

# IRS ISSUES SECTION 1446(F) FINAL REGULATIONS

Date: 28 October 2020

## **U.S. Corporate Tax Alert**

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On 7 October 2020, the Treasury Department and the Internal Revenue Service (IRS) released final regulations under Code Section 1446(f)<sup>1</sup> (the Final Regulations), which clarify aspects of the withholding requirements with respect to the disposition of partnership interests by non-U.S. persons.<sup>2</sup>

## **BACKGROUND OF SECTION 1446(F)**

The 2017 Tax Cuts and Jobs Act<sup>3</sup> added Section 864(c)(8), which provides that gain or loss from the sale, exchange, or other disposition of a partnership interest by a non-U.S. person is effectively connected with the conduct of a trade or business in the United States to the extent that the person would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value.<sup>4</sup> The withholding regime created under Section 1446(f) is the enforcement mechanism for Section 864(c)(8) and provides for a 10 percent withholding tax applicable on amounts realized from the disposition of a partnership interest by a non-U.S. person, unless an exception to withholding applies.<sup>5</sup> If the transferee fails to withhold any amount required, the partnership must withhold from any distributions made with respect to the partnership interest an amount equal to 10 percent of the amount realized (reduced by any amounts withheld by the transferee) plus any interest.<sup>6</sup>

The IRS previously released Notice 2018-29, which announced its intent to issue regulations under the new Section 1446(f) for non-publicly traded partnerships and introduced five exceptions. Proposed regulations on Section 1446(f), released on 13 May 2019 (the Proposed Regulations), clarified several aspects of this withholding regime, including the relevant exceptions to withholding.<sup>8</sup> In addition to the exceptions introduced in Notice 2018-29, the Proposed Regulations addressed treaties, stating that when a transferor of an interest certifies that it is not subject to tax on gain from the transfer under an income tax treaty in effect between the United States and another country, the 10 percent withholding tax does not apply.<sup>9</sup>

## **HIGHLIGHTS OF THE FINAL REGULATIONS**

The Final Regulations retain the basic structure and adopt the exceptions in the Proposed Regulations with certain revisions. The Final Regulations follow the general rule that withholding equal to 10 percent of the amount realized is required with respect to the transfer of a partnership interest by a non-U.S. person unless an exception or an adjustment applies.<sup>10</sup> However, if the transferee can demonstrate that the transferor has no liability under Section 864(c)(8), then the transferee will have no liability for the Section 1446(f) withholding tax or interest and penalties.

### **Withholding Exceptions Under the Final Regulations**

The six exceptions to withholding are listed below. Any modifications made by the Final Regulations are noted.

### ***Non-Foreign Status Exception***

As described above, a transferee may rely on a certification from the transferor that states the transferor is not a non-U.S. person. The certification must include the transferor's name, taxpayer identification number, and address, and it must be signed under penalty of perjury. However, a transferee may not rely on a certification if it has actual knowledge that it is incorrect or unreliable.<sup>11</sup>

### ***No Gain Realized Exception***

A transferee may rely on a certification from the transferor that states the transfer of the partnership interest would not result in any realized gain (including ordinary income arising from Section 751). To address access-to-information issues concerning a partnership's unrealized receivables or inventory items, the Final Regulations add that a transferor may rely on a certification from the partnership stating that, as of the determination date, the transfer of a partnership interest would not result in ordinary income arising under Section 751.<sup>12</sup>

### ***Less than 10 Percent Effectively Connected Gain Exception***

The Final Regulations provide an exception from withholding using a hypothetical sale. A transferee may rely on a certification from the partnership stating that if the partnership were to sell all of its assets at fair market value, either (1) the partnership would have no effectively connected gain or a net amount of effectively connected gain that would be less than 10 percent of the total net gain, or (2) the transferor's distributive share of net effectively connected gain would be either zero or less than 10 percent of the transferor's distributive share of the total net gain from the partnership.<sup>13</sup> The general partner or other individual that has authority to sign for the partnership under local law must sign the certification.<sup>14</sup>

The Final Regulations retain the rule allowing partnerships to make the relevant determination at the partnership level as of the determination date, without regard to the transferor's distributive share. However, the Final Regulations simplify the partnership-level exception to withholding by combining the Proposed Regulations into a single rule. The Final Regulations also add an exception from withholding if the partnership was not engaged in a U.S. trade or business at any time during the taxable year of the partnership through the date of transfer.<sup>15</sup>

### ***Less than 10 Percent ECI Exception***

Under the Proposed Regulations, to qualify for the less than 10 percent effectively connected income (ECI) exception, a transferor must have (1) been a partner in a partnership for the immediately prior taxable year and the two preceding taxable years (the look-back period), and (2) had an allocable share of effectively connected taxable income (ECTI) that was less than 10 percent of its total distributive share of net income received from the partnership. The allocable share of ECTI must have been less than \$1 million in each of those years.<sup>16</sup> The Proposed Regulations relied on Form 8805 to determine a transferor's allocable share. This effectively caused the exception to only apply when a transferor was allocated a positive amount of ECTI or an effectively connected loss.

The Final Regulations modify the exception to withholding by looking to the gross amounts of income. A transferor may qualify if its distributive share of gross ECI from the partnership for each taxable year within the look-back period was less than \$1 million and less than 10 percent of the transferor's total distributive share of gross income from the partnership for that year.<sup>17</sup> The Final Regulations also now rely on Schedule K-1 (Form 1065) or other statements furnished to the partner instead of Form 8805, so that a transferor who is not allocated any ECI or loss in any relevant year can still use the exception.<sup>18</sup>

### ***Nonrecognition Transfer Exception***

Withholding is not required when the transferor is not required to recognize any gain or loss with respect to the transfer by operation of a nonrecognition provision of the Code. The transferor must provide a certification describing the transfer with the relevant law and facts.<sup>19</sup> Rules for a transfer resulting in partial nonrecognition are also included in the Final Regulations.<sup>20</sup>

### ***Income Tax Treaties Exception***

The Final Regulations memorialize the income tax treaty exception introduced in the Proposed Regulations as the exclusive means to claim an exception to withholding by reason of treaty benefits.<sup>21</sup> If the transferor is not subject to tax on any gain from the transfer pursuant to an income tax treaty in effect between the United States and a foreign country, withholding is not required. The Final Regulations allow a transferor to use the applicable withholding certificate as the certification for making a claim for benefits under an income tax treaty.<sup>22</sup> The Final Regulations also provide rules for situations where treaty benefits only apply to a portion of the gain.<sup>23</sup>

### **Other Highlights**

In response to comments, the IRS confirmed that the amount realized upon the transfer of a partnership interest includes any reduction in the transferor's share of partnership liabilities. The Final Regulations modify the Proposed Regulations by allowing the transferee, rather than the partnership, to directly claim and obtain a refund for any excess amount withheld.<sup>24</sup> Generally, a partnership is not required to withhold on distributions that are made after the transferee disposes of the interest, unless the partnership has actual knowledge that the acquirer is a related person.<sup>25</sup> However, the Final Regulations add a new rule that relieves any person, including a partnership, that fails to comply with the withholding requirements from liability, interest, and penalties if it establishes to the satisfaction of the Commissioner that the transferor had no gain under Section 864(c)(8) subject to tax on the transfer.<sup>26</sup>

### ***Publicly Traded Partnerships***

On 29 December 2017, the IRS issued Notice 2018-08, suspending withholding obligations on the sale or disposition of publicly traded partnership (PTP) interests otherwise imposed under Section 1446(f). Unlike the rules for non-publicly traded partnerships, a transferee of a PTP interest generally is not required to withhold under Section 1446(f) where the transfer is effected through one or more brokers. The Final Regulations place this obligation on the broker, unless an exception applies.<sup>27</sup> The exceptions largely follow those included in the Proposed Regulations; however, the Final Regulations remove the qualified current income distribution exception<sup>28</sup> completely and add an exception for transferors that are dealers in securities. The Final Regulations also provide guidance on the qualified intermediary agreement<sup>30</sup> and decline to add an exception for delivery versus payment transactions.

## **IMPLICATIONS**

Under the Final Regulations, an investor purchasing a partnership interest now has more certainty about exceptions to the withholding obligation. When purchasing a partnership interest, an investor should be aware of the potential exceptions that could be available upon selling the interest. The Final Regulations provide a 2022 start date for the withholding obligations on partnerships whose partners did not withhold the applicable amount.

Partnerships may wish to begin to prepare for this over the next year by developing certifications to ensure that withholding occurs between partners, or the partnership will become responsible for withholding itself.

Please contact the authors of this client alert or your usual K&L Gates lawyer for further insight with respect to the Final Regulations.

## FOOTNOTES

<sup>1</sup> All references to Sections and the Code are to the U.S. Internal Revenue Code of 1986, as amended.

<sup>2</sup> T.D. 9926.

<sup>3</sup> Pub. L. 115-97.

<sup>4</sup> I.R.C. § 864(c)(8)(B).

<sup>5</sup> *Id.* § 1446(f)(1).

<sup>6</sup> Treas. Reg. § 1.1446(f)-3(a)(1), (c)(2).

<sup>7</sup> Notice 2018-29, 2018-16 I.R.B. 495.

<sup>8</sup> REG-105476-18.

<sup>9</sup> Prop. Reg. § 1.1446(f)-2(b)(7).

<sup>10</sup> Treas. Reg. § 1.1446(f)-2(a), (c)(1)–(2).

<sup>11</sup> *Id.* § 1.1446(f)-2(b)(1)–(2).

<sup>12</sup> *Id.* § 1.1446(f)-2(b)(3)(i)–(ii).

<sup>13</sup> *Id.* § 1.1446(f)-2(b)(4)(A).

<sup>14</sup> *Id.* § 1.1446(f)-1(c)(2)(iii).

<sup>15</sup> *Id.* § 1.1446(f)-2(b)(4)(B).

<sup>16</sup> Prop. Reg. § 1.1446(f)-2(b)(5).

<sup>17</sup> Treas. Reg. § 1.1446(f)-2(b)(5).

<sup>18</sup> *Id.* § 1.1446(f)-2(b)(5)(C).

<sup>19</sup> *Id.* § 1.1446(f)-2(b)(6)(i).

<sup>20</sup> *Id.* § 1.1446(f)-2(c)(4)(v).

<sup>21</sup> Prop. Reg. § 1.1446(f)-2(b)(7); Treas. Reg. § 1.1446(f)-2(b)(7)(iii).

<sup>22</sup> Treas. Reg. § 1.1446(f)-2(b)(7)(i).

<sup>23</sup> *Id.* § 1.1446(f)-2(c)(4)(vi).

<sup>24</sup> *Id.* § 1.1446(f)-3(e)(2).

<sup>25</sup> *Id.* § 1.1446(f)-3(a)(3).

<sup>26</sup> *Id.* § 1.1446(f)-5(b).

<sup>27</sup> *Id.* § 1.1446(f)-4(a)(1)–(2).

<sup>28</sup> Prop. Reg. § 1.1446(f)-4(b)(4).

<sup>29</sup> Treas. Reg. § 1.1446(f)-4(b)(6).

<sup>30</sup> *Id.* § 1.1446(f)-4(a)(7)–(8).

## KEY CONTACTS



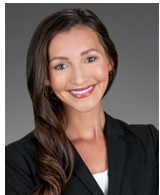
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