

Reducing Withholding On Nonresident Alien Partners By Utilizing Individual Partner Losses

Executive Summary



US partnerships with foreign partners may now avoid overpaying withholding taxes on effectively connected taxable income by utilizing new IRS regulations.

Discussion

Treasury regulations now allow, under certain circumstances, for foreign partners to certify deductions and losses to a partnership in order to reduce the withholding tax imposed under Internal Revenue Code Section (IRC Sec.) 1446. Moreover, the regulations now permit partnerships to consider the relevant type of income or gain when determining the highest rate of tax to apply against the effectively connected income.

Generally, IRC Sec 1446 requires a partnership, which has effectively connected income from a trade or business conducted in the U.S., to pay federal income tax on each foreign partner's share of such effectively connected income. Under previous regulations, partnerships were required to withhold U.S. taxes at the highest marginal rate without consideration of the types of income or the availability of other deductions or losses of the various foreign partners. Accordingly, it was quite often the case that nonresident alien partners found themselves overpaid.

Under regulations issued in 2005, foreign partners who have certified to the partnership their status as foreign partners and have filed U.S. income tax returns and paid any amounts due for the previous four years are permitted to certify deductions and losses to the partnership in order to reduce the tax imposed under IRC Sec. 1446.¹

Provided these requirements are met, foreign partners must submit their certifications thirty days prior to an

instalment due date. For example, a calendar-year domestic partnership generally must receive certification from a foreign partner on or before March 16th for the partnership to consider it for its first instalment due date of IRC Sec 1446 tax on April 15th. While no specific form is required for the certification, certain information is required.²

A law firm partner may certify that he/she has deductions and losses, including the character of the deductions and losses (e.g., ordinary, capital), other than charitable deductions, from the partnership. The partner must reasonably expect these deductions to be available to reduce the partner's U.S. income tax liability on the partner's allocable share of effectively connected income or gain from the partnership for the partner's taxable year. A partner may not consider anticipated losses or deductions. Further, the foreign partner must certify that the deductions and losses are connected with gross income which is effectively connected with the conduct of the partner's trade and business in the US. The foreign partner may certify a loss suspended due to a prior basis limitation.

A foreign partner can also certify that he/she has deductions and losses and the character of those deductions and losses, other than charitable contributions, from sources other than the partnership that the partner reasonably expects to be available to reduce the partner's US income tax liability. The foreign partner must certify that the deductions and losses are connected with the conduct of the partner's trade or business in the US.

¹ If a foreign partner's U.S. Federal Income Tax return for a preceding year has not been filed at the time that the partner submits his/her first certification, the partner needs to set forth the due date and submit an updated certification within ten days after filing the return.

² Required information includes the partner's name, address, taxpayer identification number, date, name of the partnership and the partnership taxable year for which the certificate is submitted. Additionally, the certification needs to represent status as foreign partners and that the partner has timely filed U.S. income tax returns and paid any amounts due for the previous four years. Further, the partner must represent that the deductions and losses have not been disallowed by the IRS. The document should indicate the type of taxpayer (e.g. individual, corporate) certifying the deductions and losses. The certification must be signed under penalty of perjury.



These deductions must be reflected on a Schedule K-1 issued (or to be issued) to the partner by the other partnership for a prior taxable year. The partner may not certify to the partnership a loss suspended due to a basis limitation from another partnership.

The regulations limit the extent to which the partnership considers the certified deductions and losses. For example, the partnership may not consider a partner's net operating loss greater than 90 percent of the partner's allocable share of effectively connected taxable income. Moreover, the partnership remains liable for the full tax if the certification is inaccurate.

A partnership would, however, be able to avoid penalty and interest provided it does not have knowledge that the certification is inaccurate.

A partnership may also consider the character of the current income and losses, as well as those of certified deductions and losses, when determining their liability. This change allows a partnership to apply a reduced rate of tax depending on the character of income. For example, provided the partner has certified its status as an individual, the partnership could apply the long-term capital gain rate to any type of long-term capital gain income.

A partnership that relies in whole or in part on a partner's certificate must include this information when preparing the required Form 8813 "Partnership Withholding Tax Payment Voucher (Section 1446)" and Form 8804, "Annual Return for Partnership Withholding Tax (Section 1446)" and Form 8805, "Foreign Partner's Information Statement of Section 1446 Withholding Tax," whichever is applicable, for the period the certificate is considered, even if no tax (or an instalment of tax) is due. The partnership is required to attach a copy of the certification and its computation of the tax due for each partner to both the Form 8813 and Form 8805, filed with the IRS for any period the certificate is considered.

Conclusion

In addition to the certification of deductions and losses and the ability to consider the character of income when determining a law firm's withholding rate, there are many other areas of these highly complex regulations, (clarification of potential deemed distribution issues, de minimis exceptions, tiered partnership rules, changes to notice requirements and new refund procedures) that law firms should consider in determining their IRC Sec 1446 liability. The professionals at PwC have been helping firms successfully alter their processes and procedures to bring value to their foreign partners and to mitigate tax exposure. If we can assist your firm with any aspect of IRC Sec 1446 please contact Stanley Kolodziejczak at (646) 471-3160 or Hal Berman at (646) 471-3434.

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