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Section 1446(f) – The Confounding And Unavoidable U.S. Tax Withholding Regime That Applies to Nearly All Transfers of Partnership Interests

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Prior to the 2017 Tax Cuts and Jobs Act ("TCJA"), the topic of whether a foreign partner that sells its interest in a partnership engaged in a U.S. trade or business would be subject to U.S. tax on its gain from the sale attributable to the partnership's U.S. trade or business was in dispute. The IRS took the position that foreign partners were indeed subject to such a tax.[1] However, the 2017 Tax Court ruling in *Grecian Magnesite Mining Industrial & Shipping Co. v. Commissioner* made clear that the IRS's interpretation of the law was invalid.[2] Taxpayers celebrated the ruling, but the victory was not long lasting. Only five months later, the TCJA introduced §864(c)(8) to the Internal Revenue Code,[3] codifying the IRS's pre-*Grecian Magnesite* position and applying it to all transfers of partnership interests occurring on or after November 27, 2017.

Generally, §864(c)(8) treats gain or loss from the sale of a partnership interest (ordinarily treated as foreign source capital gain under §741) as income effectively connected with the conduct of a U.S. trade or business ("ECI"). The amount of gain or loss treated as ECI is equal to the distributive share of ECI the transferring partner would be allocated if the partnership sold all of its assets as of the date of the transfer (less any amounts treated as ECI under FIRPTA).[4] Section 1446(f), also added to the Code by the TCJA, is the enforcement mechanism for §864(c)(8). Section 1446(f) backstops §864(c)(8) by imposing an obligation on the transferee to deduct and withhold 10% of the amount realized by the transferor if *any* of the gain recognized by the transferor would be treated as ECI under §864(c)(8) unless certain exceptions, discussed below, apply.

Under final regulations published on November 30, 2020 (the "2020 Regulations"), a transferee is required to withhold under §1446(f) on the transfer of *any* partnership interest, domestic or foreign, unless an exception applies or the interest is in a publicly traded partnership (a "PTP") and the transfer is effected through a broker.[5] In other words, the 2020 Regulations assume almost every transfer of a partnership interest is subject to withholding until it is established otherwise. To encourage compliance by transferees, if a transferee fails to withhold any amount that was required to be withheld, §1446(f) requires the partnership whose interest was transferred to withhold from distributions to the transferee part-

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[1] *See* Rev. Rul. 91-32.

[2] 149 T.C. 63 (2017), *aff'd*, 926 F. 3d 819 (D.C. Cir. 2019).

[3] Section references hereinafter refer to Sections of the Code.

[4] I.R.C. §864(c)(8)(B).

[5] Transfers of PTP interests effected through brokers are discussed in Part II of this article.

ner to satisfy the withholding obligation, unless certain exceptions apply.[6] Because of the 2020 Regulations' far-reaching (over-reaching?) scope, buyers and sellers of any partnership interests must be aware that they could have a U.S. withholding tax liability or collection obligation imposed on them. In addition, general partners or managers of partnerships should be aware that a partnership itself might have a U.S. withholding tax obligation imposed on it if a partner that acquires an interest in the partnership from another partner fails to properly withhold. Fund investors and those who invest in or represent investment funds should be particularly conscious of these rules, whether the investor or fund has a U.S. connection or not. For our friends north of the border, who frequently find themselves invested in U.S. funds or across from a U.S. buyer when selling a fund investment, §1446(f) is likely to come up during a sale process and can impose a substantial burden on selling a fund interest.

In addition to providing some necessary background and context regarding §1446(f), this article attempts to provide everything the reader needs to know about §1446(f) withholding but didn't know enough to ask. The following discussion has become unavoidable due to the scope of the withholding tax regime and the potential for complexity it introduces to all secondary sales of partnership interests for buyers, sellers, and the partnerships involved. In Part I of this article, we discuss the exceptions available to sellers to avoid being withheld upon, the compliance burden imposed to prove that some of these exceptions apply, and also the burden of complying when an exception doesn't apply. In Part II, we discuss the rules applicable to sales of PTP interests effected through brokers and recent guidance providing some relief to brokers by narrowing the circumstances under which they will be required to withhold.

DIRECT SECONDARY SALES OF PARTNERSHIP INTERESTS

For dispositions of partnership interests not effected through a broker, §1446(f) and the 2020 Regulations provide six possible exceptions to withholding. Each of these exceptions requires a certification be delivered to the transferee. If none of these exceptions apply, however, the transferor may be required to provide one of several forms of certification as to the amount realized by the transferor, specifically with respect to any reduction in the transferor's share of partnership liabilities. Otherwise, the transferee may be, or may take the position that it is, required to withhold 100% of the amount realized (in that case, not taking into account any reduction in the transferor's share of partnership liabilities).[7]

Avoiding Withholding on Transfers of Non-PTP Partnership Interests

Generally, transferors may avoid being withheld upon if the transferee receives any of the following certifications:

1. that the transferor is not a foreign person (the "Non-Foreign Exception");[8]

2. that no gain will be realized by the transferor;[9]

3. a "Less than 10% EC Gain" certification (discussed below);[10]

4. a "Less than 10% ECI" certification (discussed below);[11]

5. that the transaction is a nonrecognition transaction and no gain or loss will be recognized;[12] or

6. that a U.S. tax treaty exempts the gain from tax in the United States.[13]

Some of these certifications, if applicable, are relatively simple for transferors to provide. If the transferor is a U.S. person, will realize no gain, has structured the disposition as a nonrecognition transaction, or has the benefits of a tax treaty with the U.S. that exempts the gain from U.S. federal income tax, the transferor should be able to easily provide the applicable certification and avoid any withholding. Because these four certifications are relatively straightforward for transferors to provide, we will not discuss them at length here. However, where none of those four exceptions is available, transferors may look to provide either a Less than 10% EC Gain or Less than 10% ECI certification, both of which may be difficult to confirm as applicable and, even when applicable, may be difficult to provide.

Less than 10% EC Gain Certification

A "Less than 10% EC Gain" certification is a certification from the partnership the interest of which is

[6] *See* Reg. §1.1446(f)-3(a). Discussed below at Part I.D "*Partnership's Obligation to Withhold on Transferee*."

[7] *See* Reg. §1.1446(f)-2(c)(3)(ii).

[8] Reg. §1.1446(f)-2(b)(2). A transferor may provide an IRS Form W-9 to establish that this exception applies.

[9] Reg. §1.1446(f)-2(b)(3).

[10] Reg. §1.1446(f)-2(b)(4).

[11] Reg. §1.1446(f)-2(b)(5).

[12] Reg. §1.1446(f)-2(b)(6).

[13] Reg. §1.1446(f)-2(b)(7). Article VII of the U.S.-Canada tax treaty, for example, provides an exemption from U.S. tax for the business profits of a Canadian resident not attributable to a permanent establishment within the United States.

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being transferred that, in a deemed sale of the partnership's assets at fair market value as of the determination date, either (a) the partnership would have no gain that would have been ECI or, if the partnership would have a net amount of such gain, the amount of the partnership's net effectively connected gain would be less than 10% of the total net gain; or (b) the transferor would not have a distributive share of net gain from the partnership that would have been ECI, or, if the transferor would have a distributive share of such gain from the partnership, the transferor's distributive share of net effectively connected gain from the partnership would be less than 10% of the transferor's distributive share of the total net gain. Alternatively, the partnership may provide a certification that it was not engaged in a U.S. trade or business at any time during the partnership's tax year through the date of transfer.[14]

Because a Less than 10% EC Gain certification must be provided by the partnership, transferors face some hurdles in obtaining the certification. When we represent non-U.S. fund investors, we expect §1446(f) will come up if the investor ever desires to sell its interest. Accordingly, there is usually some negotiation at the time the investment is made with respect to whether the fund will provide a Less than 10% EC Gain certification, if it is able to do so at the time of a sale by the investor. However, because the certification is made under penalties of perjury, managers and their counsel tend to be cautious in obligating themselves to provide the certification, even if the facts are such that the fund may be able to provide it. It is also doubtful that a fund manager would be willing to provide the certification unless it is certain that the certification would be true. Even when a fund intends not to make unblocked U.S. flow-through investments and believes that it has not done so, the fund could be hesitant to provide the certification without conducting a full analysis. Funds may then balk at the expense or difficulty of performing the calculations necessary to make the certification, or it may be impracticable to do so in the case of a fund of funds or a fund that has numerous tiers of flow-through investments. It may also come down to a matter of time. If §1446(f) compliance is not considered early in the transaction, then a fund may not be able to get comfortable providing the certification in time to meet a closing deadline.

Less Than 10% ECI Certification

A "Less than 10% ECI" certification is provided by the transferor certifying that, during the lookback period (generally, the preceding three tax years), the transferor's distributive share of gross ECI from the partnership for each of the tax years in the lookback period was less than $1 million and less than 10% of the transferor's total distributive share of gross income from the partnership in each year. The first hurdle in providing this certification is that the transferor must have been a partner at all times during the lookback period.[15] Next, if the transferor was not allocated any gross income in one or more of the lookback years, the transferor may not provide the certification.[16] This rule can be particularly frustrating for investors in the fund space, where capital appreciation is regularly favored over current yield and therefore the fund may not have any income to allocate in some years. For purposes of making this certification, transferors generally must rely on Schedules K-1 they receive from the partnership. For investors in non-U.S. funds, however, this option is often not available as a non-U.S. fund may not issue Schedules K-1 at all. Non-U.S. funds may not be required to file U.S. tax returns or, even if required to file U.S. tax returns, may be required to provide Schedules K-1 or equivalent statements only to U.S. partners.[17] Another potential hurdle is that partners seeking to dispose of their interests early in the life of a partnership, before it has realized any income, may find themselves unable to provide this certification. Non-U.S. fund investors may also experience this problem simply because the fund uses a blocker below the partnership to shield the non-U.S. investor from ECI, which also effectively blocks the partner from receiving a distributive share of any income absent distributions from the blocker.

Compliance When No Exception to Withholding Applies

If no exception to withholding is available, the parties to the transfer still have work to do with respect to §1446(f), unless the transferor is willing to accept being withheld upon at a 100% rate. The transferee must generally withhold 10% of the transferor's amount realized, but establishing what the amount realized is for this purpose is where much of the complexity lies when §1446(f) withholding cannot be avoided.

In general, the transferor's amount realized is determined under §1001 and regulations thereunder.[18] Accordingly, the amount realized includes (i) the amount of cash paid, (ii) the fair market value of property transferred, (iii) the amount of liabilities assumed by

[14] Reg. §1.1446(f)-2(b)(4)(i)(B).

[15] Reg. §1.1446(f)-2(b)(5)(i)(A).

[16] Reg. §1.1446(f)-2(b)(5)(iii).

[17] *See* Reg. §1.6031(a)-1(b).

[18] Reg. §1.1446(f)-2(c)(2).

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the transferee, and (iv) any reduction in the transferor's share of partnership liabilities that occurs as a result of the transfer.[19] If the transferee is unable to determine the amount realized because it does not have actual knowledge of the transferor's share of partnership liabilities and hasn't received a certification as to the amount of such liabilities, the transferee will be required to withhold 100% of the amount realized (not including any reduction in partnership liabilities).[20]

Alternative Procedure for Establishing Transferor's Share of Partnership Liabilities Included in Amount Realized

While §1001 and regulations thereunder prescribe no method for establishing the amount of partnership liabilities from which a transferee is relieved, the 2020 Regulations provide an ''alternative procedure'' for transferees to determine the extent to which a reduction in partnership liabilities is included in the amount realized.[21] Because transferees will rarely have actual knowledge of the transferor's share of partnership liabilities and the alternative procedure avoids 100% withholding in the absence of such knowledge, the ''alternative procedure'' is now generally the default method to establish the amount realized for §1446(f) withholding purposes. Under the alternative procedure, a transferee can rely on a certification of the transferor's share of liabilities provided by either the transferor or the partnership.

Transferor's Certification of Share of Partnership Liabilities

A transferee may rely on a certification from a transferor, other than a controlling partner, that provides the amount of the transferor's share of partnership liabilities reported on the most recent Schedule K-1 issued by the partnership, so long as the last day of the partnership taxable year for which the K-1 was issued was no more than 22 months before the date of the transfer.[22] If the transferor's actual share of liabilities at the time of the transfer differs from the amount reported on that K-1, the certification may still be relied upon if the transferor also certifies that it does not have actual knowledge of any events occurring after receiving the K-1 and before the date of the transfer that would cause the amount of the transferor's share of partnership liabilities at the time of the transfer to be more than 25 percent different from the amount shown on the K-1.[23] While seemingly straightforward, transferors may still experience problems when trying to provide this certification. As noted above, transferors may not receive a Schedule K-1 from the partnership because the partnership may not be not required to file a U.S. tax return or to issue K-1s to non-U.S. investors. Another not-so-infrequent issue occurs where the transferor's share of partnership liabilities is not shown on the face of the K-1. Sometimes the amount is detailed in a statement attached to the K-1, but more conservative practitioners may not be comfortable relying on the statements. Other times, there is nothing on the face of the K-1 or in its statements regarding the partner's share of liabilities. Query whether the absence of information on a K-1 regarding debt allocation can be relied upon to make a certification that the transferor has no reduction in partnership liabilities to take into account in the amount realized.

Transferor's Certification of Share of Partnership Liabilities

A transferee may also rely upon a certification from the partnership that provides the amount of the transferor's share of partnership liabilities.[24] If the transferor's actual share of liabilities at the time of the transfer differs from the amount on the certification, the certification may still be relied upon if the partnership also certifies that it does not have actual knowledge of any events occurring between the date such amounts were determined and the transferee receives the certification that would cause the amount of the transferor's share of partnership liabilities at the time of the transfer to be more than 25 percent different from the amount shown on the certification.[25] If the transferor cannot certify as to its share of partnership liabilities based on its K-1s, it must rely on the partnership to make the certification. If the partnership is uncooperative (e.g., because it would be too time consuming or costly to accurately determine the transferor's allocable share of liabilities), transferors may be stuck with 100% withholding.

Certification of Maximum Tax Liability to Reduce Withholding

If a foreign transferor's maximum tax liability on disposition is less than the amount required to be withheld, a transferee may rely on a certification from the transferor as to that lower amount of tax and with-

[19] *Id.*

[20] Reg. §1.1446(f)-2(c)(3)(ii).

[21] *See* Reg. §1.1446(f)-2(c)(2)(ii).

[22] Reg. §1.1446(f)-2(c)(2)(ii)(B).

[23] *Id.*

[24] *See* Reg. §1.1446(f)-2(c)(2)(ii)(C).

[25] *Id.*

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hold that amount instead of 10% of the amount realized.[26] The certification must include:

A. A statement that the transferor is either a nonresident alien individual, a foreign corporation, a foreign partnership, or a foreign trust;

B. The transferor's adjusted basis in the transferred interest;

C. The transferor's amount realized on the determination date as determined in accordance with the rules discussed above regarding establishing such amount;

D. Whether the transferor remains a partner immediately after the transfer;

E. The amount of outside ordinary gain and outside capital gain that would be recognized and treated as effectively connected gain under Reg. §1.864(c)(8)-1(b) (''effectively connected gain'');

F. The transferor's maximum tax liability;

G. A representation from the transferor that the transferor determined the amount of effectively connected gain referred to in (E) based on a statement from the partnership providing the transferor's deemed aggregate effectively connected ordinary and capital gain (as determined under Reg. §1.864(c)(8)-1(c)(3)(ii)(B), if applicable); and

H. A representation from the transferor that it has provided the transferee with a copy of the statement from the partnership referred to in (G).[27]

Transferors may run into problems providing this certification for many of the same reasons we mentioned with respect to the other certifications that require the partnership's cooperation. Certifying as to the amount realized for this purpose will generally require that the transferor be able to provide a certification as to its share of partnership liabilities, creating the same difficulties as discussed above with respect to providing such a certification. In addition, the transferor may have difficulty obtaining the statement from the partnership referred to in (G) and (H) above for many of the same reasons that a partnership may be hesitant or unable to provide a Less than 10% EC Gain certification – the partnership may not wish to bear the expense or difficulty of performing the calculations necessary to provide the statement.

Partnership's Obligation to Withhold on Transferees

Buyers and sellers are not the only parties that need to be cognizant of §1446(f). As the obligation to withhold may ultimately fall on the partnership whose interest was transferred, general partners and managers of partnerships need to also be aware of the rules. If a transferee fails to withhold any amount that was required to be withheld or does not certify to the partnership that it properly withheld (as discussed below), the partnership must withhold 100% of all distributions to the transferee partner until the transferee's withholding obligation (and interest on the underwithheld amount) is satisfied, unless certain exceptions apply.[28] For transferors and transferees, the possibility that the partnership may be required to take on the administrative burden of withholding can encourage general partners and managers to cooperate in providing the certifications discussed above, but may not be enough to offset the time and expense of doing the calculations necessary for the partnership to deliver the certifications.

Generally, a transferee must certify to the partnership within 10 days of the transfer the extent to which the §1446(f) withholding liability has been satisfied (a ''Withholding Certification'').[29] A Withholding Certification must either include a copy of Form 8288-A that the transferee files with respect to the transfer or state the amount realized and the amount withheld on the transfer. The certification must also include any certifications that the transferee relied on to apply an exception to withholding or to determine the amount to withhold.[30] The partnership may rely on a Withholding Certification and not withhold unless it knows, or has reason to know, that the certification is incorrect or unreliable.[31] A partnership that does not receive or cannot rely on a Withholding Certification must withhold tax equal to the full amount of each distribution made with respect to a transferred interest until it receives a certification on which it can rely.[32] Accordingly, in an illustration of the over-reaching nature of the 2020 Regulations, all partnerships, whether domestic or foreign, have a U.S. tax withholding obligation with respect to every transfer of an interest until the partnership receives a valid Withholding Certification.

Fortunately, a partnership is not required to withhold on a transferee if it already possesses an IRS Form W-9 from the transferor or a certification of the transferor's non-foreign status that (i) states the transferor is not a foreign person, (ii) provides the transferor's name, taxpayer ID number, and address, and (iii) is signed under penalties of perjury, unless the partnership knows or has reason to know the certifi-

[26] Reg. §1.1446(f)-2(c)(4).

[27] Reg. §1.1446(f)-2(c)(4)(iii).

[28] Reg. §1.1446(f)-3(a).

[29] Reg. §1.1446(f)-2(d)(2).

[30] *Id.*

[31] Reg. §1.1446(f)-3(a)(1).

[32] Reg. §1.1446(f)-3(c)(2)(iii).

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cation is incorrect or unreliable.[33] However, if the partnership receives a Withholding Certification that is inconsistent with a non-foreign certification it has on file, the partnership may not rely on such non-foreign certification.[34]

Finally, even if the partnership receives what appears to be a valid Withholding Certification, it may ultimately have a withholding obligation under §1446(f) if the IRS later determines that the transferee provided incorrect information in the Withholding Certification regarding the amount realized or the amount the transferee actually withheld and remitted.[35] If the partnership receives a notice from the IRS to such effect, the partnership must begin withholding on all distributions made to the transferee on or after the 15th day after it receives the notice until the amount prescribed in the notice has been withheld.[36]

WITHHOLDING ON TRANSFERS OF PTP INTERESTS EFFECTED THROUGH BROKERS

After the enactment of §1446(f), brokers and other interested parties convinced the IRS that withholding on transfers of interests in PTPs effected through a broker was administratively unfeasible. Even after the 2020 Regulations were released with rules on PTP transfers effected through brokers, the IRS deferred any withholding obligation on such transfers until 2023 to give brokers and PTPs time to create systems to administer the new rules. In addition, in December 2022, the IRS released a notice that will reduce the burden on brokers to determine whether a non-U.S. entity that is traded only on non-U.S. exchanges is a PTP for U.S. federal income tax purposes the transfer of which would be subject to §1446(f) (the ''PTP Notice'').

Now that 2023 has arrived, withholding under §1446(f) with respect to PTPs is in effect, and we provide an overview of the applicable rules below.

Under the 2020 Regulations, a broker effecting a transfer of a PTP interest, whether the PTP is U.S. or non-U.S., is required to withhold 10% of the gross proceeds under §1446(f), unless an exception applies. In addition to the Non-Foreign Exception, the 2020 Regulations contain four exceptions from withholding for a broker with respect to a transfer of a PTP interest, and the PTP Notice provides two additional exceptions.

Similar to the exception for transfers of non-PTP partnerships, an exception applies if the transferor properly claims treaty benefits, but the exception is available for transfers of PTP interests only if treaty benefits eliminate tax on all of the gain on the transfer (*i.e.*, there is no method to certify as to the transferor's maximum tax liability taking into account treaty benefits and reduce withholding accordingly). Other exceptions apply if the transferor is subject to backup withholding with respect to the proceeds of the transfer, or if the transferor certifies that it is a dealer in securities and any gain would be effectively connected with the conduct of a trade or business within the United States (without taking into account the rule that treats gain from the sale of an interest in a partnership that is engaged in a trade or business within the United States as effectively connected income).

The last exception in the 2020 Regulations applies if a broker relies on a ''qualified notice'' posted by the PTP within the 92-day period ending on the date of the transfer. A qualified notice must state that the ''10-percent exception'' applies, and the 10-percent exception applies if, as of a date no more than 92 days prior to the date the qualified notice is posted (the ''PTP designated date''), either (1) the PTP's gain on a deemed sale of all of its assets for fair market value would be comprised of less than 10% ECI (or no gain would be ECI) or (2) the PTP was not engaged in a U.S. trade or business at any time during its taxable year through the PTP designated date.

In response to concerns about the difficulty for brokers to determine whether a non-U.S. entity is a PTP for U.S. federal income tax purposes, the PTP Notice describes proposed regulations that the IRS intends to issue, and which can be relied upon currently, that would allow a broker that effects a sale of an interest in a non-U.S. entity that is traded only on non-U.S. exchanges to presume that the entity is not a PTP for U.S. federal income tax purposes unless the broker has actual knowledge otherwise. Once a broker has knowledge that an entity is a PTP, however, all of the withholding rules generally applicable to transfers of interest in PTPs apply.

Finally, the proposed regulations described in the PTP Notice would provide an exception from withholding under §1446(f) with respect to short sales of a PTP interest, including on the sale to market of the PTP interest acquired on the entry into the short sale or on the later transfer of an identical PTP interest to the original PTP interest owner. However, this exception would not apply if, on the date that the sale of the PTP interest to market is entered on the books of the broker, the transferor holds ''substantially identical property'' (within the meaning of §1233 of the Code) in an account with the broker or the broker has actual knowledge that the taxpayer holds substantially identical property in an account with another broker, be-

[33] Reg. §1.1446(f)-2(b)(2).

[34] Reg. §1.1446(f)-3(b)(1).

[35] Reg. §1.1446(f)-3(a)(2).

[36] *Id.*

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cause, in these cases, gain on the transfers would be attributable (at least to some extent) to ownership of a substantially identical PTP interest separate from the short sale.

The proposed regulations described in the PTP Notice would also allow a broker to rely on certifications received within one year after a payment to eliminate withholding under §1446(f), but in the case of a certification received more than 30 days after the date of payment, the certification would need to contain a signed affidavit stating that the information and representations on the certification were accurate as of the time of payment.

CONCLUSION

While §1446(f) is now five years old, new regulatory developments are still keeping practitioners on their toes. Continued increase in the volume of secondary sales of fund interests also means that §1446(f) will remain relevant for tax advisors who represent funds and their investors. And, thanks to Treasury's penchant for making the world responsible for enforcing U.S. tax laws, it's not only U.S. practitioners that must pay attention to §1446(f) issues. Due to its close proximity to and frequent dealings with the United States, Canadians should take note. Inbound investment from Canadians into U.S. funds and secondary sales of fund interests by Canadians to U.S. buyers is quite common – making §1446(f) concerns something they should consider when making investments in partnerships or when they sell such interests.

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