Final Partnership Withholding Regulations Map New Terrain for Private Equity Investors and Sponsors

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The Treasury and the IRS have released final regulations under Section 1446(f) (the "Final Regulations") providing guidance on the rules governing withholding on transfers of partnership interests. The 2017 Tax Cuts and Jobs Act imposes US federal income tax on a non-US seller on the gain from the sale of an interest in a partnership engaged in a US trade or business to the extent such gain does not exceed the non-US seller's share of the partnership's built-in ECI gain ("ECI Gain"). Under Section 1446(f), a purchaser of a partnership interest must withhold 10% of the amount realized by a non-US seller unless an exception applies.

The Final Regulations generally retain the same structure and general rules as the proposed regulations issued in 2019 (the "Proposed Regulations"), including many of the important exceptions to withholding such as the Non-Foreign Status Exception, Nonrecognition Exception and No Gain Exception (all described below). However, the Final Regulations modify some of the rules in a way that should allow more taxpayers to qualify for withholding exemptions or reductions, though non-US sellers may still face challenges establishing eligibility for such exemptions or reductions.

In general, the Final Regulations apply to transfers that occur on or after sixty days after the Final Regulations are published in the Federal Register, *i.e.*, from mid-December. However, a partnership's secondary withholding obligations apply to transfers that occur on or after January 1, 2022.

We summarize certain withholding rules below with a focus on key changes and takeaways for sponsors of private equity funds and participants in the increasingly active secondaries market.

The Transferee's and the Partnership's Responsibility for Withholding

Liability for Failure to Withhold

- The Final Regulations retain the presumption that a transferee is required to withhold 10% of the amount realized by the transferor, including the transferor's share of partnership liabilities, unless the transferee obtains a certification from the transferor or the partnership that establishes an exemption or reduction to withholding.

Comment: The presumption means that the Section 1446(f) withholding rules implicate transfers with no direct connection to the United States (*e.g.*, transfers by non-US parties of non-US partnerships that do not invest in the United States). However, the Final Regulations also provide that neither a transferee nor a partnership will be liable for failing to withhold if it can be established to the satisfaction of the IRS that the transferor had no ECI Gain on the transfer. Failure to withhold thus does not mean per se liability but only creates a presumption that can be rebutted, though given the practical difficulties that may arise in establishing that a transferor had no ECI Gain, transferees should still consider establishing a basis for an exemption rather than relying on persuading the IRS.

- Consistent with the Proposed Regulations, the Final Regulations provide that if a transferee fails to withhold on a transfer on or after January 1, 2022, the partnership will be required to withhold the amount that should have been withheld (plus interest) from future distributions (including tax distributions) to the transferee.

Comment: After this rule becomes effective in 2022, we expect partnerships will increase their diligence efforts to ensure that the transferee either provides a certificate to establish an exception or withholds on the transfer. Partnerships with blocked structures or structures with *de minimis* effectively connected income ("ECI") may be more willing to provide the certificate based on the Partnership Deemed Sale Exception (discussed below) or otherwise cooperate with the transferor to avoid a later partnership withholding obligation.

Reliance on Certifications

- The Final Regulations require that the transferee provide the partnership a certification stating whether it has complied with its withholding obligation, including any certification the transferee is relying on for a reduction or exemption from withholding, as well as proof of any required withholding.

- A transferee may rely on the certifications it receives from a transferor or the partnership in order not to withhold unless it has actual knowledge that the certification is incorrect or unreliable. The partnership may rely on a certification received from the transferee unless the partnership knows or has reason to know it is incorrect or unreliable.

- A transferee will still be subject to partnership withholding if the partnership has actual knowledge, or has reason to know (*e.g.*, it has information in its books and records inconsistent with the certification), that the certification is incorrect or unreliable—even where the transferee had no reason to know of such invalidity.

Comment: In this environment, transferees may want to seek assurances from the partnership that they will not be subject to withholding by either preclearing any transferor certificates with the partnership or obtaining partnership certificates instead.

Withholding Exceptions Based on Transferor or Partnership Certifications

The Final Regulations generally retain the withholding exceptions in the Proposed Regulations with some modifications. In order to benefit from an exception from withholding, one of the seven certificates noted below will need to be provided by either the transferor or the partnership.

Comment: While the Final Regulations stop short of requiring a partnership to provide a requesting transferor a certificate to avoid withholding, if applicable, sponsors will likely need to be involved in the process nonetheless. For example, although the Final Regulations have expanded the ability for transferors to provide a less than 10% ECI certificate (as discussed below), this certificate may not be available in many circumstances, in which case the only way to avoid withholding may be via a partnership certificate.

(1) Non-Foreign Status Exception

- A transferor may provide a certificate that it is a US person (a Form W-9 is acceptable, and partnerships may use a Form W-9 on file to establish exemption from backup withholding).

(2) Transferor's ECI Share

- A transferor may provide a certificate stating that (i) the transferor has held its interest for the three (3) full prior tax years, (ii) the transferor's allocable share of gross ECI in each of those years is less than 10% of its total share of gross partnership income, (iii) the transferor's and its related partners' allocable share of gross ECI in

each of those years was less than $1,000,000 in the aggregate, and (iv) the transferor's share of ECI was timely reported on its tax return, and all US taxes with respect to such ECI were paid. A transferor cannot provide such a certification unless it has received a Schedule K-1 (or other required statement) reflecting distributable gross income for each of the prior three years.

- The Proposed Regulations required that the transferor have ECI gain and receive a Form 8805, or ECI loss, in each of the three (3) prior years in order to qualify for this exception, effectively making this exception unavailable for partners of partnerships with no ECI. Helpfully, the Final Regulations no longer require a Form 8805 or ECI loss in such years but still maintain that the transferor must have been a partner and received a Schedule K-1 (or other required statement) reflecting distributable gross income for each of the prior three years.

Comment: While the broadening of this exception to partnerships without ECI is helpful, the requirement that the transferor must have received Schedule K-1s (or other required statements) with allocations of gross income for each of the three most recent prior tax years will continue to limit the use of this exception. Many non-US partnerships without ECI do not provide Schedule K-1s to their non-US partners. In addition, this exception does not apply to a transferor of a partnership that does not have gross income in any of the three years (not an uncommon fact pattern for private equity funds that invest in corporations and do not have ECI).

(3) Partnership Deemed Sale Exception

- The partnership may provide a certificate that if the partnership sold all of its assets on the determination date, either the partnership's net gain that would be ECI or the transferor's allocable share of the partnership's net gain that would be ECI would be less than 10% of partnership total net gain or the partner's allocable share of total net gain from such sale, as applicable. 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: The Proposed Regulations applied this test on all partnership income without reference to the transferor's allocable share of partnership income. The addition of an exception focused on the net ECI Gain allocated to the transferor should allow partnerships that either excuse partners or utilize "below-the-fund" blocker structures for ECI investments to be able to provide this certification to excused or blocked partners.

(4) New No US Trade or Business Exception

- The partnership may now provide a certificate that it was not engaged in a US trade or business during the year through the date of the transfer.

Comment: This new exception should be helpful for certain real estate, infrastructure and energy funds that make investments via REITs or blocker structures that are treated as US real property holding companies. While these types of investments generally generate ECI under the Partnership Deemed Sale Exception, they do not cause the funds to be engaged in a US trade or business. However, note that FIRPTA withholding may still apply to transfers of such funds.

(5) Treaty Claim Exception

- Consistent with the Proposed Regulations, the Final Regulations allow a transferor to 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. A transferor must include a valid tax form supporting the treaty claim.

Comment: This exception was unchanged from the Proposed Regulations. Utilizing this exception will require particular attention to the activities of the underlying partnership since the IRS's position is that a US office of the partnership satisfies the permanent establishment requirement under tax treaties. 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.

(6) No Gain Exception

- A transferor may provide a certification that no gain will be realized by the transferor. The Final Regulations require that in order for the transferor to provide this certification the partnership would also need to provide the transferor a certification that certain types of ordinary income (*i.e.*, "hot assets" attributable to a US business) would not be recognized in connection with the transfer.

(7) Nonrecognition Exception

- A transferor may provide a certificate that nonrecognition rules fully apply to the transfer. There is also a partial nonrecognition exception.

Determining the Amount to Withhold

- Section 1446(f) withholding is based on 10% of the amount realized by the transferor, which generally includes the consideration paid by the transferee and the transferor's share of partnership liabilities.

- The Final Regulations retain a helpful look-through rule for a foreign partnership transferor with direct or indirect US partners and expanded such rule to apply to direct or indirect non-US partners that qualify for the Treaty Claim Exception.

- The Final Regulations retain that a transferee may rely on a certification from the transferor as to its share of partnership liabilities as shown on its most recent Schedule K-1 (which may cover a tax year ending up to 22 months prior to transfer). As an alternative, a transferee may rely on a certification from the partnership detailing the amount of the transferor's share of partnership liabilities on the determination date.

- The Final Regulations retain that withholding cannot exceed the amount realized determined without taking into account the transferor's share of partnership liabilities (generally, the consideration paid by the transferee).

Max Tax Exception

- Consistent with the Proposed Regulations, the Final Regulations allow a transferor to provide a certificate as to the maximum tax liability it would have to pay on its transfer as of the determination date. The transferee may withhold this amount if the conditions for this certification are met.

Comment: The transferor will need to obtain a statement from the partnership certifying the transferor's share of ECI Gain as of the determination date in order to be able to provide this certificate. While a partnership is required to provide non-US transferors their ECI Gain as part of the Schedule K-1 information the partnership sends, the partnership may not have finalized this information prior to transfer.

Applicable Transfers

Application to Subsequent Closings

- Many commentators asked the IRS to exclude "disguised sales" of partnership interests from the scope of Section 1446(f) withholding, noting that there are no regulations on partnership interest disguised sales and the breadth of regulations on the analogous disguised sale to or from a partnership may leave primary investors in a partnership guessing whether a subsequent distribution by the partnership may result in a retroactive disguised sale. The IRS unfortunately rejected these arguments and instead clarified in the Final Regulations that the rules apply to disguised sales of partnership interests. Therefore these rules may apply to a typical private equity subsequent closing arrangement where proceeds from new partners are paid to existing partners, as these arrangements are often viewed as a sale from the existing partners to the new partners.

Comment: While the Final Regulations clearly impact the secondary market in private equity fund interests, the application of these rules to subsequent closings will also impact sponsors' fundraising activities. Non-US investors may request assurance that they will not face withholding if diluted in a subsequent closing, and all partners investing in a subsequent closing may request assurances that they do not need to withhold. Sponsors, especially those with funds that make unblocked ECI investments, should consider strategies, such as the use of feeder structures or "dry" closings, to address Section 1446(f) withholding risk on subsequent closings.

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