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Report No. 1387
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The Honorable David J. Kautter
Acting Commissioner
Internal Revenue Service
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The Honorable William M. Paul
Principal Deputy Chief Counsel and
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Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Request for Immediate Guidance under Sections 864(c)(8) and 1446(f)*

Dear Messrs. Kautter and Paul:

The New York State Bar Association Tax Section (the "Tax Section") is submitting this letter[1] to request immediate guidance under Sections 864(c)(8) and 1446(f) (collectively, the "Provisions") of the Internal Revenue Code of 1986, as amended (the "Code"), which were added to the Code pursuant to P.L. 115-97 (the "Act") on December 22, 2017.

[1] The principal drafters of this letter were Robert Cassanos and Michael Shulman with contributions from Stanley A. Barsky, Kimberly S. Blanchard, Charles W. Cope, Ze'ev Deutsch, Tim Devetski, Phillip J. Gall, Rafael Kariyev, Michael Karlin, Abraham Leitner, Michael Miller, Erika W. Nijenhuis, Harsha Reddy, Tyler Robbins, David R. Sicular, Michael Schler, Eric B. Sloan, Karen G. Sowell, Chaim Stern, and Gordon E. Warnke. This letter reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

As discussed below, while the Provisions raise numerous technical and interpretative issues that should be addressed through regulations, there is a pressing need for immediate guidance regarding the Provisions, particularly in light of the current requirement to withhold tax under Section 1446(f) in connection with the transfer of certain partnership interests and the effect of Section 864(c)(8) on the structuring of certain transactions. Such guidance would allow affected transactions to proceed in a workable manner while the government considers how to address the broader set of issues raised by the Provisions.

I. <u>Background</u>

Section 864(c)(8) provides that gain or loss recognized by a nonresident alien individual or foreign corporation from the sale, exchange or disposition of a directly or indirectly held partnership interest generally is treated as effectively connected with the conduct of a U.S. trade or business 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 fair market value as of the date of the transfer. Section 1446(f) provides that a transferee of such a partnership interest generally must withhold tax equal to 10% of the amount realized upon the disposition of a partnership interest if any gain on the transfer of such interest would be treated as effectively connected with the conduct of a U.S. trade or business under Section 864(c)(8). If the transferee fails to withhold the correct amount of tax under Section 1446(f), the obligation to collect is shifted to the partnership, which is required to withhold from distributions to the transferee partner any amount required to be, but not, withheld by the transferee.

The enactment of Section 864(c)(8) was intended to override the result in *Grecian Magnesite Mining Co. v. Commissioner*, 149 T.C. No. 3 (July 13, 2017) ("*Grecian Magnesite*"), and to codify the holding in Revenue Ruling 91-32, 1991-1 C.B. 107. In *Grecian Magnesite*, the Tax Court held that gain recognized on a sale or exchange by a foreign person of an interest in a partnership that is engaged in a U.S. trade or business generally does not constitute income that is effectively connected with a U.S. trade or business ("ECI"). In *Grecian Magnesite*, the court rejected the position of the Internal Revenue Service (the "Service") in Revenue Ruling 91-32 that gain or loss recognized by a foreign person upon its disposition of a partnership interest generally constitutes effectively connected gain or loss to the extent of the foreign person's distributive share of unrealized gain or loss of the partnership attributable to effectively connected property of the partnership.

The Provisions, however, go well beyond a codification of Revenue Ruling 91-32. Most notably, Section 1446(f) imposes a new withholding regime on transfers of partnership interests after December 31, 2017. As a result, partnership interest transfers occurring in 2018 are potentially subject to withholding tax without the benefit of much-needed guidance on the scope and manner of this new withholding regime.

Section 864(c)(8) also differs in certain important respects from the holding in Revenue Ruling 91-32 and is ambiguous in many respects. Moreover, Revenue Ruling 91-32 itself raised numerous interpretative questions, resulting in substantial commentary from practitioners, the issuance of a prior report by the Tax Section[2] and the initiation of a project at the Department of the Treasury ("Treasury") and the Service regarding the implementation of the ruling.[3] Most of these questions continue to apply to the application of Section 864(c)(8).

In response to concerns expressed by taxpayers and practitioners, Treasury and the Service issued Notice 2018-8, 2018-4 I.R.B. (Jan. 2, 2018), which suspended all withholding in connection with the sale or other disposition of publicly traded partnership ("PTP") interests under Section 1446(f) until regulations or other guidance under such section are issued. Notice 2018-8 also requested comments on whether a temporary suspension of Section 1446(f) withholding for partnership interests other than PTP interests is needed and what additional guidance may be needed to assist taxpayers in applying the Provisions.[4]

Part II of this letter recommends that immediate guidance be provided on certain critical issues in order for the withholding regime under Section 1446(f) to operate in a workable manner until more detailed guidance can be issued or, alternatively, that withholding be delayed until guidance is issued. Part III of this letter makes recommendations for immediate guidance under Section 864(c)(8) (regardless of whether withholding under Section 1446(f) is delayed) in order to clarify certain matters that could meaningfully affect the structuring of current transactions. Finally, in Part IV of this letter, we provide a brief summary of a number of other important issues raised by the Provisions that should be addressed through guidance.

II. Recommendations Regarding Section 1446(f)

Although Section 1446(f) is currently in effect for partnerships that are not PTPs, applying its provisions as written in a sensible manner has proven to be challenging in a number of circumstances. In particular, the manner in which Section 1446(f) was drafted leaves many interpretative gaps. Ideally, guidance to address such gaps should be prompt but also thorough and workable. Given the need for thought and care in handling many of the difficult issues that arise under the statute, there is some tension between the goals of speed and thoroughness/workability. Accordingly, we recommend that the Service consider extending to all partnerships the delay in implementation of Section 1446(f) currently in effect for PTPs until practical guidance can be issued if Treasury and the Service conclude that they cannot provide workable guidance in a very short time frame.

The following two examples illustrate some of the many challenges withholding agents currently face in implementing the withholding regime under Section 1446(f) without further guidance.

2 *See* N.Y. ST. BA. ASS'N, TAX SEC., *Report on Guidance Implementing Revenue Ruling 91-32* (Jan. 21, 2014).

3 *See* Joint Treasury, IRS 2013-2014 Priority Guidance Plan.

4 We understand that Treasury and the Service are presently crafting a procedure to implement Section 1446(f) withholding for PTPs and that this procedure may place the responsibility for withholding on the broker of the transferor of the partnership interest. In light of this ongoing process, we are not commenting further on issues specific to PTP withholding in this letter.

Example 1: Open-ended domestic fund classified as a partnership for U.S. federal income tax purposes ("PRS") periodically redeems interests of holders, each of whom has provided PRS with a Form W-9 certifying its status as a U.S. person. PRS has a U.S. trade or business ("USTB"), which constitutes less than 1% of its gross assets. As drafted, PRS apparently must either obtain affidavits from each redeeming partner or withhold 10% of the amount realized on the disposition by such redeeming partner because it is not clear that a Form W-9 is considered an "affidavit" for this purpose (and notwithstanding the fact that less than 1% of PRS's assets are used in a USTB).

Example 2: A foreign person ("FP") is a partner in a foreign partnership ("FPRS") that to the best knowledge of FP does not have a USTB. FP wishes to sell its partnership interest to another foreign person. Under the statutory provision, although there is in fact no withholding obligation, there is no practical procedure for the buyer in this transaction to avoid the requirement to withhold because there is no reasonable cause exemption. Even if FPRS were willing to certify that it has no USTB assets, the statute does not permit a buyer to rely on such certification to avoid withholding.

We make below two alternative recommendations concerning the effective and orderly implementation of Section 1446(f), given the lack of guidance. Specifically, we recommend that either (i) Treasury and the Service issue immediate guidance that addresses the most pressing issues regarding the manner in which withholding under Section 1446(f) is to be conducted or (ii) if workable guidance cannot be issued in a very short period of time, the application of withholding for all partnership interests be delayed until regulations or other guidance is issued. We believe that at a minimum such "workable guidance" should address the issues set forth in this letter with respect to both Section 864(c)(8) and Section 1446(f). We note that there are many other important interpretative issues to be addressed, some of which are briefly summarized in Part IV below.

A. Alternative 1: Provide Immediate Guidance Allowing for Orderly Application of Withholding Rules until More Detailed Guidance Is Provided

We recommend that the government provide immediate and temporary guidance (until further guidance is issued) that would provide basic and needed direction so that withholding may be done in a reasonable manner in advance of broader guidance being issued. As described below, we believe that such immediate guidance should provide that (i) no withholding is required if the effectively connected assets of the partnership do not constitute a substantial portion of the partnership's total assets, (ii) a transferee may rely on certification provided by the underlying partnership to determine whether withholding is required, (iii) a transferee of a partnership interest generally may rely on a Form W-9 to certify the U.S. status of the transferor, and (iv) nonrecognition transactions (with certain appropriate carve-outs) are exempt from withholding.

1. No Withholding Where the Partnership's Effectively Connected Assets are Less than a Specified Percentage of the Partnership's Total Assets

The statute by its terms appears to require withholding of 10% of the entire amount realized by a seller of a partnership interest if the seller recognizes any gain on the sale and there is even a dollar of gain that would be treated as ECI on a sale of partnership assets. The fact that withholding is required with respect to amounts not attributable to USTB assets can result in the withholding of tax in an amount that is grossly disproportionate to the amount of tax that will ultimately be due. Although Section 1446(f)(3) allows taxpayers to make an application to the Service to reduce the amount required to be withheld, there is presently no procedure in place to obtain such relief. Moreover, even if there were, such relief would have to be given on a case-by-case basis and, in any event, would in many cases be unnecessarily costly and burdensome to both taxpayers and the Service, particularly where the value of USTB assets held by the underlying partnership is relatively small.

Section 1446(f)(6) provides the Secretary with regulatory authority to provide exceptions from the requirement to withhold. We believe that this authority should be utilized to create an exception from the requirement to withhold in connection with the transfer of a partnership interest where the value of the partnership's USTB assets is less than a specified percentage of the value of the partnership's total assets. An application for relief from withholding should still be available under Section 1446(f)(3) to cover situations where the exception does not apply but the amount of tax due will be less than the amount required to be withheld.

For purposes of identifying a model for interim guidance, we considered the withholding regime for FIRPTA (the Foreign Investment in Real Property Tax Act of 1980), which generally provides that gain realized on the disposition of a U.S. real property interest ("USRPI") is considered effectively connected income, which in certain cases requires withholding upon the transfer of an interest in a partnership that holds a USRPI. Withholding under the FIRPTA regime is required upon the transfer of a partnership interest only if (i) 50% or more of the value of the gross assets of such partnership consists of USRPIs and (ii) 90% or more of the value of the gross assets of the partnership consists of USPRIs plus any cash or cash equivalents (the "50%/90% rule"). *See* Treas. Reg. §§ 1.897-7T(a) and 1.1445-11T(b). This is a ready-made rule that is familiar to both taxpayers and the Service, which could be adopted for Section 1446(f) by substituting USTB assets for USRPIs. We note that this standard would allow for withholding tax to be avoided even on the transfer of an interest in a partnership substantially more than half of whose assets consist of USTB assets. In that regard, the rule could be modified, if desired, to use only the 50% prong for purposes of Section 1446(f). Under this approach, withholding under Section 1446(f) would be required only if 50% or more of the value of the partnership's gross assets consists of USTB assets. With or without such a "de-coupling," using Section 1445 principles, at least on a temporary basis, would have certain benefits. First, as noted above, the framework for such an exception is already in place in the FIRPTA context and is familiar to both the Service and practitioners. Thus, using the framework in this context would allow for a smoother implementation of the new withholding regime than if a completely new approach were adopted. Second, using this framework for the new withholding regime might allow for easier coordination between the different withholding regimes under Section 1445 and Section 1446(f). For example, income and loss with respect to USRPIs often are effectively connected with a U.S. trade or business.

If the 50% threshold is lowered for this interim guidance, we recommend that the principles and procedures of the 50%/90% test be used. In considering which threshold to use, we would note the following factors: (i) the calculations required are extremely complex and burdensome; (ii) the higher the threshold, the more readily certification may be obtained; and (iii) a higher threshold serves to mitigate to a greater extent the difficulties of complying with the "amount realized" requirement discussed below.

Whether a 50% threshold is adopted, or a lower threshold is used, consideration should be given to integrating the procedures under Section 1445 relating to transfers of partnership interests with those under Section 1446(f) so that the two procedures can work in tandem even if the thresholds are different (*e.g.*, the Section 1446(f) regime should allow the use of the same forms and certification procedures as the Section 1445 withholding regime), although for the reasons set forth above, it would be preferable if the procedures were the same, at least for the immediate future.[5]

2. <u>Allow Transferees to Rely on Certifications</u>

Section 1446(f) does not by its terms permit certification as to the underlying partnership's USTB assets to be given or relied on by any person (either the transferee or the partnership itself) to avoid withholding under Section 1446(f). The absence of a reliable certification process can place transactions at risk since in many cases the buyer can only avoid liability by withholding and allowing the seller to file for a refund, which in many cases will be unduly burdensome since the amount of the tax may not have a strong relationship to the amount of withholding.

Section 1445 permits a transferee of a partnership interest to rely on certification from the underlying partnership to determine if the partnership satisfies the 50%/90% test. We recommend that discretionary certification by a partnership equivalent to that permitted for purposes of the 50/90% test under the FIRPTA regime be permitted to allow transferees to determine whether the underlying partnership is under the applicable threshold for USTB assets (as described in Part II.A.1 above) for purposes of determining whether withholding is required.

We note, however, that because Section 1446(f) imposes secondary liability on the partnership to withhold from distributions to the transferee if the transferee fails to withhold, partnerships may be reluctant or unwilling to provide such a certification because relieving the transferee of withholding responsibility causes the partnership to be potentially liable for any underwithholding if the certification were ultimately determined to be incorrect. This dynamic is part of a larger challenge created by the Provisions, which is that the proper calculation of whether tax is due under the Provisions, and the amount of any such tax, will require the underlying partnership to provide detailed information to the transaction parties (including the liabilities allocable to the transferred interest, the amount of net gain inherent in the partnership's USTB assets and the portion of any such gain allocable to the interest), each of which (except for the first) is a purely hypothetical calculation. The overall construction of the statute and, in particular, the potential secondary liability of the partnership for any under-withholding may make efforts of the affected parties to comply with the Provisions without undue burden or inefficiency more difficult precisely because the partnership (which is best positioned to provide accurate information) is incentivized not to cooperate in this process. To address this issue, the secondary withholding

[5] In this regard, we note that Section 1446(f) provides no direction on the timing or manner of remitting amounts withheld under that provision. Immediate guidance should address this by either directing withholding agents to use the same withholding remittance procedures set forth in Section 1445 or requiring the remittance of any tax withheld under Section 1446(f) no earlier than 30 days after guidance addressing such procedures is issued. In addition, Sections 1445 and 1446(f) should be coordinated to prevent the possibility that withholding of tax under both provisions may be required, for example, in the case of the transfer of an interest in a partnership whose assets principally consist of USRPIs but that also holds non-USRPI assets that comprise a USTB.

liability could be relieved in cases where the partnership provides a certification or other information under penalties of perjury and such certification or information was prepared reasonably and was consistent with the partnership's tax reporting.

Certification issues may also arise when partnerships make cash distributions to continuing partners. In that case, assuming the distribution is not part of a disguised sale of a partnership interest and there is no alteration in the distributee partner's share of Section 751(b) property, the distribution generally does not result in gain except to the extent that the amount of the distribution exceeds such partner's basis in its partnership interest. Such gain is treated as gain from the sale or exchange of the partnership interest of the distributee partner. Section 864(c)(8) requires a sale, exchange or disposition of a partnership interest in order to potentially characterize gain or loss as effectively connected with a U.S. trade or business; Section 1446(f) requires a disposition of a partnership interest in order to potentially impose a withholding obligation. Accordingly, to the extent a partnership cash distribution does not exceed the distributee partner's basis, there should be neither a substantive tax nor a requirement to withhold. The foregoing should be confirmed through immediate guidance.

Even though withholding should not be required where a cash distribution does not exceed the distributee partner's basis, the partnership may not have knowledge of sufficient facts to determine such partner's outside basis. As a result, because a partner's basis may be less than the partnership would expect as a result of facts not within the knowledge of the partnership, the partnership may decide to withhold on all distributions of cash (including operating cash flow distributions in the ordinary course) in order to avoid potential exposure to transferee liability if a cash distribution were found to exceed the distributee partner's basis. Accordingly, we recommend that, for purposes of Section 1446(f), a partnership be allowed to rely on its books and records to determine which portion, if any, of a distribution is in excess of a partner's basis, provided it does not know or have reason to know that such partner's basis is not accurately determined by such information. A partnership also should be allowed to rely for purposes of the withholding tax determination under Section 1446(f) on a certification received from a distributee partner as to such partner's basis, provided that the partnership does not know or have reason to know that the certification is incorrect. A partnership that meets either standard should be relieved of any liability for underwithholding. Failure to promulgate such a rule could result in partnerships with USTBs withholding on all cash distributions to foreign partners to avoid withholding liability.

> *Example*: PRS is engaged solely in a USTB. Based on its books and records, PRS determines that FP has a tax basis of $10X in its PRS interest, after taking into account FP's distributive share of income and loss for the current and prior periods and all prior distributions to FP. PRS makes a distribution of $8X of cash to FP. No withholding should be required in this case because PRS has determined, based on information within its control, that there has been no amount treated as gain from the sale or exchange of FP's interest. If, however, unbeknownst to PRS, FP's basis was in fact only $6X, FP would recognize $2X of gain, characterized as ECI under Section 864(c)(8). Nevertheless, because PRS did not know or have reason to know that the cash distribution exceeded FP's basis, PRS should be relieved of any liability for underwithholding with respect to the $2X of gain.

3. Treatment of Form W-9 as a Nonforeign Affidavit for Purposes of Section 1446(f)(2)

Section 1446(f)(2) provides that no withholding is required if the transferor furnishes 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. In many cases, the exception has limited efficacy, however, by placing undue compliance burdens on partners, partnerships and other withholding agents. For instance, in the case of domestic partnerships that periodically redeem the interests of their partners, all of the partners may be U.S. persons and have certified that fact under penalty of perjury on a Form W-9. However, if the partnership cannot rely on a Form W-9 to eliminate its withholding liability, the partnership will be required to either obtain separate affidavits from each of its partners (which may prove burdensome) or withhold with respect to each redemption, despite the fact that such redemptions are not subject to tax by virtue of Section 864(c)(8).

The Form W-9 requirements (*i.e.*, provision of a U.S. taxpayer identification number and certification that the person providing the Form W-9 is a U.S. citizen or other U.S. person, both under penalty of perjury) match the requirements set forth in the exception for a nonforeign affidavit. While the Form W-9 would therefore appear to meet the substantive requirements of Section 1446(f)(2), any uncertainty in this regard could frustrate the purpose of the exception. Thus, to achieve the intended objective of the nonforeign affidavit exception without requiring duplicative and burdensome documentation requirements, we recommend Treasury and the Service issue guidance that confirms that a duly certified Form W-9 is an acceptable certification for purposes of Section 1446(f)(2).

4. Provide for No Withholding in the Case of Nonrecognition Transfers

For the reasons discussed in Part III.A below, we believe that Section 864(c)(8) should not be interpreted to override nonrecognition treatment (except where recognition treatment is necessary in order to prevent the permanent elimination of gain through the use of a nonrecognition provision). We recommend that immediate guidance provide that, in the case of any partnership interest transfer that is eligible for nonrecognition treatment, other than a form of transfer that is specifically identified in such guidance, no withholding under Section 1446(f) is required. If desired, the transferor could be required to provide certification of nonrecognition treatment to the transferee and also to notify the Service.

B. Alternative 2: Delay Withholding on Transfers of Non-Publicly Traded Partnership Interests

We believe that, in the absence of guidance addressing the issues discussed in Alternative 1 and Part III below, implementation of the withholding tax regime under Section 1446(f) should be delayed until such guidance is released. As it currently operates, the application of the statutory withholding provision is overinclusive and imposes an undue burden on withholding agents. Without immediate guidance addressing the issues raised in this letter or a temporary delay in withholding, many partnership interest transfers may be delayed or abandoned in light of the many uncertainties associated with the Provisions.

In addition, we note that in many if not almost all cases, partners in non-traded partnerships which have a U.S. trade or business are already subject to "regular" withholding under Section 1446, and so are already in the U.S. tax filing system. This may reduce the risk to the U.S. tax system of a short-term delay in the implementation of Section 1446(f) withholding. Extending the delay set forth in Notice 2018-8 to the application of withholding under Section 1446(f) to all partnership interests would give practitioners and other interested parties the opportunity to identify issues and propose solutions and would provide the government with time to consider such comments in drafting guidance that is reasonable, workable and thorough. Such a delay would have no effect on the amount of U.S. tax ultimately owed by the foreign partner by virtue of Section 864(c)(8). We note, however, that even if withholding of tax under Section 1446(f) is delayed, it is critical that immediate guidance still be issued clarifying the application of Section 864(c)(8) to nonrecognition transactions and treaties, as discussed in Part III below.

III. Recommendations Regarding Section 864(c)(8)

A. Interaction of Section 864(c)(8) with Nonrecognition Provisions

By its terms, Section 864(c)(8) does not purport to override nonrecognition provisions, and instead merely characterizes gain or loss as effectively connected. Nevertheless, some practitioners have suggested that the statute could be read as requiring gain recognition in connection with a partnership interest transfer, even where a nonrecognition provision otherwise applies. We believe that the statute only characterizes gain or loss as effectively connected gain or loss and is not intended to change the determination of whether gain or loss is recognized. This view is consistent with the approach taken in Revenue Ruling 91-32, which provided a rule for characterizing recognized gain or loss, and did not itself require the recognition of gain or loss.

Given the apparent confusion on this point, however, we think it is important for immediate guidance to confirm that, except as provided in regulations (or other published guidance), the Provisions do not apply to transactions otherwise eligible for nonrecognition treatment. In this regard, we note that Section 864(c)(8)(E) provides the Secretary with regulatory authority in appropriate cases to require the recognition of gain or loss upon the transfer of a partnership interest even where nonrecognition treatment would otherwise be available. We briefly discuss below in what circumstances it might be appropriate for this authority to be used to override nonrecognition treatment.

One approach in evaluating whether Section 864(c)(8) should override a particular nonrecognition provision would be to align, where possible, the treatment of partnership interest transfers with the treatment of comparable transfers of U.S. branches holding the same assets (the "Branch Consistency Approach"). Under this approach, a nonrecognition provision would continue to apply to a foreign person's transfer of a partnership interest to the extent that a transfer of the partnership's underlying assets in a comparable transaction would be eligible for nonrecognition treatment. The focus of this approach would be on whether the gain that would have been subject to U.S. tax if the partnership interest at issue were sold is preserved in a manner that will continue to be subject to U.S. tax, such that there is no erosion of the U.S. tax base.[6]

[6] A special rule might be necessary for a limited class of transactions, for example those involving certain provisions of Subchapter K where there is no ready analogy to a branch transaction, but no base erosion is present.

Another approach would be to provide that gain inherent in the foreign partner's interest that would be taxable under Section 864(c)(8) upon a sale would be triggered unless the interest is exchanged in a nonrecognition transaction for an interest that would be subject to U.S. tax in the hands of the transferor upon a subsequent sale to at least the same extent (the "Transferor Gain Approach"). Under this approach, the focus would be on ensuring that the foreign partner cannot escape U.S. tax with respect to its partnership interest even if the amount of income and gain that will ultimately be subject to U.S. tax has not changed and even if the identical transaction would not have been taxable had it been an asset transfer, rather than an interest transfer.

We consider below three types of nonrecognition transactions involving partnership interests and the extent to which it may be appropriate for any guidance to override nonrecognition treatment.

> *Section 721(a) Contributions*. FP contributes its interest in PRS1 to PRS2 in a transaction qualifying under Section 721(a). Assume PRS1 has a USTB. A contribution by a foreign person of the assets of a U.S. branch to a partnership generally does not give rise to the recognition of gain or loss. The same rule should apply in this case because Section 704(c) generally causes any pre-contribution gain or loss with respect to the PRS1 interest to be allocated to FP. Thus, using either approach outlined above, Section 864(c)(8) should not override nonrecognition treatment in this case.
>
> *Section 351(a) Contributions*. FP holds an interest in PRS, which it contributes to a newly formed U.S. corporation ("Corp") in a transfer qualifying for nonrecognition treatment under Section 351(a). A contribution by a foreign person of the assets of a U.S. branch to a corporation generally qualifies for nonrecognition treatment under Section 351(a), except with respect to the assumption of certain liabilities. Thus, under the Branch Consistency Approach, nonrecognition treatment should be available to the extent that, due to having a carryover basis of the PRS interest, Corp (whether it is domestic or foreign) will ultimately be taxed on (or otherwise take into account) all of the pre-contribution built-in gain in the PRS interest. Under the Transferor Gain Approach, however, even though the gain otherwise would remain subject to U.S. taxation in a modified form of ownership, the contribution would be taxable to FP because, after the contribution, FP would not be subject to U.S. tax on a subsequent disposition of its stock in Corp (unless Corp is a United States real property holding corporation). Appropriate adjustments would need to be made to the basis of Corp's assets to reflect the gain recognized.
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> *Section 731(a) Distributions*. FP and a U.S. person ("USP") hold interests in PRS. PRS has a USTB and also holds non-USTB assets. In a transaction ordinarily qualifying as a nonrecognition transaction, PRS distributes the non-USTB assets to FP in complete redemption of its interest in PRS. In such a case, while USP remains fully subject to tax, FP has gone from partially subject to U.S. tax (because it indirectly held a share of the USTB through PRS) to not being subject to U.S. tax because it no longer holds any interest in PRS. In such case, under either approach, nonrecognition treatment may not be appropriate. Nevertheless, depending on the factual circumstances (*e.g.*, where the parties have a strong business purpose for causing FP to be redeemed for non-USTB assets), there may be

situations where nonrecognition may still be appropriate. We believe further study is warranted to determine the circumstances in which it is necessary to override the nonrecognition rule in Section 731, as we believe the determination may not be susceptible to a hard and fast rule.

The foregoing examples are intended to illustrate that the application of many nonrecognition provisions to transfers of interests in partnerships with a USTB do not create the potential for inappropriate results, but that there are circumstances where an override of otherwise-applicable nonrecognition provisions may be appropriate. Given the number of potential fact patterns and the complexity of these issues (as illustrated above), in an effort to provide near-term guidance, we recommend that any guidance confirm that the Provisions do not override nonrecognition provisions except as provided in future guidance, perhaps with a carve-out at least for transactions that would have the effect of causing gain that would have been subject to U.S. tax to no longer be subject to U.S. tax. If desired, the Tax Section would be happy to provide more detailed analysis and recommendations on this issue.

B. Interaction of Section 864(c)(8) and Treaty Provisions

The application of U.S. income tax treaties to transactions described in Section 864(c)(8) should be clarified. In particular, Treasury and the Service should confirm whether (i) Section 864(c)(8) is intended to override treaty provisions and other reciprocal agreements, given that such agreements are nowhere mentioned in the section, and (ii) the approach taken in Revenue Ruling 91-32 (Situation 3) will apply to the application of Section 864(c)(8).

In Revenue Ruling 91-32 (Situation 3), a foreign partner was eligible for the benefits of an income tax treaty which provided that gain recognized by a resident of the treaty partner from the disposition of movable property was exempt from U.S. tax except to the extent such gain is from the disposition of assets of a permanent establishment in the United States ("USPE"). The ruling then held that gain from the disposition of the foreign partner's partnership interest will be subject to U.S. tax only to the extent such gain is attributable to unrealized gain of the partnership's assets attributable to the partnership's USPE. We recommend that guidance confirm this approach, including nontaxation in cases where the relevant partnership has no USPE. In addition, we recommend that the withholding rules be coordinated to reflect this conclusion (for example, for purposes of calculating the threshold amount to determine if withholding is required).[7] We note that the interaction of treaties and the Provisions is a complex topic that will likely require further study and guidance.

[7] We also recommend that such guidance permit an exemption from withholding tax under Section 1446(f) to the extent that the treaty eligibility of the transferring partner will cause the gain from the sale to be fully exempt from U.S. tax (or the portion of the partnership's assets attributable to a USPE is less than the threshold percentage for withholding described above). *Cf.* Treas. Reg. § 1.1446-2(b)(2)(iii) (in determining the amount of effectively connected taxable income of a partnership subject to withholding tax under Section 1446(a), such income does include income or gain exempt from tax by operation of a U.S. income tax treaty or reciprocal agreement).

IV. Other Issues to be Addressed

The issues addressed above are only a small subset of the significant issues raised by the Provisions. Other issues that Treasury and the Service should consider promptly addressing in subsequent guidance include:

- the fact that the mechanical application of Section 864(c)(8) may result in the taxation of the same items of unrealized gain in USTB assets more than once in the case of partial transfers of a partner's interest or multiple transfers of the same partnership interest,
- the effect, if any, of special allocations of income, gain, loss or deduction on the application of Section 864(c)(8), including the intended effect of the flush language following Section 864(c)(8)(B),
- how to make determinations necessary to apply the Provisions when partnership interest transfers occur during the middle of a tax accounting period,
- the manner of determining the source of effectively connected gain or loss recognized under Section 864(c)(8),
- the interaction of the Provisions with the FIRPTA tax and withholding regime of Sections 897 and 1445,
- the interaction of the Provisions with the partnership audit rules of the Bipartisan Budget Act of 2015,
- the application of the Provisions to tiered partnership arrangements,
- the effect of a shift in a foreign partner's share of USTB assets in a transaction not otherwise resulting in the recognition of gain or loss,
- the application of Section 1446(f) where proceeds are received by a partner in connection with a transaction treated as a disguised sale of a partnership interest,
- whether the secondary liability of a partnership to withhold tax under Section 1446(f) where the transferee failed to do so continues to apply after the transferee transfers the acquired interest to another party,
- the manner in which tax should be withheld under Section 1446(f) in the case of transfers of PTP interests,
- the manner in which a partnership with a USTB may confirm that tax has been withheld on a transfer of a partnership interest in order to eliminate its secondary obligation to withhold on distributions to the transferee, and
- definitional issues with respect to the defined terms provided in Section 1446(f), including the fact that (i) the "transferor" and "transferee" as used in Section 1446(f), by virtue of its

cross-reference to Section 1445, appear to be limited to the persons who transfer or receive a "U.S. real property interest" (rather than the partnership interest) and (ii) a "qualified foreign pension fund" is apparently permitted to avoid withholding by providing a nonforeign affidavit (even though such a fund would still be subject to tax on a partnership interest transfer).

The Tax Section would be happy to issue a more detailed report addressing some or all of the issues listed above. We note that certain of these issues (such as the definitional issues under Section 1446(f)) may be more properly addressed through technical corrections.

* * *

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this letter, please feel free to contact us and we will be glad to discuss or assist in any way.

Respectfully submitted,

Karen G. Sowell

Karen Gilbreath Sowell
Chair

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