an entity**

Under sec. 1446, the partnership entity is regarded separately from that of its partners for the purposes of passing on taxable income to those partners. Regarding the nature of a partnership as a conduit for tax purposes, the United States Supreme Court stated the following:

> *[W]hile the partnership itself pays no taxes, 26 U.S.C. § 701, it must report the income it generates and such income must be calculated in largely the same manner as an individual computes his personal income. For this purpose, then, the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. Once its income is ascertained and reported, its existence may be disregarded since each partner must pay a tax on a portion of the total income as if the partnership were merely an agent or conduit through which the income passed.*
>
> *United States v. Basye*, 410 U.S. 441, 448 (1973)

Jurisdiction and Source

The Sixteenth Amendment settled the dispute over whether Congress had the authority to levy taxes on incomes within its jurisdiction.

> *The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.*
>
> *U.S. Const., Amend. XVI*

The taxing authority in the amendment is Congress—not the several States. If Congress has jurisdiction, whether by virtue of (1) the source, (2) the status of the person, or (3) both, the tax is constitutionally levied when consistent with jurisdictional substance contemplated in the amendment. In the wake of the amendment's passage, the Supreme Court ruled upon the nature of the tax vis-à-vis the two species of taxation permitted under the Constitution—direct but apportioned, and indirect and uniform. In *Stanton v. Baltic Mining Co.*, *infra*, the Supreme Court addressed the source issue as it related to the income tax.

> *In other words, we are here dealing solely with the restriction imposed by the Sixteenth Amendment on the right to resort to the source whence an income is derived in a case where there is power to tax for the purpose of taking the income tax out of the class of indirect to which it generically belongs and putting it in the class of direct to which it would not otherwise belong in order to subject it to the regulation of apportionment.*
>
> *Stanton v. Baltic Mining Co., 240 U.S. 103, 113 (1916)*

Whereas, in *Cook v. Tait*, the status issue of the taxpayer and its effect as it intersected the income tax was addressed.

> *[T]he basis of the power to tax was not and cannot be made dependent upon the situs of the property in all cases, it being in or out of the United States, and was not and cannot be made dependent upon the domicile of the citizen, that being in or out of the United States, but upon his relation as citizen to the United States and the relation of the latter to him as citizen.*
>
> *Cook v. Tait, 265 U.S. 47, 56 (1924)*

Legislative draftsman F. Morse Hubbard addressed the matter before Congress in 1943 as the tax extended its reach, as there was much confusion, as there is today, over what is taxed and why.

> *"The income tax is, therefore, not a tax on income as such. It is an excise tax with respect to certain activities and privileges which is measured by reference to the income which they produce. The income is not the subject of the tax; it is the basis for determining the amount of tax."*
>
> *F. Morse Hubbard, Legislative draftsman, United States Treasury, 2 Cong. Rec. 2580 (1943)*

In consideration of the foregoing, it becomes important to understand the ways an income's source intersects foreign and domestic persons—especially where partnerships or other flow-through entities are involved. The following representation is helpful.

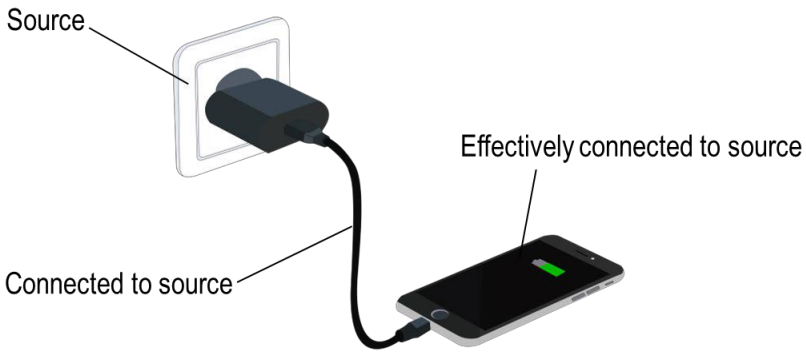

Figure 2. **Connected and effectively connected to the source**

Partnership-Partner Combinations

Partnership entities and their partners, as well as the object of their investment can exist in a variety of combinations. For simplicity, a domestic investment source will be considered for all examples—a United States real property interest. S*ee* sec. 897. Also, for simplicity, only non-tiered partnerships and natural person partners are considered. ***Figure 3.*** below presents some possible scenarios: **(A)** A foreign partnership with a nonresident alien partner; **(B)** A domestic partnership with a nonresident alien partner; **(C)** A domestic partnership with a United States person partner; and **(D)** A foreign partnership with a United States person partner.

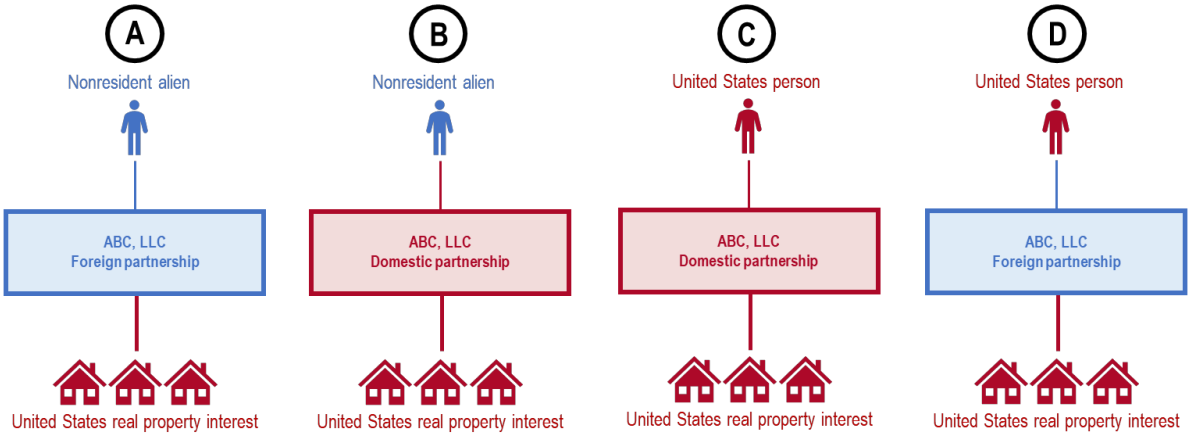

Figure 3. **Domestic & foreign partnerships with U.S. person & Nonresident alien partners**

Because a United States person is without the scope of sec. 1446, analysis of scenarios **(C)** and **(D)** are irrelevant and need not be addressed. Additionally, it is commonly accepted that a United States person is generally not subject to withholding if a Form W-9 is issued to the payer.

Scenario (A) – Foreign partnership & nonresident alien partner

Figure 4. **Foreign partnership & nonresident alien partner**

The scenario depicted in ***Figure 4.*** requires withholding under sec. 1446. The Federal income tax is imposed upon a nonresident alien individual in sec. 871, which is entitled, **"Tax on nonresident alien individuals."** The salient portion of the statute reads as follows:

> ***(b) Income connected with United States business—graduated rate of tax***
>
> > ***(1) Imposition of tax***
> > *A nonresident alien individual engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 1 or 55 on his taxable income which is effectively connected with the conduct of a trade or business within the United States.*
> >
> > ***(2) Determination of taxable income***
> > *In determining taxable income for purposes of paragraph (1), gross income includes only gross income which is effectively connected with the conduct of a trade or business within the United States.*
>
> *26 U.S.C. § 871(b)*

Section 871(b)(2) indicates that only income which is effectively connected with the conduct of a trade or business within the United States constitutes gross income for a nonresident alien. For this reason, income accrued to a nonresident alien must be characterized as "effectively connected" before it can be included in the nonresident alien's gross income.

Income and gain accrued to a foreign partnership from a United States real property interest constitutes United States sourced income. The following statute establishes its "effectively connected" character.

> ***(2) Periodical, etc., income from sources within United States—factors***
> *In determining whether income from sources within the United States of the types described in section 871(a)(1), section 871(h), section 881(a), or section 881(c), or whether gain or loss from sources within the United States from the sale or*

exchange of capital assets, is effectively connected with the conduct of a trade or business within the United States, the factors taken into account shall include whether—

(A) the income, gain, or loss is derived from assets used in or held for use in the conduct of such trade or business, or

(B) the activities of such trade or business were a material factor in the realization of the income, gain, or loss.

In determining whether an asset is used in or held for use in the conduct of such trade or business or whether the activities of such trade or business were a material factor in realizing an item of income, gain, or loss, due regard shall be given to whether or not such asset or such income, gain, or loss was accounted for through such trade or business.

(3) Other income from sources within United States
All income, gain, or loss from sources within the United States (other than income, gain, or loss to which paragraph (2) applies) shall be treated as effectively connected with the conduct of a trade or business within the United States.

26 U.S.C. §§ 864(c)(2) and (3)

Because the foreign partnership has accrued income directly from a United States real property interest, sections 864(c)(2) and (3) direct the income to "be treated as effectively connected with the conduct of a trade or business within the United States." The statutory mechanism of treating directly sourced United States income "as effectively connected" provides Congress the avenue to impose a duty to perform upon the recipient (in this case, a duty to withhold by the foreign partnership) from the "effectively connected income" allocable to persons otherwise without the jurisdiction of Congress but for the income's treatment—that is, the foreign partners of the foreign partnership. After withholding is accomplished, the foreign partner is incentivized to file a return and claim a refund on amount withheld—an amount that generally exceeds the foreign partner's overall tax obligation. This is the purpose of sec. 1446.

Scenario (B) – Domestic partnership & nonresident alien partner

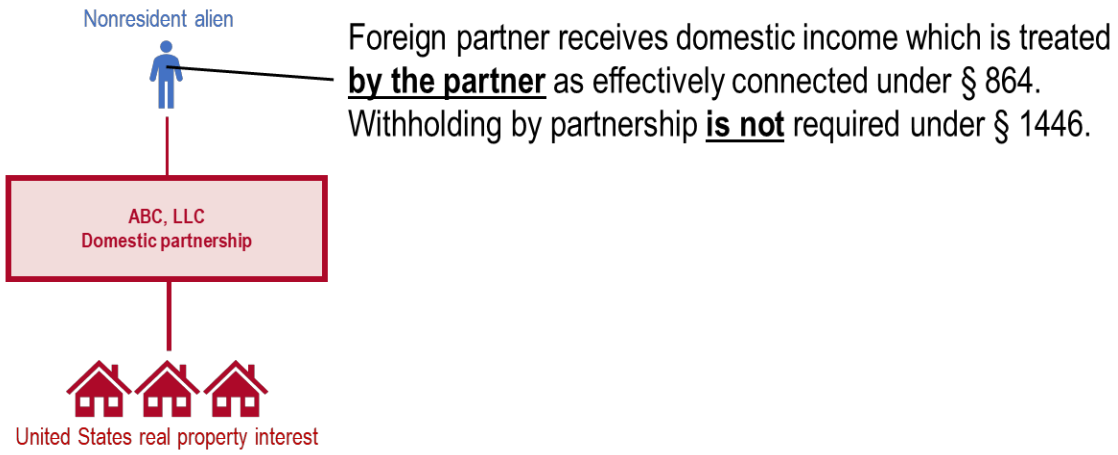

Figure 5. **Domestic partnership & nonresident alien partner**

The scenario depicted in ***Figure 5.*** represents the instance where sec. 1446 is most often misapplied. In this scenario, the domestic partnership is directly engaged in a United States trade or business through its investment in a United States real property interest. The domestic partnership (like the foreign partnership of ***Figure 4.***) is receiving income directly from a United States source. The domestic partnership then distributes income to the nonresident alien partner.

The misapplication of sec. 1446 stems from confusion over the similarities between,

A. A nonresident alien partner receiving income characterized as "effectively connected" under sec. 864(c) by the foreign **partnership before** it is distributed to the foreign partner. (*See* ***Figure 4.***, sec. 1446 withholding required); and

B. A nonresident alien partner receiving income characterized as "effectively connected" under sec. 864(c) by the foreign **partner after** it is distributed by the domestic partnership. (*See* ***Figure 5.***, sec. 1446 withholding not required).

In scenario **(B)**, "a nonresident alien partner shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged." *See* sec. 875(1). The "effectively connected" characterization is accomplished by the nonresident alien partner so that the income comports with requirements under the sec. 871(b) imposition of tax to a "nonresident alien individual engaged in trade or business within the United States . . . on his taxable income which is effectively connected with the conduct of a trade or business within the United States." Sec. 871(b)(1). Why? Because "[i]n determining taxable income for purposes of paragraph (1), gross income includes only gross income which is effectively connected with the conduct of a trade or business within the United States." Sec. 871(b)(2). This characterization is required of nonresident aliens for the computation of gross income. But this income is not subject to withholding in this instance because it is directly United States sourced when it is received by the nonresident alien.

The foregoing is verified by the withholding regulations under sec. 1441 associated with U.S. partnerships. The following regulation addresses payment by a payee to a partnership and withholding amounts subject to withholding under sec. 1441. Sec. 1441(c) addresses exceptions to withholding otherwise required under sec. 1441(a). Part 1.1441-5(b)(2)(i)(A) demonstrates that a foreign partner is subject to withholding under sec. 1441(a) when not excepted under sec. 1441(c) or otherwise subject to withholding under sec. 1446. This regulation proves that sec. 1446 is not the default "go-to" statute associated with foreign partner withholding. Withholding scenarios are more complex than many first presume, as source and tiers must be considered.

(2) Withholding by U.S. payees-

(i) U.S. partnerships-

(A) In general. *A U.S. partnership is required to withhold under §1.1441-1 as a withholding agent on an amount subject to withholding (as defined in §1.1441-2(a)) that is includible in the gross income of a partner that is a foreign person. Subject to paragraph (b)(2)(v) of this section, a U.S. partnership shall withhold when any distributions that include amounts subject to withholding (including guaranteed payments made by a U.S. partnership) are made. To the extent a foreign partner's distributive share of income subject to withholding has not actually been distributed to the foreign partner, the U.S. partnership must withhold on the foreign partner's distributive share of the income on the earlier of the date that the statement required under section 6031(b) is mailed or otherwise provided to the partner or the due date for furnishing the statement.*

26 C.F.R. S 1.1441-5(b)(2)(i)(A)

Additionally, part 1.1441-5(b)(2)(i)(B) addresses "effectively connected income in the hands of the partners who are foreign persons . . . ." Recall the only foreign persons withholding under sec. 1446 are foreign partnerships. This regulation must not be misapplied to a nonresident alien.

(B) Effectively connected income of partners. *Withholding on items of income that are effectively connected income in the hands of the partners who are foreign persons is governed by section 1446 and not by this section. In such a case, partners in a domestic partnership are not required to furnish a withholding certificate in order to claim an exemption from withholding under section 1441(c)(1) and §1.1441-4.*

26 C.F.R. § 1.1441-5(b)(2)(i)(B)

Additionally, § 1.1441-5(b)(2)(i)(B) indicates that foreign partners, whether upper-tier foreign partnerships or nonresident alien partners not otherwise subject to sec. 1446 withholding, need not "furnish a withholding certificate in order to claim an exemption from withholding under section 1441(c)(1) and § 1.1441-4." If the exceptions under 1441(c)(1) are not applicable, and sec. 1446 withholding does not apply, then withholding and its exceptions under sec. 1441 is applicable as § 1.1441-2 and § 1.1441-5 indicate.

Exception to Figure 5. – Nonresident alien election under sec. 871(d)

There is a statutory exception which makes a nonresident alien partner of a domestic partnership subject to withholding under sec. 1446. That exception occurs if the nonresident alien partner makes an election to treat real property income as income connected with United States business under sec. 871(d). Without this election, sec. 1446 remains otherwise inapposite.

(d) Election to treat real property income as income connected with United States business

(1) In general

A nonresident alien individual who during the taxable year derives any income—

(A) from real property held for the production of income and located in the United States, or from any interest in such real property, including (i) gains from the sale or exchange of such real property or an interest therein, (ii) rents or royalties from mines, wells, or other natural deposits, and (iii) gains described in section 631(b) or (c), and

> *(B) which, but for this subsection, would not be treated as income which is effectively connected with the conduct of a trade or business within the United States, may elect for such taxable year to treat all such income as income which is effectively connected with the conduct of a trade or business within the United States. In such case, such income shall be taxable as provided in subsection (b)(1) whether or not such individual is engaged in trade or business within the United States during the taxable year. An election under this paragraph for any taxable year shall remain in effect for all subsequent taxable years, except that it may be revoked with the consent of the Secretary with respect to any taxable year.*

26 U.S.C. § 871(d)

The regulation addressing "Election by partnership" is found at 26 C.F.R. § 1.871-10(d)(3).

> ***(3) Election by partnership.*** *If a non-resident alien individual or foreign corporation is a member of a partnership which has income described in paragraph (b)(1) of this section from real property, any election to be made under this section in respect of such income shall be made by the partners and not by the partnership. A nonresident alien or foreign corporation that makes an election generally must provide the partnership a 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 attach to such form a copy of the election (or a statement that indicates that the nonresident alien or foreign corporation will make the election). However, if the nonresident alien or foreign corporation has already submitted a valid form to the partnership that establishes such partner's foreign status, the partner shall furnish the partnership a copy of the election (or a statement that indicates that the nonresident alien or foreign corporation will make the election). To the extent the partnership has income to which the election pertains, the partnership shall treat such income as effectively connected income subject to withholding under section 1446. See also § 1.1446-2.*

26 C.F.R. § 1.871-10(d)(3)

Notable is that a partnership election under § 1.871-10 is not made by the partnership, that is, the partnership manager, but is effectuated by each partner individually. Once the election is made, the partnership "shall treat such income as effectively connected income subject to withholding under section 1446. See also § 1.1446-2." 26 C.F.R. § 1.871-10(d)(3).

If sec. 1446 is to be applied to a foreign partner in every instance, then the regulations addressing partnership withholding under sec. 1441 (such as 1.1441-5(b)(2)(i) above) and partnership elections under § 1.871-10(d)(3) would not only be superfluous, but errant. Sec. 1446 applies to a narrow set of circumstances—circumstances in which the partnership is allocating "effectively connected income." Barring an election under sec. 871(d), sec. 1446 does not apply to a domestic partnership with a nonresident alien partner. Additionally, applying sec. 1446 directly to a nonresident alien's allocable share of partnership income he or she subsequently classifies as "effectively connected income" to comply with the requirements of sec. 871(b) for individual purposes is a misapplication of the statute.

Conclusion

The proper application of sec. 1446 is dependent upon identifying the ***source*** of the "effectively connected income" characterization—not merely the ultimate possession of "effectively connected income" by the foreign partner. If the partnership entity ***itself has***

"effectively connected income" allocable to a foreign partner, then sec. 1446 applies. If the foreign partner receives income from a domestic partnership, and then subsequently characterizes that income as "effectively connected income" pursuant to statute, then sec. 1446 does not apply. The exception to this occurs when a nonresident alien partner makes an election under sec. 871(d) and its implementing regulation, 1.871-10, to treat income from a United States real property interest as "effectively connected income." In this instance, sec. 1446 also applies. Sec. 1446 has a narrow application. The withholding regulations under sec. 1441 and the election under sec. 871(d) and its regulations prove this.