FINAL REGULATIONS FOR WITHHOLDING ON FOREIGN PARTNERS' TRANSFERS OF SPECIFIED PARTNERSHIP INTERESTS – CONSTRUCT, EXCEPTIONS, AND REPORTING

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Treas. Reg. §1.1446(f)-1 to -5
Treas. Reg. §1.864(c)(8)-1, -2
Treas. Reg. §1.897-7(c)

For U.S. tax purposes, gain or loss upon a sale or exchange of property is generally sourced based on the tax home of the seller. For a foreign person investing in a partnership conducting a U.S. trade or business ("specified partnership"), it is important to keep in mind that when at some later date she sells or otherwise disposes of the investment, and no matter where she resides, she will be subject to tax on gain deemed to be effectively connected with a U.S. trade or business.

Code §864(c)(8), added by the Tax Cuts and Jobs Act of 2017 ("T.C.J.A."), and repealing the holding of the *Grecian Magnesite* case,[1] recharacterizes a sale of a partnership interest as a sale of partnership assets, resulting in gain to the selling foreign partner. Under Code §1446(f), withholding tax of 10% applies to the seller's amount realized.

I.R.S. Regulations adopted in 2020 address sales and comparable transactions by non-U.S. persons of direct and indirect interests in a U.S. partnership. Final regulations under Code §1446(f) (T.D. 9926) provide the mechanical rules for withholding by transferees (acquirers) and follow up on previously released guidance under Code §864(c)(8) (T.D. 9919) which contained substantive rules. In short, the acquirer or transferee of the partnership interest is required to deduct and withhold 10% of the gross purchase price. Foreign partners in partnerships with U.S. fixed offices and U.S. trades or businesses will want to master these rules and exceptions.

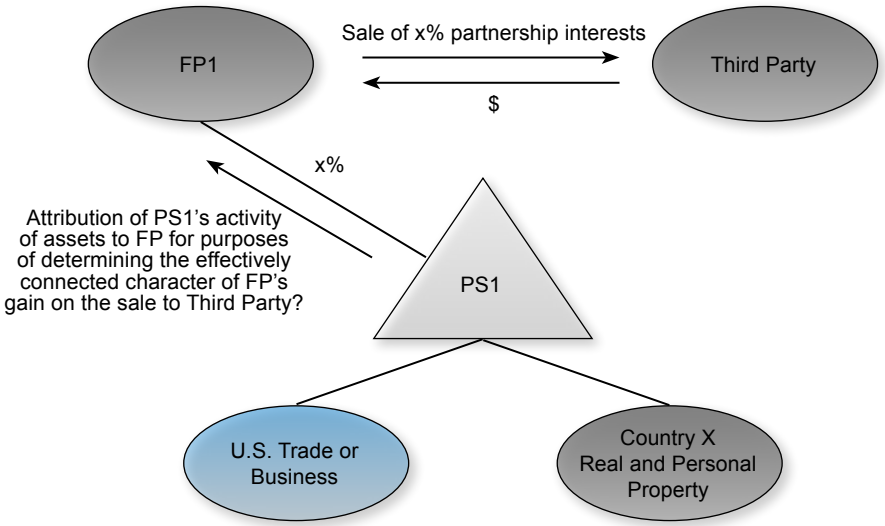
BACKGROUND

The statutory enactment of Code §§864(c)(8) and 1446(f) could be viewed as the final word by the I.R.S. in a long-standing, heated back-and-forth conversation.

In Rev. Rul. 91-32, 1991-1 C.B. 107, a foreign partner ("FP1") in partnership PS1, sold its interests for cash, as depicted below.

[1] *Grecian Magnesite Mining, Indus. & Shipping Co. v. Commr.*, 149 T.C. 63 (2017), aff'd, 926 F.3d 819 (D.C. Cir. 2019).

Rev. Rul. 91-32 (Situation 1)



Concluding that for treaty purposes a portion of the resulting gain relating to FP1's partnership interests should be treated as E.C.I. attributable to a U.S. permanent establishment ("P.E."),[2] the I.R.S. could not rely on Code §864(c)(8) (which did not exist) so it analogized based on rules like Code §875(1).[3]

This was followed by an important *Tax Notes* article six years later, criticizing the ruling and arguing that it should be set aside;[4] a 2017 Tax Court case, *Grecian Magnesite* refusing to follow the ruling as "cursory in the extreme" (affirmed by the D.C. Circuit Court of Appeals); and the 2017 legislative enactment repealing *Grecian Magnesite* and providing a statutory basis for the I.R.S. position.

Effectively Connected Income

A foreign person engaged in a trade or business in the United States is taxed on income effectively connected with that conduct of the trade or business ("E.C.I."). Partners are treated as engaged in the conduct of a business if the partnership is so engaged.[5] A U.S. trade or business exists for each year that a foreign person engages in "considerable, continuous, and regular" activity in the U.S.[6] Tests are applied to determine whether income, gain or loss is effectively connected with assets used in that trade or business ("asset use test"), or activities of the business were a material income-producing factor ("business activities test"). Code §865(e) treats gain on the sale of personal property attributable to a U.S. office as U.S. source unless a foreign office materially participated in the sale (the "U.S. office rule").

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2 The P.E. question is addressed in Situation 3.

3 Code §875(1) provides that "a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged." Also see *Donroy, Ltd. v. U.S.*, 301 F.2d 200 (9th Cir. 1962).

4 Kimberly Blanchard, "IRS Rev. Rul. 91-32: Extrastatutory Attribution of Partnership Activities to Partners," Tax Notes, Sept. 14, 1997.

5 Code §875.

6 For example, see *Pinchot v. Commr.*, 113 F.2d 718 (2d Cir. 1940).

The new regime does not change these rules, nor create a new rule of income recognition; rather it simply recharacterizes the sale of partnership interests as a disposition of assets. The recharacterization requires facts-and-circumstances rules like the above to be applied to a fictional sale. The Regulations explain how.

FINAL REGULATIONS

"It is important to note that if a partnership distribution results in gain recognition, these new rules may be implicated."

T.D. 9919 — Substantive Rules under §864(c)(8)

Final regulations under Treas. Reg. §1.864(c)(8)-1 determine the disposing partner's effectively connected gain or loss or "aggregate deemed sale E.C.I." ("A.D.S.E.C.").

The Regulations address how the deemed sale is to be analyzed for the business activities test or U.S. office rule, where no actual sale takes place and include special rules for inventory,[7] intangibles, and other property. Modified sourcing rules apply. The partner's distributive share of A.D.S.E.C. may vary based on the partners' agreement. Special rules apply to publicly traded partnerships. This article focuses on non-publicly traded partnerships.

It is important to note that if a partnership distribution results in gain recognition, these new rules may be implicated.

T.D. 9926 — Withholding of 10% Tax under §1446(f)

The Regulations under T.D. 9926 address the numerous practical matters relating to a sale of partnership interests, including required notifications (see end of this article). If the transferor is a U.S. person and provides Form W-9, then 10% withholding is inapplicable. Otherwise, the transferee must withhold 10% of the amount realized and submit the same to the I.R.S. unless an exception or adjustment applies.

Exceptions include the following cases:

- The transferor certifies non-foreign status.
- The transferor certifies that no gain, including ordinary income from deemed sales of "hot assets", will be realized by reason of the transfer.
- The transferor certifies that gain will not be recognized because the transaction is a nonrecognition exchange, or that the provisions of a tax treaty apply.
- The transferor certifies that during a prescribed look-back period the transferor was a partner throughout such period, and that the transferor's distributive share of gross E.C.I. was less than $1 million and less than 10% of the transferor's total distributive share of gross income (and that other technical requirements are satisfied).
- The partnership certifies that effectively connected gain is less than 10% of the total net gain inherent in its assets.
- The partnership certifies that based on partnership allocations, the transferor would be allocated E.C.I. equal to less than 10% of the total amount allocable.
- The partnership certifies it was never engaged in a U.S. trade or business.

[7] Historical sales data is used to determine the transferor's A.D.S.E.C.

Other certifications and circumstances may result in a reduction of the amount to be withheld. For example, a transferor is permitted to present a certification of its maximum tax liability expected in connection with the deemed sale. Furthermore, if a portion of the gain realized is due to the transferor's reduction in partnership liabilities (treated under the tax laws as a deemed distribution), the amount otherwise required to be withheld may be reduced so that it only reflects the gain realized without regard to the decrease in the transferor's share of partnership liabilities. This prevents the need to withhold on phantom (non-cash) gain.

If no exception applies and the transferee fails to withhold, the partnership is required to withhold from subsequent distributions to the transferee until the missed amount is made up, plus interest.[8] While the new withholding rules are reminiscent of certain of the F.I.R.P.T.A. rules, Code §1446(f) Regulations dispense with major elements of F.I.R.P.T.A. such as withholding certificates, relying instead on notifications between the parties. Another point of departure is the supplemental withholding by the partnership where the transferee fails to withhold.

F.I.R.P.T.A. OVERLAP – EXCEPTION

Recognizing that there will be cases governed by both the new partnership rule and the preexisting F.I.R.P.T.A. rules of Code §897, Code §864(c)(8)(C) provides:

> If a partnership described in subparagraph (A) holds any United States real property interest (as defined in section 897(c)) at the time of the sale or exchange of the partnership interest, then the gain or loss treated as effectively connected income under subparagraph (A) shall be reduced by the amount so treated with respect to such United States real property interest under section 897.

In addition, Treas. Reg. §1.864(c)(8)-1(d) provides that if a foreign transferor transfers an interest subject to Code §864(c)(8) and the partnership has U.S. real property interests (as defined under the F.I.R.P.T.A. rules), the gain or loss analyzed under Code §864(c) will not be reduced (and Code §897(g) no longer applies); presumably this will simplify calculations for many foreign partners tangled in the U.S. tax net.[9] However, if the transaction is a nonrecognition exchange with respect to the F.I.R.P.T.A. asset, the F.I.R.P.T.A. rules applicable to such transfers apply.[10]

The F.I.R.P.T.A. rules treat sales of U.S. real property interests as E.C.I., whether or not such income would have been E.C.I. under general tax principles. Thus, as a general matter, to the extent that a U.S. real property interest is used in a U.S. trade or business, withholding at a rate of 10% will apply. If the asset is not used in a U.S. trade or business, the withholding rules applicable to transfers of F.I.R.P.T.A assets will continue to apply. While U.S. tax will apply to the transfer, F.I.R.P.T.A. withholding (generally at a rate of 15%) does not apply, unless the partnership is a "50/90" partnership (a partnership in which fifty percent or more of the value of the gross assets consist of U.S. real property interests, and ninety percent or more of the value of the gross assets consist of U.S. real property interests plus any cash or cash equivalents).

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8 Code §1446(f)(4); Treas. Reg. §1.1446(f)-3(a)(1).Treas. Reg. §1.1446(f)-3 indicates its effective date is January 1, 2022.

9 A cross-reference is included in Treas. Reg. §1.897-7(c).

10 Treas. Reg. §1.864(c)(8)-1(d) (last sentence).

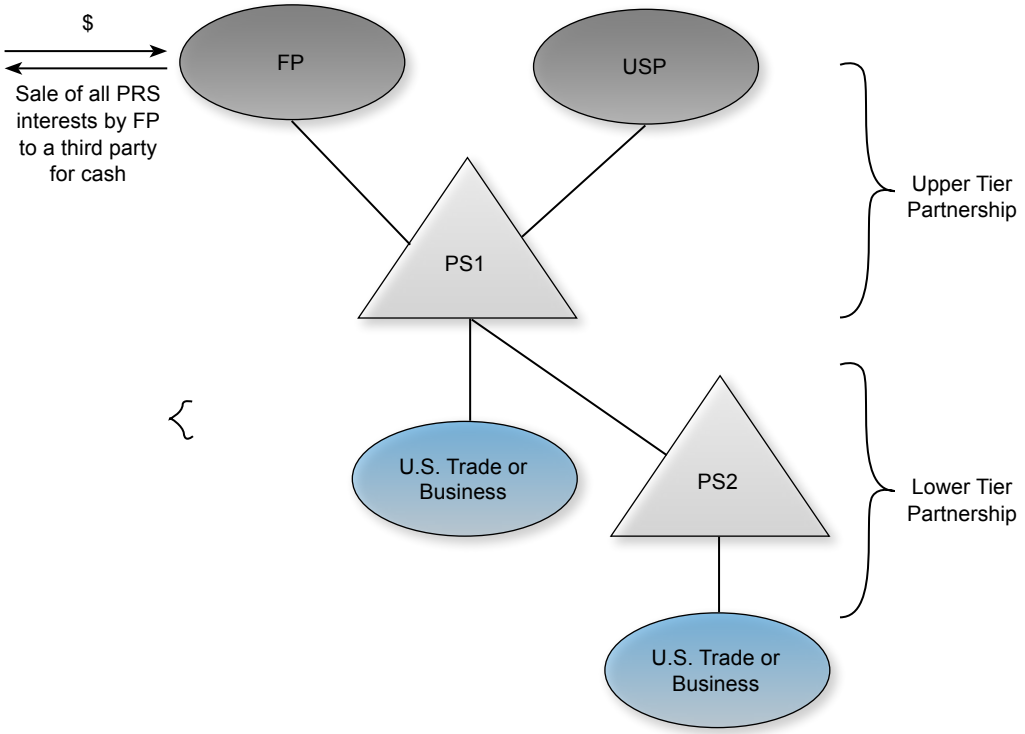
In other words, a transferee that is otherwise required to withhold with respect to a transfer of an interest in a 50/90 partnership under Code §1445(e)(5) as well as under the new partnership withholding provisions under Code §1446(f) because the activities of the 50/90 partnership give rise to E.C.I. will be subject only to the payment and reporting requirements of Code §1445, and not section Code §1446. However, if the transferor has applied for a F.I.R.P.T.A. withholding certificate the transferee must withhold the greater of the amounts required under Code §1445(e)(5) or Code §1446(f)(1). A transferee that has complied with the withholding requirements under either Code §1445(e)(5) or Code §1446(f)(1), as applicable, will be deemed to satisfy the withholding requirement imposed by the new partnership withholding rules.

TIERED PARTNERSHIPS

In the case of tiered partnerships like PS1 (an "upper-tier partnership") and PS2 (a "lower-tier partnership") illustrated below, gain can be recharacterized as E.C.I. to the extent of both their assets where FP sells a PS1 partnership interest. Beginning with the lowest-tier partnership in a chain of partnerships that is engaged in the conduct of a trade or business within the United States and going up the chain, each partnership that is engaged in the conduct of a trade or business within the United States is treated as selling its assets in a deemed sale.

In addition, if PS1 owned no U.S. trade or business except through PS2, and PS1 disposed of any interest in PS2, FP's A.D.S.E.C. includes gain on the deemed sale of PS2 assets, and will be allocated to FP.[11]

Tiered Partnership – Example



[11] Treas. Reg. §1.864(c)(8)-1(e)(2).

NOTICES, FORMS, AND PAYMENTS

The transferee is required to report and pay the 10% tax withheld to the I.R.S. within 20 days using 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*.[12] If the transferee is not required to withhold, however, the forms are not required.[13] The I.R.S. will stamp Form 8288-A to show receipt and mail a stamped copy back.[14]

In addition, the following actions are required, with various deadlines:

- ***Transferee*** — is required to
  - certify to the partnership within 10 days the extent to which it satisfied its obligation to withhold, including either (a) Form 8288-A filed with respect to the transfer, or (b) a certification of the amount realized and the amount withheld, in addition to any special certifications relied on to determine the amount realized or to reduce withholding;[15] and
  - if the transferor provided a certification to benefit from reduced treaty withholding, mail a copy to the I.R.S. within 30 days.[16]
- ***Transferor*** — is required to
  - provide the partnership with notice in writing of the transfer within 30 days, including identifying details of transferor and transferee(s);[17] and
  - if the transferor is a foreign partnership, it may provide the transferee a certification of a modified amount realized based on presence of both U.S. and non-U.S. interest holders, using Form W-8IMY, *Certificate of a Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding and Reporting*.[18]
- ***Partnership*** — is required to
  - provide the transferor a statement detailing transferor's share of A.D.S.E.C. items described in Treas. Reg. §1.864(c)(8)-1(c)(3)(ii) by

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12 Treas. Reg. §1.1446(f)-2(d).

13 *Id.*

14 Treas. Reg. §1.1446(f)-2(e)(3). The transferor attaches the stamped form to its return to claim a credit.

15 Treas. Reg. §1.1446(f)-2(d)(2). The Preamble to T.D. 9926 clarifies that the notification is intended to allow for sufficient time to consult with the partnership as to transferor's eligibility for any claimed exception to withholding in advance, and if appropriate to release an amount withheld to transferor rather than deposit it with the I.R.S.

16 Treas. Reg. §1.1446(f)-2(b)(7)(i).

17 Treas. Reg. §1.864(c)(8)-2(a). This notification requirement is inapplicable for transfers of interests in publicly traded partnerships, or transactions in which a partnership is treated as the transferee because it redeems its interests from a partner.

18 Treas. Reg. §1.1446(f)-2(c)(2)(iv).

the time it issues to transferor a Schedule K-1, *Partner's Share of Current Year Income, Deductions, Credits, and Other Items*;[19]

- if the transferor is relying on the maximum tax liability rule to reduce withholding, provide a certification of the transferor's A.D.S.E.C. ordinary income and A.D.S.E.C. capital gain on the relevant determination date;[20] and
- if the transferee failed to withhold or pay the full amount withheld, the partnership must commence withholding beginning 30 days after the transfer or 15 days it acquires (or is deemed to acquire) actional knowledge of the transfer, whichever date is later.[21]

Partnership's Supplemental Withholding

Tax withheld on distributions by the partnership must be reported and paid using Forms 8288, *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests*, and 8288-C, *Statement of Withholding Under Section 1446(f)(4) for Withholding on Dispositions by Foreign Persons of Partnership Interests*. The transferee may apply for a refund for any excess withholding.[22]

Foreign persons who dispose of interests in partnerships conducting a U.S. trade or business should note that withholding by the transferee will not relieve them from U.S. income tax filing obligations with respect to the transfer, or the requirement to pay any unsatisfied tax.[23] To meet these requirements, foreign partners must obtain a U.S. tax identification number.

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19 Treas. Reg. §1.864(c)(8)-2(b)(3).

20 Treas. Reg. §1.1446(f)-2(c)(4)(iv). The determination date referenced is one of a number of dates, including the transfer date —see Treas. Reg. §1.1446(f)-1(c)(4).

21 Treas. Reg. §1.1446(f)-3(c)(1).

22 Treas. Reg. §1.1446(f)-3(e)(2).

23 Treas. Reg. §1.1446(f)-2(e)(1).