

# Transferring Partnership Interests: Buyer Beware of Withholding Obligations, Seller Beware of Tax Liability

## WRITTEN BY

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The U.S. federal taxation of non-U.S. persons who transfer interests in partnerships has a long and storied history. The government staked out its position in 1991, effectively providing that a non-U.S. partner should be taxed on a sale of a partnership interest as if the partnership had sold all of its assets.<sup>1</sup> Many practitioners disagreed, and the Tax Court ultimately held that the IRS's position was not correct.<sup>2</sup>

The Tax Cut and Jobs Act enacted in 2017 legislatively overruled the court, providing for the taxation of the partner and, even more importantly, providing for a new 10 percent withholding tax that applies on every transfer of a partnership interest, unless an applicable exception applies. The withholding obligation should be read as broadly as the prior sentence implies. Any transfer of a partnership interest is subject to the withholding rules. It does not matter if the partnership is a "U.S." partnership or a "foreign" partnership. At first blush, it does not matter if the partnership is engaged in a business in the United States. Unless one of the exceptions applies and the proper certification is obtained, the withholding tax applies. For this purpose, a transfer of a partnership interest includes a sale, exchange or any other disposition of the partnership interest. Thus, a redemption of a partnership interest by the partnership is a covered transfer. This article provides a brief overview of these provisions and common issues that arise for non-U.S. persons selling a partnership interest.<sup>3</sup>

## The New Withholding Rules

Section 1446(f) provides that:

If any portion of the gain (if any) on the disposition of an interest in a partnership would be treated under section 864(c)(8) as effectively connected with the conduct of a trade or business within the United States, the transferee shall be required to deduct and withhold a tax equal to 10 percent of the amount realized on the disposition.

On its face, the section appears to tie the withholding obligation to the existence of effectively connected income (ECI) realized by a non-U.S. person on the transfer of the partnership interest. The problem, however, is that the transferee does not know if the conditions are satisfied, absent certain proof. In addition, the rule as written creates a cliff — if the transferor realizes \$1 of effectively connected gain, the 10 percent withholding is based on the entire amount realized.<sup>4</sup> For these reasons, it is reasonable to think of section 1446(f) as a rule that requires withholding of 10 percent on all transfers of *any* partnership interest unless there is an identifiable exception.

The statute grants broad regulatory authority for the Treasury Secretary to prescribe, among other things, reduced amounts of withholding and to promulgate regulations that provide for exceptions to withholding.<sup>5</sup>

While no regulations have been issued under section 1446(f), two Notices that evidence the intention of Treasury to make use of the regulatory authority granted have been published.<sup>6</sup> The first, Notice 2018-08, suspended application of section 1446(f) to transfers of publicly traded partnerships until further notice. The second, Notice 2018-29, provides substantive guidance on the application of section 1446(f) for nonpublicly traded partnerships. It provides that no withholding needs to occur if one of the following applies:

- The transferor provides a certification on which the transferee can rely that the transferor is a U.S. person
- The transferor provides a certification on which the transferee can rely that there will be no gain realized on the transfer
- The transferor certifies that she has realized less than 25 percent of her income from the partnership as ECI in the prescribed time period
- The partnership certifies that if it sold all of its assets at fair market value, less than 25 percent of the income would be ECI
- The transferor provides a certification on which the transferee can rely that the transferee meets the requirements of a nonrecognition provision of the Code.

Notice 2018-29 also provides that section 1446(f)(4), which places a withholding obligation on the partnership if the transferee failed to withhold, is suspended until regulations are issued. As of January 31, 2019, no further guidance has been forthcoming.<sup>7</sup>

In general, the certifications need to be made under penalties of perjury, and the transferee cannot know that they are wrong to rely on them.

#### *Determining Amount Realized for Withholding*

Absent future guidance to the contrary, amount realized is determined by including the proceeds received and any relief of liability that comes with the transfer of the partnership interest.<sup>8</sup> In documenting and reporting amount realized, the transferee may rely upon either (i) the transferor's certification, under penalties of perjury (A) as to its share of partnership liabilities on the last Schedule K-1 for the partnership's tax year that closed no more than 10 months before the transfer and (B) that the transferor does know of events that would change that amount by more than 25 percent, or (ii) the partnership's certification, under penalties of perjury as to (A) the transferor's share of partnership liabilities on the last Schedule K-1 and (B) that the partnership does not know of events that would change that amount by more than 25 percent.<sup>9</sup>

#### **Section 864(c)(8) — Tax Liability of the Non-U.S. Partner Disposition of a Partnership Interest**

Section 864(c)(8) provides that a non-U.S. person partner in a partnership will have ECI on the disposition of a partnership interest if such income would have arisen if the partnership sold all of its assets in transfers that occurred after November 27, 2017.<sup>10</sup>

Note that all gain on the disposition is ECI, except to the extent provided in section 864(c)(8)(B), and "sale or exchange" is defined in section 864(c)(8)(D) to mean "any sale, exchange or other disposition." There are certain limitations on the basic rule that are based on the portion of the partner's distributive share of gain connected to a

U.S. business, and whether any of the gain is connected to a U.S. business.<sup>11</sup>

### *Calculation of the Effectively Connected Gains and ECI — Complete Transfers*

On December 20, 2018, the Treasury Department released proposed regulations under section 864(c)(8).<sup>12</sup> They provide detailed rules on how to calculate the ECI. Generally, the rules provide that the amount of the gain or loss, and the character, of the transfer of the partnership interest is calculated under the general rules of sections 741 and 751, giving rise to outside capital gain or loss and outside ordinary gain or loss.<sup>13</sup> Section 864 and the proposed regulations are then applied to calculate the amount of these categories that produce effectively connected gain or loss (EC gain/loss) and ECI or ECL.

The proposed regulations contain a limited anti-stuffing rule, which provides that, if the non-U.S. person who is transferring the partnership interest (or a related person) transfers property to the partnership with a principal purpose of reducing the amount of EC gain or increasing the amount of the EC loss, the transfer of the property into the partnership is ignored for purposes of applying section 864(c)(8).<sup>14</sup>

### *Calculating ECI — Sales and Other Transfers*

If the rules of sections 864(c)(8)(A) and (B) are applied literally, a transfer of a portion of an interest in the partnership can result in accelerating the taxation of ECI. The proposed regulations helpfully provide that, in certain partial sales, the foreign transferor's distributive share of deemed sale EC gain is that which is attributable to the portion of the partnership interest that was transferred.<sup>15</sup> In evaluating the consequences in an asset sale, section 864(c)(8) provides that a sale or exchange includes "any disposition." This includes, for example, the transfer of a partnership interest to a corporation as part of the incorporation of that partnership. Given the impact of the rules under sections 864(c)(8) and 1446(f), and the new, lower corporate tax rate, these types of transactions are being considered on a regular basis. section 864(c)(8)(E) provides the Treasury Secretary with authority to promulgate regulations as are appropriate to implement the section in respect of certain corporate transactions, such as transactions covered by section 351. The proposed regulations do make it clear, however, that section 864(c)(8) does not create gain that is otherwise not recognized by reason of one or more nonrecognition sections of the Code.<sup>16</sup>

## **Pepper Perspective**

Before the Tax Cut and Jobs Act, non-U.S. persons were starting to be more accepting of investing in partnerships that produced ECI. Today, with the certainty that on a taxable exit they will be subject to U.S. tax on the ECI and the difficulties of the withholding tax determinations, certain investors may favor investing only in corporations. As noted above, exceptions do apply, and certain non-U.S. persons may still be interested in investing in certain partnerships, including those that do not produce ECI (e.g., the partnership only invests in C corporations) and those that can and will provide certifications to preclude the section 1446(f) withholding. We also note that, although Notice 2018-29 provides helpful guidance for the implementation of section 1446(f), the IRS is aware of certain procedural issues with the provision and is currently considering how to address these practical application matters. Until that guidance is issued, transfers of partnership interests will continue to raise significant tax issues.

## **Endnotes**

<sup>1</sup> Rev. Rul. 91-32, 1991-1 C.B. 107. For purposes of this article, a “partnership” is any entity that is classified as a partnership for federal income tax purposes. This includes domestic multimember LLCs that have not elected to be treated as corporations, non-U.S. entities that have elected to be classified as partnerships for U.S. tax purposes (they “checked the box”), non-U.S. entities that default to partnership status, and, of course, domestic limited and general partnerships.

<sup>2</sup> *Grecian Magnesite Mining v. Comm’r*, 149 T.C. 63 (2017), *appeal argued*, No. 17-1268 (D.C. Cir. Oct. 9, 2018). The case makes for great reading and presents many interesting technical issues. But alas, the Act has rendered most of them moot, and they are not addressed in this article. See Alan I. Appel et al., *Taxation of Foreign Persons Who Dispose of Interests in Partnerships*, Tax Series Special Update: Tax Practice After the Tax Cuts and Jobs Act, at 243, 241-55 (PLI 2018) for a detailed description of the case.

<sup>3</sup> *Note*: A version of this article will be published in a New York University publication in the near future.

<sup>4</sup> I.R.C. § 1446(f)(1) (2017).

<sup>5</sup> I.R.C. § 1446(f)(3), (6) (2017).

<sup>6</sup> Notice 2018-29, 2018–16 I.R.B. 495.

<sup>7</sup> We note that the December 2018 proposed regulations for I.R.C. § 864(c)(8) do not address the I.R.C. § 1446(f) issues.

<sup>8</sup> I.R.C. §§ 1001(b), 752(d) (2017). Note that if 10 percent of the amount realized is greater than the proceeds, or if the transferee cannot determine the transferor’s share of liabilities, the Notice provides in section 8 that the withholding is for the entire amount paid.

<sup>9</sup> Notice 2018-29, 2018–16 I.R.B. 495.

<sup>10</sup> See *generally* I.R.C. §§ 875, 871 (2017).

<sup>11</sup> A similar rule applies to losses. See I.R.C. § 864(c)(8)(B)(ii). In addition, there are coordination rules for U.S. real property interests held by the partnership, as they are subject to the rules of § 897 and § 1445. See I.R.C. § 864(c)(8)(C) (2017).

<sup>12</sup> REG-113604, 83 Fed. Reg. 66,647 (Dec. 27, 2018).

<sup>13</sup> Preamble, REG-113604, 83 Fed. Reg. at 66,649.

<sup>14</sup> Prop. Treas. Reg. § 1.864(c)(8)-1(h).

<sup>15</sup> Prop. Treas. Reg. § 1.864(c)(8)-1(c)(3)(iii).

<sup>16</sup> Prop. Treas. Reg. § 1.864(c)(8)-1(b)(2)(ii).

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