# Proposed Regulations on Foreign Partner's Interest Sale — What Sponsors Should Know About Withholding

**May 15, 2019**

The Tax Cuts and Jobs Act imposes a tax on a foreign seller on gain from the sale of a partnership interest to the extent such gain does not exceed the foreign seller's share of the partnership's built-in ECI gain ("ECI Gain"). Moreover, under Section 1446(f), a purchaser of a partnership interest must withhold 10% of the amount realized by a foreign seller unless an exception applies.

Debevoise & Plimpton

Treasury has provided additional guidance (the "Proposed Regulations") governing when such withholding is required and how it is applied. The Proposed Regulations follow in many respects prior IRS guidance provided in IRS Notice 2018-29 (the "Notice"). The Proposed Regulations will apply to transfers that occur 60 days after final regulations are published, although taxpayers are generally permitted to rely on them before finalization.

In light of the importance of these issues, we highlight some key changes and takeaways for private equity funds below.

## PROPOSED REGULATIONS

### Partnership Responsible for Withholding

- If a transferee fails to withhold and none of the exceptions detailed below is met, the partnership will be required to withhold the amount that should have been withheld (plus interest) from future distributions to the transferee. To determine if it must withhold, the partnership may rely on a certification received from the transferee unless the partnership has reason to know it is incorrect or unreliable.

- Note that the obligation to withhold from distributions applies even with respect to tax distributions.

- This obligation was previously suspended by the Notice. The Proposed Regulations reinstate the obligation of the partnership to withhold in the event the transferee does not.

**Comment**: We expect partnerships will increase their diligence efforts with respect to transfer requests to ensure that the transferee provides a certificate to establish an exception or withholds. Partnerships with blocked structures or structures with *de minimis* effectively connected income ("ECI") may also have an increased incentive to provide the partnership certificate based on a "deemed sale" discussed below. The Preamble to the Proposed Regulations clarifies that the IRS expects a partnership to review certifications provided by the transferee to determine if it has reason to know they are incorrect. While it is unclear on which standard of review the market will settle, the IRS notes that a partnership may, for example, have reason to know a certificate is incorrect because of exclusive information the partnership has in its books and records.

### Withholding Exceptions Based on Transferor or Partnership Certifications

The Proposed Regulations generally retain the withholding exceptions in the prior Notice (though narrowing some) and add a few new helpful categories.

### Modified Exception Based on Transferor's ECI Share

- A transferor may provide a certificate stating that (i) the transferor has held its interest for three (3) full years, (ii) the transferor's allocable share of ECI in each of those years is less than 10% of its total share of net partnership income, (iii) the transferor's allocable share of ECI in each of those years was less than $1,000,000 and (iv) the transferor's share of income or loss was reported on its tax return and all U.S. taxes were paid. The Notice was more generous by allowing 25% and did not impose the $1 million limit.

**Comment**: Note that a transferee cannot provide this certificate if the partnership does not issue K-1s (K-1 equivalents are not sufficient), issues K-1s reflecting no net income or does not issue Form 8805s (i.e., the partnership does not have any ECI income or loss).

### Modified Exception Based on Partnership's Deemed Sale

- The partnership may provide a certificate that if the partnership sold all of its assets on the determination date, the ECI from this deemed sale would be less than 10% (the Notice was more generous at 25%) of the partnership's total net gain from such sale. The determination date is generally the transfer date or any day within the 60-day period prior to the transfer date and, for certain transferors, the beginning of the taxable year.

**Comment**: We expect transferors and transferees to request a partnership certificate for funds where there is no ECI (i.e., a parallel fund structure designed for non-U.S. investors that uses blockers on ECI deals). In a case where there is no ECI, the transferor is not permitted to provide a certificate based on the prior three-year K-1

history. Where a fund has ECI investments, it may be difficult for it to provide this certificate unless it is confident about the valuations and built-in gain. In this case, it would be preferable for a transferor to provide the certificate based on the prior three-year K-1 history to the extent available.

### New Exception Based on Treaty Claim

- A transferor may now provide a certificate that it is not subject to tax on any gain upon transfer of the partnership interest because of applicable tax treaty benefits that require a permanent establishment in the United States before business profits may be taxed. Transferor must include a valid tax form supporting the treaty claim.

**Comment:** The IRS's position is that a U.S. office of the partnership satisfies the permanent establishment requirement under tax treaties. This exception will be useful for debt funds engaged in loan origination activities that do not have an office in the United States. Transferees in other funds with ECI should be wary of accepting this certificate. In contrast to the other exceptions, the transferee must mail a copy of the certification to the IRS within 30 days after the date of transfer.

### Max Tax Exception

- Under a new provision, a transferor may provide a certificate as to the maximum tax liability it would have to pay on its ECI Gain as of the determination date. The transferee may withhold this amount if the conditions for this certification are met.

**Comment:** This procedure requires the partnership to issue a statement to the transferor certifying the transferor's ECI Gain as of the determination date. While a partnership is required to provide non-U.S. transferors their ECI Gain as part of the K-1 information the partnership sends, the GP may not have finalized this information prior to transfer.

### Other Exceptions

- A transferor may provide a certificate that it is a U.S. person (existing W-9 on file is acceptable).

- A transferor may provide a certification that no gain will be realized by the transferor.

- A transferor may provide a certificate that nonrecognition rules apply to the transfer and thus the transferor will not realize gain on the transfer.

**Comment**: The Proposed Regulations added a helpful look-through rule for a foreign partnership transferor with direct or indirect U.S. partners. In this case, the transferor may provide a W-8IMY, attaching W-9 forms of its U.S. partners and a withholding

statement that provides the percentage of gain that is allocable to the U.S. partners. A transferee in this case may avoid withholding on the portion of the proceeds allocable to the U.S. partners. However, the look-through rule does not apply to allow indirect foreign partners to avoid withholding based on an exemption that would have been available to them (e.g., treaty exception, nonrecognition exception, no-gain exception).

### Determining Debt to Include in Amount Realized

- 1446(f) withholding is based on 10% of the amount realized, which includes the partner's share of partnership liabilities. The Proposed Regulations allow a transferee to rely on a certification from the transferor detailing the amount of the transferor's share of partnership liabilities as shown on its most recent K-1 (which may cover a tax year ending up to 22 months prior to transfer). As an alternative, a transferee may rely on certification from the partnership detailing the amount of the transferor's share of partnership liabilities on the determination date.

**Comment**: Prior IRS guidance only allowed using a K-1 if the transfer occurred within 10 months of the taxable year to which such K-1 applied. The IRS recognized that this was not workable and has therefore increased the time limit to 22 months.

* * *

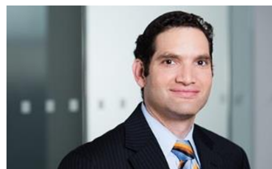
Please do not hesitate to contact us with any questions.

NEW YORK

Michael Bolotin
mbolotin@debevoise.com

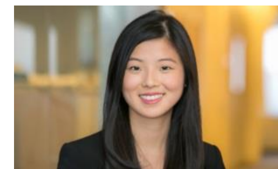
Peter A. Furci
pafurci@debevoise.com

Rafael Kariyev
rkariyev@debevoise.com



Yehuda Y. Halpert
yyhalpert@debevoise.com

Molly B. Klinghoffer
mbklinghoffer@debevoise.com



T. Tina Xu
ttxu@debevoise.com