

STATE BAR OF CALIFORNIA TAXATION SECTION INTERNATIONAL COMMITTEE

WHY SECTION 2104 MUST ADDRESS WHEN PARTNERSHIP INTERESTS OWNED BY FOREIGN INVESTORS ARE (AND ARE NOT) SUBJECT TO UNITED STATES ESTATE TAX

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Patrick W. Martin principally prepared this proposal as Chair Elect of the International Committee of the State Bar of California Taxation Section.¹ The author wishes to thank Kurt Kawafuchi for his valuable contribution to this paper.²

EXECUTIVE SUMMARY

Internal Revenue Code Section 2104³ generally defines the type of assets that are deemed “situated in the United States” for a “nonresident not a citizen of the United States” and therefore subject to estate tax upon the individual’s death. Section 2105 is a companion provision that defines properties not situated in the United States, for a nonresident who is not a citizen of the United States, and therefore not subject to estate tax upon death.

The statute and the regulations clarify the estate tax treatment of stock of domestic and foreign corporations, among other items, but fail to address whether and when an interest in a partnership⁴ is property situated in the United States (or not) under Code Section 2104. The lack of clarity in this area of the law not only complicates the enforcement of these provisions by the Internal Revenue Service (the “Service”), but also frustrates the proper administration by executors and administrators of foreign estates that own partnership interests.

The partnership entity has existed many centuries,⁵ long before the United States estate tax was enacted in 1916⁶, yet the situs laws for partnerships have yet to be defined for estate tax purposes as it applies to nonresidents who are not citizens of the United States. This creates uncertainty in the law, which is a compliance burden for practitioners and the Service. The need for predictability (and the ability of the Service to administer the law) urges clarification to Sections 2104 and the regulations thereunder. The statute and regulations should be amended and clarified to define when an interest in a domestic⁷ and foreign⁸ partnership⁹ is, and is not, situated in the United States for a nonresident not a citizen of the United States.

¹ Although the participants on the project might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been engaged by a client to participate on this project.

² Mr. Kawafuchi is the Director of Taxation, State of Hawaii Department of Taxation and the comments are his individual views and do not represent the position of the State of Hawaii Department of Taxation.

³ All statutory references are to the Internal Revenue Code of 1986, as amended, and its regulations (the “Code”).

⁴ See I.R.C. § 7701(a)(2) which defines a partnership and partner as follows:

The term “partnership” includes a syndicate, group, pool, venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term “partner” includes a member in such a syndicate, group, pool, joint venture, or organization.

⁵ Partnerships have existed at least since the 18th century in the United States. See *M’Carty v. Emlen*, 2 U.S. 277 (1797), a U.S. Supreme Court case involving an international claim brought by a partnership against a partnership debtor.

⁶ See David Joulfaian, United States Department of the Treasury (Financial Economist, Office of Tax Analysis), *The Federal Estate and Gift Tax: Description, Profile of Taxpayers, and Economic Consequences (OTA Paper 80)* (December 1998).

⁷ See I.R.C. § 7701(a)(4) that defines a domestic partnership as follows:

The term “domestic” when applied to a corporation or partnership means created or organized in the United States or under the law of the United States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations.

⁸ See I.R.C. § 7701(a)(5) which further clarifies that “The term ‘foreign’ when applied to a corporation or partnership means a corporation or partnership which is not domestic.”

⁹ See Treas. Reg. § 301.7701-5 which further defines when a partnership is a resident and nonresident partnership in relevant part as follows:

... 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.

The author proposes adoption of a new and simple rule that is patterned after the current law regarding the situs of stock of domestic and foreign corporations. The proposal also includes amending the regulations to requiring a tax clearance certificate be obtained from the Service before a tax matters partner transfers a partnership interest in a domestic partnership without liability.

Clear rules will allow practitioners and executors of foreign estates to know when the United States estate tax applies to these ownership interests in partnerships and when they should be reported and disclosed on a United States estate tax return. This is of particular importance since the estate tax exemption equivalent is only \$60,000 for foreign persons compared to \$1 million for United States citizens and domiciles.

Clarity will also enable the Service to more effectively enforce and collect United States estate taxes applicable against foreign estates which hold partnership interests.

DISCUSSION

I. PROBLEM: CURRENT LAW AND REASON FOR PROPOSED CHANGE

The United States estate tax has limited application to nonresident decedents who are not citizens of the United States. The tax generally only extends to assets defined as “situated in the United States” under Code Section 2104 at the time of death.¹⁰ The application of the estate tax can be particularly harsh since the current unified credit for nonresident decedents not citizens of the United States exempts only \$60,000 of the taxable estate.¹¹ In contrast, a United States citizen receives a unified credit amount for 2003 that exempts \$1 million of the taxable estate, which increases to \$3.5 million in 2009.¹²

A. Ambiguous Law Since 1916?

The current law definition of “situated in the United States” does not expressly address partnership interests (nor do the relevant regulations) and is therefore unclear and ambiguous and needs clarification. Partnership interests are not defined anywhere in either Sections 2104 or 2105 and the only arguable implicit reference to partnerships is found in the regulations¹³ at Treasury Regulation Sections 20.2104-1(a)(3) and (4) which provide, in relevant part, that the following intangible properties are deemed situated in the United States:

(3) . . . written evidence of intangible personal property which is treated as being the property itself, such as a bond for the payment of money, if it is physically located in the United States; except that this subparagraph shall not apply to obligations of the United States (but not its instrumentalities) issued

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.

¹⁰ See I.R.C. § 2101(a).

¹¹ Additionally, foreign estates are not eligible to deduct expenses, indebtedness, taxes and costs of estate administration unless the executor also discloses on the U.S. estate tax return the value of the worldwide gross estate not situated in the United States. See IRC § 2106(b) and Treas. Reg. §§ 20.2106-1(b) and 20.2106-2. The calculations required under the regulations also require the worldwide estate must be valued and then converted to dollars for purposes of calculating the proportional value of that part of the estate situated in the U.S. compared to that portion situated outside the United States. See Treas. Reg. § 20.2106-2(a) and (a)(2).

¹² The Economic Growth and Tax Relief Reconciliation Act of 2001 changed the estate and gift tax rates and exemption equivalent for U.S. citizens, but not the exemption equivalent for transfers at death for nonresident decedents who are not U.S. citizens as follows:

Death in year	Estate Tax Exemption Equivalent for Non-U.S. Citizens with Foreign Domicile	Estate Tax Exemption Equivalent for U.S. Citizens and U.S. Domiciles	Highest estate tax rate
2002	\$60,000	\$1,000,000	50%
2003	\$60,000	\$1,000,000	49%
2004	\$60,000	\$1,500,000	48%
2005	\$60,000	\$1,500,000	47%
2006	\$60,000	\$2,000,000	46%
2007	\$60,000	\$2,000,00	45%
2008	\$60,000	\$2,000,000	45%
2009	\$60,000	\$3,500,000	45%

¹³ See Robert F. Hudson, Jr., *Post-1989 Tax Planning for Foreign Direct Investment in the United States: The Era of the Non-Corporate Vehicle?* in *International Estate Planning, [International Estate Planning-Principles And Strategies (Kozusko & Schoenblum eds., 1991).*

before March 1, 1941, if the decedent was not engaged in business in the United States at the time of his death.

(4) . . . intangible personal property the written evidence of which is not treated as being the property itself, if it is issued by or enforceable against a resident of the United States or a domestic corporation or governmental unit.

A reading of these provisions provides no clarity that partnership interests are, or should be, identified as “. . . written evidence of intangible personal property which is [or is not] treated as being the property itself . . .” This begs the question: if a foreign individual owns a partnership interest at the time of her death, is or is it not subject to United States estate tax?¹⁴

B. No Case Law Authority and IRS Will Not Issue Rulings

There are also no cases addressing the application of Sections 2104 or 2105 to partnership interests so neither the Service nor private practitioners can glean any guidance from case law authority.¹⁵

The Service will not generally issue rulings as to whether a partnership interest is intangible property for purposes of section 2501(a)(2) (dealing with gift transfers of intangible property by a nonresident not a citizen of the United States).¹⁶ Additionally, the Service will not issue determination letters on matters concerning the application of the estate tax to the prospective estate of a living person.¹⁷ The inability to obtain rulings on these issues frustrates practitioners, foreign taxpayers and their ability to have any certainty as to the application of the United States estate tax to foreign persons who own partnership interests upon death.

C. Various Theories Can be Asserted to Thwart the Estate Tax

Since practitioners do not know if, or when, a partnership interest is subject to United States estate tax, they can generally apply one of a number of different theories to argue that a partnership interest is never subject to United States estate tax.¹⁸ Many commentators have discussed in some detail the various theories that can be used to assert if or when a partnership interest should be deemed property situated in the United States.

These theories include the application of the “aggregate theory” to conclude that the property interest of a deceased partner for federal estate tax purposes is his share of the assets of the partnership and each specific asset of the partnership should therefore be independently analyzed to determine its situs.¹⁹ Another theory looks to the last domicile of the decedent to determine the situs of the partnership interest.²⁰

An additional theory looks to where the partnership carried on business and, indeed, this approach was used by the Service in a 1955 Revenue Ruling and a 1937 General Counsel Memorandum.²¹ Yet another theory looks to the location of the general partners or place of management/administration of the partnership.²² Finally, yet another theory looks to where the “ownership records are maintained and title transfer takes place.”²³

¹⁴ See, for instance, M. Annette Glod, *United States Estate and Gift Taxation of Nonresident Aliens: Troublesome Situs Issues*, *The Tax Lawyer*, 51 *Tax Law.* 109 (1997); Robert F. Hudson, Jr., *Current Techniques for Investing in the United States*, 22 *TAX PLAN. INT'L REV.* (1995). These authors articulate various legal theories that can be posited to arrive at one conclusion or another, as to when and whether partnership interests should be deemed property situated in the United States under I.R.C. § 2104.

¹⁵ Stafford Smiley, *Dispositions of United States Partnership Interests by Nonresident Aliens*, 8 *J. PARTNERSHIP TAX'N* 133, 143 (1991).

¹⁶ See Rev. Proc. 2003-7, 2003-1 I.R.B. 233 (Section 4, .01, (26)).

¹⁷ See Rev. Proc. 2003-1, 2003-1 I.R.B. 1 (Section 5, .05).

¹⁸ *Supra* footnote 14.

¹⁹ Robert C. Lawrence III, *International Tax And Estate Planning* § 3:2.6 (3d ed. 1996), citing *Sanchez v. Bowers*, 70 F. 2d 715 (2d Cir. 1934) to support the proposition that the underlying assets of the partnership should be considered to identify the situs of each asset of the partnership.

²⁰ *Supra*, Robert C. Lawrence III § 3:2.6, citing to *Blodgett v. Silberman*, 277 U.S. 1 (1928), for the proposition that the domicile of the decedent should control.

²¹ Rev. Rul. 55-701, 1955-2 C.B. 836; Gen. Couns. Mem. 18,718, 1937-2 C.B. 476 (declared obsolete by Rev. Rul. 70-59, 1970-1 C.B. 280).

²² This proposition rests on the theory that the partnership relationship on death of a partner is that of a debtor and creditor with the other partners. The situs of the partnership interest is determined, the theory goes, like a debt obligation and then analyzed under I.R.C. § 2104(c). See D. Chase Troxell, *Aliens--Estate, Gift, and Generation-Skipping Taxation*, 201 *TAX MNGT. PORT. (BNA)* A-26 (1991); Sanford H. Goldberg, *Critical Tax Concepts in International Estate Planning*, in *INT'L EST. PLAN. PRINCIPLES & STRATEGIES* 19, 40 (Donald D. Kozusko & Jeffrey A. Schoenblum eds., 1991); and Glod, *supra* at footnote 14.

²³ *Supra*, Sanford H. Goldberg.

This ambiguous treatment of partnership interests thwarts the proper administration of the United States estate tax, prevents any kind of certainty as to its applicability, and breeds contempt for its application with respect to partnership interests owned at death by nonresident individuals who are not United States citizens.²⁴ These multiple theories also provide taxpayers with leeway to take inconsistent positions and to avoid listing interests in domestic partnerships on the estate tax return, IRS Form 706NA.

In 1954,²⁵ Congress clarified the situs treatment of stock of domestic corporations versus foreign corporations to provide a bright-line test for determining United States estate taxation for ownership interests in corporations.²⁶ A similar clear rule could and should be adopted for partnerships, which are becoming increasingly common as a form of conducting business and holding investments throughout the world.

II. PROPOSED ACTION

The author proposes a new and simple rule be adopted that is patterned after the current law regarding the situs of stock of domestic and foreign corporations under Section 2104 and consistent with Revenue Ruling 55-701.²⁷ Section 2104 would be amended to read similarly to Section 2104(a) as follows:

For purposes of this subchapter **interests in a partnership** [~~shares of stock~~] owned and held by a nonresident not a citizen of the United States shall be deemed property within the United States only if issued by a domestic **resident partnership** [~~corporation~~].

Treasury Regulation Section 20.2105-1 would also be amended to read like Section 20.2105-1(f) that defines property not situated in the United States as follows:

Interests in a partnership [~~Shares of stock~~] issued by a **partnership** [~~corporation~~] which is not a domestic **partnership** [~~corporation~~], regardless of the location of the **partnership agreement or membership interests or certificates** [~~certificates~~].

The author further recommends a new regulatory rule be adopted that will help facilitate the enforcement of these provisions by the Service in collecting the United States estate tax from foreign estates. Specifically the regulations can be amended requiring the tax matters partner obtain a tax clearance certificate before transferring a partnership interest in a domestic partnership without liability. It would be patterned after the current rule regarding transfers of stock of a corporation, which provides as follows:

“ . . . no **tax matters partner of a** domestic **partnership** [~~corporation~~] or its transfer agent **shall** transfer **a partnership interest** [~~stock~~] registered in the name of a non-resident decedent (regardless of citizenship) except such **partnership interests** [~~shares~~] which have been submitted for transfer by a duly qualified executor or administrator who has been appointed and is acting in the United States, without first requiring a transfer certificate covering all of the decedent's **partnership interests** [~~stock~~] of the **partnership** [~~corporation~~] and showing that the transfer may be made without liability.”²⁸

This proposal would have the effect that if a domestic partnership is engaged in a trade or business within the United States, the entire value of a partnership interest owned by a nonresident not a citizen of the United States at the time of death, will be part of the taxable estate.

III. SUPPORT FOR PROPOSED ACTION

Total foreign investment in United States equity and debt instruments is immense. The United States Treasury reports that foreign portfolio investment in United States long-term securities, such as stocks and debt instruments with an original term-to-maturity in excess of one year has increased at a rapid rate over the last twenty-nine years.

²⁴ Curiously, there were only 552 and 438 total nonresident estate tax returns (IRS Forms 706NA) filed in the years 1999 and 2000, respectively. See Darien Berkowitz Jacobson, *Federal Estate Tax Returns Filed for Nonresident Aliens, 1999 and 2000*. In contrast, there were 117,226 and 121,171 total estate tax returns filed in the fiscal years 1999 and 2000. See *Number of Returns Filed, by Internal Revenue Region and District, Fiscal Year 1999, 1999 IRS Data Book, June 2001 and Number of Returns Filed, by Type of Returns and State, Fiscal Year 2000, 2000 IRS Data Book, September 2001*.

²⁵ S. REP. 83-1622 (1954).

²⁶ H.R. REP. 83-1337 (1954), reflecting the change in the law whereby “ . . . stock held by nonresident aliens is treated as property situated in the United States if it is stock of a domestic corporation regardless of where the certificates are located” Prior to this change in the law stock of a foreign corporation was also deemed property situated in the United States if the certificates were physically located in the United States.

²⁷ 1955-2 C.B. 836.

²⁸ Treas. Reg. § 20.6325-1(a).

Foreign investments in United States Treasury Debt went from \$463 billion in 1994 to \$1,053 billion in 1997 and \$884 million in 2000 (the latest years in which a completed survey was made). Interestingly, of the total \$2,741 billion of total United States Treasury Debt issued in 1997, 38.4 percent was owned by foreign investors. This demonstrates the importance of in-bound foreign investment and foreign capital into the United States.

Foreign Portfolio Investment in Long-Term Securities
By Type of Security (Source: United States Treasury Department)²⁹
(Amounts in USD Billions)

Type of Security	1974	1978	1984	1989	1994	1997	2000
United States Agency Debt	-	\$ 5.2	\$ 12.8	\$ 47.7	\$ 107.1	\$ 252.0	\$ 261.0
Corporate & Municipal Debt	-	6.9	32.3	191.0	275.6	572.0	703
Equities	24.7	47.8	104.9	275.2	397.8	929.0	3,558.0
United States Treasury Debt	23.8	38.6	118.1	333.2	463.5	1,053.0	884.0
Totals	48.5	98.5	268.1	847.1	1,244.0	2,806.0	5,406.0

Foreign investment in United States long-term securities has also played an increasing importance over the last twenty-nine years to the United States economy. The same United States Treasury report reflects an increase in foreign investment in publicly traded “equities” from a mere \$24.7 billion in 1974 increasing to \$929 billion in 1997 to a staggering \$3.558 trillion in the year 2000.

The estate tax treatment of foreign decedents who own stock of United States corporations and debt instruments (including “portfolio interest” from United States sources as defined in Section 871(h)) at their death is clear.³⁰ Unfortunately, partnership interests and their “situs” for Section 2104 is not clear and likely will continue to discourage foreign investors from investing in partnerships without a clear understanding of the United States tax costs caused at their death.

A. Benefits of Clarification

The principal benefit of this proposal is to provide clarity to the law and to better enable the Service to enforce the collection of United States estate taxes as they apply to foreign estates owning domestic partnerships. Providing clarity in the law should also encourage foreign investors to make investments in domestic partnerships and understand the United States estate consequences of doing so.

Businesses can now choose a wide range of entities for new business ventures and investments at little cost with the “check the box” regulations.³¹ This enables the easy selection of corporate, partnership or disregarded income tax treatment for both domestic and foreign entities. This check the box system provides certainty as to the income tax treatment of various interests in companies. However, the uncertainty of the estate tax treatment of partnership interests remains.

1) Increased Collection of Estate Taxes

The proposal should not have any negative impact on tax receipts and is likely to increase federal tax revenues. This should occur under the proposal, since partnership interests of domestic resident partnerships necessarily will be taxable and therefore, disclosed on the estate tax return. Estate tax revenues should therefore increase from foreign estates. An increase in tax revenues is likely since tax matters partners could be made liable if they

²⁹ See U.S. Treasury’s Benchmark Survey of Foreign Holdings of U.S. Long-Term Securities as of 3/31/2000 (April 2002).

³⁰ See I.R.C. §§ 2104(a), (c) and 2105(b).

³¹ See Treas. Reg. §§ 301.7701-1, 2 and 3.

do not obtain a tax clearance certificate from the Service before transferring to foreign heirs the partnership interest in domestic partnerships.

The total United States estate taxes paid by foreign estates was only \$30.8 million for the year 2000 (of which \$11.1 million came from apparently a single Moroccan estate).³² Moreover, approximately 44 percent of the total taxable foreign estates consisted of United States stock (publicly traded and closely held stock) as reported on the non-resident estate tax returns for 2000.³³ United States real estate consisted of 38 percent of all foreign taxable estates, whereby stock and real estate combined, represented the vast majority of all taxable assets “situated in the United States” pursuant to Section 2104(a) and Treasury Regulation Section 20.2104-1(a)(1).³⁴

In 1999, the total estate tax paid by all foreign estates was less than half of the year 2000 amount at only \$14.6 million. Curiously, the largest foreign estate reported in 1999 was an Afghanistan estate. As was the case in 2000, stock and real estate represented the vast majority of the total assets of foreign taxable estates. Stock represented approximately 36 percent and real estate represented 44 percent of the United States total gross estates of all of these foreign estates.³⁵

In contrast to the modest estate taxes paid by foreign estates, the total United States estate taxes paid in 1999 and 2000 was \$28.4 and \$29.7 billion, respectively.³⁶ Accordingly, estate tax collections from foreign estates typically only represents less than one-tenth of one percent (0.051% for 1999 and 0.104% for 2000) of the total annual estate taxes collected by the United States.

Unfortunately, this United States Treasury study of non-resident estate tax returns filed in 1999 and 2000 did not separately identify partnership interests (if any) that were reported and reflected on the non-resident estate tax returns. Were any domestic partnership interests reported on United States estate tax returns of foreign estates? As was explained above, the current ambiguity in the law can enable private practitioners to argue that no partnership interests are ever property “situated in the United States” by applying various legal theories. This provides the opportunity for the foreign estate to not report any partnership interests (either domestic or foreign) on the United States estate tax return.³⁷

These statistics are illuminating, when considering the total foreign investment in United States long-term securities in the year 2000 was reported at \$5.4 trillion.³⁸ These estate tax return statistics strongly imply that possibly large numbers and values of domestic partnership interests go unreported on United States non-resident estate tax returns.³⁹

2) Proposal is Consistent with Rev. Rul. 55-701 and United States’ Estate Tax Treaties

The proposal provides a rational approach of taxing foreign domiciled decedents with respect to partnership interests and is consistent with Rev. Rul. 55-701. The 1955 ruling addressed a British citizen domiciled in England who was a partner in a partnership conducting business in New York. The ruling also analyzed the then applicable estate tax treaty between the United States and United Kingdom.⁴⁰

In resolving the issue of partnership situs, the Service considered three different theories (each of which is explained above). First, should the partnership interest be treated as debt? Second, should the physical location of the individual partnership’s assets control? Third, should the location where business is carried on

³² *Supra*, footnote 24.

³³ *Supra*, footnote 24, Darien Berkowitz Jacobson, *Federal Estate Tax Returns Filed for Nonresident Aliens, 1999 and 2000, providing a break down by country of Form 706NA estate tax returns filed in treaty countries.*

³⁴ *See supra*, footnote 26, explaining bright-line test adopted in statute for stock of domestic and foreign corporations.

³⁵ *Supra*, footnote 24.

³⁶ *See Treasury Department Gross Tax Collections: Amount Collected by Quarter and Fiscal Year, 1987-2002. SOI Bulletin, Historical Table. Issued Quarterly.*

³⁷ *See William W. Bell & David B. Shoemaker, TAMRA Increases Estate Tax Rates of Nonresident Aliens, 6 J. PARTNERSHIP TAX’N 79 AT 82 (1989), where the authors conclude that the “most well-informed practitioners advise their NRA clients that investing in U.S. real property through a partnership . . . will subject the investment to U.S. estate taxation . . . [but] [t]he lack of clear authority, leaves an opening to ethically sanction the exclusion of partnership interests . . . [and] [o]ne suspects that, more often than not, the result is that no U.S. estate tax return is filed at all.” Id. at 81-2.*

³⁸ *Supra* footnote 29. *These amounts do not even include foreign investment in U.S. real estate or other types of U.S. investments.* **Error! Bookmark not defined.**

³⁹ *See William W. Bell & David B. Shoemaker, supra* footnote 37.

⁴⁰ Currently, the U.S. has estate tax treaties with the following seventeen different countries: Australia, Italy, Austria, Japan, **Canada, Netherlands, Denmark, Norway, Finland, Republic of South Africa, France, Sweden, Germany, Switzerland, Greece, United Kingdom and Ireland. **Article XXIX B of the United States-Canada Income Tax Treaty.

determine the situs of the partnership interest? By applying the estate tax treaty and concluding a partner has no direct ownership rights in each specific property of the partnership, the Service concluded the location of where the business is carried on should determine the situs of the partnership interest.

Similarly, the proposal would clarify and impose taxation on the entire value of a foreign decedent's interest in a domestic partnership. A domestic resident partnership is already defined in the Code and regulations: "... [A] partnership engaged in a 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."⁴¹

The existing definition of a domestic resident partnership is one engaged in a trade or business within the United States, which is the same basis by which the Service determined estate tax situs of the partnership interest owned by the British decedent in Revenue Ruling 55-701.

Additionally, the proposed rule is consistent with each of the seventeen United States estate tax treaties, only five of which expressly reference partnership interests.⁴² A country-by-country analysis and comparison of each estate tax treaty is reflected in the attached Exhibit "A."

3) Voluntary Compliance with United States Estate Tax Should Improve

Finally, clarity in the law and potential personal liability for the tax matters partner will strongly encourage compliance. Remember, the proposal to amend the regulations will provide the Service with a better enforcement mechanism for collecting United States estate tax from foreign estates. The proposal requires that the tax matters partner of a partnership, can avoid personal responsibility for the estate tax of the foreign estate by requiring transfers of partnership interests be accompanied by a tax clearance certificate. Clarifying the law will also require executors and practitioners to necessarily include the entire value of interests in domestic resident partnerships to be disclosed on the United States estate tax return.

The Service is not required to make any formal assessment, recording, or filing, for the "silent" estate tax lien to become effective against the worldwide assets of the estate.⁴³

When a foreign estate has no assets located in the United States (due to post-death transfers), however, the Service probably will have little to no success in suing a foreign estate in the courts of another country in order to collect taxes owed to the United States. This problem exists, even if the United States first reduces the taxpayer's obligation to a judgment of a United States court. This is illustrated in United States v. Harden.⁴⁴ In Harden, the Supreme Court of Canada declined to enforce the tax claims of the United States federal government since the Court held that such claims invaded the independent sovereignty rights of Canada. The Canadian Court articulated that the tax laws of one country often represent strong public policies not shared by the country in whose courts enforcement is sought.⁴⁵

Both foreign and United States executors and administrators of estates, certain persons in possession of property, and transferees, can already be personally liable for the United States estate tax when it comes due.⁴⁶ However, with this international impediment to enforcing the U.S. estate tax laws abroad, the proposed personal liability to the tax matters partner should increase compliance and respect for the United States estate tax system by administrators of foreign estates.

⁴¹ See I.R.C. § 7701(a)(2) and Treas. Reg. § 301.7701-5.

⁴² The one possible qualification relates to Article III(1)(g) of the United States-Australia Estate Tax Convention, which seems to allow for taxation of partnership interests only to the extent of the partnership's business at that place. The rule proposed herein would allow the United States to impose taxation of the entire interest in a domestic resident partnership, even if it also conducted partnership business outside of the United States whether that be in Australia or any other country. Accordingly, the author urges that any amendment to I.R.C. § 2104 that might arguably effect the Australian or any other estate tax treaty should include specific legislative history providing that any such amendment is not intended to be a legislative override of any existing estate and gift tax treaty commitments of the United States. See I.R.C. § 7852(d) and Tag Albert v. Rogers, 267 F.2d 664 (1959), cert. den. 362 US 904 (1960), reh. den. 362 U.S. 957 (1960) and Hing Lowe v. U.S., 230 F.2d 664 (1956).

⁴³ See I.R.C. § 6324(a)(1). Estate tax lien arises against the gross estate of the decedent, and continues for a period of ten years after the date of death. The Supreme Court has upheld as Constitutional that the Service is not required to make any formal assessment, recording, or filing, for this special estate tax lien to become effective giving the Service a right as a secured creditor in the property. Detroit Bank v. United States, 317 U.S. 329 (1943).

⁴⁴ 11 AFTR2d 849 (C.A. Brit. Col. 1962), aff'd, 12 AFTR2d 5736 (Sup. Ct. Can. 1963).

⁴⁵ See also Her Majesty the Queen v. Gilbertson, 597 F.2d 1161 (9th Cir. 1979), where the ninth circuit similarly refused to enforce a Canadian tax assessment stating that "... if the court... was compelled to recognize the tax judgment from a foreign nation, it would have the effect of furthering the governmental interests of a foreign country, something which our courts customarily refuse to do." *Id* at 1165.

⁴⁶ See I.R.C. § 6324(a).

By making a tax matters partner potentially directly liable for the estate tax not collected against the foreign estate, there will be yet greater incentive for the executors of foreign estates and United States tax matters partner to comply so as to avoid personal liability.

IV. CONCLUSION

The current law does not address whether and when an interest in a partnership is property situated in the United States (or not) under Section 2104 and therefore taxable to a foreign estate. This ambiguity thwarts the proper application and administration of the estate tax to foreign estates. Clarifying the law, by adopting a proposal patterned after the current law regarding the situs of stock of domestic and foreign corporations will assist the Service in the proper administration of the tax and reduce the ability of taxpayers from taking inconsistent tax positions. The proposal also recommends amending the regulations to require the tax matters partner obtain a tax clearance certificate before transferring a partnership interest in a domestic partnership without liability. Finally, this proposal, to define an interest in a partnership as “situated in the United States” if it is engaged in a trade or business within the United States, is consistent with the United States estate tax treaties and the principles articulated in Revenue Ruling 55-701.

EXHIBIT "A" – ESTATE TAX TREATY

COUNTRY BY COUNTRY ANALYSIS

<i>Tax Treaty Country</i>	<i>Applicable Article</i>	<i>Taxation of Partnership Interests – Situs (Relevant Provision from Estate Tax Treaty)</i>
Australia	Art. III(1)(g)	(g) A partnership, shall be deemed to be situated at the place where the business of the partnership is carried on, but only to the extent of the partnership business at that place
Italy	N/A	* No mention of partnership interests in Treaty
Austria	N/A	* No mention of partnership interests in Treaty
Japan	N/A	* No mention of partnership interests in Treaty
Canada**	N/A	* No specific mention of partnership interests in Treaty with respect to Article XXIX B (Taxes Imposed by Reason of Death).
Netherlands	Article 7(1) and (2)	<p>(1) Except as provided in Article 6, assets . . . forming part of the business property of a permanent establishment may be taxed by a State if the permanent establishment is situated in that State.</p> <p>(2) For purposes of this Convention, the term “permanent establishment” means a fixed place of business through which a decedent was engaged in trade or business. A decedent shall be deemed to have been engaged in trade or business through a fixed place of business whether he is so engaged as a sole proprietor or through a partnership or other unincorporated association, but in the case of a partnership or association, only to the extent of his interest therein. References in this article to a “decedent” shall be deemed to include such interests.</p>
Denmark	N/A	* No mention of partnership interests in Treaty
Norway	N/A	* No mention of partnership interests in Treaty
Finland	N/A	* No mention of partnership interests in Treaty
South Africa	N/A	* No mention of partnership interests in Treaty
France	Article 6 (1) and (2)	<p>(1) Except as provided in Article 5, assets . . . used in or held for use in the conduct of the business of a permanent establishment may be taxed by a Contracting State if the permanent establishment is situated therein.</p> <p>(2) For purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on. If an individual is a member of a partnership or other association that is not a corporation which is engaged in industrial or commercial activity through a fixed place of business, he shall be deemed to have been so engaged to the extent of his interest therein.</p>

Sweden	Article 79(1) and (2)	<p>PROPERTY NOT EXPRESSLY MENTIONED</p> <p>(1) Transfers and deemed transfers by an individual domiciled in a Contracting State of property other than property referred to in Articles 5 and 6 shall be taxable only in that State.</p> <p>(2) If the law of a Contracting State treats a property right as property described in Article 5 or 6, but the law of the other Contracting State treats that right as an interest in a partnership or trust governed by paragraph 1, the nature of that right shall be determined by the law of the Contracting State in which the transferor or deemed transferor is not domiciled.</p>
Germany	Article 8	<p>INTERESTS IN PARTNERSHIP</p> <p>An interest in a partnership which terms part of the estate of or a gift made by a person domiciled in a Contracting State, which partnership owns property described in Article 5 or 6, may be taxed by the State in which such property is situated, but only to the extent that the value of such interest is attributable to such property.</p>
Switzerland	N/A	* No mention of partnership interests in Treaty
Greece	N/A	* No mention of partnership interests in Treaty
United Kingdom	N/A	* No mention of partnership interests in Treaty
Ireland	N/A	* No mention of partnership interests in Treaty

**Article XXIX B of the United States-Canada Income Tax Treaty

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