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TAXATION
A Section of the American Bar Association

Section of Taxation

Suite 400
1050 Connecticut Avenue, NW
Washington, DC 20036
202-662-8670
FAX: 202-662-8682
E-mail: tax@americanbar.org

March 19, 2018

The Honorable David Kautter
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Comments on Need for Guidance Under Sections 864(c)(8) and 1446(f)

Dear Acting Commissioner Kautter:

Enclosed please find comments regarding the need for published guidance with respect to sections 864(c)(8) and 1446(f) which were added to the Code on December 22, 2017 (the “Comments”). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

The Section of Taxation will be pleased to discuss the Comments with you or your staff.

Sincerely,

Karen L. Hawkins
Chair, Section of Taxation

Enclosure

cc: Hon. William M. Paul, Acting Chief Counsel and Deputy Chief Counsel (Technical), Internal Revenue Service
Hon. David Kautter, Assistant Secretary Office of Tax Policy, Department of the Treasury
Thomas West, Tax Legislative Counsel, Department of the Treasury
Chip Harter, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury
Marjorie Rollinson, Associate Chief Counsel (International), Internal Revenue Service
Doug Poms, International Tax Counsel, Office of International Tax Counsel, Office of Tax Policy, Department of the Treasury
Brenda Zent, Special Advisor to the International Taxation Counsel, Office of Tax Policy, Department of the Treasury

AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

COMMENTS ON SECTIONS 864(c)(8) AND 1446(f) AS ADDED TO THE INTERNAL REVENUE CODE OF 1986 BY P.L. 115-97 ON DECEMBER 22, 2017

These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Alan I. Appel of the Section's U.S. Activities of Foreigners and Tax Treaties Committee (the "Committee"). Substantial contributions were made by Peter H. Blessing and Michael J. A. Karlin. The Comments were reviewed by Jason Bazar, the Chair of the Committee, Summer A. LePree, the Committee's Chair-Elect and Edward Tanenbaum. The Comments were further reviewed by Joan C. Arnold of the Section's Committee on Government Submissions, Carol Tello, the Section's Council Director for the Committee, and Julian Kim, the Section's Vice Chair (Government Relations).

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact : Alan I. Appel
(212) 324-6554
alan.appel@nyls.edu

Date : March 19, 2018

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SUMMARY OF RECOMMENDATIONS

These Comments address the need for published guidance regarding sections 864(c)(8) and 1446(f) of the Code.[1] Sections 864(c)(8) and 1446(f), enacted by Public Law 115-97 (the "2017 Act"), were added to the Code on December 22, 2017. Section 864(c)(8) has an effective date of November 27, 2017, and section 1446(f) an effective date of January 1, 2018.

We respectfully request that the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") issue guidance on an urgent basis addressing the following items:

1. Affirmation that, until guidance is provided to the contrary, section 864(c)(8) will not cause there to be an inclusion of taxable income if the transaction in question is a non-recognition transaction pursuant to another section of the Code.

2. The computation of effectively connected gain or loss under section 864(c)(8), including by reason of the interaction with section 897.

3. Guidance regarding the exemption from taxation and withholding for 5% or less partnership (and trust) interests regularly traded on an established securities market set forth in Treasury regulation section 1.897-1(c)(2)(iv) in light of section 864(c)(8).

4. The interaction between treaties and section 864(c)(8) and in particular, affirmation that in the case of a partnership that does not have a permanent establishment in the U.S., applicable treaty protection may avoid taxation of gain or loss in respect of transactions described in section 864(c)(8).

5. Interim guidance under section 1446(f) waiving the withholding requirement from January 1, 2018, generally, as described below. If that is not feasible, we suggest deferring in all cases the requirement to deposit tax, and waiving the requirements to withhold and deposit tax under broadly defined exceptions. We suggest that the exceptions permitting the deferral of the obligation to withhold and deposit should include all situations in which a non-recognition provision would apply apart from section 864(c)(8), a small transaction exception, and a *de minimis* exception, as described further herein. We suggest that the waiver be in place for the period preceding issuance of guidance in a form on which taxpayers may rely, with reasonable exceptions.

6. Guidance that will minimize the potential for over- or underwithholding.

7. A permanent exemption from withholding for non-recognition transfers of partnership interests in cases generally, in which gain is not recognized for purposes of section 864(c)(8), as described below.

[1] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

8. A permanent exemption from withholding where the partnership does not have a U.S. permanent establishment (and in such other circumstances, if any, in which Treasury may determine the transferor's gain to be exempt from tax under an applicable treaty).

9. Adoption of certain certification procedures regarding various factual matters, including the foreign or domestic status of the transferor; the absence of effectively connected assets or, if there are effectively connected assets, the percentage by value of effectively connected assets and other assets, if any; and the partnership indebtedness taken into account in determining amount realized.

10. How section 1446(f) interacts with the partnership audit rules.

These issues are discussed in greater detail below, in addition to certain other recommendations.

DISCUSSION

I. Section 864(c)(8)

A. Background

In 1991, the Service issued Rev. Rul. 91-32,[2] which concluded that a foreign person who sells an interest in a partnership is subject to U.S. tax if the partnership is engaged in a U.S. trade or business through a U.S. office, to the extent the gain is attributable to property of the partnership which was used to produce effectively connected income ("ECI"). The Obama Administration, in its proposed budget, recommended codifying the result in Rev. Rul. 91-32 and adding a withholding obligation.[3]

In July 2017, the U.S. Tax Court, in *Grecian Magnesite Mining Co. v. Commissioner*[4] ("*Grecian Magnesite*"), rejected Rev. Rul. 91-32. The Court held that gain or loss recognized by a foreign person upon the disposition of a partnership interest is generally not considered effectively connected gain or loss with respect to a U.S. trade or business.

Congress, as part of the 2017 Act,[5] reversed the holding in *Grecian Magnesite* (retroactively to November 27, 2017) by enacting section 864(c)(8). Section 864(c)(8)(A) provides that, notwithstanding any other provision of subtitle A (Income Taxes) of the Code, gain or loss of a nonresident alien individual or foreign corporation from the sale, exchange, or other disposition[6] of a "directly or indirectly" held partnership interest shall be treated as effectively connected to the extent that such gain or loss does not exceed the gain or loss such person would have recognized as effectively connected gain or loss had the partnership sold all of its assets at their fair market value as of the date of the transfer. The Conference Report makes clear that interests in a partnership that holds effectively connected gain assets and that is held by a partner indirectly through other partnerships is subject to the provision.[7]

Section 864(c)(8)(C) provides that the amount of gain or loss on the sale, exchange or other disposition of the partnership interest that is treated as ECI under subparagraph (A) shall be reduced by the amount of gain or loss on such disposition that is treated as effectively connected under section 897.

[2] 1991-1 C.B. 107.
[3] Office of Management and Budget, 2013. Budget of the United States Government, Fiscal Year 2013. Office of Management and Budget, Washington, DC.
[4] 149 T.C. No. 3 (July 13, 2017), *appeal pending*.
[5] An Act to provide for reconciliation pursuant to the Titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97, 131 Stat. 2054.
[6] By its terms, section 864(c)(8)(A) applies solely to a sale or exchange, but section 864(c)(8)(D) specifically states that the term sale or exchange means "any sale, exchange, or other disposition."
[7] H.R. Rep. No. 115-466, 115th Cong., 1st Sess., at 368 (2017).

Section 864(c)(8)(E) directs the Treasury to promulgate regulations or other guidance determined to be appropriate for the application of section 864(c)(8), including with respect to various corporate non-recognition provisions.[8]

Congress also enacted a new withholding requirement, section 1446(f). Section 1446(f) provides that, if any portion of the gain (if any) on a disposition of an interest in a partnership would be treated under section 864(c)(8) as income effectively connected with the conduct of a trade or business within the U.S. ("ECI"), the transferee of the partnership interest must withhold tax equal to 10% of the amount realized on the disposition.[9] Section 1446(f) is discussed in part II of these Comments.

Many questions are raised by these provisions and the need for guidance is urgent. While other issues will require coverage in regulations, we focus here on certain issues of particular concern and urgency.

B. Interaction of Section 864(c)(8) with Non-Recognition Provisions

We note that the question of the interaction among section 864(c)(8) and non-recognition provisions has been the subject of comments from multiple constituencies.[10] Regulatory authority is provided to address this issue, and particular reference is made to certain corporate non-recognition provisions.[11]

1. Status Absent Regulations

Section 864(c)(8) does not purport to override non-recognition provisions. It only characterizes certain gain or loss on the sale, exchange or other disposition of a partnership interest as effectively connected. The characterization of treatment of gain or loss as effectively connected is neutral on the question of whether the gain or loss is recognized, as is the case elsewhere in section 864(c).[12] Sections 871(b) and 882(a) tax effectively connected amounts only if they are included in "taxable income." Under section 63, taxable income is defined as "gross income" minus deductions that are allowed. In the case of property transactions, gross income

[8] Specifically, I.R.C. § 332 (liquidation of a corporation into its 80% parent corporation, I.R.C. § 351 (tax-free incorporation), I.R.C. § 354 (corporate reorganizations), I.R.C. § 355 (spinoffs, etc.), I.R.C. § 356 (boot in I.R.C. § 351 and I.R.C. § 354 transactions), and I.R.C. § 361 (treatment of corporations in reorganizations).

[9] I.R.C. § 1446(f)(1).

[10] *See, e.g.*, Letter to Treasury and IRS from New York State Bar Association re "Request for Immediate Guidance under sections 864(c)(8) and 1446(f)" (February 2, 2018) available at www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Section_Reports_2018/1387_Letter.html; letter to IRS from PricewaterhouseCoopers LLP re "IRS Notice 2018-08: Request for Comments" (January 10, 2018), available at www.pwc.com/us/en/tax-services/publications/insights/assets/pwc-irs-notice-2018-08-request-for-comments.pdf; letter to IRS from Securities Industry and Financial Markets Association ("SIFMA") re "Request for delay in implementation of section 1446(f) for non-publicly traded partnerships" (February 13, 2018), available at www.sifma.org/wp-content/uploads/2018/02/Request-for-delay-in-implementation-of-Section-1446f.pdf.

[11] We note that the grant of authority, as well as the Conference Report, makes specific reference to corporate non-recognition provisions but not, for example, to other non-recognition provisions such as I.R.C. § 721(a) (contribution to U.S. partnership in exchange for partnership interest); I.R.C. § 731(a) (distribution by partnership); or even, arguably, I.R.C. § 643(e)(2) (amount of distribution where trust distributes property in kind).

[12] *See, e.g.*, I.R.C. § 864(c)(7).

excludes gain that is described in non-recognition exchanges.[13] Further, dispositions that are not sales or exchanges may include distributions. Unless specifically provided otherwise in the Code,[14] distributions do not appear to result in gross income to the distributing entity, as no consideration is received (actually or constructively) therefor.[15]

Section 864(c)(8) presents certain similarities with the Foreign Investment in Real Property Tax Act 1980[16] ("FIRPTA") regime contained in section 897 in that each (to different extents, however) treats a partnership as an aggregate of its members for purposes of taxation of a disposition of a partnership interest. However, regarding non-recognition transactions, the two are very different. Section 897(e)(1) provides that, except as otherwise provided by regulation, non-recognition provisions shall apply to the foreign transferor only to the extent that the foreign transferor receives property the immediate sale of which would be taxable under section 897. The approach under section 864(c)(8) is the converse. Section 864(c)(8)(E) does not call off the non-recognition provisions, only stating that the Secretary will provide guidance as appropriate with respect to the non-recognition provisions. We suggest that, given the time likely required to fully resolve the relevant issues in guidance, interim guidance be issued promptly confirming that non-recognition provisions apply in full under the statute, unless and until guidance to the contrary is issued.

2. Guidance and Regulatory Approach

Section 864(c)(8)(E) directs the Treasury to prescribe regulations generally, including in respect of possible application of the corporate non-recognition provisions. We suggest that, in accordance with normal practice, any such regulations not have an effective date prior to at least the date proposed regulations are released.

We believe there is an urgent need for guidance because non-recognition events, such as tax-free incorporations, are extremely common. For example, startup businesses frequently are organized as partnerships for U.S. tax purposes and then reorganized as corporations when they go public, and such partnerships can include foreign persons. As described below, we suggest that guidance confirm to taxpayers that they may change their form of doing business in the most basic way consistent with the purpose of provisions such as section 351, and that such guidance would not undercut the purposes of section 864(c)(8).

Consider the case of a simple incorporation of a partnership with assets having effectively connected gain, in connection with which the transferors each exchange (or in effect exchange)[17] interests in the partnership for shares in a domestic corporation. If non-recognition under section 351 were eliminated in this context, the incorporation would be taxable for any foreign transferor. We believe this would be inappropriate for several reasons.

[13] Reg. § 1.61-6(b).
[14] Examples are sections 311(b) and 336 (dealing with assets leaving corporate solution) and section 904(f)(3).
[15] An example is I.R.C. § 731. See also I.R.C. § 761(e).
[16] P.L. 96-499, §1125(c), 94 Stat. 2599 (1980).
[17] In Rev. Rul. 84-111, 1984-1 C.B. 88, the Service describes three means by which such an incorporation may occur. Although each of these means may have different tax basis and holding period consequences, we assume that there should be no difference for purposes of section 864(c)(8).

Most fundamentally, if the business had been operated entirely by a foreign person directly or in branch form, the incorporation would be tax-free under section 351, and section 864(c)(8) would not have had any potential applicability. Prior to the incorporation there would have been U.S. income tax imposed on a disposition of the assets. After the incorporation, the appreciation in the assets would be preserved, and subject to U.S. tax on a disposition by the corporation.[18] The same would be true in the case of a partnership incorporation. The only distinction between a branch and a partnership for federal income tax purposes is that a branch has one owner and partnership has more than one owner. There is no good reason why there should be a distinction between a branch incorporation and a partnership incorporation.

Second, disallowance of non-recognition would place a premium on the form in which a taxpayer invested initially. A foreign person who chooses to invest through a domestic corporation in the first instance would have one regime, whereas a foreign person who had not would be economically blocked from converting to that regime, if the conversion would give rise to taxable effectively connected gain. Such tax friction impeding continuing commercial operation in a different legal form in which taxable gain is preserved is not consistent with U.S. tax policy generally.

Third, a significant policy concern motivating Rev. Rul. 91-32 and enactment of section 864(c)(8) is that the purchase of an interest in a partnership holding effectively connected assets that are appreciated could allow the purchaser to obtain an increase in the tax basis of the assets (if the partnership ceased to exist as the result of a single owner) or adjustments to account for the difference between the purchaser's outside tax basis and its share of the adjusted basis of the partnership's assets (if the partnership continued to exist and a section 754 election was in effect). This ability of the parties to cause an increase (or the effect of an increase) in tax basis at no tax cost to the seller, and the similarity to the effect of a direct purchase of the property, is noted in the description of Present Law in the Conference Report.[19] That is not the case where the assets have been transferred with a carryover or substitute basis into a domestic corporation.[20] The purpose of section 864(c)(8) is to prevent foreign partners who dispose of partnership interests from achieving more favorable results than the results that would arise from an asset sale by the partnership and distribution of the proceeds. In circumstances in which an actual transfer of assets by the partnership would be tax-free, as in the case of a typical incorporation transaction, the policy underlying section 864(c)(8) generally does not support a gain-recognition requirement.

A different result than suggested here obtains under FIRPTA, but FIRPTA is based on different policies and concerns expressed in the analysis and debates leading to its enactment and, as noted above, reflected in the statute itself (*i.e.*, section 897(e)).[21] The underlying context

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[18] In addition, distribution of the proceeds by the corporation generally would be subject to a second level tax.

[19] The Conference Report notes with respect to the section 743(b) adjustments pursuant to a section 754 election: "The effect of the adjustments on the basis of partnership property is to approximate the result of a direct purchase of the property by the transferee partner." H.R. Rep. No. 115-466, *supra* note 7, at 366.

[20] Under Rev. Rul. 84-111, the relevant basis may vary depending on the form chosen. Leaving aside the effect of section 1014 on basis of the partnership interest, section 864(c)(8) should avoid at least generally an outside basis increase without gain recognition.

[21] *See, e.g.*, Kaplan, "Creeping Xenophobia and the Taxation of Foreign-Owned Real Estate," 71 Geo. LJ 1091, 1092-1103 (1983).

of those provisions was concern (including political concerns) about foreign persons purchasing U.S. real property for investment, including undeveloped land and passively leased property.[22] Taxation of indirect transfers (transfers of interests in domestic entities holding U.S. real property) was viewed by Congress as necessary to prevent easy avoidance of the provision, including through the ability to sell appreciated assets (whereby the purchaser would obtain a cost basis) and liquidate the corporation on a tax-free basis under the pre-1986 Code.[23] Therefore, with FIRPTA, Congress created a regime in which the foreign owner of an interest in U.S. real property generally will be subject to U.S. tax on gain on a transfer, with very limited ("hot" to "hot") tax-free rollover potential, effectively targeting the foreign owner.

Section 864(c)(8) has a very different purpose than FIRPTA, as it is not limited to one asset class, but rather impacts business operations of every sort. The approach of section 864(c)(8)(E) is to allow Treasury and the Service to consider whether non-recognition should be disallowed in certain cases, but not to mandate or even suggest that disallowance is appropriate. Outside of a FIRPTA context, a basic tenet of U.S. tax law (including treaty policy) is that a foreign taxpayer owning a U.S. business in the form of a domestic corporation may sell the shares of that corporation without U.S. tax. This policy reflects the fact that the residence country is recognized as having taxing jurisdiction in respect of such a transaction. Under the same rationale, the foreign holder of U.S. business assets may transfer those assets on a rollover basis to a domestic corporation under the normal nonrecognition rules, even though a transfer of the shares is not subject to U.S. taxation; the asset gain remains subject to U.S. taxation and the share transfer is subject to taxation by the residence country of the taxpayer.[24]

We note that the exception to the primacy of residence taxation under FIRPTA was made for a particular asset class, and one with a unique connection to the U.S. Congress acknowledged that the special regime created resulted in a treaty override, clearly articulated the rationale and provided transition rules. Neither section 864(c)(8) nor its legislative history suggests that Congress determined to depart from the established U.S. tax and treaty policy described above, particularly since the provision applies to partnership business operations generally rather than a single asset class with nexus to the U.S. Further, overriding non-recognition provisions under the statute would require Treasury and the Service on their own initiative to adopt a rule that may well be inconsistent with income tax treaties.[25]

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[22] *See id.*; U.S. Department of the Treasury, Taxation of Foreign Investment in U.S. Real Estate (May 4, 1979) p.47; A. Yu, The U.S. Foreign Investment in Real Property Tax Act—A Practical Guide (Kluwer Law International 2017) § 1.03 at n. 25: "In the late 1970s,…there was public concern that US farmers were being priced out of the market due to increased foreign purchases of US farmland. This apprehension in the general public led to a study by the Treasury Department in 1978 that concluded foreign investors had a tax advantage over US investors under the laws in effect at that time." (Footnotes omitted.)

[23] *See* Yu, *supra*, § 1.04 at n. 35. *See generally* S. Rep. No. 504, 96th Cong., 1st Sess. 6, at 511 (1979); H.R. Rep. No. 96-1167 2d Sess., at 530 (1980).

[24] The fact that an individual may have been subject to a 37% federal income tax rate whereas the corporation would be subject to a 21% federal income tax rate should not be relevant, as that difference exists for a domestic individual as well.

[25] Even if an incorporation of a partnership is considered an alienation of the permanent establishment (see discussion below), the Nondiscrimination article of treaties arguably impose restrictions in connection with denial of non-recognition rules in this context. *See, e.g.,* paragraph 2 of article 24 of the 2016 U.S. Model Income Tax treaty.

We also note that the incorporation of a partnership business could be done in a manner that would not be within the scope of section 864(c)(8). For example, a partnership might contribute its assets to a domestic corporation in a transaction governed by section 351 and simply remain in existence holding the shares, preserving any gain on the effectively connected assets at the corporate level. We suggest that there is no reason why the treatment should be radically different even if the partnership is dissolved.

Alternatively, at some later point and in a separate transaction, the partnership might distribute the stock in the corporation to the foreign partner, or the partner might sell the partnership interest, or the partnership might sell the stock of the corporation and if it holds no other assets dissolve. In none of those cases would the foreign person be subject to U.S. tax. For example, to the extent the partnership interest is disposed of, it would not be an interest in a partnership described in section 864(c)(8) because as of the date of the disposition of the partnership interest, the partnership would not be engaged in a U.S. trade or business, and would not hold any effectively connected assets.[26] Section 864(c)(7) would not apply to the transaction, since the partnership interest itself would not be "used or held for use in connection with the conduct of a trade or business in the U.S.," and section 864(c)(8) does not change that.

We have focused above on one example of a non-recognition transaction, in part because questions may arise in view of the special FIRPTA regime, which we believe should be inapposite. The partnership analogue of section 351, section 721, is not specifically mentioned in section 864(c)(8)(E), but given the reference to non-recognition provisions generally we request that timely guidance confirm that it is not impacted by section 864(c)(8). Further, with respect to the other non-recognition provisions mentioned, we are unaware of any reason why they should not be applicable under section 864(c)(8).

C. Computation of Gain or Loss

There is a pressing need for guidance on how gain is to be calculated under section 864(c)(8). Section 864(c)(8)(A) determines the effectively connected status of the gain or loss on the disposition of a partnership interest (the "outside gain or loss"). Thus, although the effectively connected measure under that provision is made by reference to the gain or loss that would have been realized if the partnership had sold its assets (the "inside gain or loss"), outside gain or loss is the maximum amount potentially recognized as effectively connected on a taxable disposition of a partnership interest by a foreign taxpayer.

As we read the statute, the amount of outside gain or loss potentially treated as effectively connected under section 864(c)(8) is reduced by the amount of outside gain or loss treated as effectively connected under section 897 (apparently, even if such amount would have been effectively connected apart from section 897).[27] Accordingly, references to "effectively connected" or ECI below in these Comments generally refer to assets and amounts so treated under section 897.

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[26] I.R.C. §§ 864(c)(8)(A) and (B)(i)(I).
[27] I.R.C. § 864(c)(8)(C).

Section 864(c)(8) appears to require the following steps in respect of the transfer of a partnership interest by a foreign taxpayer:

(i) determine outside gain or loss;

(ii) determine the portion thereof governed by section 897, taking into account section 897(g);

(iii) with respect to the balance of the outside gain or loss, determine the portion thereof treated as effectively connected based on the statute's hypothetical deemed sale approach for effectively connected assets (including goodwill) held by the partnership that were not taken into account for purposes of section 897, netting gains and losses without regard to character (see below); and

(iv) treat any remaining outside gain or loss as non-effectively connected gain or loss.

In the case of tiered partnerships, it is not entirely clear whether the gain should be measured by considering the outside basis of each partnership as being sold (proceeding seriatim down the chain) or instead by, in effect, consolidating the tiered partnerships. The Conference Report, in referring to effectively connected assets held "directly or indirectly through other partnerships," suggests the latter approach.

To the extent there are section 897 losses but section 864(c) effectively connected gains (or vice versa), the amounts may be netted under the Code rules governing the taxation of ECI to determine a taxpayer's taxable income, but for purposes of section 1446(f) withholding (discussed below), netting apparently would not be permitted absent regulatory relief. On the other hand, as discussed in part II below, under existing Treasury regulations, withholding under section 1445 is only required in respect of partnerships that primarily hold U.S. real property interests.

The flush language at the end of section 864(c)(8)(B) provides that a partner's distributive share of gain or loss on the deemed sale of ECI assets "shall be determined in the same manner as such partner's distributive share of the non-separately stated taxable income or loss of the partnership." This seems intended to result in netting of gain or loss and to cause all items of effectively connected gain or loss under section 864(c), regardless of character, to be combined into a single calculation in order to determine an aggregated amount for purposes of measuring inside effectively connected gain or loss, after giving effect to section 897 amounts, against the outside gain or loss.

It appears, however, that character of gain or loss is not intended to be changed by the provision. Rather, we believe the normal rules in respect of a disposition of a partnership interest, including section 751, are intended to apply. We note, however, that although section 751 normally can result in ordinary gain or loss in excess of the total outside gain or loss in certain cases,[28] that possibility appears to be foreclosed for a foreign partner that is taxed only on ECI.

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[28] *See* Reg. § 1.751-1(a)(2), -1(g) Ex. 1.

Another issue is the determination of the amount realized in the context of partnership liabilities. Under general rules, the "amount realized" on the transfer of property includes liabilities assumed by the transferee or to which the property is subject. In the case of the transfer of a partnership interest, relevant liabilities include the partner's share of liabilities of the partnership under section 752(d). Notice 2018-8 (the "Notice") requests comments on how partnership liabilities should be taken into account under section 752(d).[29] The allocation of liabilities to a partner under section 752 is not information that normally would be available to a purchaser and can be subject to uncertainty.

D. Interaction with Income Tax Treaties

The U.S. taxes ECI under sections 871(b) and 882, but a foreign taxpayer may nevertheless be exempt from the tax on ECI pursuant to the provisions of an applicable income tax treaty. The statute and legislative history to section 864(c)(8) do not address whether section 864(c)(8) overrides income tax treaty provisions. Most U.S. income tax treaties include provisions dealing with business profits and with capital gains. In such provisions, it is typically provided that the U.S. may tax gains from the alienation of movable property forming part of the business property of a permanent establishment in the U.S., including gains from the alienation of the permanent establishment (as well as business profits attributable to a permanent establishment in the U.S.).

Under section 864(c)(8), the amount taxable as ECI is determined as if the partnership had sold its assets, but with a ceiling based on the amount of gain in respect of the partnership interest. Although literally the deemed sale treatment is only for purposes of determining the amount treated as effectively connected rather than more generally, it could be read as indicative of an intention that such deemed asset sale character be applied in testing eligibility for treaty protection. Under that reading, when construing the term "alienation of a permanent establishment," the provision would support treating the disposition of an interest in a partnership having a U.S. permanent establishment as the alienation thereof for U.S. treaty purposes. In other words, rather than a treaty override,[30] it may be seen as a permitted change in U.S. domestic law regarding how a sale of a partnership interest is viewed (though only where the sale is by a foreign person).[31] We note that, in the absence of an explicit Congressional override of the treaty expressed in the statute or in legislative history, the statute and treaty should be interpreted (so far as possible) harmoniously, to give effect to both.

Regardless of whether the provision is intended generally to result in an alienation of a U.S. permanent establishment in a treaty context, we suggest that there is no intention to preempt treaty relief to the extent that the partnership does not have a permanent establishment in the U.S. (as defined in the treaty applicable to the foreign transferor) or to the extent that gain on the notional sale of the partnership's assets, even if it would have been ECI, would not have been attributable to such a permanent establishment. In such a case, a deemed asset sale would not

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[29] 2018-4 IRB 352 (January 2, 2018).

[30] Under the law as it existed prior to the 2017 Act, it was doubtful, by analogy to the reasoning in *Grecian Magnesite*, that gain from the sale of a partnership could be attributed to a U.S. permanent establishment of a partner that exists solely by attribution from the partnership.

[31] This position might be questioned given that the treatment on which the construction of the treaty term is reliant was enacted and applies only for transfers of partnership interests by foreign persons rather than generally.

have given rise to U.S. taxation of the gain if the assets were held directly, and the result should not be worse if they are held through a partnership.[32]

We respectfully request the Treasury to provide published guidance on the interaction between treaties and section 864(c)(8).

E. Effect of FIRPTA Publicly Traded Partnership Exception

In many cases, a partnership that holds U.S. real property interests, the disposition of which has been addressed in the regulations under FIRPTA, will also potentially be subject to section 864(c)(8) (and 1446(f), discussed below). An immediate concern in this regard is the effect of the new provisions on sales of interests in partnerships that hold U.S. real property interests that also reflect effectively connected gain, where the sale of such interests qualifies for the exception for 5% or less interests in partnerships regularly traded on an established securities market under section 1.897-1(c)(2)(iv) of the Treasury regulations. The portion of the effectively connected assets of such partnerships that are U.S. real property interests will vary.

It is unclear to us whether the new provisions were intended to override the existing exception. The Conference Report suggests that broker withholding may be appropriate in the case of publicly traded partnerships, but does not foreclose the possibility of a *de minimis* exception or address the interaction with the FIRPTA rule.

We believe that if a transaction is covered by the above referenced regulation, it should not be subject to section 864(c)(8), and request that this be clarified as soon as feasible .

II. Section 1446(f)

A. Rules Provided by Statute

As stated above in Part I(A), section 1446(f) provides that if any portion of the gain (if any) on any disposition of an interest in a partnership would be treated under section 864(c)(8) as ECI, the transferee of the partnership interest must withhold tax equal to 10% of the amount realized on the disposition.[33] Although section 864(c)(8) applies to dispositions of partnership interests occurring on or after November 27, 2017, section 1446(f) applies only to dispositions occurring after December 31, 2017.[34]

The transferee generally does not have to withhold any amount if the transferor provides to the transferee an affidavit stating, under penalty of perjury, the transferor's U.S. taxpayer identification number and that the transferor is not a foreign person.[35] This exception does not apply if the transferee has actual knowledge that the affidavit is false or receives a notice from an agent for the transferor or the transferee that the affidavit or statement is false.[36] The exception also does not apply if regulations require the transferee to furnish a copy of the affidavit or

[32] This result would be consistent with Rev. Rul. 91-32 (situation 3).
[33] I.R.C. § 1446(f)(1).
[34] Pub. L. 115-97, *supra* note 5, at § 13501(c).
[35] I.R.C. § 1446(f)(2).
[36] I.R.C. § 1446(f)(2)(B)(i). The notice is required to be in the form described in I.R.C. §1445(d).

statement and the transferee fails to furnish such copy at the prescribed time and in the prescribed manner.[37] Agents of both the transferor and the transferee are liable if they know the affidavit is false and do not notify the transferee.[38]

The Conference Report suggests that, in the case of publicly traded partnership interests sold by a foreign partner through a broker, the broker may deduct and withhold on behalf of the transferee.[39]

Treasury is given the authority to prescribe, at the request of the transferor or transferee, a reduced amount to be withheld if it determines that the reduced amount will not jeopardize the collection of the tax imposed under section 864(c)(8).[40] In addition, Treasury is directed to "prescribe such regulations or other guidance as may be necessary or appropriate to carry out the purposes of [subsection 1446(f)], including regulations providing for exceptions from the provisions of [such subsection]."[41]

If the transferee of a partnership interest fails to withhold the 10% tax, then the partnership is required to deduct, and withhold from any distributions to the transferee, a tax in an amount equal to the amount the transferee failed to withhold, with interest.[42]

B. Notice 2018-8

In the Notice, the Service noted stakeholders' comments that, in the case of dispositions of interests in publicly traded partnerships, applying section 1446(f) without guidance presents significant practical problems. For example, the transferee of an interest in a publicly traded partnership typically will not be able to determine whether any portion of a transferor partner's gain would be treated as ECI under section 864(c)(8), in part because the transferee may not know the identity of the seller. Moreover, as noted above, while the legislative history anticipates that the government will provide guidance requiring a broker to deduct and withhold the tax, "until guidance is provided, and new withholding and reporting systems are developed, it will not be possible for brokers to perform any such withholding."[43]

Responding to these concerns and others raised by stakeholders, the Notice announced a temporary suspension of the application of withholding to dispositions of publicly traded interests and promised that the future guidance would be prospective and would include transition rules to allow sufficient time to prepare systems and processes for compliance. The suspension did not extend to non-publicly traded interests, but the Notice did request comments on whether a broader suspension should be provided.

[37] I.R.C. § 1446(f)(2)(B)(ii). We suggest it would be reasonable to expect the Service to follow the template in Reg. § 1.1445-2(b)(3), which requires the transferee of a U.S. real property interest to retain a copy of the certification until the end of the fifth taxable year following the taxable year in which the transfer takes place.
[38] I.R.C. § 1446 (f)(2)(C) (referring to I.R.C § 1445(d); *see* Reg. § 1.1445-4).
[39] H.R. Rep. No. 115-466, *supra* note 7, at 369.
[40] I.R.C. § 1446(f)(3).
[41] I.R.C. § 1446(f)(6).
[42] I.R.C. § 1446(f)(4).
[43] Notice 2018-8, *supra*, note 29.

As discussed below, we recommend an immediate suspension of withholding retroactive to January 1, 2018, be announced in respect of transfers of partnership interests generally, not just of publicly traded partnership interests, or at the least, deferral of the requirement to deposit tax in any case. If that is not feasible, we recommend the suspension of the requirement to withhold and deposit tax under certain broad exceptions discussed below. We further recommend, as discussed below, that interim procedures to mitigate withholding in certain other common situations should be promulgated.

C. General Comments

Issues already noted with respect to the substantive provisions of section 864(c)(8) raise corresponding issues with respect to the implementation of section 1446(f). In addition, numerous issues arise directly under section 1446(f).

Section 1446(f)(1) may be read to have an initial ambiguity, in that it refers to withholding on the "gain (if any)" that "would be treated under section 864(c)(8) as effectively connected…" Once that threshold is met, the withholding is 10% of the amount realized. We do not believe the statute was intended to impose withholding only in cases in which there actually can be shown to be gain in respect of the partnership interest, and hence read "if any" as "if hypothetically there were any," and believe this is consistent with the use of "would" in the same clause.

Nevertheless, the statute does appear to impose withholding only if there is, in fact, at least some effectively connected asset held by the partnership that has built-in gain and is not a U.S. real property interest; if there is not, then no amount would be "treated under section 864(c)(8) as effectively connected."[44] As we read it, section 1446(f)(1) imposes a withholding obligation only if one or more assets held by the partnership are effectively connected (disregarding section 897) and has built-in gain. Thus, under the statute itself, these two factors must be ascertainable by a withholding agent. This fact drives the desirability for permissible reliance on taxpayer certifications, perhaps to a greater extent than under section 1445.

In that regard, we note the authorization given to Treasury to allow reduced withholding upon the request of the transferor or transferee, which recalls the similar procedure under section 1445. Numerous partnerships are engaged in a U.S. trade or business or may be deemed to be so engaged because of section 875. In many cases, the U.S. trade or business of these partnerships may constitute a small portion of their overall business. Moreover, a partnership may be technically engaged in a U.S. trade or business but may never earn any ECI whatsoever. Avoiding overwithholding in these cases may be very difficult if the process required to be followed is in any way similar to the process for obtaining a FIRPTA withholding certificate. FIRPTA withholding certificates take many weeks, and sometimes months, to obtain, and the kind of information that seems likely to be required under section 1446(f) in many cases will be much more complex than the relatively straightforward information needed to determine the maximum tax liability on disposition of a U.S. real property interest. Based on our experience,

[44] Withholding also is literally not required if there is in fact no direct or indirect partner that is a nonresident alien individual or foreign corporation. Section 1446(f)(2), however, suggests that withholding is required unless an affidavit is obtained.

we are of the view that the Service, unless it is provided with significantly increased resources, will not have the resources to handle the large volume of requests it is likely to receive, or to develop the necessary procedures and staff training that will be needed.

Accordingly, we suggest that self-certification to achieve withholding relief where it is appropriate should be acceptable. We believe that the broad regulatory authority provided in section 1446(f)(6), which specifically refers to authority to allow exceptions, may be used to provide more generic relief. We believe that such relief may extend to alleviate excessive withholding, if the partnership and transferor are able to provide certification, under penalties of perjury, of reasonable estimates of the amount of effectively connected gain.

Nevertheless, we understand that for certain situations, pre-transaction filing with the Service (or even ad hoc requests) may be appropriate, pursuant to promulgated guidance effective prospectively. For example, assuming that the taxpayer may proceed without any obligation to withhold on the basis of a filing made if there has been no response following a certain "waiting period," as in the section 1445 regulations in respect of non-recognition transfers,[45] such a procedure may be operable, though we question whether pre-transaction filing in respect of non-recognition transactions generally has proven sufficiently useful to the Service to justify that approach as opposed to a taxpayer certification approach.

The statute was enacted with an effective date that left many taxpayers and even many tax advisors unaware of the need for withholding on generic transactions involving transfers of partnership interests.[46] In many cases, no underlying tax is, in fact, due for reasons that can include a domestic transferor, no effectively connected assets at all, no net gain in such assets, or a non-recognition transaction.[47] In such cases, we recommend that withholding should not be required from January 1, 2018, and at least prior to issuance of adequate guidance indicating the procedures under which withholding is not due. Even in cases in which withholding otherwise would be due, we believe that exceptions and relatively generous procedures are appropriate, at least for such interim period, in recognition of the unfamiliarity of the new regime, its applicability to many less sophisticated taxpayers as well as to taxpayers who may have very little connection to the U.S., the factual complexities presented by tiered partnerships, and the absence of guidance. The advisors in a transaction which may involve no U.S. parties and an interest in a non-U.S. partnership may have little reason to realize that the transaction involves U.S. withholding tax implications,[48] particularly where the relevant assets are multiple tiers below the partnership being sold.[49]

[45] *See generally* Reg. § 1.1445-2(d)(2).
[46] Contrast the lead time allowed in upon the enactment of section 1446. *See generally* Rev. Proc. 88-21, 1988-1 CB 777, *declared obsolete,* Rev. Proc. 89-31, 1989-1 CB 895, *modified by* Rev Proc 92-66, 1992-2 CB 428, *declared obsolete*, TD 9200 (final regulations).
[47] In certain other cases, there would be withholding under section 1445 which takes precedence.
[48] PLR 9824030 (June 12, 1998) illustrates this well. An attorney advised a foreign individual to transfer a U.S. residence that had no gain to a wholly owned foreign corporation for estate planning purposes, but (perhaps understandably) did not realize section 1445 withholding would apply on the foreign-to-foreign transfer solely for shares where there was no gain; section 9100 relief was granted. These situations are not uncommon.
[49] If the partnership has generated ECI that was taxable to the partner, that would be an indicator, but in small cases they nevertheless may not be aware of the compliance requirements on a disposition.

We recommend, therefore, a transition exemption applicable not only to transfers of interests in publicly traded partnerships, but to transfers of all other partnership interests as well, with a possible exception in the case of non-publicly traded partnerships where the relevant amounts are above a very large threshold (and even in such a case, a deferral of the requirement to deposit the tax until guidance in that regard is provided would seem appropriate). At a minimum, however, we recommend that there should be transition exceptions from withholding that include a *de minimis* exception that may utilize a higher threshold than that described below, an exception for all non-recognition transactions in which no gain is recognized, as well as the other exceptions described below. Further, we recommend that, at least during such transition period, there should be no withholding requirement if the buyer has no knowledge or reason to know that a partnership has effectively connected assets. In addition, we believe that, during such transition period and arguably even thereafter, good faith attempts to comply should be deemed to be adequate compliance.[50]

D. <u>Particular Issues Arising Under Section 1446(f)</u>

The following are some of the more pressing withholding issues for which guidance is needed for partnerships generally (apart from the additional issues presented by intermediated sales in the case of publicly traded partnerships). These Comments are intentionally selective rather than comprehensive.[51]

1. <u>*Procedures for Withholding and Deposit of Tax*</u>

A withholding and tax payment requirement cannot operate in the absence of rules establishing, for example, where and by when the amount withheld should be deposited and the information to be provided and notifications to be made in that regard. We suggest that that IRS Forms 8288 and 8288-A provide useful precedents for this purpose. Requiring deposits to be made on or before the 20th day after the transaction, as in the case of the Treasury regulations under sections 1445 and 1446(a), seems appropriate.

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[50] By the same token, a withholding agent should be protected by regulation against claims of a transferor (or transferee, in the case of secondary withholding) that an amount has been unnecessarily withheld.

[51] For example, there is the question as to which party may seek a credit or refund where amounts have been paid in excess of the tax ultimately due, given that there may be two withholding agents in addition to the taxpayer. The section 1445 and 1446 regulations indicate the range and complexity of issues that may be relevant, though section 1446(f) introduces new issues as well.

2. De Minimis Exception

Many transactions involving sales of partnership interests involve small amounts, relative to the situations that apparently motivated the statutory provisions. Further, sales involving foreign sellers tend not to involve relatively small dollar amounts. In order to alleviate compliance burdens and burdens on administrability of the statute, we recommend a *de minimis* exception or exceptions. For example, an exception might be provided for cases in which the combined sale price of partnership interests being acquired by a single or related group of buyers is less than a particular amount, such as $500,000 or $1 million.

3. Avoidance of Excessive Overwithholding

The potential for overwithholding and, theoretically, underwithholding is significant. The amount required to be withheld is 10% of the entire amount realized if there is any gain in respect of effectively connected assets, regardless of the proportion of the amount realized such gain represents. Further, to avoid potential liability for underwithholding, a transferee likely would withhold on the entire amount realized in cases in which information is lacking, even when there may be no effectively connected assets. As a result, the amount withheld may bear little or no relationship to the taxpayer's U.S. tax liability (if any) under section 864(c)(8). Thus, in many fact patterns, unnecessarily large overwithholding is inevitable unless alleviating rules are provided. We also note that refund claims may be problematic for the Service.

The Treasury regulations under section 1445 provide a relatively generous rule in the FIRPTA context, under which withholding is not required on the disposition of a partnership interest unless 50% or more of the value of the gross assets consists of U.S. real property interests *and* 90% or more of the value of the gross assets consists of such interests and cash or cash equivalents ("50-90 test").[52] It is unclear whether such a rule, which was intended as temporary but has been in effect since 1988, would be consistent with Congressional intent under section 1446(f). We note that U.S. real property interests would reduce the amount taxable under section 864(c)(8) and hence the withholding required under that section, even if the 50-90 test for section 1445 withholding is not met.

If the 50-90 test, or a modified version thereof, is not considered appropriate under section 1446(f) taking into account legislative intent, we recommend an approach that includes features such as the following be considered.

- A certification by the partnership (or the partnership and transferor) concerning the estimated amount of net ECI from the deemed asset sale, which must be a reasonable estimate. In the case of a tiered partnership, a procedure would be needed whereby a lower tier partnership would respond to a request from an upper tier partnership to provide such information.[53]

[52] Reg. § 1.1445-11T(d).
[53] This would be a type of look though rule that runs in the opposite direction of that under Reg. § 1.1446-5(c) and relates to effectively connected gain rather than residence of owners.

- Withholding based on such certification at the highest applicable individual or corporate rate in the amount so certified.[54]

- Withholding based on such certification, using withholding bands (recognizing the difference between the withholding tax rate and the actual tax rates). Solely to illustrate the concept, this might provide for: withholding on 35% of the amount realized if the estimated net effectively connected gain represents 15% or less of the total estimated again; withholding on 75% of the amount realized if the estimated net effectively connected gain is more than 15% but not more than 35%; and withholding on 100% of the amount realized if the estimated net effectively connected gain is above 35%.

In addition, in a situation in which there is section 864(c)(8) gain and section 897 loss, or vice versa, overwithholding could result if netting is not permitted. We recommend that regulations permit netting, despite the differences in withholding rates applicable under section 1445 and section 1446(f) to the two categories.

4. Non-recognition Transactions

Section 1446(f) may be over-inclusive of transactions as well as amounts. Section 1446(f) on its face requires withholding generally on an amount realized, absent an affidavit of non-foreign status. Thus, this could apply even to non-recognition transfers of partnership interests.

We note that the approach of broad statutory application with regulatory authority to create exceptions is typical of withholding provisions.[55] In principle, withholding clearly should not be required on transfers that are respected as non-recognition transactions for purposes of section 864(c)(8). We suggest that Treasury and the Service exercise regulatory authority under section 1446(f)(3) to eliminate withholding for all non-recognition transactions, which might be on the basis of certification of the non-recognition treatment by both the transferor and transferee or, if necessary, might involve a pre-transaction filing similar to that under the section 1445 Treasury regulations,[56] with exceptions only if and to the extent that a particular form of non-recognition transaction has been identified for exception under section 864(c)(8)(E) in final regulations. We further recommend that the taxpayer be permitted to rely on such exception in the case of a non-recognition transfer that involves boot or liability assumption in excess of basis, provided that withholding is made at the highest applicable rate (individual or corporate) on the amount of boot or reasonably estimated excess liability assumed.[57]

5. Certification Procedures Regarding Foreign or Domestic Status of Transferor, Effectively Connected Assets, and Amount Realized

[54] *Compare* Reg. § 1.1445-3(c), implementing I.R.C. § 1445(c), which provided explicit statutory authority for the IRS to determine a maximum tax liability.
[55] *See, e.g.*, I.R.C. § 1445(e)(7).
[56] *See generally* Reg. § 1.1445-2(d)(2).
[57] Although the section 1445 regulations did not take this approach, we believe it is appropriate. A consideration is that, in many cases, the parties may have competing interests as the amount of gain would affect the basis.

The transferee may not be able to determine independently whether the transferor partner is foreign or domestic, whether the transferor would recognize any gain, or whether any of the gain (if any) would be ECI. It would have to rely on certifications concerning these facts from the transferor and/or from the partnership. A mechanism providing for such certifications and permitting reliance thereon would be appropriate.

In this regard, we recommend that guidance be provided that, for purposes of the statutory procedure for an affidavit of domestic status, a transferee may rely on an IRS Form W-9 (or substitute IRS Form W-9 or any document with equivalent information and certification) dated within a reasonable time.[58]

Similarly, we recommend that guidance be provided that would permit reliance on appropriate certification from the transferor or from the partnership to the effect that the partnership directly or indirectly has no (or, if a *de minimis* exception is permitted, less than such amount of) effectively connected assets. Further, if additional relief from overwithholding is permitted as suggested above, the ability to rely on certifications as to the actual range of estimated gain would be needed.

Certification of the effect of partnership liabilities on the amount realized also may be required.

As transfers generally would fall in the middle of an accounting period, conventions may be needed in order for these determinations to be made.

6. Tiered Partnerships

Under section 864(c)(8), tax is imposed on a transfer of a partnership interest that is owned "directly or indirectly." The withholding tax is imposed in respect of the partnership interest actually transferred, which raises complications in the case of tiered partnerships. Where a transfer is made of an interest in an upper tier partnership that is a partner of a second partnership, the transferee (and the upper tier partnership by reason of its potential secondary withholding obligation) may have a very heavy, perhaps impossible, burden in determining whether the transferor would recognize gain, and whether any gain would be effectively connected. Certification up the chain from the lower tier partnership would seem necessary to avoid a requirement to withhold in cases in which there are no effectively connected assets or (if permitted by regulation) reduce withholding where the amount is small.[59]

Moreover, if a foreign transferor sells an interest in a foreign partnership to a foreign transferee, and the foreign partnership is in a structure that has a U.S. trade or business, it may be difficult to hold the foreign transferee, or the foreign partnership, liable for a withholding tax even if it is aware of the obligation. In order to enhance compliance in many cases involving tiered arrangements with partners unrelated to each other, as well as to avoid withholding in cases in which there are no effectively connected gain assets, we suggest that a reporting

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[58] Compare the statement of non-foreign status required under Reg. § 1.1445-2(b)(2), implementing I.R.C. § 1445(b)(2).

[59] As noted above, this would be a look through approach in the opposite direction of Reg. § 1.1446-5(c).

obligation up the chain may be needed. Further, since the ultimate seller of a partnership interest may have only a very small interest in effectively connected assets, the suggestion above for a *de minimis* exception from the withholding obligation has particular relevance in these situations.

Unlike section 864(c)(8), which imposes tax on a nonresident alien or a foreign corporation, section 1446(f) withholding applies to any transfer of an interest in a partnership, *including* by a partnership or a disregarded entity, if the partnership interest otherwise is in scope. Thus, an upper tier partnership's disposition of an interest in a lower tier partnership may be subject to these provisions to the extent there is a partner that is a nonresident alien or foreign corporation up the chain. We suggest that if an upper tier partnership sells an interest in a lower tier partnership, a procedure analogous to that under which IRS Form W-8IMY certifications are passed down the chain under the look through rules of the section 1446 regulations would be appropriate to permit withholding only on amounts ultimately corresponding to nonresident alien individuals or foreign corporations.

7. <u>Treaty Relief</u>

If Treasury determines that a treaty provision prohibits the taxation of gain under section 864(c)(8) under certain circumstances, such as where the partnership does not have a permanent establishment in the U.S., we recommend that guidance be developed on how withholding may be avoided under such circumstances. In particular, we would recommend that a withholding agent be permitted to rely on a claim of exemption supported by IRS Form W-8BEN-E (Certificate of Status of Beneficial Owner for U.S. Tax Withholding and Reporting (Entities)), including completion of Part III of such form.

8. <u>Interest Imposed Only to the Extent an Amount Not Withheld Is Actually Due</u>

We note that interest may be imposed on a failure to withhold under sections 1445 and 1446, even if no tax ultimately is due. That is not the case for withholding under sections 1441 and 1442. Literally, section 1446(f) does not apply if there is not a nonresident alien or foreign corporate owner, and also does not apply if the partnership has no effectively connected gain asset that is not a U.S. real property interest. Regulations might require withholding absent contemporary certifications or other proof of these facts. Taking into account the compliance difficulties noted above, we suggest that the section 1441/1442 approach is the more appropriate in this context, particularly pending finalization of regulations but even thereafter.

9. <u>Partnership as Withholding Agent</u>

The potential burden of a secondary withholding tax obligation on a partnership under section 1446(f)(4) is considerable. The statute does not provide a procedure for how a partnership engaged in a U.S. trade or business may confirm that tax has been withheld on a transfer of a partnership interest. Procedures may be needed, whereby the partnership obtains certification from the transferee that tax has been withheld and deposited, and provides that certification to the Service, which should afford it protection from the need to withhold unless and until notified by the Service that the certification is incorrect.

Moreover, a partnership may not know that a transfer has occurred, since certain transactions may be treated as dispositions for tax purposes without the partnership normally being notified. For example, if a foreign company, with more than one owner, that is a partner in a partnership, had been classified as a corporation and then elects to be classified as a partnership, the election could result in a taxable transaction under section 336(a). The lower tier partnership in which such company is a partner may not be aware of such transaction.

Section 1446(f)(4) requires that the partnership withhold interest. That provision cannot be complied with until guidance is provided regarding the amount of interest and how it is calculated, and we recommend that any such guidance be prospective.

If the transferee fails to withhold and then transfers the acquired interest to another party, section 1446(f) does not provide for the second transferee to be liable and does not provide for the partnership to withhold on distributions to the second transferee. The second transferee may, however, have transferee liability.[60] The original transferee would remain liable. We request that any guidance confirm that the partnership is not required to withhold on distributions to the second transferee with respect to the partnership interest in question pursuant to section 1446(f)(4), absent exceptional circumstances.

The manner in which the partnership should withhold the secondary withholding tax is unclear. It appears that the partnership should withhold the entire amount from any amounts distributable to the transferee partner (including distributions in kind or deemed distributions resulting from an assumption of a liability, but net of any amount required to be withheld under other provisions) until the amount owed is met. It is unclear whether, for this purpose, distributions treated as compensation are intended to be covered. Rules may be necessary to address situations in which distributions are not made but rather a capital account is increased, in anticipation of a sale of the interest.

The partnership audit rules of the Bipartisan Budget Act of 2015 became effective on January 1, 2018.[61] Under the Bipartisan Budget Act, the Service makes adjustments to "partnership items" at the partnership level in a single audit proceeding (as opposed to making adjustments for individual partners) and collects taxes at the partnership level. There is a significant need for guidance concerning how section 1446(f) will interact with the partnership audit rules, including how an audit will handle the possibility of the partnership's secondary withholding tax.

10. <u>Disguised Sale</u>

By its terms, section 1446(f) applies where proceeds are received by a partner in connection with a transaction treated as a disguised sale of a partnership interest. In a series of transactions where the transferor and transferee are not interacting with each other but with the partnership, the question arises as to who is liable for the withholding tax. This question is complicated by the difficulty in ascertaining when there is a disguised sale of a partnership interest, as evidenced by the withdrawal of a regulatory project on that issue. We recommend

[60] *See* I.R.C. § 6901. In certain cases, penalties for, *e.g.*, aiding and abetting the failure to pay tax, could apply.
[61] Pub. L. No. 114-74, §1101, 129 Stat. 584 (2015).

that the transferee should be subject to withholding under section 1446(f) only if it knows or has reason to know of a disguised sale. Otherwise only the partnership should be the withholding agent in such a case.

III. Conclusion

We recognize that certain determinations in respect of issues relevant under the regulations will require significant time to analyze. Given the fact that the relevant tax and withholding provisions are currently in effect, we urge that interim guidance be issued. We appreciate your consideration of our recommendations