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Dispositions of U.S. Partnership Interests by Foreign Partners: Key Considerations to Glean From the Final Regulations

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On September 21, 2020, the IRS released final and temporary regulations implementing §864(c)(8)[1] a provision that was enacted by the Tax Cuts and Jobs Act of 2017 (TCJA)[2] to tax non-U.S. partners who sell their interests in U.S. partnerships engaged in a U.S. trade or business. This article discusses key considerations for foreign partners and U.S. partnerships affected by these regulations, as well as final regulations under §1446(f), which provide a withholding mechanism through which the tax imposed by §864(c)(8) is collected.

BACKGROUND

For many years, foreign partners in U.S. partnerships engaged in a U.S. trade or business took the position that the sale of their partnership equity interests, without the sale by the partnership of the assets used in its U.S. trade or business, did not result in gain that is subject to U.S. federal income taxation. In Rev. Rul. 91-32, the IRS challenged that position and took the position that the sale of an equity interest in a partnership that is engaged in a U.S. trade or business is deemed to be a proportionate sale of the partnership's assets used in that trade or business and any resulting gain (or loss) would be taxable as gain (or loss) that is effectively connected with the conduct of a U.S. trade or business.

In the summer of 2017, the Tax Court in, *Grecian Magnesite Mining v. Commissioner*,[3] overruled Rev. Rul. 91-32. The Tax Court held that gain (or loss) on the sale by a foreign person of a partnership interest is foreign source gain (or loss) based on the residence of the selling partner because the gain on the sale of the partnership interest is not attributable to the partnership's assets and activities.

SECTION 864(c)(8) AND THE REGULATIONS THEREUNDER

In December 22, 2017, as part of the revenue raisers in the TCJA, Congress enacted §864(c)(8), overturning the Tax Court decision in *Grecian*. New §864(c)(8), provides that gain or loss of a nonresident alien individual or foreign corporation (foreign seller) from the sale of a partnership interest is treated as effectively connected with the conduct of a trade or business within the United States to the extent the seller would have had effectively connected gain or loss if the partnership had sold all of its assets at fair market value as of the date of the sale. In other words, a partner who sells his or her partnership interest is deemed to have sold his or her proportionate share of

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[1] All section references herein are to the Internal Revenue Code of 1986, as amended (the ''Code''), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[2] Pub. L. No. 115-97.

[3] 149 T.C. 63 (2017), *aff'd*, No. 17-1268 (D.C. Cir. June 11, 2019). Although the D.C. Circuit Court Appeals affirmed the Tax Court's decision in *Grecian* after §864(c)(8) was enacted by the TCJA, its appellate decision is relevant to transactions that occurred before November 27, 2017, which are not affected by §864(c)(8) (i.e., transactions that occurred before the November 27, 2017, effective date of §864(c)(8)).

the assets the partnership uses in its U.S. trade or business.

On December 27, 2018, the IRS published proposed regulations implementing §864(c)(8).[4] On September 21, 2020, the IRS published the final and temporary regulations[5] under this provision (final regulations).

COMPUTATION OF GAIN OR LOSS ON THE DISPOSITION OF U.S. PARTNERSHIP INTERESTS

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 effectively connected income (ECI).[6] This recognition of gain or loss as ECI is limited by the amount determined under §864(c)(8)(B).

A foreign partner disposing of the partner's interest in a U.S. partnership that is engaged in a U.S. trade or business is required to first determine the amount of gain or loss on the transfer (the ''Outside Gain or Outside Loss''), and then determine the partner's share of ECI that it would have recognized if the partnership sold all of its assets immediately before the transfer. The amount of ECI on the transfer will be the lesser of (i) the foreign partner's Outside Gain or Outside Loss and (ii) the foreign partner's deemed share of ECI at the time of the transfer.[7]

The computation of ECI gain or loss under the final regulations entails the following steps.

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

The first step in determining a partner's §864(c)(8) gain is to determine the character of the partner's Outside Gain or Outside Loss. This determination is made under all relevant provisions of the tax laws. Thus, Outside Gain or Outside Loss can be capital (''Outside Capital Gain or Outside Capital Loss'') or ordinary (Outside Ordinary Gain or Outside Ordinary Loss).[8] Section 864(c)(8) must be applied separately with regard to a partner's Outside Capital Gain or Outside Gain Loss and Outside Ordinary Gain or Outside Ordinary Loss. More specifically, a non-U.S. partner must determine its Outside Gain or Outside Loss under §741 (capital) and §751 (ordinary). As a result of the interaction of these rules, a non-U.S. partner may be exposed to two potential ECI amounts: Outside Capital Gain or Outside Capital Loss under §741,[9] and Outside Ordinary Gain or Outside Ordinary Loss under §751.[10]

The final regulations specifically provide that only gain or loss otherwise recognized under the I.R.C. is taken into account in computing a partner's Outside Gain or Loss. Thus, gain or loss that would otherwise be subject to non-recognition provisions is not included.[11] For example, gain or loss from the disposition by foreign persons of equity interests in certain Real Estate Investment Trusts (REITs), which is excluded from U.S. federal income taxation under §897(k), and gain or loss from the disposition of by certain foreign pension funds of U.S. real property interests, which is excluded from U.S. federal income taxation under §897(l), are not taken into account in computing a partner's Outside Gain or Outside Loss.

Step 2: Section 864(c)(8)(B) Limitation to Outside Gain or Loss Treated as ECI

Once a partner's Outside Gain or Outside Loss is determined, it is compared to §864(c)(8)(B) limitation.[12] To arrive at this limitation, three amounts listed below 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.[13]

Amount B

This is the portion of Amount A that would be treated as effectively connected gain or loss (Deemed

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[4] *See* REG-113604-18, 83 Fed. Reg. 66,647 (Dec. 27, 2018).

[5] The temporary regulation portion of these regulations relates to the addition of paragraph (c) to Reg. §1.897-7T regarding the coordination of this temporary regulation with §864(c)(8). The text of paragraph (c) is reserved in the final regulations.

[6] §864(c)(8)(A).

[7] Reg. §1.864(c)(8)-1.

[8] Reg. §1.864(c)(8)-1(b)(2).

[9] Section 741 generally characterizes a partnership interest as a capital asset and gain or loss from the sale or exchange of a partnership interest as capital gain or loss.

[10] Section 751 is an exception to the §741 provisions. Section 751 provides that gain or loss from the sale of partnership interests that is attributable to the partnership's unrealized receivables or inventory items is characterized as an amount realized from the sale of property other than a capital asset (i.e., as ordinary gain or loss).

[11] Reg. §1.864(c)(8)-1(b)(2)(ii).

[12] Reg. §1.864(c)(8)-1(c)(2).

[13] Reg. §1.864(c)(8)-1(c)(1).

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Sale EC Gain or Loss). The provisions of §864 and the regulations thereunder apply to determine what part would be treated as ECI.[14]

In determining Amount B, one must first determine whether the gain or loss would be from U.S. sources. Only when a U.S. source is determined, can the gain or loss then be characterized as ECI. This is a factual determination.

The final regulations provide a safe harbor to prevent the conversion of gain and loss from assets that have no connection with the partnership's U.S. trade or business into ECI. Under the safe harbor, the gain or loss will not be U.S.-source if the following conditions are met: the asset produced no ECI nor effectively connected gain during the 10-year period ending on the date of the transfer and the asset was not used, or held for use, in the conduct of a U.S. trade or business during that 10-year period.[15]

Amount C

This is the non-U.S. partner's distributive share of the ordinary and capital components of any Deemed Sale EC Gain or Loss (respectively, ''Deemed Sale EC Ordinary Gain or Loss'' and ''Deemed Sale EC Capital Gain or Loss'').

The partner's Outside Ordinary Gain or Outside Ordinary Loss is then compared to that partner's Deemed Sale EC Ordinary Gain or Loss. Gains are applied towards gains, and losses are applied towards losses. The Outside Ordinary Gain or Outside Ordinary Loss constitutes ECI only to the extent it does not exceed the Deemed Sale EC Ordinary Gain or Ordinary Loss. Similarly, a partner's Outside Capital Gain or Outside Capital Loss is compared to the partner's Deemed Sale EC Capital Gain or Loss. In this regard, (i) gains are applied towards gains and losses towards losses, and (ii) the Outside Capital Gain or Loss constitutes ECI only to the extent it does not exceed the Deemed Sale EC Capital Gain or Loss.[16]

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,''[17] a term that is not defined anywhere else. The final regulations provide that the distributive share must be determined under all applicable I.R.C. sections. This includes the special allocation and basis rules described in §704, §704(c), and §743 so as to take into 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.[18]

FIRPTA and Section 864(c)(8) Coordination Provisions

Section 864(c)(8)(C) provides that any gain from the sale of U.S. real property interests (USRPIs) under §897 should decrease the §864(c)(8)(A) ECI amount. However, the final regulations provide that when a partnership holds a USPRI and the partnership is otherwise engaged in a U.S. trade or business, the entire amount of the non-US. partner's ECI is subject to §864(c)(8) and not to FIRPTA.[19] If, however, a foreign partner transfers an interest in a partnership, the transfer is not treated as subject to §864(c)(8) to the extent the gain or loss is not recognized; instead, if the partnership owns USRPIs at the time of the transfer, §897(g) and its corresponding regulations apply to the unrecognized gain or loss.[20] Under §897(g), a foreign partner that disposes of its interest in a partnership that holds USRPIs is deemed to have sold its proportionate share of the USRPIs and is subject to U.S. federal income taxation on the gain or loss from such disposition.

Section 864(c)(8) and Treaty Coordination 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[21] of the applicable treaty, provided that the partnership has a permanent establishment. A foreign transferor's distributive share of Deemed Sale EC 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.[22]

Consequently, even when a treaty applies, the provisions of §864(c)(8) should apply to the sale or exchange of a partnership interest by a non-U.S. partner

[14] Reg. §1.864(c)(8)-1(c)(2).

[15] Reg. §1.864(c)(8)-1(c)(2)(B).

[16] For a computational illustration, see Reg. §1.864(c)(8)-1(i)(3), *Ex.* 3.

[17] §864(c)(8)(B) (last paragraph).

[18] Reg. §1.864(c)(8)-1(c)(2)(iii), *Ex.* 3.

[19] Reg. §1.864(c)(8)-1(d).

[20] Reg. §1.864(c)(8)-1(d).

[21] As an example, article 13(3) of the United States-United Kingdom income tax convention (2001) grants taxing rights to gains from the sale of business property of a permanent establishment to the state in which the permanent establishment is located. There are similar provisions in most of the United States income tax treaties with other countries.

[22] Reg. §1.864(c)(8)-1(f).

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operating through a U.S. permanent establishment, unless the treaty provides a specific exemption.[23]

The final regulations reiterate the general principle that a foreign partner must satisfy the requirements of the limitation on benefits article, if any, in the U.S. income tax treaty with the jurisdiction in which the partner is resident in order to obtain the treaty-based relief from the §864(c)(8) tax liability.[24]

If, after applying treaty benefits, the only gains or losses that would be taken into account are gains or losses attributable to USRPIs, the foreign partner is required to determine its EC gain or EC loss pursuant to §897 and not under §864(c)(8).[25]

Anti-Stuffing Provisions

The final regulations contain anti-abuse provisions, which disregard allocations of effectively connected gain or loss to specific partners in order to avoid the provisions of §864(c)(8).[26] This anti-stuffing rule aims to prevent inappropriate reductions in amounts characterized as EC gain when a foreign partner (or related person) transfers property to a partnership with a principal purpose of reducing the amount of gain treated as EC gain, or increasing the amount of loss treated as EC loss, under §864(c)(8) or §897.

Applicability Dates

Section 864(c)(8) provisions apply to transfers that occurred on or after November 27, 2017. The final regulations, on the other hand, apply to transfers occurring on or after December 26, 2018.

Section 1446(f) Withholding Provisions

The other side of the §864(c)(8) ''coin'' are the withholding provisions under §1446(f) and its corresponding proposed regulations.[27] Section 1446(f) was also enacted by the TCJA. The Treasury issued the final regulations on October 7, 2020.[28]

Section 1446(f) requires the purchaser of a partnership interest to withhold 10% of the amount realized on the seller's disposition of the partnership interest unless the seller certifies that the seller is not a foreign person.

No §1446(f) withholding is required if the seller certifies to the purchaser that the seller is not a foreign person (i.e., the seller is a U.S. person) by submitting to the purchaser a valid Form W-9 *Request for Taxpayer Identification Number and Certification* prior to or on the date the sale transaction closes.[29] Form W-9 must contain the seller's Taxpayer Identification Number (TIN, e.g., the Social Security Number for individuals and Employer Identification Number for business entities), among other requirements, in order for it to be considered valid.

Exceptions to Withholding

The proposed regulations provide the following exceptions from the §1446(f) withholding requirements.

De Minims Partnership Effectively Connected Taxable Income (ECTI) Exception

This exception provides that no withholding is required if a purchaser receives from a seller a certification stating that:

(i) the seller was at all times a partner in the partnership for the immediately prior taxable year and the two taxable years that preceded it. For example, if a sale took place in 2020, the immediately prior taxable year would be 2019 and the two years that preceded it would be 2018 and 2017;

(ii) the seller's allocable share of ECTI for each of those years was less than 10% of the seller's total distributive share of the partnership's net income for that year;

(iii) in the immediately prior taxable year and the two years that preceded it, the seller's allocable share of ECTI was less than $1 million; and

(iv) the seller's distributive share of ECTI has been reported on the seller's federal income tax return for each of the three preceding taxable years, and that any tax amounts due on such income were timely paid.[30]

No Realized Gain Certification Exception

This exception requires the seller to certify that it did not realize any gain from the sale and therefore no withholding obligation is required.[31] Furthermore, the seller or transferor of a partnership interest may rely on certification from the partnership stating that the transfer of the interest would not result in any ordinary income arising from the application of §751 and

[23] Reg. §1.864(c)(8)-1(f).

[24] Reg. §1.864(c)(8)-1(f).

[25] Reg. §1.864(c)(8)-1(f).

[26] Reg. §1.864(c)(8)-1(h).

[27] *See* REG–105476–18, 84 Fed. Reg. 21,198 (May 13, 2019) (proposed regulations).

[28] *See* Withholding of Tax and Information Reporting with Respect to Interests in Partnerships Engaged in a U.S. Trade or Business, T.D. 9926, RIN 1545-BO60 (Oct. 7, 2020).

[29] Reg. §1.1446(f)-2(b)(2).

[30] Reg. §1.1446(f)-2(b)(5)(i).

[31] Reg. §1.1446(f)-2(b)(3)(i).

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Reg. §1.751-1 to the seller. The certification from the partnership must be attached to, and forms part of, the certification of no realized gain that the seller provides to the purchaser or transferee.[32]

Less Than 10 Percent Effectively Connected Gain Exception

This exception provides that a purchaser of a U.S. partnership interest may rely on certification from the partnership that states: (i) that the partnership would have no gain that would be effectively connected with the conduct of a U.S. trade or business, or, if it would have a net amount of such gain, the amount of the partnership's net EC gain would be less than 10% of the total net gain; (ii) the seller would not have a distributive share of net gain from the partnership that would have been EC gain, or, if the seller would have a distributive share of such gain from the partnership, the seller's distributive share of the net EC gain would be less than 10% of the seller's total net gain from the partnership; or (iii) the partnership was not engaged in a trade or business within the United States at any time during the taxable year of the partnership through the date of the transfer.[33]

Treaty Benefit Exception

This exception provides that a seller certifies that an applicable income tax treaty exempts gain realized from the sale from U.S. federal income taxation. This certification is made on an applicable Form W-8 (e.g., Forms W-8BEN[34] for foreign individual sellers and W-8BEN-E[35] for foreign corporate sellers).[36]

Non-Recognition Certification Exception

This exception provides that the seller certifies that the sale falls under any of the non-recognition provisions of the I.R.C. and thus exempt from U.S. federal income taxation.[37]

Secondary Withholding Obligation on Partnership when Purchaser Does Not Withhold

The Partnership is required to withhold the 10% tax if (i) the purchaser did not withhold the tax; (ii) it does not receive certification from the purchaser indicating that the tax was withheld, or that the purchaser is exempt from the withholding tax, within 30 days from the date of sale or within 15 days after the date on which the partnership acquires actual knowledge that the transfer has occurred; or (iii) it has reason to know that the certification is incorrect or unreliable.[38]

PRACTICAL CONSIDERATIONS REGARDING SECTION 864(c)(8) AND 1446(f) AND THE TREASURY REGULATION PROVISIONS

The tax landscape for foreign partners investing in U.S. partnerships engaged in a U.S. trade or business has significantly changed by the enactment of §864(c)(8) and §1446(f) and corresponding regulations. These rules affect how foreign partners decide to invest in U.S. partnerships and how they exit from such investments. The key aspects of these rules are further discussed below.

Treaty Structures

For foreign partners that were structuring their investments in active U.S. partnerships through income tax treaty structures (i.e., by holding those investments through either a U.S. corporation or foreign corporation established in a jurisdiction with which the United States has a favorable income tax treaty), the §864(c)(8) and §1446(f) rules underscore the value in this type of tax planning and its continuing relevance. For foreign partners that have been participating in active U.S. partnerships directly in the past, a reconsideration of the use of a treaty structure to provide relief from these rules is more relevant today than it was prior to the enactment of these rules.

When structuring the ownership of U.S. partnerships interests through a treaty holding entity, due care must be exercised to avoid the temptation to stretch the treaty-relief provisions of the §864(c)(8) regulations beyond their scope. The treaty relief in the regulations is narrowly drafted;[39] in practice it applies only when the deemed EC gain or EC loss is not attributed to a foreign partner's permanent establishment in the U.S. Although it is not explicitly stated in the regulations, in situations in which a U.S. partnership has an office or other fixed place of business in the United States, such fixed business location will be attributed to a foreign partner in the partnership under the §875[40] rules and the foreign partner will be deemed to have a permanent establishment in the

[32] Reg. §1.1446(f)-2(b)(3)(ii).

[33] Reg. §1.1446(f)-2(b)(4).

[34] IRS Form W-8BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting* (individuals).

[35] IRS Form W-8BEN-E, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting* (entities).

[36] Reg. §1.1446(f)-2(b)(7)(i).

[37] Reg. §1.1446(f)-2(b)(6).

[38] Reg. §1.1446(f)-3(c)(1)(ii).

[39] Reg. §1.864(c)(8)-1(f).

[40] Section 875 attributes the U.S. trade or business activities of

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United States under the *Donroy* and *Unger* line of cases.[41] Under the rationale of the holding of these cases, the §864(c)(8) treaty relief provisions would not apply.

Drafting Tax Provisions in Corporate Documents

Section 1446(f) regulations impose withholding obligations on the purchaser of U.S. partnership interests, or, secondarily, the partnership whose interests are being sold, which impact directly the scope of tax provisions that are drafted into corporate documents such as limited partnership agreements (LPAs) and limited liability company operating agreements (LLC Ops) and other contractual documents such as sale and purchase agreements and assignment agreements. To protect itself against liability under the secondary withholding obligations, a U.S. partnership may choose to include indemnity provisions in an LPA or LLC OP that requires a purchaser who is purchasing a foreign partner's partnership interest to indemnify the partnership in the event that the partnership must withhold the §1446(f) tax because the purchaser of the interest did not do so.

Due Diligence Issues

Corporate attorneys who draft corporate documents must become aware of key due diligence criterion the §1446(f) withholding rules entail. For example, if a corporate attorney is representing the purchaser, the attorney must ensure that he or she obtains appropriate certifications regarding the §1446(f) tax withholding requirements from the seller during the due diligence phase and coordinate with his or her firm's tax team to ensure that those certifications are correct or reliable. Otherwise, the attorney would have to advise the purchaser to withhold the tax. If the attorney is representing the seller, he or she must ensure that any applicable certifications regarding the §1446(f) tax liability are appropriately drafted and timely provided to the purchaser. This, again, would require coordination with the relevant tax advisors. Otherwise, the purchaser would have to withhold the tax. Similarly, if the attorney is representing the partnership whose interests are being sold by the seller, the attorney must ensure that he or she obtains the appropriate certification from the purchaser regarding the §1446(f) tax withholding and liaise with the appropriate tax team to ensure that that the certification is correct or reliable.

Tax Information Accessibility

For a foreign partner to exit, the foreign partner would need certain information from the U.S. partnership whose interests it is selling to determine whether it has any §864(c)(8) tax amounts that are subject to withholding under §1446(f). This information includes the partnership's financial information (e.g., financial statements and balance sheets) that provides the fair market value of the assets the partnership uses in its U.S. trade or business at the time of the transfer. Practically, many minority partners in a U.S. partnership may find obstacles in receiving this information from the partnership. The §1446(f) regulations mitigate, to a large extent, the adverse impact of this information stonewalling by instituting a self-policing withholding mechanism. Since the partnership is secondarily liable for withholding when the purchaser does not withhold, or withholds incorrectly, it is in the partnership's best interest to provide the necessary information to the seller and purchaser to facilitate the correct computation of the seller's withholding tax liability and purchaser's withholding amounts; or else the partnership's secondary withholding obligation would be triggered. Additionally, the partnership would also be obligated to provide the necessary information on the seller's final Schedule K-1 in order to enable the seller to compute the seller's final tax from the disposition of the partnership interest on the seller's U.S. federal income tax return accurately.

Partnership Allocations

The enforcement of the anti-stuffing rule to ensure that §864(c)(8) maintains its sting will incentivize the IRS to put partnership allocations of income and loss to partners under even greater scrutiny, especially in transactions that involve dispositions by foreign partners of their interests in U.S. partnerships. Tax attorneys who draft allocation provisions in corporate documents such as LPAs and LLC OPs cannot afford to ignore this rule when drafting such provisions.

CONCLUSION

The final regulations implementing §864(c)(8) and §1446(f) provide detailed guidance on various issues regarding the practical application of these provisions to dispositions by foreign persons of their interests in

a U.S. partnership to its non-U.S. or foreign partners and similar activities engaged in by a U.S. estate or trust to its non-U.S. or foreign beneficiaries.

[41] *Donroy, Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962); *Unger v. Commissioner*, 936 F.2d 1316 (D.C. Cir. 1991). In each of these cases, the office and activities of a U.S. partnership were attributed to its Canadian partner, with the consequence that the Canadian partner was deemed to have a permanent establishment in the United States under the United States-Canada Income Tax Treaty.

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U.S. partnerships engaged in U.S. trades or businesses. Nonetheless, additional guidance on certain issues is still needed. One of the key issues on which guidance is pending, which the preamble to the final §864(c)(8) regulations flags, is the interaction between §864(c)(8) and §731 distributions. Future guidance is expected to address this issue, among others.

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