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Notes

My article about sections 864(c)(8) and 1446(f)
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Partnerships

Gain or Loss of Foreign Persons from Sale or Exchange of Partnership Interests

By enacting section 864(c)(8), Congress may have unnecessarily blurred the differences between the aggregate and the entity concepts and it has certainly imported a vast amount of complexity into the law.

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Whether a partnership (or an entity classified as a partnership for tax purposes) should be treated as an entity or an aggregate of its assets and activities has long perplexed tax administrators, courts, as well as tax professionals and academics. It cannot be said that the law, as set out in the Internal Revenue Code (the "Code") 1 and voluminous regulations promulgated by the United States Department of the Treasury or as interpreted by courts at every level, by learned authors, or by taxpayers and their advisors, is consistent or readily understood. In the area of sales of partnership interests, for example, contortions abound. Before 2018, where a partnership with foreign partners engaged in a U.S. trade or business sold its business assets, any resulting gains were allocated to the partners and they were taxable on the gains under section 871(b) or 882. On the other hand, if the foreign partners sold their partnership interests, they could take the position that, assuming no U.S. real property interests were involved, 2 the gain was not effectively connected with the conduct of a trade or business in the United States. To rub salt in the government wound, the buyer would not only have a basis in the partnership interest equal to what it had paid (presumably fair market value) but the partnership could make an election under section 754 to step up the basis of the partnership's assets, with the benefit of the step-up being specially allocated to the buyer.

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In response, the IRS felt it necessary in 1991 to protect the fisc by inventing a rule that treats a foreign partner's disposition of its interest in a partnership that is engaged in a trade or business through a fixed place of business in the United States as a disposition of an aggregate interest in the partnership's underlying property for purposes of determining the source of the gain or loss realized by the foreign partner and is character as effectively connected income. **3** The ruling adds a presumption that all gain from sale of an interest in a partnership that is engaged in a trade or business is ECI gain, "unless the partner is able to produce upon request information showing the distributive share of net ECI and net non-ECI gain or loss that such partner would have been allocated if the partnership sold all of its assets." This ruling was widely criticized from the beginning. **4** We will not delve into these criticisms, save to say that the IRS position was quite rightly dismantled by the Tax Court in 2017. **5** Congress' response does not appear to have been driven by a thoughtful policy decision making process. Instead, the response was swift, so swift in fact, that we were left with what may be, word for word, one of the foremost examples of how not to reform the tax law. In our view, Congress may have ended up with the wrong solution to the wrong problem. **6**

Grecian Magnesite and the Legislative Response: Sections 864(c)(8) and 1446(f)

In *Grecian Magnesite*, the Tax Court agreed with the taxpayer that the gain derived from the sale of the partnership interest could not be treated as a sale of the underlying assets. The Tax Court also rejected the IRS argument that the gain was attributable to a U.S. office of the taxpayer. The taxpayer did not in fact have its own U.S. office, but the IRS argued that the office of the partnership should be attributed to the taxpayer **7** and that the sale was attributable to that office. On appeal, the IRS did not challenge the taxpayer's position that it had sold a single asset, the partnership interest, rather than an interest in the underlying assets of the partnership. But it continued to contend for its argument that the gain was attributable to a U.S. office. In 2019, the DC Circuit upheld the Tax Court and rejected that argument, holding that what the statute required was that the sale (not the gain) be attributable to the permanent establishment and that the sale was not so attributable.

While this was going on, Congress was on the lookout for revenue to offset the costs of tax reform legislation. Without holding hearings and with no apparent deliberation, it revived a proposal, first advanced under the Obama administration, **8** to tax gains of foreign partners from the sale of interests in partnerships engaged in a U.S. trade or business. **9** The proposal appeared in the fiscal 2014 budget and the Treasury also announced it was developing regulations that would have adopted the IRS position in **Rev. Rul. 91-32** , at a time when the Grecian Magnesite case had already begun its journey through the courts. The budget proposal included a 10% withholding requirement (10% was also the rate of withholding required by FIRPTA before enactment of the PATH Act in 2015). Congress did not adopt the Obama Administration proposal, nor was it taken up by the Trump Administration. Proposed regulations never saw the light of day.

One result of the revenue hunt in the last two months of 2017 was the enactment of sections 864(c)(8) and 1446(f) into the Code by Public Law 115-97 (2017), informally known as the Tax Cuts and Jobs Act (the "2017 Act"), which was enacted on December 22, 2017. **10** The time between inclusion of the provision in a bill and its enactment was brief and Congress held no hearings on the provision. The outcome, as we shall see, was a mess that was left to the Treasury Department and the IRS to clean up. Congress has shown no inclination to pause and reflect on what it had done. **11** **Section 864(c)(8)(A)** provides that gain or loss of a nonresident alien individual or foreign corporation (a "foreign transferor") from the sale, exchange, or other disposition ("transfer") of an interest in a partnership that is engaged in any trade or business within the United States is treated as effectively connected gain or loss to the extent such gain or loss does not exceed the amount determined under section 864(c)(8)(B). In general, section 864(c)(8)(B) limits the amount of effectively connected gain or loss to the portion of the foreign transferor's distributive share of gain or loss that would have been effectively connected if the partnership

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had sold all of its assets at fair market value (the deemed sale limitation).

In parallel, section 1446(f) provides that, with exceptions, if any portion of the gain (if any) on any disposition of an interest in a partnership would be treated under section 864(c)(8) as effectively connected with the conduct of a trade or business within the United States, the transferee shall be required to deduct and withhold a tax equal to 10% of the amount realized on the disposition. The only statutory exception applies where the transferor provides a nonforeign affidavit or where the IRS, on request by the transferor or the transferee, prescribes a reduced amount. If a transferee fails to withhold any required amount, the partnership is required to deduct and withhold from distributions to the transferee a tax in an amount equal to the amount the transferee failed to withhold, plus interest. The Treasury and the IRS are given broad authority to provide for exceptions to these requirements.

On September 21, 2020, the Treasury Department promulgated final regulations under section 864(c)(8). **Reg. § 1.864(c)(8)-1(b)** states a foreign transferor that directly or indirectly owns an interest in a partnership engaged in the conduct of a trade or business within the United States must treat a gain or loss from the transfer of that interest as effectively connected gain or loss to the extent such gain or loss does not exceed the amount determined under **Reg. § 1.864(c)(8)-1(b)** . **12** **Reg. § 1.864(c)(8)-1(b)** limits the amount of effectively connected

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gain or loss ("deemed sale EC gain" and "deemed sale EC loss") to the portion of the foreign transferor's distributive share of gain or loss that would have been deemed sale EC gain or loss if the partnership had sold all of its assets at fair market value. **13 Reg. § 1.864(c)(8)-1** applies to transfers made and amounts received on or after December 26, 2018 and to installment sales (453(b)) occurring on or after November 17, 2017. **14** Shortly afterwards, on November 30, 2020, the IRS promulgated final regulations under section 1446(f) **15** .

Overall, we may say that, in addressing the farrago produced by the harried drafters of the 2017 Act, the Treasury Department and the IRS have struggled mightily and, mostly, effectively. Still, it cannot be said that the overall outcome makes all that much sense, at least when one considers how much complexity has been introduced by the statute. On the other hand, given the material the tax administration was forced to work with, a completely sensible outcome was probably not to be expected.

The Substantive Taxing Rule: Section 864(c)(8) : Statutory Framework

The core provision of section 864(c)(8)(A) states:

> Notwithstanding any other provision of this subtitle, if a nonresident alien individual or foreign corporation owns, directly or indirectly, an interest in a partnership which is engaged in any trade or business within the United States, gain or loss on the sale or exchange of all (or any portion of) such interest shall be treated as effectively connected with the conduct of such trade or business to the extent such gain or loss does not exceed the amount determined under subparagraph (B).

Therefore, for the statute to apply: (1) The partnership must be engaged in a U.S. trade or business, whether directly or because of section 875(1); and (2) the foreign partner must own, directly or indirectly, an interest in the partnership. A sale or exchange includes any disposition. **16** This provision is a potential source of confusion since dispositions that are not sales or exchanges generally do not produce gain or loss. Any understanding of the statute and the regulations requires taking into account two fundamental points: First, what is being taxed is outside gain, that is the difference between the foreign partner's proceeds of sale and the basis in the partnership interest being disposed of. **Section 864(c)(8)** generally does not directly impose a tax on unrealized gains of the partnership. It taxes foreign sellers of partnership interests by characterizing gain as ECI. As we shall see, however, tax may be imposed even if there is no actual gain if there is underlying gain on section 751 assets of the partnership. Second, the entire gain or loss on the sale of the partnership interest is treated as ECI, subject to the limitation in subparagraph (B). As we shall see, this prioritizes gain attributable to increases in value in U.S. business assets over increases in value of any other partnership assets. There is no statutory rule of apportionment, where gain might be apportioned in some manner between increases in the value of the partnership's U.S. trade or business assets and increases in the value of its other assets. Perhaps treaties may require apportionment, but the statute clearly does not. **17** We can expect that in many cases, partnership interests will be sold at a discount to the underlying asset values and the prioritization will artificially shift taxation in favor of ECI gain. Moreover, as we shall see, inconsistent results will follow if the difference between outside and inside gain is the result of a sale or inheritance of a partnership interest and a section 754 election has or has not been made.

The statute does not contain a source rule. It may be that such a rule is not needed since section 871(b) and section 882 impose tax on ECI without requiring that the ECI have a U.S. source. But section 864(c)(4) provides a general rule that with exceptions that generally will not apply to the sale of a partnership interest, no income or gain from sources outside the United States is to be treated as effectively connected with a U.S. trade or business. No exception is made for income that is ECI under section 864(c)(8). We can be certain that the IRS will argue that a specific provision about partnership interests, enacted later than section 864(c)(4), will override the general rule. But as we shall see, it is perfectly possible for the two provisions to coexist, even if that is not what the IRS would like.

Calculating the Limit on the Amount of Deemed Sale EC Gain and Loss

Section 864(c)(8)(B) places a limit on the amount of gain that is treated as ECI. Leaving aside the interaction of this rule with FIRPTA, which is discussed below, the limit may have little practical effect in the case of a partnership engaged only in U.S. trade or business activities. But where the partnership is engaged in multiple activities, some of which consist of a U.S. trade or business and some of which do not, the limit comes into play. Examples might include a multinational service partnership or an investment partnership that invested in a mix of C corporations and active business LLCs. The limit is stated by the statute to be the portion of the partner's distributive share of the amount of gain which would have been ECI if the partnership had sold all of its assets at their fair market value as of the date of the sale or exchange of such interest, or zero if no gain on such deemed sale would have been ECI. We will refer to this as the "deemed sale". The regulations provide a number of rules regarding the computations required by the deemed sale. The statutory language does not adjust the limit where a partner sells less than all of a partnership interest. However, the regulations address this, as described below in relation to Step 3 of the calculation.

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The regulations provide a three-step process to determine the limit of EC capital gain or loss and EC ordinary gain or loss:

(1) Determine the amount of gain or loss that the partnership would recognize on the hypothetical sale;
(2) determine the amount of that gain or loss that would be treated as deemed sale EC gain and deemed sale EC loss; and
(3) determine the foreign transferor's distributive share of the ordinary and capital parts of any deemed sale EC gain and deemed sale EC loss. **18**

The regulations limit the amount of deemed sale EC gain and loss. [19] As a result of sections 741 and 751 and the regulations discussed below, gain or loss on a sale or exchange of a partnership interest can comprise capital gain, capital loss, ordinary income, or ordinary loss (or a combination).

Step one: Determine the sale gain or loss that the partnership would recognize with respect to each of its assets on the deemed sale. A deemed sale is defined as the sale by the partnership to an unrelated person of each of its assets for cash in an amount equal to the fair market value of each asset immediately before the deemed sale of certain partnership interests. The assets sold in the deemed sale do not include interests in partnerships if those partnerships are engaged in a U.S. trade or business. Instead, starting at the lowest tier partnership that is engaged in a trade or business, each partnership in the chain is treated as engaging in a deemed sale of its assets and must determine the distributive shares of deemed sale EC gain and loss of each partner that is a partnership or is a foreign transferor. Unfortunately, the regulations do not include an example of a tiered partnership structure. The rules may be necessary to get to the precise result anticipated by the language of the statute, but it may be expected that in multi-tiered partnerships, getting the information may prove quite challenging.

Step two: Determine the amount of the deemed sale gain or loss that would be treated as deemed sale EC gain and deemed sale EC loss connected with the conduct of a trade or business within the United States. Step 2 requires an asset-by-asset determination of gain or loss from the deemed sale and then a determination of whether any such gain or loss is treated as effectively connected. There is an immediate exception for gain or loss from an asset (other than a U.S. real property interest) that, in the previous 10 years in the hands of the partnership, the foreign transferor, or any predecessor of either, has neither produced EC income or gain nor been used or held for use in the conduct by any of the foregoing of a U.S. trade or business. The regulations provide sourcing rules for determining deemed sale EC gain and loss. These are needed because no actual sale of the partnership assets is taking place. These rules key off section 865. A general rule, subject to special rules for certain categories of assets set out below, deems all sales to be attributable to a U.S. office or fixed place of business if one is maintained by the partnership. In the absence of such an office or fixed place or business, neither the general rule nor the special rules apply, presumably leaving section 865 to apply without modification by the section 864(c)(8) regulations.

The special rules apply as follows:

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- Inventory. A portion of the deemed sale is not attributed to an office of fixed place of business to the extent of the "foreign source inventory ratio". The ratio is defined by reference to the foreign source gross income attributable to inventory sold during the three taxable years preceding the date of the deemed sale (or a shorter period starting when the partnership and any predecessor was formed and ending on the last day of the taxable year immediately preceding the date of the deemed sale).
- Intangibles. A similar rule applies to the deemed sale of intangibles, which are defined to

include going concern value. **20** The regulations require attribution based on the foreign source intangible ratio (not to exceed 1; zero if the ratio would be negative). The ratio is the gross ordinary income from foreign sources that was not ECI during the lesser of the same three-year or shorter period applicable in the case of inventory. The regulations do not change the rules under which foreign source income from inventory and intangibles can be treated as ECI. **21** In addition, bearing in mind that the three-year look-back period is intended as a reasonable way of allocating gain based on recent history, a modified look-back period may be used if use of such a period would result in a difference in the relevant ratio of at least 30 percentage points. **22**

- Depreciable personal property. This requires a two-step process. First, with respect to depreciation recapture, a deemed sale of depreciable personal property, including from the sale of an amortizable intangible, is not treated as attributable to a U.S. office or fixed place of business to the extent the deemed sale gain would be treated as foreign source after applying section 865(c)(1). **23** Second, any deemed sale gain in excess of the depreciation recapture and any deemed sale loss is determined based on location of the property.

Step three: Determine the foreign transferor's distributive share of the deemed sale EC gain or loss amounts from step two. This determination is made taking into account all applicable Code sections including, naturally, section 704 and including the allocation of tax items applying the principles of section 704(b) and (c) and section 743 basis adjustments. Although not explicitly stated, this requires application of the allocation provisions of the partnership agreement, assuming these meet the requirements for allocation to have substantial economic effect. This share does not include any amount that is excluded from the foreign transferor's gross income or otherwise exempt from U.S. Federal income tax or to which an exception under section 897 applies. Special rules for applying the provisions of U.S. income tax treaties are described below.

Ordinary gain or loss is determined by taking into account the portion of the foreign transferor's distributive share of deemed sale EC gain and loss that is attributable to the deemed sale of the partnership's assets in 751(a). Capital gain or loss is determined by taking into account the portion of the foreign transferor's distributive share of deemed sale EC gain and loss that is attributable to deemed sale of assets not 751(a) property; and the deemed sale EC gain and loss from the sale of assets that are not 751(a) and that would be allocated to the foreign transferor with respect to all interests in the partnerships that are engaged with the conduct of trade/business within the U.S. If there is a partial transfer, the distributive share of deemed sale EC gain and loss is determined by reference to the amount of deemed sale EC gain or loss that is attributable to the portion of foreign transferor's partnership interest that is transferred. **24**

Outside Gain Limitation

Critically, except as discussed below where the partnership has section 751 "hot assets", the tax can only be imposed if the amount realized by the foreign partner exceeds the basis in the partnership interest. This has a couple of obvious consequences. First, even in the case of a partnership the only activities of which consist of a U.S. trade or business, the taxable gain will be limited to the gain at the partner level. This is important because otherwise, in the absence of a section 754 election, a succession of transfers of the same partnership interest could result in repeated taxation of the same inside gain (not yet realized and perhaps never to be realized). Second, the partnership will act as a mixing bowl so that there will be no tax if the partnership has significantly appreciated U.S. business assets but depreciated other assets of any description and the result is that there is no appreciation in the value of the partnership interest. If we compare this with a partnership sale of its assets, the foreign partner would be taxable on the allocable share of the ECI gains and these would not be offset by losses on the non-ECI assets (wherever located). The following simplified example illustrates the outside gain limitation.

Special rules apply where the partnership has section 751 ordinary income or loss. In that case, it is possible for the amount receivable from section 751 assets (unrealized receivables and inventory items) to result in taxable ordinary gain even if the partnership interest is being sold at a loss. **25**

Effect of section 754 election

Consider the following example:

> P has no liabilities and a trade or business which holds ECI assets with a basis of $4,000 and a fair market value of $6,000 and other assets with a basis of $2,000 and a fair market value of $4,000. P's assets therefore total $10,000 in value and P has a total of $4,000 of unrealized appreciation. FP sells his 50% interest in P for $5,000.
>
> In many cases, especially if FP has always been a partner, his basis in his P interest will be $3,000 and his gain will consist of $1,000 of ECI gain and $1,000 of non-ECI gain.
>
> But suppose FP's basis had purchased his P interest for $4,000. His total gain is only $1,000. The ECI limitation is 50% of P's ECI gain, or $1,000. In other words, all of FP's gain will be taxable because ECI gain is prioritized over other gain, even though some of the increase in value of P is due to the appreciation in the non-ECI assets.

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Now consider the effect of a section 754 election. First, let's suppose the appreciation in the partnership's ECI assets took place after the acquisition and the appreciation of the other assets occurred before the acquisition. Let's compare the position in the above example with the position if a section 754 election had been made.

> In the above example, suppose that when FP purchased the 50% interest in P for $4,000, the ECI assets had a fair market value of $4,000 and the non-ECI assets had a fair market value of $4,000. Suppose further that the partnership made the section 754 election. Therefore, FP would be allocated special basis in the ECI assets of $2,000 and the non-ECI assets of $2,000.
>
> Now suppose that the ECI assets increase in value to $6,000, but the non-ECI assets do not appreciate and remain at $4,000. FP sells the 50% interest in P for $5,000. FP's ECI gain will be $1,000 and the non-ECI gain will be zero. That gets us the same result as in the case where no election had been made. But let's change the facts so that the ECI assets did not increase in value after FP's purchase of the interest in P but the non-ECI assets did increase.
>
> With these changed facts, the ECI assets had a fair market value at the time of the purchase of $6,000 and the non-ECI assets had a fair market value of $2,000. Again, the partnership made a section 754 election. Therefore, FP would be allocated special basis in the ECI assets of $3,000 and the non-ECI assets of $1,000.
>
> Now suppose that the ECI assets remain valued at $6,000, but the non-ECI assets appreciate from $2,000 to $4,000. FP sells the 50% interest in P for $5,000. FP's ECI gain will be $0 and his non-ECI gain will be $1,000.

In all these examples, the outside gain is $1,000 but the ECI gain differs according to whether a section 754 election was made. Should it? We think that the effect of the statute is prioritization of inside gain that is ECI gain. But, as discussed below, if there is a treaty, perhaps the result should change.

Application of Treaties to Computation of ECI Gain and Loss

An applicable treaty is taken into account when computing the amount of the foreign transferor's distributive share of deemed sale EC gain and loss. Deemed sale gains that would be exempt from tax under a treaty are not taken into account of the foreign transferor's aggregate deemed sale EC items. The foreign transferor must be a resident of the country in which it is invoking the treaty and must meet requirements of the limitation on benefits article, if any. **26** Gain or loss on the alienation of a partnership interest will be treated as EC gain or loss to the extent it is attributable to assets forming part of a permanent establishment or fixed place of business in the United States. If a gain would be ECI gain but is not attributable to a permanent establishment, based on the treaty with the country of the foreign partner, then it is not taken into account. **27** If after applying treaty benefits, the only gains or losses that would be taken into account are gains or losses attributable to U.S. real property interests, the foreign transferor determines its deemed sale EC gain and deemed sale EC loss pursuant to section 897 and not under section 864(c)(8)-1. 28

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There is an unresolved question concerning the relationship between section 864(c)(8) and gain recognition articles typically found in our income tax treaties. Most U.S. treaties contain a gains article that prevents the United States from taxing a capital gain realized by a treaty resident, with exceptions. The question can be broken down into two: First, does the typical gains article by its terms permit the taxation of section 864(c)(8) gain? Second, if it does not, would section 864(c)(8) override treaties with such an article?

Do treaties permit taxation under section 864(c)(8)? The language of gains articles in treaties varies. The U.S. Model Income Tax Treaty of 2016 provides a typical exception to the rule assigning taxing rights to the country of residence:

> Gains from the alienation of movable property forming part of the business property of a permanent establishment that an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other Contracting State. 29

We have not undertaken a comprehensive survey of capital gains articles but, at least with respect to treaties that follow the various U.S. models, the language about alienation of a permanent establishment leaves uncertain the answer to the question of whether the model treaty provision would permit tax to be imposed under section 864(c)(8).

In the preamble to the final regulations, the government states that:

> The final regulations clarify that a gains article that permits the taxation of gain from the alienation of property forming part of a permanent establishment or fixed place of business in the United States also permits the taxation of gain from the alienation of a partnership interest, to the extent the partnership's assets deemed sold under section 864(c)(8) form a part of the U.S. permanent establishment or fixed place of business of the partnership.

This is not quite what the regulations themselves say. The regulations do not say anything about permission; they merely say that gain or loss will be considered to be attributable to the alienation of assets forming part of the permanent establishment. The exact language is as follows:

> Gain or loss from the alienation of a partnership interest will be considered gain or loss attributable to the alienation of assets forming part of a permanent establishment or fixed place of business in the United States to the extent the assets deemed sold under section

> 864(c)(8) form a part of the U.S. permanent establishment or fixed place of business of the partnership.

This is a dubious piece of treaty interpretation. Treaties may permit gain from the alienation of a permanent establishment but does that do more than allow the United States to tax a treaty resident partner on his allocable share of a sale *by the partnership* of the permanent establishment? A partner that sells a partnership interest is not selling a permanent establishment. The partner is selling a capital asset, as confirmed by the courts in *Grecian Magnesite. Grecian Magnesite* was not overruled by Congress. All Congress did was to provide that gain on the sale of a partnership interest would be treated as ECI, subject to the deemed ECI limitation. There is also the problem created by the way the deemed ECI limitation works. As discussed above, the statute prioritizes ECI gain over non-ECI gain. But is this prioritization valid under the standard treaty language above, which allows taxation of "gains from the alienation of the permanent establishment"? Any reasonable analysis of the facts in the example would conclude that FP's gain was attributable to both the ECI assets and the non-ECI assets and, even if some gain is taxable, it should be apportioned in some manner.

Does section 864(c)(8) override treaties? Suppose that, contrary to the IRS contention, the standard language of the gain article of a treaty does not permit the taxation of gain from sale of a partnership interest. If so, does section 864(c)(8) override the treaty? The IRS has not felt it necessary to address this question, because it decided that taxation under section 864(c)(8) is permitted by treaties but were the question to arise we think that the answer is negative. Congress certainly has the power to override a treaty and has done so on more than one occasion in the past forty years. In the case of section 864(c)(8), however, Congress was silent, primarily because of the manner in which the 2017 Act was enacted, through the budget reconciliation process. Under the Congressional Budget Act of 1974, budget reconciliation is a procedure the purpose of which is make changes to substantive law so that revenue and mandatory spending levels are brought into line with budget resolution policies. **30** Under the Byrd rule, so-called "extraneous matter" may not be included in the reconciliation process that

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allows passage by the Senate of a budget reconciliation bill by a simple majority, rather than a filibuster-proof 60 votes. One form of extraneous matter is a provision that is outside the jurisdiction of the committee that submitted the provision. **31** Tax treaties fall within the jurisdiction not of the Senate Budget Committee or Finance Committee but of the Committee on Foreign Relations. There was no time to submit the bill that resulted in the 2017 Act to the Committee on Foreign Relations and a statutory treaty override (or even an expression of intent in the legislative history for the 2017 Act to override treaties) would have violated the Byrd rule and would likely have been rejected by the Senate parliamentarian.

We would therefore argue that Congress did not intend section 864(c)(8) to override any treaty. The IRS will have to rely on its treaty interpretation approach that taxing gains under section 864(c)(8) is permitted by standard treaty language - an approach that seems at least questionable. Any taxpayer intending to exempt gain based on a treaty should disclose the position on Form 8833 (Treaty-Based Return Position Disclosure Under **Section 6114** or **7701(b)**). Even if the taxpayer is arguing that the treaty does not permit taxation of any gain on sale of the partnership interest, contrary to the IRS interpretation, a properly worded Form 8833 disclosure should be sufficient and it will not be necessary to file Form 8275-R (Regulation Disclosure Statement). **32**

Finally, whether or not section 864(c)(8) is consistent with treaties and whether or not it is overridden by treaties, the FIRPTA treaty override remains in effect. That override took effect in 1985 and many U.S. treaties have in any case been renegotiated to give the United States the right to apply the principles of FIRPTA. **33**

Nonrecognition Rules

A foreign transferor's gain or loss recognized in connection with the transfer of the partnership interest does not include gain or loss to the extent it is not recognized by reason of one or more nonrecognition provisions of the Code. **34** The nonrecognition rule is generally favorable to taxpayers and perhaps we should not look a gift horse in the mouth. Nevertheless, it does not take much imagination to see how this rule may have questionable results. Consider first a transaction in which a foreign partner transfers a partnership interest to a domestic corporation in a simple tax-free incorporation. (Assume no U.S. real property interests are involved.) Such a transaction will not be taxable to the foreign partner. Nor would a subsequent sale of stock in the domestic corporation. The principal adverse effect to the foreign partner will be that the domestic corporation will take a carryover basis in the partnership interest and the basis in the underlying partnership assets cannot be stepped up using a section 754 election. This may not matter to the foreign partner because of the ability to sell the stock of the corporation tax-free but it will readily be understood that a buyer of the stock will likely exact a reduction in the purchase price compared to the price that would have been paid for a partnership interest or for the partnership assets. The alternative is that the buyer would insist on buying the partnership interest or, in some circumstances, the partnership assets, a transaction which in either case would be taxable to the domestic corporation. An individual foreign partner might nevertheless undertake the transaction to avoid estate tax on the value of the stock of the domestic corporation. For example, the foreign partner might be resident in a country with a suitable estate tax treaty. **35** Alternatively, the foreign partner could contribute the stock of the domestic corporation to a foreign corporation if this could be done without triggering application of the inversion rules of section 7874. **36**

Beyond a simple tax-free incorporation, consider a partnership with both U.S. trade or business assets and other assets. A foreign partner might have its

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partnership interest redeemed with the non-U.S. trade or business assets. Generally speaking, a partner does not recognize gain or loss on a redemption unless cash or other liquid assets are distributed in excess of the partner's basis in the partnership interest. The foreign partner could then dispose of the distributed assets tax-free. This does not seem consistent with the intent of section 864(c)(8), even though the unrealized gain in the partnership's U.S. trade or business assets would eventually be taxed to the remaining partners either on sale or on sale of those partners' partnership interests. Or consider a situation where a partnership with both U.S. trade or business assets and other assets distributed the U.S. trade or business assets in redemption of the interest of a U.S. partner, leaving the remaining partners as the owners of a partnership with fewer or no U.S. trade or business assets. In this situation, the foreign partner will not have disposed of anything - there has been no realization event.

The preamble to **TD 9919** recognizes that "certain nonrecognition transactions, for example certain section 731 distributions, may have the effect of reducing gain or loss that would be taken into account under the rules provided in the proposed regulations." The preamble to the proposed regulations had requested comments on this point and noted that one comment had addressed the matter in some detail. The preamble to the final regulations noted that "The Treasury Department and the IRS are continuing to study this issue and will, if necessary, address it through future rulemaking." The government appears to have authority to issue such rules, although the relevant provision does not specifically mention section 731. **37** At present, there is no active regulations project - we understand that the IRS is waiting to see if the issue is being encountered in practice and not just, perhaps, in the fevered imaginations of the authors.

Coordination with FIRPTA

Section 864(c)(8)(C) provides that if a partnership holds U.S. real property interests, EC gain or loss is reduced by the amount treated as ECI with respect to the USRPI under section 897. However, the regulations reverse this statutory rule. The regulations provide that if a foreign transferor transfers a partnership interest in a transfer that is subject to section 864(c)(8) and the partnership owns one or more U.S. real property interests, then the foreign transferor determines its effectively connected gain and effectively connected loss under the section 864(c)(8) regulations and not pursuant to section 897(g). **Section 897(g)** continues to apply if the transfer is not subject to 864(c)(8). This can occur, for example, if a nonrecognition provision would prevent the application of section 864(c)(8). **38**

The Withholding Rule: Section 1446(f)

Congress decided that compliance with section 864(c)(8) needed to be assured though a third-party withholding requirement. Therefore, section 1446(f)(1) requires the buyer of a partnership interest to withhold tax and, where the buyer failed to withhold, section 1446(f)(4) requires the partnership to withhold tax on distributions by the partnership to the buyer. The language of section 1446(f) is quite broad and has been expanded by the regulations so that withholding can apply to transactions that do not involve foreign persons at all and, at the other end of the spectrum, can apply in theory to transactions where neither the parties, nor the partnership, have any connection at all to the United States.

At present, the situation somewhat resembles the position that followed the enactment of FIRPTA withholding under section 1445 in 1984 and effective beginning in 1985. **Section 1445** requires a buyer of a United States real property interest to withhold tax at 15% (10% before enactment of the PATH Act in 2015) of the amount realized by the foreign seller unless the parties are able to take steps to reduce or eliminate withholding. It is quite simple to avoid withholding in a purely domestic transaction if the seller certifies to the buyer that it is not a foreign person and such certifications have become entirely routine in U.S. real estate transactions. But for several years after enactment of section 1445, this prophylactic measure was largely unknown to the U.S. real estate community, with the result that very many real estate transactions may have closed without transferees assuring themselves that they were dealing with a U.S. person. Had the IRS chosen to make an issue of this and conduct a campaign to impose penalties for what can reasonably be described as foot faults, it might have ensnared enormous numbers of buyers and other withholding agents (such as escrow companies, title companies, and attorneys) who could not produce evidence that the transferor was a U.S. person. At best, they would have been required to scramble to find their sellers and establish that they were domestic; at worst, they could have been subject to interest and penalties. Fortunately, the IRS did not focus on this issue and gradually the compliance problem disappeared and nonforeign certificates became a routine part of real estate closings. **39** We cannot, however, expect such restraint from the modern IRS, which in recent years has been imposing very heavy penalties with respect to international reporting forms, even in cases of minor foot faults and even when no actual income was unreported and no actual tax has been avoided.

Section 1446(f)(1) requires that if any portion of the gain (if any) on any disposition of an interest in a partnership would be treated under section 864(c)(8) as effectively connected with the conduct of a trade or business within the United States, the transferee must deduct and withhold

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an amount equal to 10% of the amount realized on the disposition. **40** This language requires that at least a portion of the gain (if any) would be ECI under section 864(c)(8). If even a tiny portion of the gain is section 864(c)(8) ECI, 10% of the entire amount realized must be withheld. There is only one statutory exception, which applies if the transferor furnishes an affidavit to the transferee under penalty of perjury providing the transferor's taxpayer identification number and stating that the transferor is not a foreign person. The IRS is given the authority to prescribe a reduced amount if it determines that the reduced amount will not jeopardize the collection of tax on section 864(c)(8) gain.

As described above, section 1446(f)(4) backs up the requirement for transferees to withhold by requiring the partnership to deduct and withhold from distributions to the transferee an amount equal to the amount the transferee failed to withhold (plus interest on such amount). The IRS has authority to prescribe regulations and other guidance to carry out the purposes of section 1446(f), including providing for exceptions to withholding.

Withholding on the Transfer of a Publicly Traded Partnership (PTP) Interest

The regulations differentiate between the transfer of a non-PTP interest and a PTP interest. Where the sale of a PTP interest is effected through one or more brokers, withholding responsibility rests with the brokers, rather than with the buyer. **41** This makes sense because in virtually all cases, a buyer and seller in the public markets may have no connection or direct dealings with each other. The requirement to withhold arises if either the broker pays an amount realized on the sale of a PTP interest to another broker that it is required to treat as foreign or if it pays such an amount to its foreign customer. **42** Where the payment is made to a foreign broker, no withholding is required if the broker making the payment obtains documentation establishing that the foreign broker is a qualified intermediary that has provided a valid qualified intermediary certificate stating that the foreign broker is assuming primary withholding responsibility. **43** Withholding is also not required if the broker is a U.S. branch of a foreign person that provides a valid U.S. branch withholding certificate that states that the U.S. branch agrees to be treated as a U.S. person with respect to the payment. **44** Qualified intermediaries and U.S. branches must assume responsibility for any distribution from a PTP for which the intermediary or branch acts as a nominee. **45**

Exceptions to Withholding

Where the payment is made to a foreign customer, withholding is required unless an exception applies. Among the exceptions:

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- U.S. clearing organizations do not need to withhold although they may continue to be subject to reporting requirements. **46**
- No withholding is required by a broker that receives a payment that has already been subject to withholding. **47**
- The broker relies on a certification of: (1) non-foreign status; **48** (2) a treaty certification; **49** (3) a certification that the transferor is a foreign dealer in securities and that any gain from the transfer of the PTP interest is effectively connected with the conduct of a trade or business within the United States; **50**
- Qualified notice exception. **51** A broker may rely on a qualified notice. **52** If a broker properly relies on a qualified notice that results in under withholding on a transfer of a PTP interest, the publicly traded partnership that issued the notice is solely liable for the under withheld tax under section 1461. **53**

- The 10-percent exception applies to a transfer if, on the PTP designated date: **54** (1) the PTP sold all of its assets at fair market value and either (i) the amount of net gain that would have been effectively connected with the conduct of a trade or business within the United States would be less than 10% of the total net gain; or (ii) no gain would have been effectively connected with the conduct of a trade or business in the United States; or (2) the partnership was not engaged in a trade or business within the United States at any time during the taxable year of the partnership through the PTP designated date.
- The amount subject to withholding under section 3406 (backup withholding). **55**

Determining the Amount to Withhold

A broker required to withhold under the PTP rules must withhold 10% of the amount realized on the transfer of the PTP interest. **56** The amount realized is the amount of gross proceeds paid or credited upon the transfer to the customer or other broker. **57** In the case of a distribution, the amount realized on a distribution from a publicly traded partnership is the amount of the distribution reduced by the portion of the distribution that is attributable to the cumulative net income of the partnership. The cumulative net income is the net income earned by the publicly traded partnership since its formation that has not been previously distributed by the partnership. A publicly traded partnership identifies such excess portion of the distribution as an amount in excess of cumulative net income on a qualified notice posted with respect to the distribution. If a broker properly withholds based on the qualified notice, the broker is not liable for any under withholding on any amount attributable to an amount in excess of cumulative net income. Rather, the publicly traded partnership that issued the qualified notice is solely liable for the under withheld tax under section 1461 on such amount that results from a broker's reliance on the notice. **58**

When a transferor is a foreign partnership, the broker may treat the modified amount realized as the amount realized to the extent it may rely on a certification from the transferor providing the modified amount realized. The modified amount realized is determined by multiplying the amount realized by the aggregate percentage computed as of the determination date. **59** The aggregate percentage is the percentage of the gain arising from the transfer that would be allocated to presumed foreign taxable persons. **60** A broker may rely on a withholding certificate and withholding statement that it already possesses from the partnership unless it has actual knowledge that the information is incorrect or unreliable. **61**

A broker that is required to withhold under this rule must pay the withheld tax pursuant to the deposit rules. **62** A broker that pays the amount realized to a foreign partnership must issue a Form 1042-S directly to the partnership rather than issuing a form to each of the partners of the partnership. A broker making a payment to a U.S. branch treated as a U.S. person must not treat the branch as a U.S. person for purposes of reporting the payment made to the branch. Therefore, a payment to that U.S. branch must be reported on Form 1042-S. A Form 1042-S issued directly to the transferor must include the TIN of the transferor unless the broker does not know the TIN at the time of issuance. **63** Withholding does not relieve a foreign person from filing a U.S. tax return with respect to the transfer and does not relieve a foreign person subject to tax on gain by reason of section 864(c)(8) from paying any tax due with the return that has not been fully satisfied through withholding. **64**

Non-PTP Interests

As noted earlier, section 1446(f)(1) requires that if any portion of the gain on any disposition of an interest in a partnership would be treated under section 864(c)(8) as ECI, the transferee must withhold a tax equal to 10% of the amount realized on the disposition. The regulations, on the other hand, provide that except as otherwise provided, a transferee is required to withhold under section 1446(f)(1) a tax equal to 10% of the amount realized on any transfer of a partnership interest. The exceptions all require the provision of certifications of one sort or another, so that even if no portion of the gain would be treated as ECI, withholding is still required. **65** This regulatory formulation appears broader than the statute and, if taken literally, results in the Mongolian sheepherder problem described below.
Determining the amount to withhold. **66**

A transferee that is required to withhold under this section must withhold 10% of the amount realized on the transfer of the partnership interest. The amount realized includes the amount of cash paid (or to be paid), the fair market value of other property transferred (or to be transferred), the amount of any liabilities assumed by the transferee or to which the partnership interest is subject, and the reduction in the transferor's share of partnership liabilities. In the case of a distribution, the amount realized is the sum of the amount of cash distributed (or to be distributed), the fair market value of property distributed (or to be distributed), and the reduction in the transferor's share of partnership liabilities.

The regulations include alternative procedures for the transferee to determine

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the extent to which a reduction in partnership liabilities is includible in the amount realized. (No procedures are provided, nor are they likely to be needed, for computing the transferor's own liabilities that are assumed by the transferee.) First, a transferee (other than partnership) may rely on a certification of liabilities *by the transferor*, other than a controlling partner, that provides the amount of the transferor's share of liabilities shown on the partner's most recent Form K-1. If the actual share of liabilities differs from the amount shown on Form K-1, the certification is still valid if the transferor certifies that it has no actual knowledge of subsequent events that would cause the figure to differ by more than 25%. The partnership taxable year from Form K-1 must not have ended more than 22 months before the date of transfer. **67**

Second, a transferee may rely on a certification of liabilities *by the partnership* that provides the amount of the transferor's share of liabilities as of the determination date. The certification will be valid if the partnership also certifies that it does not have actual knowledge of any events occurring after the determination date and before the date on which the partnership provides the certification to the transferee that would cause the amount of the transferor's share of partnership liabilities at the time of the transfer to differ by more than 25%.

Finally, where a partnership makes a distribution subject to withholding, it may rely on books and records, absent actual knowledge that actual figure differs by more than 25%. The limitation on the amount to be withheld is the total amount realized excluding debt relief. This may be helpful when liabilities cannot be determined.

The transferee must withhold the entire amount realized (excluding debt relief) if he does not have actual knowledge and has not received certification from the transferor or partnership. This amount may be greater than 10% of entire amount realized. The transferee may rely on certification from a foreign partnership transferor as to the "modified" amount realized. This reflects a reduction for portion allocable to partners that are not "presumed foreign taxable persons." **68** Presumed foreign taxable persons do not include direct or indirect partners who properly certify non-foreign status or treaty exemption. A foreign partner certifying a modified amount realized must provide Form W-8IMY, withholding statement, and certifications from direct and indirect partners that are not presumed foreign taxable persons.

The transferee (other than a partnership that is a transferee because it makes a distribution) may rely on a certification provided by a foreign transferor regarding the transferor's maximum tax liability. A partnership that is a transferee may rely on its books and records if these satisfy various requirements. The maximum tax liability is defined as the transferor's EC gain (outside ordinary gain and outside capital gain) multiplied by the applicable percentage, which depends on whether the transferor is an individual (a trust or partnership is treated as an individual for this purpose) or a corporation. **69**

The certification must include:

- a statement that the transferor is a nonresident alien individual, foreign corporation, foreign partner, or foreign trust;
- the adjusted basis in transferred interest as of the determination date;
- the amount realized on the determination date;
- whether transferor remains a partner in the partnership immediately after the transfer;
- the amounts of outside ordinary gain and outside capital gain that are recognized and treated as EC gain under the section 864(c)(8) regulations;
- the transferor's maximum tax liability on the determination date (the transferor's maximum liability is the effectively connected gain multiplied by the highest rate applicable to type of income; branch profits tax not taken into account);
- a representation that it has provided the transferee with a statement received from the partnership, which must contain information about the partnership and the amounts of deemed sale EC ordinary gain and deemed sale EC capital gain. **70**

A key point is that this certification can be provided only if the partnership chooses to assist. It is easy to think of situations where the partnership would have

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no incentive to assist, including concerns about incurring liability, administrative burden, and difficulty or expense of securing information (or complete unavailability), especially fair market values.

Under the final regulations, the transferee must withhold unless the transferee receives one of seven specified certifications. Five certifications are provided by the transferor and two certifications are provided by the partnership. There is no exception from withholding in the absence of such a certification but as explained above the amount of withholding may be reduced in certain circumstances. **71**

A transferee may rely on a certification of non-foreign status from the transferor that states that the transferor is not a foreign person. **72** For this purpose, a U.S. person includes a transferor that is a domestic partnership, irrespective of the status of the partners. While a domestic partnership may provide a certification of non-foreign status, the partnership will have to withhold under section 1446(a) on the effectively connected taxable income allocable to any foreign partner. Similarly, a domestic non-grantor trust is a U.S. person and may provide a certification of non-foreign status, irrespective of the status of the beneficiaries. **73**

The gain is exempt from tax under an income tax treaty. **74** The certification is made on the appropriate form (on a Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals), or Form W-8BEN-E, Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)). The transferee may rely on the certification only if it mails a copy of the certification to the IRS within 30 days after the date of transfer. However, the exception does not apply if the treaty benefits only apply to a portion of the gain. In that case, a treaty may be relevant to the computation of the amount of the gain. **75** Furthermore, a transferor claiming treaty benefits with respect to all of the gain from the transfer must use the exception and not any other exception or determination procedure to claim an exception to withholding by reason of a claim of treaty benefits. **76**

No gain is realized by a transferor, including no ordinary income under section 751. A transferee (other than a partnership that is a transferee because it makes a distribution) **77** may rely on a certification from the transferor that states that the transfer of the partnership interest would not result in any realized gain to the transferor as of the date of the transfer. **78** In addition, a transferee may rely on a certification from the partnership stating that as of the determination date, the transfer would not result in any ordinary income under section 751. **79** A partnership that is a transferee because it is making a distribution may rely on its books and records, or on a certification from the transferor, to determine that the distribution would not result in any realized gain to the transferor as of the determination date. **80**

10% gross ECI exception

The transferee (other than a partnership that is a transferee because it is making a distribution) may rely on a certification that for each year during the look-back period, the transferor's share of the partner's gross ECI is (i) less than 10% of transferor's share of all of partner's gross income; (ii) less than

$1,000,000 (including gross ECI of certain persons related to transferor); and (iii) it must be reflected on a Schedule K-1 (or other statement) furnished by the partner. **81** The look-back period includes the last year of transferor with or within which a partnership taxable year ended and for which a Schedule K-1 (Form 1065) was due or furnished (if earlier) before date of transfer, and two prior years of the transferor. The transferor must have a distributive share of the partnership's gross income, which means that if the partnership has no gross income for any year in the look-back period, the 10% gross ECI exception is not available.

This is not helpful for a foreign partner in a partnership that does not file U.S. returns. Because the 10% gross ECI exception looks to the transferor's share of gross ECI, rather than ECTI, a transferor that has not been allocated any effectively connected income or loss in any relevant year and has not received a Form 8805 for such year, may still use the exception. It is beneficial in the case of structures where the partner directly holds an interest in the partnership but has not been allocated any ECTI.

The disposition qualifies, in its entirety, for nonrecognition. **82** "A transferee may rely on a certification from the transferor that states that by reason of the operation of a nonrecognition provision of the Code the transferor is not required to recognize any gain or loss with respect to the transfer. The certification must briefly describe the transfer and provide the relevant law and facts relating to the certification." **83** However, this section does not apply if only a

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portion of the gain realized on the transfer is subject to a nonrecognition provision. For example, a transaction that qualifies under section 351 would still require withholding if there were any boot. **84**

Partnership certifications

10% EC Gain Exception. A transferee (other than a partnership that is a transferee because it makes a distribution) may rely on a certification from the partnership that, in case of a deemed sale of all partnership assets for FMV: (i): the partnership would have no net EC gain, (ii) the partnership would have net EC gain, but the partnership's net EC gain would be less than 10% of partnership's total net gain, or (iii) the partnership's net EC gain would not be less than 10% of partnership's total net gain, but the transferor would have no distributive share of partnership's net EC gain; or the transferor's share of partnership's net EC gain would be <10% of transferor's share of partnership's total net gain.

Not engaged in a U.S. Trade or Business Exception ("not-ETBUS").

The partnership can certify that it has not been ETBUS at any time during taxable year of the partnership through the date of the transfer. **85** Theoretically, this may be helpful, but in practice many partnerships will not provide a certification of any kind. This is especially true if the certification involves complicated and mysterious terms under U.S. tax laws. A foreign partner transferor or the partnership may need to hire a U.S. tax lawyer, with special cross-border expertise, just to figure out what the certification means. Perhaps partnerships with no U.S. connection at all will be more willing to provide a certification regarding the Not-ETBUS exception than a certification based on the 10% EC gain exception. The requirement that the certification must be made through the date of the transfer presents a troublesome practical problem - how will such a certification be issued on the date of the transfer and transmitted to the transferee on the very same day, unless, perhaps, the transferor controls the partnership or has a strong relationship with the general partner or manager? The authors understand that the IRS is not willing to moderate this requirement.

Finally, a distributing partnership is permitted to not withhold if it relies on its books and records to determine that the requirements of any of the following exceptions are met **86** :

- No realized gain exception
- 10% gross ECI exception
- Transferor must represent that its allocable share of ECTI was properly reported
- 10% EC gain exception
- Not-ETBUS exception

Coordination with FIRPTA Withholding

A transferee that is otherwise required to withhold under section 1445 **87** with respect to the amount realized, as well as under section 1446(f)(1), will be subject to the payment and reporting requirements of section 1445 only, and not section 1446(f)(1), with respect to that amount. **88** However, if the transferor has applied for a withholding certificate, the transferee must withhold the greater of the amounts required under section 1445(e)(5) or 1446(f)(1). A transferee that has complied with the withholding requirements under either section 1445(e)(5) or 1446(f)(1) is deemed to satisfy the withholding requirement.

Non-Cash Transactions

It has long been established that a transferee that is a withholding agent is not excused from the requirement to withhold just because the consideration is not paid in cash and sometimes when no payment at all is made, if the payee is realizing income. **89** However, in the context of section 1446(f), this expansive rule may produce unexpected results.

Consider, for example, the liquidation of a foreign corporation not entitled to nonrecognition because the shareholder is not an 80% corporate parent or, even if it is, the transaction is taxable under section 367(e). If the foreign corporation distributes a partnership interest to a foreign shareholder, the transaction will be treated as if the corporation had sold the interest to its shareholder for fair market value. Plainly such a sale will be taxable to the liquidating foreign corporation but what about the foreign shareholder? Does it have to withhold? What is it supposed to withhold on?

Suppose the foreign corporation does not actually liquidate but instead checks the box to be classified as a partnership or a disregarded entity. According to the entity classification regulations, this is treated as if the corporation had distributed all of its assets and liabilities to its shareholder(s) in liquidation of the corporation, and if there is more than one shareholder, immediately thereafter, the shareholders contributed all of the distributed assets and liabilities to a newly formed partnership. **90** Again, the question arises - does the foreign shareholder have to withhold? But there are two further complications. First, the foreign shareholder may not even know that the check-the-box election has taken place, since an eligible entity can make the election without shareholder consent or involvement. Second, the deemed contribution of the liquidating corporation's assets will include the partnership interest and while this should be a nonrecognition transaction under section 721, it would be

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advisable for the electing foreign corporation to require a nonrecognition certification from all the shareholders. **91**

Another variant is where a foreign corporation distributes a partnership interest in a non-liquidating transaction. In that case, section 311(b) also treats the transaction as a sale of the interest to the shareholder for fair market value. But in this case, no consideration passes from the shareholder to the corporation, not even the deemed surrender of shares that occurs in a liquidation. So the question continues to be, on what does the shareholder withhold?

Some of these issues may reflect Congress' failure to include in section 1446(f) the equivalent of section 1445(e) that applies in the context of corporate liquidations and other distributive transactions. Under section 1445(e)(2), a liquidating foreign corporation is required to withhold tax at the maximum rate on the gain resulting from a distribution of an appreciated U.S. real property interest. A similar rule under section 1446(f), which the IRS might possibly have authority to promulgate under its extensive grant of regulatory authority, should perhaps be considered.

The authors do not know the answers to the questions posed here. There are probably other situations where gain recognition occurs for the transferor where the transferee provides no consideration. In any event, for foreign corporations that own partnership interests and their advisors, we recommend that withholding and/or certifications to prevent withholding be an integral part of planning for any liquidation or check-the-box election to obtain partnership or disregarded entity treatment.

Consequences of Failure to Withhold under Section 1446(f)(1)

As in the case of other failures to withhold, a person required to withhold and pay tax under section 1446(f), but that fails to do so, is liable for the tax under section 1461, plus any applicable interest, penalties, or additions to tax. However, in an important improvement over the proposed regulations, any person required to withhold under section 1446(f) will not be liable for a failure to withhold (or for related interest, penalties, or additions to tax) if such person establishes that transferor had no gain on the transfer taxable under section 864(c)(8). **92** However, this "no harm, no foul rule" does not eliminate the legal obligation to withhold under section 1446(f)(1) on every transfer of a partnership interest, anywhere in the world, unless steps are affirmatively taken to satisfy an exception. Thus, most transferees of partnership interests, everywhere in the word, are therefore failing to comply with the section 1446(f)(1) regulations. It is hard to understand why the government has approached the withholding requirement in this manner, when it does not seem to be required by the language of the statute.

Reporting under Section 1446(f)

The transferee is required to withhold and must report to the IRS within 20 days after the transfer on forms originally designed for withholding under section 1445: Forms 8288 and 8288-A. The taxpayer identification numbers of the transferor and transferee must be included. **93** The transferor must attach Form 8288-A to its income tax return to claim a credit. **94** The transferee (other than the partnership) must report to the partnership within 10 days after the transfer and (i) must certify the extent to which it satisfied the obligation to withhold; (ii) must include a copy of Form 8288-A, if any, or state the amount realized and amount withheld; and (iii) must include any certification relied on for an exception to withholding or to determine the amount to withhold. The obligation seems to apply to all transfers of partnership interests worldwide.

Secondary Withholding under Reg. § 1.1446(f)-(3)

If the transferee fails to withhold as required under the section 1446(f)(1) regulations, the partnership generally must withhold on distributions to the transferee. This secondary withholding requirement is effective for transfers of partnership interests that occur on or after January 1, 2022. **95** It would seem that such withholding is required even if the transferee was entitled not to withhold based on a certification that the transferee could rely on but that the partnership knew to be incorrect or unreliable. The partnership has to make its own determination on whether secondary withholding is required in any particular case.

If the partnership has already received Form W-9 from the transferor, the partnership generally may rely on such form to determine that secondary withholding is not required. The partnership may rely on a certification from the transferee, as to either an exception from withholding or the proper amount thereof, unless the partnership knows, or has reason to know, certification is incorrect or unreliable, including as a result of information contained in a certification by the transferee that it has satisfied its obligations under the regulations. **96** The partnership must also withhold on distributions made 15 days or more after it receives notification from the IRS that the transferee provided incorrect information or failed to pay a reported amount to the IRS. 97

Where the partnership is required to withhold, it must withhold until it has withheld 10% of amount realized (less transferee withholding), plus interest, or the date the partnership receives and may rely on certification from transferee claiming an exception (even if late). 98 The partnership is generally not required to withhold on any subsequent transferee. There is an exception for a subsequent transferee related to the transferee or the transferor. Excess withholding may be recovered by the transferee, not the partnership.

Secondary Withholding - What's the Big Deal? The partnership may disregard a certification for any or no reason and this may provide the partnership with undue leverage to secure concessions

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from a transferee, such as changes to the operating agreement. This gives partnership a club that it can use to disadvantage transferees, including transferees who have fully complied with section 1446(f)(1). Transferees may choose to withhold the maximum amount possible under section 1446(f)(1) and force (angry) transferors to seek a refund, or to purchase, or not to withhold the maximum possible amount, only if the partnership agrees not to impose secondary withholding. This process is less problematic now that excess secondary withholding is recoverable by the transferee, rather than the partnership.

The transferee must withhold the full amount and report the transfer to the partnership within 10 days. The transferee then has 10 days to await confirmation from the partnership of no secondary withholding or else pay over to the IRS. But is it reasonable to assume the partnership will be cooperative? What is the partner's incentive to agree? If the transferee acts as the IRS expects, the transferor risks waiting a long time to recover the withheld amount. Perhaps, in the future, to-be-formed partnerships will agree to cooperate, but this is not much help for many existing partnerships.

Notwithstanding the "no harm, no foul rule," the partnership is legally required to withhold in many cases where the transferee failed to comply with the section 1446(f)(1) regulations, but where section 1446(f)(1) clearly does not apply by its own terms.

Example - Mongolian Sheep Herders: A Mongolian sheep herder sells an interest in MSLP, a partnership that herds sheep in Mongolia, to another Mongolian sheep herder. The transfer takes place on January 1, 2022. MSLP has never been ETBUS and neither the partners nor MSLP may in fact ever have heard of the United States. By its terms, section 1446(f)(1) does not apply, but the transferee did not comply with regulations. Must MSLP perform secondary withholding under section 1446(f)(4) on distributions to buyer? What is the impact of No-Harm, No-Foul Rule? What about the rule permitting the partnership to stop withholding when it receives a certification, even if late, from the transferee?

Options for Improvement and Reform

By enacting section 864(c)(8), Congress may have unnecessarily blurred the differences between the aggregate and the entity concepts and it has certainly imported a vast amount of complexity into the law. **Section 1446(f)** and in particular section 1446(f)(4) requiring the partnership to police withholding by transferees imposes responsibilities on a very large number of transactions that may have no foreign element at all or, conversely, no relationship to the United States.

We should at least ask the following question: Is it more appropriate to compare the sale by a foreign person of a partnership interest to a sale of the underlying assets of the partnership or to a sale by a shareholder of the shares of a corporation? There may be no definitive answer to this question but one way to think about it, at least from a policy viewpoint, relates to the size of the partner's percentage share. Where the seller holds a significant percentage interest in the partnership, it may be more reasonable to try to impose tax on sale of a partnership interest based on the appreciation in the underlying assets. For one thing, a seller with a significant or controlling partnership interest will likely have much greater access to the information needed to undertake complex section 864(c)(8) computations (just consider how a foreign partner is supposed to determine the fair market value of the ECI assets that are deemed sold, especially without the cooperation of the partnership) and more ability to secure cooperation from the partnership with respect to such matters as certifications that would allow for reduced withholding. But where the percentage partnership interest is small, and especially where the interest is in a PTP, it would seem more reasonable to treat the sale in the same way as a sale of stock.

A possible approach would be to repeal section 864(c)(8) (and section 1446(f)) and to disallow any step-up in basis of U.S. trade or business assets through an election under section 754 unless either the seller certified it is a U.S. person or the seller agreed to be taxed on the allocation of ECI gain. This would preserve the taxability of the inside gain and would thereby make a sale of a partnership interest and corporate stock more comparable. The possibility that a section 754 step-up in basis could prevent taxation of gain at the partnership level, was, indeed, one of the reasons for change asserted by the Treasury in the 2014 green book. **99**

Repeal of section 864(c)(8) and 1446(f) would eliminate 110 pages of regulations

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and be much less burdensome for taxpayers and especially for withholding agents. Foreign taxpayers often do not understand the difference between stock and partnership interests, especially interests in LLCs and especially in the case of investments in PTPs, and the taxation of gains on sales of such investments (and the corresponding allowance of deductions and carryovers for losses) has brought unnecessary complexity to the markets. Even in the case of non-PTPs, the elimination of section 754 step-ups (with elective taxation of ECI gain) would be a simpler approach.

It can be asked why a buyer of a partnership interest should not be allowed a step-up just because the seller is foreign. The best answer is that the United States has a legitimate interest in preserving the taxability of gain resulting from increases in value in U.S. trade or business and that an appropriate time to tax that gain is when it is realized. When the seller of the partnership interest is a U.S. person, that person will have paid tax on gain that likely bears some relation to increases in the value of the underlying assets. If the seller is foreign, that gain will escape tax if the section 754 election is permitted. The way to prevent this without the extreme complexities of sections 864(c)(8) and 1446(f) is to allow the step-up only if the foreign transferor agrees to pay tax on the underlying appreciation. It is not a great hardship for the transferee to know if the transferor is a foreign or a U.S. person.

In the case of PTPs, the mischief of the untaxed partnership-level gain is essentially non-existent. **Section 754** elections are almost never made in the case of a sale of a PTP interest since the partnership won't want to keep track of special basis adjustments for every partner. So buyers, domestic or foreign, cannot get the step-up as a practical matter. All section 864(c)(8) does is to impose a double layer of tax on foreign investors who invest in the U.S. public markets through PTPs when this would not occur if they had invested in stock.

On a more mundane level, the government should revise its approach to treaties. While the authors disagree with the IRS view that the typical gains article in a treaty permits application of section 864(c)(8), and this issue may eventually end up being decided by a court, we cannot see any defense to the argument that ECI gain should not automatically take priority over other gain in the treaty context.

So far as withholding is concerned, the requirement that a certificate by the partnership that it has not been ETBUS at any time during taxable year of the partnership must be made through the date of the transfer in practice will make such a certificate difficult or impossible to provide in many, perhaps most, cases. The IRS should consider using the approach it took in the regulations under section 1445 where a corporation the stock of which is being transferred may issue a certificate dated not more than 30 days prior to the date of the transfer that the interest in the corporation is not a U.S. real property interest. [100]

We hope the IRS will address the questions we raise about liquidating and non-liquidating distributions of partnership interests by foreign corporations, including deemed distributions on the making of a check-the-box election. We would suggest the IRS consider aligning the treatment of such distributions with the treatment of distributions of U.S. real property interests by foreign corporations under section 1445(e)(2) and eliminating the need for a nonrecognition certificate on the recontribution of a partnership interest deemed to occur under the entity classification regulations. We also request the IRS to consider if there are other distributive transactions involving partnerships, trusts and estates that raise similar or related issues.

We would like to see the IRS provide stronger incentives for partnerships to cooperate with partners both in computing their ECI gain and in connection with legitimate efforts to reduce withholding based on partnership certificates. At present, partnerships have little or no incentive to cooperate and many do not keep the records needed to assist their partners (nor have any obligation to do so). In fact, the partnership's potential obligation to withhold tax under section 1446(f)(4) may provide the partnership with a club that could easily be misused.

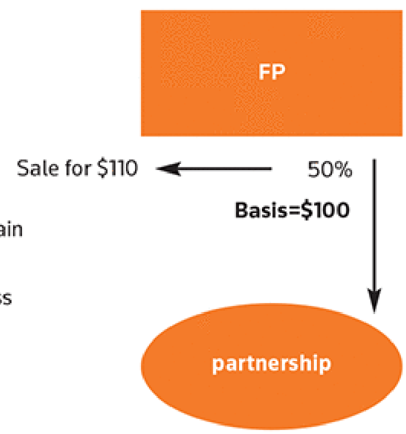
The IRS should also eliminate the Mongolian sheepherder problem. It's just silly to interpret section 1446(f) as requiring withholding in situations where there is plainly no U.S. interest in taxing the transaction and then forgiving failure to withhold under a no harm-no foul rule. The statute does not and the regulations should not require any kind of certification as a condition to there being no withholding in a case where there is no U.S. connection at all.

Finally, the IRS should state more explicitly that the no harm-no foul rule applies to back-up withholding by partnerships as it does to transferee failures.

Exhibit 1

Exhibit 1. Exhibit 1

- FP sells interest with $100 basis for $110
- Partnership's deemed sales gains:
  - $50 for Asset U (capital asset)
  - ($30) for Asset F (capital asset)
- EC vs. non-EC
  - The $50 Asset U (USTB) deemed sale gain is EC
  - The ($30) Asset F (FTB) deemed sale loss is non-EC
- Partner's share of deemed sale EC gains
  - $25, with respect to Asset U
  - All capital, since no section 751(a) assets
- Partner's EC capital gain is lesser of
  - Outside capital gain: $10, and
  - Aggregate EC deemed sale gains from non-section 751(a) assets: $25
- Partner's EC capital gain is $10



Asset	Character	Country	Cost	FMV	Gain/Loss	Partner Share
Asset U	Capital	U.S.	100	150	50	25
Asset F	Capital	Country F	100	70	(30)	(15)

1 In this article, all unprefixed references to section numbers are to the Code, as amended from time to time.

2 Where a partnership owns U.S. real property, section 897(g) and section 1445 come into play.

3 Rev. Rul. 91-32, 1991-1 C.B. 107 .

4 See, for example, Blanchard, "IRS Rev. Rul. 91-32: Extrastatutory Attribution of Partnership Activities to Partners", 15 Tax Notes Int'l 859 (Sept. 15, 1997); more recently, Ruchelman and Erwin, "Sale of an Interest by a Foreign Partner - Is **Rev. Rul. 91-32** Based on Law or Administrative Wishes?", 4 Insights No. 6 at 21. For a thoughtful retrospective of the willingness of the courts to reject sub-regulatory guidance, even of long standing, see Daily, "Guidance Is Definitive, Reality Is Frequently Inaccurate: The Lingering Saga of **Rev. Rul. 91-32** ", 50 GA Law Rev. 801 (2019).

5 *Grecian Magnesite Mining, Industrial & Shipping Co. SA v. Commissioner*, 149 T.C. No. 3 (2017), *affirmed* 926 F.3d 819 (DC Cir. 2019).

6 See the authors' recommendations for reform (or possibly repeal) of section 864(c)(8).

7 Many years earlier, the government prevailed in attributing the permanent establishment of a partnership to a foreign partner, at least for purposes of imposing tax on the partner's distributive share. *Donroy, Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962) aff'g 196 F.Supp. 54 (N.D.Cal.S.D.1961); see also *Unger v Commissioner*, T.C. Memo. 1990-15. It was doubtful whether these decisions could be stretched to attributing the permanent establishment to the foreign partner for purposes of taxing a sale of the partnership interest. As the Court of Appeals put it in *Grecian Magnesite*, "[I]t [Rev. Rul.-1-32] also cites a Tax Court decision, *Unger v. Comm'r,* which neither involved nor purported to opine on the attribution of income from the sale of personal property by a foreign partner. *See* Kimberly S. Blanchard, ***Rev. Rul. 91-32*** *: Extra statutory Attribution of Partnership Activities to Partners,* 97 Tax Notes Today 173-69 (Sept. 8, 1997) (calling the citation to *Unger* 'pointless' and the Revenue Ruling's critical sentence 'purely tautological'). We thus do not defer to the Ruling and proceed to consider the question afresh."

8 Department of the Treasury, General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals, (April 2013), at page 57, available at https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf.

9 See Parillo, "Guidance on Sale of U.S. Partnership Interest by Foreign Person Being Developed", Tax Notes May 20, 2013.

10 Having said this, the Joint Committee on Taxation's estimates of the budgetary effects of the Conference Agreement for the 2017 Act did not include an estimate for any inbound provision except the Base Erosion and Anti-Abuse Tax (BEAT). Joint Committee on Taxation, "Estimated Budget Effects of the Conference Agreement For H.R. 1, The 'Tax Cuts And Jobs Act'", JCX-67-17 (Dec. 18, 2017), available at https://www.jct.gov/publications/2017/jcx-67-17/ (viewed Feb. 15, 2021).

11 The authors are not aware of any actual member of Congress who read or understood the provision before it was enacted and they invite the Congressional staffers who wrote it to contact them, as they are genuinely interested to know more about the technical analysis that was (or was not) performed before it was introduced.

12 See **Reg. § 1.864(c)(8)-1(a)**

13 See **Reg. § 1.864(c)(8)-1(b)**

14 See **Reg. § 1.864(c)(8)-1(j)**

15 See **TD 9926**

16 **Section 864(c)(8)(D)** .

17 See the example in the text accompanying Error! Bookmark not defined. s 26 through 33. Our discussion suggests that this rule may not be consistent with the standard treaty gains article, but whatever the treaty position may be, the rule clearly applies in the absence of a treaty.

18 See **Reg. § 1.864(c)(8)-1(b)** , -1(c)

19 Section 1.864(c)(8)-1(c)

20 See section 865(d)(2).

21 See section 864(c)(4)(B)(i) and (iii).

22 Reg. § 1.864(c)(8)- 1(c)(2)(ii)(D). An example illustrates a material change in circumstances that occurred because of the partnership starting a new business and substantially reducing its U.S. business. Reg. § 1.864(c)(8)- 1(c)(2)(iii)(B).

23 **Section 865(c)(1)** allocates the gain up to the amount of prior depreciation adjustments between U.S. and foreign sources by reference to the ratio of U.S. source depreciation adjustments to all depreciation adjustments - these being normally calculated by reference to the primary place of use of the property.

24 See **Reg. § 1.864(c)(8)-1(c)(3)** .

25 See Reg sec. 1.864-1(c)(8)-1(b)(3)(iii).

26 See **Reg. §1.864(c)(8)-1(f)** . Almost but not quite all U.S. income tax treaties contain a limitation on benefits article.

27 See also **Reg. §1.864(c)(8)-1(i), Example 4** , in particular paragraph (i)(4)(ii)(3).

28 Id.

29 No actual U.S. treaty has been negotiated based on the 2016 model but the language in earlier models (1981, 1996, 2006) is essentially the same.

30 See "The Budget Reconciliation Process: The Senate's 'Byrd Rule'", Congressional Research Service (updated December 1, 2020) p. 1 (available at https://crsreports.congress.gov/product/pdf/RL/RL30862, viewed February 7, 2021)

31 Ibid. page 5.

32 Rev. Proc. 2020-54, 2020-53 IRB 1806 .

33 See P.L. 96-499, the Omnibus Reconciliation Act of 1980, section 1125, as amended by P.L. 97-34, the Economic Recovery Tax Act of 1981, section 831(h).

34 Reg. §1.864(c)(8)(b)(2)(ii).

35 While our estate tax treaties generally would require the treaty partner to provide credit to the decedent's estate for any U.S. tax, the U.S. tax might be higher than the treaty country tax. For example, an inter-spousal transfer that may be tax-free in the treaty country. The surviving spouse might well not be a U.S. citizen who does not wish to subject the inheritance to the qualified domestic trust rules of section 2056(d).

36 A discussion of the inversion rules is beyond the scope of this article.

37 Section 864(c)(8)(E) states that the Secretary "shall prescribe such regulations or other guidance as the Secretary deems appropriate for the application of this paragraph [(c)(8)], including with respect to exchanges described in section 332, 351, 354, 355, 356, or 361". The word "including" is plainly not exclusive of other exchanges or indeed other transactions.

38 Reg. § 1.864(c)(8)-1(d) .

39 Nevertheless, the authors have experienced the continuing difficulties for foreign sellers seeking to obtain FIRPTA withholding certificates where they had to establish that they had no unsatisfied withholding liability from their original purchase and their records did not include proof that the seller was domestic. See Reg. § 1.1445-3(b)(4)(B).

40 Reg. § 1.1446(f)-1 .

41 Reg. § 1.1446(f)-4(a) .

42 Reg. § 1.1446(f)-4(a)(1) and **Reg. § 1.1446(f)-4(a)(2)(i)**

43 Reg. § 1.1446(f)-4(a)(2)(ii)(A) , which refers to **Reg. § 1.1441-1(e)** . For special rules applicable to qualified intermediaries that do not assume primary withholding responsibility, see **Reg. § 1.1446(f)-4(a)(7)** .

44 Reg. § 1.1446(f)-4(a)(2)(ii)(B) , which refers to Reg. § § 1.1441-1(b) and -1(e)(3)(v). The certificate does not have to comply with the requirement in that latter section that it state that the amount is not effectively connected with a U.S. trade or business.

45 Reg. § 1.1446(f)-4(a)(8) and see **Reg. § 1.1446-4(b)(3)** .

46 Reg. § 1.1446(f)-4(a)(3) .

47 Reg. § 1.1446(f)-4(a)(4) .

48 Reg. § 1.1446(f)-4(b)(2)

49 Reg. § 1.1446(f)-4(b)(5)

50 Reg. § 1.1446(f)-4(b)(6)

51 **Reg. § 1.1446(f)-4(b)(1)** . For rules relating to qualified notices, see **Reg. § 1.1446(f)-4(b)(3)** .

52 **Reg. § 1.1446(f)-4(b)(3)(iii)**

53 **Reg. § 1.1446(f)-4(b)(3)**

54 **Reg. § 1.1446(f)-4(b)(3)(ii)(B)**

55 **Reg. § 1.1446(f)-4(b)(4)**

56 **Reg. § 1.1446(f)-4(c)(1)**

57 **Reg. § 1.1446(f)-4(c)(2)**

58 **Reg. § 1.1446(f)-4(c)(2)(iii)**

59 **Reg. § 1.1446(f)-1(c)(4)** contains a definition of the expression "determination date".

60 **Reg. § 1.1446(f)-4(c)(2)(ii)(B)** .

61 **Reg. § 1.1446(f)-4(c)(2)(ii)(C)** .

62 **Reg. § 1.6302-2** .

63 **Reg. § 1.1446(f)-4(d)** .

64 **Reg. § 1.1446(f)-4(e)(1)** .

65 **Reg. § 1.1446(f)-2(a)** .

66 Reg § 1.1446(f)-3(c)

67 Reg § 1.1446(f)-2(c)(2)(B)

68 Reg § 1.1446(f)-2(c)(2)(C)(iv)

69 **Reg. § 1.1446(f)-2(c)(4)(ii)** and § 1.1446-3(a)(2).

70 Reg § 1.1446(f)-2(c)(4)(iii)

71 See text accompanying footnotes 68 and 70 above.

72 Reg § 1.1446(f)-2(b)(2).

73 A domestic trust used to avoid application of section 1446 will subject a partnership to taxes, penalties, and interest for failure to comply with section 1446 if the partnership knows or has reason to know that a foreign person holds an interest in the partnership through a domestic trust with a principal purpose of avoiding the section 1446 tax. See **Reg. § 1.1446-3(d)(2)(iii)(B)** .

74 Reg § 1.1446(f)-2(b)(7)

75 Reg § 1.1446(f)-2(b)(7)(i), cross-referring to Reg § 1.1446(f)-2(c)(4)(vi).

76 Reg § 1.1446(f)-2(b)(7)

77 As noted above, this can be required under section 1446(f)(4)

78 Reg § 1.1446(f)-2(b)(3)(i) and (ii).

79 Reg § 1.1446(f)-2(b)(3)

80 Reg § 1.1446(f)-2(b)(3)(iii).

81 Reg § 1.1446(f)-2(b)(4)

82 Reg § 1.1446(f)-2(b)(6).

83 Reg § 1.1446(f)-2(b)(6)(i).

84 Reg § 1.1446(f)-2(b)(6)(ii).

85 Reg § 1.1446(f)-2(b)(4)(B).

86 Reg § 1.1446(f)-2(b)(4)(B)(ii)

87 Specifically, section 1445(e)(5) or §1.1445-11T(d)(1).

88 Reg § 1.1446(f)-1(d).

89 **Reg § 1.1441-2(e)(1)** .

90 Reg § 301.7701-3(g)(ii) and (iii).

91 **See Reg § 1.1446(f)-2(b)(6)(i).**

92 **Reg § 1.1446(f)-5(b)** (final sentence). This sentence was not included in the proposed regulations ((REG-105476-18).

93 The requirement for a taxpayer identification number is understandable, but given the numerous practical obstacles that the IRS has placed on foreign individuals who need to obtain or renew a TIN, we can anticipate numerous cases of foreign taxpayers being unable to provide a number.

94 **Reg § 1.1446(f)-2(d).**

95 Reg §§ 1.1446(f)-3(a) and (f).

96 Reg § 1.1446(f)-3(a)(1)

97 Reg § 1.1446(f)-3(a)(2).

98 Reg § 1.1446(f)-3(c)(1)(ii)(B).

99 2014 Green Book, footnote 8 above.

100 **Reg. § 1.1445-2(c)(3)** .