

Legal Update

IRS Issues Proposed Regulations Regarding Withholding Under Section 1446(f)

On May 7, 2019, the US Treasury Department and the Internal Revenue Service (the "IRS") released proposed regulations regarding Section 1446(f) of the Internal Revenue Code of 1986, as amended (the "Code") regarding withholding obligations related to certain transfers of interests in partnerships engaged in a US trade or business.¹ This Legal Update is intended to provide an overview of the proposed rules for withholding, reporting and paying tax under Section 1446(f).

Section 1446(f) and previous guidance

Section 1446(f) of the Code, enacted as part of the Tax Cuts and Jobs Act (P.L. 115-97), generally requires the transferee of a partnership interest to withhold a tax equal to 10% of the amount realized if the transferor is a foreign partner and any portion of the gain would be treated as effectively connected with the conduct of a trade or business within the United States under Section 864(c)(8) ("ECI") (i.e., to the extent that the partner would have recognized ECI if the partnership had sold all of its assets at fair market value at the time of the disposition).²

To the extent a transferee fails to withhold, Section 1446(f) imposes secondary liability on the partnership, which is required to withhold from distributions to the transferee. A distribution from a partnership of money in excess of a partner's

basis in its partnership interest may also require Section 1446(f) withholding, with the partnership treated as the transferee. In this situation, secondary liability is not imposed on the partnership because the partnership already has primary withholding liability as a transferee.

The US Treasury Department and the IRS previously released guidance addressing Section 1446(f) in Notice 2018-08 (which temporarily suspended withholding requirements for interests in publicly traded partnerships) and Notice 2018-29 (which provided guidance and announced the intent to issue proposed regulations with respect to non-publicly traded partnerships). These new regulations would adopt many of the rules of Notice 2018-29 with some modifications.

General rules under the proposed regulations

The proposed regulations outline the general rules for withholding on transfers of non-publicly traded partnership interests. Transfers of publicly traded partnership interests are generally subject to special rules, described below. The amount realized with respect to the transfer (from which the transferee must withhold) is generally determined under Sections 1001 and 752 of the Code.

The amount realized by the partner also includes any reduction in the transferor's share of partnership liabilities. However, because this information is often not readily available to transferee partners, the proposed regulations generally allow certifications from the transferor or partnership regarding the transferor's share of partnership liabilities. The proposed regulations follow Notice 2018-29 in recognizing that in some cases, a reduction in a transferor's share of partnership liabilities may cause the required withholding amount to exceed the amount realized. In those cases, the proposed regulations permit the withholding requirement to be computed without regard to the decrease in the transferor's share of liabilities.

Under Section 864(c)(8), gain on the sale of interests in a partnership engaged in a US trade or business is treated as effectively connected with the conduct of a US trade or business (and therefore taxable on a net basis) to the extent the gain is allocable to US business assets of the partnership. Section 1446(f) is an enforcement mechanism for the tax imposed under Section 864(c)(8). The proposed regulations provide a procedure to determine the amount to withhold that is intended to estimate the amount of tax the transferor is required to pay under Section 864(c)(8). Under this procedure, the transferee must receive certain documentation from the transferor and the partnership regarding the amount of gain.

In the case of a disposition by a foreign partnership, the proposed regulations provide a procedure to limit the amount of withholding to the portion of the amount realized that is attributable to foreign partners (subject to certain documentation requirements being satisfied, including the transferor providing the transferee with an IRS Form W-8IMY that includes evidence of non-foreign status for each partner that is treated as a US person).

A transferee must comply with the rules related to reporting and paying an amount withheld to the IRS. An amount withheld with respect to a

payment to a non-US transferor pursuant to Section 1446(f) does not relieve the non-US transferor of its obligation to comply with its US tax return filing and payment requirements.

If a transferee fails to withhold, the proposed regulations require that the partnership must withhold from any distribution made to the transferee. In general, a partnership determines whether a transferee has withheld by relying on a certification that it receives from the transferee, which the partnership may generally rely on unless it knows or has reason to know that the certification is incorrect.

Notably, the proposed regulations provide a new coordination rule for transfers of US real property interests under the so-called FIRPTA rules, pursuant to which a transferee will be subject to the withholding requirements of Section 1445 (where a 15%, as opposed to 10%, rate of withholding applies) instead of Section 1446(f).

Exceptions to withholding

The proposed regulations, generally following Notice 2018-29, provide for six exceptions to withholding by the transferee. In order to rely on any of the exceptions, described below, the transferee must obtain, from either the transferor or the partnership, a certification:

1. Of non-foreign status by the transferor, which must include the transferor's taxpayer identification number ("TIN"). A Form W-9 may be used.
2. That the transferor would not realize any gain on the transfer of the partnership interest (including any ordinary income arising from Section 751(a), which could require ordinary gain realization even if there was an overall loss on the transaction).
3. From the partnership that, if the partnership were to sell all of its assets at fair market value, the amount of net effectively connected gain resulting from the deemed sale would be less than 10% of the total gain (reduced from 25% under Notice 2018-29).

4. From the transferor stating that (1) the transferor was a partner in the partnership at all times in the three immediately prior taxable years and (2) the transferor's allocable share of effectively connected taxable income was less than \$1 million in each such year and was less than 10% of its total distributive share of the partnership's net income in each such year (reduced from 25% under Notice 2018-29).
5. From the transferor that a nonrecognition provision of the Code applies to all of the gain realized on the transfer, together with a brief description of the transfer and the relevant law and facts. An adjustment to the amount withheld may be permitted if a nonrecognition provision of the Code would apply to only part of the gain.
6. That 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. This certification must include a valid Form W-8BEN or Form W-8BEN-E. The transferee must mail a copy of this certification to the IRS by the 30th day after the date of the transfer in order to rely on it.

Withholding rules for publicly traded partnerships and brokers

The proposed regulations also provide rules for withholding and reporting on the transfer of an interest in a publicly traded partnership. These rules would end the suspension of the application of Section 1446(f) to publicly traded partnership interests under Notice 2018-08.

Under the proposed regulations, if the transfer of a publicly traded partnership interest is effected through one or more brokers, the transferee is not required to withhold, and, instead, one of the brokers must withhold. A broker for this purpose is broadly defined to include any person, foreign or domestic, that in the ordinary course of a trade or business during the calendar year stands ready to effect sales made by others and that, in

connection with a transfer of a publicly traded partnership interest, receives all or a portion of the amount realized on behalf of the transferor. If a broker is not involved, the usual rules of Section 1446(f) apply.

In the case of transfers of publicly traded partnership interests, the proposed regulations provide five exceptions to a broker's obligation to withhold:

1. A certification of non-foreign status by the transferor provided to the broker.
2. A qualified notice posted by the publicly traded partnership that states that the 10% exception applies, i.e., had the publicly traded partnership sold all of its assets at fair market value, either the amount of gain that would have been effectively connected with the conduct of a trade or business within the US would be less than 10% of the total gain, or no gain would have been effectively connected with the conduct of a trade or business within the US.
3. In the case of a distribution from a publicly traded partnership, a qualified notice from the publicly traded partnership that the distribution does not exceed the net income the partnership earned since the record date of the partnership's last distribution.
4. If the broker is already required to withhold under Section 3406.
5. A certification from the transferor that the transferor is not subject to tax on any of the gain pursuant to an income tax treaty between the United States and a foreign country.

As described above, Section 1446(f) generally provides that the "amount realized" (i.e., the amount subject to withholding) includes the relief of the partner's share of partnership liabilities. However, because of the difficulties involved with requiring a broker to timely determine a transferor's share of partnership liabilities in the case of a transfer of a publicly traded partnership interest, the "amount realized" does not include

relief of the partner's share of partnership liabilities. As a general matter, the "amount realized" is the amount of gross proceeds paid or credited upon the transfer to the customer or broker, as applicable.

With certain limited exceptions, a publicly traded partnership is not subject to the secondary liability for withholding on distributions to a transferee if the transferee fails to withhold. A publicly traded partnership would still be required to withhold on distributions if it determined that it had provided a qualified notice that falsely stated that an exemption applied.

Applicability

The proposed regulations would generally apply to transfers beginning after final regulations are published in the Federal Register, and certain provisions would apply to transfers beginning 60 days after that publication. However, until such

final regulations are issued, taxpayers may rely on Notice 2018-08, Notice 2018-29 or certain of these proposed regulations with respect to certain transfers.

For more information about the topics raised in this Legal Update, please contact any of the following authors.

Jared B. Goldberger

+1 212 506 2421

jgoldberger@mayerbrown.com

Matthew A. McDonald

+1 312 701 8321

mmcdonald@mayerbrown.com

Jonathan A. Sambur

+1 202 263 3256

jsambur@mayerbrown.com

George K. Haines

+1 312 701 8775

ghaines@mayerbrown.com

Endnotes

- ¹ The proposed regulations are available at <https://www.govinfo.gov/content/pkg/FR-2019-05-13/pdf/2019-09515.pdf>.
- ² For an overview of the proposed regulations promulgated under Section 864(c)(8), see <https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/01/treasury-adds-color-to-igreciani-repeal--proposed/files/treasury-adds-color-to-grecian-repeal-new/fileattachment/treasury-adds-color-to-grecian-repeal-new.pdf>.

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