THE ATTEMPTED EXTRASTATUTORY APPLICATION OF "WITHHOLDING" UNDER SECTIONS 1441 AND 1446 IN RESPECT OF INCOME OF CERTAIN U.S. PERSONS, THE MYSTERIOUS NATURE OF THE SECTION 1446 "WITHHOLDING TAX" LIABILITY, CERTIFIABLE HYSTERIA PRECLUDING RELIANCE ON PAYEES' CERTIFICATES AND OTHER ANOMALIES

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A. "Withholding Tax": Term of Art or Oxymoron?

Much confusion appears to have found its way into the lore/law under Chapter 3 of the Code.[1] That this confusion exists may well stem from the use/misuse of the term "withholding tax," a term not defined in Chapter 3 or in the regulations promulgated thereunder. While the term is used in at least two separate provisions,[2] it is unclear that its meaning has been carefully considered by Congress or Treasury. Indeed, when used, it is often meant as a short-hand reference to taxes imposed by the Code on a non-U.S. person with respect to an item of income upon which such person is subject to tax under an operative provision of the Code[3] and which is required to be deducted and withheld by a person other than the person subject to tax thereon. For example, Sections 1441, 1442 and 1445 impose an obligation on one party to withhold taxes due from payments of amounts in respect of income or proceeds of a non-U.S. person subject to tax on the income in respect of that payment under Section 871, 881, 882 or 897. Thus, generally, the provisions of Chapter 3 (at the risk of perpetuating the confusion, referred to as the "withholding provisions"), which require one person to withhold taxes imposed on another (such other person sometimes referred to for convenience as the "recipient") operates as a statutory mechanism for the collection of the recipient's taxes, no different from wage withholding in its

[1] Sections 1441 through 1464. All reference to the Code are references to the Internal Revenue Code of 1986, as amended; and except as otherwise stated, all references to Sections are references to Sections of the Code.

[2] Sections 1444 and 1446.

[3] See, e.g., Sections 871, 881, 882 and 897.

application.[4] The person required to withhold taxes under Chapter 3 is referred to as a withholding agent.[5]

Of course, the actual withholding of taxes by the withholding agent is not a payment of the withholding agent's taxes,[6] nor may such withheld taxes be used as a credit against such person's tax liabilities.[7] Until a tax that has been withheld is applied to a recipient, a withholding agent may obtain a refund of excess withheld taxes.[8] Once such withheld taxes have been applied to a recipient, a withholding agent may no longer obtain a refund; however, the recipient to whom the tax has been applied is credited with such tax payment and, if the tax is withheld is in excess of such person's tax liability, may claim a refund therefor. A person who has not actually withheld a tax, but later pays the tax it should have withheld, may also seek a refund therefor to the extent such paid amount exceeds the liability.

The terms "withhold" and "withheld" are not defined. Apart from Section 1446,[9] the withholding provisions impose an obligation, inter alia, to deduct and withhold from a payment (or in the case of Section 1446 as applicable to publicly-traded partnerships,[10] from a distribution) or other amounts of income within the control of the withholding agent. As noted above, in each case where the withholding provisions apply, a person other than the withholding

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4 See Sections 3401 and 3402.

5 See Treas. Reg. §1.1441-7(a)(1).

6 See Sections 1462, 1464; Treas. Reg. §1.1464-1(a). Cf. Treas. Reg. §1.1461-2(a)(1). See S-K Liquidating Co. v. Commissioner, 64 T.C. 713 (1975).

7 Treas. Reg. §1.1462-1(a).

8 Section 1464; Treas. Reg. §1.1464-1(a).

9 Discussed infra.

10 Treas. Reg. §1.1446-4.

agent is the taxpayer with respect to the income which is the subject of the withholding.[11] Indeed, wherever the term "withhold" or "withheld" appears in the Code,[12] it is preceded by the phrase "deduct and" or "deducted and," as the case may be, implying that an actual or constructive payment[13] would be required to be made to a third party from which a tax would be required to be deducted and withheld.[14]

By contrast, Section 1446 in its current form imposes a "withholding tax" on partnerships with respect to effectively-connected income allocable to foreign partners. Except in the case of publicly traded partnerships, liability under Section 1446 may arise without regard to any actual distribution or payment.[15] The use in Section 1446 of the term "withholding tax" is somewhat confusing. Apparently, the term withholding tax, as used in Section 1446, was not intended to refer to taxes in respect of which there was a required deduction and withholding from a payment. That such a limitation is not intended may be inferred from the application of Section 1446 to publicly traded partnerships. Treas. Reg. §1.1446-4(a) provides: "A publicly traded partnership … must pay 1446 tax[16] by withholding from distributions to a foreign partner," implying that the withholding required by Treas. Reg. §1.1446-4 is the method for the payment

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[11] Cf. Treas. Reg. §1.1461-2(b) (regarding the limited ability to deduct and withhold from future payments and distributions). See Treas. Reg. §1.1441-2(d)(3) (regarding the effect of the payment of tax by a withholding agent that has failed to withhold); Amy Holding Co. v. Dasyure Ltd., 2000-1 USTC ¶50212 (E.D. La. 2000) (no offset against amounts due payee for the amount of tax the payor previously failed to withhold).

[12] Cf. Section 6672 (referring to the requirement to collect and account for a tax).

[13] See Treas. Reg. §1.1441-2(e)(1) (including in the general definition of the term "payment" payments made on behalf of or credited to the beneficial owner).

[14] See Treas. Reg. §1.1441-2(d)(1) and (2); cf. Treas. Reg. §1.1441-2(e)(3); but cf. Treas. Reg. §1.1441-2(e)(2).

[15] Section 1446(b). Compare Treas. Reg. §1.1441-2(d) (providing an exception to the withholding obligation in certain cases where there is no payment).

[16] The withholding tax imposed under Section 1446 is referred to in the regulations both as the Section 1446 withholding tax and the 1446 tax. See Treas. Reg. §1.1446-3(a)(i).

of the withholding tax imposed by Section 1446 on the publicly traded partnership. Clearer still, Treas. Reg. §1.1446-1(a) provides that (when the section is applicable) a partnership must pay a "withholding tax" under Section 1446. However, no distribution is required from which such Section 1446 tax is to be deducted. Such Section 1446 tax payment is creditable toward the tax liability of the beneficial owner of the income in respect of which the Section 1446 tax was required to be paid (i.e., the foreign partner).[17]

To be sure, to the extent the Section 1446 tax payment required to be made in respect of the allocation of income to a partner gives rise to a tax credit under Section 33, it could be argued that such credit should be treated as a payment to the person receiving the credit[18] in an amount equal to the credit. In this manner, the payment of the Section 1446 tax could be viewed as a payment or constructive distribution of the tax by the partnership to the person receiving the credit, from which distribution the tax that is credited to such person is deducted and withheld. Section 1446(d)(2), which, at least for certain purposes, treats the Section 1446 tax paid as a distribution to the partner receiving the credit, appears consistent with this approach.[19] Another possibility is that the Section 1446 tax paid by the partnership on account of income allocable to a partner and credited to such partner's capital account should be reflected as a debit to such partner's capital account. In either such case, as so viewed, implicit in the requirement to pay the Section 1446 tax and the crediting thereof is arguably a deduction and withholding of the Section 1446 tax paid, presumably by virtue of the effect of such payment on the capital account of the partner entitled to the credit.

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17 Treas. Reg. §§1.1462-1(b) and 1.1446-3(d)(2).

18 Cf. Treas. Reg. §1.1441-2(d)(3).

19 Treas. Reg. §1.1446-3(d)(2)(i).

Indeed, in certain circumstances, it would make sense to treat the Section 1446 tax paid by the partnership as a debit to the capital account of the partner receiving the tax credit. Suppose, however, the provisions of the partnership agreement do not treat such a payment of Section 1446 tax as a debit to the partner's capital account. For example, assume a partnership agreement provides that any Section 1446 tax paid by the partnership is to be treated as an advance or loan to the partner that would receive the credit, and is required to be repaid – either immediately or out of the next cash distributions. Under such a provision of a partnership agreement, arguably there would be no debit to the partner's capital account at the time of the payment of the Section 1446 tax; rather, the payment would result in the creation of a receivable from the partner obligated to repay. Of course, such debit would occur if the obligation to repay were satisfied out of a distribution or possibly if the partner defaulted on the partner's obligation to repay. In that case, it would seem that the payment of the Section 1446 tax would not necessarily amount to a deduction and withholding of tax by the partnership in respect of the partner. As another example, suppose the Section 1446 tax payment is made after the tax year concerned as a result of an audit adjustment. Further, assume that at the time of the payment the partner in respect of which the adjustment was made is no longer a partner and has no capital account to be debited. The newly finalized Section 1446 regulations deem a distribution to occur notwithstanding an obligation on the part of the partner to repay the Section 1446 tax for which it has received a credit. The reason given is administrative convenience.[20]

While as noted it is possible to argue that a deemed debit to a partner's capital account of the Section 1446 tax paid would serve as a basis for concluding that the payment of the Section 1446 tax is the equivalent of a deduction and withholding of such tax, such an analysis is not entirely satisfactory. A more satisfying rationale for such treatment of the payment of the

[20] See T.D. 9200, Final Section 1446 regulations, Explanation of Provisions at C(2) (May 16, 2005).

Section 1446 tax (in a non-publicly traded partnership context) is that the Section 1446 tax is a surrogate for the estimated tax imposed on the partner in respect of which the Section 1446 tax must be paid and that such estimated tax is imputed to the partner in respect of which the tax was computed.[21] By contrast, where Section 1446 operates to require the deduction and withholding of tax on distributions in the case of publicly traded partnerships,[22] it operates no differently than Sections 1441, 1442 and 1445. In that case, the Section 1446 tax required to be paid is limited by and deducted from distributions. In such circumstances, Section 1446 imposes an obligation to withhold and the implications for not doing so are clearly found in Section 1461.[23]

Not extending the application of Section 1461 to the failure to pay withholding taxes imposed under Section 1446 in cases other than with respect to publicly traded partnerships appears to make sense. As noted earlier, Section 1446 appears to impose liability to pay the Section 1446 tax on the partnership without regard to whether such tax was required to be deducted and withheld. Where a tax is required to be deducted and withheld under Chapter 3, the person required to deduct and withhold the tax is made liable therefor under Section 1461. Thus, unless one could read the Section 1446 tax imposed on effectively-connected income as a tax withheld from a deemed distribution,[24] section 1461 by its terms would not apply to the Section 1446 tax any more than it applies to the income tax imposed on a corporation by Section 11. If, however, Section 1461 applied to the Section 1446 tax imposed on the effectively-connected income of a non-publicly traded partnership allocable to non-U.S. partners, then it

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21 Treas. Reg. §1.1446-3(f).

22 Treas. Reg. §1.1446-4.

23 As well as in Section 6672.

24 See supra.

would seem that the liability imposed by Section 1461 on the partnership would be in addition to the liability imposed by Section 1446 unless one were to read Section 1446 as not imposing liability on the partnership, a difficult conclusion to reach on the wording.[25] The final regulations appear to ignore the distinction between when Section 1446 operates as a withholding tax and when it operates as a liability imposed on the partnership for payment of tax, which tax is imputed to certain of its partners.[26] Rather, the final regulations appear to assume that the liability for the payment of the Section 1446 tax computed by reference to effectively-connected income is a liability to deduct and withhold a tax.[27]

In light of the foregoing, it is significant that, without discussing the basis therefor, the final regulations provide that the liability for a failure to pay Section 1446 tax arises under Section 1461.[28] This interpretation could be read to suggest that in all cases Section 1446, similar to Sections 1441, 1442 and 1445, imposes no independent liability, notwithstanding that the statute (and as seen above, the final regulations) seem to suggest otherwise. Furthermore, applying Section 1461 to a failure to pay Section 1446 tax (where Section 1446 does not operate to require a tax to be deducted and withheld) appears to extend Section 1461 beyond the limits of its language. Interestingly, such apparent extension of Section 1461 appears in the regulations under Section 1446 rather than under Section 1461. To be sure, as noted above, it may be

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[25] See Treas. Reg. §1.1461-3 (first sentence). Purists might argue that Section 1446 by its terms will not impose liability on the partnership unless and until the final regulations come into effect and so provide. Section 1446(a); see, e.g., Berg, Limitations on Partner-Level Deductions Affect Partnership Withholding, 4 J. S Corp. Tax'n 100, 101 & n.10 (1992). But in that case there could be no liability under Section 1461 for failure to do what is not required.

[26] But see Treas. Reg. §1.1461-1(a)(1) drawing a procedural distinction.

[27] See the references inter alia, Treas. Reg. §1.1446-3(e)(1), to Section 1463, which limits the imposition of the tax and/or penalty under Section 1461 where taxes which have been required to be deducted and withheld have been paid by the person taxable on the income in respect of which the withholding has been made.

[28] Treas. Reg. §1.1446-3(e)(1); Temp Reg. §1.1446-6T(d)(iii). See also Rev. Proc. 92-66, 1992-2 C.B. 428, Section 2; Rev. Proc. 89-31, 1989-1 C.B. 895, Section 4.02. Rev. Procs. 92-66 and 89-3will be rendered obsolete by the final regulations once they become effective. T.D. 9200, Effect on Other Documents (May 16, 2005).

possible to argue that the requirement to make a Section 1446 tax payment, even in the non-publicly traded partnership context, is, in effect, an obligation to deduct and withhold an amount equal to the tax credit allocable to a partner. Whether such an argument would prevail may well have far larger tax implications for those falling within the scope of Section 6672.

Section 6672 operates as a backstop to, inter alia, Section 1461. It imposes a penalty on any person required to "collect, truthfully account for, and pay over" any tax under the Code equal to 100% of the tax not withheld (or withheld and not paid over) if such failure was willful.[29] Section 6671(b) applies the penalty imposed by Section 6672 to what has become known as a "responsible officer," including a member or employee of a partnership (subject to the requirement to withhold) having the duty and authority to cause the withholding.

It should be noted in this connection that if the Section 1446 tax were a tax required to be deducted and withheld, then it would seem to follow that not only would the partnership that was remiss in its obligations under Section 1446 be liable for the Section 1446 tax it failed to pay,[30] each managing member of the partnership (e.g., the managers of a limited liability company) would potentially be personally liable under Section 6672. This potential burden may be particularly onerous when one considers that the Section 1446 tax may be imposed on so-called phantom income (i.e., in the absence of any cash income from which the Section 1446 tax could have been deducted),[31] or on the effectively-connected income realized by an arrangement not in partnership form but later determined to be a partnership for federal income tax purposes.

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[29] Treas. Reg. §301.6672-1; see Treas. Reg. §§1.1441-1(e)(3)(iv) and 1.1445-1(e)(2)(i); In re Smith, 99-2 U.S.T.C. ¶50,998 (D. Haw. 1999).

[30] But see Treas. Reg. §1.1446-3(e)(1).

[31] See T.D. 9200, Explanation of Provisions at B(1) (May 16, 2005) and generally Treas. Reg. §1.1446-2.

It is not entirely clear what the new final regulations say on this subject. At first glance, Treas. Reg. §1.1461-3 assumes that for years beginning after the publication of the final regulations, Section 6672 may apply both to a failure to pay the Section 1446 tax imposed on the effectively-connected income of non publicly-traded partnerships and on a failure to pay the Section 1446 tax imposed on distributions by publicly-traded partnerships. Specifically, Treas. Reg. §1.1461-1(a) (1) refers to Treas. Reg. §1.1461-3 for penalties applicable for non-compliance with Section 1446 tax obligations. Treas. Reg. §1.1461-3 refers to Section 6672 as one of the penalties that may apply to a failure to pay Section 1446 tax on effectively-connected income to the extent set forth in Section 6672 and the regulations promulgated thereunder. This, of course, brings us full circle: Treas. Reg. §1.1461-3 seems to suggest that Section 6672 applies to the extent it applies and with this fountain of wisdom we will most certainly be able to assure many managing members of partnerships.

Of course, one could write off this concern with an adaptation of the U.S. advice given to withholding agents (did I really use that term) -- when in doubt withhold -- simply by changing the word "withhold" to "pay" when it comes to the Section 1446 tax. No doubt that will be comforting to the person who may be a responsible officer within the meaning of Section 6672 if there are no funds out of which to pay the Section 1446 tax. The technicians among us might suggest were that to be the case, it would seem that one of the essential elements for the application of the penalty under Section 6672, i.e., willfulness, would be lacking. But suppose there were some funds, for example, enough funds to pay the Section 1446 tax on the effectively-connected income allocable to foreign partners, but no more. I will assume further, just for fun, that the partnership agreement provides that all distributions must be made pro-rata and there is at least one partner who is a U.S. person. Section 1446 requires that all of the funds go to pay

the Section 1446 tax and the foreign partners get a credit therefor. If Section 1446 is complied with, the U.S. partners get nothing. Could not the U.S. partners claim that the Section 1446 tax payment is a non-pro-rata distribution to the foreign partners in violation of the agreement? Obviously, that there may be other creditors of the partnership, including a U.S. partner entitled to a distribution, with competing claims for the cash necessary to pay the Section 1446 tax would not be a good defense against a claim of willfulness for the failure to pay.

B. Does Section 1461 Impose a Tax, or a Penalty?

As has been noted above, there is some confusion regarding the provision which imposes liability for the Section 1446 tax. The two likely suspects are Sections 1446 and 1461. If we were to read only the Code, an inference could be drawn that the Section 1446 tax is imposed by, of all things, Section 1446. There are similar suggestions in the regulations,[32] as well as contrary statements indicating that the liability is not imposed by Section 1446 itself, but rather by Section 1461.[33] Certainly, the liability for a failure to withhold under other provisions of Chapter 3 (e.g., Section 1441) is imposed by Section 1461 and presumably not by the provisions which require the withholding. Indeed, the liability is imposed under Section 1461 for a failure to do what the provisions of Chapter 3, which require that a tax be deducted and withheld, require. The regulations promulgated under Section 1461 generally provide the rules applicable to the payment over, the accounting for and the return filing requirements for the tax required to be withheld under Sections 1441, 1442, 1445 and so much of Section 1446 as relates to publicly-traded partnerships. However, the procedural rules relating to the payment and return of the Section 1446 tax other than in the case of publicly-traded partnerships are not found in the

[32] See, e.g., Treas. Reg. §1.1461-3 (first sentence).

[33] Treas. Reg. §1.1446-3(e)(1) (a partnership is made liable for the Section 1446 tax by Section 1461).

regulations under Section 1461,[34] but rather in the regulations under Section 1446.[35] What does one make of all this? Perhaps little.[36]

It would seem much the better (and perhaps an old fashioned) way of looking at things to consider the liability imposed by Section 1461 to be akin to a penalty which may be imposed in the circumstances indicated for bad action, rather than as a strict liability for taxes. Indeed, this seems the basis for the authorities which early on had indicated that no liability would be imposed where the withholding agent had reasonably relied on an appropriate certificate indicating that withholding would not be required.[37] This type of thinking has been the basis for the lengthy regulations under Section 1441 regarding certifications.[38] Furthermore, the liability cannot be imposed if the tax is paid[39] or if no tax is due from the recipient.[40] Nor can interest be imposed in such case.[41]

In general, a withholding agent may rely on the information contained in a certificate unless it has actual knowledge or reason to know that such certificate is untrue.[42] Reason to know is defined as knowledge of relevant facts or other statements in the certificate such that a reasonably prudent person in the position of the withholding agent would question the claims

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34 Treas. Reg. §1.1461-1(a)(1).

35 Treas. Reg. §1.1446-3.

36 See Houston Street Corporation v. Commissioner, 84 F.2d 821, 36-2 USTC 9423 (5th Cir. 1936) ([P]etitioner was made liable for the tax imposed on the nonresident aliens. We see no distinction between the phrases "liable for such tax" and "subject to tax.")

37 See Rev. Rul. 70-175, 1970-1 C.B. 184; cf. Aiken Industries, 56 TC 925 (1971) (regarding reliance, but in which the Court found that the reliance was not reasonable).

38 See, e.g., Treas. Reg. §1.1441-1(b)(2).

39 Section 1463; Treas. Reg. §1.1441-1(b)(7)(i)(B).

40 Casanova Co. v. Commissioner, 87 T.C. 214 (1986), acq. 1990-2 C.B. 1.

41 See ILM 200, 521031, 2005 TNT 103-18. But cf. Treas. Reg. §1.1441-1(b)(7)(iii).

42 Treas. Reg. §1.1441-1(e)(4)(viii).

made.[43] At least with respect to a claim of U.S. status or reduced rate, a notification by the IRS that such claim of U.S. status (or reduced rate) is incorrect constitutes actual knowledge, but only beginning 30 days after the receipt of such notice.[44]

Thus, in the case of Section 1441, a withholding agent that has received proper certification and who is not precluded from relying thereon (i.e., has no reason to know or actual knowledge that such certification is incorrect) is not liable under Section 1461 even if it turns out such certification was not correct and withholding was required. In essence, except where the withholding agent may not rely thereon, the withholding agent may use the receipt of an appropriate certificate as a defense to the imposition of Section 1461 liability.

Similarly, for purposes of the Section 1446 tax, with one exception discussed below, a partnership may rely on an appropriate certification to the effect that a partner is a U.S. person in the absence of actual knowledge or a reason to know the certification is false.[45] Reason to know for this purpose is defined in the same manner as for Section 1441.[46] However, there does not appear to be any direct statement that for purposes of Section 1446 IRS notification regarding U.S. status constitutes actual knowledge such that reliance could no longer be possible. It may be that in an appropriate circumstance such notification may of itself constitute a reason to know.

C. Extension of the Scope of Section 1446 by Regulation to Certain Domestic Trusts

In the latter connection, a domestic trust[47] is included within the term U.S. person and as such may provide a Form W-9 and thereby be treated as a U.S. person by the withholding agent.

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43 Treas. Reg. §1.1441-7(b)(2).

44 Treas. Reg. §1.1441-7(b)(1).

45 Treas. Reg. §1.1446-1(c)(iii)(A).

46 Treas. Reg. §1.1446-1(c)(iii)(B).

47 Section 7701(a)(30).

For purposes of Section 1441, such a certificate may be relied upon absent the proscribed knowledge or reason to know. A partnership receiving a Form W-9 from a domestic trust generally may also rely thereon. The final regulations under Section 1446 provide that if the domestic trust is a grantor trust, the grantor or owner of the trust must provide the appropriate certification.[48] While such requirement is clear enough, it is unclear how that requirement may affect a partnership where in fact the trust has not complied and the partnership neither had knowledge nor reason to know of the grantor trust status of the trust. Presumably, the partnership will not be held accountable for a violation by the trust to provide the required information in the absence of the proscribed knowledge, nor would the partnership have a duty to inquire, let alone an obligation to require production of the trust documents.

If a domestic trust were not a grantor trust, then it would seem such trust could not be a foreign person with respect to whom any Section 1446 tax would be due at least under the statutory provision. Moreover, this appears to be true regardless of whether the trust was a simple or complex trust and regardless of the residence of the beneficiaries. If a non-grantor domestic trust were a partner in a partnership, it would seem, therefore, that Section 1446 could have no application to the income allocated to such partner. Of course, any nonresident alien beneficiary of such trust would be considered engaged in a U.S. trade or business of a trust which were so engaged.[49] And a trust which was a member of a partnership that was so engaged, would be so considered.[50] However, such trust would be liable for U.S. income tax under Section 1 on its income, if not distributed or required to be distributed currently by such

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[48] Treas. Reg. §1.1446-1(c)(2)(ii)(E).

[49] Section 875(2).

[50] Section 875(1).

trust.[51] A subsequent distribution of income not distributed currently, in excess of the current year's trust income, would not again be taxable to the beneficiary. Of course, distributions by a trust to the extent of current income are deductible by the trust and includible in income by the beneficiary. Such income has the same character to the beneficiary as it had to the trust. Thus, a current distribution of effectively-connected income to a nonresident alien beneficiary would constitute effectively-connected income to such beneficiary taxable at the rates prescribed by Section 1. The beneficiary would be required to file a tax return and pay tax on any such distribution and may also be required to pay estimated taxes. However, neither Section 1446 nor any other provision[52] requires the domestic trust to withhold on any such distribution.

As noted above, if there had not been a current distribution by the trust to the nonresident alien beneficiary, the trust would pay tax on its allocable share of partnership income and, subject to ordinary rules, the nonresident alien should not pay any tax with regard thereto.

Following the approach first set out in the proposed regulations, Treas. Reg. §1.1446-3(d)(2)(iii)(B) appears to attempt to extend the scope of Section 1446 so that at least in certain, possibly rare, circumstances it could be applied to require a partnership to pay Section 1446 tax with respect to the effectively-connected income of a domestic trust as if it were a foreign trust. In order for such obligation to arise, the partnership must know or have reason to know that a foreign person holds its interest in the partnership through a domestic trust which was formed or availed of with a principal purpose of avoiding the Section 1446 tax.

The only possible basis in Section 1446 for this regulation is the language all too frequently used in the Code contained in Section 1446(f) – the Secretary may prescribe such

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[51] See generally, Feingold, The Complex Domestic Trust, a Potential Vehicle for Reducing the Tax on U.S. Source Non-Effectively Connected Dividend Income of Non-U.S. Persons and Capital Gains of Certain Corporations? (The Tax Club, September, 2003)

[52] See Section 1441(c).

regulations as may be necessary to carry out the purposes of Section 1446. One might ask what is the Section 1446 purpose sought to be carried out by this particular regulation. Certainly not that a partner which itself is a transparency may be disregarded, since Section 1446 does not apply to a partner that is a domestic partnership absent an election otherwise. And in any event, apart from grantor trusts, trusts generally are not transparencies. They are taxable entities which may or may not obtain a deduction in respect of distributions. But even if one were to assume a domestic simple trust is close enough to a transparency that it should be considered as such, that would prove only that perhaps Section 1446 needs to be expanded to treat at least certain domestic trusts in the same manner as partnerships. Of course, this would require an amendment to the statute, and could not be imposed by regulation.

Moreover, it is unclear when a partnership could ever have sufficient knowledge to determine whether a domestic trust were formed or availed of within the proscribed purpose. Surely it could not be that partnerships will be required to insist that any partners that are domestic trusts certify the status of their beneficiaries as there is nothing in the regulations which seems to so require. Perhaps the regulation was directed against the possible use of complex domestic trusts to get around the absurdity of 30% withholding on U.S. source dividends which are taxable to U.S. individuals at a 15% rate.[53]

The above suggests that Treasury may have gone somewhat overboard and that this provision may not be enforced except in the most egregious cases. Egregiousness, like beauty, is the eye of the beholder.

Suppose a nonresident alien wished to invest in a partnership that is engaged in a U.S. trade or business and the partnership, to avoid the onerous provisions of Section 1446, suggests the nonresident alien participate through a domestic trust. It is fairly easy to avoid grantor trust

[53] See Feingold, supra note 51.

status for a nonresident alien,[54] for example, by ensuring that the settlor and his spouse are not the sole beneficiaries and by ensuring that the trust is not revocable. The suggestion, if implemented, would ostensibly avoid Section 1446 as to that partner. This may well be the case sought to be caught by the regulations. The partnership would have actual knowledge of its suggestion for the use of a domestic trust and the suggestion was made for its convenience to avoid being burdened with Section 1446. A principal purpose of the suggestion was to permit the domestic trust to be availed of to permit the partnership to avoid Section 1446. But the avoidance of Section 1446 may have no beneficial effect on the domestic trust. Whose principal purpose counts for purposes of this regulation? In any event, notwithstanding the suggestion, the partnership may not have any knowledge of the terms of the trust or indeed who the beneficiaries are. Nor am I certain what the partnership might suppose as a principal purpose if there were both U.S. and non U.S. beneficiaries and the trust provided for discretion regarding distributions.

[54] See Section 672(f).

D. Arbitrary Notice that U.S. Status Not to be Relied Upon

In general, a U.S. corporation is entitled to provide a Form W-9 claiming its status as a U.S. person not subject to withholding under Chapter 3. Significantly, however, as has been noted above, Treas. Reg. §1.1441-7(b) provides that notification by the IRS that a claim of U.S. status is incorrect constitutes actual knowledge after 30 days that a claim of U.S. status is not to be relied upon.

Consider the case of a U.S. corporation which furnishes the services of its employees to a third party and is contractually entitled to receive from the third party U.S. source compensation for such services. Further assume that one or more of the employees whose services are being furnished is (or may be) a nonresident alien. If the U.S. corporation were an agent of the employee providing the services, rather than a principal in the transaction, and such employee were a nonresident alien, the payment to the U.S. corporation would constitute the gross income of the employee subject to tax under Section 871(b) and withholding under Section 1441.[55] By contrast, if the U.S. corporation were a principal in the transaction, income to which it is entitled under its agreement with such third party would not be subject to withholding under Chapter 3. Of course, the U.S. corporation would have to withhold U.S. federal income and employment taxes on the payment of wages to its employees. That withholding is imposed under provisions other than Section 1441. [56]

In a case where a nonresident alien performs services in the U.S. as an independent contractor, payments of compensation for such services would subject the nonresident alien to tax at the regular U.S. tax rates; and the payor would be required to deduct and withhold a tax of 30% of the gross amount under Chapter 3. Treas. Reg. §1.1441-4(b)(3) allows for a reduction of

[55] See Treas. Reg. §1.1441-1(b)(2)(ii).

[56] See, e.g., Section 3402.

the amount of tax which is required to be withheld under Chapter 3 in such circumstance to an amount more closely approximating the nonresident alien's tax liability provided an agreement (the so-called "central withholding agreement") is entered into pursuant to that section.[57] Since the procedures for entering into central withholding agreements apply exclusively in the context of reducing or eliminating the withholding otherwise required by Section 1441, these procedures could have no application to payments by third parties to a U.S. corporation providing services of its nonresident alien employees unless the U.S. corporation were an agent of such employees.[58] Nor, generally could Chapter 3 have any application to compensation paid to employees for services in the U.S.

Faced with the dilemma that Chapter 3 does not apply to payments to U.S. corporations that are not agents and that the procedures for entering into central withholding agreements would have no application to nonresidents whose services are being furnished by U.S. companies which employ them absent an agency relationship, the Service has appeared to adopt an informal "policy" at least with respect to foreign entertainers and athletes which can be described only thusly:

1. Unless a U.S. corporation employing a nonresident alien entertainer or athlete which may be in control of such corporation agrees to enter into an agreement with the Service regarding withholding in form and substance satisfactory to the Service and provide certain information regarding its projected receipts and expenditures, the Service will (threaten to) issue a notification ostensibly pursuant to Treas. Reg. §1.1441-7(b) to the effect that the claim of U.S. status by such corporation is to be disregarded and that a payor of U.S. source

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[57] See Rev. Proc. 89-47, 1989-2 C.B. 598.

[58] Treas. Reg. §1.1441-1(b)(2)(ii).

compensation to such company must deduct and withhold a tax at a 30% rate thereon or face liability under Section 1461.

2. The alleged basis for the notification is that if the U.S. corporation is providing services of one or more nonresident alien individuals who are in a position to control the company, then without regard to any other facts (and without regard to the law[59]) such company will ipso facto be regarded as an agent of the nonresident alien individuals whose services are being provided.

3. The Service will not entertain or, if entertained, will generally ignore any submissions provided for the purpose of establishing in a given case that the U.S. company is the employer, rather than the agent, of its nonresident alien employees. Moreover, this is true regardless of the record of past tax compliance.

4. Almost unbelievably, the Service will not also view such a U.S. company as an agent of its employees who may be U.S. citizens or who are considered U.S. residents under Section 7701(b).

5. The Service will, however, enter into an agreement, the details of which are a matter of some negotiation, pursuant to which they will agree not to provide such a notification and further to notify any third party that withholding under Chapter 3 is not required on payments to such company.[60] Such a "clear payment notice" in effect becomes the certification upon which the third party may rely, although it is unclear that any third party would be wise to forgo receiving a Form W-9 in addition.

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[59] See Sargent v. Commissioner, 929 F.2d 1252 (8th Cir. 1991), and cases cited therein; Johnson v. Commissioner, 78 T.C. 882, 890 (1982), aff'd, 734 F.2d 20 (9th Cir.), cert. denied, 469 U.S. 857 (1984); Fogelsong v. Commissioner, 621 F.2d 865 (7th Cir. 1980); Pacella v. Commissioner, 78 T.C. 604 (1982).

[60] As to why such notification may be necessary, see below.

6. The Service will not point to a statutory or any other basis for entering into any such agreement. Nevertheless the Service is willing to acknowledge in writing that they have such authority although it seems clear they do not. The Service acknowledges that they deem the agreement to be necessary regardless of whether jeopardy for payment of taxes exists. Indeed, the Service has informally acknowledged that they would be hard-pressed to rely on or obtain the relief they wish under the jeopardy or termination provisions of the Code, nor apparently do they wish to be restricted to the rights given taxpayers under those provisions. Rather, they wish to rely on the *in terrorem* effect of the threatened notification.

7. While as noted, certain of the terms (and indeed some terms of some significance) are a matter of negotiation, certain provisions are generally included.

(a) An independent U.S. person of substance, for example, an accounting firm, must accept the responsibility to withhold taxes on the payments the company makes to its nonresident alien employees. (If pressed, it will be acknowledged that those taxes will be withheld pursuant to the provisions of Section 3402, not Section 1441.)

(b) Projections of income must be provided as well as copies of relevant agreements.

(c) Copies of all payments of taxes withheld required under the agreement must be forwarded to the Service personnel administering the program.

(d) Regardless of the contractual arrangements, payments generally must be made before the end of the calendar year in which services are performed by the employees of the U.S. company at least to the extent the U.S. company has realized net income before deducting salary to its employees.

(e) An accounting of the company's income and expense must be provided before year end.

(f) The Service may review the figures provided, generally over some short period of time, and disallow certain expenses thought to be compensatory; if the parties disagree regarding such disallowance they may negotiate in good faith to resolve the differences but ultimately the Service can require "withholding" on what they believe the amount and source of the income of the nonresident alien employee to be. The Service will not enter into an agreement unless it contains a provision to the effect that the limited review referred to above does not constitute an audit for the purposes of the second audit proscription.

Not only has the Service "quietly" adopted the above policy, it is understood that certain large purchasers of services have been told by the IRS on audit that withholding on payments to U.S. companies providing services of nonresident individuals was required even where they had previously received an appropriate Form W-9, had no proscribed knowledge or reason to know and had not received the notification referred to above. One obvious *in terrorem* effect of these audits was to ensure that the large purchasers of services would not enter into any agreement with service providers in the future without in effect requiring the U.S. company service provider to seek a clear payment notice pursuant to an agreement with the Service along the lines described above.

If, as has been suggested above, there is no basis for entering into such an agreement, why do so? Could the Service issue a notice to disregard a Form W-9 provided by a U.S. corporation where it has no basis for reasonably believing that the U.S. corporation is to be regarded as an agent of its nonresident alien employees? Assume for the moment (only because it is true) that the only basis the Service is willing to put forth to support its agency theory is that

all personal service companies owned or controlled by nonresident aliens are as a matter of law agents for such nonresident alien individuals. Under the line of cases referred to above, there is no basis for such a legal conclusion. Could the Service then back-track from its broad legal posturing and state that in the particular case it does not have sufficient information to rule out an agency theory? While such an argument might have some merit if the Service were to require information and none was forthcoming, it is difficult to see how there can be any justification for refusing to look at any documents or information submitted which may be relevant. Moreover, it appears that if the most the Service can say is that they do not have sufficient information to rule out an agency, that should not be enough for them to issue a notice. At best as we can understand it, the Service's view appears to be that unless an agreement along the lines is entered into, they have a reasonable justification for believing a U.S. company furnishing a Form W-9 is doing so in bad faith and is an agent, but if such agreement were entered into there is no longer such justification. Thus, the only information that will convince the Service there is no reasonable justification for issuing the notice is an executed agreement for which there is no statutory or regulatory authority.

Effectively requiring such an agreement, where none is required under the applicable regulations, and using the absence of such agreement as the only justification for a notice appears to be a violation of the regulations which provide for a certification process. Certainly, it could not be, and to the Service's credit the Service has not been willing to admit (out loud), that the Service may issue such a notice when it has no reasonable basis therefor. Thus, it would appear that the issuance of a notice without a reasonable basis therefor would be a violation of the regulations which the Service is required to follow.

Not too long ago the Supreme Court[61] reminded the Tax Court that although it had some leeway in interpreting its own rules, it was required to follow its own rules and could not unreasonably interpret them to convey that which they were not meant to convey. If, as appears, the Service's new policy is to treat U.S. corporations providing the services of certain nonresident aliens (i.e., entertainers and athletes) differently from others where there is no distinction in the law or in the regulations which would allow the Service to do so, the policy appears suspect.[62]

E. Reliance Upon Which No One Can Rely Upon – The -6T Regulations

Section 1446 requires that a Section 1446 tax be computed by reference to the effectively-connected income allocable to non-U.S. partners multiplied by the applicable tax rate for the income in question. There is nothing in Section 1446 which permits a partnership to take into account losses or other deductions of a partner which could reduce such partner's tax liability or take into account estimated tax paid by such partners. Indeed, the Section 1446 tax creditable to a partner may reduce the estimated tax due and payable by a partner, but not the other way round.

Thus, under the statute, there is no mechanism for a non-U.S. partner who has had net operating losses which may be carried over to the current year to use these losses to reduce the Section 1446 tax required to be paid with respect to effectively-connected income allocable to such partner for the current year. Temp. Reg. §1.1446-6T provides a mechanism which purports to permit in limited circumstances a reduction in the Section 1446 tax which is required to be

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[61] Ballard v. Commissioner, 544 U.S. __ (2005). While Ballard directly appears to go to the issue of whether a court may, or may not, deviate from its own rules, that the Court chose to support its holding by citing to two of its prior cases in which it held that an administrative agency must follow its published rules suggests there is a common set of policy regarding violations by a Court or an agency of its own rules, and thus the lessons of Ballard should apply to administrative agencies such as the Service. Cf. U.S. v. Caceres, 400 U.S. 741 (1979).

[62] See also U.S. v. Kaiser, 363 U.S. 294 (1960), concurring opinion of J. Frankfurter (the Service cannot tax one and not tax another without some rational basis for the difference).

computed in respect of certain partners which are the subject of the Section 1446 tax. However, as will be described below, the mechanism provided must obviously have been intended as one that would be used very rarely, if ever.

If a qualifying partner has timely filed or will timely file a tax return for each of the four years preceding the tax year in question (but not less), has paid or will pay all tax shown on such returns and files a certificate with the partnership more than 30 days prior to the due date for a Section 1446 installment regarding the amount and nature of losses to be taken into account (not including any anticipated loss for the current year) all of which losses have been or will be reflected on a prior year's tax return, then the partnership may, but is not required to, take such losses or deductions into account in computing the Section 1446 tax in respect of such partner.[63]

Reasonable reliance on a certificate provided to the partnership under this temporary regulation relieves the partnership from the estimated tax penalties under Section 1446,[64] but not the "1446 tax under Section 1461" nor any interest or other penalties[65] if the IRS in its sole discretion determines the certificate is invalid because, e.g., the required number of tax returns has not been filed.[66] If the determination by the IRS is that the losses set forth on the certificate are excessive, then the partnership's liability for the tax is limited to the Section 1446 tax on the excess losses.

Conspicuously absent from the regulation is any express requirement for such IRS determination to be furnished to the partnership. If the IRS makes the determination, then the tax was due. While one would assume the Service will notify a partnership as soon as it has made a

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63 Temp. Reg. §1.1446-6T. But not more than 90% of the partner's net operating loss deductions may be taken into account. Temp. Reg. §1.1446-6T(d)(1)(iii).

64 Temp. Reg. §1.1446-6T(d)(2).

65 Temp. Reg. §1.1446-6T(d)(2)(iii).

66 Id.

determination, there is nothing in the temporary regulations which appears to require it to do so at all, let alone timely. Would a partnership otherwise having a right to rely on a certificate be able to argue an estoppel against the Service for not timely notifying it of a determination? That may depend on whether one views the Section 1446 tax imposed under Section 1461 as a penalty or a tax. For those voting for the former, an estoppel argument may be in order.

Note that the temporary regulations provide that the determination by the IRS may be made within the sole discretion of the Service.[67] Notwithstanding that the words "sole discretion" are typically used in agreements to mean the party having such discretion may exercise it unreasonably or arbitrarily, it is unclear the regulations permit (or could permit) such discretion to be used arbitrarily, and indeed the temporary regulations seem to imply that the Service should not do so.[68] Nevertheless, that the partnership will be held liable for the Section 1446 tax with respect to a certificate which is defective, or for excess deductions, even though it had reasonably relied on such certificate suggest strongly that no partnership should ever willingly agree to accept any such certificate, particularly in light of the uncertainty regarding the exposure of the managing partner to personal liability. Indeed, one might suspect that the -6T temporary regulations were intentionally drafted so as to encourage nonacceptance of the certificate prescribed therein. For example, there is no implicit requirement for a partnership to accept the certificate; it or the Service in the exercise of its sole discretion may reject it.[69]

As noted above, there may be implied limits to the Service's determinations under -6T. Quite likely there also could be implied limits to the nonacceptance by a partnership absent a

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[67] See the discussion supra regarding the notice under Treas. Reg. §1.1441-7(b).

[68] See Temp. Reg. §1.1446-6T(c)(3)(i) (referring to a determination made on audit or otherwise by the Service that it lacks sufficient information to determine if the certificate is defective after written request to the partner for verification of the statements on the certificate).

[69] See T.D. 9200, Explanation of Provisions at G(3) (May 16, 2005) (partnership not obligated to consider the certificate).

clear entitlement to do so under an appropriate provision of a partnership agreement. Partnership agreements which do not provide for such absolute right of the partnership not to accept a certificate under -6T may present partnerships with a more difficult issue, particularly where the partnership agreement provides for the payment back to the partnership by a partner of any Section 1446 tax paid in respect of such partner, the partnership is suitably secured in respect of such payment obligation, and the partner is willing to provide all information that would be necessary to determine whether such partner may provide the certificate and the amount and nature of the losses the partner wishes to be taken into account. One might want to consider whether a provision in a partnership agreement which covers the repayment of taxes paid in accordance with Section 1446 covers the tax/penalty imposed under Section 1461. Such a payment obligation may be in the nature of an indemnity and there is at least some uncertainty as to whether indemnities for failure to withhold (did I use that term?) are enforceable without any express provision permitting such enforcement[70] or are unenforceable as against public policy. In any event, who should bear the cost of the review of such information and the consideration of these issues will no doubt be the subject of interesting conversation.

F. Conclusion

So we end this paper where it begins. A state of confusion exists regarding the nature of the liability imposed by Section 1461 as a tax strictly imposed or as a penalty not to be imposed in the event the requirements of the withholding provisions are observed in good faith. At least insofar as the application of Section 1461 to withholding required by Sections 1441, 1442 and 1445 are concerned, the liability under Section 1461 for the tax appears more like a penalty for bad action.

[70] See Amy Holding Co. v. Dasyure Ltd., supra.

The Section 1446 tax imposed in the case of the effectively-connected income allocable to non-U.S. partners of non publicly-traded partnerships literally does not appear to fall under Section 1461, even though the regulations clearly say otherwise; and indeed it may be possible to stretch the application of the Section 1446 tax in such case to meet the requirement of a tax required to be deducted and withheld, absent which requirement there could be no liability under Section 1461 or for that matter Section 6672. The potential application of Section 6672 to the Section 1446 tax in a non publicly-traded partnership context will no doubt raise a whole host of concerns for persons who fit within the responsible person definition of Section 6671(b), not the least of which is how to deal with the competing interests of U.S. and non-U.S. partners and their own personal exposure. At the minimum, partnership agreements may have to be reviewed to ensure there is adequate discretion reserved to a partnership to reject, perhaps without consideration, a certificate offered under -6T of the temporary regulations and to protect against subsequent audit adjustments.

The attempted (blatant) extension by regulation of the scope of Section 1446 to non-grantor U.S. trusts may yet raise additional strains on the relationships among partners, and between partnerships and their managing members, in circumstances where it is extremely unlikely that the concerns sought to be remedied are likely to obtain, or even if they did, could be remedied by regulation, let alone the wording of the regulation which purports to deal with it.

The "sole discretion" on the part of the Service in connection with the enforcement of the -6T temporary regulations is bound to lead to disputes and potential litigation absent reasonable restraints on its exercise. Similarly, the current attempt to ignore existing law regarding the efficacy of personal service corporations insofar as services of certain nonresident aliens are

concerned not only is not in accord with the case law, it is bad policy and potentially subject to challenge under the authorities cited above.

And where did at least some of this confusion start? Perhaps within the inartful use of the term "withholding taxes" without consideration of its meaning, and from this humble beginning we have proceeded. So I fear this tale of withholding taxes –

> " I shall be telling with a sigh
> Somewhat ages and ages hence:
> Two roads diverged in a wood, and I
> I took the one less traveled by,
> And that has made all the difference."[71]

[71] Excerpt from Frost, "The Road Not Taken."