Partnership-Related Withholding Rules for Interest Payments

By Jonathan Zhu

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Interest that is (a) U.S.-source income,1 (b) paid to a foreign payee,2 (c) not effectively connected with a U.S. trade or business,3 and (d) not otherwise exempt4 is subject to withholding.5

The classic treatment of withholding remains “Withholding Tax on Payments to Foreign Persons,”6 which “focus[ed] on the problems of withholding agents.”7 This article focuses narrowly on a particular kind of income — interest income — but takes the point of view of a person — a partnership — that may, depending on the transaction, take on a different role,8 and that, depending on its role, may or may not be a withholding agent.9

By tracing an interest payment from a payer to the partnership and in turn to the partners or from the partnership to another recipient, this article has three aims: (a) introducing a tripartite organizing structure to the array of partnership-related withholding rules for interest payments, (b) illustrating both the coherence and the discontinuity within the structure, and (c) describing a specific withholding rule for interest payments made by a domestic partnership not engaged in a U.S. trade or business that does not appear to have been widely recognized or at least publicly asserted.

This article has five parts. Part I sets up the tripartite structure of partnership-related withholding rules for interest payments. Part II describes the rules when the partnership is the recipient of an interest payment. Part III describes the rules when a partnership is considering withholding in connection with distributive shares of interest income to its partners. Part IV considers the rules when the partnership is the payer, and focuses on the “secret” rule alluded to above. Part V concludes the article.

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1Sections 1441(a)(1) and 1442(a). In general, interest from the United States, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of noncorporate residents or domestic corporations is U.S.-source income. Section 861(a)(1); Treas. reg. section 1.861-2. All other interest income is income from sources without the United States. Section 862(a)(1); Treas. reg. section 1.862-1(a)(1)(i). That source rule looks to the residency of a noncorporate obligor and the domesticity of a corporate obligor. However, for a foreign corporation engaged in a U.S. trade or business or having gross income that is treated as effectively connected with a U.S. trade or business, interest paid by its U.S. trade or business is treated as if paid by a domestic corporation. Section 884(f)(1); Treas. reg. section 1.884-4. Section references are to the Internal Revenue Code of 1986 or the regulations promulgated thereunder, except as otherwise noted.

2Section 1441(a) and 1441(b); Treas. reg. section 1.1441-1(b)(1). For definition of a payee, see Treas. reg. section 1.1441-1(c)(12).

3Sections 1441(c)(1); Treas. reg. section 1.1441-4(a). Section 864(c) and Treas. reg. section 1.864-4 define income effectively connected with the conduct of a U.S. trade or business (“effectively connected income,” “income effectively connected,” or “ECI” in the balance of this article). Compensation for personal services performed by an individual or personal service contract income of a foreign corporation is not, for this purpose, categorically exempted as effectively connected income. Treas. reg. section 1.1441-4(a)(1). The former falls under the rules of Treas. reg. section 1.1441-4(b), which coordinate with the wage-withholding rules of section 3402.

4Sections 871(h) and 881(c) (portfolio interest exemption); Treas. reg. section 1.1441-1(b)(4) (complete exemption list including, among others, treaty-based exemption and non-U.S.-source exemption).

5See generally sections 1441 and 1442; Treas. reg. sections 1.1441-0 through 1.1441-9 and 1.1442-1 through 1.1442-3.


7Id. at 49, especially those of a withholding agent that underwithholds, id. at 77-95.

8A payer, Treas. reg. section 1.1441-1(c)(19), a recipient that is, however, not necessarily a payee, see Treas. reg. section 1.1441-1(c)(12), or simply a partnership qua partnership regarding distributive shares of income to its partners.

9Treas. reg. section 1.1441-1(c)(7) and 1.1441-7(a). The term “withholding agent” means any person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Section 1441(a); Treas. reg. section 1.1441-7(a)(1).
I. Three Sets of Rules

Any analysis must begin with an explicit recognition that a partnership must grapple with three distinct sets of rules, dealing with three distinct scenarios.10

The three scenarios are depicted in the chart (see next page). First, under what circumstances would interest payments made to a partnership be subject to withholding? Second, under what circumstances would interest income of a partnership, as the income is allocated to its partners, be subject to withholding? Third, under what circumstances would interest payments made by a partnership be subject to withholding?

Very different criteria apply in determining whether the interest in each of the three scenarios is subject to withholding. In a vastly simplified formulation, the first two sets of rules look primarily to the domesticity of the partnership, whereas the third turns solely on its residency.

The rules defining the domesticity and the residency of a partnership are straightforward; one has nothing to do with the other. A partnership is domestic if it is "created or organized in the United States or under the law of the United States or of any state unless . . . the Secretary provides otherwise by [R]egulations."11 A partnership is foreign if it is not domestic.12

A partnership is a resident of the United States in any tax year if it "at any time during its tax year is engaged in a trade or business in the United States."13 It is not a resident of the United States for a tax year if at no time during the tax year is it engaged in a trade or business in the United States.

One might think — based on an "intuition" of continuity — that the rules dealing with the first scenario (payments to a partnership) should match or at least resemble the rules dealing with the third (payments by a partnership). The intuition, however, does not bear the weight of reflection: In many or perhaps a majority of cases, a partnership receiving interest payments does not make any interest payments. There is no connection between the two sets of rules.

II. Partnership as Recipient

Only payments made to a foreign payee are subject to withholding.14 Whether a recipient partnership is also the payee depends primarily on its domesticity.

If the partnership is domestic, it is the payee.15 Regardless of the status of the partners, no withholding is required for any interest payment made to a domestic partnership.16

If the partnership is foreign, the withholding agent is required to look through to the status of the partners in determining whether the payee is foreign and whether the respective distributive share of the payment is subject to withholding.17

There are two exceptions to that look-through requirement. The first is procedural. No withholding is required if a payment is made to a withholding foreign partnership.18 A withholding foreign partnership assumes the primary withholding responsibility, so the withholding obligation associated with the payment to the partnership devolves to the partnership itself.

The second is substantive. No withholding is required if a payment to a foreign partnership is income effectively connected with the partnership's conduct of a trade or business in the United States.19 The withholding obligations under sections 1441 and 1442 disappear altogether.20 New withholding obligations, however, arise under sections 1445 and 1446 and are imposed on the partnership.21 The new obligations are described next in Part III.

14Treas. reg. section 1.1441-1(b)(1).
15Treas. reg. section 1.1441-1(c)(1).
16Treas. reg. section 1.1441-5(b)(1). See Treas. reg. section 1.1441-5(d)(2) (presumption rules for determining partnership domesticity in the absence of documentation). The discussions in Part II refer to interest, but they apply to other types of fixed or determinable annual or periodic income (FDAP income). Sections 871(a)(1)(A) and 881(a)(1).
17Treas. reg. section 1.1441-5(c)(1)(i) (enumerating the look-through scenarios); Treas. reg. section 1.1441-5(d)(3) (describing presumption rules when a partner's status may not be reliably determined).
18Treas. reg. section 1.1441-5(c)(1)(ii)(A) (no look-through required) and 1.1441-5(c)(2)(iii) (no withholding required).
19Treas. reg. section 1.1441-5(c)(1)(ii)(B). The same rule applies when the withholding agent can presume the income to be effectively connected income. Treas. reg. section 1.1441-5(c)(1)(ii)(C).
20Section 1441(c)(1).
21Sections 1445 and 1446. Dale's article on withholding appeared before sections 897, 1445, and 1446 were enacted. Dale, supra note 6, at 60-61.
III. Partnership vis-à-vis Partners

A partnership may have withholding obligations with respect to the distributive share of its interest income allocated to a partner. To the extent that there are such obligations, the partnership itself is liable.\footnote{Section 1461. Regulations under section 1446 specifically refer to that liability. Treas. reg. section 1.1446-3(e); see also Rev. Proc. 89-31, 1989-1 C.B. 895, sections 4.01 (joint and several liability for general partners) and 4.02 (partnership liability under section 1451) (before T.D. 9200, 2005-23 IRB 1158, promulgating the current regulations under section 1446). The discussions in Part III refer to interest, but most of them apply to other types of FDAP income. See supra note 16.}

For interest income that is not effectively connected income, domesticity again controls. The rules here match the rules dealing with interest payments made to a partnership: If the partnership is domestic, interest payments made to it are not subject to withholding, but the partnership must withhold, if any partner is a nonresident alien individual or a foreign corporation, on that partner’s distributive share;\footnote{Section 1441(b). Treas. reg. section 1.1441-5(b)(2)(i)(A) provides more specific rules: A U.S. partnership is required to withhold under [Treas. reg. section] 1.1441-1 as a withholding agent on an amount subject to withholding . . . that is includible in the gross income of a partner that is a foreign person. Subject to [Treas. reg. section 1.1441-5(b)(2)(v)], a U.S. partnership shall withhold when any distributions that include amounts subject to withholding (including guaranteed payment made by a U.S. partnership) are made. To the extent a foreign partner’s distributive share of income subject to withholding has not actually been distributed to the foreign partner, the U.S. partnership must withhold on the foreign partner’s distributive share of the income on the earlier of the date that the statement required under [section] 6031(b) is mailed or otherwise provided to the partner or the due date for furnishing the statement. This statement on its face requires withholding if the foreign partner is itself a partnership. But the look-through rules, along with the exceptions, discussed in Part II, supra, should apply.} and if the partnership is a nonwithholding foreign partnership,\footnote{A withholding foreign partnership is treated for this purpose as a domestic partnership. Treas. reg. section 1.1441-5(c)(2)(iii).} interest payments made to it are already subject to withholding, so the partnership would not be required to withhold again.\footnote{Provided certain procedural requirements are met. Treas. reg. section 1.1441-5(c)(3)(v).}

If any interest income is, or is treated as, effectively connected income, the rules here again match the rules dealing with payments made to a partnership. Only the partnership — not anyone else in connection with the payments — is required to withhold, and the partnership’s domesticity is irrelevant. The withholding rules under sections 1441 and 1442 do not apply.\footnote{T.D. 9200, 2005-23 IRB 1158. For guidance in effect before T.D. 9200, see Rev. Proc. 92-66, 1992-2 C.B. 428, Rev. Proc. 89-31, 1989-1 C.B. 895 (obsoleting Rev. Proc. 88-21, 1988-1 C.B. 777).}

The withholding rules under sections 1441 and 1442 do not apply. Instead, the rules are governed by the newly promulgated regulations under section 1446.\footnote{Rev. Proc. 89-31, 1989-1 C.B. 895, sections 4.01 (joint and several liability for general partners) and 4.02 (partnership liability under section 1451) (before T.D. 9200, 2005-23 IRB 1158, promulgating the current regulations under section 1446). The discussions in Part III refer to interest, but most of them apply to other types of FDAP income. See supra note 16.}

Under section 1446, interest income that is effectively connected with the conduct of a nonwithholding foreign partnership, interest payments made to it are already subject to withholding, so the partnership would not be required to withhold again. If any interest income is, or is treated as, effectively connected income, the rules here again match the rules dealing with payments made to a partnership. Only the partnership — not anyone else in connection with the payments — is required to withhold, and the partnership’s domesticity is irrelevant. The withholding rules under sections 1441 and 1442 do not apply. Instead, the rules are governed by the newly promulgated regulations under section 1446. Under section 1446, interest income that is effectively connected with the conduct of a nonwithholding foreign partnership, interest payments made to it are already subject to withholding, so the partnership would not be required to withhold again. If any interest income is, or is treated as, effectively connected income, the rules here again match the rules dealing with payments made to a partnership. Only the partnership — not anyone else in connection with the payments — is required to withhold, and the partnership’s domesticity is irrelevant. The withholding rules under sections 1441 and 1442 do not apply. Instead, the rules are governed by the newly promulgated regulations under section 1446.
U.S. trade or business is treated like any other kind of effectively connected income. A partnership, whether domestic or foreign, must withhold, on a net basis, on a foreign partner’s allocable share of the partnership’s effectively connected tax income.  

Ordinarily, interest income does not result from disposition of interest in U.S. real property, and is therefore not subject to section 897 (or the companion section 1445), which treats any gain or loss from such disposition by a nonresident alien individual or a foreign corporation as effectively connected with a U.S. trade or business. However, interest income may arise, for example, as gain from disposition of an original issue discount debt obligation that is U.S. real property interest. In any such case, however, the fact that the income may be interest income has no bearing on the withholding obligation imposed on the partnership. Under Treas. reg. section 1.1446-2(b)(2)(ii), the section 1446 regime covers any partnership income that is treated as effectively connected income under section 897. So, for any such income, a domestic partnership is subject to the regimes of sections 1446 and 1445(e)(1) and a foreign partnership is subject to the regimes of sections 1446 and 1445(a).

In such an event, for a domestic partnership, the amounts to be withheld under sections 1446 and 1445(e)(1) are different, with the former being generally lower. A coordination rule under Treas. reg. section 1.1446-3(c)(2)(i) provides that, to the extent both sections 1446 and 1445(e)(1) apply to a domestic partnership, the partnership’s effectively connected tax income may allow for deductions, such as ongoing operating expenses of the partnership, compliance with section 1446 will be deemed also to be compliance with section 1445(e)(1).

A foreign partnership is in a different situation when it disposes of a U.S. real property interest. On one hand, the transferee in the disposition is required to withhold in the amount of 10 percent of the amount realized under section 1445(a). On the other hand, the partnership itself must also withhold under section 1446. A coordination rule under Treas. reg. section 1.1445-3(c)(2)(ii) provides that the foreign partnership may credit the amount withheld by the transferee under section 1445(a) against the amount to be withheld by it under section 1446 to the extent the section 1445(a) withholding is allocable to a foreign partner.

IV. Partnership as Payer

Whereas the rules in Parts II and III bear close linkage, entirely different rules apply in determining whether interest payments by a partnership debtor to a foreign creditor are subject to withholding. The crux of the matter here lies not in the withholding rules, but in the income source rules. Although the withholding requirements are not necessarily coterminous with the underlying tax liability, a foreign person’s non-U.S.-source income that is not effectively connected income is not subject to either a U.S. tax or any U.S. withholding.

Section 861(a)(1) provides that, in general, U.S.-source interest income includes interest on “bonds, notes, or other interest-bearing obligations of noncorporate residents.” Section 862(a)(1) provides that this definition is exclusive: “[I]nterest other than that derived from sources within the United States as provided in [section] 861(a)(1)” shall be treated as income from sources without the United States. So, in general, interest income from a partnership debtor that is a U.S. resident is...
U.S.-source income, and interest income from a partnership debtor that is not a U.S. resident is not U.S.-source income.

The regulations under section 861 define the residency of a partnership. Regardless of its domesticity, a partnership is a U.S. resident if it “at any time during its tax year is engaged in a trade or business in the United States.”

Under that rule, “[t]he purpose for which the debt is incurred, the nature or location of any assets securing the debt, the location of the interest-bearing obligations or the funds used to pay the interest, and the method and the place of interest payment generally do not affect the source of interest income.” Also, “[u]nder this test of residency for partnerships, the place of organization or formation of the partnership and the nationality or residence of the partners are irrelevant.” Further, in the case of a guaranteed debt, the source of interest income continues to be determined by reference to the primary obligor, even after the guarantor has assumed the payment obligations.

Until August 12, 2004, that rule of partnership residency applied beyond the section 861 context:

A partnership engaged in trade or business within the United States is referred to in the regulations in this chapter as a resident partnership, and a partnership not engaged in trade or business within the United States, as a nonresident partnership. Whether a partnership is to be regarded as resident or nonresident is not determined by the nationality or residence of its members or by the place in which it was created or organized.

That general rule of partnership residency was removed from the books on August 12, 2004, as part of the overhauling of rules dealing with entities with dual charters entities organized under both domestic laws and foreign laws. But the specific rule under section 861 remains.

On one hand, the rule, especially the “at any time during its tax year” language, is harsh. “[A] foreign partnership with all foreign partners nonetheless will be a U.S. resident for interest-sourcing purposes if the partnership engages in a U.S. trade or business at any time during its tax year.” Under that rule, “[a] partnership apparently may be a U.S. resident . . . even though it is not engaged in a U.S. trade or business when the interest is paid if the partnership was engaged in a U.S. trade or business at some other time during the tax year in which the creditor receives or accrues the interest.”

The American Jobs Creation Act of 2004 responded to those concerns of overbreadth. New section 861(a)(1)(C) now provides that interest on obligations of a foreign partnership is not U.S.-source income if two conditions are met: The partnership is predominantly engaged in the active conduct of a trade or business outside the United States, and the interest is not paid by a trade or business engaged by the partnership in the United States and not allocable to income that is effectively connected (or treated as effectively connected) with the conduct of a U.S. trade or business.

There is, however, the other side of the coin. Under that rule of partnership residency, interest from any partnership not engaged in a trade or business in the United States is not U.S.-source income. That includes interest from any domestic partnership not engaged in a trade or business in the United States, even if the partnership has only U.S. partners and even if all its activities take place within the United States.

Consider both the breadth and the limitations of that rule. First the breadth. A venture capital fund or a buyout fund is generally believed not to be engaged in a trade or

IRS are continuing to explore whether, and under what circumstances, a different definition [for domestic partnerships] may be appropriate,” and that “[i]f any change . . . were to be proposed, it would only apply to partnerships created or organized” thereafter. Regarding the general rules of residency, T.D. 9153 states that “the definitions of resident foreign corporations, nonresident foreign corporations, resident partnership and nonresident partnership [are removed] because these terms have become obsolete due to statutory changes since the final regulations were published in 1960.”

Footnote continued in next column.)
business. If the fund elects, as it typically does, to be treated as a partnership under the check-the-box rules,

interest on its debt would follow the source rule based on its residency. Even if the fund (i) has only U.S. partners, (ii) invests solely in U.S. companies, and (iii) has all its activities within the United States and none outside it, interest on its debt would not be U.S.-source income to a foreign creditor, regardless of whether and how the partnership debtor and the foreign creditor may be related.

The author is not aware of any publication in which that aspect of the rule is explicitly so stated. But the logic leading to it is both simple and sound. The regulations stating the rule have been on the books for a very long time. There have been two statutory changes to section 861(a)(1) in, respectively, 1986 and 2004. The 1986 amendment installed a new regime for sourcing interest paid by corporations, but left unchanged the source rule for interest paid by noncorporate obligors including partnerships. The 2004 amendment relaxed the source rule for certain foreign partnerships, but again left unchanged the source rule for domestic partnerships. There has been ample opportunity for Congress and the Treasury Department to change the rule regarding domestic partnerships not engaged in a U.S. trade or business. They have not done so.

It is important here to note that a partnership that derives income subject, at the partner level, to section 897 is not, by that fact alone, engaged in a U.S. trade or business. The authority to provide that all domestic corporations were residents. The 2004 amendment relaxed the application of the provision only to foreign partnerships, without mentioning the House report seeks to harmonize treatment of foreign corporations with foreign partnerships, without mentioning the disparity between domestic corporations and domestic partnerships.

The Tax Reform Act of 1986, Pub. L. No. 99-514 section 1214(a), 100 Stat. 2085 (contemporaneous with the introduction of the branch profit rules); Jobs Act section 410(a) (discussed above, see supra note 52 and accompanying text).

Two aspects of the legislative history are noteworthy. First, the House report seeks to harmonize treatment of foreign corporations with foreign partnerships, without mentioning the disparity between domestic corporations and domestic partnerships. RIA’s Complete Analysis of the American Jobs Creation Act of 2004 at 2666 (RIA, 2004). Second, the Senate report would have limited the application of the provision only to foreign partnerships principally owned by foreign persons, id. at 2607, but that partial look-through approach was rejected.

The constancy of the rule does not stand in the way were the Treasury to decide to change it. It was under the statutory language “residents, corporate or otherwise” that the regulations provided that all domestic corporations were residents. T.D. 7378, 1975-2 C.B. 272. It seems to be within the Treasury’s authority to provide that all domestic partnerships are residents under section 861, given the current statutory language of “noncorporate residents or domestic corporations.”

It is ordinarily very difficult for an investor to be a “trader.” See, e.g., Chen v. Commissioner, 87 T.C.M. (CCH) 1388, Doc 2004-11591, 2004 TNT 106-7 (June 1, 2004) (a section 475(f) case but citing broadly case law regarding trading and trade or business). Although Treas. reg. section 1.864-2(c)(1) provides that, in determining whether trading in stocks or securities constitutes a U.S. trade or business, “[t]he volume of stock or security transactions effected during the tax year shall not be taken into account,” it is widely accepted that the foreign partners in a U.S. venture capital fund or a buyout fund ordinarily are not engaged in a trade or business merely on account of the fund’s investments in portfolio companies that are corporations for tax purposes. A challenge by the IRS to this widely-accepted position would be a jolt to the myriad of foreign investors in those funds. See, e.g., Victor Fleischer, “The Rational Exuberance of Structuring Venture Capital Start-Ups,” 57 Tax L. Rev. 137, 156 (2003) (describing the effectively connected income issues for a foreign partner in a venture capital partnership investing in start-ups organized as partnerships and the use of blocker-entity for dealing with those issues); Ronald J. Gilson and David M. Schizer, “Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock,” 116 Harv. L. Rev. 874, 909 n.115 (2003) (also observing that investing in a start-up company organized as a partnership may give rise to effectively connected income for a foreign partner in a venture capital fund).


53 On the authority that investing one’s own money is not a trade or business. The commonly cited case is Higgins v. Commissioner, 312 U.S. 714 (1941).

The regulations under section 864 do not require a different result. Under Treas. reg. section 1.864-2(c)(2)(ii), which refers to the partners rather than the partnership, a member of a partnership, whether domestic or foreign, is not considered to be engaged in a U.S. trade or business solely because the partnership effects transactions in the United States in stocks or securities for the partnership’s own account.

That rule does not apply to any member of a partnership that meets all of the following three conditions: (i) the principal business of the partnership is trading in stocks or securities for its own account, (ii) the principal office of the partnership is in the United States at any time during its tax year, and (iii) at any time during the second half of its tax year, not more than 50 percent of either the capital interest or the profits interest is owned, directly or indirectly, by five or fewer partners who are individuals. Treas. reg. section 1.864-2(c)(2)(ii) (providing also another exception to the rule in the event the partnership is a dealer in stocks or securities). See also Michael P. Collins, “The Treatment of Foreign Partners of Tiered Securities Partnerships,” 7 J. Tax’n Investments 23 (1989). Condition (ii) above no longer applies. Taxpayer Relief Act of 1997, P.L. No. 105-34 section 1162(a), 111 Stat. 788.

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54Treas. reg. section 301.7701-1 through 301.7701-4.

In comparison, the portfolio interest exemption does not apply to interest received by any person owning 10 percent or more of the capital or profits interest in the partnership, sections 871(h)(3)(B)(ii) and 881(c)(3)(B), with the ownership interest computed under the attribution rules, section 871(h)(3)(C).

55See, e.g., Kuntz and Peroni, 1 U.S. International Taxation, supra note 13, at A2-23 (describing the harshness of the residency rule for a foreign partnership without commenting on the rule for a domestic partnership); Fuller, supra note 50, at 761-762 (commenting on the new section 861(a)(1)(C) and calling for an extension to domestic partnerships without mentioning this aspect of the rule for a domestic partnership).


58The Tax Reform Act of 1986, Pub. L. No. 99-514 section 1214(a), 100 Stat. 2085 (contemporaneous with the introduction of the branch profit rules); Jobs Act section 410(a) (discussed above, see supra note 52 and accompanying text).

59Two aspects of the legislative history are noteworthy. First, the House report seeks to harmonize treatment of foreign corporations with foreign partnerships, without mentioning the disparity between domestic corporations and domestic partnerships. RIA’s Complete Analysis of the American Jobs Creation Act of 2004 at 2666 (RIA, 2004). Second, the Senate report would have limited the application of the provision only to foreign partnerships principally owned by foreign persons, id. at 2607, but that partial look-through approach was rejected.

60The constancy of the rule does not stand in the way were the Treasury to decide to change it. It was under the statutory language “residents, corporate or otherwise” that the regulations provided that all domestic corporations were residents. T.D. 7378, 1975-2 C.B. 272. It seems to be within the Treasury’s authority to provide that all domestic partnerships are residents under section 861, given the current statutory language of “noncorporate residents or domestic corporations.”
business and therefore a U.S. resident. The section 897 approach is to treat such a partner “as if [it] were engaged in a trade or business within the United States during the tax year,” and such income “as if [it] were effectively connected with such trade or business,” even though the partner or the partnership may not be so engaged and the income may not be so connected. As a result, such a partnership may convert at least some of its section 897 income otherwise allocable to a foreign partner to non-U.S.-source interest income by borrowing from the foreign partner. The partnership gets the interest deduction but is not required to withhold on interest payments to the foreign partner.

The usefulness of the rule should not be overstated. If the domestic partnership is not engaged in a U.S. trade or business and does not have any (actual or deemed) effectively connected income, the borrowing from a foreign partner would not reduce the tax imposed on the foreign partner or the withholding obligation imposed on the partnership regarding any U.S.-source FDAP income, which tax and withholding obligation are imposed on a gross basis without allowing for any deductions.

Finally, a partnership is constantly in the midst of an identity crisis: Is it a separate entity or an aggregate of entities? But, given the extraordinary conceptual complexity and practical difficulties, any aggregate approach to the interest source rule, whether or not limited

V. Conclusion

In considering partnership-related withholding rules for interest payments, it is critical to clarify, at the outset, the role of the partnership regarding the interest payment. Interest on an obligation of any partnership, even if domestic, that is not engaged in a U.S. trade or business is not U.S.-source income to the creditor.

61So that, for example, the very expansive rules defining income effectively connected with a U.S. trade or business under Treas. reg. section 1.864-4(b) would not, without more, be activated. Under section 875(1), if a partnership is engaged in a U.S. trade or business, its foreign partners will also be considered to be so engaged.

62Section 897(a)(1) (emphasis added).

63Id. (emphasis added).

64As discussed earlier, a member of a partnership is not considered to be engaged in a U.S. trade or business solely because the partnership effects transactions in the United States in stocks or securities for the partnership’s own account, which may, obviously, give rise to section 897 income. See supra note 53.

65See Treas. reg. section 1.861-9T(e). Certain limitations may apply to the deductibility at the partner level. See infra note 66.

66As a variation of the above, consider the following. A foreign corporation has a U.S. subsidiary (U.S. sub). The U.S. sub has its own U.S. subsidiary (U.S. sub-sub), which is consolidated with the U.S. sub but which has elected corporation rather than disregarded entry classification. The U.S. sub and U.S. sub-sub form a U.S. partnership, Rev. Rul. 2004-77, 2004-31 IRB 119, that undertakes certain activities not amounting to a U.S. trade or business. The U.S. partnership borrows, possibly with a guarantee by the U.S. sub, from the foreign parent. See supra note 45 and accompanying text. Interest on that borrowing is not U.S.-source income, even as the U.S. sub guaranteeing the debt may be able to deduct the entire amount of the interest (both its own distributive share and that of the U.S. sub-sub), subject to limitations such as under section 163(j).

67American Law Institute, Federal Income Tax Project: International Aspects of United States Income Taxation 73-74 (1987) (arguing that a pass-through approach that determines the residency of individual partners and attributes a proportionate share of the interest payment to each partner is difficult to administer and proposing that resident for interest source purposes should include a domestic partnership).