Latham & Watkins Transactional Tax Practice

January 10, 2019 | Number 2431

IRS Issues Guidance on Transfers by Non-US Partners of Interests in Partnerships With US Assets

Proposed regulations under Section 864(c)(8) provide guidance for determining a foreign partner's effectively connected gains or losses from a transfer of its interest in a partnership engaged in a US trade or business.

Key Points:

- Proposed regulations establish a three-step process for determining the extent to which gains and losses recognized by a foreign partner upon a disposition of its partnership interest will be subject to US income tax under Section 864(c)(8).
- Capital gain or loss and ordinary income or loss is required to be computed separately, consistent with general partnership tax principles.
- Foreign partners will likely need detailed information from partnerships to calculate the amount of income subject to tax under Section 864(c)(8).
- Section 864(c)(8) generally will not override non-recognition rules in the Code.
- Income tax treaties generally will not override Section 864(c)(8).

On December 20, 2018, the US Treasury Department issued proposed regulations under Section 864(c)(8)[1] that provide guidance for calculating the amount of a foreign partner's gain or loss that will be treated as effectively connected with a US trade or business (and thus subject to US federal income tax) when a foreign partner disposes of its interest in a partnership engaged (directly or indirectly through a lower-tier partnership) in a trade or business within the United States. The proposed regulations do not address the threshold determination of when a partnership will be treated as engaged in a US trade or business.

Section 864(c)(8), enacted as part of the Tax Cuts and Jobs Act,[2] generally provides that a gain or loss recognized by a foreign person from the sale, exchange, or other disposition (a "transfer") of a partnership interest is treated as an effectively connected gain or loss to the extent the foreign partner would have recognized the effectively connected gain or loss had the partnership sold all of its assets for fair market value on the date the foreign partner transferred its interest. Section 864(c)(8) codifies the position of the Internal Revenue Service (IRS) set forth in Revenue Ruling 91-32[3] and overrules the US Tax Court's decision in *Grecian Magnesite Mining v. Commissioner*,[4] which invalidated the IRS's position for lack of statutory authority.

Disposition of a Partnership Interest

A partner generally recognizes a gain or loss on the transfer of an interest in a partnership equal to the amount realized less the partner's adjusted tax basis in the partnership interest. Under Section 741, a gain or loss on the transfer of a partnership interest is considered a capital gain or loss except to the extent provided in Section 751. Under Section 751, a transferor partner is required to recognize ordinary income or loss equal to the amount of income or loss attributable to unrealized receivables or inventory items (commonly referred to as "Section 751(a) property") that would have been allocated to the transferor partner had the partnership sold all of its assets for fair market value. A partner's capital gain or loss under Section 741 generally is adjusted by the amount of ordinary income or loss required to be recognized under Section 751, such that the overall net gain or net loss amount is the same amount.

Three-Step Computational Approach

The proposed regulations set forth the following three-step process for calculating the amount of gain or loss otherwise recognized by a foreign partner on the transfer of a partnership interest that is treated as an effectively connected gain or loss under Section 864(c)(8):

1. Determine the partnership's deemed sale gain or loss.

- A partnership's deemed sale gain or loss is equal to the amount of gain or loss the partnership would recognize upon a sale of its assets to an unrelated third party for cash equal to fair market value.
- A partnership must determine the amount of deemed sale gain or loss separately for each asset.

2. Determine the amount of the partnership's deemed sale gain or loss that would be treated as an effectively connected gain ("deemed sale EC gain") or loss ("deemed sale EC loss").

- Under the proposed regulations, the deemed sale gain or loss determined in Step 1 is treated as attributable to an office or other fixed place of business maintained by the partnership in the United States, unless the exception described below applies. This presumption generally results in the deemed sale gain or loss being treated as from sources within the United States and thus effectively connected with the partnership's US trade or business.
- Under an exception to the presumption, a deemed sale gain or loss is not to be treated as US-source if (i) no income or gain produced by the asset was taxable as effectively connected income of the partnership (or a predecessor of the partnership) during the 10-year period ending on the date of transfer and (ii) the asset has not been used, or held for use, in the conduct of a business within the United States by the partnership (or a predecessor of the partnership) during the 10-year period ending on the date of sale.[5]
- The presumption of being US-source may result in the amount treated as deemed sale EC gain or loss being greater than the amount of gain or loss that would be treated as effectively connected under the general income sourcing rules if the partnership had actually sold all of its assets. Under the general income sourcing rules, a gain or loss from the sale of inventory is not treated as US-source if the inventory is sold for use, disposition, or consumption outside the United States and an office or other fixed place of business maintained by the partnership in a foreign country materially participated in the sale.
- Given the potential for greater US tax liability, foreign partners should consider how best to structure a sale transaction when an exit can be structured as either an actual asset by the partnership (followed by a liquidating distribution) or the sale of partnership interests.

3. Determine the foreign partner's distributive share of the partnership's deemed sale EC gain or deemed sale EC loss from each asset.

- A foreign partner's distributive share of deemed sale EC gain or loss generally is equal to the amount of such gain or loss that would be allocated to the partner under the partnership agreement, taking into account all applicable Code provisions, including Section 704(c) principles and any Section 743 basis adjustment. If a foreign partner transfers only a portion of its interest, the distributive share of the deemed sale EC gain or deemed sale EC loss is determined in respect of the transferred portion of the interest.
- The foreign partner's distributive share of the partnership's deemed sale EC gain or loss attributable to the partnership's unrealized receivables and inventory items (*i.e.*, Section 751(a) property) is aggregated separately from the foreign partner's distributive share of the partnership's deemed sale EC gain or loss attributable to the partnership's other assets.
- The amount of ordinary income or loss recognized by the foreign partner under Section 751 will be treated as an effectively connected gain or loss under Section 864(c)(8) to the extent of the foreign partner's aggregate deemed sale EC gain or loss attributable to Section 751(a) property.
- The amount of capital gain or loss recognized by the foreign partner under Section 741 will be treated as an effectively connected gain or loss under Section 864(c)(8) to the extent of the foreign partner's aggregate deemed sale EC gain or loss attributable to the partnership's assets that are not Section 751(a) property.

Tiered Partnerships

The proposed regulations generally adopt a look-through approach to tiered partnership structures. Accordingly, if a foreign partner transfers an interest in a partnership that owns an interest in one or more lower-tier partnerships engaged in a US trade or business, the foreign partner or the upper-tier partnership must determine the deemed sale gain or loss and the deemed sale EC gain or loss in each lower-tier partnership, beginning with the lowest partnership in the chain of ownership. This look-through approach also applies if an upper-tier partnership with a (direct or indirect) foreign partner transfers its interest in a lower-tier partnership.

Non-Recognition Rules

The proposed regulations provide that gain or loss on the transfer of a partnership interest that is subject to tax as effectively connected gain or loss is limited to the gain or loss otherwise recognized under the Code.[6] This is welcome news for foreign partners, as practitioners were concerned that Treasury could seek to limit the ability of a foreign partner to engage in a non-recognition transaction.[7] However, additional guidance is needed for transactions that only partially qualify for non-recognition treatment. The proposed regulations do not address how the general rules described above would apply when only a portion of the foreign partner's gain or loss is recognized. In addition, the Treasury is considering if non-recognition transactions under Section 731 that reduce the scope of assets subject to US tax should be subject to special rules.

Coordination Rule for Partnerships That Own US Real Property Interests

Under Section 897(g), a foreign person is generally subject to tax on the sale of a partnership interest to the extent that the gain on the sale is attributable to US real property interests. To prevent amounts from being subject to tax under both Sections 864(c)(8) and 897(g), the proposed regulations provide that if a partnership owns US real property interests and is also subject to tax under Section 864(c)(8) because it is engaged in the conduct of a trade or business within the United States without regard to Section 897, the foreign transferor will be subject to tax under Section 864(c)(8) and not Section 897(g).

Coordination With Treaties

The proposed regulations also contain special provisions that are intended to prevent US tax treaties with foreign countries from overriding Section 864(c)(8) in the case of a foreign partner in a partnership that has a permanent establishment in the United States. Generally, the proposed regulations provide that the transfer of a foreign partner's interest in a partnership with a US permanent establishment is treated as a disposition of the partnership's assets that form part of the permanent establishment, such that the foreign partner's share of the deemed sale EC gain or loss generally will not be exempt from US taxation under the gains article of most US tax treaties.

Anti-Stuffing Rule

The proposed regulations contain an anti-stuffing rule to prevent inappropriate reductions in amounts characterized as an effectively connected gain or loss subject to tax under Section 864(c)(8). Under this rule, a transfer is disregarded for the purposes of calculating the amount under Section 864(c)(8) (and Section 897) if a foreign transferor (or a person that is related to a foreign transferor within the meaning of Section 267(b) or 707(b)) transfers property to a partnership with a principal purpose of reducing the amount of gain treated as effectively connected gain, or increasing the amount of loss treated as effectively connected loss. The proposed regulations do not contain examples to illustrate when this rule would be applicable, and therefore the scope of the rule is not clear.

Effective Date

The proposed regulations apply to transfers occurring on or after November 27, 2017, the effective date of Section 864(c)(8). However, if any provision is finalized after June 22, 2019, the Treasury Department and the IRS expect that such provision will apply only to transfers occurring on or after the provision's filing in the Federal Register.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Cheryl M. Coe
cheryl.coe@lw.com
+1.202.637.2157
Washington, D.C.

Julie M. Marion
julie.marion@lw.com
+1.312.876.7700
Chicago

Gaston Soler
gaston.soler@lw.com
+1.202.637.2280
Washington, D.C.

You Might Also Be Interested In

US Tax Reform Resource Center

US Tax Reform: Key Business Impacts, Illustrated With Charts and Transactional Diagrams

Withholding Guidance Issued on Sale of Interests in a Partnership with US Assets

Endnotes

1 All references to "Section" refer to sections of the Internal Revenue Code of 1986, as amended (the "Code").

2 Public Law No. 115-97 (Dec. 22, 2017). Shortly before final Congressional approval of the legislation, the Senate parliamentarian struck the previously attached short title, the "Tax Cuts and Jobs Act." While the final legislation no longer bore a short title, many commentators have continued to refer to it as the Tax Cuts and Jobs Act.

3 1991-1 C.B. 107.

4 149 T.C. No. 3 (July 13, 2017), appeal argued, No. 17-1268 (D.C. Cir. Oct. 9, 2018).

5 The 10-year period is consistent with the rule in Section 864(c)(7) that treats income from the sale of assets as being "effectively connected" if the assets were used in a U.S. trade or business sometime during the 10-year period preceding the sale.

6 See Prop. Treas. Reg. § 1.864(c)(8)-1(b)(2)(ii).

7 See Section 864(c)(8)(E) directing Treasury to "prescribe such regulations or other guidance as" it may determine "appropriate for the application of this paragraph, including with respect to exchanges described in Section 332, 351, 354, 355, 356, or 361."