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# IRS Proposes New Rules for Withholding on Interest Transfers in Certain Partnerships

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The landmark U.S. tax reform legislation that was enacted at the end of 2017 contained a new federal income tax on gain realized by a foreign seller on the transfer of an interest in a partnership that is engaged in a U.S. trade or business. This measure reversed a court decision that had exempted such gains from federal income tax. In order to enforce that new tax, the legislation also included a new withholding provision under section 1446(f) of the Code, which requires a purchaser of such an interest to withhold tax from the sale proceeds at a rate of 10%. On May 7, 2019, the IRS released proposed regulations with guidance on how to apply the section 1446(f) withholding tax. The proposed regulations are potentially relevant to any foreign investor in a partnership (including a limited liability company classified as a partnership for U.S. federal tax purposes) that carries on a trade or business in the United States or otherwise realizes income effectively connected with such a trade or business (ECI).

## Background

The proposed regulations follow two notices (the Notices) issued in 2018, which provided interim guidance on the application of section 1446(f) withholding.[1] In addition, the Notices delayed the implementation of section 1446(f) withholding with respect to the transfer of interests in a publicly traded partnership (PTP) and with respect to distributions from a partnership to a transferee partner that failed to withhold in accordance with section 1446(f). Once the proposed regulations are finalized, they will end these delays.

The proposed regulations relate only to section 1446(f) withholding, which is essentially an advance payment of the selling partner's underlying tax on ECI resulting from the sale. The IRS issued proposed regulations on the underlying tax in December 2018.

## The Proposed Regulations

The proposed regulations make important, and some surprising, changes to the interim guidance. Significant changes include the following:

- The Notices provided several exceptions from section 1446(f) withholding, including (i) an exception when the partnership certifies that the amount of effectively connected gain on a hypothetical sale of a partnership's assets would be below a threshold percentage, and (ii) an exception when a transferor certifies that less than a threshold percentage of its share of the partnership's income was ECI. The proposed regulations would reduce the applicable threshold (to 10%, from 25%).
- The proposed regulations provide an exception from withholding for transfers of interests where the transferor would be exempt from tax on ECI under a tax treaty. It is not yet known if a U.S. court would interpret the U.S.–Canada tax treaty to exempt a Canadian seller from that tax.
- A self-certification procedure would limit withholding to the transferor's maximum tax liability on a disposition of the partnership interest.
- In order to facilitate the exchange of information required to compute the underlying tax liability, the proposed regulations would require a transferor to notify the partnership of the transfer within 30 days of the date of the transfer. The partnership would then have to provide the information necessary for the transferor to compute its tax liability by the due date of the Schedule K-1 for the year in which the transfer took place.

- Under the Code, a partnership is required to withhold on distributions to a transferee that fails to withhold. The proposed regulations would provide that, in order to avoid withholding by the partnership, a transferee must provide a certification to the partnership within 10 days of the transfer that the transferee has complied with the applicable withholding requirements. In addition, the IRS has the right to require withholding anyway on the grounds that the transferee's certification is inaccurate. If the partnership is required to withhold, it withholds 100% of distributions otherwise payable to the transferee until the withholding is satisfied.
- In the case of PTPs, section 1446(f) withholding would apply to brokers, although exemptions may be available.

## Effective Dates

The effective date of the new rules is generally 60 days after the proposed regulations are finalized, although certain aspects of the new rules may be relied upon immediately.

## Conclusion

The proposed regulations are generally remarkable for the strict procedures and certification requirements required to minimize or eliminate withholding and interest charges, avoid withholding by the partnership on distributions made to a transferee partner, and obtain credit for any tax withheld. These strict procedures may create challenges for sellers and partnerships seeking to certify to transferees that no section 1446(f) withholding is required, even in situations in which the underlying tax should not be applicable. In any case, it will be important to provide certifications and notices in a timely manner, request and retain required information from partnerships, and withhold and pay tax in accordance with the timelines provided.

[1] Notice 2018-08 and Notice 2018-29.

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