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New US Withholding on Sales of US Partnership Interests by Non-US Partners

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Under 1991 US guidance, if a non-US partner sold its interest in a US partnership, the selling partner would look through to the business of the partnership and would be required to file a US tax return and pay US tax if the partnership would have had income effectively connected ("ECI") to a US trade or business on a deemed sale of its assets. But that guidance was dramatically reversed in a 2017 tax court case called *Grecian Mining*. Then the US position was reversed again in the Tax Cuts and Jobs Act (TCJA), when the US Congress reversed *Grecian Mining*, codified the 1991 guidance and implemented withholding on the sale of a US partnership interest by a non-US person.

Since the new withholding was implemented at the beginning of the year, the Internal Revenue Service (the "Service") has issued two new pieces of guidance to assist taxpayers in determining and executing the withholding. However, taxpayers still await formal regulations on the new withholding.

Non-US Investor Concerns About ECI

A US partnership does not usually pay US taxes on its income; instead, the partnership allocates income to each partner, and the partners pay tax on their shares of income, gain, loss, deductions or credits.[1] Unless the gain is recharacterized under Section 751 due to certain ordinary income assets held by the partnership, the general rule is that gain from the sale of a partnership is capital gain under Section 741. In general, gain is not taxable to non-US investors unless the gain is attributable to a US business.

A. Non-US Investors and US Tax (ECI)

Income of a non-US person that is effectively connected to a US trade or business may be taxed by the United States at the same graduated income tax rates that apply to US residents – obviously an undesirable outcome.[2]

A non-US resident may be taxed on income that is effectively connected to its own US trade or business. And when there is a partnership involved, a non-US resident partner may also be taxed if it is a partner in a partnership that engages in a US trade or business with income that is effectively connected to that trade or business.[3]

It is not always obvious whether a US investment vehicle is treated as a partnership for US tax purposes. And some investment vehicles that are intended to be disregarded entities or trusts could later become partnerships. For example, under the US business entity classification rules, if a US business entity has one owner then it is, by default, disregarded for federal tax purposes.[4] But, if the business entity has two or more owners, then it is a partnership by default and can elect to be a corporation.[5] Whether or not an investor is an "owner" depends on a debt vs. equity characterization of the investment, which in turn depends on a complicated multi-factor test. An investor who initially believes that the investor's investment is a debt investment (*i.e.,* non-ownership investment) may later be determined to be an equity owner, thereby increasing the number of owners so that the entity may become a partnership instead of a disregarded entity. Therefore, non-US residents that invest in US investments should be aware of the potential risks of investing in a US partnership.

B. What Is ECI?

If a non-US taxpayer operates a US trade or business (or is a partner in a partnership that has a US trade or business), there are several ways that its income can be categorized as ECI, depending on whether the income is US source or non-US source.

First, US-source income from a US trade or business of a non-US person or corporation (other than the passive-type income in the next rule) is generally ECI.[6]

Second, for US-source passive-type income (including capital gain and periodical income such as interest and dividends), there are two statutory factors that help determine whether US source income is effectively connected with the conduct of a trade or business within the United States: an asset test and a business activities test.[7] Under the asset test, taxpayers consider whether the income, gain or loss is derived from assets used or held for use in the conduct of US trade or business.[8] But under the business activities test, taxpayers should consider whether the activities of the trade or business are a material factor in the realization of the income, gain or loss.[9]

Third, certain non-US source income may be categorized as ECI in limited cases. Specifically, non-US source income of a non-US taxpayer with a US trade or business may be categorized as ECI if the person has an office or other fixed place of business within the United States to which the income is attributable.[10]

C. Source Rules: What Is US and Non-US Source under US Rules?

As noted above, the application of the ECI rules depends on whether income is US or non-US source. For a transfer of personal property, including a partnership interest, the income is sourced based on the residence of the seller.[11] However, if a nonresident makes a sale through an office or fixed placed of business in the United States, income from the sale of personal property attributable to such office or fixed place of business shall be sourced in the United States.[12]

A non-US partner of a partnership that is engaged in a trade or business in the United States through a fixed place of a business is treated as if it has itself a fixed place of business in the United States, since the non-US partner is considered to be engaged in such trade or business pursuant to Section 875(1).

D. FIRPTA

Another type of withholding similar to the new withholding described below already exists under the Foreign Investment in Real Property Tax Act ("FIRPTA"), which imposes a tax on capital gains derived by non-US persons from the disposition of US real property interests.[13] Specifically, the non-US person who disposes of a US real property interest ("USRPI") must treat the gain or loss from the disposition as income or loss ECI, which would require the non-US person to be subject to federal tax at the same rates as a US person.[14] To help ensure collection of this tax, the purchaser of a USRPI is obligated to withhold, and pay over to the IRS, 15 percent of the amount realized, instead of making a full payment to the non-US seller.[15] This withholding tax is credited to the non-US person's final US tax obligation, which may be more or less than the withholding tax.

1991 Revenue Ruling: Hypothetical Sale Of Partnership Assets

In 1991, the Service determined in Revenue Ruling 91-32 (the "1991 Ruling") that a non-US partner's gain from the sale of a partnership interest should be treated as ECI to the same extent that the partner's share of the sale of the partnership's assets would be treated as ECI.[16] In other words, to establish the amount of ECI gain for a non-US partner upon the sale of its interest in the partnership, the 1991 Ruling directed a taxpayer to calculate the share of ECI that it would have

had if the partnership sold all its assets. Thus, the sale of the interest would ultimately be treated as if the assets of the partnership were being sold and not the partnership interest – this method follows an aggregate rather than an entity view of the nature of partnerships, as discussed below.

The 1991 Ruling assumed that an individual person was a non-US partner in a partnership that was engaged in a US trade or business through a fixed place of business in the United States.[17] The partnership owned non-ECI property (appreciated real and personal property) in a non-US country, as well as ECI property in the United States (appreciated personal property used in its US trade or business).

First, without much discussion, the 1991 Ruling found that the income from the disposition of the partnership interest would be considered US source. It stated that income from the disposition of a partnership interest by the non-US partner would be attributable to the non-US partner's fixed place of business in the United States, presumably because partners are considered to be engaged in the trade or business of their partnership. The 1991 Ruling cited a case in which the permanent establishment of a partnership in the United States was attributed to its non-US partners under treaty rules.[18]

Because the income from the sale of the partnership interest was US source, the 1991 Ruling stated that the appropriate ECI test to use in this case was the asset test (rather than the business activities test) since the gain or loss from the disposition of its interest in a partnership was not gain or loss realized directly from the active conduct of a US trade or business.[19] The asset test takes into account whether the income, gain or loss "is derived" from assets used in or held for use in the conduct of the US trade or business.[20] The 1991 Ruling concluded that an interest in a partnership that was engaged in a trade or business through a fixed placed of business in the United States was an ECI asset of the non-US partner because:

1. The US trade or business of the partnership through a fixed office in the United States was imputed to the non-US partner; and
2. The value of the trade or business activity of the partnership affected the value of the non-US partner's interest in the partnership.

In the 1991 Ruling, the partnership had a total of USD400,000 unrealized gain in its assets. Of that amount, USD300,000 was from personal property used in its US trade or business – that is, ECI gain. The remaining USD100,000 of unrealized gain was the result of netting a

USD500,000 non-ECI gain on real property outside the United States and a USD400,000 non-ECI loss on machinery outside the United States. The non-US partner had a distributive share of 25 percent of income, gain, loss, deduction and credit of the partnership and sold his interest for a USD100,000 gain.

The 1991 Ruling concluded that the gain or loss from ECI property that was attributable to the non-US partner was determined by multiplying the gain or loss from the sale of the partnership interest by a ratio meant to represent the partner's share of ECI gain in the hypothetical sale over the partner's total share of gain (ECI and non-ECI gain) in the hypothetical sale.

In this example, a hypothetical sale of all the assets of the partnership yielded USD300,000 total ECI gain. Under the partnership agreement, the non-US partner would receive 25 percent of the ECI gain (25 percent of USD300,000 = USD75,000). The total ECI and non-ECI gain to the partner would be 25 percent of the total unrealized gain in the assets of the partnership (25 percent of USD400,000 = USD100,000). The ratio of the partner's ECI share over the partner's total (ECI and non-ECI) share would be 75 percent (USD75,000/USD100,000), and 75 percent of the gain from the sale of the partnership interest (75 percent of USD100,000) was USD75,000. Therefore, the partner would have USD75,000 of ECI, taxable in the United States.[21]

The remaining USD25,000 of the partner's gain would be non-US source income that would not be attributable to a US trade or business because it was attributable to real property and machinery outside the United States. Thus, the remaining USD25,000 was not ECI.

Grecian Mining: A Short-Lived Reversal Of The 1991 Ruling

Decades later, in 2017, a tax court case called *Grecian Mining* reversed the holding of the 1991 Ruling and rejected the hypothetical sale method.[22] Instead, it held that when a non-US person sells its partnership interest in a partnership that operates a US trade or business, the gain or loss is generally non-US source and therefore not generally subject to US tax.

In *Grecian Mining* a non-US corporation named Grecian Magnesite Mining (GMM) was a partner in a US partnership. GMM redeemed its interest in the partnership and received a distribution from the partnership in exchange for its partnership interest. GMM conceded that a portion of the gain pertained to USRPI and was subject to FIRPTA, but the remainder of the gain was in dispute. The Service argued that GMM should be liable for tax on the disputed gain because it was US-source ECI. But the taxpayer argued that, other than the portion of the gain that was

attributable to USRPI and taxable under FIRPTA, the Service should not look through the partnership to evaluate whether the assets of the partnership caused the partner to have ECI.

The tax court in this case discussed the entity vs. aggregate theories of partnership treatment. Entity treatment means the partnership itself is the focus of the inquiry, while aggregate treatment examines the traits of the individual partners. Sometimes, for tax purposes, partnerships are treated as aggregates of the partners' interests; however, for other purposes the partnership itself is treated as the entity under examination.

In support of the entity theory, the tax court reminded us that partnerships are not subject to tax; instead, partners are liable for income tax only in their separate or individual capacities.

In addition, the language in Section 741 itself states that the sale of the partnership interest shall be considered the sale of a "capital asset," not "assets." The court took this to mean that capital asset refers to the partnership interest itself and not the multiple assets that would make up the assets of the partnership.

The court applied entity treatment to the sale of a partnership, with only particular, named exceptions. Specifically, it said, Section 741 capital asset treatment is a general rule to which certain exceptions may apply (the exceptions being Section 751 ordinary assets and FIRPTA withholding). The court also stated that the legislative history indicated that Section 741 was intended to operate separately from the general rules for the definition of a capital asset under Section 1221 and was intended to implement the entity theory over the aggregate theory for partnerships.

In sum, the tax court held that entity treatment generally applies to the gain or loss from the redemption of a partner's partnership interest. Therefore, GMM's gain from the redemption of its partnership interest was gain from the sale or exchange of the partnership interest itself – an indivisible capital asset – and not gain from the sale of the partnership assets.

Accordingly, once the tax court decided that entity treatment should apply, it then applied the source rules to the redemption of the partnership interest, not to the assets of the partnership. If the sale of the partnership interest would have caused US-source gain, then the gain may have been ECI. But, if the sale of the partnership interest had created non-US source gain, the income would only be ECI if it were attributable to a fixed place of business in the United States.

As the court was focused on the entity theory of partnership, it ultimately decided that the US office of the partnership was not a material factor in the production of the income because the increased value of the partnership interest gained through the operations of the US office was not realized until the partnership interest was actually redeemed, and the partnership's US office was merely performing clerical functions. Thus, the sale of the partnership interest was not US-source income and not ECI.

In the end, the tax court in *Grecian Mining* took a strong position and concluded that, other than the FIRPTA gain, the sale of a partnership interest by a non-US partner would not be taxed in the United States as ECI.

Congress Has A Powerful Response To Grecian Mining

A few months after the tax court's ruling in *Grecian Mining*, Congress reversed the decision, codified the 1991 Ruling and went even further than the 1991 Ruling by implementing a withholding regime to enforce it.

The TCJA first added a new Code Section 864(c)(8), which allows a portion of the gain or loss to be treated as effectively connected with a US trade or business when a non-US partner sells its interest in a partnership with a US trade or business. It followed the methodology of the 1991 Ruling by imagining a hypothetical sale of the partnership's assets to determine the amount of income that would be treated as effectively connected to a US trade or business.

The TCJA also added a new Code Section 1446(f), which implemented a withholding regime to enforce the new rules. In general, the purchaser of a partnership interest from a non-US partner is now required to withhold 10 percent of the purchase price.

The Code states that this withholding is necessary if "any portion of the gain" on the disposition would be treated as effectively connected with the conduct of a trade or business within the United States under the rules of Code Section 864(c)(8) above – a low threshold. However, there is an exception to the withholding requirement if the seller delivers an affidavit, under penalty of perjury, providing the seller's US taxpayer identification number and stating that the seller is a US person. If the buyer has actual knowledge that the affidavit is false or if it receives a notice that the affidavit is false, then the exception will not eliminate the withholding requirement.

If the purchaser fails to obtain the affidavit or fails to withhold, then the partnership itself must withhold.

Further Guidance Facilitates Withholding

Operationally, collecting affidavits from selling partners to prevent withholding is problematic. In the case of publicly traded partnerships, for example, investors will typically not be able to determine whether the selling partner is US or non-US because publicly traded partnerships are held in street name by a broker and transferred through a clearinghouse. It would also be difficult to determine whether any portion of a gain would be treated as ECI. Moreover, a particular sale may be aggregated with other sales and purchases of partnership interests by other customers of the same broker. To address these difficulties, in January the Service issued Notice 2018-8, which exempts publicly traded partnerships from the withholding requirement under Section 1446(f).[23]

Practitioners appreciated the withholding exemption for publicly traded partnerships but respectfully requested an expansion of the withholding exemption to other partnerships until further guidance could be issued.[24] Among other issues, practitioners requested:

1. Guidance on when and how to inform transferees about whether a deemed asset sale would generate ECI gain or loss;
2. When purchasers should be able to rely on an affidavit of non-US status;
3. How to let the partnership know that withholding was imposed by the partner purchaser;
4. Guidance regarding multi-tiered partnerships; and
5. Guidance on which transactions will be exempt.

The Service acknowledged these requests for guidance in Notice 2018-29, issued in April 2018, but did not suspend withholding obligations for partnerships other than publicly traded partnerships.[25] Notice 2018-29, however, did provide limited, temporary guidance regarding some mechanics of the new withholding. Generally, to address the lack of forms and instructions for the new withholding, the Notice instructs taxpayers to use the forms and procedures related to FIRPTA withholding under Section 1445. Also, to show that it is a US person, a seller partner may provide an affidavit under the FIRPTA rules or a W-9.

Notice 2018-29 also stated that the Service intends to issue regulations to the effect that withholding will not be necessary in the following cases:

1. If the purchaser receives a certification, issued by the seller, stating that the transfer will not result in realized gain;

2. If the purchaser receives a certification that the seller had less than 25 percent ECI in the three years prior;
3. If the purchaser receives a certification from the partnership that the amount of ECI gain from a deemed sale of the partnership assets would make up less than 25 percent of the total gain; and
4. If the seller is not required to recognize gain by reason of a nonrecognition provision of the Code.

Furthermore, the Service intends to issue regulations providing that if a purchaser is required to withhold under FIPRTA and Section 1446(f), then the purchaser generally will only be subject to the payment and reporting requirements of FIRPTA.

Notice 2018-29 also provides guidance regarding partnership liabilities and the new withholding. First, the Service intends to issue regulations providing that a transferee may rely upon a certification from the partnership or the selling partner to determine the amount of liabilities of the partnership that will be included in the amount realized on the transfer. Also, the Service intends to issue regulations providing that if the amount otherwise required to be withheld under Section 1446(f) exceeds the amount realized less the decrease in the transferor partner's share of partnership liabilities, the amount of withholding required is the amount realized minus the decrease in the selling partner's share of partnership liabilities. But if a purchaser is unable to determine the amount realized because it does not have knowledge of the selling partner's share of partnership liabilities, then the amount of withholding required is the entire amount realized, determined without regard to the decrease in the selling partner's share of partnership liabilities.

Finally, Notice 2018-29 delayed the rule requiring withholding by the partnership itself in the event the purchasing partner does not withhold. It states that the Service intends to issue regulations to the effect that the withholding requirements for partnerships will not apply until regulations or other guidance have been issued under Section 1446(f)(4). But on the other hand, it did not suspend withholding for transfers of partnerships that hold other partnerships. However, it intends to issue regulations stating that in situations where the lower-tier partnership would have ECI gain under a deemed sale of its assets, a portion of the gain on the transfer of the upper-tier partnership will fall under the new rules and require withholding.

Treaty Issues

Under US rules, if a provision in the Code conflicts with a treaty provision, generally the one adopted later in time controls.[26] The US Model Treaty provides that (other than gains from the sale of real property and other specified gains) gains from the sale of property are taxed only in the seller's jurisdiction.[27] Therefore, residents in treaty countries may be surprised to discover that the sale of their partnership interest is taxable in the United States.

In addition, another complication arises because of the different treatment of limited liability companies ("LLCs") by different jurisdictions. Non-US countries often treat LLCs as corporations, while the United States may, by default, treat LLCs as partnerships if they have more than one owner. Under US tax treaties, generally, terms that are not defined in a treaty are defined by the local law of the treaty partner that is applying the treaty.[28] Therefore, if the United States is applying the new withholding tax under Section 1446(f), it may be able to treat an LLC like a partnership and look through to the business of the LLC to determine if any of the assets are ECI assets. A non-US business may not expect to find that its non-US "corporate" entity has become partially transparent for US purposes and that the sale of an interest in that entity has become taxable by the United States.

Conclusion

Grecian Mining was a strong departure from years of tax policy. Congress had an even stronger reaction to *Grecian Mining* when it rejected the tax court's holding, codified the 1991 Ruling and enacted a strict withholding regime. Now, with the new withholding under Section 1446(f), US issuers have another reason to restrict non-US persons from holding US partnership interests or interests in entities that may someday be treated as partnerships.

Endnotes

1 Code Sections 701 and 702. All references to "Code" or "Section" refer to the Internal Revenue Code of 1986, as amended.

2 Code Sections 882, 871(b) and 864(c).

3 Code Section 875(1).

4 Treasury Regulations Section 301.7701-3(b).

5 Treasury Regulations Section 301.7701-3(b).

6 Code Section 864(c)(3).

7 Code Section 864(c)(2).

[8] Code Section 864(c)(2)(A).

[9] Code Section 864(c)(2)(B).

[10] Code Section 864(c)(4).

[11] Code Section 865(a).

[12] Code Section 865(e)(2).

[13] Code Section 897(a).

[14] Code Sections 897(a) and 882(a).

[15] Code Section 1445(a).

[16] Rev. Rul. 91-32, 1991-1 CB 107 (the "1991 Ruling").

[17] Assume that the partnership is not a publicly traded partnership under Section 7704 and that the ECI property is not subject to FIRPTA withholding under Code Section 897.

[18] *Unger v. Commissioner*, T.C. Memo 1990-15.

[19] Treasury Regulations Section 1.864-4(c)(2)(i).

[20] Code Section 864(c)(2)(A).

[21] Note that if the partnership's assets included US real property interests under FIRPTA, the partner would also be subject to FIRPTA tax.

[22] *Grecian Magnesite Mining v. Commissioner*, 149 TC No. 3 (2017).

[23] Notice 2018-8, 2018-4 IRB (January 2, 2018).

[24] "PwC Seeks Expansion of Withholding Obligation Suspension," *Tax Notes Today*, January 10, 2018; "NYSBA Members Request Guidance on Disposition of Partnership Interests," *Tax Notes Today*, February 2, 2018; Stephanie Cumings, "Suspension of PTP Withholding Was Necessary, Practitioners Say," *Tax Notes Today*, January 15, 2018; "SIFMA Seeks Withholding Relief for Non-Publicly Traded Partnerships," *Tax Notes Today*, February 13, 2018.

[25] Notice 2018-29, 2018-16 IRB 1 (April 2, 2018).

[26] Code Section 7852(d)(1).

[27] United States Model Income Tax Convention (2016) ("US Model Treaty"), Article 13, Paragraph 6.

[28] US Model Treaty, Article 3, Paragraph 2.