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Buyer Beware: Withholding When Purchasing Partnership Interests from Non-U.S. Persons

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Non-U.S. persons investing in private equity funds and other partnerships that are engaged in trade or business (ETB) in the United States are subject to U.S. federal income tax on their share of the partnership's effectively connected income (ECI).[1] To ensure tax is paid, partnerships are required to withhold tax on the non-U.S. investor's share of ECI.[2] The 2017 Tax Cuts and Jobs Act (TCJA)[3] expanded upon that concept by providing that a non-U.S. person's sale of an interest in a partnership that generates ECI will also be subject to tax.[4] To ensure tax is paid, the buyer and possibly the partnership itself are required to withhold tax.[5] The IRS has issued guidance to implement these provisions, which illustrate the complexity for sellers, buyers, withholding agents, and partnerships in ensuring they are met. Failure to comply can expose all parties to liability, which necessitates understanding actions needed to be taken.[6]

BACKGROUND

The TCJA change requiring tax to be imposed on a partnership sale only applies to sales or exchanges made on or after November 27, 2017,[7] while the related withholding obligation only applies to sales made on and after December 31, 2017.[8] As a result, the law in effect prior to the 2017 Act still has an impact on sales made before November 27, 2017, and

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[1] §864(b), §864(c), §871(b), §882(a). All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[2] §1446. The withholding tax rate for ECI allocable to noncorporate foreign partners is 37%, and 21% for corporate foreign partners.

[3] Pub. L. No. 115-97, §13501(a)(1) (adopting §864(c)(8)).

[4] §864(c)(8). The Foreign Investment in Real Property Tax Act, Pub. L. No. 96-499 (FIRPTA) also imposes tax on a sale of an interest in a partnership whose predominant asset is real estate, and FIRPTA has been in effect since 1980. §897(g); Reg. §1.897-7T(a); Notice 88-72. To prevent possible double taxation of gain under FIRPTA and the new law, §864(c)(8)(C) contains a FIRPTA coordination rule that prevents double taxation by reducing the amount of gain that is treated as ECI under the new law by the amount of gain that is treated as ECI under FIRPTA.

[5] §1446(f). Withholding also applies to gain taxed under FIRPTA, but only in the case of a sale of an interest in a partnership if both 50% or more of the value of the partnership's gross assets consists of USRPIs and 90% or more of the value of its gross assets consists of USRPIs plus any cash or cash equivalents. Reg. §1.897-7T(a), §1.1445-11T

[6] Prop. Reg. §1.1446(f)-5(a), REG-105476-18, 84 Fed. Reg. 35,581 (July 24, 2019).

[7] Notice 2018-08, §2; Prop. Reg. §1.864(c)(8)-1(j), REG-113604-18, 84 Fed. Reg. 21,198 (May 13, 2019).

[8] Notice 2018-08, §2.

there is a gap period[9] in which tax is due under the new law, but no withholding is required.

In Rev. Rul. 91-32, the IRS addressed the issue of whether a foreign investor's gain from the sale of an interest in a partnership that had generated ECI should be governed by the aggregate or entity theory of partnership taxation. The IRS adopted the aggregate theory and imposed tax by treating the foreign investor as if they sold their allocable share of the partnership assets. As a result, all or a portion of the gain realized by a foreign investor on the sale could be treated as ECI subject to U.S. taxation.

Despite the IRS's position, §741 requires use of the "entity" theory in taxation relating to investments in partnerships *unless* an exception to the general rule applies.[10] Since there is no exception contained in the I.R.C. prior to the TCJA, many advisors[11] believed the entity theory applied to the sale of a partnership interest and advised taxpayers that no tax was due. In 2017, the Tax Court was confronted with one such situation, which involved the sale of an interest in a partnership that held both U.S. real estate as well as other U.S. assets that generated ECI. The taxpayer conceded that four million of their six million gain on sale was attributable to U.S. real estate, but the IRS relied on its 1991 Notice to assert the full six million was ECI. The Tax Court held the IRS was incorrect and applied the "entity" theory to limit taxation to only the four million FIRPTA gain.[12] As a result, the foreign investor was not subject to U.S. tax *except* to the extent U.S. real estate was owned by the partnership, which implicated FIRPTA tax and withholding.[13]

This taxpayer victory was short-lived since the TCJA changed the I.R.C. to mandate use of an aggregate theory requiring tax to be imposed and requiring buyers to withhold the tax to ensure the tax is collected.[14] The IRS appealed *Grecian Magnesite*. On June 11, 2019, the Tax Court's opinion was affirmed by the U.S. Court of Appeals for the District of Columbia,[15] which is helpful for taxpayers that sold their partnership interest prior to the effective date of the new law (November 27, 2017) and may be disputing with the IRS whether tax is due.

DETERMINING THE TAX DUE ON SALE

On the sale of a partnership interest, the amount realized (AR) on the sale of the partnership interest must first be determined in order to compute the gain or loss. For a sale of a partnership interest, the AR is equal to the sum of the price paid by the buyer *plus* the partner's share of partnership liabilities. Inclusion of liabilities complicates the determination of taxable gain or loss, and can, in some cases, leave the selling partner with insufficient cash to pay the resulting tax. For example, if a partner receives $100 cash for a sale of its partnership interest and that partner's share of partnership liabilities is $900, the AR is $1,000. If the seller's tax basis is $400, the taxable gain is $600 and for an individual, the 20% long term capital gains tax would be $120, which is $20 more than the cash paid by the buyer. We will return to other issues resulting from liability inclusions later when we focus on the withholding burden faced by a buyer.

If a partnership only holds assets that produce ECI, *all* the gain or loss on a sale of that partnership interest would generate ECI and be taxable. However, in some cases, a partnership holds assets that produce ECI (i.e., business assets) and assets that do not produce ECI (i.e., investment assets such as stock and debt instruments). In that case, only *part* of the gain is attributable to the ECI producing assets and subject to tax. The percentage of the gain or loss on sale of that partnership interest treated as ECI is based on how much of the gain from a deemed sale of all partnership assets for their FMV would be attributable to gain from assets whose sale would generate ECI.[16]

On December 20, 2018, the IRS released proposed regulations determining how to determine the taxable gain or loss, what exemptions may apply and other related matters.[17] The proposed regulations apply ECI treatment to *any* transfer of a partnership interest,[18] which includes a sale of a partnership interest to a third party, another partner, or the partnership itself (e.g., a redemption). In addition, a distribution of cash by a partnership to a partner in excess of the partner's basis is also subject to tax since such cash distribution is treated as deemed gain from a sale of a partnership interest.[19]

The proposed regulations provide that §864(c) does not override otherwise applicable nonrecognition pro-

[9] For sales made on or after November 27, 2017, and before January 1, 2018.

[10] FIRPTA may override the entity theory, but only where U.S. real estate is involved.

[11] Including the authors.

[12] *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner*, 149 T.C. 63 (2017), *aff'd*, 926 F.3d 819 (D.C. Cir. 2019).

[13] §897, §1445.

[14] §864, §1446(f).

[15] *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner*, 926 F.3d 819 (D.C. Cir. 2019).

[16] §864(c)(8).

[17] Prop. Reg. §1.864(c)(8)-1.

[18] Prop. Reg. §1.864(c)(8)-1(b)(1).

[19] §731(a). Prop. Reg. §1.1446(f)-3 details the procedures by which the partnership must withhold on distributions to a partner.

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visions.[20] As a result, a contribution of a partnership interest to another partnership or a distribution of a partnership interest from a partnership to its partners can escape taxation under these new rules.[21] The Preamble, however, requests comments on whether other I.R.C. provisions adequately address transactions that rely on §731 partnership distributions to reduce the scope of assets subject to U.S. federal income taxation and notes that Treasury and IRS may propose rules addressing these types of transactions.[22] While a gift of property normally does not generate taxable gain, a gift of an interest in a partnership that has debt can be treated as a part gift and part sale, which implicates this new tax.[23]

To calculate the ECI, the proposed regulations first require a foreign investor to determine their overall gain or loss on a sale of a partnership interest. Normally, a sale of a partnership interest generates capital gain or loss. However, if a partnership holds ''hot assets'' whose sale would generate ordinary income (such as inventory or long term sales or service agreements),[24] then the portion of the gain on a sale of the partnership interest attributable to hot assets is taxed as ordinary income and only the balance of the gain is taxed as capital gain. If the partnership holds hot assets, the proposed regulations require the investor to first bifurcate its gain into an ordinary income and a separate capital gain component before moving to the next step.[25]

Next, the proposed regulations specify a three-step process to derive the limitation in §864(c)(8)(B) against which the outside gain or loss is compared:

1. For each asset of the partnership, determine the amount of gain or loss that the partnership would recognize in connection with a deemed sale for FMV (determined immediately before the partner's sale) to an unrelated party in a fully taxable transaction for cash;

2. Determine the amount of that gain or loss that would be treated as effectively connected gain or loss (''deemed sale ECI gain or loss''); and

3. Determine the foreign transferor's distributive share of the ordinary and capital components of any deemed sale ECI gain and deemed sale ECI loss.[26]

The I.R.C. and the proposed regulations do not address the source of gain or loss from the transfer of a partnership interest. Nonetheless, the proposed regulations provide that gain or loss recognized on the transfer may be treated as ECI even if it is from sources without the U.S. Treasury and the IRS have requested comments as to whether, and what, additional guidance is necessary regarding the source of gain or loss subject to tax.[27]

The proposed regulations state that, when a partnership holds U.S. real property interests (USRPIs) and is also subject to §864(c)(8) because it is engaged in the conduct of a trade or business within the U.S. without regard to §897, the amount of the foreign transferor's effectively connected gain or loss will be determined under §864(c)(8) and not under §897(g).[28] Thus, these new rules override FIRPTA.

Tax treaties can exempt from U.S. tax gain from the sale of property *unless* the gain is attributable to a U.S. permanent establishment (e.g., a U.S. office).[29] The proposed regulations adopt the approach that a treaty can apply but a partnership's U.S. permanent establishment (PE) is attributable to its partners for purposes of applying tax on a sale of a partnership interest. As a result, treaty relief may be difficult to achieve since transfer of an interest in a partnership that has a PE will be treated in the same manner as a sale of property forming part of a PE or a sale of the PE itself.[30]

An anti-stuffing rule would prevent inappropriate reductions in amounts characterized as effectively connected gain when a foreign partner (or related person) transfers property to a partnership with a principal purpose of reducing the amount of gain treated as effectively connected gain (or increasing the amount of loss treated as effectively connected loss) under §864(c)(8) or §897.[31]

TRANSFEREE REPORTING

The proposed regulations require non-U.S. persons and certain domestic partnerships with non-U.S. direct or indirect partners that transfer an interest in a

[20] Prop. Reg. §1.864(c)(8)-1(b)(2)(ii).

[21] §721, §731.

[22] RIN 1545-BO86, Explanation of Provisions, §I(A)(2). For example, if a partnership that is ETB owns property not subject to tax under §871(b) or §882(a) in the hands of a foreign partner, the partnership may distribute that property to the foreign partner rather than a U.S. partner.

[23] *See* Reg. §1.1001-1(e)(1).

[24] §751.

[25] Prop. Reg. §1.864(c)(8)-1(b)(2).

[26] Prop. Reg. §1.864(c)(8)-1(c).

[27] RIN 1545-BO86, Explanation of Provisions, §I(C).

[28] Prop. Reg. §1.864(c)(8)-1(d).

[29] *E.g.,* U.S.-UK Tax Treaty, Art. 13(1), 13(3).

[30] Prop. Reg. §1.864(c)(8)-1(f). A partnership that regularly lends money in the U.S. may take the position that the income is ECI, but the partnership has no PE. In that case, a partner may be able to claim an exemption from tax under an applicable treaty because no PE is attributed to the partner.

[31] Prop. Reg. §1.864(c)(8)-1(h).

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partnership covered by §864(c)(8) to provide a statement to that partnership within 30 days of the transfer. The statement must include the date of the transfer and identifying information for the transferor and the transferee.[32]

A partnership that receives such a statement (or otherwise knows that a transfer has occurred) generally must provide information to the transferor partner so that partner may be able to compute the tax on sale.[33]

WITHHOLDING OVERVIEW

When a non-U.S. person sells or transfers an interest in a partnership earning ECI, the buyer or transferee is required to withhold 10% of the AR. A failure to properly withhold can result in personal liability on the buyer or its agents.[34] If the seller is a U.S. person, the buyer needs to obtain certification of that fact to eliminate withholding.[35] The proposed regulations provide that a certification by the transferor of U.S. status on Form W-9 is proof that the transferor is a U.S. person and exempt from withholding. Undocumented transferors are presumed to be foreign. A foreign partnership can be treated on a look-through basis if it certifies its status on Form W-8IMY.[36] Other exemptions from withholding discussed below may apply if the seller is a non-U.S. person.

If the seller is a non-U.S. person, the AR includes the sum of (1) the amount of cash paid, or to be paid, to the seller plus (2) the fair market value (FMV) of property given to the seller plus (3) the seller's share of partnership liabilities. For example, if a buyer pays one million cash to buy a partnership interest and the seller's share of partnership liabilities is four million, the AR is five million and the withholding tax is $500K (i.e., 10% of five million). This same withholding tax will apply even if the one million cash is to be paid in a later year or in installments over several years.

Since liabilities are included in the AR, it is possible that the withholding tax may exceed the cash or FMV of property paid to the seller. For example, if a buyer pays one million in cash to buy a partnership interest and the seller's share of partnership liabilities is $10 million, the AR is $11 million and the withholding tax due is $1.1 million (i.e., 10% of $11 million), which exceeds the amount of the cash being paid by $100K. To eliminate the need for the buyer to come out-of-pocket to pay the extra $100K, the proposed regulations provide that the required 10% withholding amount should not exceed the AR minus any partnership liabilities included in the AR if the seller's share of partnership liabilities was determined under one of the procedures created by the regulations, as discussed below.[37] In that case, the maximum amount of withholding imposed on the buyer is $1 million (i.e., $11 million minus $10 million). However, to make-up the short fall, the proposed regulations impose an obligation on the partnership to collect the short fall from future distributions, as discussed below.

DETERMINATION DATES AND DETERMINING LIABILITIES

To determine the amount to withhold, the proposed regulations require determination of the seller's share of partnership liabilities, the FMV of any property given to the seller, and other relevant factors to be made as of a determination date. The determination date can be either: (1) the transfer date; (2) a date no more than 60 days before the transfer date; or (3) the later of the first day of the partnership's tax year for the year of the transfer or the date of the most recent revaluation event under §704 before the transfer (e.g., admission of a new partner). If the transferor is a controlling partner, however, the determination date must be determined under item (1) or (2) above.[38]

For a given transfer, there may be only one determination date for all determinations required under these regulations. Since the possible exemptions from withholding discussed below are made on the determination date, choosing a determination date *before* the date of transfer should make it easier to determine if an exemption may apply.

To alleviate the difficulty in determining the seller's share of partnership liabilities, a buyer may rely on the amount of partnership liabilities reported as allocable to the seller on the most-recent Schedule K-1 received by the seller provide that the last day of the partnership taxable year for which the Schedule K-1

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[32] Prop. Reg. §1.864(c)(8)-2(a)(1). This notification requirement does not, however, apply to a transfer of certain interests in publicly traded partnerships or a partner receiving a distribution from a partnership that may be treated as a deemed sale of the partnership interest. Prop. Reg. §1.864(c)(8)-2(a)(2).

[33] Prop. Reg. §1.864(c)(8)-2.

[34] Prop. Reg. §1.1446(f)-5.

[35] Prop. Reg. §1.1446(f)-2(b)(2).

[36] The proposed regulations provide a procedure for non-U.S. partnerships to limit the amount realized for withholding purposes to the portion of the amount realized that is attributable to non-U.S. partners. The portion of the amount realized attributable to a direct or indirect partner is determined based on the percentage of gain allocable to that partner. For example, if the partnership determines that only 40% of the gain is allocable to non-U.S. partners then the amount to withhold may be limited to 40% of the AR.

[37] Prop. Reg. §1.1446(f)-2(c)(3).

[38] Prop. Reg. §1.1.1446(f)-1(c)(4).

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was provided was no more than 22 months before the date of the transfer.[39] In addition, the K-1 must be accompanied by a statement that the person making the certification (usually the seller) has no actual knowledge of events that would alter such amount by 25% or more.

Alternatively, a buyer may rely on a certification from the partnership that provides the amount of the seller's share of partnership liabilities. This certification must be made on one of the determinant dates listed earlier and cannot be based on the most recent K-1. Lastly, if the partnership itself is the transferee, the partnership may rely on its books and records to determine the transferor's share of partnership liabilities as of the determination date. This last situation will apply if the partnership is redeeming (or purchasing) a partnership interest or the partnership is making a cash distribution in excess of basis, which is treated as a deemed sale of a partnership interest.[40]

REPORTING AND PAYING THE WITHHOLDING TAX

The regulations adopt the same procedures for reporting and paying over withheld amounts used under FIRPTA.[41] As a result, reporting and paying over any withheld amount within 20 days of the relevant transfer is required. Transferees will use Forms 8288, *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests* , and 8288-A, *Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests*, the FIRPTA withholding forms, with modifications to show the form is being used under §1446(f).[42] After receipt, the IRS will then stamp Form 8288-A to show receipt and mail a stamped copy to the transferor.

A transferee that is required to pay over a withholding tax is made liable for that tax under §1461 (including any applicable penalties and interest). A person that is required, but fails, to pay over the withholding tax may also be subject to civil and criminal penalties. Officers or other responsible persons of either an entity that is required to pay over the withholding tax or any other withholding agent may be also subject to a civil penalty under §6672.

The withholding tax may sometimes exceed the actual tax due. In the case of a sale of U.S. real estate or a U.S. real property interest by a non-U.S. person, FIRPTA withholding addressed that concern by allowing a buyer or seller to file Form 8288-B before the sale and request an IRS withholding certificate allowing for reduced withholding tax to equal the actual tax liability or no withholding if a loss occurred om the sale.

The proposed regulations allow for the withholding tax to be reduced to equal the actual tax due on the sale, but not by filing a request with the IRS for a reduced withholding certificate. Rather, the seller can supply the buyer with a certification of maximum liability, which sets forth detailed information as to show to the buyer how the maximum tax was computed.[43] This procedure is better than that created under FIRPTA since there is no need to have to wait for the IRS to issue a withholding certificate and have to escrow money at closing to hold until the IRS responds. However, this new procedure requires a buyer to have to review the certification to ensure it is correct and complete.

The proposed regulations also recognize that the withholding tax may, in some cases, exceed the cash or other property paid by the buyer due to the inclusion of partnership liabilities. To alleviate that possibility, a buyer's withholding tax obligation is limited to the cash or other property paid to the seller.[44]

Given the complexity of these rules, errors may occur. To address that possibility, the regulations provide procedures to address both under-withholding and over-withholding.[45]

EXEMPTIONS FROM WITHHOLDING

The IRS had initially proposed five possible ways in which a sale by a non-U.S. person could be exempt from withholding.[46] The proposed regulations maintained those exemptions but tightened up some of the eligibility requirements.

1. **Certification of No Gain**: Withholding is generally not required where a transferor certifies that no gain will be realized in the disposition. However, if a transferor realizes ordinary income under the ''hot assets'' rule of §751(a) in connec-

[39] Prop. Reg. §1.1446(f)-2(c)(2)(ii)(B). Notice 2018-29 had only used a 10-month look-back period, which the regulations expanded to 22 months. Use of a 22-month period will make this option easier to use.

[40] §731(a)(1).

[41] FIRPTA withholding occurs under §1445.

[42] The transferee must include the statement ''Section 1446(f)(1) withholding'' at the top of both Form 8288 and the Form 8288-A. Except as provided in §8 of Notice 2018-29, the transferee must also enter the amount subject to withholding under §1446(f)(1) on line 5b of Part I of the Form 8288 and on line 3 of Form 8288-A and enter the amount withheld on line 6 of Part I of Form 8288 and on line 2 of Form 8288-A. Notice 2018-29, §5.

[43] Prop. Reg. §1.1446(f)-2(c)(4).

[44] Prop. Reg. §1.1446(f)-2(c)(3).

[45] Prop. Reg. §1.1461-2(a), §1.1461-2(b).

[46] Notice 2018-29.

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tion with a transfer, the exception is not available even if there is an overall loss on the transfer.[47]

2. **Certification of De-Minimis Gain on Deemed Sale**: No withholding is required if a partnership provides the transferee a certification stating that if the partnership sold all of its assets at the FMV, the amount of net effectively connected gain resulting from the deemed sale would be less than 10% of the total net gain. Notice 2018-29 contained a similar exception, but at a 25% threshold. As a result, the de-minimis exception has been narrowed.[48]

3. **Certification of De-Minimis Partnership ECI**: No withholding is required if a transferor provides a certification that its allocable share of partnership ECI for each of the preceding three years is less than 10% of the transferor's total distributive share of net partnership income and the ECI in each of those years was less than one million. Notice 2018-29 contained a similar exception but using a higher 25% threshold. As a result, this exception has also been narrowed. The certification must also state that the transferor was at all times a partner in the partnership for the immediately prior taxable year and the two taxable years that precede it, the ECI has been reported on a timely filed tax return and all taxes have been timely paid. The certification may not be used unless the seller received a Form 8805, *Foreign Partner's Information Statement of Section 1446 Withholding Tax* from the partnership for these three years reporting its share of ECI; however, if a loss arose, a Form 8805 for that year is not required to rely on this procedure. When the partnership is acquiring the interest (including a distribution in excess of basis that is treated as a deemed sale of a partnership interest), the partnership may rely on its own books and records, provided that the transferor makes a representation that the relevant tax reporting and filing requirements have been satisfied.[49]

4. **Certification of Non-Recognition:** No withholding is required if a transferor provides a certification that states the transferor is not required to recognize any gain or loss with respect to the transfer pursuant to an applicable provision of the I.R.C.[50] The certification must briefly describe the transfer and provide the relevant law and facts relating to the certification. A transferor may obtain a partial withholding reduction based on partial nonrecognition if the transferor certifies to the relevant law and facts to support partial non-recognition and certifies as to the actual tax due based on the procedures outlined below.[51]

5. **Certification of Treaty Exemption:** No withholding is required if a transferor certifies that it is not subject to tax pursuant to an income tax treaty in effect between the United States and another country. This exception applies only when a transferor (as opposed to owners of an interest in the transferor) qualifies for the benefits of an income tax treaty. Thus, partnerships may not claim treaty benefits on behalf of their partners.[52]

WITHHOLDING AND PUBLICLY TRADED PARTNERSHIPS

The IRS had initially not applied withholding to a sale of an interest in a publicly traded partnership (PTP).[53] However, the proposed regulations adopted withholding on a sale of an interest in a PTP, but with some helpful modifications.[54]

Since interests in PTPs are usually held by banks, brokers, and custodians, the proposed regulations require banks, brokers, and custodians to perform withholding on transfers by non-U.S. persons of those PTP interests. In the case of a sale of a PTP, the AR for purposes of withholding, only includes the amount of cash paid or to be paid plus the FMV of property given to the seller but does not include the seller's share of partnership liabilities.

A distribution made to a partner in excess of its tax basis for its partnership interest is treated as gain from the sale of a partnership interest subject to withholding. However, if a PTP does not distribute more than its net income since the last distribution and publishes a qualified notice to that effect, however, a special rule provides that the distribution is not subject to withholding.

COORDINATION WITH FIRPTA

When a partnership owns substantial U.S. real property interests (USRPIs), the proposed regulations would generally apply 15% FIRPTA withholding under §1445(a), rather than 10% withholding under §1446(f). If, however, the transferor applies for a

[47] Prop. Reg. §1.1446(f)-2(b)(3).

[48] Prop. Reg. §1.1446(f)-2(b)(4).

[49] Prop. Reg. §1.1446(f)-2(b)(5).

[50] For example, contributions to partnerships or controlled corporations pursuant to §721 or §351.

[51] Prop. Reg. §1.1446(f)-2(b)(6).

[52] Prop. Reg. §1.1446(f)-2(b)(7).

[53] Notice 2018-08.

[54] Prop. Reg. §1.1446(f)-4.

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withholding certificate to reduce or eliminate §1445 withholding, the amount to withhold is the greater of the amounts required under each of the regimes.[55]

PARTNERSHIP BACK-UP (OR SECONDARY) OBLIGATION TO WITHHOLD

If the buyer does not withhold the full 10% amount owed, the IRS has the power to require the partnership to act as a back-up withholding agent responsible to withhold on future distributions to the buyer until the shortfall in tax withheld is made up.[56] The IRS initially chose to not exercise this power.[57] However, the IRS changed course in the proposed regulations, which may require partnerships to withhold on partnership interests previously transferred by a non-U.S. partner if the correct tax was not withheld at the time of the transfer.[58]

Under the proposed regulations, a partnership would have to withhold from any distribution made to a transferee to make up a shortfall in tax withheld if (i) a transferee fails to make a certification to the partnership describing the transaction, providing the amount withheld and describing any exception to withholding, (ii) the partnership receives such certification and after review, knows or has reason to know that the transferee's certification (or an underlying certification from the transferor) is unreliable or incorrect, or (iii) the IRS notifies the partnership that the transferee provided incorrect information about the amount withheld or failed to deposit the amount withheld. This withholding obligation does not apply if withholding has been fully satisfied by the buyer or the partnership is a publicly traded partnership.[59]

A partnership is required to start withholding on distributions to transferees on the later of 30 days after the transfer or 15 days after it knows of the transfer. If the partnership receives a notification from the IRS, it must start withholding 15 days after receiving such notification.[60] Withholding is equal to the full amount of the distribution until the unpaid 10% withholding tax has been paid in full plus any interest on such amount.[61] The partnership must report and pay the tax withheld using Forms 8288 and 8288-C.[62]

When the partnership is a transferee because of a distribution (including a redemption of a partnership interest), the proposed regulations clarify that back-up withholding does not apply.[63] However, the partnership is liable for withholding under the general rule because it is treated as the transferee.

CONCLUSION

Non-U.S. investors in partnerships doing business in the United States must now consider U.S. federal income tax when they dispose of their investment, which adds both a financial and administrative burden. The caveat ''buyer beware'' also rings true in any purchase of a partnership interest since a buyer is liable for any failure to properly withhold the correct amount with the partnership serving as a backstop. Since the seller's share of partnership liabilities directly affects the determination of tax due, the task of computing the tax and withholding the full amount is made even harder. The bottom line is sales of partnership interests have become a more complicated task and failing to follow IRS guidelines can lead to lingering liabilities for taxes not withheld. For all involved, proceed with caution and the help of your tax advisors.

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[55] Prop. Reg. §1.1446(f)-1(d).

[56] §1446(f)(4).

[57] Notice 2018-08.

[58] Prop. Reg. §1.1446(f)-3(a).

[59] Prop. Reg. §1.1446(f)-3(b)(1), §1.1446(f)-3(b(2).

[60] Prop. Reg. §1.1446(f)-3(c)(1).

[61] Prop. Reg. §1.1446(f)-3(c)(2).

[62] Prop. Reg. §1.1446(f)-3(d). Since these are FIRPTA forms, the partnership will note on these forms they are being used to pay withholding tax under §1446(f).

[63] Prop. Reg. §1.1446(f)-3(b)(3).

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