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Current date

To: Client file

Facts

1. The name of the US client is MacKenzie, Inc. ("MI")

2. The JV partner is a Turkish company, Turk Contracting and Trading Company ("Turk-Company")

3. The joint venture vehicle is a Nevada ("NV") LLC, named MacKenzie-Turk Construction LLC ("MT LLC")

4. The joint venture will be entering into a contract with the customer, a Cayman company with an Iraqi operation

5. The contract is a fixed price contract with the customer

6. Each JV partner has estimated the costs for their portion of the contract, assume $4 million for Turk-Company, and $1 million for MI

7. MT LLC will be charged the fixed price from each JV partner, and together with the direct costs incurred by MT LLC, a margin will be added to all the costs, resulting in a price for the fixed price contract with the customer

8. In order to ensure each JV partner is responsible for managing the respective costs for which they have quoted and are responsible it is preferable not to co-mingle the costs of the two partners. In essence, each partner is providing a service to the JV to fulfill the contract requirements

9. In addition to the Iraqi branch registration for MT LLC, each JV partner intends to register an Iraqi branch for their respective parts of the proposed operation to fulfill the contract obligations

10. The customer will likely withhold 7% from the gross payment to MT LLC.

11. Turk-Company will be doing the building and installation

12. MI will be providing project management, QC, EH&S, cost scheduling, interface with the customer in Iraq, interface with the customer in the US (approx. 10% of the work performed by MI will be done in the US).

Issues

1. Can the activities of a partner be attributed to the partnership?

2. Is it possible to utilize the Turkey-US tax treaty to avoid a Permanent Establishment ("PE") in the US for Turk-Company?

3. Is it possible to form a non-US partnership between the two partners to undertake the foreign activities and have no services performed in the USA so that there is no little or no US ECTI?

4. What if the amounts to be paid to both partners in MT LLC are structured as guaranteed payments?

5. If the payments for services to both partners are structured as guaranteed payments are there specific recommendations in regard to the guaranteed payments?

Conclusions

1) It is likely the activities of MI would be attributed to MT LLC, and thus Turk-Company would have a US trade or business, and thus US ECTI and the associated § 1446 withholding.

2) There are court cases that would suggest that the Turk-Company would have a PE in the US from the activities of the partnership, MT LLC, and thus the income would likely be US ECTI with the associated § 1446 withholding.

3) The formation of a non-US partnership with a US partner, MI, would likely still result in the same result of US ECTI and associated § 1446 withholding.

4) If the payments for the services provided by both members of MT LLC are structured as guaranteed payments, then arguably the payment to the foreign partner, Turk-Company is not US ECTI and is not subject to § 1446 withholding.

5) If guaranteed payments are to be utilized with respect to payments made to the foreign partner for services performed for the partnership, it is recommended that there be a written

agreement, including: identifying the nature of the services; the place where the services will be performed; and the fact that any payments are not dependent on partnership income

Analysis

Can the activities of a partner be attributed to the partnership?

Generally a partner can act on behalf of the partnership, as well as deal with the partnership in a separate contracting capacity[1]. IRC § 875(1) does not distinguish between general and limited partners, and when considering whether the activities of the partner can be attributed to the partnership this may be an important factor, such that, the activities of a general partner, generally possessing the authority to bind the partnership, would seem to be more easily imputed to the partnership than those of a limited partner (who runs the risk of losing his limited liability protection if he actively participates in the management of the partnership's affairs). As the partnership is a Limited Liability Company, as MI is the managing partner, it is likely that activities of MI would be attributed to MT LLC.

Further, in the case *U.S. v. Balanovski*[2], it was held that Balanovski's activities were imputed to the partnership, and accordingly the partnership (in which he was an 80% partner) was engaged in a U.S. trade or business (and thus the 20% foreign partner was engaged in a trade or business pursuant to § 875(1)). Specifically, Balanovski (i) made important partnership decisions in the U.S., (ii) maintained a bank account for the partnership in the U.S., and (iii) operated out of the partnership's New York office (a hotel room), and those facts all suggested that Balanovski was acting on behalf of the partnership and not for his own account. Thus, there is precedent that the activities can be attributed to the partnership.

Accordingly, it is likely the activities of MI would be attributed to MT LLC, and thus Turk-Company would have a US trade or business, and thus US ECTI and the associated § 1446 withholding.

Is it possible to utilize the Turkey-USA tax treaty to avoid a Permanent Establishment ("PE") in the US for Turk-Company?

As a general rule, under a tax treaty, a foreign person engaged in a trade or business activity in the U.S. will only be taxable on "business profits" generated from that to the extent the foreign person has a PE in the USA to which the profits are "attributable." The taxation of trade or business income under the Code is generally a lower taxable threshold than the taxable threshold

[1] Refer to § 707
[2] 236 F.2d 298 (2d Cir. 1956), *rev'g on this issue* 131 F. Supp. 898 (S.D.N.Y. 1955), *cert. denied*, 352 U.S. 968 (1956).

for a PE, and may be supplanted by treatment of the income under an applicable treaty to the extent the treaty is invoked by the taxpayer. The US requires the taxpayer to file a disclosure that they are electing treaty benefits.

Although most treaties do not specifically address the issue of the foreign partner having a PE, the Service has taken the position that the imputation rule of § 875(1) also applies for purposes of determining a partner's permanent establishment status[3]. Several U.S. court cases have also considered the issue and held in accordance with the Service's position[4].

Accordingly, it is likely Turk-Company would have a PE in the US from the activities of the partnership, MT LLC, and thus the income would be US ECTI with the associated § 1446 withholding.

Is it possible to form a non-US partnership between the two partners to undertake the foreign activities and have no services performed in the USA so that there is no US ECTI?

In Rev. Rul. 2004-3[5], the IRS considered the application of § 875(1) to a service partnership that had been formed under German law and had two equal partners, one a U.S. resident and one a German resident. The German resident partner performed no service in the United States. The IRS ruled, pursuant to provisions of § 875(1), and the decisions in *Donroy* and *Unger*, that the German resident partner should be treated as having a fixed base regularly available to him in the United States and was therefore subject to U.S. taxation on his allocable share of income from the German service partnership to the extent that such income was attributable to the partnership's fixed base in the United States. This result was reached without regard to whether the German resident partner performed any services in the United States.

Accordingly, establishing a foreign partnership, instead of MT LLC, to undertake the proposed Iraqi contract would not provide a different result. The foreign partnership would be seen as having an office in the US by virtue of the US office of MI, and thus there would be US ECTI and associated § 1446 withholding.

What if the amounts to be paid to both partners in MT LLC are structured as guaranteed payments?

In listening to the description of the facts of the proposed contract and the business arrangement, it appears that both members of MT LLC are providing services to MT LLC in regard to their respective areas of expertise. Further, the expected profit margins differ for each service. An

[3] *See* Rev. Rul. 90-80, 1990-2 C.B. 170; Rev. Rul. 85-60, 1985-1 C.B. 187
[4] *Donroy Ltd. v. U.S.*, 301 F.2d 200, (9th Cir. 1962); *Unger v. Comr.*, T.C. Memo 1990-15, *aff'd*, 936 F.2d 1316 (D.C. Cir. 1991).
[5] 2004-7 I.R.B. 486

overriding business requirement is that each partner is independently responsible for the performance of their portion of the contract – risk and reward is on the partner, not the partnership. The amount that can be charged to MT LLC is limited to the amount that was used for the original bid proposal.

The US partnership rules adopt the entity model with respect to transactions in which a partner is acting at arms-length with the partnership[6], and treats the transactions as if occurring between the partnership and a third party. Thus, if a partner performs services for a partnership to which the partner belongs, the partner will include any payment in income based on the partner's method of accounting, and the partnership will deduct or capitalize the payment under its method of accounting. Such payments are generally described as a guarantee payment.

Guaranteed payments are similar in some respects to the distributive share payments (in that the partner is acting in his or her capacity as a partner), but also share some of the characteristics of § 707(a) payments (in that the partner's receipt of such payment is not dependent on the income of the partnership). As provided in § 707(c) and the regulations thereunder, guaranteed payments are fixed payments by a partnership for services (where such payment is not dependent on partnership income).

If a guaranteed payment to a foreign partner is characterized as a payment for services, and if those services are performed outside the United States (and not in connection with a U.S. trade or business), then arguable that income is likely to constitute foreign source income and, accordingly, it would not be subject to U.S. taxation[7].

It should be noted there is some language that may cause some concern in that § 707(c) and the associated regulations may appear to limit this separate treatment[8].

There is no direct IRS or case authority addressing treatment of guaranteed payments to a foreign partner for purposes of § 871. However, for purposes of the foreign earned income exclusion of § 911, both the Tax Court[9] and the Court of Claims[10] have held that guaranteed payments from a partnership to a foreign partner for services performed by the partner are excludable from gross income as foreign source compensation.

[6] Refer to § 707(a)
[7] Refer to § 862(a)(3)
[8] Specifically § 61(a) (relating to gross income) and § 162(a) (relating to trade or business expenses) would be treated as separate payments, and for other purposes of the tax rules, guaranteed payments are regarded as a partner's distributive share of ordinary income
[9] *Miller v. Comr.*, 52 T.C. 752 (1969), *acq.*, 1972-2 C.B. 2.
[10] *Carey v. U.S.*, 427 F.2d 763 (Ct. Cl. 1970).

In *Carey*[11], the Court of Claims stressed (as the Tax Court had in *Miller*[12]) that failure to treat the guaranteed payment as compensation for purposes of § 911 would unfairly discriminate between a partner who performed services for the partnership outside the U.S. and an employee who performed services for the partnership outside the U.S. Both Courts also found that denial of the § 911 treatment for the service provider who also happened to be a partner in the partnership was inconsistent with the policy underlying § 707(c)[13][14].

So although the tax cases and other authorities are in regard to the treatment of guaranteed payments is in relation to § 911, and not in relation to § 871, it does not appear unreasonable to apply the same reasoning that similar payments to a foreign partner would be foreign source compensation income for purposes of § 871[15].

If the payments for services to both partners are structured as guaranteed payments are there specific recommendations in regard to the guaranteed payments?

If guaranteed payments are to be utilized with respect to payments made to the foreign partner for services performed for the partnership, it is recommended that there be a written agreement, including the following items:

- identifying the nature of the services,
- the place where the services will be performed; and
- the fact that any payments are not dependent on partnership income

[11] *Carey v. U.S.*, 427 F.2d 763 (Ct. Cl. 1970).
[12] *Miller v. Comr.*, 52 T.C. 752 (1969), *acq.*, 1972-2 C.B. 2.
[13] The Tax Court noted that the legislative history suggested that the words "but only" under § 707(c) were intended to make clear that guaranteed payments are not treated as compensation for purposes of determining when such payments are included in income but instead are included in income at the same time as the partner's distributive share
[14] In TAM 7939005, the IRS followed Miller and Carey and, in reaching its conclusion, the IRS also acknowledged that § 861(a)(3) (and Regs. § 1.861-4(a)(1)) applied for purposes of sourcing the compensation income.
[15] The same discriminatory treatment that the Courts objected to in the § 911 context would appear to exist if guaranteed payments were not treated as compensation for purposes of § 871.