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International Tax ADVISORY ■

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Hold Up, Partner: Proposed Regulations Address Withholding on Foreign Partner Dispositions

On May 7, 2019, the Treasury and IRS released proposed regulations under Section 1446(f), regarding withholding tax on foreign partners who dispose of an interest in a partnership that is engaged in business in the United States. The proposed rules largely reflect guidance in Notice 2018-29, with some friendly and less friendly changes. The regulations also activate withholding for publicly traded partnerships (PTPs) and secondary withholding by partnerships on distributions to transferees, which had been suspended in interim guidance.

Background

Under Code Section 864(c)(8), added by the Tax Cuts and Jobs Act of 2017, gain or loss on a foreign partner's disposition of an interest in a partnership that is engaged in business in the U.S. may be treated as effectively connected income (ECI). The foreign partner would face U.S. tax to the extent of the partner's allocable share of ECI from the partnership's hypothetical sale of its assets. Section 864(c)(8) prospectively overturns the 2017 Tax Court decision in *Grecian Magnesite Mining v. Commissioner* (149 T.C. No. 3) and codified the IRS's position in Revenue Ruling 91-32.

Section 1446(f) requires a transferee of a partnership interest to withhold 10 percent of the amount realized if any portion of the gain on disposition would be taxable under Section 864(c)(8). A statutory exception applies if the transferor partner certifies that it is not a foreign person. If the transferee fails to withhold, Section 1446(f)(4) obligates the partnership to withhold the tax from distributions to the transferee, plus interest ("secondary withholding"). Section 1446(f) generally applies to dispositions after December 31, 2017.

Notice 2018-08 suspended Section 1446(f) withholding on dispositions of interests in PTPs. Notice 2018-29 provided implementing guidance for non-PTPs, referring to procedures under Section 1445 (relating to FIRPTA) and enumerating limited exceptions. Under Notice 2018-29, withholding would not be required if:

(1) The transferor certifies non-foreign status;

(2) The transferor certifies that it will not realize gain on the disposition of its partnership interest;

(3) The transferor certifies that its allocable share of ECI was less than 25 percent of its total distributive share for each of the transferor's three most recent tax years;

(4) The transferor is not required to recognize any gain or loss due to a nonrecognition provision of the Code and satisfies notice requirements under Section 1.1445-2(d); or

(5) The partnership certifies that the amount of gain that would be ECI, if the partnership sold its assets at fair market value, would be less than 25 percent of the total gain.

Notice 2018-29 also addressed how to determine the amount of partnership liabilities included in the amount realized and postponed secondary withholding.

Proposed Regulations

The proposed regulations mostly adopt Notice 2018-29 but with some modifications (and even improvements). The regulations introduce a notification requirement: a foreign partner that transfers an interest in a partnership engaged in business in the U.S. must notify the partnership within 30 days. The notified partnership is then required to provide information to the foreign partner to help it determine the gain required to be recognized under Section 864(c)(8).

The proposed rules tighten Notice 2018-29's withholding exceptions. The threshold for ECI-related exceptions (3 and 5, above) is lowered to 10 percent. A transferor invoking the proposed rules' (now) less-than-10 percent ECI exception must also certify that the transferor's allocable share of ECI was less than $1 million—including ECI allocated to certain related persons—and that the transferor properly reported ECI on U.S. tax returns, if required to be filed, in each of the three preceding tax years. For the no-gain-realized exception (2, above) a transferor must additionally attest that it does not have to recognize ordinary income due to "hot assets" under Section 751. Helpfully, the proposed regulations add a withholding exception for a transferor that certifies that it is not subject to tax on any gain pursuant to a treaty—a position that the transferor would generally have to disclose on its U.S. tax return. Also, if a partnership is the transferee (due to a distribution), the partnership may rely on its books and records, rather than certifications.

In calculating the tax to withhold, the proposed rules confirm that amount realized includes cash, the fair market value of other property, and liabilities assumed by the transferee or to which the partnership interest is subject, plus the reduction in the transferor's share of partnership liabilities. A transferee must withhold the full amount realized without regard to reduction in partnership liabilities if either the amount to be withheld exceeds the amount realized without regard to reduction in partnership liabilities or the reduction in partnership liabilities cannot be determined. Notice 2018-29 had limited this rule to third-party transfers, but the proposed regulations extend it to partnership distributions. The proposed regulations offer two other provisions to mitigate over-withholding risk. In the case of a transferor that is a foreign partnership, the amount realized can be reduced by amounts allocable to U.S. partners. Withholding can also be reduced if, based on certifications by the transferor and the partnership, the required withholding amount would

exceed the maximum tax liability—such as in cases where a treaty or nonrecognition provision reduces, but does not eliminate, tax on the gain.

The proposed regulations activate PTP withholding, which Notice 2018-08 had suspended temporarily, providing special rules to ease administration. Importantly, transferees are not required to withhold under Section 1446(f) if the transfer of a PTP interest is effected through a broker. Instead, withholding is done by any broker who either pays amounts realized to another broker that is a foreign person that has not assumed primary withholding responsibility or effects the transfer on behalf of the transferor. A broker is not required to withhold if:

- The transferor certifies either non-foreign status or treaty-based exemption of all gain.
- The PTP has provided a "qualified notice" in its SEC filings that (1) less than 10 percent of the total gain on a hypothetical sale of the PTP's assets would be ECI; or (2) the entire amount of a PTP distribution is a distribution of current income.
- The amount realized is subject to backup withholding.

For purposes of broker withholding, the amount realized means gross proceeds paid or credited to the transferor or other broker or, in the case of a PTP distribution, the amount of cash plus the fair market value of any property distributed. The amount realized may be reduced if the transferor is a foreign partnership with U.S. partners; however, PTP withholding cannot be reduced on the basis that the maximum tax liability is less than the required withholding. Transfers of PTP interests not effected through brokers are subject to the general rules for withholding on transfers of non-PTP interests.

The proposed regulations also implement secondary withholding by a partnership on distributions to a transferee who fails to properly withhold under Section 1446(f). The transferee must provide withholding certifications to the partnership to avoid secondary withholding. If the partnership does not receive such certifications, it must withhold the full amount of any distribution to the transferee until the withholding is satisfied. Critically, secondary withholding would not relieve the transferor's tax obligation and is not credited against the transferor liability. Although the proposed rules state that tax would not be collected twice, there is no express indication of how double collection would be avoided or cured. Presumably, if a transferor pays its Section 864(c)(8) liability, secondary withholding should be refunded to the transferee (or to the partnership on the transferee's behalf). Parties may want to adopt contractual provisions, in partnership and/or transfer agreements, to cover, if not prevent, double collection problems.

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