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TCJA Significantly Impacts Secondary Sales Of Fund Interests

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On Dec. 22, 2017, U.S. President Donald Trump signed into law the Tax Cuts and Jobs Act, P.L. 115-97, and with it sweeping tax reform. The new legislation includes a provision that reverses the U.S. Tax Court's Grecian Magnesite Mining decision[1] and introduces a new 10 percent withholding tax on the sale of certain partnership interests. This new provision has significant implications for buyers and sellers of interests in investment fund vehicles classified as partnerships for U.S. federal income tax purposes and the funds themselves. The new provision will also have significant implications for mergers and acquisitions transactions involving partnerships.

Grecian Magnesite Mining Reversed

TCJA revises Section 864(c) of the Internal Revenue Code 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. This reverses the U.S. Tax Court's recent ruling in Grecian Magnesite Mining, where the Tax Court concluded under the facts at issue that a non-U.S. partner is not subject to U.S. federal income tax on gain from the sale of a partnership interest in a partnership conducting business in the United States — in other words, applying an "entity" approach to the U.S. federal income taxation of gain derived from the sale of the partnership interest as opposed to an "aggregate" approach — except for gain attributable to the partnership's "United States real property interests." In doing so, the Tax Court rejected the Internal Revenue Service's longstanding position to the contrary as stated in Revenue Ruling 91-32. TCJA directs the secretary of the treasury to issue regulations regarding the application of this new rule.

New 10 Percent Withholding Tax

TCJA also introduces new Section 1446(f), which 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 revised Section 864(c),

described above, and the seller does not provide a certification of non-foreign status. TCJA 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. The 10 percent withholding tax applies to the “amount realized” by the seller in the sale, which would include the seller’s share of partnership liabilities. It is possible, 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 seller’s share of partnership liabilities in order to compute the correct withholding amount.

Practical Considerations

The new 10 percent withholding tax presents additional complexity and risk for participants in secondary sales of fund interests in cases where the fund is treated as a partnership for U.S. federal income tax purposes, as is most often the case. To help avoid bearing the new 10 percent withholding tax, buyers of fund interests in such secondary transactions will need to seek additional assurances or documentation from the sellers and/or the funds to provide comfort that no withholding is required — e.g., a seller certificate of non-foreign status. Buyers might also consider additional security features in their purchase agreements, such as specific indemnity or escrow provisions relating to this withholding tax. Further, a buyer may wish to consider seeking comfort from a fund that the fund will not withhold this new tax from distributions made to the buyer to the extent that the buyer determines based on its diligence efforts that it is not required to withhold this new tax from its purchase price paid to the seller. The new law authorizes the IRS to permit a reduced amount of withholding, but it will likely be some time before the IRS issues guidance specifying the procedures that must be followed to obtain a withholding certificate or other permission to apply a reduced rate of withholding.

The additional complexities and risks facing participants in secondary transactions are also present in M&A transactions involving the purchase and sale of interests in operating businesses organized as partnerships.

Because partnerships now have a withholding obligation with respect to the buyer of a partnership interest in a transaction where the buyer fails to properly withhold, fund sponsors and other parties managing partnerships might consider strengthening provisions in the partnership agreement relating to transfers, withholding, and information from the buyer and seller in order to protect the partnership and the other partners with respect to such withholding taxes.

We note, however, that the IRS has stated in Notice 2018-08 that it is temporarily suspending the application of the withholding tax to sales of certain publicly traded partnership interests held by non-U.S. sellers. Although withholding on sales of non-publicly traded partnership interests by non-U.S. sellers is not suspended, the IRS has requested comments on whether a temporary suspension of this withholding requirement for non-publicly traded partnership interests is needed.

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[1] Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner, 149 T.C. No. 3 (July 13, 2017)