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IRS Guidance Fills Out Grecian Magnesite's Statutory Repeal

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On Dec. 20, 2018, the U.S. Department of the Treasury and the Internal Revenue Service released proposed regulations on the treatment of a foreign partner's transfer of an interest in a partnership that is engaged in the conduct of a trade or business in the United States.[1] The proposed regulations provide much-awaited guidance to Internal Revenue Code Section 864(c)(8), a new code section introduced by the 2017 Tax Cuts and Jobs Act.[2] If the proposed regulations are finalized by June 22, 2019, then they would be retroactively effective as of Nov. 27, 2017. If they are not finalized by such date, then they would prospectively be effective as of Dec. 20, 2018. This article provides an overview of certain aspects of the proposed regulations.

Background of Section 864(c)(8)

Section 864(c)(8) was enacted as a return to the IRS' long-held position in Revenue Ruling 91-32,[3] which had been successfully challenged in the U.S. Tax Court in Grecian Magnesite Mining Industrial & Shipping Co. SA v. Commissioner of Internal Revenue.[4]

In Revenue Ruling 91-32, the IRS took an aggregate approach to the taxation of partnerships with income effectively connected with the conduct of a U.S. trade or business. Where a partnership is engaged in a U.S. trade or business through its U.S. fixed place of business, the IRS ruled that a foreign partner's gain or loss on a transfer of an interest in such partnership will be treated as ECI, to the extent such gain or loss is attributable to ECI property of such partnership. However, in Grecian Magnesite, the Tax Court rejected the IRS' reasoning in this ruling and held that a foreign partner's gain or loss on a transfer of an interest in the partnership should generally not be treated as ECI unless certain exceptions apply. That was because a partnership interest in the hands of a foreign partner is personal property and, therefore, gain or loss on such interest would be treated as foreign source items pursuant to the source rule applicable to a sale of personal property.

Section 864(c)(8) was enacted to overturn the result of Grecian Magnesite. It expressly provides that gain or loss of a foreign partner from a transfer of an interest in a partnership generally will be treated as ECI to the extent that such partner would have had ECI if the partnership had sold all of its assets at fair market value as of the date of the transfer.[5]

Corresponding Withholding Regime

As a companion to Section 864(c)(8), the TCJA introduced new Section 1446(f) that requires the transferee of a partnership interest to withhold 10 percent of the amount realized on the disposition of a partnership interest if any portion of the gain on such disposition would be treated as ECI, unless the transferor certifies that the transferor is not a foreign person. Treasury and the IRS released Notice 2018-08, which temporarily suspends the withholding requirement in connection with a transfer of certain interests in publicly traded partnerships, and Notice 2018-29, which describes the withholding requirements that apply in the case of a disposition of a partnership interest that is not publicly traded.

The proposed regulations do not change the application of such notices nor provide any guidelines regarding Section 1446(f). Rather, the preamble to the proposed regulations notes that Treasury and the IRS intend to issue separate guidance under Section 1446(f) expeditiously.

Until such guidance is issued, Notice 2018-29 continues to govern, and a transferee is generally required to withhold unless (i) the transferee receives a certification from the transferor stating that the transfer of its partnership interest will not result in realized gain, (ii) the transferor certifies that for each of the past three years the transferor's ECI from the partnership was less than 25 percent of the transferor's total income from the partnership or (iii) the transferee receives a certification from the partnership that the partnership's effectively connected gain under Section 864(c)(8) would be less than 25 percent of the total gain on the deemed sale of all its assets.

Determination of ECI

Pursuant to Section 864(c)(8), in order to determine the amount of ECI on a foreign partner's transfer of a partnership interest, the foreign partner should first determine (i) the amount of gain or loss on the transfer — an "outside gain or loss" — and then (ii) the amount of ECI that it would have recognized if the partnership sold all of its assets immediately before the transfer — an "ECI share".

The amount of ECI on such transfer will be the lesser of (i) such foreign partner's outside gain or loss on the transfer and (ii) such foreign partner's ECI share at the time of such transfer. Pursuant to this method, in certain instances, the amount of ECI gains of a foreign partner with respect to a transfer of its interest in a partnership may be reduced by non-ECI losses attributable to such interests.

Determination of Outside Gain or Loss

The proposed regulations do not provide a special method for determining the transferor's outside gain

or loss. Rather, the proposed regulations confirm that the amount and character of the transferor's outside gain or loss is determined under all relevant provisions of the code and the regulations thereunder, specifically referring to Section 741 and Section 751.

Under Section 741, gain or loss recognized by a partner on the transfer of its partnership interest is generally considered capital gain or loss. However, Section 751 requires the transferor to recognize ordinary income or loss with respect to its share of the partnership's unrealized gain or loss that is attributable to certain "hot assets" — i.e., unrealized receivables or inventory items — of the partnership.

To take into account Section 751 for purposes of computing ECI, the proposed regulations provide that a transferor should separately apply Section 864(c)(8) for its capital gain or loss and its ordinary gain or loss. Under this bifurcated approach, it is possible that a foreign transferor may recognize (1) ECI gain even if it recognizes an overall net loss with respect to the transfer of the partnership interest, (2) ECI loss even if it recognizes an overall net gain or (3) ECI gain and ECI loss even if it has zero ECI on an overall basis. It is unclear how this bifurcated approach will interact with the withholding requirements under Section 1446(f).

The proposed regulations generally provide that a foreign transferor's gain or loss recognized in connection with a transfer of its partnership interest does not include gain or loss to the extent that such gain or loss is not recognized pursuant to one or more nonrecognition provisions of the Code. Any nonrecognition provision that reduces a transferor's outside gain or loss will not reduce — proportionately or otherwise — such transferor's corresponding ECI share. Therefore, in certain circumstances where only a portion of the transfer is subject to a nonrecognition provision, a transferor should investigate the possibility of bifurcating the transaction in order to mitigate certain adverse tax consequences that might arise as a result of this rule.

Treasury and the IRS have invited comments regarding the application of nonrecognition provisions, as they recognize that certain nonrecognition transactions may have the effect of reducing gain or loss that would be taken into account for U.S. federal income tax purposes. For example, if a partnership that conducts a trade or business within the United States owns property not subject to tax in the hands of a foreign partner, the partnership may distribute such property to the foreign partner rather than a U.S. partner, thereby allowing such foreign partner to avoid recognizing its share of ECI. We expect there to be more guidance forthcoming on these issues.

Determination of ECI Share

The proposed regulations provide a three-step method to determine a transferor's ECI share with respect to a transfer.

The first step is to determine the amount of gain or loss the partnership would recognize with respect to each of its assets upon a deemed sale on the date of the transfer. For this purpose, a deemed sale is a hypothetical sale by the partnership to an unrelated person of each of its assets in a fully taxable

transaction for cash in an amount equal to the fair market value of each such asset immediately before a transferor partner's transfer of its interest in the partnership. It is not clear how the fair market value is determined for this purpose.

In a tiered-partnership context, the proposed regulations provide that if a foreign transferor transfers an interest in an upper-tier partnership that owns, directly or indirectly, an interest in a lower-tier partnership that is engaged in a U.S. trade or business, the deemed sale gain or loss must be computed with respect to such lower-tier partnership based on a deemed sale of such lower-tier partnership's assets, and then allocated up to the upper-tier partnership.

Without any minimum ownership threshold in a lower-tier partnership, this look-through approach may impose significant burdens in applying the deemed sale rule to a transfer occurring at an upper-tier partnership level. Further, the upper-tier partnership may not be in a position to require the lower-tier partnership to value its assets as of the date of the transfer occurring at the upper-tier partnership level.

The proposed regulations also clarify that when a foreign transferor is a partner in an upper-tier partnership and the upper-tier partnership transfers an interest in a lower-tier partnership that is engaged in a U.S. trade or business, the upper-tier partnership must determine its ECI by applying the principles of the proposed regulations, including the tiered partnership rules described above.

The second step is to determine the amount of gain or loss that would be treated as ECI with respect to each asset that is subject to a deemed sale under the first step. This determination is made under the general rules of Section 864, but the proposed regulations treat each deemed sale as attributable to a U.S. fixed place of business maintained by the partnership, and therefore as generating ECI unless a limited exception applies as discussed below.

For example, it appears that the proposed regulations could deem a partnership to maintain a U.S. fixed place of business for this purpose even if such partnership does not actually have any U.S. fixed place of business. This may pose an interesting issue for an ECI-generating partnership that is structured to avoid a U.S. fixed place of business. The proposed regulations also deny the use of the foreign office material participation rule where such rule would result in the income not being ECI in the case of an actual sale.

The just-described expansion of the ECI rules is ameliorated somewhat in certain circumstances. Gain or loss from the deemed sale of an asset of a partnership that is engaged in a U.S. trade or business will not be treated as ECI as a result of being deemed attributable to the partnership's U.S. fixed place of business only if (1) no income or gain previously produced by the asset was taxable as ECI by the partnership — or its predecessor — during the 10-year period ending on the date of the transfer and (2) the asset was not used, or held for use, in the U.S. trade or business of the partnership — or its predecessor — during the 10-year period ending on the date of the transfer. It appears that this 10-year lookback period is intended to match the 10-year lookback period in Section 864(c)(7) for the taxation of property formerly used to generate ECI.

This apparent deemed attribution of a U.S. fixed place of business may effectively convert certain non-

ECI items to ECI items, thereby increasing the amount of ECI recognized in connection with a transfer. Because neither Section 864(c)(8) nor its legislative history suggests that Congress intended this result, it is questionable whether Treasury has the authority to effect this result through the creation of this deemed attribution rule.

The third step is to determine the foreign transferor's distributive share of deemed-sale ECI. The proposed regulations provide that a partner's distributive share of ECI from the deemed sale is determined under all applicable code sections, taking into account any allocations under Section 704(c) and any basis adjustment under Section 743. This is a welcoming clarification for taxpayers and may mitigate the potential double taxation issue that can arise when the same interest changes hands among multiple foreign investors. But the preamble to the proposed regulations notes that Treasury and the IRS are still considering whether Section 704 and the regulations thereunder adequately prevent the avoidance of the purposes of Section 864(c)(8) through allocations of ECI to specific partners, and, therefore, additional guidance or clarification may be forthcoming.

Coordination with Other Sections

Section 864(c)(8)(C) provides that the amount of the partner's effectively connected income under Section 864(c) will be reduced by the amount taxed under Section 897 — the Foreign Investment in Real Property Tax Act, or FIRPTA. However, the proposed regulations provide that when a partnership holds U.S. real property interests and is also subject to Section 864(c)(8), the amount of the foreign transferor's ECI will be determined under Section 864(c)(8) and not under Section 897(g). Because the proposed regulations clarify that Section 864(c)(8) trumps Section 897(g), it is no longer necessary to provide that any ECI recognized under Section 897(g) should reduce the amount of ECI under Section 864(c)(8).

In addition, the proposed regulations clarify that they do not prevent any portion of gain or loss recognized on the transfer of a partnership interest from being treated as ECI under other provisions of the code. In other words, even if a transfer is not treated as generating ECI under Section 864(c)(8), a taxpayer may still recognize ECI on such transfer as a result of the general ECI rules.

Treaties

The proposed regulations provide that the treaty provision applicable to gains from the alienation of a permanent establishment, or PE, applies to the transfer by a foreign transferor of an interest in a partnership. The preamble to the proposed regulations indicates that this rule is intended to preserve the United States' taxing jurisdiction over the gain on the transfer of a partnership interest that is subject to tax under Section 864(c)(8), because many U.S. income tax treaties allow the country in which a PE is located to tax gains from the alienation of a PE in such country. However, this provision applies only to a partnership that has a PE in the United States.

Therefore, if a partnership is structured to avoid having any PE in the United States, this treaty provision in the proposed regulations does not seem to permit the United States to tax gains that are otherwise

exempt under other applicable provisions of the treaty. Similarly, if gains are exempt under a tax treaty even in the presence of a PE — e.g., as is often the case in respect of ships and aircraft — such exemption will continue to apply despite the treaty rules of the proposed regulations.

Anti-Stuffing Rule

The proposed regulations include an anti-stuffing rule. This rule is intended to prevent inappropriate reductions in amounts characterized as ECI on the transfer of an interest in a partnership by stuffing certain assets — e.g., assets that have built-in losses or that are expected to lose value — into the partnership in connection with such transfer.

While the proposed regulations under Section 1446(f) are still forthcoming, there may be similar anti-stuffing rules to prevent taxpayers from stuffing certain assets into the partnership in order to qualify for the 25 percent ECI limitations that exempt withholding under Section 1446.

Concluding Observations

The proposed regulations provide a relatively straightforward method for determining the amount of a foreign partner's ECI upon a sale of its partnership interest in a partnership with a U.S. trade or business. However, in many instances the method may not reflect economic reality because it appears to require any gain on the deemed sale of the partnership's assets to be attributed to a deemed U.S. fixed place of business, thereby generating ECI, unless certain narrow exceptions apply. This expansion of the general ECI rules arguably exceeds Treasury's authority as applied in a number of circumstances. However, if properly structured, a foreign partner may be able to reduce the amount of ECI on the transfer of a partnership interest through the application of a treaty or otherwise.

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[1] The proposed regulations are available at https://www.irs.gov/pub/irs-drop/reg-113604-18.pdf.

[2] 115 P.L. 97. For an overview of the TCJA and related IRS guidance implementing the same, see the Mayer Brown Tax Reform Roadmap, available at https://www.mayerbrown.com/experience/us-tax-reform-roadmap/.

[3] 1991-1 C.B. 107.

[4] Grecian Magnesite Mining v. Commissioner, 149 T.C. No. 3 (2017), appeal argued, No. 17-1268 (D.C. Cir. Oct. 9, 2018).

[5] Although Section 864(c)(8) is dispositive of the issue for taxable years beginning after Dec. 31, 2017, Grecian Magnesite remains relevant for prior taxable years. While the IRS is currently appealing Grecian Magnesite, we believe there are strong arguments in support of the Tax Court's view.