

Inside Recent IRS Guidance On Withholding In Partner Sales

By **Richard Zarin, William Zimmerman and Gabriel Quihuis**

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The Internal Revenue Service issued Notice 2018-29 on April 2, announcing that the U.S. Treasury Department and IRS intend to issue rules, regulations, and procedures that will provide qualifications from or reductions in the amount of withholding required to be imposed on the transfer of nonpublicly traded partnership interests by non-U.S. persons, as well as other clarifications on implementing this rule. The notice also contains interim guidance on which taxpayers may rely pending issuance of such regulations.

Background

Section 864(c)(8) of the Internal Revenue Code was recently enacted to provide that with respect to sales or exchanges of partnership interests on or after Nov. 27, 2017, gain or loss from the sale of a partnership interest is treated as effectively connected with a U.S. trade or business to the extent that the seller of such interest would have had effectively connected gain or loss had the partnership sold all of its assets for their fair market value as of the date of sale.

To help facilitate collection of tax on this "effectively connected income," or ECI, the recent tax reform act also introduced new Section 1446(f). This section requires the buyer of a partnership interest to withhold a 10 percent tax on the "amount realized" by the seller on the sale or exchange of a partnership interest occurring after Dec. 31, 2017, if any portion of the seller's gain on the sale of the interest would be effectively connected income under Section 864(c)(8) and the seller does not provide a certification of nonforeign status. Section 1446(f) also provides that, in the event the buyer fails to withhold the correct amount of tax, the partnership shall deduct and withhold from distributions to the buyer an amount equal to the tax that the buyer failed to withhold from the seller. This 10 percent withholding tax — referred to as "ECI withholding" — applies to the amount realized by the seller in the sale, which, under general partnership tax principles, would include a reduction in the seller's share of partnership liabilities. Under a literal reading of these new provisions, it is feasible, therefore, that the required withholding amount could exceed the amount of cash paid by the buyer in the sale. In many cases, it may be difficult for the buyer to ascertain the reduction in seller's share of



Richard Zarin



William
Zimmerman



Gabriel Quihuis

partnership liabilities in order to compute the correct withholding amount.

Relief and Guidance Under the Notice

In the notice, the IRS acknowledged a number of comments received highlighting various practical problems in implementing ECI withholding to a transfer of partnership interests. The guidance in the notice is intended to address the following practical problems faced by taxpayers in implementing the new withholding rule:

- How and when to deposit withheld taxes
- Procedures for seller to furnish an affidavit of nonforeign status to buyer
- Withholding in nonrecognition transactions or where seller has no gain on transaction
- Withholding where amount of ECI to be recognized by selling partner would be zero or de minimis
- Determination of amount realized in computing proper withholding amount
- Application of ECI withholding to distributions by a partnership that exceed the partner's adjusted basis in its partnership interest immediately prior to the distribution
- The interaction between ECI withholding and withholding required with respect to dispositions of U.S. real property interests under Section 1445 (referred to as "FIRPTA withholding," or Foreign Investment in Real Property Tax Act withholding)

Guidance on Withholding Procedures

Until now, there have been practical problems with ECI withholding due to lack of specific forms, instructions and guidance on when and how to deposit the withheld tax. The notice announces that until specific forms, guidance and instructions are issued with respect to ECI withholding, taxpayers must use the forms and deposit procedures applied with respect to FIRPTA withholding. This will involve using IRS Forms 8288 and 8288-A and the procedures described in the instructions to such forms to report and deposit ECI withholding taxes. Buyers performing ECI withholding and using these forms will need to include the statement "Section 1446(f)(1) Withholding" at the top of the forms to communicate to the

IRS that such forms are being used for ECI withholding purposes.

Exceptions to Withholding

The notice announces several exemptions to ECI withholding based on certain factual certifications made to the buyer of the partnership interest either by the seller of the partnership interest or the partnership itself.

Certification by Seller of nonforeign Status. As noted above, ECI withholding does not apply to sales by U.S. persons. The notice provides that until regulations are issued to deal with certification of nonforeign status, a seller of a partnership interest may certify its nonforeign status by using the similar certification used by a U.S. person to prevent the application of FIRPTA withholding, modified to take Section 1446(f) into account. Alternatively, a Form W-9 may be used for this purpose so long as the form contains the name and U.S. taxpayer identification number of the seller and the certifications and penalties-of-perjury jurat on the form have not been deleted. Note, in contrast, a Form W-9 is not sufficient to prevent application of FIRPTA withholding.

Certification by Seller of No Realized Gain on Sale. According to the notice, forthcoming regulations will provide that no ECI withholding is required where the seller of the partnership interest certifies — under penalties of perjury and including the seller’s U.S. taxpayer identification number — no earlier than 30 days prior to the transfer of the interest that the transfer will not result in realized gain for the seller. Note, however, that if gain is realized in a transfer but not recognized as a result of a nonrecognition provision, the buyer cannot rely on this certification. However, see discussion below on “Nonrecognition Transactions.”

Certification by Seller that Allocations of ECI to Seller Are Less than 25 percent of Total Income. The notice states forthcoming regulations will provide that no ECI withholding is required where the seller of the partnership interest certifies — under penalties of perjury and including the seller’s U.S. taxpayer identification number — no earlier than 30 days prior to the transfer of the interest that for the seller’s immediately prior taxable year and the two taxable years that precede it, the seller was a partner in the partnership for the entirety of each of those years, and that the transferor’s allocable share of “effectively connected taxable income” — as determined under Treasury Regulation §1.1446-2 — from the partnership for each of those taxable years was less than 25 percent of the transferor’s total distributive share of income from the partnership for that year. Various other requirements apply to such a certificate, which may narrow the ability of taxpayers to provide it.

Certification by Partnership that “Effectively Connected Gain” Is Less than 25 percent of Total Gain. Similar to the immediately preceding exception, regulations will be issued to provide that no ECI withholding is required where the partnership certifies — under penalties of perjury — no earlier than 30 days prior to the transfer of the interest that if the partnership had sold all of its assets at their fair market value, the amount of gain that would have been treated as ECI would be less than 25 percent of the total gain. For this purpose, “ECI” includes gain from the sale of U.S. real property interests. The notice states that the Treasury department and the IRS intend to provide future guidance that will lower these 25 percent thresholds.

Nonrecognition Transactions. The FIRPTA regulations currently provide an exception to withholding on the transfer of a U.S. real property interest by a non-U.S. person where such person, by reason of a “nonrecognition” rule in the Code, is not required to recognize gain or loss on the transfer — e.g., where such non-U.S. person transfers the property to a partnership or corporation in exchange for interests in

such entity. The notice announces that forthcoming regulations will apply rules similar to the foregoing so that ECI withholding is not required with respect to such "nonrecognition transactions", provided that the buyer of the interest is notified in a manner similar to the notification rules set forth in the FIRPTA regulations. Until such regulations are issued, no ECI withholding will be required with respect to nonrecognition transactions.

Determination of Amount Realized

As noted above, ECI withholding is imposed on the amount realized by the seller of a partnership interest, and such amount reflects not only the cash and other property transferred to the seller in exchange for the interest, but also the decrease in the seller's share of partnership liabilities that results from the transaction. The notice announces that regulations will provide for two alternative certifications from either the seller or the partnership on which the buyer of the partnership interest may rely with respect to the amount of liabilities of the partnership included in the seller's amount realized.

First, with respect to a seller that is not a "controlling partner," — meaning, a seller that owns less than a 50 percent interest in capital, profits, deductions, or losses in the 12 months preceding a transfer — the seller may certify to the buyer (i) the amount of the seller's share of partnership liabilities reported on the most recent Schedule K-1 received from the partnership for a taxable year that closed no more than 10 months prior to the transfer date and (ii) that the seller does not have actual knowledge of events that would cause such share of liabilities at the time of transfer to be more than 25 percent different from the amount shown on the Schedule K-1 — a "significant difference."

Alternatively, the partnership may certify to the buyer, under penalties of perjury, (i) the amount of the seller's share of partnership liabilities (which could be those shown on the most recent Schedule K-1 for such partner); and (ii) that the partnership does not have actual knowledge of events occurring after determination of the seller's liability share that would result in a significant difference. As noted, a certification provided by the partnership is the only type of certification available to controlling partners.

In certain cases, the total amount of ECI withholding will be limited to the total amount of cash and other property to be transferred. The notice states that regulations will be issued providing that if the ECI withholding amount exceeds the amount realized less the decrease in the seller's share of partnership liabilities, then the ECI withholding amount is equal to the amount realized less the decrease in the seller's share of partnership liabilities. Also, where a buyer is unable to determine the amount realized because it does not have knowledge of the seller's share of partnership liabilities — and does not receive one of the two certifications regarding partnership liabilities described above — then the ECI withholding amount is the entire amount realized, determined without regard to the decrease in the seller's share of partnership liabilities. This rule may only be relied on if the buyer is (i) not the partnership in which the seller is a partner and (ii) is not a related person to the seller. A buyer applying one of these exceptions will indicate so on the IRS Form 8288 that is filed by the buyer with respect to the withheld tax. These exceptions will not apply after guidance is issued providing for withholding certificates or otherwise providing for withholding determined by reference to gain recognized by the seller, as discussed above.

Partnership Distributions

Under general partnership tax principles, partnership distributions may be treated as a sale by the partner of a portion of its interest in the partnership where the cash distributed to the partner exceeds

the partner's adjusted basis in its partnership interest immediately prior to the distribution, thus potentially implicating ECI withholding where the partner is not a U.S. person. A partnership will not necessarily know the partner's adjusted tax basis in its partnership interests. Regulations will be issued to provide that a partnership may rely on its own books and records, or on a certification from the distributee partner to determine whether the distribution exceeds the partner's adjusted basis.

Coordination with FIRPTA Withholding

In some cases, the sale by a non-U.S. person of an interest in a partnership holding significant amounts of U.S. real property interests will be subject to a 15 percent withholding tax on the amount realized by the seller of the partnership interest under the FIRPTA rules. Absent coordinating rules, there are situations where both FIRPTA withholding and ECI withholding could potentially apply. The notice announces that regulations will be issued to provide that a buyer that is required to perform FIRPTA withholding and ECI withholding will only need to perform the 15 percent FIRPTA withholding and not ECI withholding. This applies only where the buyer has not received a withholding certificate from the seller indicating reduced withholding is appropriate. Where such a certificate is obtained, then the buyer must withhold the greater of the FIRPTA withholding or ECI withholding.

Tiered Partnerships

Regulations will be issued to clarify that in the case of a sale of an upper-tier partnership, a portion of the seller's gain on the upper-tier partnership interest will be characterized as ECI where a lower-tier partnership held directly or indirectly by the upper-tier partnership would generate ECI if it were to sell all of its assets as of the time of the transfer of the upper-tier partnership interest.

Temporary Suspension of Partnership Withholding "Backstop" Rule

Under Section 1446(f)(4), if the buyer of a partnership interest fails to withhold any amount required to be withheld from the seller, the partnership shall be required to deduct and withhold from distributions to the transferee a tax equal to the amount the buyer failed to withhold (plus applicable interest). The notice announces that the Treasury department and IRS are considering rules relieving a partnership of its obligation to withhold the tax from distributions to the buyer of a partnership interest where the buyer failed to withhold some or all of the tax required to be withheld, if the partnership provides the information required by a buyer and seller to comply with the requirements under Section 864(c)(8) and 1446(f), including applicable certifications and computations relating to the withholding tax. In the interim, partnerships are relieved of their obligation to withhold tax from distributions to the buyer until such regulations are issued.

What the Notice Does Not Do

The notice deals only with practical issues in ECI withholding. It does not impact the amount of tax that is ultimately imposed on the seller's gain on the sale of the partnership interest under Section 864(c)(8). The notice also does not expand the blanket suspension of ECI withholding currently applicable to publicly traded partnerships to transfers of nonpublicly traded partnerships. Likewise, the notice only applies to nonpublicly traded partnerships. New rules will be provided for publicly traded partnerships once the suspension provided in Notice 2018-08 has been lifted.

Call for Comments

The IRS is currently seeking comments from the public regarding rules to be issued on the ECI withholding requirement. Comments are specifically requested on the following:

- Rules concerning determination of the amount realized by a seller of partnership interests
- Procedures for limiting withholding of tax to the gain recognized
- Procedures for claiming credits or refunds of withheld tax
- Rules relating to the obligation of a partnership to withhold tax from a buyer of partnership interests where ECI withholding was not performed or inadequately performed
- Coordination of ECI and FIRPTA as applied to sales of partnership interests
- Calculation of gain or loss on the sale of a partnership interest that is deemed to be effectively connected with a U.S. trade or business as a result of the rule in Section 864(c)(8)

Key Takeaways

The notice provides needed interim guidance on ECI withholding to participants in transactions involving transfers of partnership interests. In particular, the safe harbors contained in the notice help parties reduce the risk of over-withholding or, arguably, unnecessary withholding with respect to sales by U.S. persons, sales not involving gain, nonrecognition transactions, sales of interests in partnerships with low ECI exposure, and sales of interests in partnerships with liabilities allocated to the seller. Further, buyers of partnership interests may have lower risk exposure from not withholding if a safe harbor is available.

The temporary suspension of the secondary partnership level withholding requirement in the notice provides helpful relief to partnerships that would otherwise have to engage in complex and costly analysis to determine if proper withholding was applied. Finally, the notice announces regulations that are expected to add clarity with respect to partnership distributions treated as sales, tiered partnership arrangements, and the interplay between FIRPTA and ECI withholding.

Morgan, Lewis & Bockius LLP partners Richard S. Zarin and William P. Zimmerman, and associate Gabriel A. Quihuis counsel clients on tax matters involving international and U.S. transactions.

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