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Client Alert

January 29, 2018

Tax Act Provisions Affecting Sales of Interests in Partnerships

The Tax Act, signed into law in December 2017, added new IRC sections 864(c)(8) and 1446(f) pertaining to sales of interests in partnerships. Section 864(c)(8) provides that effective for sales after November 27, 2017, if a non-U.S. person sells an interest in a partnership that is engaged in a U.S. trade or business, any gain that is attributable to the partnership's U.S. trade or business will be treated as income that is effectively connected to a U.S. trade or business ("ECI") and subject to U.S. income tax.

This provision is consistent with Rev. Rul. 91-32 which provided that gains from a disposition of an interest in a partnership that conducts a trade or business through a fixed place of business or has a permanent establishment in the U.S. is ECI. The recent change to section 864 effectively overturns the Tax Court decision in *Grecian Magnesite Mining v. C.I.R.*, (149 T.C. 3) that held a foreign partner's gain from the redemption of its interest in a partnership did not constitute ECI under Section 882.

Section 1446(f) provides that a purchaser of a partnership interest is generally required to withhold 10% of the amount realized on the disposition and remit the withheld amount to the IRS if any portion of the seller's gain is ECI under section 864(c)(8). Importantly, this withholding provision applies to sales of both U.S. and non-U.S. partnerships that are engaged in a U.S. trade or business. Withholding is required unless:

- The purchaser receives an affidavit from the seller stating it is a U.S. person (a "non-foreign affidavit");
- The purchaser determines (and presumably documents) that no portion of the gain is attributable to a U.S. trade or business;
- The IRS provides for reduced withholding through issuance of a withholding certificate; or
- The partnership is publicly traded (*see* Notice 2018-08).

Note that withholding apparently applies to the entire sale proceeds even if only a small amount of realized gain is ECI. Purchasers of partnership interests should protect themselves against withholding liability by obtaining a non-foreign affidavit from the seller or obtaining appropriate assurances that the partnership is not engaged in a U.S. trade or business. If it is unclear whether an activity rises to the level of a trade or business, contractual safeguards may help mitigate the risk of under withholding.

The section 1446(f) withholding requirement is structurally similar to the section 1445 withholding tax on sales of U.S. real property interests. As with FIRPTA withholding, the obligation to withhold falls on the purchaser unless it obtains a non-foreign affidavit or

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satisfies one of the other specific exceptions. This potential tax liability should alter due diligence procedures affecting dispositions of partnership interests.

How the changes to sections 864 and 1446 will affect persons in countries with which the United States has an income tax treaty is unclear. U.S. tax treaties typically exclude gains from a U.S. trade or business if the non-U.S. person does not have a permanent establishment in the United States. As a general rule, newer domestic laws operate to override older treaty provisions. Thus, it's unclear whether a non-U.S. person can successfully claim exemption from the new rule if the person is not operating through a permanent establishment in the United States.

Non-U.S. persons that wish to invest in U.S. businesses may find that a corporate structure is preferable to a pass-through. The benefits of using a corporate structure (no attribution of U.S. trade or business and no requirement for shareholders to file a U.S. tax return) are now enhanced as a result of the reduced income tax rates for corporations.

Please contact us should you have any questions regarding the new rules discussed above.

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