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SEPTEMBER 30, 2014

BY E-MAIL

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Re: Section 1446 Tax and Reimbursement / Set-Off Procedures

Dear Mr. Gootzeit,

The member banks of the Association of Global Custodians ("AGC" or "Association")[1] would like to take this opportunity to respond to your invitation to follow up on our recent telephone conference by providing some background on why they believe the regulations under Sections 1446 and 1461 of the Internal Revenue Code of 1986, as amended (the "Code") should be amended to allow the use of reimbursement and set-off procedures when a withholding agent discovers that there has been an over-withholding of Section 1446 tax.

Background

The Code imposes two sets of withholding obligations that are potentially applicable to custodians holding interests in publicly traded partnerships ("PTPs")[2] as nominees for foreign partners. First, Sections 1441 and 1442 generally impose a withholding obligation with respect to items of U.S. source "fixed or determinable, annual

[1] The Association is an informal group of 11 member banks that provide securities safekeeping and asset serving functions to cross-border institutional investors worldwide. Members provide custody-related services to most types of institutional investors, including investment funds, pension funds, and insurance companies.

[2] The term "publicly traded partnership" in this letter refers to an entity treated as a partnership under Section 7704(c) of the Code. Unless otherwise indicated, all section references herein are to the Code or the Treasury Regulations promulgated thereunder.

or periodic gains, profits, or income" ("FDAP") of nonresident alien individuals, foreign partnerships and foreign corporations. FDAP consists largely of income items such as dividends, interest, rents, and royalties, and does not include income "effectively connected" with the conduct of a trade or business within the United States ("ECI").[3] Unless a statutory exemption applies, tax must be withheld on FDAP either at the statutory rate of 30 percent or a reduced treaty rate, if applicable. Any person with control, receipt, custody, disposal or payment of an item of U.S. source FDAP of a foreign person covered by Section 1441 or 1442 may be a withholding agent for purposes of those Sections.

Second, Section 1446 imposes a withholding tax on foreign partners' allocable share of a partnership's effectively connected income, gain or loss. In the case of PTPs, the tax is withheld from distributions to foreign partners at the highest applicable statutory rate.[4] The PTP generally is responsible for withholding any tax due under Section 1446; however, a domestic person that holds an interest in a PTP on behalf of a foreign person is considered a nominee and may be treated as the sole withholding agent for purposes of Section 1446.[5]

Current PTP Market Conditions

When PTPs first became broadly available and accepted as an asset class, they were almost entirely oil and gas pipelines or otherwise focused on energy infrastructure assets. The quarterly distributions paid by these PTPs were comprised solely of ECI. Over the past few years, the nature of the businesses classified as PTPs has expanded. Investment management businesses have adopted PTP structures recently, including AllianceBernstein Holding LP, Apollo Global Management LLC, The Blackstone Group LP, and Fortress Investment Group LLC. The qualified notices issued with respect to distributions paid by the investment management businesses show that the distributions are predominately comprised of FDAP income and capital gains, with minimal or no ECI.

Due to the automated nature of the accounting systems used by custodians, the difficulties encountered in obtaining qualified notices on a timely basis,[6] and the risks inherent in under-withholding, most custodians in the absence of information will treat 100 percent of PTP distributions as ECI and withhold under Section 1446 at the applicable tax rate. We anticipate that, notwithstanding the proposed improvements in the qualified notice publication procedures we understand are currently under discussion at the IRS, there will still be PTPs with respect to which custodians will experience difficulties in reliably obtaining clear qualified notices on a timely basis. Therefore, even if qualified notice publication procedures are enhanced, investors in investment management businesses structured as PTPs the interest of which are held at custodians will continue to face the possibility of over-withholding at the date of distribution.

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[3] Code Section 1441(c)(1).
[4] Treasury Regulations Section 1.1446-4(a), (b)(2).
[5] Treasury Regulations Section 1.1446-4(b)(3), (d).
[6] AGC Letter to Internal Revenue Service dated March 22, 2010.

Over-Withholding and Refunds

Treasury Regulations Section 1.1461-2(a) provides a withholding agent that has over-withheld and deposited an amount of tax with two procedures, a reimbursement procedure[7] and a set-off procedure,[8] to adjust the amount of the over-withholding and repay the excess tax to the beneficial owner. Under the reimbursement procedure, the withholding agent repays the beneficial owner the amount of tax over-withheld and reimburses itself by reducing its tax deposit for a subsequent payment period. Under the set-off procedure, the withholding agent repays the beneficial owner by setting off the over-withheld amount against the tax that otherwise would be required to be withheld by the withholding agent on a subsequent payment to that person.

Tax withheld under Section 1446 is specifically excluded from eligibility for applying either the reimbursement or set-off procedures.[9] Treasury Regulations Section 1.1446-4(c) also states the reimbursement and set-off procedures do not apply to paying and reporting the Section 1446 tax with respect to distributions made by PTPs to foreign partners. The absence of a reimbursement or set-off procedure for over-withheld Section 1446 tax means that the affected foreign partner will not recover his over-withheld tax until he files a tax return and claims a refund in the subsequent year, which can result in a significant cash flow detriment to that investor. Moreover, where the withholding agent belatedly learns that none of the distribution was actually ECI, the absence of a reimbursement or set-off procedure to deal with the over-withheld Section 1446 tax can mean that the foreign partner must file, and the IRS must process, an otherwise unnecessary tax return to allow that partner to obtain a refund of his over-withheld Section 1446 tax.

Request for New Guidance

Due to the increased popularity of PTPs as investment vehicles and the expansion of the types of businesses using this structure, there has been a substantial increase in the number of foreign investors holding PTP units through custodians. An increasing number of PTPs are in businesses that generate all or a substantial majority of their income from dividends, interest and capital gains. These PTPs generate no or a very small amount of ECI. Primarily as a result of the market driven changes and to some extent the issues previously raised with respect to the availability of qualified notices, custodians are encountering many situations where Section 1446 tax is being over-withheld.

Accordingly, the Association members respectfully request that the Internal Revenue Service and the Treasury make available the reimbursement and set-off procedures of Treasury Regulations Section 1.1461-2 to situations in which custodians over-withhold Section 1446 tax. Allowing custodians to apply the reimbursement or set-off procedures to Section 1446 tax withholding would permit custodians to more accurately withhold and report on FDAP and ECI derived from PTPs. To the extent a PTP holder is allocated an amount of ECI, it will still be issued a Form 1042-S reporting the amount of income and related withholding and be obligated to file an income tax return with the Internal Revenue Service. Adopting this request would be in keeping with

[7] Treasury Regulations Sections 1.1461-2(a)(2), 1.1461-2T(a)(2).
[8] Treasury Regulations Section 1.1461-2(a)(3).
[9] Treasury Regulations Section 1.1461-2(a)(1).

the changes in the market place (the increase in the volume of non-ECI distributions by PTPs) since the Treasury Regulations were last revised.

The Association members appreciate your willingness to consider the views expressed in this letter. We would be pleased to provide further information upon request in relation to the concerns we have raised.

Sincerely yours on behalf of the Association,

Mary C. Bennett
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Counsel to the Association