FOREIGN INVESTOR IN A U.S. L.L.C. – HOW TO MINIMIZE WITHHOLDING TAX ON SALE OF L.L.C. INTEREST

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INTRODUCTION

On April 2, 2018, the I.R.S. published Notice 2018-29 (the "Notice"), describing Treasury Regulations it intends to issue with regard to the new withholding requirement on transfers of partnership interests by non-U.S. partners. This withholding requirement is codified under new Code §1446(f). While clarifying certain procedural aspects, the Notice also creates an unanticipated result in providing for the withholding of 100% of the sales proceeds when non-recourse liabilities are involved. Even if a refund request should ultimately reduce the U.S. income tax liability to the appropriate tax on the gain, this overwithholding may result in substantial cash-flow issues for foreign investors in U.S. partnerships, especially if a tax payment is due in the foreign investor's country of residence prior to the time of payment of the U.S. tax refund.

CODE §§864(C)(8) AND 1446(F)

Code §1446(f) was enacted on December 22, 2017, by Public Law 115-97 ("P.L. 115-97"). P.L. 115-97 also added new Code §864(c)(8). Both provisions are interrelated.

Code §864(c)(8) provides that gains or losses realized upon the direct or indirect disposition of a U.S. partnership interest by a non-U.S. partner generally constitute effectively connected income ("E.C.I.") to the extent that a fair-market-value sale by the partnership of all its assets would have generated effectively connected gain or loss in the hands of the transferor partner.

As a general rule, Code §1446(f) provides that if any gain on the disposition of a partnership interest is treated as E.C.I. pursuant to Code §864(c)(8), the transferee must withhold 10% of the amount realized on the sale. Here is the problem. The amount realized includes not only payments made by the purchaser but also the amount of the seller's distributive share of partnership debt. That share provided the selling partner with basis in the partnership interest at the time of acquisition or refinance. When that share of debt is eliminated as a result of the sale, the partner is considered to realize additional amounts in the sale.

The Notice provides that, pending further guidance by the I.R.S., a transferee of a non-publicly traded partnership interest must use the Foreign Investment in Real Property Tax Act ("F.I.R.P.T.A.") withholding principles for Code §1446(f) purposes, as modified by the Notice.

F.I.R.P.T.A. provides for withholding obligations when a non-U.S. person sells an interest in U.S. real property. Under both F.I.R.P.T.A. and Code §1446(f)(1), the withholding agent is generally the transferee.

The Notice further specifies that the transferee can use F.I.R.P.T.A. Form 8288, *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests*, and Form 8288-A, *Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests*. The Notice also provides that the I.R.S. does not intend, for the moment, to issue withholding certificates similar to Form 8288-B, *Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests*. Further, in cases in which both F.I.R.P.T.A. withholding and Code §1446(f) withholding apply to the transfer of a partnership interest and the transferor has not obtained a withholding certificate requesting a reduced withholding amount under F.I.R.P.T.A., only the F.I.R.P.T.A. provisions apply.[1] If such a withholding certificate has been obtained, the transferee must withhold the higher of the F.I.R.P.T.A. withholding or the Code §1446(f)(1) withholding.

Compliance with one of these provisions is deemed compliance with the other provision. Note that the rate of F.I.R.P.T.A. withholding was increased to 15% in most instances effective after February 16, 2016.

AMOUNT REALIZED

The Notice focuses on two key elements for Code §1446(f) withholding purposes: the notion of "amount realized" and certain exceptions to the withholding requirement. As mentioned earlier, when partnership liabilities are involved, the withheld Code §1446(f)(1) amount can equal the entire sales proceeds.

"This cap on withholding benefits purchasers, not sellers."

As stated above, Code §1446(f) requires the transferee to withhold a 10% withholding tax on the amount realized by a foreign partner upon the sale of his or her U.S. partnership interest. The amount realized includes a reduction in the transferor's share of non-recourse partnership liabilities or other partnership liabilities to the extent the transferor partner is discharged from such liabilities.[2]

The Notice provides that if the amount required to be withheld exceeds the amount realized decreased by the transferor partner's share of partnership liabilities, the amount withheld equals the amount realized less the decrease in the transferor partner's share of partnership liabilities.[3] In other words, 100% of the sales proceeds could end up being withheld pursuant to the Notice.

Example 1

> A, a non-U.S. individual, sells his interest in U.S. partnership X for $5 million to B. A is not relieved from any partnership liabilities upon the sale. B must withhold $500,000 under Code §1446(f)(1).

Example 2

> Same as Example 1 but upon the sale of his interest in X, A is relieved from X liabilities in the amount of $50 million. The amount realized by A in this example is $55 million and B would have to withhold $5.5 million, which exceeds the cash portion of the sales proceeds. Pursuant to the Notice, the amount

[1] Notice 2018-29, Section 10, referencing to the withholding certificate mentioned in the last sentence of Treas. Reg. §1.1445-11T(d)(1).

[2] Treas. Reg. §1.752-1(h); Treas. Reg. §1.1001-2.

[3] Section 8 of the Notice.

to be withheld in this example is limited to $5 million.[4] Thus, A's entire sales proceeds of $5 million would be withheld. It almost goes without saying that this cap on withholding benefits purchasers, not sellers.

Code §864(c)(8) treats gains or losses realized upon the direct or indirect disposition of a U.S. partnership interest by a non-U.S. partner as E.C.I. to the extent that a fair-market-value sale by the partnership of all its assets would have generated effectively connected gain or loss in the hands of the transferor partner. As explained, in determining the amount of gains and losses, a partner's share of partnership liabilities is included in the amount realized. But since the seller's basis also reflects such share, the effect of liabilities is generally netted out at the time the actual gain or loss is computed. The actual amount subject to U.S. taxation under Code §864(c)(8) would thus be lower than 100% of the sales proceeds withheld under Code §1446(f). The transferor partner would have to file a U.S. tax return requesting a refund of the difference between the amount withheld and the actual tax liability.

In addition to not having access to cash between the withholding event and the time of reimbursement, larger refund requests may go through a heavier internal refund process. For individuals, refund requests in excess of $2 million are subject to the Joint Committee on Taxation's staff refund review mechanism.[5] The threshold amount for C-corporations is $5 million. This only adds to the cash-flow issue.

WITHHOLDING EXCEPTIONS

Code §1446(f) and the Notice provide for several exceptions to the 10% withholding requirement.

Nonforeign Status Affidavit Provided by Transferor

Under Code §1446(f)(2), no withholding is required if the transferor furnishes a nonforeign affidavit to the transferee. Such affidavit must be signed under penalties of perjury and state the transferor's U.S. taxpayer identification number and the transferor's U.S. status. The Notice further states that the I.R.S. intends to issue regulations applying rules substantially similar to the F.I.R.P.T.A. nonforeign status certification rules. Under these rules, the nonforeign status affidavit must be furnished to the transferee prior to or at the time of the transfer.[6] Alternatively, the Notice provides that the transferor may use Form W-9, *Request for Taxpayer Identification Number and Certification,* for this purpose if certain conditions are met:

- The form includes the name and U.S. taxpayer identification number of the transferor.
- The form is signed and dated by the transferor.
- The jurat has not been deleted (*i.e.*, the affidavit is signed under penalties of perjury).

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[4] The amount realized of $55 million decreased by A's share of partnership liabilities of $50 million.

[5] Joint Committee on Taxation, "Joint Committee Statutory Refund Review," February 18, 1970.

[6] Treas. Reg. §1.1445-2(b)(2)(i); Section 6.01 of the Notice.

Pending further notice by the I.R.S., the nonforeign status affidavit does not need to be sent to the I.R.S.

No Gain Realized by Transferor

The Notice provides that regulations will be issued providing that if the transferor provides a certification to the transferee, stating that, under penalties of perjury, the transferor will not realize any gain on the transfer of the partnership interest, the transferee is relieved from its withholding obligation under Code §1446(f)(1). An example of an transaction in which no gain is realized is a gift of shares in a partnership that has no debt on its balance sheet.

Gain Realized but Not Recognized by Transferor

If the transferor realizes gain on the transfer but does not recognize such gain for income tax purposes pursuant to a nonrecognition provision of the Code or pursuant to the provisions of a U.S. treaty, the transferee may be exempt from its Code §1446(f)(1) withholding obligation. For this exception to apply, the transferor must provide a nonrecognition notice to the transferee. The content of the notice is based on F.I.R.P.T.A. nonrecognition notices under Treas. Reg. §1.1445-2(d)(2), as adjusted for purposes of Code §1446(f). Here again, the mailing of a copy of the notice to the I.R.S. is not required.

LESS THAN 25% E.C.T.I. OR LESS THAN 25% E.C.I. GAIN EXCEPTION

The Notice provides for two additional exceptions to the Code §1446(f) withholding obligation:

- The transferor certifies that for the transferor's prior taxable year and the two taxable years that precede it (the "Applicable Three-Year Period") the transferor was a partner in the partnership for the entirety of each of those years, and that the transferor's allocable share of effectively connected taxable income ("E.C.T.I.") for each of those taxable years was less than 25% of the transferor's total distributive share of income for that year (the "25% E.C.T.I. Exception").
- The partnership certifies that less than 25% of the total gain realized on a sale of all of its assets at fair market value would constitute E.C.I. gain (the "25% E.C.I. Gain Exception").

Under the 25% E.C.T.I. Exception, no withholding is required by the transferee if the following requirements are met:

- The transferor provides a certification to the transferee.
- The certification is signed under penalties of perjury and, to the extent required, contains the transferor's U.S. tax identification number.
- The certification is provided to the transferee no earlier than 30 days before the transfer.
- The certification provides that the transferor was a partner in the partnership for the entirety of the Applicable Three-Year Period.

For this purpose, the transferor's prior taxable year is the most recent taxable year of the transferor that includes the partnership taxable year that ends with or within the transferor's taxable year and for which both a Form 8805, *Foreign Parner's Information Statement of Section 1446 Withholding Tax*, and Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*, were due (including extensions) or filed (if earlier) by the time of the transfer.

- The certification provides that for each of the years in the Applicable Three-Year Period, the transferor's allocable share of E.C.T.I. was less than 25% of the transferor's total distributive share of income for each year.

Under the 25% E.C.I. Gain Exception, no withholding is required under Code §1446(f)(1) if the following requirements are met:

- The partnership issues a certification to the transferee, signed under penalties of perjury.
- The certification states that if the partnership had sold all of its assets at their fair market value, the amount of gain that would have been E.C.I. would be less than 25% of the total gain. For this purpose, E.C.I. gain includes any F.I.R.P.T.A. gain under Code §897.
- The certification is provided to the transferee no earlier than 30 days before the transfer.

POTENTIAL SOLUTION

Since the Notice provides, *inter alia*, for an exception from Code §1446(f)(1) withholding when (i) the transferee receives a nonrecognition notice from the transferor or (ii) the transferee receives a nonforeign affidavit from the transferee, the following steps are suggested to provide a solution to the cash-flow issue. It does not, however, offer a solution to reduce the ultimate U.S. income tax liability on the sale.

- The non-U.S. partner contributes his partnership interest into a U.S. partnership, in exchange for an interest in such U.S. partnership. To the extent properly planned, this would constitute a nonrecognition transaction under Code §721. If the transferring partner provides a nonrecognition notice to the transferee partnership, no Code §1446(f)(1) withholding would apply. The capital account of the transferor would be booked up to fair market value, and the gain to that point would be entirely allocable to that partner.
- The U.S. transferee partnership would sell the transferred partnership interest. It would provide a nonforeign status affidavit to the acquirer and the acquirer would not have to withhold 10% of the amount realized under Code §1446(f)(1). The selling partnership would pay the equivalent of estimated tax to the I.R.S. on behalf of its foreign member(s) using the maximum tax set forth for the taxpayer based on its status as an individual or corporation with the gain that is allocable to the partners. The tax base would be computed by reference to the gain recognized by the partnership and allocated to each non-U.S. partner.[7]

[7] Code §1446(b).

Because the ultimate tax of the foreign partner would not be reduced by following the suggested plan, concepts such as step transaction, business purpose, and economic substance should not be relevant. The suggested plan merely aligns withholding tax to the ultimate tax on the gain, using the highest applicable rate for withholding tax purposes.

CONCLUSION

The new withholding tax rules can lead to severe overwithholding of tax when a foreign person holds U.S. business assets through a partnership or L.L.C. However, with planning there is an opportunity to significantly reduce the overwithholding to a manageable level. It is doubtful that the I.R.S. would ever consider this type of planning to be abusive.

"The effect of liabilities is generally netted out at the time the actual gain or loss is computed. The actual amount subject to U.S. taxation under Code §864(c)(8) would thus be lower than 100% of the sales proceeds withheld under Code §1446(f)."

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