

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

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. Part I [\[add hyperlink\]](#) of our two-part summary of these regulations provided background on Section 1446(f) and summarized the withholding rules applicable to the transferee of the partnership interest. This Part II summarizes the withholding rules applicable to a partnership when a transferee fails to comply with its withholding obligations under Section 1446(f). As noted in Part I of the posting, the summaries cover the regulations only as they relate to non-PTP Interests and do not discuss the rules applicable solely to PTP Interests. As also noted in Part I, references in this summary to partnerships are inclusive of any entities taxed as partnerships such as multi-member LLCs that have not elected to be treated as corporations.

### **When a Partnership Must Withhold on Distributions to Transferee**

Code Section 1446(f)(4) provides that if a transferee fails to withhold any amount it was required to withhold under Section 1446(f), the partnership must withhold the required tax (and interest) from future distributions to the non-compliant transferee. Thus, Section 1446(f)(4) acts as a collection backstop which (i) shifts the obligation to withhold and pay over the tax to the partnership in which the interest was transferred, and (ii) imposes the economic burden directly on the transferee since it is paid from partnership distributions after the transfer rather than from proceeds payable to the transferor.

A partnership’s obligation to withhold on distributions to the transferee would generally arise in one of three situations. First, where the partnership becomes aware of the transfer (*e.g.*, upon a request to reflect the transferee as the owner) but it has not received a certification from the transferee that it has met its withholding obligations under Section 1446(f) or that the transfer was exempt from withholding. However, the partnership is not required to withhold in this situation if the partnership already possesses a valid W-9 (or other certification of non-foreign status) from the transferor. Second, the partnership will be required to withhold if it receives notification from the IRS regarding transferee non-compliance. Finally, the partnership will generally be required to withhold where it receives a certification from the transferee but the partnership knows or has reason to know that the certification is incorrect or unreliable (*e.g.*, the transferor’s certification claiming the effectively connected income exception to withholding is inconsistent with partnership operations). Thus, even though a transferee may have properly relied on a transferor certification that the transferee had no reason to question, the transferee will bear the cost of inadequate withholding. Therefore, the transferee’s ability to rely on a transferor’s claim to an exemption from or adjustment to withholding is effectively conditioned on the partnership’s acceptance of the transferor’s claim.

If a transferee subject to withholding on partnership distributions later transfers its partnership interest to an unrelated party, the partnership is no longer required to withhold on distributions made after the subsequent transfer. However, if the partnership interest is transferred to a related person, such related subsequent transferee becomes liable for the withholding tax to the same extent as the initial transferee, and the partnership will be required to withhold on distributions if it has actual knowledge that the subsequent transferee is related to the initial transferee.

### **Amount and Timing of Withholding**

A partnership that is required to withhold under Section 1446(f)(4) must withhold the full amount of each distribution made until it has withheld (i) tax equal to 10% of the amount realized (*i.e.*, consideration paid to the transferor plus the reduction in the transferor's share of partnership liabilities) and (ii) interest on the unpaid tax amount. Interest is computed at the underpayment rate for the period beginning 20 days after the date of the transfer until the tax is paid to the IRS. The partnership must determine the amount realized on the transfer based on a certification from the transferee (regardless of when provided). If the partnership does not receive such certification (or cannot rely on it), the partnership is required to withhold tax equal to the full amount of each distribution until it receives the certification. Any required partnership withholding on distributions must commence on the later of (a) the date that is 30 days after the transfer, or (b) the date that is 15 days after the date on which the partnership becomes aware that the transfer has occurred.

A partnership is treated as satisfying its withholding obligation under Section 1446(f)(4) and may stop withholding on distributions on the earlier of (i) the date on which the partnership has withheld and paid the full amount of tax and interest required to be withheld, or (ii) the date on which the partnership receives a certification from the transferee that the transfer was excepted from withholding (including any certifications from the transferor). Since a partnership may stop withholding in the situation described in clause (ii) regardless of the fact that the certifications were not initially timely provided, the transferee can stop distribution withholding by later obtaining from the transferor and providing to the partnership a certification that the transfer was excepted from withholding.

### **Reporting and Liability**

A partnership required to withhold tax from distributions must report and pay over the tax using Forms 8288 and 8288-C in accordance with instructions to be provided.

Withholding and payment of tax by the partnership does not relieve the foreign transferor from its obligation to file a US tax return to report gain on the sale of a partnership interest or relieve the transferor from paying tax that was not satisfied by withholding by the transferee. The transferor cannot receive a credit for taxes withheld by the partnership from distributions to the transferee.

With respect to a non-compliant transferee, taxes withheld and interest paid by the partnership are treated as having been paid by the transferee. To the extent that the partnership withholds amounts in excess of the transferee's liability for withholding taxes and interest with respect to the transfer, the transferee may claim a refund for the excess.

### **Effective Date**

The final regulations relating to partnership withholding on distributions to non-compliant transferees apply only to transfers occurring on or after January 1, 2022. Consequently, under IRS Notice 2018-19, partnership-level withholding on distributions will not be required until 2022.

### **Practical Implications**

**Transferees:** As is the case with a transferee's direct withholding obligation under Section 1446(f), a transferee will need to collect a certification from the transferor of a partnership interest claiming an exception to withholding under Section 1446(f) or withhold tax from the purchase price in order to avoid personal liability for payment of the tax (whether assessed directly by the IRS or collected through withholding on partnership distributions). Moreover, because the partnership must withhold on distributions if the partnership knows or has reason to know that a certification provided by the transferor is incorrect or unreliable, the regulations effectively require the partnership to review and bless the transferor's certification. A transferee may therefore wish to withhold 10% of the amount realized even where the transferor provides a certificate claiming a withholding exception pending partnership approval. If the partnership approves the certificate, the withheld amounts would be released to the transferor, and if the partnership does not approve, the transferee would pay the withheld tax to the IRS.

**Partnerships:** To avoid any withholding obligations under Section 1446(f)(4) or liability for failure to make such withholdings, partnerships may want to consider including provisions in their operating agreements that condition transfers of partnership interests on the partnership's approval of a transferor's certification claiming a withholding exception or full compliance with the transferee withholding obligations. In all events, when a partnership interest is transferred, if the partnership does not already have in its possession a W-9 or other certification of non-foreign status from the transferor partner, the partnership should withhold distributions from the transferee until such time as the partnership is satisfied that an exception to withholding applies and has been adequately certificated or the full withholding obligation has been satisfied.