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International Tax ADVISORY ■

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Another Chapter in the Effectively Connected Income Saga—IRS Issues Proposed Regulations on Sales of Partnership Interests by Foreign Partners

The rules addressing the taxation of income effectively connected with a U.S. trade or business (ECI) are voluminous and complex, but the latest regulatory guidance focuses on one particular aspect—certain partnership interest sales by foreign partners. In this particular context, a foreign partner has always been deemed to be indirectly engaged in a U.S. trade or business of a partnership that is itself engaged in a U.S. trade or business. This means that, while it is a partner, the foreign partner's distributive share of partnership income that is ECI is taxed as ECI to the foreign partner. But as a result of a change in law in 2017, this also means that, when a foreign partner sells its interest in the partnership, the gain or loss would also be taxed as ECI to the partner. The latest proposed regulations focus only on the scenario in which a foreign partner that does not otherwise directly conduct a trade or business in the U.S. sells its interest in a partnership that is so engaged, and whether in that circumstance the gain or loss from the sale is ECI.

Background

In Rev. Rul. 91-32, the IRS published its view that such gain or loss should generally give rise to ECI to the selling foreign partner, even if the gain or loss is not effectively connected to a U.S. trade or business conducted directly by the foreign partner. The IRS adopted an aggregate approach, viewing a foreign partner's disposition of its interest in a partnership that is engaged in a U.S. trade or business as a disposition of an aggregate interest in the partnership's underlying assets for purposes of determining the source and ECI character of the foreign partner's gain or loss. Thus, the IRS ruled that gain or loss on the sale is generally ECI to the foreign partner to the extent that a sale by the partnership of its assets would give rise to ECI.

For many years, this was the controlling standard. Then in 2017, in *Grecian Magnesite Mining v. Commissioner*, to the surprise of many, the Tax Court rejected the IRS's longstanding position in Rev. Rul. 91-32. The Tax Court was persuaded that the applicable tax provisions in this context mandate an entity approach, rather than an aggregate approach, and, therefore, that a sale of a partnership interest is not attributable to the partnership's underlying assets and activities. Accordingly, the Tax Court held that partnership dispositions by foreign partners generally should not give rise to ECI because gain or loss on dispositions by foreign persons of personal property (including an interest in a partnership) is generally foreign source.

The IRS appealed the decision in *Grecian*, but before the appeal was concluded, the Tax Cuts and Jobs Act (TCJA) was enacted on December 22, 2017, and it included new Section 864(c)(8), which effectively repealed the holding in *Grecian* and codified the IRS's position in Rev. Rul. 91-32.

The New Law

New Section 864(c)(8) provides that gain or loss of a nonresident alien individual or foreign corporation from the sale, exchange, or other disposition of a partnership interest is treated as effectively connected with the conduct of a trade or business within the U.S. to the extent that the foreign transferor would have had effectively connected gain or loss if the partnership had sold all of its assets at fair market value as of the date of the sale or exchange. It achieves this result by limiting the gain or loss on the sale of the partnership interest treated as ECI to the portion of the foreign partner's distributive share of gain or loss that would have been ECI had the partnership sold all of its assets at fair market value on the date of the disposition of the partnership interest. This section is effective for sales, exchanges, and dispositions on or after November 27, 2017.

The TCJA also added a corollary provision in new Section 1446(f) to address withholding. If any portion of the gain on a disposition of a partnership interest would be treated as ECI under new Section 864(c)(8), new Section 1446(f) requires that the transferee withhold 10% of the amount realized (or the partnership itself must withhold, if the transferee fails to do so), unless the transferor furnishes an affidavit stating that it is not a foreign person. Proposed regulations under Section 1446(f) are forthcoming, but in the meantime the IRS has issued two notices under Section 1446(f) providing interim guidance and suspending the withholding requirement for publicly traded partnerships and for partnerships in which a transferee has failed to make the required withholding.

The Proposed Regulations

Ordinarily, under Section 864(c)(4), gains of a foreign person from the sale of personal property (other than inventory) must also be U.S. source to be treated as ECI, and Rev. Rul. 91-32 relied on Sections 865(e)(2) and (3) to convert otherwise foreign-source partnership interest gain to U.S. source by attributing the gain to the U.S. office or fixed place of business of the partnership. New Section 864(c)(8) instead effectively attributes to the partner the U.S.-source income that would be generated from a deemed sale of partnership assets.

The proposed regulations under Section 864(c)(8) provide a complex formula for determining a foreign partner's gain or loss taxable as ECI upon the transfer of a partnership interest. First, a foreign partner is generally required to determine the actual amount and character of its gain or loss on the transfer of its partnership interest under the usual Code provisions applicable to such transfers under Subchapter K (e.g., Section 741,

which generally treats partnership interest sale gain as capital, and Section 751, which could recharacterize gain as ordinary to the extent attributable to the partnership's "hot assets"), resulting in its "outside capital gain or loss" and "outside ordinary gain or loss" on the transfer. Next, the proposed regulations require the partner to determine the foreign transferor's distributive share of the ordinary and capital components of the amount of gain or loss that the partnership would recognize and treat as ECI if all of its assets were sold to an unrelated party in a fully taxable transaction for cash equal to the asset's fair market value.

That share is compared to the foreign transferor's corresponding outside capital and ordinary gain or loss amounts to determine the amounts taxable as ECI. For example, a foreign transferor would compare its outside capital gain to its distributive share of effectively connected capital gain from the partnership's deemed asset sale, treating the former as ECI only to the extent it does not exceed the latter, and the same for outside ordinary income.

Importantly, the proposed regulations permit the foreign partner's distributive share of deemed asset sale ECI to be determined under all applicable Code provisions, including allocations under Section 704 and basis adjustments under Section 743, which according to the preamble better equates the outcome with the results of an actual asset sale by the partnership.

The proposed regulations also provide rules to coordinate new Section 864(c)(8) with Section 897(g), which governs the taxation of sales of partnership interests in partnerships that hold U.S. real property interests. When a partnership holds U.S. real property interests and is subject to both sections, the proposed regulations indicate that the amount of the foreign transferor's gain or loss treated as ECI will be determined under Section 864(c)(8) and not Section 897(g).

The proposed regulations also confirm that Section 864(c)(8) applies to tiered partnerships. Therefore, when an upper-tier partnership owns an interest in one or more lower-tier partnerships that are engaged in a U.S. trade or business, the foreign partner's ECI on a sale of the upper-tier partnership is determined based on the allocable share of the deemed asset sale ECI of each lower-tier partnership. Similarly if the upper-tier partnership were to transfer its interest in a lower-tier partnership, the upper-tier partnership would determine its ECI based on the deemed asset sale of the lower-tier partnership. This can significantly increase compliance costs for foreign transferors because obtaining the necessary information about a lower-tier partnership's assets may be administratively burdensome; meanwhile, the threat of withholding under Section 1446(f) looms large for such transfers.

For treaty purposes, the proposed regulations provide that a disposition of a foreign partner's interest in a partnership is treated as a disposition of the partner's permanent establishment. Thus, the proposed regulations state that, in general, the permanent establishment paragraph of the gains article in a treaty will preserve the United States' taxing jurisdiction over the gain on the transfer of a partnership interest that is subject to tax under Section 864(c)(8). Without providing much of an explanation, the IRS seems to just assume that a deemed sale construct similar to new Section 864(c)(8) should apply in the treaty context, even though the statute and the legislative history are silent on the matter.

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