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Tax Traps for U.S. Partnerships With Foreign Partners: Distributions, Sale of Interests, Withholding and Reporting

IRC 871 and 881, IRC 1446(f), FIRPTA, IRC 864(c)(8), Issues for Tiered Partnerships, and More

TUESDAY, OCTOBER 6, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Tax Traps for U.S. Partnerships with Foreign Partners

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CPAs AND ADVISORS

Agenda

- **Overview of Key Tax Issues**
  - Formation
  - Operational
- **Distributions and Transfers of Interests**
  - FDAP vs ECI vs Capital Gains
  - Temporary & Final Regs. re: withholding and sales of partnership interests
- **Estate & Gift Planning Issues**
  - Residency vs. domicile
  - Situs

OVERVIEW

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Tax Traps

Interplay Between Partnership and International Tax

- Subchapter K contains some provisions that treat a partnership as merely an aggregation of its members and some that treat it as a separate entity.
- The aggregate concept supports the flow-through tax treatment for partnerships, but the entity treatment supports the computation and characterization of income of the partnership at the partnership level, based on accounting methods and elections made by the partnership (and not the individual partners).

Tax Traps

Interplay Between Partnership and International Tax

- When members of a partnership have different tax objectives, they may desire to avoid the uniform treatment of items of income and expense imposed at the partnership level and instead be taxed in a manner consistent with the mere joint ownership of property.
- §761(a) provides a means whereby members in certain arrangements that would be treated as partnerships for federal income tax purposes may elect to have the venture excluded from the operation of subchapter K.

FORMATION

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Tax Traps

Formation of U.S. Partnership with Foreign ("4N") Partners

- In general, a partnership and its partners do not recognize gain or loss when a partner contributes money or property in exchange for an interest in the partnership. (§721(a))
- 3 notable exceptions unique to 4N partners:
  - when encumbered property is contributed and the portion of the liability assumed by the partnership exceeds the partner's basis in the contributed assets (§752)
  - when a partner contributes services (instead of property) to the partnership in exchange for a capital interest in the partnership (§1.721-1(b))
  - when a 4N partner contributes a United States real property interest to the partnership (§897(e))

Tax Traps

Encumbered Property

- **General Rule**
  - Contributing partner typically continues to be liable, as a partner, for a portion of the liability assumed
  - For tax purposes, contributing partner is treated as having received cash from the partnership in the amount of liability relief
  - §752 addresses 2 type of liabilities – Recourse & Non-recourse, allocated as follows:
    - Recourse – based on risk of loss
    - Non-recourse – based on the partners' profit ratios

Tax Traps

Encumbered Property

- **Gain Calculation**
  - If property contributed is subject to a recourse liability, the contributing partner will be relieved of a portion of the liability and that amount will be treated as a cash distribution, with 2 possible treatments:
    - Disguised sale of the contributed property
    - As a sale of the partner's interest in the partnership
  - General rule is that such relief will be a disguised sale
  - Exception – when the liability encumbering the property transferred was incurred > 2 years before the transfer

Tax Traps

Encumbered Property

- **Gain Calculation (con't.)**
  - In such circumstances, partner recognizes gain to the extent the partner's liability exceeds the basis of his partnership interest
  - Example: 4N partner contributes personal property with an adjusted basis of $800 and a FMV of $1,500, and subject to a recourse mortgage of $1,200, to ABC, a U.S. partnership with 5 partners, each holding a 20% interest in the profits & losses
  - General rule is that this is a disguised sale (of a partnership interest).

Gain Calculation (con't.)

• Portion of mortgage assumed by other partners treated as a distribution to 4N partner (80% x $1,200)	$960
• LESS: adjusted basis of partnership interest	(800)
• Net liability relief in excess of basis	$160
• (Nonrecourse, generally NO gain recognition.)	

Tax Traps

What if Contributing Partner is 4N?

- Whether the gain is subject to U.S. taxation turns on 2 queries:
  - What is the ***source*** of the income?
  - If the gain is U.S. source, what ***type*** of income is it, FDAP, ECI or sale of a capital asset?
- The dispositive query is whether the partnership is treated as an aggregate, an entity or a combination of both.
- The answer can lead to different tax consequences for the 4N partner.

Tax Traps

Partner contributes services (instead of property).

- §721 non-recognition does not apply.
- The contributing partner is taxed on the FMV of the partnership interest transferred "either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services.”
- It is possible for a 4N taxpayer to join a partnership as the service partner and receive a capital interest in return.

Tax Traps

Partner contributes services (instead of property).

- Services performed within the U.S. generate U.S.-source income unless the services fall within a *de minimis* exemption for individuals.
- Services performed outside the U.S. generate 4N-source income.
- The regulations treat the income derived upon receipt of a capital interest in return for the rendition of services as a guaranteed payment.
- Sourcing the income according to the location of the services to be performed would be consistent with rule.

Tax Traps

Partner contributes a USRPI to the partnership.

- When a non-resident individual or 4N corporation disposes of a USRPI, the gain or loss is treated as effectively connected with a U.S. trade or business and is subject to U.S. income tax.
- To prevent 4N taxpayers from circumventing this rule by exchanging a USRPI for a non-USRPI in a nonrecognition transaction and then recognizing the exempt capital gain when the non-USRPI is sold, §897(e) overrides the non-recognition rule of §721(a) (as well as other non-recognition provisions), unless the partnership interest received in the exchange would be subject to U.S. tax when sold.

Tax Traps

Partner contributes a USRPI to the partnership.

- Regulation §1.897-6T(a)(1) provides that non-recognition treatment is available only to the extent:
  - (i) the partnership interest received in exchange for the USRPI is itself a USRPI which, immediately following the exchange, would be subject to U.S. tax when sold and
  - (ii) the 4N partner complies with certain filing requirements
- Under §897, the partnership interest is only treated as a USRPI to the extent the gain on the disposition is attributable to the partnership's USRPIs.

Tax Traps

Partner contributes a USRPI to the partnership.

- §897(g) provides a look-through rule when a 4N partner sells a partnership interest in which the partnership owns USRPIs.
- Thus, the amount realized from the sale of a partnership interest, to the extent attributable to the partnership's USRPIs, is treated as a sale of such USRPIs by the 4N partner.

Tax Traps

Partner contributes a USRPI to the partnership.

- §721(a) may not defer the entire gain realized when a 4N corporation transfers a USRPI to a partnership in exchange for a partnership interest if, immediately after the contribution, the built-in gain in the partnership's assets includes gains attributable to non-USRPI assets.
- Unfortunately, it is not clear how one determines the portion of the gain that is attributable to the partnership's USRPIs under §897(g).

OPERATIONAL

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Tax Traps

Operational Considerations for U.S. Partnership with 4N Partners

- The seminal issues are: (1) type of income and (2) source of income.
  - *Type* of Income:
    - Fixed, determinable, annual and periodic income that is sourced within the U.S. (“FDAP”); or
    - Income that is effectively connected with a trade or business of the taxpayer within the U.S. (“effectively connected income” or “ECI”)
  - *Source* of Income - principally applying the source rules of §861, §862, §863 and §865.
- *(Gain from the sale or exchange of a capital asset, when such asset is not effectively connected to a U.S. trade or business, is not subject to tax in the hands of a 4N corporation and is taxable to a nonresident alien individual only in extremely narrow situations income.)*

Tax Traps

A Note on Capital Gains

- An exception to the rule that a 4N partner is not subject to tax on U.S.-source capital gains is found in §871(a)(2), which provides that, in the case of NRAs only, if the taxpayer is physically present in the U.S. for 183 days or more during the taxable year, any U.S.-source gains from the sale of capital assets are subject to a flat 30% tax.
- Note this is a different result as when that same NRA would be exempt from income tax despite spending > 183 days.

Tax Traps

A Note on Capital Gains

- It would seem that so long as the 4N partner is not physically present in the U.S. for 183 days or more during the taxable year, the non-effectively connected U.S. source capital gains of the partnership would not be taxable in the hands of a 4N partner.
- Reg. 1.871-7(d)(2)(iii) specifically provides that the U.S. presence of an individual's partners or agents is not attributable to the individual for purposes of applying the 183-day test.

Tax Traps

Operational Considerations for U.S. Partnership with 4N Partners

- Even if an item of FDAP (investment) income is sourced within the U.S. within the scope of income identified in §871(a) or §881(a), the item may not be subject to U.S. tax — either because a specific Code provision exempts the income from U.S. taxation (e.g., portfolio interest) or because of preferential tax treaty treatment.
- If an item of U.S. source FDAP (investment) income is deemed to be effectively connected to the taxpayer's U.S. trade or business under §864(c)(2), the trade or business tax regime trumps §871(a) and §881, and the income is taxed as ECI.

Tax Traps

What is FDAP?

- The statutory language in §§871 & 881 specifically refers to “dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, [and] emoluments”.
- Royalties also fall within FDAP.
- FDAP also includes: (1) proceeds from the sale of certain timber, coal or iron ore with a retained economic interest; (2) original issue discount; and (3) gain from the sale of certain intangible properties.

How is FDAP Taxed?

- In the case of FDAP income earned by a partnership that has 4N partners, the issue of whether the income is characterized and sourced at the partnership or partner level is critical to the manner in which a 4N partner is taxed on the income, ***as well as determining the withholding obligations of the partnership***.
- While there is little authority, the character of a partner's distributive share of income or loss, whether domestic or 4N, is generally determined as if the partner realized the income or loss directly from the source realized by the partnership.

Tax Traps

How is FDAP Taxed?

- If a 4N partner's share of distributive income consists solely of FDAP income, the partner will generally not be entitled to claim deductions against such income (i.e., the withholding tax is imposed on a flat 30% basis – unless reduced by treaty).
- This does not mean that expenses with respect to FDAP income will not be allocated to the 4N partner, but only that such expenses will not be deductible.
- It is generally preferable to allocate expenses relating to FDAP income to the domestic partners of the partnership to the extent permitted under §704(b).

U.S. Taxation of Effectively Connected Income

- Unlike FDAP, ECI is taxed on a net basis and at graduated tax rates.
- Whether income of a 4N person is taxable as trade or business income requires analysis of two key issues:
  - (1) is the taxpayer engaged in a trade or business conducted within the United States, and
  - (2) if so, to what extent is income of the taxpayer effectively connected to the taxpayer's U.S. trade or business.

Tax Traps

Trade or Business Requirement

- The Code itself does not provide a general definition of the phrase “trade or business”.
- Most cases fall somewhere in-between the two extremes. In these cases, the determination of whether the taxpayer's activity rises to the level of a trade or business ultimately depends on the proverbial “facts and circumstances”.

Tax Traps

Rental Real Estate

- Ownership of rental real estate involves both an investment and active management component.
- Special taxing regime.
- An NRA individual or 4N corporation which invests in domestic realty on its own account may elect to have income treated as business income or possibly under a tax treaty.
- A 4N person who is a member of a partnership may also elect, even though the investments are made by the partnership.

Tax Traps

Rental Real Estate

- *Pinchot v. Commissioner* held that a 4N taxpayer who owned several large pieces of rental property, and managed such properties through an agent (who leased the property, collected rents and paid expenses on behalf of the taxpayer), was engaged in "considerable, continuous and regular" activity amounting to a trade or business.

Tax Traps

Rental Real Estate

- *Pinchot* spawned the following:
  - 3 adjectives – “considerable, continuous and regular”
  - A taxpayer may be engaged in a U.S. trade or business solely by virtue of the activities of the taxpayer's agent.
- The imputation of trade or business activity is hugely important in the partnership context, because, as a statutory matter, the partnership's trade or business is automatically imputed to its partners, with no distinction between general/active or limited partners.

Tax Traps

Investment and Trading Partnerships

- Many partnerships formed to invest or trade in stocks, securities, or commodities may be found to be engaged in a U.S. trade or business under the traditional common law approach of focusing on the facts and circumstances.
- To encourage 4N investment in the capital markets of the U.S., Congress created statutory safe harbors to exempt from trade or business classification the trading in stock, securities, or commodities for a taxpayer's own account.

Tax Traps

Investment and Trading Partnerships

- The rules generally state that a 4N person who is a partner will not be considered to be engaged in a United States trade or business solely because that partnership trades in stocks and securities for its own account.
- The Regulations also provide, however, that this exemption will not be available to any 4N person who is a member of a partnership which is a dealer in stock or securities.

Tax Traps

What is “Effectively Connected Income”?

- All U.S. source income of a 4N taxpayer other than FDAP or capital gain income is treated as effectively connected to the taxpayer's trade or business. §864(c)(3).
- Note that any U.S. source FDAP or capital gain may be treated as effectively connected but only to the extent such income either:
  - (1) is derived from assets used or held for use in the taxpayer's trade or business (“asset-use test”) or
  - (2) the activities of the taxpayer's trade or business were a material factor in the production of the income (“material factor test”).

Tax Traps

What is “Effectively Connected Income”?

- The “asset-use test” is designed to capture traditional FDAP income that is derived from assets held for use in the taxpayer's business (e.g., interest earned on cash deposits held to meet present (as opposed to future) business).
- The “material factor test” is designed to capture traditional FDAP income that is more properly regarded as business income given the direct relationship between the taxpayer’s active business activities and the realization of the income, e.g. royalties.

How is “Effectively Connected Income” Taxed?

- A 4N partner is taxable on his or her distributive share of partnership income as if he or she had realized the income in the same manner as realized by the partnership.
- Both the character of a partner’s distributive share of partnership income, and the source of such income, are generally determined at the partnership level.

Tax Traps

A Note on Foreign Corporate Partners

- A 4N corporate partner of a partnership engaged in a U.S. trade or business may be subject not only to tax on its distributive share of U.S. source ECI and FDAP income, but also to the Branch Profits Tax (“BPT”).
- The BPT seeks to impose a 30% flat tax on earnings of a 4N corporation to the extent those earnings are removed from the corporation's U.S. base assets.

Tax Traps

A Note on Foreign Corporate Partners

- The regulations provide that a 4N corporation's interest in a partnership — and not its pro rata interest in the partnership's underlying assets — is what must be taken into account in determining its U.S. assets.
- For purposes of determining the proportion of a partnership interest that is a U.S. asset, a 4N corporation may elect to use either the asset method or the income method.

A Note on Foreign Corporate Partners

- The *asset method* generally requires treating a partnership interest as a U.S. asset in the same proportion that the partner's share of the adjusted bases of all partnership assets that would be treated as U.S. assets if the partnership were a 4N corporation bears to the partner's share of the adjusted bases of all partnership assets.
- Under the *income method*, a partner's interest is treated as a U.S. asset in the same proportion that the partner's distributive share of ECI bears to its distributive share of all partnership income for the year.

Tax Traps

Source of Income

- The general rule is that the source of partnership income items is determined at the partnership level.
- Thus, a partner's distributive share is treated as realized directly from the source from which it was realized by the partnership.
- In the international arena, some items may be sourced with a focus on the individual partner. IRC §§865(e), 865(i), and 865(j).
- Guaranteed payments sourced under the general rule of personal services.

Tax Traps

Source of Income

- Service income included in a partner's distributive share may reflect income which is domestic or 4N sourced because services were performed within and without the U.S.
- The partnership may attempt to allocate the income among its partners so as to minimize their tax liability to the U.S.
- What about cloud computing and other digital activities?

DISTRIBUTIONS

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Tax Traps

Distributions to a Foreign Partner

- If a partner receives cash which exceeds the adjusted basis of the partner's partnership interest immediately before the distribution, the partner is treated as recognizing gain from the sale or exchange of a partnership interest.
- What is the *source* of the gain?
- What is its *character*, i.e., is this gain FDAP income; ECI; taxable gain from the sale or exchange of a capital asset; or capital gain which is not effectively connected and therefore not subject to U.S. tax?

Tax Traps

Distributions to a Foreign Partner

- Neither of these issues has been directly addressed by either the IRS or the courts.
- The recently released final regulations on disposition of partnership interests contain a provision for partial transfers of partnership interests and appear to cap the amount of gain or loss taken into account at the foreign partner's distributive share of the ECI amount the partnership would realize had it sold all of its assets.

TRANSFER OF INTERESTS

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Tax Traps

From Rev. Rul. 91-32 to Today

- Rev. Rul. 91-32 – IRS publishes its view that such gain or loss should generally give rise to ECI to the selling 4N partner, even if the gain or loss is not effectively connected to a U.S. trade or business conducted directly by the 4N partner.
- *Grecian Magnesite Mining v. Commissioner* (2017) – held that partnership dispositions by 4N partners generally should not give rise to ECI because gain or loss on dispositions by 4N persons of personal property (including an interest in a partnership) is generally 4N source.

Tax Traps

From Rev. Rul. 91-32 to Today

- TCJA (Dec. 22, 2017) – effectively repealed the holding in *Grecian* and (retroactively to Nov. 27, 2017) codified the IRS' position in Rev. Rul. 91-32.
  - §§864(c)(8) and 1446(f)
  - gain or loss of a NRA individual or 4N corporation from the sale, exchange or other disposition of a partnership interest is treated as effectively connected with the conduct of a trade or business within the U.S. *to the extent that the 4N transferor would have had effectively connected gain or loss if the partnership had sold all of its assets at FMV as of the date of the sale or exchange.*

Tax Traps

From Rev. Rul. 91-32 to Today

- "…*to the extent that the 4N transferor would have had effectively connected gain or loss if the partnership had sold all of its assets at FMV as of the date of the sale or exchange*."
- A 4N person that transfers its partnership interest generally will not be able to compute its income tax liability under this construct unless the partnership provides certain information to the foreign partner.
- Enter Prop. Regs. (published Dec. 27, 2018)

Tax Traps

From Rev. Rul. 91-32 to Today

- Prop. Regs. – provide a 3-step process for calculating the amount of gain to be treated as ECI under §864(c)(8)
  - Step 1: determine the selling partner's tax gain or loss under existing tax law, separating out ordinary and capital components applying the general rules that apply to the sale of partnership interests
  - Step 2: determine the partner's allocable share of capital gain and ordinary income (or loss, as appropriate) that would be treated as ECI if the partnership sold all of its assets at FMV, taking into account any special adjustments normally required under generally applicable principles that apply to partnerships

Tax Traps

From Rev. Rul. 91-32 to Today

- Prop. Regs. – provide a 3-step process for calculating the amount of gain to be treated as ECI under §864(c)(8) (cont'd)
  - Step 3: separately for ordinary and capital components, treat the lesser of the amount determined in step 1 and step 2 as ECI
- Because of the separate computation of capital and ordinary components, this can result in a situation where a 4N partner may have to pay tax on gain treated as ECI, even if the overall sale transaction results in a loss.

Tax Traps

From Rev. Rul. 91-32 to Today

- Provide that any gain on the disposition of a partnership interest attributable to a U.S. real property interest is not also taken into account under the rules governing sales of USRPI (the FIRPTA rules)
- Taxpayers resident in jurisdictions that have tax treaties with the U.S. and would allow taxpayers to claim benefits under those treaties, under certain circumstances.

Tax Traps

From Rev. Rul. 91-32 to Today

- Final Regs. (September 21, 2020)
  - retain the basic approach and structure of proposed regs
  - add rules for sourcing gain or loss from specific assets (inventory, intangibles and depreciable personal property) that may be particularly difficult to source in a deemed sale
  - modify the relevant testing period for the 10-year exception by providing that the holding period will be the lesser of the 10-year period ending on the date of the transfer or the period when the partnership held the asset

Tax Traps

From Rev. Rul. 91-32 to Today

- Final Regs. (September 21, 2020)
  - 10-year exception (meaning sale will not yield ECI) if:
    - No income or gain produced by the asset was taxable as income that was effectively connected with the conduct of a trade or business within the U.S. by the partnership (or the 4N transferor, a predecessor of the 4N transferor, or a predecessor of the partnership) during the holding period; and
    - The asset has not been used, or held for use, in the conduct of a trade or business within the U.S. by the partnership (or the 4N transferor, a predecessor of the 4N transferor, or a predecessor of the partnership) during that same period

Tax Traps

Prop. Regs. - §1446(f) (May 13, 2019)

- A “notifying transferor” that “transfers” an interest in a “specified partnership” must notify the partnership of the transfer in writing within 30 days of the transfer
- Notifying transferor
  - Any 4N person;
  - Any domestic partnership that has a 4N person as a direct partner; and
  - Any domestic partnership that has actual knowledge that a 4N person indirectly holds, through one or more partnerships, an interest in that partnership

Tax Traps

Prop. Regs. - §1446(f) (May 13, 2019)

- Transfer – a sale, exchange, or other disposition, a distribution from a partnership to a partner to the extent that gain or loss is recognized on the distribution, as well as a transfer treated as a sale or exchange under §707(a)(2)(B)
- Specified Partnership – means a partnership that:
  - Is engaged in the conduct of a trade or business within the U.S.; or
  - Owns (directly or indirectly) an interest in a partnership engaged in the conduct of a U.S. trade or business; and
  - May include a PTP interest

Tax Traps

Prop. Regs. - §1446(f) (May 13, 2019)

- Contents of Notification
  - names and addresses of the notifying transferor and the transferee or transferees;
  - the taxpayer identification number (TIN) of the notifying transferor, and, if known, the transferee or transferees; and
  - the date of transfer
- PTPs are excepted as are partial or non-liquidating distributions

Tax Traps

Prop. Regs. - §1446(f) (May 13, 2019)

- Reporting Requirements (statement contents):
  - the items described in Prop. Reg. § 1.864(c)(8)-1(c)(3)(ii), namely, the 4N transferor's aggregate deemed sale EC items (including items derived from lower-tier partnerships); and
  - any other information required by forms, instructions or other guidance
- Provide statement on or before the due date (including extensions) for issuing the K-1 to the transferor for the tax year of the transfer

ESTATE & GIFT ISSUES

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Tax Traps

Transfer Tax Considerations

- $60,000
  - Estate tax exclusion
  - 40% tax rate above $1M (effectively 32.6% on 1st $1M)
  - Few exceptions, e.g. bank accounts not used in a trade or business, otherwise U.S. situs assets subject to tax
- U.S.-situs
  - Non-U.S. sitused assets are not subject to U.S. transfer tax when donor is not domiciled in U.S.
  - Intangible assets are not subject to gift tax for a non-resident donor *regardless of situs*

Tax Traps

Residence Means Domicile

- Congress has not provided transfer tax definitions for the terms “resident” and “nonresident.”
- The regulations define the term “domicile” by general description, as opposed to a precise definition:
  - A person acquires a domicile in a place *by living there*, for even a brief period of time, with no *definite present intention* of later removing therefrom.
  - Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.

Tax Traps

U.S.-situs

- A sampling of property owned by a nonresident non-citizen (NRNC) having situs within the U.S. for federal estate tax purposes:
  - Realty
  - Tangible personal property
  - Intangible property
  - Stock in U.S. corporation
- Properties with *Unsettled* Situs Rules:
  - U.S. partnership interests

Tax Traps

U.S.-situs of Partnership Interests

- The Code is silent as to the situs of partnership interests.
- The regulations attempt to provide rules that address the situs of other categories of property that are not provided for in the Code, but the regulations fail to state anything with specific regard to partnership interests.

Tax Traps

U.S.-situs of Partnership Interests

- 4 possible approaches:
  - situs is based on the location of the partnership's “trade or business”;
  - situs is based on domicile of the holder of the partnership interest;
  - situs is based on location of the partnership assets; or
  - situs of a partnership interest, like corporate stock, depends on whether the issuing partnership simply is or is not formed under domestic law.

Tax Traps

U.S.-situs of Partnership Interests

- Where to look for guidance:
  - Rev. Rul. 55-701
  - *Blodgett v. Silberman* 277 U.S. 1 (1928)
  - The common law maxim *mobilia sequunter personam*
  - Reg. §301.7701-5
  - Organization for Economic Cooperation and Development (OECD) Model Estate and Gift Tax Treaty, Article 8

Tax Traps

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Tax Traps for U.S. Partnerships With Foreign Partners

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Agenda

- Withholding & Reporting
- Use of U.S. Income Tax Treaties
- CODI

Withholding Scenarios

- Foreign partner's share of US-connected partnership income
  - US partnerships treated differently than foreign partnerships
- US source fixed determinable annual or periodic ("FDAPI") income
- FIRPTA withholding on disposition of US real property interest
- US source services income
- FATCA

Withholding Agent

- Withholding agent –
  - the term withholding agent means any person, U.S. or foreign, that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding… Treas. Reg. § 1.1441-7(a)(1)
    - Withholding agent primarily liable - 26 USC § 1461

Withholding - FDAPI

- Statutory 30% withholding on certain fixed, determinable, annual periodic income 26 USC § 1441, et. seq.
  - First need to determine source before whether WHT applicable
- Interest
- Dividends
- Rents
- Royalties

Withholding Reporting - FDAPI

- Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
- Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding
- Form 1040-NR, U.S. Nonresident Alien Income Tax Return
- Form 1120-F, U.S. Income Tax Return of a Foreign Corporation

Withholding - ECI

- Trade or business – No definition within the IRC; largely case law
  - ECI for purposes of 26 USC §1446 means the taxable income of the partnership which is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the US. 26 USC § 1446(c)
- Statutory withholding on ECI. 26 USC § 1446(a)(2)
  - the highest rate of tax specified in section 1 in the case of the portion of the ECI income which is allocable under section 704 to foreign partners who are not corporations
  - the highest rate of tax specified in section 11(b) in the case of the portion of the effectively connected taxable income which is allocable under section 704 to foreign partners which are corporations.

Withholding - ECI

- Certain gains/losses from sources within the U.S. such as a partnership interest are ECI. See 26 USC §864(c)(8); TCJA "reviving" Rev. Rul. 91-32
  - Final regulations issued September 21, 2020; TD 9919.
  - Must file a US tax return and pay tax due on a transfer subject to 26 USC § 864(c)(8).

Withholding - ECI

- The transferee is required to deduct and withhold a tax equal to 10 percent of the amount realized on the disposition of a partnership interest. 26 USC § 1446(f)
  - Notice 2018-29 - exceptions
    - Non-foreign status
    - No realized gain
    - Less than 25% ECI
    - Less than 25% effectively connected gain
    - Non-recognition transaction
  - Proposed regulations (REG-105476-18)

Withholding - ECI

- Notice 2018-29 Tiered Partnerships
  - If a transferor transfers an interest in a partnership (upper-tier partnership) that owns an interest (directly or indirectly) in another partnership (lower-tier partnership), and the lower-tier partnership would have effectively connected gain upon the deemed transaction described in section 864(c)(8)(B)(i)(I) that would be taken into account by the transferor at the time of the transfer of the interest in the upper-tier partnership, a portion of the gain recognized by the transferor is characterized as effectively connected gain. These regulations will require lower-tier partnerships to furnish information to their partners in order for their indirect partners to be able to comply with sections 864(c)(8) and 1446(f). See section 6031(b); § 1.6031(b)-1T.

Withholding Reporting - ECI

- Form 8804, Annual Return for Partnership Withholding Tax
- Form 8805, Foreign Partner's Information Statement of Section 1446 Withholding Tax
- Form 8813, Partnership Withholding Tax Payment Voucher
- Form 1120-F, U.S. Income Tax Return of a Foreign Corporation

Withholding - FIRPTA

- A partnership interest will be considered a USRPI if (1) 50 percent or more of the value of the partnership's gross assets consists of U.S. real property interests, and (2) 90 percent or more of the value of the partnership's gross assets consists of U.S. real property plus cash or assets readily convertible into cash.

Withholding - FIRPTA

- Triggered in connection with the disposition of a US real property interest (USRPI) by a foreign person.
- Buyer (US or foreign) must withhold 15% of foreign seller's amount realized in connection with a disposition of USRPI. 26 USC § 1445(a)
  - Amount realized = gross proceeds + liabilities assumed

Withholding Reporting - FIRPTA

- Form 8288, U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests
- Form 8288-A, Statement of Withholding on Dispositions by Foreign persons of USRPI

Use of Tax Treaties

- Have the full force and effect of law.
- Over 50 bilateral income tax treaties
- Savings clause – policy is to prevent a tax treaty from reducing U.S. taxes of a U.S. partner.

Use of Tax Treaties

- Key considerations
  - Resident – need to be a resident to claim treaty benefits
  - LOB – prevent treaty shopping
  - Permanent Establishment
  - Business profits
  - Withholding

Use of Tax Treaties

- Business Profits – profits of a foreign partner must be attributable to a PE
  - E.g., Foreign partner's share of ECI
- PE
  - Office or other fixed place of business
  - Dependent agents and employees even if not working at a fixed place of business

Use of Tax Treaties

- "Last in time" rule.
  - SCOTUS has ruled that statutes and self-executing treaties that do not require implementing legislation to be given effect are of equal authority under the US Constitution so that "a treaty may supersede a prior act of Congress, and an act of Congress may supersede a prior treaty."
    - Last in time trumps – Whitney v. Robertson, 124 U.S. 190, 8 S. Ct. 456, 31 L. Ed. 386 (1888); Cook v. U.S., 288 U.S. 102, 53 S. Ct. 305, 77 L. Ed. 641, 1933 A.M.C. 209 (1933).

Use of Tax Treaties - Reporting

- Forms W-8
  - Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)
  - Form W-8BEN-E, Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)
  - Form W-8ECI, Certificate of Foreign Person's Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States

Use of Tax Treaties - Reporting

- Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)
  - Used by a taxpayer to make the treaty-based return position disclosure.

Basis & Bankruptcy

- Sec. 61(a)(11) provides that gross income includes cancellation of indebtedness.
- Sec. 108 provides an exclusion for a taxpayer where the CODI arises as a result of a discharge under Title 11.
  - Partnership: exclusion tested at the partner level for a bankrupt partnership.
  - Insolvent partner or partner in bankruptcy.
  - S Corporation: exclusion tested at the entity level (Congressional fix to Gitlitz, 531 U.S. 206 (2001)). Watch Sec. 357(c) if considering converting to an S Corporation; 2nd class of stock (see, e.g., PLR 201930023).

Basis & Bankruptcy – cont'd

- "Exclusion" is deferral
- Sec. 108(b) – cost of exclusion
- Sec. 1017 – reduction of basis
- Insolvency Exclusion
  - Excess of liabilities over fair market value of assets
  - Going concern value; not book or tax.
  - Exclusion to the extent of insolvency
  - Valuation required
  - Bankruptcy exclusion trumps insolvency exclusion

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Darren Mills focuses his practice on income taxation and bankruptcy. Throughout his career, Darren has been a frequent speaker on various tax topics. He also has authored numerous articles on tax law that have appeared in professional journals. Darren has taught graduate tax classes on estate and gift taxation, federal income taxation of trusts & estates, S corporations and corporate reorganizations.

Darren obtained his B.S. in accounting and J.D. from Seton Hall University. He has a Masters in Taxation from Fairleigh Dickinson University where he was inducted into Tau Alpha Chi, a national tax honor society. He also holds a CPA license in the States of Florida and New Jersey.

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