

## **Final Regulations on Withholding on the Disposition of a Partnership/LLC Interest by a Non-US Partner – Part I: Withholding by the Transferee**

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On October 7, 2020, the US Department of Treasury and the Internal Revenue Service issued final regulations with respect to the withholding tax obligations under Section 1446(f) of the Internal Revenue Code (the “Code”) imposed in respect of the sale, exchange or redemption of a partnership interest held by a foreign partner. What follows is the first of a two-part summary of these regulations. Part I provides some background on Section 1446(f) and summarizes the withholding rules applicable to the transferee of the partnership interest. Part II of the posting will summarize the withholding rules applicable to the partnership when a transferee fails to comply with its withholding obligations under Section 1446(f). The regulations have separate rules applicable to transfers of interests in a publicly traded partnership that are publicly traded on an established securities market or readily tradable on a secondary market (“PTP Interests”) and transfers of partnership interests that are not PTP Interests (“non-PTP Interests”). These summaries will cover only the rules relating to non-PTP Interests. References in this summary and in the regulations to partnerships are inclusive of any entities taxed as partnerships regardless of their form of organization, such as multi-member LLCs that have not elected to be treated as corporations.

### **Background**

A non-US person (a “foreign person” in US tax parlance<sup>1</sup>) is generally not subject to US tax on gain resulting from the sale of property (other than US real property) if such gain is not effectively connected to a trade or business conducted by such person in the US. Although a partnership interest is property, the IRS long maintained the questionable position that the sale of a partnership interest by a foreign person gave rise to effectively connected income taxable in the US if the partnership was engaged in a US trade or business. In 2017, the Tax Court rejected the IRS’s position, and from that decision followed the enactment of Code Sections 864(c)(8) and 1446(f) as part of the Tax Cuts and Jobs Act. For transactions after December 31, 2017, Section 864(c)(8) provides that a portion of the gain or loss of a foreign person from the disposition of a partnership interest is treated as gain or loss effectively connected to a US trade or business (*i.e.*, “effectively connected gain” subject to US tax) if the partnership is engaged in a US trade or business. In general terms, the amount and character of effectively connected gain of the transferring foreign partner is determined by reference to the amount and type of effectively connected gain that would have been allocated to the partner if the partnership had sold all of its assets for fair market value in a hypothetical taxable sale. Since it is incumbent on the foreign transferring partner to report and pay tax on any taxable gain arising under Section 864(c)(8) and the IRS faces certain limitations enforcing tax obligations against persons located outside the US, Section 1446(f) serves as a collection mechanism for

the tax by requiring the transferee of the partnership interest to withhold and pay over to the IRS 10% of the amount realized by the transferor on the transfer.

### **Section 1446(f) Withholding Presumption and Exceptions**

The Section 1446(f) regulations operate on the presumption that any transferred non-PTP Interest is an interest in a partnership conducting a US trade or business transferred by a foreign person. That is, the regulations require a transferee to withhold 10% of the amount realized on the transfer (determined as discussed below) unless an exception applies. A transferee is not required to withhold under Section 1446(f) if any of the following exceptions apply:

- **US Transferor** – the transferor certifies that it is not a foreign person, including by furnishing a Form W-9;
- **No Gain or Income** – the transferor certifies that the transfer of the partnership interest would not result in any realized gain or other income as of the *determination date*<sup>ii</sup>;
- **Less than 10% Effectively Connected Gain** – the partnership certifies that if it sold all its assets for fair market value on the determination date, either (i) the partnership would have no effectively connected gain or the net gain that is effectively connected with a US trade or business would be less than 10% of total net gain, or (ii) the transferor partner’s distributive share of net effectively connected gain would be less than 10% of the transferor’s distributive share of total net gain;
- **No US Trade or Business** – The partnership certifies that it was not engaged in a trade or business in the US at any time during the taxable year of the partnership through the date of the transfer;
- **Less than 10% Effectively Connected Income** – the transferor certifies that (i) the transferor was a partner in the partnership during the transferor’s most recent taxable year for which the partner received a Schedule K-1 from the partnership and the two taxable years preceding such year, (ii) the amount of gross effectively connected income allocated to the partner and certain related persons from the partnership as reflected on Schedule K-1 was less than \$1 million for each of such preceding three years; (iii) the transferor’s distributive share of gross effectively connected income from the partnership for each of such three preceding years was less than 10% of the transferor’s total share of all gross income from the partnership in each such year, (iv) the transferor reported its distributive share of effectively connected income for each of such preceding three tax years on a timely filed US tax return and timely paid all taxes on such amounts; and (v) the transferor had a distributive share of gross income from the partnership in each of the three preceding years;
- **Nonrecognition Transfer** – the transferor certifies that it is not required to recognize any gain or loss with respect to the transfer by reason of the operation of a nonrecognition provision of the Code (e.g., transfer of the interest to another partnership); or

- **Nontaxable Under Treaty** – the transferor certifies on the applicable withholding certificate that the transferor is not subject to tax in the US on any gain from the transfer pursuant to an applicable income tax treaty.

A transfer of a non-PTP Interest includes any sale, transfer or other disposition, including a disguised sale of the interest under Code Section 707(a)(2)(B) and a distribution from the partnership that is treated as an exchange with respect to the interest. If the partnership is the transferee with respect to a distribution to a partner, the partnership can generally rely on any of the above exceptions with these additional considerations:

- The partnership can rely on either a certification from the partner or on a determination from its books and records for the exceptions under the headings (i) No Gain or Income, (ii) Less than 10% Effectively Connected Gain, and (iii) No US Trade or Business.
- For the Less than 10% Effectively Connected Income exception, the partnership can also rely on its own books and records to determine effectively connected amounts provided the partner provides a certification that it has complied with its US tax reporting and payment requirements with respect to such income.

The *amount realized* on which a transferee must withhold 10% if an exception does not apply includes (i) the amount of cash paid (or value of property transferred) to the transferor and (ii) the reduction in the transferor's share of partnership liabilities as a result of the transfer. The transferee may rely on a certification from the transferor (subject to restrictions for controlling partners or significant changes from the prior K-1) or from the partnership to determine the reduction in the transferor's share of partnership liabilities. The final regulations provide that the amount of withholding tax may be reduced in certain situations including where (i) the transferor is a foreign partnership with one or more US partners, (ii) the withholding amount exceeds the cash proceeds paid (e.g., if the amount realized consists largely of a reduction in share of partnership liabilities), and (iii) the transferor certifies to a lower maximum tax liability.

### **Liability and Reporting**

As noted above, the regulations require that a transferee presume that a transfer is subject to full 10% withholding unless it obtains an applicable certification from the transferor or the partnership establishing otherwise. In the absence of such certification, the transferee is liable for the amount of tax it should have withheld as well as any interest and penalties. The final regulations include a limited exception by providing that a transferee will not be liable for a failure to withhold under Section 1446(f) if the transferee establishes to the satisfaction of the IRS that the transferor had no US effectively connected gain on the transfer.

A transferee that is required to withhold tax under the regulations must report and pay the withheld tax to the IRS by the 20<sup>th</sup> day after the transfer date using IRS Form 8288 and 8288-A. A transferee must also certify to the partnership within 10 days after the date of transfer regarding the extent to which it has satisfied its obligation to withhold under Section 1446(f). The certification must include a copy of Form 8288-A (or other certification of the amount

realized the amount withheld) and must also include a copy of any certifications that the transferee relied on as an exception to withholding. Part II of this summary will discuss the partnership's obligation to withhold on distributions to the transferee partner if the partnership does not receive the transferee's certification.

With respect to the transferor of a partnership interest, withholding by the transferee does not relieve a foreign transferor of its obligation to file a US tax return with respect to the transfer. Nor does transferee withholding relieve a foreign transferor of any tax liability on gain that has not been fully satisfied through withholding. The regulations provide rules for foreign transferors to claim credit for the amount of any tax withheld pursuant to the regulations.

### **Effective Date**

The final regulations applicable to transferee withholding apply to transfers that occur 60 or more days after the publication of the final regulations in the Federal Register. Prior to that time, transferees may rely on the guidance provided in IRS Notice 2018-29.

### **Practical Implications – Purchases of Partnership Interests**

Any person purchasing a partnership or LLC interest must withhold 10% of the purchase price unless the purchaser receives a qualifying certification excepting the transfer from withholding. Because the purchase price for this purpose (the amount realized) includes the amount by which the transferor's share of partnership liabilities will be reduced by reason of the transfer, if an exception to withholding does not apply, the purchaser will need information regarding the transferor's share of partnership liabilities. From the purchaser's perspective, any interest purchase agreement should (i) specify that a portion of the purchase price will be withheld pursuant to Section 1446(f) unless the seller provides a proper certification of an exception, and (ii) require cooperation of the seller to determine the amount realized and any other information needed to comply with Section 1446(f).

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<sup>i</sup> A foreign person for US tax purposes includes an individual who is neither a US citizen nor US tax resident, a company organized outside the US or a trust which is not both controlled by US persons and over which a US court has primary administrative authority.

<sup>ii</sup> The determination date can be any of the following dates chosen by the certification provider: (a) the date of transfer, (b) any date not more than 60 days before the date of transfer, or (c) the later of (i) the first day of the partnership's tax year in which the transfer occurs or (ii) the date of the partnership's most recent capital account revaluation event on or prior to the transfer.