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Proposed regulations have recently been issued by the U.S. Internal Revenue Services (IRS) under a withholding provision of U.S. tax law enacted in 2017 that imposes withholding tax on a non-U.S. person's sale (or other transfer) of a partnership interest. The relatively new withholding tax provision has the potential to significantly complicate secondary sales of partnership interests for those parties who are unfamiliar with it. This alert focuses in particular on determination of the withholding amount and the importance for buyers and sellers to be aware of the role of partnership liabilities in making this calculation.

Background

The new rules impose U.S. income tax on the gain realized by a non-U.S. person that sells (or otherwise transfers) an interest in a partnership (or an entity treated as a partnership for U.S. tax purposes) to the extent the gain is considered effectively connected to a U.S. trade or business of the partnership ("effectively connected income" or "ECI"). As a collection measure, the buyer of the interest is required to withhold U.S. tax. If the buyer fails to properly withhold, not only is the buyer liable for the underwithholding but the partnership itself is then required to withhold the tax from future distributions to the buyer.

Certain withholding exceptions are potentially available but they depend on the seller or the partnership being able or, in many cases, willing to make certain factual certifications that are sworn to under penalties of perjury.

As a result, the withholding requirement can be disruptive to completion of secondary transactions absent advance planning. A buyer will generally seek to minimize its withholding tax risk by obtaining certification of an applicable exception. Late in the due diligence process, the buyer may find that the facts of the transaction do not support an exception or that the seller and/or the partnership are unwilling to undertake the due diligence necessary to confirm the accuracy of a certification or may simply be unwilling to take on any unknown risk with regard to issuing a certificate.

Where a withholding exception is not available, the buyer is obligated to withhold 10% of seller's "amount realized" which includes the entire purchase price for the partnership interest (not just the portion attributable to a U.S. trade or business) plus the seller's share of partnership liabilities. If the share of partnership liabilities cannot be established by a permitted method, the seller may find itself subject to withholding of 100% of the purchase price. If the buyer is not

knowledgeable enough to withhold the full purchase price, the buyer may be subject to liability for underwithholding. If the buyer underwithholds, the partnership may be obligated to withhold the underpayment amount against future distributions to the buyer.

To avoid such unwelcome surprises, buyers, sellers and partnerships need to be familiar with IRS guidance regarding the calculation of the withholding amount, including the permitted methods for establishing the seller's share of partnership liabilities.

IRS Guidance

The IRS previously released interim guidance with respect to the application of the withholding provision. Notice 2018-08 temporarily suspends the withholding requirement with respect to the sale of a publicly-traded partnership interest. Rather than also suspend the withholding requirement with regard to an interest in a partnership that is not publicly traded, the IRS issued Notice 2018-29 to provide temporary withholding guidance pending the issuance of proposed regulations. Notice 2018-29 also temporarily suspends the secondary liability of the partnership for the withholding.

On May 7, 2019, the IRS released proposed regulations that, once finalized, will supersede the interim guidance, effective in general for transfers occurring on or after the date that is 60 days after the finalization date. Among other provisions, the proposed regulations end the suspension of withholding on sales of publicly-traded partnership interests and also end the suspension of the secondary withholding obligation imposed on the partnership where the buyer has failed to withhold.

Comments on the proposed regulations or requests for a public hearing will be accepted by the IRS until July 12, 2019, suggesting that the proposed regulations likely will not be finalized until at least summer or later in 2019. Until the proposed regulations are final, the interim guidance continues to apply, although taxpayers can choose to apply the proposed regulations in their entirety to a transfer of a non-publicly traded partnership interest taking place before finalization.

This alert does not address all aspects of the interim guidance and proposed regulations and focuses only transactions that involve the sale of non-publicly traded partnership interests. For information on other aspects of this withholding rule and the related IRS guidance, please reach out to us.

Withholding Exceptions

Notice 2018-29 provides for six exceptions to withholding based on certain certifications to be provided by the seller or by the partnership to the buyer that the buyer is permitted to rely upon to eliminate or reduce withholding. The possible certifications are:

1. the seller is a not a foreign person,
2. no gain will be realized by seller on the sale of the partnership interest,
3. less than 25% of the seller's distributive share of partnership income constituted ECI for each of the previous three years,
4. effectively connected gain upon the partnership's deemed sale of assets would be less than

25% of the total gain,

5. a nonrecognition provision applies to all of the seller's gain, or
6. the seller's gain is exempt from U.S. taxation under an income tax treaty.

The buyer, the seller and the partnership need to pay close attention to the detailed requirements that apply with respect to the certifications, including the requirement that, in each case, the certification must be signed under penalties of perjury. Furthermore, to rely on a certification, the buyer must not have actual knowledge or reason to know that it is incorrect.

The proposed regulations adopt the same six withholding exceptions with various modifications, some of which impose more stringent requirements or conditions. As an example, the 25% threshold with respect to exceptions (3) and (4) above is lowered to 10% and new restrictions are added for exception (3). Consequently, if the proposed regulations are adopted as final in their current form, fewer transactions may qualify for a withholding exception, making it (even more) important for buyers and sellers to understand the calculation of the withholding amount.

Withholding Amount

If no withholding exception can be certified, the buyer is generally required to withhold 10% of seller's "amount realized," which includes the purchase price (in cash or property) plus the reduction in the seller's share of partnership liabilities.

Certification of Partnership Liabilities

The interim guidance allows the buyer to rely on a certification from either the seller or the partnership to establish the amount of partnership liabilities that are included in the seller's amount realized. The proposed regulations also adopt this approach with certain modifications.

Seller Certification. Under the interim guidance, the seller can provide a certification of its partnership liabilities where the following conditions are met:

1. Seller (and related persons) owns less than a 50% interest in the partnership throughout the 12 months before the transfer;
2. Seller has a U.S. taxpayer ID number;
3. Seller has received a Schedule K-1 (Form 1065) from the partnership for a taxable year that closed no more than 10 months before the transfer date; and
4. Seller does not have actual knowledge of events occurring after the Schedule K-1 was issued that could cause the amount of its share of partnership liabilities at the time of the transfer to be more than 25% different from the amount shown on the Schedule K-1.

In such cases, the seller is allowed to certify to the amount of its share of partnership liabilities as shown on the Schedule K-1.

The 10 month rule presents a problem for parties that wish to transfer an interest at year-end (assuming the partnership has a calendar tax year) because the prior year's Schedule K-1 may be relied upon only if the transfer occurs before November 1 of the current year. If the transfer does

not occur until later, the parties may have to wait several months for the seller's next Schedule K-1 to be prepared before the transaction can be completed with a seller certification of partnership liabilities.

Additionally, because the prior year Schedule K-1 does not have to be prepared before March 15 of the current year, and may be prepared much later (up to August 15 of the current year) under a filing extension, there may be a short "window of opportunity" before November 1 to close on the sale with a seller certification of partnership liabilities.

The proposed regulations attempt to address these concerns and ease up the requirements by expanding the 10-month rule to a 22-month rule so that the seller may provide a certification based on a Schedule K-1 received from the partnership for a taxable year that closed no more than 22 months before the date of the transfer.

Partnership Certification. As an alternative to the seller certification, the partnership may issue a certification as to the amount of seller's share of partnership liabilities. Under the interim guidance, the partnership may rely on the most recently prepared Schedule K-1 unless the partnership has actual knowledge of events occurring after its determination that would cause the amount of the seller's share of partnership liabilities to be more than 25% different from the amount shown.

The partnership is not subject to the same 10-month window that applies to the seller, presumably because the partnership should have more updated information on its outstanding liabilities than is available to the seller.

In practice, however, some partnerships may simply be unwilling to provide the certification when the seller is unable to do so during the period from November 1 and until the next Schedule K-1 is issued.

The proposed regulations tighten up the requirements for a partnership certification as the partnership may not rely on the most recent Schedule K-1. Instead, the partnership must make its determination of the seller's share of partnership liabilities as of the transfer date (or as of a "determination date" as prescribed under the proposed regulations). As under the interim guidance, the proposed regulations provide the certification will not be treated as incorrect or unreliable if the partnership also certifies that it does not have actual knowledge of any events occurring after its determination that would cause the amount of seller's share of partnership liabilities to be more than 25% different from the amount shown.

Withholding Amount Exceeds Purchase Price

If a partnership is heavily levered, the required withholding amount could exceed the consideration actually paid. In that circumstance, under both the interim guidance and proposed regulations, the buyer is permitted to limit withholding to 100% of the purchase price. As an example, if a buyer pays cash of 100 and seller's share of partnership liabilities is 1,000, the buyer's withholding obligation is reduced from 110 (10% of amount realized of 1,100) to 100

(amount realized of 1,100 less decrease in liabilities of 1,000). Thus, to the relief of the buyer, it would not be obligated to remit a withholding payment that exceeds the consideration it actually pays.

Partnership Liabilities Cannot Be Established

If neither certification to establish partnership liabilities is able to be provided and buyer cannot otherwise determine that amount, both the interim guidance and the proposed regulations require that the buyer withhold 100% of the amount realized less the reduction in partnership liabilities—in other words, 100% of the purchase price must be withheld. A seller for whom this result would be unacceptable needs to plan ahead and negotiate under the transaction agreement for mitigation provisions or exclusion rights.

Certification of Maximum Tax Liability – Proposed Regulations Only

A new procedure available only under the proposed regulations allows the withholding amount to be reduced in certain cases where the seller's maximum tax liability arising from the sale is less than the required withholding amount. To qualify for the reduction, the seller must certify certain information (for example, its effectively connected capital gain and ordinary gain) and make certain representations establishing a lower maximum tax liability (based in part on gain information that must be provided by the partnership).

Partnership Liability for the Withholding Amount – Proposed Regulations Only

Under the proposed regulations, the partnership is required to withhold on future distributions to the buyer unless the buyer certifies to the partnership that a withholding exception applies or that the required withholding has been done. The partnership must review the buyer's certification and any underlying certification on which the buyer has relied. If the partnership knows or has reason to know that an underlying certification is incorrect or unreliable (for example, based on information in its books and records that is not available to the buyer), the partnership must withhold from distributions to the buyer even though the buyer properly relied on the certification. Consequently, an informed buyer would check with the partnership before relying on a certification.

Seller's Obligations

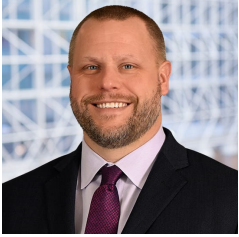
The above rules apply only for purposes of the withholding requirement. They do not affect the seller's actual tax liability except that the amount withheld by the buyer generally may be credited against the seller's U.S. tax liability. The seller must file a U.S. tax return and pay to the IRS any amount of tax due in excess of the withheld amount. A claim for refund may be made for an overpayment.

To Be Continued...

Industry professionals and foreign advisors across the globe, as well as U.S. tax practitioners, are reacting to the interim guidance and the proposed regulations. Some have observed that the proposed regulations may be a significant hindrance to many transactions. We expect the IRS

may receive significant comments. Although it may be months before the proposed regulations are finalized, they will likely impact future transactions for years to come. Please let us know if you would like to be apprised of new developments.

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