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ALERT

Tax

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# IRS issues guidance on dispositions of partnership interests by non-U.S. investors

On April 2, 2018, the Internal Revenue Service ("IRS") issued Notice 2018-29 (the "Notice"), which provides important interim guidance on the new withholding regime created as part of last December's tax reform legislation, commonly referred to as the Tax Cuts and Jobs Act ("TCJA"). This guidance will impact planning relating to dispositions and redemptions of partnership and LLC interests and is expected to be particularly relevant for private equity and hedge funds.

<u>Background</u>. The TCJA clarified that non-U.S. investors are subject to U.S. federal income tax on gain recognized from the sale or exchange of interests in partnerships that carry on a U.S. trade or business – for example, U.S. operating partnerships. The TCJA also added a new Section 1446(f) to the Internal Revenue Code, which imposes a requirement that buyers collect a 10% withholding tax from any seller that does not provide an affidavit stating that it is a U.S. person. A redeeming partnership also has this collection obligation in a redemption transaction with respect to a member that does not provide such an affidavit. The amount of the withholding tax is based on the "amount realized" from the disposition of partnership interests and therefore takes into account as proceeds the seller's allocable share of any partnership liabilities. In the case of any under-withholding by the buyer, Section 1446(f) holds the issuer partnership secondarily liable for the under-withheld amounts by requiring the partnership to remit to the IRS the under-withheld amount, funded from amounts otherwise distributable to the buyer.

The IRS previously issued guidance that suspended the new withholding tax only in respect of transfers of interests in publicly traded partnerships (e.g., MLPs). Parties executing ordinary course transactions involving non-publicly traded partnerships have encountered difficulties created by significant uncertainties in the law, including with respect to non-recognition transactions, the treatment of "subsequent closings" during a fundraising period of a private equity fund, and the method of determining whether a sale would result in income effectively connected with a U.S. trade or business.

<u>Key Takeaways from the Notice</u>. The Notice announces that Treasury and the IRS intend to issue regulations under new Section 1446(f) with respect to dispositions of private partnerships. The Notice also provides interim guidance upon which taxpayers are permitted to rely pending the issuance of the regulations. Key elements and takeaways from the Notice include:

1. *The IRS has <u>not</u> broadly suspended the new withholding tax for private partnerships.* Unlike the approach taken for publicly traded partnerships, the IRS has decided to leave in place the new withholding tax rules for transfers of interests in private partnerships, including the requirement that the withholding agent report and pay over any withholding within 20 days of a transfer. The Notice does make several important exceptions to the rules, which are outlined below.

    - *Key Takeaway:* It will remain essential for buyers (i) to obtain documentation from sellers proving that they are U.S. persons wherever possible, and (ii) to consider the extent to which any transfer of partnership interests by a non-U.S. seller may trigger a withholding tax obligation in respect of the non-U.S. seller.

2. *Exemptions are available for non-recognition transactions:* Until further guidance is issued, the new withholding tax does not apply to various non-recognition transactions if the required notification and procedural steps are taken.

   - *Key Takeaway:* We expect this exemption to facilitate many affiliate transfers and internal restructurings. Some non-U.S. investors and funds may consider restructurings in the short term in order to facilitate future sale transactions.

3. De minimis exemptions provide additional flexibility: The guidance provides two de minimis exemptions:

   a) The new withholding tax will not apply if the seller certifies to the buyer that less than 25% of the seller's allocable share of income from the issuer partnership consisted of income effectively connected with a U.S. trade or business ("ECI") in each of the three taxable years preceding the transfer.

      - *Key Takeaway:* This exception may be particularly helpful in the case of redemptions from hedge funds that own relatively small stakes in ECI-generating assets, e.g., interests in MLPs. It may also be helpful for certain private equity funds, although in the private equity fund context ECI assets are often held through separate partnerships that primarily recognize ECI, in which case this exemption would be irrelevant.

   b) The new withholding tax will not apply if the issuer partnership delivers to the buyer a certification that less than 25% of the gain the partnership would recognize in a hypothetical sale transaction of all of its assets would be ECI.

      - *Key Takeaway:* While this exemption could be helpful in the case of many private equity partnerships, it is not yet clear how market practice will evolve in terms of funds being willing to provide such certifications.

4. *Guidance on the impact of partnership-level liabilities.* As noted above, a seller's allocable share of the liabilities of a partnership is taken into account in the calculation of the seller's "amount realized" and thus affects any withholding tax calculation. A seller's allocable share of such liabilities may vary during a taxable year. The Notice describes alternatives to address the issue. For example, in the case of a purchase of an interest from a non-U.S. seller that does not control the issuer partnership, a buyer generally may rely on a certification from the transferor (x) describing its share of the partnership liabilities as reported on its most recent Schedule K-1 from the issuer partnership for a taxable year that ended within 10 months of the transfer and (y) that it is not aware of a significant change in its share of partnership liabilities.

   In addition, the Notice provides a practical ceiling that limits the new withholding tax to the amount of cash or other property that the seller would, but for withholding, receive from the buyer.

   - *Key Takeaway:* This exception could be helpful in avoiding withholding in connection with subsequent closings during a private equity fund's fundraising period. Under general tax principles, it is possible that each "additional closing" that occurs during the fundraising period of a private equity fund may be treated as a "disguised sale" of interests in the private equity fund, which would implicate the new withholding tax rules. Based on the Notice, certain funds might structure such closings and activities during the fundraising period to minimize any risk of withholding. For instance, certain private equity funds may choose to have partners not contribute capital to the fund during the fundraising period, and instead obtain any needed capital through short-term borrowing arrangements.

5. *Issuer partnerships do not have secondary liability for under-withholding pending further guidance.* The potential secondary liability for withholding by the issuer partnership outlined in Section 1446(f) will not apply until more specific rules are issued.

    - *Key Takeaway:* This suspension may moderate the sensitivities currently associated with sponsors of private funds and other partnerships agreeing to approve transfers.

6. *Distributions by a partnership to non-U.S. partners may be subject to withholding.* The Notice confirmed that the new withholding rules may apply to a distribution by a partnership to a non-U.S. partner or a redemption of a partnership interest where the proceeds from such distribution or redemption exceed the partner's outside basis in its partnership interest.

    - *Key Takeaway:* Helpfully, the guidance permits a partnership to rely on its books and records or a certification from the distributee partner to determine whether the distribution exceeds basis for purposes of withholding. These rules may be particularly relevant for hedge funds in connection with redemption distributions to non-U.S. investors (or to non-U.S. feeders).

7. *U.S.-Person Certificates and W-9s are acceptable as U.S. affidavits.* The Notice resolves some of the uncertainty regarding the acceptable forms of U.S. person affidavits and the procedural aspects of collecting and remitting the new withholding tax. The Notice adopts many of the mechanisms currently in place for other withholding regimes, and permits the transferor to provide a valid Form W-9 to certify it is a U.S. person until more specific rules are issued.

8. *Tiered partnerships will have additional information reporting obligations.* The Notice confirmed that the new withholding tax regime will apply to sellers of interests in an upper-tier partnership that itself owns an interest in a lower-tier partnership that is a U.S. operating partnership. The Notice provides that future regulations will require any such lower-tier partnership to provide to the upper-tier partnership information to enable the partners of the upper-tier partnership to calculate the withholding and other tax obligations arising from the sale of interests in the upper-tier partnership.

    - *Key Takeaway:* These information reporting obligations may be burdensome in some cases, and it is not yet clear how market practice will evolve. Partnerships may require additional cost reimbursements from the parties triggering these reporting obligations. It is also possible that certain partnerships will seek to impose additional limitations on indirect transfers of their interests, in order to avoid the reporting obligations.

In short, the Notice provides significant practical assistance to partnerships or those that invest in partnerships, though some uncertainties remain.

If you would like to discuss the Notice or any other related matter, please contact your usual Ropes & Gray tax advisor.



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