IRS Releases Proposed Regulations on Partnership Interests

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On December 20, 2018, the Internal Revenue Service (the "IRS") and the Treasury Department released proposed regulations (the "Proposed Regulations") under Section 864(c)(8), a provision providing for U.S. federal taxation of a foreign partner's gain on the sale or exchange of certain partnership interests.

Background

Before the 2017 Tax Cuts and Jobs Act (TCJA), it was unclear whether foreign persons were taxable on gain from the sale or exchange of an interest in a partnership that was engaged in a U.S. trade or business (USTB). Generally, foreign persons are subject to U.S. taxation on income that is effectively connected (ECI) with a USTB, including income derived through a partnership. Section 875 of the Code provides that a foreign partner is considered to be engaged in the USTB of a partnership of which he is a member. Foreign persons who qualify for treaty benefits under a double tax treaty are generally only taxable on ECI to the extent it is attributable to a permanent establishment (PE) in the U.S. In both instances, it was unclear whether the sale of a partnership interest with a USTB or PE would be taxable to a foreign partner who was not otherwise engaged in business in the U.S.

In 1991, the IRS issued Revenue Ruling 91–32, holding that a foreign partner is subject to U.S. federal taxation on the sale or exchange of a partnership interest to the extent the gain was attributable to assets used in a USTB. In such a case, the partner was deemed to have ECI from the sale or exchange of the partnership interest in an amount equal to the partner's share of ECI that would have been recognized by the partnership if it had sold all of its assets.

In 2017, the U.S. Tax Court refused to follow Revenue Ruling 91–32 in Grecian Magnesite Mining, Industrial & Shipping Co. SA v. Commissioner, 149 T.C. No. 3 (July 13, 2017). Instead, the Tax Court held that the foreign partner's gain on sale of an interest in a U.S. partnership was separate and distinct from the built–in gain on partnership assets and was not effectively connected to the USTB of the partnership.[1]

The TCJA effectively overruled Grecian Magnesite. As a result, section 864(c)(8) now provides that a foreign partner's gain or loss from the sale of partnership interests is treated as ECI with a USTB to the extent the partner would have had effectively connected gain or loss if the partnership had sold its assets. Section 864(c)(8) is effective for transfers on or after November 27, 2017.

Key Points of Proposed Regulations

- Determination of Gain or Loss. Under the Proposed Regulations, a partner's effectively connected gain or loss under Section 864(c)(8) is limited to the partner's outside gain or loss in the partnership interest. Thus, the partner must first determine its gain or loss on the sale of the partnership interest under general rules ("outside gain or loss"). This amount acts as a limitation, such that the partner may not be treated as recognizing more ECI gain or loss than its outside gain or loss. The partner then must determine the distributive share of effectively connected gain or loss that the partner would have from a deemed sale of all of the partnership's assets at fair market value ("deemed sale gain or loss"). The partner will then recognize ECI to the extent of the lower of (i) the partner's outside gain or loss, or (ii) the partner's distributable share of the partnership's deemed sale gain or loss. If there is an outside gain and a deemed sale loss (or vice versa), no ECI gain or loss is recognized. (See the example below.)

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- **Character of Income.** As noted above, the partner must determine the outside gain or loss, as well as the partner's share of the deemed sale gain or loss. The partner then must determine the portion of each type of gain or loss that is ordinary and capital. Thus, she will determine the amount of (i) net outside ordinary gain or loss, (ii) net outside capital gain or loss, (iii) her distributive share of the deemed sale effectively connected ordinary gain or loss, and (iv) her distributive share of the deemed sale effectively connected capital gain or loss. The outside gain or loss will generally be treated as capital gain or loss. However, a portion of the outside gain or loss will be treated as ordinary gain or loss to the extent attributable to "hot" assets (generally, partnership assets that produce ordinary income on a sale). Once a partner has determined its amounts of capital and ordinary gain or loss, the outside gain or loss limitation described above must be applied to each category (i.e. a limitation is determined in regard to capital gains or losses and separately determined in regard to ordinary gains or losses). Under the proposed rules, a partner could be treated as having ordinary income and capital loss, or vice versa. In such a case, the loss would not generally offset the gain.
- **Nonrecognition Transactions.** The Proposed Regulations provide that gain or loss that is ECI is limited to gain recognized under the Internal Revenue Code. Thus, when a nonrecognition provision applies in whole or in part to the disposition of a partnership interest, section 864(c)(8) applies only to the portion of income actually recognized as ECI. For example, if a partner contributes her partnership interest to a corporation in a section 351 transaction and does not recognize gain or loss, the transfer of the partnership interest will not be taxable to the partner.
- **Source of Income.** The Proposed Regulations do not provide rules for determining the source of gain or loss from the sale or transfer of a partnership interest that is taxable under section 864(c)(8). The preamble to the Proposed Regulations does state, however, that gain or loss is treated as ECI under section 864(c)(8) even if the gain or loss is from foreign sources.
- **Ten-Year Exception.** The deemed sale of an asset (other than a USRPI) is exempt from being treated as ECI if it was not used in a USTB (and did not produce ECI) in the prior ten years. This should help reduce recordkeeping and compliance costs. Without this provision, even a partnership that has not recently derived ECI would need to review its entire history to determine whether its foreign partners are subject to U.S. tax on the deemed sale gain or loss under section 864(c)(8).
- Coordination with FIRPTA. In situations where both Section 864(c)(8) and FIRPTA apply (i.e. where a partnership is engaged in a USTB and holds USRPIs), only Section 864(c)(8) will apply in determining the partner's effectively connected gain or loss. Essentially, Section 864(c)(8) overrides FIRPTA, where both apply to the sale of a partnership interest. However, if Section 864(c)(8) does not apply to any asset, FIRPTA remains applicable.
- **Non-Exclusivity.** With the exception of FIRPTA discussed above, in the event another provision would apply to characterize income as ECI, Section 864(c)(8) will not act as a limitation. Rather, if more than one provision applies, the provision resulting in the larger amount of ECI will be applied.
- **Tiered Partnerships.** Section 864(c)(8) also applies to partners who indirectly hold interests in a partnership engaged in a USTB. Thus, a partner in an upper–tier partnership that holds interests in partnerships engaged in one or more USTBs must determine her share of ECI pursuant to Section 864(c)(8) on the sale or exchange of the upper–tier partnership. A similar rule applies if an upper–tier partnership recognizes gain or loss on the sale or exchange of a lower–tier partnership.
- Treaties. Treaties may be of limited use to foreign persons under Section 864(c)(8). In many cases, activities constituting a USTB will also constitute a permanent establishment under the relevant treaty. The Proposed Regulations provide that a disposition of a partnership interest will be treated as a disposition of a permanent establishment of the partnership. Thus, gain or loss determined under Section 864(c)(8) will generally be subject to tax. However, specific exemptions in a treaty will still apply (e.g., exemptions for certain ships or aircraft).
- **Anti-Stuffing Rule.** Taxpayers or related parties may not transfer property to a partnership with a principal purpose of reducing the amount of gain treated as effectively connected gain or of increasing the amount of loss treated as effectively connected loss. Any such transfers will be disregarded for purposes of Section 864(c)(8) or FIRPTA. Absent these rules, a taxpayer could have reduced the outside basis (and thereby reduce the limitation on ECI) by contributing foreign assets with built–in losses.
- **Partnership Compliance.** The Proposed Regulations do not impose specific recordkeeping or reporting requirements on partnerships with foreign partners, though it will be necessary in any case for someone to prepare the calculations that are needed to determine the deemed sale gain or loss. While many such partnerships will help their foreign partners with these calculations, others will not (either due to cost or lack of expertise).

Example

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Assume a foreign person (FP) and a U.S. person (USP) holds equal interests in a U.S. partnership. Each contributed $100 to the partnership. All income and losses are allocated in proportion to their ownership interests. The partnership engages in both USTB and non–U.S. activities. All of its assets would give rise to ordinary income or loss if sold.

The partnership has the following inside basis in its assets:

USTB Assets: $100

Non–US Assets: $100

The partnership's assets have the following fair market values:

USTB Assets: $150

Non–US Assets: $80

FP sells his interest in the partnership to X (an unrelated party) for $115.

Determining Limitation. FP's outside basis in the partnership is $100 (assuming no differences in inside and outside and outside basis). Thus, he has realized a $15 gain on the sale of his partnership interest ($115 amount realized – $100 outside basis). Per the Proposed Regulations, FP may not recognize more than $15 of ECI.

Determining ECI Recognized. If the partnership were to sell its underlying assets, FP would be treated as having ECI equal to his distributive share of the gain or loss on the USTB assets. The partnership would recognize a $50 gain on the sale of its USTB assets ($150 FMV of USTB Assets – $100 inside basis of USTB assets). FP's distributive share of the deemed sale gain would be $25. However, FP's ECI recognition is limited to $15 (the outside gain). Thus, FP would recognize $15 of ECI gain on the sale of his partnership interest.

The Withholding Mechanism

The TCJA also added Section 1446(f). This provision requires the transferee of any partnership interest to withhold 10 percent of the purchase price if any portion of the gain is subject to section 864(c)(8) unless the transferor certifies it is a U.S. person. In December 2017, the IRS released Notice 2018–08 temporarily suspending application of section 1446(f) to certain transfers of interests in publicly–traded partnerships.

In April 2018, the IRS released Notice 2018–29 announcing its intention to release proposed regulations on withholding of transfers of partnership interests that are not publicly–traded partnerships. Notice 2018–29 also contained temporary guidance for partners of non–publicly traded partnerships. Under this guidance no withholding is generally required if the transferor certifies that (i) it is a US person, (ii) it will not realize any gain, or (iii) its share of the partnership's ECI was less than 25 percent of its total distributive share of income for each of the prior three taxable years.

The Proposed Regulations do not provide any further guidance on section 1446(f) withholding. Proposed regulations under section 1446(f) are expected shortly.

ALVAREZ & MARSAL TAXAND SAYS: The proposed regulations provide much–needed details on the scope and application of Section 864(c)(8). One area that had been of concern to many practitioners was the potential taxation that could arise on transfers of a partnership interest in a transaction that would otherwise be tax–free under a nonrecognition rule (such as tax–deferred reorganizations under Section 368 or exchanges for shares under section 351). Fortunately (and appropriately), the proposed regulations do not impose taxation in these situations even though Congress gave the Treasury Department the authority to do so. Many foreign partners had been hesitant to engage in such transfers (e.g., in the context of a group restructuring). This proposed regulation should provide comfort for those partners and allow such transactions to proceed.

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[1] Note that the Grecian Magnesite case did not involve a partnership that held a U.S. real property interest (USRPI). Therefore, the Foreign Investment in Real Property Act (FIRPTA) did not apply.

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 [3]

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