CPE ARTICLE

TAX TREATMENT OF A FOREIGN PARTNER'S SALE AND RELATED WITHHOLDING

By Matthew M. Mortimer

CURRICULUM: Tax

LEVEL: Basic

DESIGNED FOR: Tax practitioners; public practice

OBJECTIVES: To assist practitioners in navigating the technical issues associated with partnership tax accounting, and illustrate how to apply the new effectively connected income (ECI) characterization and related withholding rules pursuant to a nonresident partner's sale of interest in a U.S. partnership

KEY TOPICS: ECI characterization and rules established by the Tax Cuts and Jobs Act; ECI calculation processes; withholding requirements; threshold for a partner's share of effectively connected taxable income (ECTI) and net ECI gain; partnership liabilities

PREREQUISITES: None

ADVANCED PREPARATION: None

When a partner sells U.S. partnership interest, the gain is characterized and sourced as a capital asset[1], with a look-through exception for "hot assets."[2] However, since 1991, the Internal Revenue Service (IRS) has treated the sale of a nonresident partner's interest in a U.S. partnership as a sale in the interest of each underlying asset.

Revenue Ruling 91-32 (hereinafter referred to as Ruling) stated the reasoning and rules for this approach. Until recently, practitioners looked to the Ruling for guidance when characterizing the gain or loss of a nonresident partner's sale of partnership interest as effectively connected income (ECI). In July 2017, the U.S. Tax Court ruled in favor of Grecian Magnesite Mining, Industrial, and Shipping Co., which filed a tax return position contrary to the Ruling (*Grecian Magnesite Mining v. Commissioner*, 149 TC 3).

When assessing the technical merits of the IRS' position, the court found the Ruling "improperly interprets the text of relevant statutes and has inadequate reasoning"[3] and gave no deference to it. While the IRS filed an appeal for the *Grecian* decision, the Tax Cuts and Jobs Act of 2017 codified a statute in the Internal Revenue Code (IRC) similar to the Ruling in IRC §864(c)(8). Congress also introduced a withholding requirement on nonresident partnership interest sales in IRC §1446(f).

Navigating the technical issues associated with partnership tax accounting paired with the burdensome process and procedure common in international transactions is no simple task. This article illustrates how to apply the new ECI characterization and related withholding rules pursuant to a nonresident partner's sale of interest in a U.S. partnership.

ECI Characterization

In the Ruling, the IRS assesses the ECI of a nonresident partner's sale of partnership interest by using a deemed sale of the partnership's assets at fair market value. This approach is in contrast to assessing the gain or loss as the sale of a capital asset, which risked sourcing U.S.-generated gains abroad. The Ruling allocated gain or loss of ECI property in the partnership to the nonresident according to the partner's distributive share if the partnership disposed of all its assets at fair market value.[4] Net ECI gain and net non-ECI gain were computed independently as to not offset one another.

Although IRC §864(c)(8) borrowed much of its mechanics from the Ruling, there are subtle differences in the language that warrant examining the statutory ECI characterization of a nonresident's sale of U.S. partnership interest in its entirety. These rules established by the Tax Cuts and Jobs Act, P.L. 115-97, are effective for nonresident sales of U.S. partnership interest on or after Nov. 27, 2017.

When determining the ECI gain or loss pursuant to the sale of a nonresident's U.S. partnership interest, one must first calculate the gain or loss to the partnership in a deemed sale of all the partnership's assets. This is done to disaggregate the overall realized gain or loss on the sale of the partnership interest into the composite gains and losses attributable to each asset or goodwill. Then, apply the partnership's distribution rules in the partnership agreement as if apportioning non-separately taxable income.[5]

Once the partner's distributive share of the gain or loss from each deemed sale is determined, assets should be sorted into two categories: ECI and non-ECI. Source rules to determine ECI from non-ECI assets depend on the type of asset. For instance, inventories are sourced according to IRC §§861(a)(6), 862(a)(6) and 863; personal property sales are sourced under IRC §865; and U.S. real property interests are sourced as ECI under IRC §897. Income from the sale of real property interest outside of the U.S. is sourced under IRC §862.

Once the partner's distributive share of the gain or loss from each deemed sale is determined, assets should be sorted into two categories: ECI and non-ECI.

After applying the relevant IRC section to source each asset, net the gains and losses from ECI assets and net the gains and losses from non-ECI assets. Any remaining gain or loss not attributable to any of the assets, ECI or non-ECI, after the deemed sale and netting is treated as non-ECI gain or loss, as this ECI characterization is limited to the amount determined in IRC §864(c)(8)(B).[6] In following these netting rules, it is possible to have a loss on the sale of partnership interest, but still have a net ECI gain on the deemed sale of the underlying assets. The converse is also possible where a realized gain on the partnership interest sale can yield a net ECI loss.

In coordination with IRC §897, any ECI gain or loss determined in the process is reduced by ECI gains or losses attributable to U.S. real property interests, which are separately assessed and reported as ECI.[7] This is done to disallow any double benefit for U.S. real property interest loss or double taxation on U.S. real property interest gain separately assessed and reported as ECI.

For example, Partner C, of ABC Partnership, is a nonresident alien with residence in country F. ABC maintains a fixed place of business in the U.S. and Partner C is selling her 40% partnership interest to newly admitted Partner D for $150. Partner C's basis in her partnership interest is $100, so she will have a $50 realized gain. IRC §864(c)(8) characterization rules apply whether Partner D is a nonresident or not. See Exhibit 1 for the application of ECI characterization rules on the sale.

Be aware there is an anti-stuffing provision in proposed regulations that disregards property transferred into a partnership with the principal purpose of offsetting ECI gain.[8] Moreover, proposed regulations require the nonresident partner selling interest to notify the partnership within 30 days of the transfer so the partnership can provide relevant information to the selling partner by the due date, including extensions, of the Schedule K-1.[9]

Withholding on the Sale

When a nonresident engages in a taxable transaction in the U.S., the IRS is concerned about the collectability of the tax due: thus, withholding on the gross amount received by the nonresident is common practice. Unless otherwise provided in a tax treaty, withholding is often applied to dividends and interest, as well as to effectively connected income from services or U.S. real property interest. The Tax Cuts and Jobs Act introduced a new withholding requirement for those purchasing U.S. partnership interest from nonresidents in IRC §1446(f). Purchasers of a nonresident's U.S. partnership interest after Dec. 31, 2017, are required to deduct and withhold 10% of the amount realized if any of the nonresident partner's gain is treated as ECI gain under IRC §864(c)(8).[10]

Proposed regulations require the buyer to report and pay the withholding within 20 days of the transfer and

EXHIBIT 1.

	Partner-ship Basis	Fair Market Value	Gain from Deemed Sale	Partner C's 40% Share of Deemed Gain	ECI	Non-ECI
Cash	100	100	-	-	-	-
Net Equipment (U.S.)	50	100	50	20	20	-
Net Equipment (Abroad)	50	75	25	10	-	10
Land (U.S.)	75	100	25	10	10[a]	-
Excess Realized Gain	-	-	-	-	-	10[b]
Total	275	375	100	40	30	20

[a] Excluded from final §864(c)(8) ECI, but USRPI included as §IRC 897 ECI
[b] Total realized gain less gain from deemed sale of partnership assets

the buyer must provide a withholding certification to the partnership within 10 days of the transfer.[11] A notable statutory provision of this withholding, however, is that if the purchaser fails to withhold 10% of the amount realized, the partnership is compelled to deduct and withhold any remaining tax due (including interest) from future distributions to the purchasing partner.[12] Despite this being a statutory provision, it is suspended until the issuance of further guidance or regulations, which may be soon.[13] As of May 2019, proposed regulations for §1.864(c)(8) and §1446(f) were issued, but will not have effect until 60 days following adoption as final regulations.

Among the proposed regulations is guidance for partnerships to withhold distributions to buyers if the partnership has not received certification assuring the buyer satisfied withholding requirements.[14] Withholding is also suspended for publicly traded partnerships (PTPs) until regulations are issued.[15] However, proposed regulations include guidance for applying §1446(f) withholding to sales of PTP interest, so PTP withholding may apply soon.[16]

For illustration, when Partner D, from the previous example, completes the purchase of Partner C's partnership interest, Partner D will withhold $15 (10% of the $150 purchase price) from the sale. If Partner D fails to withhold, the partnership should be prepared to withhold the $15 plus accrued interest from future distributions to Partner D if she fails to withhold.

The withholding obligation is waived if the selling partner provides a non-foreign affidavit to the buying partner.[17] The affidavit should state the partner is in fact a U.S. person and provide a U.S. taxpayer identification number (TIN). This requirement can be satisfied with a Form W-9, provided it has the seller's name and TIN, is dated and signed by the seller, and the memorandum noting who, when and where the affidavit was signed has not been deleted.[18]

However, the waiver is disallowed if the purchaser has "actual knowledge" the affidavit is false or received a notice from an agent, of the buyer or seller, stating the affidavit is false.[19] The waiver is also disallowed if regulations require the purchaser to submit a copy of the affidavit to the IRS and the purchaser fails to do so.[20] For now, the IRS does not need to receive a copy of the affidavit,[21] but practitioners should watch for future regulation requiring purchasers to do otherwise. For guidance concerning the agents of buyers or seller and non-foreign affidavits, IRC §1445(d) is explicitly referenced and will apply in the same manner as rules for U.S. real property interests.[22]

The IRS issued interim guidance to the Section 1446(f) withholding requirement through Notice 2018-29. The Notice applies many of the rules from IRC §1445 withholding for IRC §1446(f). Primarily, until further guidance, the IRS directs taxpayers to apply the rules, regulations and forms governing IRC §1445. When withholding following the sale of a nonresident's partnership interest, the purchaser must file both a Form 8288 U.S. *Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests* and Form 8288-A *Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests.* It is important to include the statement "Section 1446(f)(1) withholding" at the top of both Form 8288 and Form 8288-A to distinguish the forms from U.S. real property interest withholding.[23] Prospectively, the IRS stated its intention to modify forms, instructions and publications to more appropriately address §864(c)(8) reporting and §1446(f) withholding requirements.[24]

After requests for comments, the IRS established relief provisions waiving the withholding requirement for purchasers without non-foreign affidavits in certain circumstances. For instance, there is no withholding requirement if the seller provides certification to the buyer declaring for the three prior taxable years that the seller's allocable share of the partnership's effectively connected taxable income (ECTI) was less than 25% of the partner's total distributive share of income that year.[25] Withholding is also unnecessary if the buyer received certification from the partnership stating the net ECI gain recognized after applying IRC §864(c)(8) rules is less than 25% of the total gain on the sale.[26]

The IRS established relief provisions waiving the withholding requirement for purchasers without non-foreign affidavits in certain circumstances.

Be aware that Proposed Regulation §1.1446(f)-2 lowered the 25% threshold for a partner's share of ECTI and net ECI gain to 10% and also requires a nonresident partner's share of ECTI is less than one million dollars. Furthermore, proposed regulations introduce a "determination date" with which withholding exclusions using ECTI and net ECI gain are determined. The determination date may be the date of the transfer, any date 60 days prior to the transfer or, for non-controlling partners, the latter of the first day of the partnership's tax year or the most recent valuation of partnership assets.[27]

Other exceptions or reductions to withholding present in proposed regulations include if no realized gain occurs in a deemed sale as of the determination date, when non-recognition provisions apply, or if a tax treaty with the nonresident partner's home country reduces or eliminates withholding.[28]

Partner D will not be obligated to withhold if she received a certificate from Partner C declaring for the last three years her proportionate ECI was $20 and her proportionate share of overall partnership income was $100. The 20% ($20 share of ECI divided by $100 overall partnership income) ECTI is below the 25% threshold and Partner C's sale of partnership interest meets the relief provision in Notice 2018-29.

Also, in the first example, if the ECI attributable to IRC §864(c)(8) is only $10, instead of $20, then Partner D is exempt from withholding if the partnership provides a certificate stating the ECI from IRC §864(c)(8) is only 20% ($10 ECI from deemed sale of assets divided by $50 gain on sale of partnership interest) of the total gain on the sale. Partner D must receive either certificate within 30 days before the sale of Partner C's interest.

There is also a provision for the IRS to reduce the withholding amount from 10% if the reduced amount will not threaten the collectability of the tax arising from the ECI gain.[29] To claim this withholding relief, the buyer or seller must file a form similar to 8288-B *Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests.* Currently, Proposed Regulation §1446(f)-2 indicates the IRS will allow a reduction in the amount realized using Form W-8IMY, likely in the event a foreign partnership with U.S. partners sells interest in a U.S. partnership. Because U.S. residents are not subject to ECI, being taxed on worldwide income, establishing how much of the gain would be allocated to U.S. resident partners instead of nonresident partners provides relief from over-withholding.

In the sale of a partnership interest, the purchasing partner assumes the selling partner's share of partnership liabilities. Doing so is an effective additional payment to the selling partner increasing the amount realized on the sale of partnership interest beyond any cash or property transferred. Since the amount realized on the sale determines the withholding amount, the liabilities assumed by the purchasing partner can inflate the withholding amount.

Consequently, the total amount of withholding could exceed the cash or property consideration. To address this issue, the IRS will limit withholding to the amount realized reduced by the share of the partnership's liabilities assumed by the purchaser if the amount of the liabilities is known. If unknown, the maximum amount of withholding is still the amount of cash and property realized. This provision is disallowed if the purchaser is either a partner in the relevant partnership or is a related person to the seller. To apply this provision, the purchaser must check the box on line 5c of Part I of Form 8288.

Unless the transaction qualifies for any of the relief provisions previously described, buyers should plan to

report the total amount realized as subject to withholding. This number is reported on line 5b of Form 8288 and line 3 of Form 8288-A. Purchasers should also withhold 10% of the amount realized, up to the amount paid, and disclose this number on line 6 of Part I on Form 8288 and line 2 on Form 8288-A.

Summary

Although professionals have relied on guidance provided by Revenue Ruling 91-32, statutory changes from the Tax Cuts and Jobs Act justify reassessing existing ECI calculation processes when selling a nonresident's partnership interest for proper compliance with IRC §864(c)(8). Furthermore, purchasers of a nonresident's partnership interest should understand the conditions under which withholding is required and the process through which to satisfy the withholding requirements.

Both parties, and their respective agents, should remain watchful for further IRS guidance regarding partnership withholding for the purchasing partner. In addition, buyers should be prepared to utilize forms and procedures for withholding certificates, reducing the withholding requirement when available.

For now, Notice 2018-29 is the chief resource for interim guidance. The proposed regulations made slight changes to Notice 2018-29 and should be a reliable indication of the final regulations for §864(c)(8) and §1446(f).

About the Author:

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[1]See IRC §741
[2]See IRC §751
[3]Grecian Magnesite Mining v. Commissioner, 149 TC, No. 3, 3, July 13, 2017
[4]Rev. Rul. 91-32
[5]See IRC §864(c)(8)(B)
[6]See IRC §864(c)(8)(A)
[7]See IRC §864(c)(8)(C)
[8]Proposed Treasury Regulation §1.864(c)(8)-1(h)
[9]Proposed Treasury Regulation §1.864(c)(8)-2
[10]See IRC §1446(f)(1)
[11]Proposed Treasury Regulation §1.1446(f)-2(d)
[12]See IRC §1446(f)(4)
[13]IRS Notice 2018-29 Section 11.00
[14]Proposed Treasury Regulation §1.1446(f)-3
[15]IRS Notice 2018-08 Section 1.00
[16]Proposed Treasury Regulation §1.1446(f)-4
[17]See IRC §1446(f)(2)(A)
[18]IRS Notice 2018-29 Section 6.01
[19]See IRC §1446(f)(2)(B)(i)
[20]See IRC §1446(f)(2)(B)(ii)
[21]IRS Notice 2018-29 Section 6.01
[22]See IRC §1446(f)(2)(C)
[23]IRS Notice 2018-29 Section 5.0
[24]84 FR 21198
[25]IRS Notice 2018-29 Section 6.03
[26]IRS Notice 2018-29 Section 6.03
[27]Proposed Treasury Regulation §1.1446(f)-1(c)(4)
[28]Proposed Treasury Regulation §1.1446(f)-2
[29]See IRC §1446(f)(3)
[30]IRS Notice 2018-29 Section 8.0

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Today's CPA offers the self-study exam for readers to earn one hour of continuing professional education credit. The questions are based on technical information from the preceding article. If you score 70 or better, you will receive a certificate verifying you have earned one hour of CPE credit – granted as of the date the test arrived in the TXCPA office – in accordance with the rules of the Texas State Board of Public Accountancy (TSBPA). If you score below 70, you will receive a letter with your grade.

1. When does §864(c)(8) apply?
A. When a U.S. partner sells interest in a foreign partnership
B. When a U.S. shareholder redeems shares in a foreign corporation
C. When a foreign partner sells interest in a U.S. partnership
D. When a foreign shareholder redeems shares in a U.S. corporation

2. How is ECI calculated in §864(c)(8)?
A. Deemed sale of all partnership assets
B. Deemed sale of partnership domestic assets
C. Apportioning realized gain on sale to domestic assets
D. When the partnership liquidates upon dissolution

3. Which of the following is possible after applying §864(c)(8)?
A. Overall realized gain and net ECI gain
B. Overall realized gain and net ECI loss
C. Overall realized loss and net ECI gain
D. All of the above

4. Why is §864(c)(8) ECI gain offset by gains and losses attributable to U.S. real property interest?
A. U.S. real property interest is not subject to ECI
B. To avoid double taxation or benefit with §897
C. To increase residual non-ECI gain
D. To coordinate with the U.S. Model Tax Treaty

5. Under §1446(f), how much is the purchaser required to withhold?
A. 15% of the net gain
B. 10% of the net gain
C. 15% of the amount realized
D. 10% of the amount realized

6. Should the purchaser fail to withhold, who will statutorily be responsible to withhold?
A. The purchaser remains liable for withholding until tax is paid
B. The partnership must withhold future distributions to purchaser
C. The seller must pay estimated payments in lieu of withholding
D. No parties are compelled to withhold

7. Among the proposed regulations is guidance for partnerships to withhold distributions to buyers if the partnership has not received certification assuring the buyer satisfied withholding requirements. Withholding is also suspended for ___________ until regulations are issued.
A. General partnerships
B. Publicly traded partnerships (PTPs)
C. Limited partnerships
D. Limited liability partnerships

8. Which of the following is not an exception to withholding (disregarding proposed regulations)?
A. Non-foreign affidavit provided to purchasing partner
B. Selling partner's ECTI for last three years was less than 25 percent of distributive share of partnership income
C. Net ECI from §864(c)(8) is less than 25 percent of the total gain on the sale
D. Selling partner is a foreign partnership with U.S. partners

9. To determine withholding obligations, proposed regulations include a "determination date" that may be:
A. The date of the transfer
B. Any date 60 days prior to the transfer
C. The latter of the first day of the partnership's tax year or the most recent valuation of partnership assets
D. All of the above

10. Partnership liabilities assumed by the purchasing partner have what potential effect on withholding?
A. Reduce the amount realized and total withholding
B. Increase the amount realized and total withholding
C. Increase the amount realized and reduce total withholding
D. Reduce the amount realized and increase total withholding

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