PROPOSED CODE §864(C)(8) REGULATIONS CODIFY TAX ON GAIN FROM SALE OF PARTNERSHIP INTEREST

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INTRODUCTION

Code §864(c)(8) was enacted on December 22, 2017, by Public Law 115-97 ("P.L. 115-97"). P.L. 115-97 also added new Code §1446(f). Both provisions are interrelated and address the treatment of a foreign partner's gain on the sale of a U.S. partnership interest.

Code §864(c)(8) was enacted to codify the holdings of Rev. Rul. 91-32[1] and overturn the result of the *Grecian Magnesite* case.[2] 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 of all the partnership assets would have generated effectively connected gain or loss in the hands of the transferor partner. Absent this characterization as E.C.I., gain (other than gain attributable to U.S. real estate) realized by nonresident individuals or non-U.S. corporations would not be taxable in the U.S.[3]

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. The amount realized includes not only payments made by the purchaser but also the amount of the seller's distributive share of partnership debt, which ordinarily provides the selling partner with a 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. This can result in the withholding of 100% of the sales proceeds when non-recourse liabilities are involved.

On April 2, 2018, the I.R.S. published Notice 2018-29 (the "Notice"), describing Treasury Regulations it intended to issue with regard to the new withholding requirement on transfers of partnership interests by non-U.S. partners.[4]

On December 20, 2018, the U.S. Treasury Department and the I.R.S. released proposed regulations containing guidance under new Code §864(c)(8).[5] The preamble to the proposed regulations states that while the proposed regulations issue no

1 Rev. Rul. 91-32, 1991-1 C.B. 107.

2 *Grecian Magnesite Mining v. Commr.*, 149 T.C. No. 3, 2017; see "Foreign Partner not Subject to U.S. Tax on Gain from Redemption of U.S. Partnership Interest," *Insights* 5, no. 8 (August 2017).

3 *Id.*; Code §§871, 881.

4 "Foreign Investor in a U.S. L.L.C. – How to Minimize Withholding Tax on Sale of L.L.C. Interest," *Insights* 5, no. 5 (June 2018).

5 REG-113604-18.

Code §1446(f) guidance, the Treasury Department and the I.R.S. intend to issue such guidance "expeditiously."

The proposed regulations address the following:

- Rules to compute the amount of gain or loss that must be treated as E.C.I. under Code §864(c)(8), including (i) the determination of gain and loss as ordinary or capital, (ii) the fact that only realized gain and loss are to be taken into account, (iii) sourcing rules, (iv) the definition of "non-separately stated taxable income or loss of the partnership," and (v) the interaction with the Code §751 "hot assets" rules
- Coordination of Code §864(c)(8) with Code §897
- Coordination of Code §864(c)(8) with U.S. income tax treaties
- Anti-abuse rules

"The foreign partner is required to first determine the amount of gain or loss on the transfer and then determine the partner's share of E.C.I. that it would have recognized if the partnership sold all of its assets immediately before the transfer."

Further, the proposed regulations provide that when both Code §864(c)(8) and another Code section apply, and the taxable E.C.I. amount is greater under the provisions of the other Code section, the larger amount is treated as E.C.I.[6]

The proposed regulations generally apply to transfers occurring on or after November 27, 2017. However, to the extent any provision is finalized after June 22, 2019, it is expected to apply only to transfers occurring on or after December 26, 2018.

COMPUTATION OF E.C.I. GAIN OR LOSS

A non-U.S. individual or corporation holding a direct or indirect interest in a U.S. partnership that is engaged in a U.S. trade or business must generally treat any gain or loss recognized on the sale or exchange of such partnership interest as E.C.I.[7] This recognition of gain or loss as E.C.I. is limited by the amount determined under Code §864(c)(8)(B).

The foreign partner is required to first determine the amount of gain or loss on the transfer (the "Outside Gain or Loss") and then determine the partner's share of E.C.I. that it would have recognized if the partnership sold all of its assets immediately before the transfer. The amount of E.C.I. on the transfer will be the lesser of (i) the foreign partner's Outside Gain or Loss and (ii) the foreign partner's deemed share of E.C.I. at the time of the transfer.

Step 1: Characterization of Outside Gain or Loss on Sale or Exchange

Source of Gain or Loss on Sale or Exchange

By generally characterizing the sale or exchange of a partnership interest as E.C.I., Code §864(c)(8), with important limitations, is essentially overriding the Code §864(c)(4) sourcing rules that generally prevent non-U.S.-source income from being treated as E.C.I. As a result, and as explained by the preamble to the proposed regulations:

[6] Prop. Treas. Reg. §1.864(c)(8)-1(b)(1).

[7] Code §864(c)(8)(A).

> Gain or loss recognized on the transfer of an interest in a partnership that is engaged in a trade or business within the United States may be treated as effectively connected gain or loss even if it is from sources without the United States.

Presumably, a partner will be entitled to the benefit of foreign tax credits for foreign income taxes paid on the sale or exchange to the extent E.C.I. would be characterized as non-U.S.-source.

Ordinary v. Capital Gain Characterization

The actual first step in determining a partner's Code §864(c)(8) gain is to determine the character of the partner's Outside Gain or Loss. This determination is made under all relevant provisions of the Code. Thus, Outside Gain or Loss can be capital ("Outside Capital Gain or Loss") or ordinary ("Outside Ordinary Gain or Loss").

As explained in further detail below, Code §864(c)(8) must be applied separately with regard to a partner's Outside Capital Gain or Loss and Outside Ordinary Gain or Loss. More specifically, a non-U.S. partner must determine its Outside Gain or Loss under Code §741 (capital) and Code §751 (ordinary).[8] This effectively results in a non-U.S. partner having two maximum amounts of potential E.C.I.:

- Outside Capital Gain or Loss under Code §741
- Outside Ordinary Gain or Loss under Code §751

Further, the proposed regulations specifically state that only gain or loss otherwise recognized under the Code is taken into account in computing a partner's Outside Gain or Loss. Thus, gain or loss that would otherwise be subject to nonrecognition provisions is not included.

The I.R.S. and the Treasury continue to consider, and request comments on, distributions such as certain Code §731 distributions of property to non-U.S. partners (instead of U.S. partners) that would result in no gain or loss recognized under Code §871 and Code §881.

Step 2: Code §864(c)(8)(B) Limitation to Outside Gain or Loss Treated as E.C.I.

Once determined, a partner's Outside Gain or Loss is compared to the Code §864(c)(8)(B) limitation. To arrive at this limitation, three amounts must first be determined:

- **Amount A.** This is the amount of gain or loss that the partnership would recognize in a fully taxable transaction with respect to each of its assets were it to sell each asset in a cash transaction at fair market value to an unrelated third party immediately prior to the partner's transfer of the partnership interest.[9]
- **Amount B.** This is the portion of Amount A that would be treated as effectively connected gain or loss ("Deemed Sale E.C. Gain or Loss").[10] The principles of Code §864 and the regulations thereunder apply to determine what part

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[8] Prop. Treas. Reg. §1.864(c)(8)-1(b)(2)(i).

[9] Prop. Treas. Reg. §1.864(c)(8)-1(c)(1).

[10] Prop. Treas. Reg. §1.864(c)(8)-1(c)(2).

would be treated as E.C.I. See below for more details as to the determination of Amount B.

- **Amount C.** This is the non-U.S. partner's distributive share of the ordinary and capital components of any Deemed Sale E.C. Gain or Loss (respectively, "Deemed Sale E.C. Ordinary Gain or Loss" and "Deemed Sale E.C. Capital Gain or Loss"). See below for more details as to the determination of Amount C.

The partner's Outside Ordinary Gain or Loss is then compared to that partner's Deemed Sale E.C. Ordinary Gain or Loss. Gains are applied towards gains, and losses are applied towards losses. The Outside Ordinary Gain or Loss constitutes E.C.I. only to the extent it does not exceed the Deemed Sale E.C. Ordinary Gain or Loss.

Similarly, a partner's Outside Capital Gain or Loss is compared to the partner's Deemed Sale E.C. Capital Gain or Loss. Here again, (i) gains are applied towards gains and losses towards losses, and (ii) the Outside Capital Gain or Loss constitutes E.C.I. only to the extent it does not exceed the Deemed Sale E.C. Capital Gain or Loss.

Determination of Amount B and Applicable Sourcing Rules

In determining Amount B, one must first determine whether the gain or loss would be from a U.S. source. Only to such extent can the gain or loss then be characterized as E.C.I. The determination is factual, and the proposed regulations provide that all gain or loss is U.S.-source, as if the partnership maintains an office or other fixed place of business in the U.S.[11] Since this rule could convert gain and loss from assets that have no connection with the partnership's U.S. trade or business into E.C.I., the proposed regulations provide a safe harbor rule. The gain or loss will not be U.S.-source if the following conditions are met:[12]

- The asset produced no E.C.I. nor effectively connected gain during the ten-year period ending on the date of the transfer.
- The asset was not used, or held for use, in the conduct of a U.S. trade or business during that ten-year period.

Determination of Amount C

A partner's distributive share of gain or loss on the deemed sale is determined in the same manner as the partner's distributive share of the "non-separately stated taxable income or loss of the partnership."[13] This term is not defined anywhere.

The proposed regulations provide that the distributive share must be determined under all applicable Code sections. This includes the special allocation and basis rules described in Code §704, Code §704(c), and Code §743 so as to take into

[11] *Id.* The proposed regulations are not entirely clear on the treatment of a case where the taxpayer has no office or other fixed place of business in the U.S. Some commentators believe that U.S. taxation would occur even under these circumstances.

[12] Prop. Treas. Reg. §1.864(c)(8)-1(c)(2)(ii).

[13] Code §864(c)(8)(B), last para.

account the economic agreement among the partners and most closely reflect the tax consequences to the partners of an actual sale of the partnership assets.

The I.R.S. and the Treasury are considering whether anti-abuse provisions are necessary in order to avoid allocations of effectively connected gain or loss to specific partners in order to avoid the provisions of Code §864(c)(8).

F.I.R.P.T.A. AND CODE §864(C)(8) E.C.I.

Code §864(c)(8)(C) provides that any F.I.R.P.T.A. gain should decrease the Code §864(c)(8)(A) E.C.I. amount. However, the proposed regulations provide that when a partnership holds a U.S. real property interest and the partnership is otherwise engaged in a U.S. trade or business, the entire amount of the non-US. partner's E.C.I. is subject to Code §864(c)(8) and not to F.I.R.P.T.A.

While this may, in the long term, facilitate the computation of E.C.I. in this fact pattern, it has adverse tax consequences in the short term, pending favorable Code §4116(f) regulations. Indeed, no withholding certificates similar to the ones allowable under F.I.R.P.T.A. can be filed under Code §1446(f).

INTERACTION WITH TREATY PROVISIONS

For purposes of applying U.S. income tax treaty provisions, a sale or exchange of a partnership interest by a non-U.S. transferor is generally treated as a sale of a permanent establishment or the sale of the assets of a permanent establishment under the gains article of the applicable treaty, provided that the partnership has a permanent establishment.[14] A foreign transferor's distributive share of Deemed Sale E.C. Gain or Loss is determined with respect to the assets of the partnership that form part of the permanent establishment to the extent not otherwise exempt from U.S. taxation under the treaty.

As a result, even with the application of a treaty, the provisions of Code §864(c)(8) should apply to the sale or exchange of a partnership interest by a non-U.S. partner operating through a U.S. permanent establishment, unless the treaty exempts certain items.

ANTI-ABUSE RULE

The proposed regulations provide that any transfer by a non-U.S. transferor of property, including a partnership interest, to a partnership with the principal purpose of reducing the amount of E.C.I. under Code §864(c)(8) or Code §897 will be disregarded or recharacterized in accordance with its substance.

CONCLUSION

While the proposed regulations clarify the actual application of Code §864(c)(8), no clear and complete regime is available until the issuance of proposed regulations under Code §1446(f).

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[14] Prop. Treas. Reg. §1.864(c)(8)-1(f).

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