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Proposed Regulations Under Section 1446(f) Miss the Donut

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On May 7, 2019, the IRS released proposed regulations under **§1446(f)** [1] (the "Proposed Regulations"), which requires withholding of U.S. tax on certain dispositions of interests in partnerships conducting a U.S. trade or business.[2] The withholding rule of **§1446(f)** enforces the substantive tax rule of **§864(c)(8)**. Both rules were enacted by the Tax Cuts and Jobs Act.[3]

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[1] All section references are to the **Internal Revenue Code**, as amended (Code), or the Treasury regulations thereunder, unless otherwise indicated.

[2] **REG-105476-18**, Doc. 2019-17878, **84 Fed. Reg. 21,198**–21,224 (May 13, 2019).

[3] **Pub. L. No. 115-97** (Dec. 22, 2017).

If and when finalized, the Proposed Regulations would replace two Notices issued in 2018 addressing withholding obligations under **§1446(f)**. The first, **Notice 2018-08**,[4] temporarily suspended the withholding requirement altogether with respect to dispositions of interests in publicly traded partnerships. The second, **Notice 2018-29**,[5] provided temporary rules applicable to withholding on disposition of interests in non-publicly traded partnerships. This commentary will focus on only the portions of the Proposed Regulations dealing with non-publicly traded partnerships.

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[4] **2018-7 I.R.B. 352**.

[5] **2018-16 I.R.B. 495**.

Section 1446(f) requires a transferee of a partnership interest to withhold a tax equal to 10% of the amount realized on the disposition of a partnership interest. If one were to stop there, it would be easy for a transferee to determine the amount to withhold and thus to satisfy its legal obligation to withhold. However, such a rule would require withholding on every transfer by a foreign person of an interest in any partnership anywhere in the world, regardless of any connection to the United States or to the substantive rule in **§864(c)(8)**. This was clearly not Congress's intent. The statute appropriately narrows the scope of the withholding obligation by requiring withholding only when the disposition results in gain, any portion of which is treated as effectively connected with the conduct of a U.S. trade or business ("ECI") under **§864(c)(8)** (the "ECI Gain Condition").

Section 864(c)(8) treats as ECI the gain or loss realized by a foreign person on the disposition of an interest in a partnership only if the partnership is engaged in a U.S. trade or business. The statute had to deal with the fact that "outside gain," measured by reference to the partner's outside basis in its interest, may not equal any "inside" gain

measured by reference to the partnership's basis in its assets. The statute also had to deal with the fact that gain or loss, however measured, might be composed of ECI and non-ECI items, with a loss in one category potentially offsetting a gain in the other category. **Section 864(c)(8)** tries to cope with these measurement problems by defining ECI gain or loss as the portion of the selling partner's distributive share of the amount of ECI gain or loss that hypothetically would be realized by the partnership on a deemed sale of its assets.

A withholding agent has strict liability for the tax, plus interest and penalties. It is therefore critical that the amount required to be withheld be reasonably determinable and clearly required by statute. The problem for the transferee withholding agent under **§1446(f)** is that it has absolutely no way of knowing whether the disposition results in gain at all, much less ECI gain. The transferee can try to ask the transferor, but in the usual case the transferor will not know the amount of its ECI gain, since the amount is determined at the partnership level based on facts knowable only to the partnership. And since the partnership itself is not a party to the standard disposition of a partnership interest,[6] we have a problem.

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[6] The Proposed Regulations, like the Notices before them, fill in a gap left by the statute and apply to partnership redemptions. That type of disposition is not addressed by this commentary.

The point of the Proposed Regulations should be to solve this problem. However, the Proposed Regulations utterly fail to address the problem in the great majority of real world cases. These cases fall into two categories. The first category consists of cases where there is no connection to the United States at all. The second category consists of those where a foreign person sells an interest in a partnership in which ECI investments are selectively blocked.

The Proposed Regulations deliberately ignore the ECI Gain Condition of the statute. Instead, they require withholding in all cases, subject to six exceptions. Each of these exceptions requires someone to deliver a certificate to the transferee:

1. The transferor can provide a certificate of non-foreign status.[7]

2. The transferor can provide a certificate stating that no gain was realized on the sale.

3. The partnership can provide a certificate stating that upon a hypothetical sale of its assets, net ECI gain would be less than 10% of total gain.

4. Subject to the further conditions discussed below, if the transferor has been a partner for at least three years, it can provide a certificate stating that its share of ECI for each of those years was less than 10% of its total distributive share in that year, and less than $1,000,000.

5. The transferor can provide a certificate stating that the transfer is subject to a nonrecognition provision of the Code.

6. Finally, the transferor can provide a certificate that it is exempt from tax by reason of a treaty (e.g., because the ECI would not rise to the level of income from a U.S. permanent establishment).

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[7] A foreign person described in **§897(l)** (qualified foreign pension fund) uses a non-foreign affidavit under Reg. **§1.1445-2** to attest to that status. Absent clarification, a QFPF might believe it can provide the same affidavit for **§1446(f)** purposes. The final regulations should make clear that this is not the case.

Given the statutory ECI Gain Condition, one might have supposed that one of the exceptions would not require the delivery of any certificate by any person and would apply when there is no connection to the United States at all. If a Mongolian sheepherder sells to a Chinese buyer an interest in a French partnership that has never had any connection to the United States, one of the certificates above must be delivered to avoid subjecting the Chinese buyer to withholding tax liability. If the Chinese transferee fails to withhold and remit to the IRS a 10% tax on the amount realized by the Mongolian seller, then, pursuant to **§1446(f)(4)** and the Proposed Regulations, the French partnership will be required to withhold tax (plus interest) from distributions to the Chinese transferee, on pain of itself becoming liable for the tax as well as interest and penalties.

In the real world, neither the Chinese buyer nor the French partnership is going to be providing any certifications or withholding U.S. tax. They will simply be unaware of these

rules, which cannot possibly apply to them. The obvious way to deal with this reality is to craft an exception, which would not require any knowledge of the existence of **§1446(f)** or **§864(c)(8)**, that would apply where the partnership in question could never have ECI, or where the transferor could never have **§864(c)(8)** ECI gain. At the least, a presumption of non-applicability should apply where the partnership is a foreign partnership that has never filed or been required to file a Form 1065.

Even in the case where one could reasonably expect the parties to file some sort of certificate, the Proposed Regulations miss the donut by focusing only on the hole. The Proposed Regulations assume that foreign persons who invest in partnerships either invest directly, in which case **§1446(f)** is implicated, or invest solely through U.S. corporations, in which case they would never be disposing of a partnership interest. This misses the many cases involving investment in partnerships that selectively block ECI investments.

In very many investment partnerships, foreign partners, as well as U.S. tax-exempt partners,[8] are selectively "blocked" from ECI through the use of, for example, below-the-fund blockers, but are not blocked with respect to other investments of the partnership. Because the foreign and U.S. tax-exempt partners remain direct partners with respect to ordinary corporate portfolio companies, they have to deal with **§1446(f)** on a sale of those interests even though they will, by definition, never be allocated any ECI or receive any Form 8805.

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[8] U.S. tax-exempt partners have tax constraints similar to those of foreign persons when an investment partnership invests in a portfolio company operating partnership, because the portfolio company will generate unrelated business income, the counterpart to ECI. Oddly, no rule similar to **§864(c)(8)** applies to U.S. tax-exempts, even though the "evil" to which **§864(c)(8)** was addressed (a tax-free basis step-up on sale) applies with equal force to sales by U.S. tax-exempts. See Blanchard, **Rev. Rul. 91-32**: Extrastatutory Attribution of Partnership Activities to Partners, 76 Tax Notes 1331 [¶¶ 75–77 in online version] (Sept. 8, 1997) (mentioning a House bill that would have treated gain on a sale of a partnership interest as unrelated business income).

The IRS has been blind to this problem for a very long time. Regulations under **§875** have long provided that any foreign person who is a partner of a partnership that is engaged in a U.S. business is itself considered to be engaged in a U.S. trade or business.[9] Technically, a foreign partner of a partnership that earns all of its income attributable to an ECI-generating portfolio investment through a corporate blocker is described in that regulation, even though it cannot be allocated any ECI. It is unknown how many foreign investors file a U.S. tax return with zeros on it in this situation. But the stakes have been considerably raised by **§1446(f)**.

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[9] Reg. **§1.875-1**.

Note that this problem is not a problem of substantive tax law. In this type of situation, the foreign partner that sells its partnership interest will have no share of any ECI earned by the partnership, and will therefore not be subject to tax under **§864(c)(8)**. The problem is simply one of withholding.[10]

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[10] The IRS appears to believe that taxpayers actually care whether the ECI threshold for exception 3 and 4 is set at 10% as opposed to the 25% threshold in **Notice 2018-29**. But in the real world, the percentage threshold will usually be completely irrelevant, because the percentage will typically be zero.

Return to the six exceptions above. Let's assume, as would often be the case, that the transferor is a foreign person who is not a resident of a treaty country and who recognized gain in a recognition transaction. That rules out exceptions 1, 2, 5, and 6 above, leaving only 3 and 4. Exception 4 is within the control of the foreign transferor, but cannot always be used.

The first problem with exception 4 is that is requires the foreign transferor to have been a partner for at least three years. This was also the rule in **Notice 2018-29**. The preamble to the Proposed Regulations justifies the three-year requirement on the basis that any shorter period of time would tend to be unrepresentative of the average amount of ECI that a partnership might generate. While this is certainly true, it means that exception 4 will not be available to any person that has not been a partner for three years, even if there is no possibility of ECI. The fourth exception also requires that the foreign transferor have received a Form 8805 from the partnership in each of the years it was a partner, unless its share of ECI in that year was zero due to ECI loss or deductions.[11] This rule makes it impossible to rely on the fourth exception if the partnership has no ECI, or the

foreign partner owns any ECI-generating investments of the partnership through a blocker.

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[11] Prop. Reg. **§1.1446(f)-2(b)(5)(iii)**.

This leaves only exception 3, which requires input from the partnership itself. In an ideal world, the problems identified above would all be solved by asking the partnership to deliver the certificate referred to in that exception. But experience with **Notice 2018-29** suggests that many partnerships are unwilling to do the necessary work and/or to provide a certificate that could theoretically expose them to liability in a case in which a partner is disposing of its partnership interest. Even if a partnership were willing to do so, it is not clear whether a partnership that selectively blocks ECI would be permitted to deliver a certificate contemplated by the Proposed Regulations. In calculating its ECI, it is unclear whether the partnership must count all of the gain that would be ECI if allocated to a foreign person, or need only count ECI that would actually be allocated to foreign persons.

This problem could be solved simply by adding an exception where the foreign partner cannot be allocated ECI of the partnership. But the larger problem with the Proposed Regulations — that they require a certificate to be delivered to the IRS for every transfer of every partnership in the world — cannot be fixed without starting over. The Proposed Regulations' failure to engage with these realities, when coupled with strict liability for withholding, virtually ensures that these regulations, if adopted in their present form, would be successfully challenged in court.