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Final regulations - Foreign partner's U.S. tax liability on transfer of partnership interest

Given the overall development of the secondaries market and the increasing volume and size of secondary funds, the U.S. tax and withholding regime that applies to a foreign partner transferring an interest in a partnership that is engaged in a U.S. trade or business, enacted as part of 2017 U.S. tax reform, has become an important consideration in structuring and negotiating secondary transactions, even those transactions that do not involve U.S. investments.

Recently, the U.S. Internal Revenue Service (IRS) issued final regulations under IRC Section 864(c)(8) that address the U.S. tax liability imposed on the transferring partner. At a future date, final regulations under IRC Section 1446(f) are expected to be issued addressing the buyer/transferee's obligation to deduct and withhold tax arising from the transfer and making effective a secondary withholding tax obligation imposed on the partnership that is currently suspended.

Background

On September 21, 2020, the IRS issued final and temporary regulations (the Final Regulations) ([T.D. 9919](#)) under Section 864(c)(8) of the Internal Revenue Code of 1986, as amended (IRC), addressing the tax treatment of gain recognized by a non-U.S. partner on the sale (or other transfer, including a redemption) of an interest in a partnership engaged in a U.S. trade or business resulting in the gain being considered effectively connected to such U.S. trade or business (ECI).

According to the IRS, final regulations applicable to withholding under Section 1446(f) are to be issued at a later date.

For the most part, the Final Regulations adopt the proposed regulations that were issued on December 20, 2018 (the Proposed Regulations) but include some

beneficial clarifications. The Final Regulations generally apply to transfers occurring on or after December 26, 2018. Certain key provisions are summarized below.

Calculating ECI

In general, when determining the tax implications under Section 864(c)(8)(A) for a non-U.S. partner who sells (or otherwise transfers) an interest in a partnership that is engaged in a U.S. trade or business, the seller's effectively connected gain or loss is limited to the portion of the non-U.S. partner's distributive share of the gain or loss that would have been effectively connected if the partnership had sold all its assets at fair market value. The Proposed Regulations were, in certain respects, over-inclusive of what would constitute ECI upon a deemed sale of the partnership's assets, as compared to an actual asset sale. The Final Regulations revise the method by which ECI is calculated, adding more specific rules regarding the attribution of gain to a U.S. office of the partnership and with respect to certain categories of assets (e.g., inventory, depreciable personal property, and intangibles). These changes may lead to lower U.S. tax exposure on transfers by non-U.S. partners.

Tax treaty coordination

The Final Regulations clarify the applicability of U.S. income tax treaties when computing a non-U.S. partner's ECI on the transfer of a partnership interest and make clear that applicable tax treaties may exempt from this computation gain or loss resulting from the deemed sale of certain assets.

Partner-specific exclusions and exceptions

The Final Regulations confirm that a non-U.S. partner's distributive share of effectively connected gain or loss arising from the deemed sale of partnership assets does not include an amount that is exempt from U.S. tax by

reason of an applicable provision of the IRC, including exceptions under Section 897 (relating to dispositions of U.S. real property interests) applicable with regard to a Real Estate Investment Trust (Section 897(k)) or to a Qualified Foreign Pension Fund (Section 897(l)).

Section 731 distributions

The Final Regulations note that the IRS continues to study the effect of certain nonrecognition transactions (such as Section 731 distributions) on ECI calculations and will, if necessary, address this issue in future rulemaking.

Coordination on U.S. real property interests

The Final Regulations provide that the transfer of a partnership interest that qualifies under a nonrecognition provision exempting it from taxation under Section 864(c)(8) may nevertheless be subject to the rules of Section 897(g) if the partnership owns one or more U.S. real property interests.

Information exchange between a partnership and non-controlling partners

The Final Regulations were not revised to allow non-U.S. partners to estimate their ECI due to an inability to obtain partnership information. Instead, the IRS points to the proposed withholding regulations under Section 1446(f), which include a proposed regulation under Section 864(c)(8) that requires a partnership to provide a non-U.S. partner with the information necessary to calculate its ECI even if the non-U.S. partner does not hold a controlling interest in the partnership. The IRS notes in the preamble to the Final Regulations that it is still considering this issue as part of the proposed withholding regulations under Section 1446(f), which will be finalized at a future date.

Section 1446(f) Final Regulations

In the preamble to the Final Regulations, the IRS states that it plans to publish at a later date final withholding and information reporting regulations applicable to the transfer of an interest in a partnership that is engaged in a U.S. trade or business by a non-U.S. person. Proposed Section 1446(f) withholding and information reporting regulations were issued on May 13, 2019. We intend to issue a new alert once these regulations are finalized.

In the meantime, please reach out to any of the contacts listed to the right for additional information or to respond to questions.

Contributors



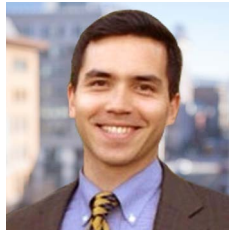
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