The US Department of the Treasury and Internal Revenue Service (IRS) recently issued final regulations under section 1446(f), a provision enacted as part of the Tax Cuts and Jobs Act of 2017 (TCJA) that generally imposes a withholding obligation on transfers of certain partnership interests (Note: All references to “section” are to the Internal Revenue Code of 1986, as amended (the “Code”) unless otherwise indicated). That provision, in conjunction with the enactment of section 864(c)(8) also under the TCJA, imposes a new statutory scheme in response to the ruling of the Tax Court in Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner, 149 TC No. 3 (2017), aff’d, 926 F.3d 819 (DC Cir. June 11, 2019). The final regulations largely retained the rules set forth in the proposed regulations, with some additions and modifications. The following discusses some of the noteworthy
provisions in the regulations.

IN DEPTH

SECTIONS 864(C)(8) AND 1446(F): IN GENERAL

Section 864(c)(8) generally provides that gain or loss derived by a nonresident individual or foreign corporation from the sale or exchange (or other disposition) of an interest in a partnership engaged in a US trade or business is treated as effectively connected income (ECI) to the same extent as such partner’s portion of distributive share of gain or loss that would have been ECI if the partnership had sold all of its assets at their fair market value as of the date of the partner’s sale or exchange. Section 864(c)(8) further provides that withholding is not required to the extent a transferor provides a nonforeign affidavit to the transferee, or if other regulatory exceptions are adopted (as discussed below).

Section 1446(f) generally requires a transferee of a partnership interest described in section 864(c)(8) to withhold 10% of the amount realized by the transferor. Moreover, if the transferee fails to withhold such amount, the partnership is required to deduct and withhold from distributions to the transferee a tax equal to the amount the transferee failed to withhold plus interest.

EFFECTIVE DATES

Generally, the final regulations apply to transfers of partnership interests occurring on or after 60 days after the final regulations are published in the Federal Register (i.e., December 2020). However, a partnership’s requirement to withhold amounts not withheld by the transferee applies to transfers that occur on or after January 1, 2022.

AMOUNT TO WITHHOLD

Amount Realized

The final regulations retained the definition of “amount realized” set forth in the proposed regulations, namely, that it generally includes (i) consideration paid by the transferee and (ii) the transferor’s share of partnership liabilities (determined under section 752 and the regulations promulgated thereunder). Thus, the amount realized includes any reduction in the transferor’s share of partnership liabilities. One commentator suggested the inclusion of any reduction to a transferor’s share of partnership liabilities could cause liquidity concerns when the amount of liabilities assumed exceeds the cash or other property exchanged in the transfer. Treasury and the IRS concluded that it was inappropriate to exclude a reduction in a transferor’s share of partnership liabilities from the amount realized, citing that such concerns are addressed in regulation 1.1446(f)-2(c)(3).

For purposes of determining the amount realized, the final regulations retain the look-through rule set forth in the proposed regulations for situations involving a
transfer by a foreign partnership transferor that has a direct or indirect partner not subject to tax on gain from such transfer as a result of an applicable US income tax treaty. Specifically, the final regulations provide that a treaty-eligible partner is not a presumed foreign taxable person for purposes of determining the modified amount realized. A foreign partnership that provides a certification of modified amount realized must include, in addition to IRS Form W-8IMY (Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding and Reporting) and a withholding statement, the certification of treaty benefits (on IRS Form W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)) or Form W-8BEN-E (Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)), as applicable from each direct or indirect partner that is not a presumed foreign taxable person.

Certification of Maximum Tax Liability

The final regulations adopt the procedure in the proposed regulations limiting the withholding amount based on the maximum tax liability the transferor would be required to pay on the gain attributable to the partnership interest transfer. Specifically, the procedure allows a transferee to withhold based on a certification received from the transferor containing certain information relating to the transferor and the transfer, including the transferor’s maximum tax liability. A transferee may rely on a certification received from a transferor that is a foreign corporation, a nonresident alien individual or a foreign partnership regarding the transferor’s maximum tax liability. In addition, the final regulations permit transferors that are foreign trusts to use the maximum tax liability procedure to reduce the amount otherwise required to be withheld. Similar to the approach taken with respect to foreign partnerships, such rules treat the foreign trust as a nonresident alien individual for purposes of computing its maximum tax liability.

OBLIGATION TO WITHHOLD

In general, as noted earlier, the transferee of a partnership interest must withhold a tax equal to 10% of the amount realized by the transferor on any transfer of a partnership interest unless an applicable exception applies (as discussed below).

The final regulations maintain this broad presumption, despite comments to the proposed regulations noting that such presumption may impose a withholding obligation on any transfer of a partnership interest, regardless of whether the partnership in question has assets in, or a connection to, the United States. Treasury and the IRS justified this broad approach in the final regulations by noting that a transferee will not know whether a transfer results in tax on gain without information from the transferor or the partnership. Therefore, the transferee must presume that a transfer is subject to withholding unless it obtains a certification establishing otherwise.

Given the broad application of the final regulations, even non-US partners in non-US partnerships may be caught up in the withholding requirements of partnership interest transfers. This can be a trap for the unwary because it is not always obvious whether a non-US entity or investment vehicle is, by default, classified as a
partnership for US income tax purposes. For example, in the absence of a US entity classification election confirming its US income tax classification, the US income tax classification of Brazilian funds, such as FIMs (fundos de investimento multimercado) and FIPs (fundos de investimento em participações), depends on certain peculiarities of the given entity’s governing documents. Thus, investors and their advisors should be careful to consider the impact of the final regulations not only on US partnerships but also on non-US partnerships and investment vehicles.

The final regulations provide that a partnership is permitted to determine that it does not have a withholding obligation under the final regulations if it possesses a valid IRS Form W-9 (Request for Taxpayer Identification Number and Certification) for the transferor to establish the transferor’s non-foreign status, even if the transferee does not provide a withholding certificate to the partnership.

**LIABILITY FOR FAILING TO WITHHOLD**

As noted above, if a transferee fails to withhold any amount required to be withheld, the partnership must deduct and withhold from distributions to the transferee a tax in an amount equal to the amount the transferee failed to withhold, plus interest. A partnership may determine its withholding obligation by relying on information provided in a certification received from the transferee (i.e., a withholding certificate). Generally, a transferee is required to provide a partnership with a certification that it has complied with its partnership interest transfer withholding obligation, including whether it is relying upon an exemption from such withholding. The final regulations add a provision that any person required to withhold is not liable for failure to withhold, including any interest or penalties resulting therefrom, if such person establishes to the satisfaction of the IRS that the transferor had no effectively connected gain subject to tax on the transfer of the partnership interest. However, it may be difficult for the withholding agent to convince the IRS that no such taxable gain exists without cooperation from the transferor.

Because partnerships can become liable for deducting and withholding tax (and interest) that a transferee failed to withhold from a transferor, partnerships should consider reviewing their partnership agreements and due diligence requirements related to transfers of partnership interests. For instance, a partnership may include provisions in its partnership agreement that a transfer of a partnership interest may only be permitted if (among other customary requirements) a transferee provides a valid certificate establishing an exception to withholding or certifies that it will withhold on the transfer (accompanied by proof of such actual withholding).

**RELIANCE ON CERTIFICATIONS PROVIDED BY TRANSFEROR, TRANSFEE AND PARTNERSHIP**

In order not to withhold or to withhold a reduced amount, a transferee is permitted to rely on a certification it receives from a transferor or the partnership unless it has actual knowledge that the certification is incorrect or unreliable. Moreover, the partnership may rely on a certification received from the transferee unless the partnership knows or has reason to know it is incorrect or unreliable. Such “reason to know” standard requires the partnership to review the certification to confirm that it does not have information suggesting the certificate is incorrect or
unreliable. On that basis, transferees might consider including a pre-closing condition (and other relevant contractual provisions) in a purchase agreement that the partnership will confirm the certification from the transferor and/or the partnership will itself provide a certification.

**WITHHOLDING EXCEPTIONS**

The final regulations generally retain the withholding exceptions of the proposed regulations with certain modifications. Importantly, the transferor’s distributive share of ECI exception no longer requires effectively connected income or loss in a given tax year, and a new no trade or business exception has been adopted.

The final regulations do not include any withholding exceptions for: (i) disguised sales; (ii) transferors that are “withholding foreign partnerships” and “withholding foreign trusts” if they enter into a withholding agreement with the IRS; and (iii) earnout payments entitling the transferor to future payments based on specific goals or metrics.

**Non-foreign Status**

The transferor may provide a certificate to a transferee certifying as to its non-foreign status. For that purpose, a certification of non-foreign status includes a valid IRS Form W-9. Moreover, a transferee may rely on a valid Form W-9 it already possesses from the transferor provided it meets the certification requirement as set forth in the final regulations.

**No Gain**

The transferor may provide a certification that no gain will be realized by the transferor. Importantly, the transferor must certify that ordinary income attributable to property described in Code section 751 (“hot assets”) utilized in or attributable to a US trade or business would not be recognized in connection with the transfer.

**Deemed Sale**

A transferee (other than a partnership that is a transferee because it makes a distribution) may rely on a certification from the partnership that if the partnership sold all of its assets on the “determination date,” either: (1) the partnership would have no effectively connected gain, or if the partnership would have a net amount of such gain, the amount of the partnership’s net gain that would have been effectively connected gain would be less than 10% of the total net gain; or (2) the transferor would not have a distributive share of net gain from the partnership that would be ECI, or if the transferor would have a distributive share of ECI, the transferor’s allocable share of the partnership’s net ECI would be less than 10% of the transferor’s distributive share of the total net gain from the partnership. For this purpose, and generally, the “determination date” is the transfer date or any day that is no more than 60 days before the date of the transfer.

**No US Trade or Business**
Addressing comments to the proposed regulations, Treasury and the IRS included a new exception from withholding not included in the proposed regulations. Specifically, a transferee (other than a partnership that is a transferee because it makes a distribution) may rely on a certification from the partnership that it was not engaged in a US trade or business during the partnership’s tax year, up to and including the date of the transfer. Partnerships that invest in assets that do not give rise to ECI (e.g., corporations, real estate investment trusts, etc.) should find this exception useful.

**Transferor’s Distributive Share of ECI**

A transferee (other than a partnership that is a transferee because it makes a distribution) may rely on a certification from the transferor stating that: (a) it has held its partnership interest for the prior three tax years (the “look-back period”); (b) the transferor’s (and its related partners' within the meaning of sections 267(b) and 707(b)) distributive share of gross ECI in each of the taxable years within the look-back period was less than $1 million in the aggregate; (C) the transferor’s distributive share of gross ECI in each of the years within the look-back period is less than 10% of its total distributive share of gross partnership income; and (D) the transferor’s share of ECI was timely reported on its tax return and all US taxes on such ECI were timely paid.

Notably, a transferor may only provide a certificate pursuant to that exception if it has received a Schedule K-1 from the partnership reflecting distributable gross income for each of the years within the look-back period. Importantly, unlike the proposed regulations, the final regulations do not require that the transferor have received an IRS Form 8805 (Foreign Partner’s Information Statement of Section 1446 Withholding Tax) and have effectively connected gain or loss, thus making this exception available for partners of partnerships without ECI. Practically, the use of this exception may be limited because some partnerships do not provide K-1s to their foreign partners unless and until the partnership derives ECI.

**Certification of Nonrecognition by Transferor**

A transferee may rely on a certification from the transferor stating that by reason of the operation of a nonrecognition provision of the Code, the transferor is not required to recognize any gain or loss with respect to the transfer of the partnership interest. The final regulations also contain a partial nonrecognition exception that may apply in certain circumstances.

**Treaty Claims**

A transferor may provide a certification to the transferee that it is not subject to tax on any gain upon transfer of the partnership interest because of an applicable tax treaty limiting the ability of the United States to tax income that does is not attributable to a permanent establishment. To avail itself of that exception, the transferor must make the certification on a valid IRS Form W-8BEN, or Form W-8BEN-E. In addition, the transferee must mail a copy of the certification to the IRS within 30 days of the transfer. Before making such certification for purposes of invoking the
treaty claim exception, a transferor should consider other factors that may give rise to a permanent establishment, including whether the US office of the partnership constitutes a fixed place of business as defined by the applicable treaty.

The IRS indicated its intention to revise the instructions to Forms W-8BEN and W-8BEN-E to describe the information required to be provided for making a treaty benefits claim for purposes of section 1446(f), including a treaty claim made with respect to a transfer of a publicly traded partnership (PTP) interest.

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