Bloomberg Tax

Tax Management
International Journal™

Gain or Loss on Sales of Partnership Interests by Foreign Partners: Issues for Guidance Under §864(c)(8) and §1446(f)

By Kimberly S. Blanchard, Esq.
Weil, Gotshal & Manges LLP
New York, New York

This commentary lists some issues that will require guidance from the IRS in respect of new tax code §864(c)(8) and §1446(f), added by the recently enacted tax reform legislation, Pub. L. No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (herein, the ''2017 tax act''). Section 864(c)(8) provides that if a foreign person disposes of an interest in a partnership that carries on a U.S. business, gain or loss shall be treated as ''effectively connected income'' (ECI) to the extent not in excess of the partner's distributive share of the gain or loss that would have been ECI upon a deemed disposition by the partnership of its assets. That section is effective for dispositions on or after November 27, 2017. Section 1446(f) provides that if any portion of the gain on a disposition of a partnership interest would be treated as ECI under §864(c)(8), the transferee must withhold a tax equal to 10% of the amount realized on the disposition. The withholding requirement is effective for dispositions after December 31, 2017.

In light of these immediate effective dates, prompt guidance from the IRS is imperative in order for foreign sellers and their withholding agents to comply with the new law. Pending such guidance, penalties should be waived for cases in which the taxpayer made a good faith effort to comply, using any reasonable approach to resolve the many unanswered questions raised by the new law.

Guidance Needed Under §864(c)(8)

1. The statute appears to cap the amount of gain or loss taken into account at the foreign partner's distributive share of the ECI amount the partnership would realize had it sold all of its assets — for example, in cases where the partner's outside basis in its partnership interest is lower than the partnership's inside basis in its assets. Guidance is needed for a selling partner (and the transferee as withholding agent) to be informed of what the partnership's deemed gain or loss would be, and how much of such deemed gain or loss would be treated as ECI.
2. A selling partner's distributive share is to be determined using its share of ''non-separately stated taxable income.'' Guidance is needed as to whether this language was intended to ignore special allocations, or merely to refer to the amount of income that would be reported on line 1 of Schedule K-1 in the event of a sale of partnership assets. Guidance is further required as to whether any special allocations of ECI to non-foreign partners, assuming such allocations have substantial economic effect, would be respected for these purposes.
3. Guidance is needed as to how ECI gains would be netted against non-ECI losses, or vice-versa. Guidance should also be issued as to how ECI gains and losses from different partnerships may be netted.
4. Guidance is needed as to how to apply §752(d), which treats the assumption of a partner's share of partnership liabilities as an amount realized, in calculating the selling partner's gain or loss. Many selling partners and withholding agents would not have this information, at least as of the date of the sale.
5. Guidance is needed to coordinate §864(c)(8) with §751(a).
6. Guidance is needed as to what types of dispositions are covered; for example, are gifts to family members counted?

ISSN 0090-4600

7. Guidance is needed coordinating the new rules with the nonrecognition provisions of the Code, perhaps mirroring some of the exceptions set out in §897(d) and §897(e). At a minimum, no gain should be recognized if the full amount of ECI is preserved for future taxation.

8. Guidance is needed in the case of tiered partnerships. The statute speaks in terms of a foreign person who owns, directly or indirectly, an interest in a partnership that is engaged in a U.S. business, but is silent concerning the case in which a passive holding partnership sells an interest in an underlying business partnership. Presumably the normal rules of §1446 apply in this case.

9. The normal rules of §1446 provide an exception from tax and withholding where the ECI is treaty-protected (e.g., because the partnership does not have a U.S. permanent establishment that can be attributed to the foreign partner). Similar treaty guidance will be required under the new rules.

10. Under §906, a foreign person engaged in a U.S. trade or business is entitled to claim foreign tax credits for foreign tax paid on such income. Guidance is needed as to how to offset the new tax and withholding for allowable foreign tax credits.

Guidance Needed Under §1446(f)

11. The statute requires withholding at 10% of the total amount realized if ''any portion'' of the gain on a foreign partner's sale of its partnership interest is ECI. Especially given the 10 guidance questions above, guidance is needed as to how a transferee knows whether any portion of the seller's gain is ECI. A moratorium on withholding, similar to that given to publicly traded partnerships by Notice 2018-08, should be issued until these questions can be resolved.

12. Even if the transferee knows that a portion of the seller's gain is ECI, it is unreasonable to impose a 10% withholding tax requirement where the actual tax due may be very much less. Rules similar to those set out in the regulations under §1446(a) might be issued, although they would require the participation of the partnership, which may be difficult especially where the partnership has hundreds of small partners. Other alternatives include:

    a. Provide a *de minimis* exception from withholding such as that provided under the FIRPTA regulations at Reg. §1.1445-11T.

    b. Provide a withholding tax certificate mechanism similar to that provided under the FIRPTA regulations at Reg. §1.1445-3.

13. The statute provides that if the transferee fails to withhold, the partnership is liable to withhold from future distributions to the transferee, with interest. Guidance is needed for cases in which a foreign partner's entire partnership interest is redeemed by the partnership. It is unclear who the transferee is in this case, and there is no possibility of withholding from the transferee's future distributions in the event of a failure to withhold.

14. Guidance is needed for those cases where there is withholding under both §1445 and §1446(f). Although current regulations provide that regular §1446 withholding trumps FIRPTA withholding, those regulations are incapable of being applied in a case in which the withholding agent is a third-party buyer. Section 864(c)(8) provides that the ECI tax shall be reduced by the FIRPTA tax, but there is no mechanism for applying this rule to withholding agents. Moreover, as noted below, there is no extant guidance regarding the calculation of the §897(g) tax.

Conclusion

Many of the issues presented by these new provisions are similar to those presented by §897(g) and §1445. In the 38 years since the Foreign Investment in Real Property Tax Act (FIRPTA) was enacted, *no substantive guidance has been issued by the IRS as to how to calculate the tax due under §897(g)*. Perhaps recognizing the difficulties entailed in the calculations, the §1445 regulations have long excused withholding for all but ''U.S. real estate rich'' partnerships.

This history does not bode well for needed guidance under §864(c)(8). The calculations and procedural issues raised by new §864(c)(8) and §1446(f) are far more complex and difficult than those presented by FIRPTA. As noted above, there are issues under §752(d) and §751. Moreover, although it's usually fairly clear whether or not a partnership owns a U.S. real property interest, it's not always clear whether a partnership is engaged in a U.S. business and, if so, which assets are used in that business. There are also potential treaty issues regarding ECI and the lack of a permanent establishment that do not arise under FIRPTA. And of course there are coordination issues with tax and withholding under FIRPTA.

On top of all this, the knowledge issues in this context present more difficulties than they do under FIRPTA. If a buyer (even a foreign buyer) purchases a partnership interest in a partnership that owns a building in Manhattan, it is likely that the seller and buyer will at least know there is tax and withholding, even if they are not quite sure how much of the gain or loss is ''attributable to'' the partnership's building. But if a buyer is buying a worldwide consulting business held in partnership form, it defies common sense to suppose that either party has any idea what amount might be subject to tax and withholding.

ISSN 0090-4600