

Client Update

New Guidance on Withholding on Sales of Partnership Interests

On April 2, 2018, the Treasury Department and the Internal Revenue Service (the “IRS”) issued Notice 2018-29 (the “Notice”) regarding the withholding on the sale of nonpublicly traded partnership interests under the recently enacted Tax Cuts and Jobs Act (the “TCJA”).

Overturning a recent taxpayer court victory, the TCJA codified the IRS’s long-standing position that treats a foreign partner’s gain from the sale of a partnership interest as effectively connected with the conduct of a U.S. trade or business (“ECI”) to the extent the foreign partner would have had ECI had the partnership sold all of its assets at fair market value. Additionally, the TCJA introduced a **10% withholding** on the **amount realized** on the sale of the partnership interest if any portion of the gain would be treated as ECI (“1446(f) Withholding”).

The Notice provides interim guidance that taxpayers **may rely on** until new regulations are issued. Importantly, unlike the prior IRS guidance on publicly traded partnerships that suspends withholding altogether, the Notice does not extend this blanket exemption to other partnerships. Instead, the Notice provides a number of exemptions and simplifications aimed at making the withholding administrable. The Notice does not affect the actual tax liability imposed on the foreign partner under the TCJA.

Our summary below highlights these key areas of guidance and other notable provisions, and calls attention to several areas that are not addressed by the Notice.

EXCEPTIONS TO WITHHOLDING

U.S. Sellers

Generally may avoid withholding on the sale of a partnership interest by providing either a **Form W-9** or a **certificate of nonforeign status** (similar to those used for FIRPTA).

Comment: Although a U.S. person can certify its nonforeign status by providing a W-9, the Notice does not appear to allow a foreign partnership with U.S. partners to

pass through their W-9 forms to avoid withholding in connection with the sale of a lower-tier partnership interest.

Foreign Sellers

Generally may avoid withholding on the sale of a partnership interest if:

- *Seller Certificate*: The seller certifies no earlier than 30 days before the sale that it has been a partner in the partnership for **all** of the **three prior taxable years** and **the partner's share** of ECI for each of those years was **less than 25%** of its total share of income for such year.
- *Partnership Certificate*: The seller provides a certificate issued by the partnership no earlier than 30 days before the sale that certifies that the **partnership's** built-in gain that is ECI represents **less than 25%** of the total built-in gain.

Comment: These certificates will allow buyers to purchase partnership interests with no or limited amounts of ECI, without fear of failing to satisfy their withholding obligations. However, the Notice indicates that the IRS intends to provide future guidance that will **reduce** both thresholds **below 25%**.

- *No Gain*: The seller certifies that the sale of its partnership interest will result in **no realized gain**.
- *Nonrecognition Transactions*: The seller provides notice to the buyer that it is engaged in a **nonrecognition transaction**.

Comment: The IRS is studying the appropriate treatment of nonrecognition transactions on the underlying tax liability. The IRS is likely to be more concerned with nonrecognition transactions that have the potential to reduce the ability of the IRS to collect tax on the ECI gain than with nonrecognition transactions that preserve the ECI gain in the U.S. tax basis. For instance, a foreign person holding multiple partnership interests may combine a partnership with built-in ECI gain with a partnership with built-in loss in order to take advantage of the “no gain” rule above.

AMOUNT OF THE WITHHOLDING LIABILITY

Withholding is imposed on 10% of the **amount realized** on the sale of a partnership interest. The amount realized generally includes any **cash** and other proceeds plus the seller's **share of partnership liabilities**. The Notice provides some helpful guidance on determining partnership liabilities. However, if the buyer is not provided with appropriate certification as to the amount of liabilities to be taken into account, the buyer must withhold all the proceeds.

Determining the Amount of Partnership Liabilities

- *Seller Certification:* A **noncontrolling partner** (i.e., a partner that owned directly or indirectly less than 50% of the capital, profits, deductions and losses for last 12 months) may certify (1) the amount of its share of partnership liabilities based on its **most recent** Schedule K-1 that it received from the partnership, for a partnership taxable year that has closed **within 10 months** of the date of the sale and (2) that it does not have **actual knowledge** that its share of partnership liabilities has changed significantly (**25% or less**) since it received the Schedule K-1.

Comment: This rule is likely to provide little comfort to sellers because it is fairly common for partnerships to significantly extend their tax filing deadlines, resulting in any Schedule K-1 relied on by the seller being **stale**.

- *Partnership Certification:* Similarly, a partnership may issue a certificate no earlier than 30 days before the sale that provides (1) the partner's share of partnership liabilities, which **may be** the amount reported on the most recently prepared Schedule K-1 and (2) that the partnership does not have **actual knowledge** that the seller's share of partnership liabilities has changed significantly (**25% or less**) since the certification.

PROCEDURE AND OTHER NOTABLE PROVISIONS

- The Notice provides that until further notice, the procedure for FIRPTA withholding should be used for 1446(f) Withholding. A buyer that obtains a certification generally must retain the document for **five** calendar years. Generally, a buyer will be required to report and pay amounts withheld within **20 days** of a transfer. However, taxpayers will have until May 31, 2018 to report and remit withheld amounts that are retroactively due prior to that date.
- Certifications are generally signed under penalties of perjury and must be signed by an **individual** that is an officer, director, general partner or managing member (if the authorized person is itself an entity, then they must look through the tiers of entities until an individual is identified).

Partnership Level Withholding

- The Notice **suspends** the application of the new law that required the partnership to withhold on distributions to the buyer in the event the buyer failed to withhold.

Comment: This will allow fund sponsors (for now) to be more flexible about permitting transfers because there is no residual liability for the partnership.

AREAS NOT ADDRESSED

Treaties

- The Notice does not address how to handle situations in which a foreign seller relies on a treaty to avoid U.S. tax. This occurs where a partnership has ECI but no permanent establishment in the United States.

Disguised Sales

- The Notice does not address whether disguised sales transactions are subject to withholding obligations.

Comment: Taxpayers commonly face this situation in the private equity fund context when a partnership admits additional partners in a subsequent closing with true-up payments made to existing partners, often treated as “disguised sales” of partnership interests for tax purposes.

Prior Transactions

- The Notice generally does not address sales that occurred in 2018 before the Notice was published. For instance, it is not clear whether a foreign seller can provide a buyer a retroactive certificate claiming exemption from withholding and retrieve from the buyer any amounts withheld that have not been deposited with the IRS.

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Please do not hesitate to contact us with any questions.

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