authority supported a burden of proof shift in these circumstances.

Had section 7491 applied, would the IRS's failure to afford the taxpayer a nondocketed Appeals hearing, standing alone, have resulted in a shift in the burden of proof? Aside from a net worth limitation, which applies to partnerships, corporations, and trusts, the conditions that must be satisfied to cause the burden to shift represent affirmative obligations on the *taxpayer's* part. Among other requirements, the taxpayer must supply credible evidence supporting the taxpayer's factual assertions, satisfy applicable substantiation requirements, and cooperate with IRS requests for "witnesses, information, documents, meetings, and interviews." I.R.C. § 7491(a)(1), (2). The legislative history to section 7491 expands upon the cooperation requirement: "A necessary element of fully cooperating with the Secretary is that the taxpayer must exhaust his or her administrative remedies (including any appeal rights provided by the IRS)." H.R. Conf. Rep. No. 105-599, 105th Cong., 2d Sess. 239.

Thus, while a taxpayer seeking a burden shift under section 7491—much like a taxpayer seeking litigation costs under section 7430—is compelled to have participated in Appeals consideration, if available, nothing in the burden of proof shift rules appears to establish an obligation on the IRS's part to provide taxpayers in deficiency cases with access to administrative settlement procedures. The statute merely requires that the IRS's requests for information and access be "reasonable;" it does not establish conditions under which those requests must be made. I.R.C. § 7491(a)(2)(B).

In contrast with deficiency cases, a taxpayer who is the subject of a federal tax lien or levy proceeding has the affirmative right to request an Appeals hearing as part of the Collection Due Process (CDP) procedures. I.R.C. §§ 6320(b)(1) (CDP appeal rights triggered by notice of federal tax lien); 6330(b)(1) (CDP appeal rights available prior to levy). Unless the taxpayer failed to receive a notice of deficiency or did not otherwise have an opportunity to challenge the underlying tax liability, the taxpayer may not dispute the existence or amount of the asserted liability during the CDP hearing. I.R.C. § 6330(c)(2)(B). *Cf.* Montgomery v. Comm'r, 122 T.C. 1 (2004) (holding that taxpayers who had not been sent notice of deficiency could challenge amount of self-reported liability). The taxpayer may raise spousal defenses and discuss collection alternatives during the CDP hearing. *See* Treas. Reg. § 301.6320-1. The taxpayer also has the right to obtain judicial review of the Appeals Officer's determination. I.R.C. § 6330(d).

Since the CDP process was established in 1998, the IRS and the courts have struggled to establish the precise rules for requesting and conducting CDP hearings. *See, e.g.,* Keene v. Comm'r, 121 T.C. 8 (2003) (reviewed by the court) (Tax Court decision finding taxpayer entitled to audio record a CDP hearing despite previously issued Treasury Regulations); Nestor v. Comm'r, 118 T.C. 162 (2002) (reviewed by the court) (Tax Court considered but did not decide whether taxpayer was entitled to a copy of his transcript of account from Appeals officer). Nonetheless, if the taxpayer properly requests Appeals consideration as part of the CDP process, some form of Appeals consideration usually must occur. Treas. Reg. § 301.6330-1(d)(1). *But see* Lunsford v. Comm'r, 117 T.C. 183 (2001) (reviewed by the court) (Tax Court refused to remand the case for a CDP hearing and decided case on the record before it); Chief Counsel Notice CC-2003-031 (Sept. 11, 2003) (taxpayer not entitled to face-to-face CDP hearing if taxpayer intends to raise only frivolous arguments).

Thus, generally a taxpayer who receives a 30-day letter has the opportunity to request Appeals consideration as part of a deficiency case, and may wish to do so to protect procedural opportunities under sections 7430 and 7491. A taxpayer who petitions the Tax Court in response to a 90-day letter may also end up negotiating with Appeals but lacks a formal opportunity to request an Appeals conference. The deficiency context contrasts with collection cases, in which the taxpayer, having received a lien or levy notice, has the affirmative right to request Appeals consideration. The *Estate of Weiss* case confirms that, outside the CDP context, there is no substantive right to an Appeals conference.

LIMITED RELIEF FROM OVER-WITHHOLDING FOR PARTNERSHIPS AND THEIR FOREIGN PARTNERS: NEW SECTION 1446 REGULATIONS

by Nancy Beckner, Newville, PA

A previous Point that appeared in the Fall 2003 issue of this NewsQuarterly briefly described section 1446 withholding and what were then newly proposed section 1446 withholding regulations (the "2003 Proposed Regulations"), as part of a broader discussion of the use of partnerships by inbound foreign investors. Treasury has now published final section 1446 regulations (Treas. Reg. §§ 1.1446-1 through -5 [the "Final Regulations"]), and temporary and proposed regulations (Temp. Reg. §1.1446-6T and Prop. Reg. §1.1446-6 [collectively, the "Temporary Regulations"]). These regulations (T.D. 9200, 70 Fed. Reg. 28702, May 18, 2005) are generally effective for partnership taxable years beginning after May 18, 2005, but a partnership may elect to have them apply to partnership taxable years beginning after December 31, 2004. The preamble (the "Preamble") includes an extensive description of both the Final and Temporary Regulations.

OVERVIEW OF SECTION 1446 REGIME

Section 1446 requires partnerships having foreign partners to withhold U.S. income tax with respect to each foreign partner's allocable share of

partnership effectively connected taxable income ("ECTI"). Tax must be withheld even if the partnership makes no distributions, and the partnership is required to pay estimated section 1446 tax in installments during the partnership's taxable year. (A different rule applies to publicly traded partnerships having effectively connected gross income; such partnerships pay the section 1446 tax by withholding on distributions to foreign partners under Reg. §1.1446-4.) Tax must be withheld at the highest applicable rate (the section 1 rate for non-corporate partners and the section 11 rate for corporate partners); however, under the Final Regulations, the partnership may be able to consider preferential rates applicable to long-term capital gains or other special items of partnership income or gain. (Reg. §1.1446-3(a)(2)(ii)). A foreign partner takes the withheld tax into account in determining estimated tax and also credits it against such partner's actual tax liability for the year with respect to effectively connected income, claiming a refund if the withheld tax exceeds the actual tax due.

The section 1446 withholding regime can result in tax being withheld in excess of a foreign partner's actual tax liability because, with limited exceptions under the Temporary Regulations, a partnership cannot take into account its foreign partners' effectively connected losses from non-partnership activities or such partners' loss carryovers in determining the amount of section 1446 tax, and current year partner-level items cannot be taken into account. Also, because the requirement to pay installments of section 1446 tax is not dependent on the partnership having cash available for distribution to foreign partners, from which the tax can be withheld, the withholding requirement can place a burden on non-foreign partners, particularly in partnerships that have cancellation of indebtedness ("COD") income. The Final and Temporary Regulations do not resolve either of these problems, except to the limited extent the certification procedures of the Temporary Regulations may reduce a partnership's section 1446 tax obligation with respect to certain foreign partners. Drafters of partnership agreements should, therefore, continue to consider mechanisms to address the possibility that section 1446 withholding tax could exceed foreign partners' shares of distributable cash and could have an adverse economic affect on other partners. For further discussion of issues posed by the May 18, 2005 proposed regulations, *see* letter of Nov. 4, 2005, submitted by the Section. Michael J. Karlin and Alan I. Appel had principal responsibility for preparing those comments, which raised concerns relating to both the Proposed/Temporary Regulations and the Final Regulations and recommended several changes. *ABA Tax Section Comments on Proposed Regs on Partnership Withholding*, 2005 TNT 215-11 (November 8, 2005).

FINAL REGULATIONS

The Final Regulations modify and clarify the 2003 Proposed Regulations in several ways, including the following: (1) they more closely align section 1446 documentation requirements with the section 1441 withholding regime, including use of Forms W-8ECI and W-8EXP (Reg. §1.1446-1); (2) they clarify certain documentation questions involving tiered partnerships; (3) they clarify that, if a foreign tax exempt organization is a partner, section 1446 withholding applies only to the partner's allocable share of ECTI which is includable in the partner's calculation of unrelated business taxable income under section 512 (Reg. §1.1446-3(c)(3)); (4) they address several tax calculation, payment and reporting matters (Reg. §1.1446-3), including: retention of the rule that section 1446 trumps section 1445 withholding with respect to dispositions of U.S. real property interests, retention (with two exceptions) of the 2003 Proposed Regulation's partner notification requirements, treatment of a partnership's payment of withholding tax installments as "advances or drawings," introduction of a rule permitting section 1446 withholding at preferential rates for long-term capital gains and certain other items, and modification of the deemed filing and payment rules which can affect additions to tax, interest and penalties for noncompliance with section 1446; and (5) they provide special rules for tiered trust or estate structures, clarify certain notice provisions involving publicly traded partnerships, eliminate a publicly traded partnership's ability to elect withholding based on shares of ECTI rather than distributions and address certain "look through" rules for tiered partnership structures.

Notwithstanding comments to the contrary suggesting other approaches, the Final Regulations do not offer any exception with respect to foreign partners' allocable shares of partnership COD income and gain from foreclosures, with section 1446 tax ameliorated only to the extent available using the certification procedures of the Temporary Regulations (see Part B. of the Preamble).

SOME PROVISIONS OF SPECIAL INTEREST

1. Use of Preferential Rates. In determining the rate of section 1446 tax, a partnership may now consider the type of income or gain applicable to a foreign partner and the preferential rates applicable to such income, rather than using the highest section 1 or section 11 rates otherwise mandated. Thus, for example, for long-term capital gains allocable to a non-corporate foreign partner, the partnership can pay section 1446 tax at the highest capital gains rate. However, a partnership cannot use a preferential rate where the rate depends upon the corporate or non-corporate status of a partner and such status has not been established by documentation or the regulations otherwise direct the partnership to use the highest applicable section 1446(b) rates.

2. Deemed Cash Distributions under Section 1446(d). When a partnership pays section 1446 tax with respect to a partner, the payment is

generally deemed to be a distribution to the partner. To reduce the likelihood that installment payments during the year, if treated as distributions, will trigger gain recognition under sections 731 and 741, the Final Regulations treat the deemed distribution as an advance or drawing (within the meaning of section 1.731-1(a)(1)(ii)) against the partner's distributive share of partnership income. Consequently, the ramifications of the partnership's payment of section 1446 tax will generally be considered by the partner at the end of partnership's taxable year. This special rule does not affect the date the partnership (or partner) is considered to have paid the tax for purposes of section 6654 and section 6655 failures to pay estimated tax.

3. Refunds. Non-publicly traded partnerships may obtain refunds for section 1446 taxes paid to the extent that the amounts are not reflected on a Form 8805 issued to a partner. Publicly traded partnerships (which pay tax based on distributions) are still subject to the refund provisions of section 1464 and its regulations.

4. Additions to Tax, Interest and Penalties. Part C.6 of the Preamble addresses additions to tax, interest and penalty matters, and Treas. Reg. §1.1446-3(e)(4) offers several important examples of how these provisions function. The following provisions are of special interest:

(i) Effect on Partnership of Partner Estimated Tax Payments. If a partnership fails to file and pay its section 1446 tax, a partner's payment of estimated tax will not provide the partnership with any benefit with respect to the partnership's computation of underpayment additions to tax under section 6655; the partnership is deemed to have paid the tax only when the partner has paid the tax, with such payment being credited to the partnership's account on the later of the date the tax is considered paid by the partner for purposes of sections 6511(b)(2), (c) and 6512 or the last date for paying the section 1446 tax without extensions.

(ii) Elimination of Deemed Filing Rule. The partnership "deemed filing" rule is eliminated. Thus, a partnership will not be "deemed" to have filed Forms 8804 or 8805 at any time, and once the failure to file penalty under section 6651(a)(1) begins to accrue, a partnership may affirmatively stop the accrual only by filing Form 8804. In other words, if a partnership fails to file Form 8804 and section 1446 tax has not been paid (or deemed paid) by the prescribed payment date, the failure to file penalty begins to accrue and can only be stopped by filing or when the statutory limit of the penalty has been reached.

TEMPORARY REGULATIONS

In a departure from the 2003 Proposed Regulations, the Temporary Regulations permit a partnership to adjust its section 1446 tax to consider a foreign partner's deductions and losses that are reasonably expected to be available to reduce the partner's U.S. income tax liability on the partner's share of ECTI from the partnership. Certain foreign partners may certify deductions and losses to the partnership to reduce section 1446 tax, but a certification will only be effective for the partnership year for which it is submitted. Before each installment date or Form 8804 filing date, the partnership will then consider whether the procedures in the Temporary Regulations apply. A partnership is not obligated to consider a partner's certified deductions or losses or may consider only a portion of such certified amounts.

A partner may submit a certificate only if the partner has met the Reg. §1.1446-1 documentation requirements and can represent either that he timely filed, or will timely file, a U.S. income tax return for each of the preceding four years and for the partner's taxable year for which the certificate is considered. The partner must also make certain representations regarding timely payment of tax. Generally foreign trusts and estates are not permitted to use the certification procedure, except for certain grantor trusts when the grantor meets the documentation and other requirements of the Temporary Regulations. There are also limitations and special procedures for tiered partnerships.

A foreign partner can only certify deductions and losses that are or will be reflected on the partner's U.S. return filed for a taxable year ending prior to the installment due date (or Form 8804 filing date) for the partnership taxable year for which the certificate is considered. A partner may also certify a loss that was set forth on a Form K-1 from the partnership in a prior year but was not reflected on a prior year return's because it was suspended under section 704(d). The partnership may not consider certified net operating loss deductions in excess of 90% of the partner's allocable share of ECTI.

A partnership is generally not relieved from liability for section 1446 tax (or penalties and interest) if the partnership or the IRS determines a partner's certificate is defective or is updated and the section 1446 tax increases. If the partnership has reasonably relied on the certificate, it should not be subject to the section 6655 additions to tax. The Temporary Regulations provide several examples of the effect on a partnership when a partner's certificate is found defective. Counsel and other partnership advisors should analyze carefully the certification procedures and ascertain the level of risk the partnership assumes if it takes into account such certificates in determining the partnership's section 1446 withholding tax. The certification process may also raise additional conflict of interest issues among partners and between certain partners and the partnership.

CONCLUSION

The foregoing discussion is intended to highlight some of the more important features of the Final and Temporary section 1446 Regulations and to identify a few of the concerns which partnerships and partners may encounter under the section 1446 withholding tax regime.