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Report No. 1419
July 12, 2019

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1419 – Report on Section 1446(f) Proposed Regulations*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1419 commenting on the Proposed Regulations issued by the Department of the Treasury and Internal Revenue Service under Internal Revenue Code Section 1446(f). Section 1446(f) provides a backstop to Section 864(c)(8) in the form of a withholding mechanism. Our Report supplements our prior Letters and Reports, dated February 2, 2018, August 10, 2018 and March 22, 2019. We commend the Department of the Treasury and Internal Revenue Service for the Proposed Regulations, which address many of the issues discussed in the prior Letters and Reports. The recommendations in this Report aim primarily at ensuring that the Regulations are administrable and of appropriate scope.

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

Respectfully submitted,

Deborah L. Paul
Chair

Enclosure

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Report No. 1419

**New York State Bar Association Tax Section**

*Report on Section 1446(f) Proposed Regulations*

July 12, 2019

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# I. Introduction

The New York State Bar Association Tax Section (the "Tax Section") is submitting this report (the "Report")[1] to comment on proposed regulations (the "Proposed Regulations")[2] issued by the Internal Revenue Service ("IRS") and the Department of the Treasury ("Treasury") to implement section 1446(f) of the Internal Revenue Code (the "Code"). Section 1446(f) was added to the Code pursuant to P.L. 115-97 (the "2017 Tax Act")[3] along with section 864(c)(8). Section 864(c)(8) treats certain gain from the transfer of a partnership interest as income effectively connected with the conduct of a trade or business within the United States, subjecting the transferor to U.S. tax filing obligations and to U.S. net federal income tax liability (such business a "USTB", and such effectively connected income "ECI" and any effectively connected loss, "ECL"). Section 864(c)(8) effectively codifies the holding of Revenue Ruling 91-32, 1991-1 C.B. 107 and overrides the result in *Grecian Magnesite Mining Co. v. Commissioner*[4] (hereinafter, "GMM"). Section 1446(f) provides a backstop to section 864(c)(8) in the form of a withholding mechanism. This Report supplements the Tax Section's prior letters and reports, dated February 2, 2018, August 10, 2018 and March 22, 2019, which discussed issues under sections 1446(f) and 864(c)(8) (the "Prior Reports") and requested guidance.[5] We commend the IRS and Treasury for the Proposed Regulations, which address many of the issues discussed in the Prior Reports.

Section II below, provides a general description of section 1446(f), the Proposed Regulations, and their history. Section III then summarizes the recommendations contained in this Report, and Sections IV through IX describe the reasons underlying our recommendations in greater detail. The recommendations in this Report aim primarily at ensuring the Proposed Regulations are administrable and of appropriate scope.

# II. Background

## *A. General Rules*

The Proposed Regulations provide general rules in respect of transfers of interests in privately held partnerships and transfers that are not broker-intermediated of interests in publicly traded partnerships that are not treated as corporations for U.S. federal income tax purposes

[1] The principal drafter of this Report was William McRae, with assistance from Daniel Hanna, Amy Hinz and Susanna Parker. Helpful comments were received from Andy Braiterman, Kimberly Blanchard, Robert Cassanos, Peter Connors, Patrick Cox, Jason Factor, Stephen Land, Deborah Paul, Michael Schler, and Diana Wollman. 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.

[2] REG-105476-18, 84 FR 21198, May 13, 2019.

[3] 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, December 22, 2017. Unless otherwise indicated, all section references in this Report are to the Code or to Treasury regulations promulgated thereunder.

[4] *Grecian Magnesite Mining Co. v. Commissioner*, 149 T.C. 63 (2017), *aff'd*, No. 17-1268 (D.C. Cir. 2019).

[5] New York State Bar Association Tax Section Report No. 1387, Request for Immediate Guidance under Sections 864(c)(8) and 1446(f) (February 2, 2018); New York State Bar Association Tax Section Report No. 1398, Report on Sections 864(c)(8) and 1446(f) (August 10, 2018); New York State Bar Association Tax Section Report No. 1414, Letter on Section 864(c)(8) Proposed Regulations (March 22, 2019). For additional background, see also New York State Bar Association Tax Section Report No. 1297, Report on Guidance Implementing Revenue Ruling 91-32 (January 21, 2014).

("PTPs"). Those rules are discussed in this Section II.A, and an alternative set of rules for broker-intermediated transfers of PTP interests that are publicly traded on an established securities market or readily tradable on a secondary market (or the substantial equivalent thereof) is discussed in Section II.B, below. All discussions below related to broker-intermediated transfers of PTP interests are labelled as such, and all other discussions relate to the general rules.

As discussed above, section 864(c)(8), added to the Code pursuant to the 2017 Tax Act, provides that a nonresident alien individual or a foreign corporation that sells an interest in a partnership that is engaged in a USTB shall treat any gain or loss as ECI or ECL to the extent such partner's distributive share of gain or loss would have been effectively connected with a USTB if the partnership had disposed of all its assets at fair market value in a hypothetical taxable sale. Section 864(c)(8) codifies the holding of Revenue Ruling 91-32, 1991-1 C.B. 107 and overrides the result in GMM, in which the Tax Court (later affirmed by the United States Court of Appeals for the District of Columbia Circuit) rejected Revenue Ruling 91-32 and held that the foreign corporation's gain upon the redemption of its interest in a partnership that was engaged in a USTB was not ECI.

Section 1446(f) provides for a withholding tax equal to 10% of the amount realized by the transferor of a partnership interest if any portion of gain realized in respect of the transfer would be subject to section 864(c)(8), and the Proposed Regulations propose a detailed set of rules, pursuant to authority granted to Treasury and the IRS under section 1446(f)(6), for assessing and collecting the withholding tax. As discussed below, the Proposed Regulations establish a base rule, under which the 10% withholding tax is imposed with respect to any transfer of a partnership interest,[6] and then provide the following exceptions to withholding where the transferred interest is not an interest in a PTP transferred in a broker-intermediated transaction:

1. The "Non-Foreign Status Exception"[7] under which no withholding is required in respect of the transfer of a partnership interest if the transferor certifies that it is not a foreign person, either by providing a valid Form W-9 or acceptable substitute documentation.

2. The "No Gain Exception"[8] under which no withholding is required in respect of the transfer of a partnership interest if the transferor certifies that the transfer of the partnership interest would not result in any realized gain (or any amount subject to the application of section 751).

3. The "Less-Than-10% ECG Exception"[9] under which no withholding is required in respect of the transfer of a partnership interest if the

[6] Prop. Treas. Reg. § 1.1446(f)-2(a).
[7] Prop. Treas. Reg. § 1.1446(f)-2(b)(2).
[8] Prop. Treas. Reg. § 1.1446(f)-2(b)(3).
[9] Prop. Treas. Reg. § 1.1446(f)-2(b)(4).

partnership certifies that, if the partnership sold all its assets at fair market value as of a specified "determination date," then:

a. The amount of net gain that would have been ECG is less than 10% of the total net gain that would have been realized;[10] or

b. There would be no ECG.[11]

4. The "<u>Three-Year Exception</u>"[12] under which no withholding is required in respect of the transfer of a partnership interest if the transferor certifies that:

a. The transferor has been a partner in the partnership for each of the three most recent taxable years for which Schedule K-1s of the partnership have been provided (or were required to be provided);[13]

b. The transferor's allocable share of ECI was less than $1,000,000 in each of those three taxable years;[14]

c. The transferor's allocable share of ECI (as provided on the Form 8805) in each of the three taxable years was less than 10% of the transferor's total distributive share of net income as provided on the Schedule K-1;[15] and

d. The transferor's distributive share of income or gain that is effectively connected has been reported on a federal income tax return, and all amounts due have been timely paid to the IRS.[16]

One important condition to the Three-Year Exception, however, is that a transferor must have been allocated some amount of ECI (or ECL) in each of the three taxable years described above. Proposed Treasury regulation section 1.1446(f)-2(b)(5)(iii) states that a transferor can make this certification only if the transferor received a Form 8805 in each of the three years (except for years in which the transferor had an allocable share of ECL). Proposed Treasury regulation section 1.1446(f)-2(b)(5)(iv) states that a transferor that had no net distributive

[10] Prop. Treas. Reg. § 1.1446(f)-2(b)(4)(i)(A).
[11] Prop. Treas. Reg. § 1.1446(f)-2(b)(4)(i)(B).
[12] Prop. Treas. Reg. § 1.1446(f)-2(b)(5).
[13] Prop. Treas. Reg. § 1.1446(f)-2(b)(5)(i)(A), (ii).
[14] Prop. Treas. Reg. § 1.1446(f)-2(b)(5)(i)(B).
[15] Prop. Treas. Reg. § 1.1446(f)-2(b)(5)(i)(C).
[16] Prop. Treas. Reg. § 1.1446(f)-2(b)(5)(i)(D).

share of income from the partnership in any of the three taxable years also is unable to qualify for the Three Year Exception.

5. The "Nonrecognition Exception"[17] under which no withholding is required in respect of the transfer of a partnership interest if the transferor certifies that, by reason of a nonrecognition provision of the Code, the transferor is not required to recognize any gain or loss with respect to the transfer.

6. The "Tax Treaty Exception"[18] under which no withholding is required in respect of the transfer of a partnership interest if the transferor certifies that the transferor is not subject to tax on any gain from the transfer pursuant to an income tax treaty in effect between the United States and a foreign country and if certain other requirements are met.

In addition, proposed Treasury regulation section 1.1446(f)-2(c)(4) provides for a reduction in withholding if a transferor can establish the "maximum tax liability" that the transferor could realize as a substantive matter under section 864(c)(8). In order to take advantage of this provision, the transferor must provide a certification that includes:[19]

1. A statement that the transferor is either a nonresident alien individual, a foreign corporation, or a foreign partnership;

2. The transferor's adjusted basis in the transferred interest and amount realized on the determination date;

3. Whether the transferor remains a partner immediately after the transfer;

4. The amount of outside ordinary gain and outside capital gain that would be recognized and treated as ECG under proposed Treasury regulation section 1.864(c)(8)-1(b) on the determination date, and a representation that such amount has been determined based on the certification from the partnership discussed below; and

5. The transferor's maximum tax liability on the determination date, which equals the product of (a) the amount of the transferor's effectively connected gain and (b) the applicable percentage (*i.e.*, the federal tax rate indicated in Treasury regulation section 1.1446-3(a)(2)).

In addition, the partnership must certify:[20]

[17] Prop. Treas. Reg. § 1.1446(f)-2(b)(6).
[18] Prop. Treas. Reg. § 1.1446(f)-2(b)(7).
[19] Prop. Treas. Reg. § 1.1446(f)-2(c)(4)(iii).
[20] Prop. Treas. Reg. § 1.1446(f)-2(c)(4)(iv).

1. The partnership's name, address, and TIN; and

2. The transferor's aggregate deemed sale effectively connected ordinary gain and the transferor's aggregate deemed sale effectively connected capital gain on the determination date.

If a transferee (other than a partnership that makes a distribution)[21] fails to withhold any amount required to be withheld under section 1446(f)(1), the partnership has a secondary withholding obligation, and is required to deduct and withhold from distributions to the transferee such amount (plus interest).[22]

*B. Special Rules for Certain Transfers of PTP Interests*

The Proposed Regulations provide an alternate set of rules for transfers of interests in PTPs where (1) the transferred interest is publicly traded on an established securities market or is readily tradable on a secondary market (or the substantial equivalent thereof), and (2) the transfer is intermediated through one or more brokers. Under these alternate rules, the brokers have liability for withholding in the first instance, because broker-intermediated transactions typically do not involve a direct flow of funds or information between the transferor and transferee. The broker therefore may be best positioned to carry out the withholding obligations that would otherwise fall on the transferee.

In general, a broker is required to withhold under the Proposed Regulations if it (a) pays the amount realized to a broker that is a non-U.S. person (subject to certain exceptions) or (b) is effecting the transaction for a non-U.S. transferor that is the broker's customer.[23] Certain exceptions apply, which are discussed below in Section II.B.ii. Where a broker fails to withhold due to certain types of faulty information from the partnership, the transferee (including subsequent transferees) may be subject to secondary withholding under section 1446(f)(4) in respect of future distributions by the PTP.[24] Those rules are discussed immediately below in II.B.i-iii.

i. General Withholding Obligations of Brokers

Under proposed Treasury regulation section 1.1446(f)-4(a)(2) a broker is required to withhold under section 1446(f), subject to the exceptions discussed below, if it pays the amount realized from the transfer of a PTP interest to a broker that is not a U.S. person (a "foreign broker")[25] other than (a) a qualified intermediary that has assumed primary withholding liability,[26] or (b) a U.S. branch of a foreign person that has provided a valid U.S branch

[21] Prop. Treas. Reg. § 1.1446(f)-3(b)(3).
[22] Section 1446(f)(4); Prop. Treas. Reg. § 1.1446(f)-3(a).
[23] Prop. Treas. Reg. § 1.1446(f)-4(a)(2).
[24] Prop. Treas. Reg. § 1.1446(f)-3(b)(2).
[25] A broker is presumed to be a foreign person in the absence of documentation establishing otherwise. Prop. Treas. Reg. §§ 1.1446(f)-4(a)(2)(iv), (b)(2).
[26] Prop. Treas. Reg. § 1.1446(f)-4(a)(2)(i)(A).

withholding certificate.[27] In addition, a broker that effects the transfer for the transferor as its customer is required to withhold.[28]

Under proposed Treasury regulation section 1.1446(f)-4(a)(2)(iii), however, a "broker is not required to withhold under [these rules] if it knows that the withholding obligation has already been satisfied."

ii. Exceptions from Withholding in the PTP Context

The Proposed Regulations provide certain exceptions from withholding in cases where the transferor is a U.S. person and where the amount of ECG recognized by the transferor is presumed to be low.

First, a remitting broker is not required to withhold if the transferor has provided a certificate of non-foreign status on a Form W-9 or valid substitute that meets the requirements of Treasury regulation section 1.1441-1(d)(2).[29] A remitting broker may also rely on a certification in its possession. If there is a second broker (as defined in Treasury regulation section 1.6045-1(a)(1)) that acts as agent for the transferor, and the second broker does not receive the amount realized from the transfer of the PTP interest, the remitting broker may instead rely on a certification from the second broker stating the TIN and status of the transferor and that the second broker has collected a valid certification of non-foreign status from the transferor.[30]

Second, a remitting broker is not required to withhold if the PTP has provided a "qualified notice" stating that, if the PTP had sold all of its assets at their fair market value as of a specific "PTP designated date"[31], the amount of ECG realized would be less than 10% of the total net gain (or, alternatively, no ECG would have been realized).[32] This "PTP 10% Exception" mirrors the Less-Than-10% ECG Exception discussed above.

Third, a remitting broker is not required to withhold upon a distribution made by the PTP in cases where the PTP provides a "qualified notice" designating the entire amount of a distribution as "qualified current income" — that is, the PTP has certified that the distribution does not exceed the net income of the PTP since the record date of the prior PTP distribution.[33] This "Qualified Current Income Exception" appears from the preamble to the Proposed Regulations ("Preamble") to be premised on the assumption that a distribution out of current income would not be in excess of the basis of the interest-holder, and therefore is not a distribution that is treated for tax purposes as a disposition of the PTP interest by the distributee.[34]

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[27] Prop. Treas. Reg. § 1.1446(f)-4(a)(2)(i)(B).
[28] Prop. Treas. Reg. § 1.1446(f)-4(a)(2)(ii).
[29] Prop. Treas. Reg. § 1.1446(f)-4(b)(2).
[30] Prop. Treas. Reg. §1.1446(f)-4(b)(2).
[31] The PTP designated date is any date for a deemed sale determination that is designated by the PTP in a qualified notice, but must be not more than 92 days prior to the PTP posting the qualified notice that indicates the PTP designated date. Prop. Treas. Reg. § 1.1446(f)-4(b)(3)(ii)(B).
[32] Prop. Treas. Reg. § 1.1446(f)-4(b)(3).
[33] Prop. Treas. Reg. § 1.1446(f)-4(b)(4).
[34] Preamble at V.B.3 ("In general, under section 705(a)(1), a partner's basis in its interest is increased by its distributive share of income for the taxable year, such that a distribution by the partnership not in excess of that income generally does not result in the recognition of gain under section 731(a)(1). Accordingly, the proposed

Finally, a remitting broker is also not required to withhold if it receives a certification from the transferor that states that the transferor is not subject to tax on any gain from the transfer pursuant to an income tax treaty similar to the Tax Treaty Exception discussed above.[35]

iii. PTP Secondary Withholding Under Section 1446(f)(4)

In a rule similar to that contained in proposed Treasury regulation section 1.1446(f)-3(a)(1), the transferee of a PTP interest in a broker-intermediated transaction may be subject to secondary withholding in respect of future distributions by the PTP, but only in cases where the failure to withhold was due to a faulty qualified notice that stated incorrectly that either the 10% PTP Exception or the Qualified Current Income Exception was available.[36] Furthermore, in contrast to transfers of interests in partnerships that are not PTPs, a PTP's obligation to collect secondary withholding in respect of partnership distributions does not cease when the transferee transfers its PTP interest to another person — instead, the withholding liability remains with the PTP interest, regardless of how many times the interest changes hands, until the full amount of the withholding liability, plus interest, is satisfied, either through withholding from PTP distributions or through a certification demonstrating that an exception from withholding applies.[37]

## III. Summary of Recommendations and Requests for Guidance

A. Scope of Withholding Obligation

- The scope of the general withholding obligation should be limited to transfers of interests in partnerships that file (or are required to file) a Form 1065.

B. Exceptions to Withholding

- The Three-Year Exception should be replaced with an exception that eliminates the obligation to withhold where the partnership has generated either no gross amounts of ECI or ECL or only *de minimis* gross amounts of ECI or ECL, in each case allocable to the non-U.S. transferor.

- The Less-Than-10% ECG Exception should be revised to (i) refer to the non-U.S. transferor's *distributive share* of such ECG and (ii) provide that the

regulations provide that when a qualified notice posted by a publicly traded partnership indicates that the distribution does not exceed the net income the partnership earned since the record date of the partnership's last distribution, no withholding is required with respect to the distribution.").

[35] Prop. Treas. Reg. § 1.1446(f)-4(b)(6).

[36] Prop. Treas. Reg. § 1.1446(f)-3(b)(2).

[37] The PTP's secondary withholding obligation is satisfied on the earlier of (i) the date on which the amount required to be withheld has been withheld and paid or (ii) the date on which the partnership receives a certification from the transferee described in proposed Treasury regulation section 1.1446(f)-2(d)(2) that claims an exception from withholding. Prop. Treas. Reg. § 1.1446(f)-3(c)(1)(ii). We suspect that the reference to Treasury regulation section 1.1446(f)-2(d)(2) is incorrect insofar as the special PTP rules are concerned, and that the intention was to reference exceptions to withholding that are specific to broker-intermediated transfers of PTP interests.

distributive share of ECG allocable to a transferor will be zero where the transferor or the partnership has claimed treaty benefits establishing that no ECI generated by the partnership would be taxable to the transferor.

- Final regulations should allow a transferor to rely on the No Gain Exception by making certain assumptions about the amount of gain attributable to section 751 property that might be generated on the transfer.

- Final regulations should include an exception from withholding for income realized by a non-U.S. transferor pursuant to an "equalization procedure", solely to the extent such income is attributable to a time-value-of-money return provided under the fund documents at the time of the fund's inception. Alternatively, consideration should be given to whether it would be useful to provide a procedure whereby the partnership can certify that it is in the process of raising funds and that it does not believe that a sale of its investments made as of the relevant transfer date would generate significant ECI allocable to non-U.S. investors.

- Final regulations should exempt a non-U.S. transferor from withholding under section 1446(f) if the relevant partnership interest is held by the transferor in connection with a U.S. trade or business and the transferor delivers an IRS Form W-8ECI (or other documentation establishing that fact).

C. Valuation Issues

- Final regulations should allow partnerships and transferors to value assets and calculate ECG by reference to the actual amount realized by the transferor to the extent the purchase price is known as of the relevant time.

- Final regulations should be clarified to allow different valuations for different transfers, so long as the valuation for a particular transfer is the arm's-length agreed price at which the transferor and transferee execute their transaction.

- Final regulations should clarify that for purposes of determining a transferor's substantive liability under section 864(c)(8), valuations based on the actual amount realized are required.

D. No Harm, No Foul

- Final regulations should relieve a transferee of withholding liability where it is later determined that the transfer resulted in no ECG to the transferor as a substantive matter under section 864(c)(8).

E. Application of 1446(f) Withholding Rules to Transfers of PTP Interests

- Final regulations should remove the requirement that secondary withholding liability remain with a PTP interest after the initial transferee has disposed of the interest.

- Final regulations should include specific rules or presumptions that allow a broker to forego withholding on the basis of evidence that the withholding obligation has already been satisfied.

F. PTP Distributions: Coordination between Section 1446(a) and Section 1446(f)

- Final regulations should include a coordination rule under which distributions of ECI taxed under section 1446(a) are not also subject to withholding under section 1446(f).

G. Miscellaneous

- Final regulations should provide a safe harbor that would allow transferors and transferees to calculate the basis of a partnership interest (solely for purposes of section 1446(f)) by reference to reasonable assumptions that can be made at the time of the transfer.

- Final regulations should provide relief from failure to satisfy section 1446(f) withholding obligations to the extent attributable to inadvertent participation by the transferor in a disguised sale that occurs over a significant period of time.

- Final regulations should allow a foreign partnership to be treated as a U.S. person to the extent that its partners have provided certifications of their non-foreign status meeting the requirements of the regulations. Final regulations should also permit a look-through approach for claims of eligibility for treaty benefits.

- Final regulations should make clear that qualified foreign pension funds may provide a non-foreign person affidavit only for the purposes of section 1445, and not for the purposes of section 1446.

- Final regulations should allow a transferee to rely upon other means to ascertain the non-foreign status of the transferor, in cases where a certification cannot be obtained (consistent with the analogous rule under Treasury regulation sections 1.1445-2(b) and 1.1446-1(c)).

- Final regulations should allow transferees subject to secondary withholding by the partnership to claim a refund on their own behalf.

## IV. Limiting the Scope of the Withholding Obligation

This Section IV discusses the scope of a transferee's obligation to withhold in respect of the disposition of a partnership interest, and provides recommendations to limit the scope in a manner that we believe will make the overall withholding system more administrable without posing a material threat to the goal of revenue collection.

### *A. Scope of the General Obligation to Withhold: United States Nexus*

By its terms, section 1446(f) applies only in cases where: "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 [ECG]."[38] This language reflects the role of section 1446(f) as a collection mechanism for taxes otherwise due from non-U.S. transferors under section 864(c)(8), rather than an independent source of revenue.

Proposed Treasury regulation section 1.1446(f)-2(a), by contrast, extends in the first instance to all transfers of a partnership interest. The regulation states that:

> "[e]xcept as otherwise provided in this section, a transferee is required to withhold under section 1446(f)(1) a tax equal to 10 percent of the amount realized on any transfer of a partnership interest."

Thus, by its literal terms, proposed Treasury regulation section 1.1446(f)-2(a) imposes a withholding obligation on any transfer of any partnership interest, regardless of whether the partnership in question has any assets in the United States or any U.S. partners. To give an extreme example, if a Chinese widget maker operates a purely Chinese widget business through a partnership and chooses to transfer an interest in that partnership interest to another Chinese business person, the transferee is required under the Proposed Regulations to withhold 10% of the purchase price in the absence of one of the certifications contained in proposed Treasury regulation section 1.1446(f)-2(b), discussed in more detail below. We do not believe that such a result was intended, or that the IRS likely has any interest in (1) receiving certifications in such a situation or (2) requiring partnerships to engage in secondary withholding under section 1446(f)(4) in such a situation. Instead, we believe that the general obligation to withhold under section 1446(f) should exclude partnerships with no meaningful connection to the United States.

In order to address this concern, we recommend that Treasury and the IRS consider limiting the scope of the general withholding obligation to transfers of interests in partnerships that file (or are required to file) a Form 1065. This standard is straightforward, and we believe that a rule based on filing obligations could be easy to administer. Such a rule would retain the requirement to withhold (absent an exception) for transfers of interests in all domestic

[38] Section 1446(f)(1).

partnerships with taxable income, deductions or credits,[39] and all non-U.S. partnerships with ECI.[40]

One way to implement the rule would be to allow partners to rely on certifications from the partnership that the partnership has not filed a Form 1065 for some past number of years (say, three years) and does not expect to be required to file a Form 1065 for the taxable year in which the transfer occurs. We would not recommend that the IRS *require* such a certification at the time of the transfer, however, because in the cases where it is most obvious that withholding should not apply (such as the example discussed above) the partners are least likely to be aware of the need for section 1446(f) withholding in the first place.

### *B. Exceptions to Withholding: Little or No ECI*

The recommendations contained in this Section IV.B are intended to help provide exceptions to withholding that are administrable and that take account of certain common structures involving blocker corporations that minimize the risk of a non-U.S. partner ever realizing ECI directly. As Treasury and the IRS consider the policies underlying sections 864(c)(8) and 1446(f), we believe that it is important to keep in mind that the fact pattern in GMM — a non-U.S. operating company investing directly in a partnership with a USTB and realizing ECI in the form of a distributive share of partnership income — is unusual, at least in our experience. Specifically, in order for a substantive tax liability to arise under section 864(c)(8), a non-U.S. person must be a partner in a partnership that is engaged in the conduct of a trade or business in the United States (or deemed to be so engaged), and the partnership must be structured so that the income or loss from that business is attributed directly to the partner as a distributive share of ECI or ECL. As discussed below, most non-U.S. investors in our experience structure their investments in partnerships to avoid this outcome and, we believe, will continue to do so.

For decades, it has been a common market practice for investment partnerships with non-U.S. investors to hold U.S. businesses either entirely or partially within entities treated as corporations for U.S. federal income tax purposes and referred to colloquially as “blockers” with the result that: (i) amounts that might otherwise appear on the non-U.S. investor’s Schedule K-1 as items of ECI or ECL instead are realized by the corporate blocker and taxed at the corporate level in the United States, and (ii) the non-U.S. investors realize returns from the U.S. businesses in the form of dividends and gains or losses in respect of corporate stock (and perhaps also in the form of interest, if the blocker has been financed with any shareholder debt). In cases where an investment is expected to generate a significant amount of ECI or ECL, the blocker typically would be a U.S. corporation, which, among other matters, allows the ECI to be subject to corporate-level tax but not branch profits tax.[41] Non-U.S. blockers may be used, however, to

[39] Treas. Reg. § 1.6031(a)-1(a)(3).

[40] Treas. Reg. § 1.6031(a)-1(b)(1). There are also filing requirements for non-U.S. partnerships that have U.S.-source income and one or more direct or indirect U.S. partners, with an exception where the non-U.S. partnership has less than $20,000 of U.S.-source income and less than 1% of its profits allocated to direct U.S. partners). Treas. Reg. §§ 1.6031(a)-1(b)(2), (3)(iii).

[41] Of course, dividends paid by a U.S. blocker could be subject to withholding tax, but the timing of the dividends is under the investors’ control to a greater extent than the timing of income inclusions subject to the branch profits tax. In the case of an interest in a United States real property holding corporation within the meaning of section 897

protect a non-U.S. investor against the risk of ECI or ECL in situations where material amounts of ECI are not expected and where there is a wish to avoid bringing all of the blocker's income into the U.S. tax net. Blockers serve the function of filling out tax returns and paying the relevant taxes, so that their shareholders do not have to do so.

Blocker corporations are common regardless of whether non-U.S. investors invest in a single U.S. business or in multiple U.S. businesses through investment partnerships, such as private equity funds, real estate funds, venture capital funds or any other kind of investment fund that could hold an interest in a U.S. trade or business. For example, in accordance with a common market practice that has existed for decades, a typical private equity fund is likely to be formed as a limited partnership that invests primarily in "portfolio companies," which in turn typically are corporations. The mere holding of stock in portfolio companies, however, would not give rise to ECI or ECL. The non-U.S. investors in such funds opt for their investments in U.S. businesses to be taxed in the United States under a corporate model (where the corporation is subject to tax at the entity level and files a U.S. federal net income tax return), rather than a partnership model.

Indeed, in this regard, it is longstanding market practice for investment funds to *covenant* to structure investments in a manner that avoids the direct recognition of ECI by non-U.S. investors. Often, these covenants require that interests in a U.S. trade or business be held by a corporate "blocker"— which, as discussed above, is an entity (usually domestic)[42] that is treated as a corporation for U.S. tax purposes, and that is formed for the purpose of holding the interest in the trade or business, paying tax on the relevant income and filing the necessary tax returns. The non-U.S. investor, through its interest in the blocker corporation's stock, realizes its investment return only after U.S. taxes have been paid at the corporate level, but is not required to recognize ECI directly or file a U.S. tax return directly.

Appendix A provides an overview of blocker corporation structures that are common for U.S. investment partnerships. Such structures are also often used for U.S. tax-exempt investors that wish to avoid the direct recognition of "unrelated business taxable income" under section 511 and for foreign sovereign investors that wish to avoid the direct recognition of "commercial activity" income under section 892.

We believe that Treasury and the IRS should consider modifying the exceptions from withholding discussed above to make the exceptions more readily available to transferors where the practical risk of withholding remains low. The following are two specific recommendations toward this end.

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("USRPHC"), however, we note that certain gain subject to FIRPTA is not also subject to branch profits tax. Treas. Reg. § 1.884-1(f)(2)(iii). Therefore, some non-U.S. investors choose to hold USRPHC interests through non-U.S. blockers.

[42] As discussed above, and in Example 2 of Appendix A, non-U.S. investors might use a non-U.S. blocker for protection against the risk of ECI in cases where ECI is not expected at all or is not expected to constitute a sufficiently large portion of the return on an investment to justify placing all of the relevant assets in a U.S. corporation and subjecting all returns to U.S. tax.

a. The Three-Year Exception Should Not Require ECI or ECL Recognition

In cases where partnerships are not generating ECI for non-U.S. investors, investors should have access to an exception from withholding that does not require extensive input from the partnership at the time of the transfer. We believe that the Three-Year Exception was intended to fulfill this function, but in its current form, the exception is not likely to fulfill that purpose.[43]

The Three-Year Exception as currently drafted requires a non-U.S. transferor either to recognize a positive amount of ECI in each year of the three years preceding the transfer (as evidenced by withholding recorded in a Form 8805), or to have recognized an ECL.[44] Accordingly, the many non-U.S. investors that do not directly recognize ECI or ECL, as discussed above, are ineligible for the benefits of the Three-Year Exception. We find this result to be counter-intuitive and inconsistent with the statutory scheme. The complete absence of ECI inclusions by a non-U.S. investor appears to us to be a meaningful indicator that the relevant partnership either has no interest in a USTB, or holds that interest through a blocker corporation. In neither of those cases would the transfer of the partnership interest by the relevant non-U.S. investor be expected to generate ECI. Section 1446(f) withholding was intended to apply only "if any portion of the gain . . . would be treated under section 864(c)(8) as [ECI]", and not in the complete absence of ECI.[45]

We question the policy justification for requiring a partner to have realized net income and realized ECI (or an ECL) in each year over a three-year period as a condition to benefitting from the Three-Year Exception, because we do not believe that the absence of ECI or taxable income in prior years should be viewed as a negative factor in determining withholding liability. Perhaps the IRS viewed the presence of section 1446(a) withholding as an indication that the partnership and partners are complying with their obligations to ensure that ECI is taxed properly, but in our experience, as discussed above, partnerships are not likely to allocate ECI directly to non-U.S. partners and thus, in many cases, a non-U.S. transferor would not be able to satisfy the condition that it have recognized some amount of ECI or ECL in the prior three taxable years.

Accordingly, we recommend replacing the Three-Year Exception as currently drafted with an exception allowing a transferee to avoid withholding under section 1446(f) in cases where the partnership has generated either no gross amounts of ECI or ECL or only *de minimis* gross amounts of ECI or ECL allocable to the non-U.S. transferor.

Our recommendation refers to *gross* amounts of ECI or ECL in order to address situations where a business might generate large amounts of gross income that are offset by

[43] The Less-Than-10% ECG Exception and the "maximum tax liability" rule may also have been intended to address cases where non-U.S. investors do not derive ECI from a partnership, but we are skeptical that investment partnerships generally will be able or willing to undergo the expense and incur potential legal risk to provide certifications to their investors under those rules. Our recommendations regarding the Less-Than-10% ECG Exception, discussed below, are intended to address those concerns.
[44] Prop. Treas. Reg. § 1.1446(f)-2(b)(1).
[45] Section 1446(f)(1).

losses or deductions, leading to only a small net profit or no profits at all.[46] In such a situation, there can be little assurance that a prior history of small amounts of *net* ECI is any meaningful indicator of the gains that might be realized if the relevant business were to be sold. Many Silicon Valley startups, for example, survived for several years generating net losses before being sold at amounts that generated significant gains for the initial investors.

In addition, we also recommend that the Three-Year Exception contained in final regulations abandon the requirement that a transferor of a partnership interest have held that interest for three years. The Three-Year Exception appears to be premised on the notion that a partner must hold a partnership interest for three years in order to establish the lack of significant amounts of ECI generated by the partnership. The clear implication of such an approach is that non-U.S. partners are presumed to realize ECI through their partnership interests and that such partners must disprove the presumption consistently over three years in order to rebut the presumption effectively. As discussed above, we do not believe this presumption is consistent with the reality of longstanding market practice concerning the use of blockers, and we do not believe it is appropriate to deny a withholding exception to a transferor merely because the transferor cannot provide three years' worth of Schedules K-1 or Forms 8805. Instead we recommend that the exception from withholding be available to a non-U.S. transferor that (i) has held the relevant partnership interest long enough to have received at least one Schedule K-1, (ii) has not been allocated any non-*de minimis* amounts of gross ECI or gross ECL from the partnership recently (say, within the last five taxable years, for taxpayers that have such long-term holding periods) and (iii) has no knowledge that the partnership in question is engaged in a USTB that is reasonably expected to generate future ECI for the transferor.

b. The Less-Than-10% ECG Exception Should Be Determined by Reference to Distributive Share

We believe that the Less-Than-10% ECG Exception should refer to the amount of ECG that would be allocated to the relevant non-U.S. transferor of a partnership interest upon the hypothetical disposition by the partnership of all of its assets, rather than to the aggregate amount of ECG that would be realized by the partnership, irrespective of whether such ECG is allocated to the relevant non-U.S. transferor, or to another non-U.S. partner or a U.S. partner. Consider the following example (which is based on Example 10 in Treasury regulation section 1.704-1(b)(5)):

> A foreign partner ("FP") and a U.S. Partner ("USP") enter into a partnership agreement to form ABC, a partnership, for the purpose of operating a travel agency. The partnership has a USTB that accounts for 20% of its profits and 20% of its assets by value, and the remainder of ABC's business occurs outside of the United States and does not give rise to ECI or ECL. Under the terms of the ABC partnership agreement, all income and loss are to be allocated 50% to FP and 50% to USP, except that all items related to the USTB (including gain or loss from the sale of the USTB's assets) are be allocated 90% to USP and 10% to FP.

[46] This may require partnerships to modify existing reporting practices, although we expect that partnerships would already have access to this information so it may only be an additional administrative hurdle to incorporate reporting thereof to partners.

FP decides that it would like to sell its partnership interest and asks ABC for the certification establishing FP's entitlement to the Less-Than-10% ECG Exception. ABC values its assets and discovers that, upon a hypothetical sale of all of the partnership's assets, 20% of the net gain would be ECG, and 80% would not. Under this fact pattern, ABC is unable to make the required certification that ECG would account for less than 10% of the total net gain realized on the sale.

We believe that this result is inappropriate, because ECG accounts for less than five percent of the net gain that would be allocated to FP. Specifically, if there were $1000 of total net gain, $800 would not be related to the USTB and would be allocated $400 to FP and $400 to USP. The remaining $200 of gain would be allocated $20 to FP and $180 to USP. Consequently, ECG accounts for only 20/420 (or 4.76%) of the gain reflected in FP's distributive share.

Insofar as the Less-Than-10% ECG Exception is intended to be available for non-U.S. transferors realizing small amounts of ECG, we believe this exception should be available for FP.[47]

In the example above, we believe that it would be inappropriate to subject FP to section 1446(f) withholding. By the same token, if for some reason the USTB amounted to less than 10% of the net gain that would be realized in the hypothetical asset sale but that gain would make up more than 10% of the distributive share of a non-U.S. transferor (*e.g,* if income from the USTB were specially allocated to the non-U.S. transferor), then we believe that the non-U.S. transferor should not get the benefit of the exception from withholding.

For these reasons, the Less-Than-10% ECG Exception should refer, not merely to ECG that would be generated by a sale of partnership assets, but to the selling partner's distributive share of such ECG. We recommend revising the Less-Than-10% ECG Exception, and specifically proposed Treasury regulation section 1.1446(f)-2(b)(4)(i), as follows:

(A) The transferor's distributive share ~~amount~~ of net gain that would have been effectively connected with the conduct of a trade or business within the United States would be less than 10 percent of the transferor's distributive share of the total net gain; or

(B) No gain attributable to the transferor's distributive share would have been effectively connected with the conduct of a trade or business within the United States.

[47] Another case that raises this problem involves "below the fund" blockers in the investment fund context, a structure described in Example 4 of Annex A. Under that structure a non-U.S. partner may have no ECI because its proportionate share of an investment in a USTB is held through a blocker corporation and any ECI earned that otherwise might have been allocated to the non-U.S. partner is allocated instead to the blocker corporation. The non-U.S. partner has a special allocation of any partnership items related to the blocker's stock (*e.g.,* dividends, gain or loss from the sale of the stock, etc.). Assuming that the allocations are respected for tax purposes, the non-U.S. partner would realize no ECG on the sale of its partnership interest, and yet the partnership also might be unable to provide the required certification if a portion of the USTB is held directly on behalf of U.S. partners and accounts for more than 10% of net gain in respect of the hypothetical sale of partnership assets — notwithstanding that all ECG would be allocated to U.S. partners.

We also recommend that the Less-Than-10% ECG Exception contained in final regulations provide explicitly that, where a partner in a partnership (including indirect partners in such partnership), or the partnership itself, is entitled to treaty benefits such that no ECI generated by the partnership would be taxable to that partner, the relevant partner's distributive share of ECG will be deemed to be zero.[48] In making the suggestion above, we note that it might also be possible to achieve a similar result through the provisions allowing a transferor to reduce its withholding liability to match its maximum tax liability, although perhaps with more informational demands on the partnership. Specifically, a non-U.S. transferor otherwise subject to withholding (such as FP in the example above) should be able to demonstrate that its maximum tax liability is zero under the procedures described in proposed Treasury regulation section 1.1446(f)-2(c)(4) in the case discussed above.

*C. Exceptions to Withholding: Section 751 and the No Gain Exception*

As discussed above, a non-U.S. transferor of a partnership interest can qualify for the No Gain Exception to withholding if the transferor certifies that the transfer of the partnership interest would not result in realized gain, including ordinary income arising from the application of section 751. We believe that the No Gain Exception has the potential to serve a valuable function by allowing non-U.S. transferors realizing an overall loss to avoid withholding through a certification procedure that could be administrable and efficient. One primary obstacle to the administrable and efficient operation of the No Gain Exception, however, relates to section 751. Indeed, unless section 751 is addressed, we believe that the No Gain Exception will not function as an effective exception to withholding tax, because virtually no one will be able to use it in any situation that would not otherwise have been covered by one of the other exceptions.

Specifically, under section 751 and section 864(c)(8) (as interpreted in the regulations currently proposed under that section), a transferor of a partnership interest can realize net effectively connected gain in respect of section 751 "unrealized receivables" and "inventory items" ("Section 751 Property") even when the transfer generates an overall loss.[49] Because section 751 requires Section 751 Property to be separately valued for purposes of creating a separate item of ordinary income or loss, a transferor cannot make the certification required by the No Gain Exception merely by certifying that the amount realized on the transfer is less than the transferor's basis in the partnership interest — instead the transferor must allocate the amount realized between Section 751 Property and the other assets of the partnership, and then determine whether any gain would be realized in respect of either category.

For that reason, at least in cases where there is a possibility that the partnership in question holds Section 751 Property, the transferor cannot qualify for the No Gain Exception without determining whether the partnership in fact has Section 751 Property, as well as the value of any such Section 751 Property relative to that of other assets in the partnership, the tax

[48] While the income received by a partner or partnership may be ECI, the partners may not be subject to tax on such amounts under the relevant treaty because they or the partnership are not treated as having a permanent establishment in the United States.

[49] *See* Prop. Treas. Reg. § 1.864(c)(8)-1(i), Example 3; Treas. Reg. § 1.751-1(a)(2).

basis of such Section 751 Property and, finally, the amount of gain or loss potentially realized in respect of such Section 751 Property.

We believe that transferors are not likely to have ready access to the necessary information at the time of the transfer to make the required certifications to the transferee with full confidence. First, the transferor is likely to require information from the partnership in order to determine whether the transferor has realized gain in respect of Section 751 Property. Under current law, however, partnerships are not required to provide a determination as to the amount of ordinary gain a transferor might have realized under section 751: only the transferor is required to make such a determination, which is provided with the transferor's tax return, as provided in Treasury regulation section 1.751-1(a)(3). Although the partnership is required to file a Form 8308,[50] that form under current law contains only limited information disclosing the fact that the transfer occurred, the date of the transfer, the identity of the transferor and transferee, and that the partnership held (or may have held) Section 751 Property at the time of the transfer. Furthermore, the partnership must provide a copy of the Form 8308 to the transferor and transferee by January 31 of the calendar year following the calendar year in which the section 751(a) exchange occurred (or, if later, 30 days after the partnership is notified of the exchange).[51]

The Proposed Regulations would change Treasury regulation section 1.6050K-1(c) to require Form 8308 to contain information necessary for the transferor to make the determinations required under Treasury regulation section 1.751-1(a)(3). The Proposed Regulations would not, however, accelerate the date for providing the Form 8308 and thus would not ensure that the transferor would have the information necessary to provide a certification at the time of the transfer.

By requiring a transferor of a partnership interest to provide a certification at the time of the transfer that it has no gain attributable to Section 751 Property, the Proposed Regulations would therefore accelerate the timeframe in which a transferor must allocate its overall purchase price to Section 751 Property as a condition for allowing the transferor to benefit from the No Gain Exception. We believe that this point is likely to prevent many non-U.S. transferors that realize an overall economic loss on the transfer of a partnership interest from utilizing the No Gain Exception.

Although partnerships, at least theoretically, could provide such information to the transferor, the task of making the necessary determinations involves: (i) determining the fair market value of partnership assets implied by the amount realized by the transferor, and (ii) allocating that value among the partnership assets. Partnerships may not be willing to perform that exercise for each transferor at the time of each transfer due to the time and expense required. Furthermore, we expect that transferees are likely to have a very low tolerance for risk on this point because a transferee may not rely on a certification if it has actual knowledge that the certification is incorrect or unreliable.[52]

[50] Treas. Reg. § 1.6050K-1(a).
[51] Treas. Reg. § 1.6050K-1(c).
[52] Prop. Treas. Reg. § 1.1446(f)-2(b)(1); Prop. Treas. Reg. § 1.1446(f)-3(a)(1).

Therefore, if the No Gain Exception is to be used readily by transferors realizing an economic loss on the transfer of a partnership interest, we believe that the inherent uncertainty in determining ordinary gain or loss under section 751 needs to be addressed. We recommend that Treasury and the IRS consider regulatory safe harbors that could allow transferors to make the certifications required by the No Gain Exception with some level of confidence. For example, we believe it would be appropriate to allow a non-U.S. transferor to make reasonable assumptions about the value of Section 751 Property relative to other partnership assets based on recent financial information – such as, for example, the calculations used by the partnership in preparing a recent Form 8308 (assuming the proposed requirement that a Form 8308 contain section 751 calculations becomes final). The taxpayer might be allowed to use such information in the absence of any specific reason to believe that the relative value of Section 751 Property and other partnership assets has changed dramatically since the information was first provided. A rule of this sort might be modeled on the rule contained in proposed Treasury regulation section 1.1446(f)-2(c)(2)(ii)(B), which provides that, for purposes of determining the amount realized on the transfer of a partnership interest, the transferor is allowed to rely on liabilities allocated to the transferor on the most recent Schedule K-1, provided that the Schedule K-1 is not more than 22 months old and that the transferor has no reason to believe that its share of partnership liabilities has changed by more than 25 percent.

Alternatively, an argument can be made that section 751 should simply be inapplicable for the limited purpose of determining whether the No Gain Exception applies (or perhaps inapplicable in the absence of knowledge that the Section 751 Property is related to a USTB) on the grounds that section 751 is fundamentally about the character of income and loss and arguably therefore should not be used to collect withholding tax from a transferor realizing an overall loss.[53]

### *D. Exceptions to Withholding: More General Point About Section 751*

The effects of section 751 extend beyond the No Gain Exception discussed above in Section IV.C as section 751 also has implications for the Less-That-10% ECG Exception and the determination of Maximum Tax Liability under Treasury regulation section 1.1446(f)-2(c)(4). Both of those rules require extensive information from the partnership prior to the time of transfer. A transferor realizing an overall gain in respect of the transfer of a partnership interest may not be able to determine the amount of that gain without a detailed knowledge of the partnership's Section 751 Property. For example, an overall gain of $5 could be the combination of a $15 effectively connected ordinary gain and a $10 ordinary loss that is not effectively connected. As discussed above, we are skeptical that partnerships will be willing and able to provide extensive information of this sort on a regular basis as required to make these provisions widely effective. Also, as discussed below, in Section IX.A, the transferor's basis in the partnership interest may not be knowable at the time of the transfer.

[53] Section 751(c)(flush language) provides an extensive list of assets that can give rise to ordinary gain, and some of them (*e.g.*, debt with market discount and stock in a foreign corporation subject to section 1248) generally would not be expected to give rise to ECG.

### *E. Exceptions to Withholding: Subsequent Closings*

The application of section 1446(f) to "multiple closings" of private equity funds, real estate funds and similar investment vehicles has the potential to create a significant administrative burden for both taxpayers and the IRS. As discussed below, we believe that it would be appropriate to add an exception from the withholding and certification requirements of section 1446(f) for certain transactions that occur in connection with the formation and initial funding of an investment partnership and potentially could be characterized as disguised sales of partnership interests.

By way of background, when a private equity fund, real estate fund or similar investment fund is in the initial process of seeking capital from potential investors, it usually would *not* expect to receive the full amount of sought capital in the form of a single up-front contribution to the fund made by each investor upon the formation of the fund. Instead, the sponsor organizing the fund will undertake negotiations with numerous potential investors about the terms on which the potential investors will make "capital commitments," commitments by each of the investors to provide up to a specified amount of capital to the fund, over time and on an as-needed basis, as the fund manager identifies investment opportunities that it wishes to exploit. As the sponsor reaches agreements with different investors, the investors are admitted as limited partners of the fund in a series of "closings." This process, known as a "fund raise," typically lasts from six to eighteen months.

The fund manager, however, is unlikely to wait six to eighteen months before beginning to deploy capital. Instead, as soon as a critical mass of investors is willing to provide capital commitments to the fund, the fund will execute an "initial closing" in which those investors become limited partners in the fund and are contractually committed to provide capital to the fund when requested in accordance with their capital commitments. Other investors will be admitted as limited partners in one or more subsequent closings as they finish their negotiations with the fund sponsor, complete necessary due diligence, etc.

The issue described in the first paragraph of this section arises where the general partner of the fund calls capital in order to make an investment before all of the closings have been completed, and thus before all of the investors have been admitted to the fund. In such a situation, it is a virtually universal market practice for the fund documents to contain an "equalization procedure" intended to place subsequent investors in the same position as if they had been admitted to the fund at the initial closing. Specifically, where investors are admitted to a fund during the term of the fund raise but at a time when the fund has already deployed capital, they are required to contribute capital to the fund immediately, and a portion of what they have contributed will be returned to the prior investors.

For example, imagine that Investors A and B are admitted to Fund XYZ at the initial closing with equal capital commitments, and then the fund calls $600 from each of them to purchase an illiquid investment for $1,200. Then, six months after the fund has called the $1200 from each of Investors A and B, Investor C is admitted to the fund and, to keep the math easy, makes the exact same capital commitment that A and B have made. Upon being admitted to Fund XYZ, Investor C would be expected to contribute capital immediately in order to put the parties in the same position as if Investor C had funded one third of the $1,200 when the investment was made. Accordingly, in a typical equalization arrangement, Investor C would contribute $400 to the fund and an amount intended to represent the time value of money for the six months the fund has held the investment). Of the $400 (plus the time-value-of-money component) contributed by Investor C, $200 (plus the appropriate time-value-of-money component) would be returned to each of Investors A and B. The result is that each of the investors has funded one third of the investment, and will have one-third of the returns generated by the investment from the date the investment was made (provided no additional investors are admitted to the fund).

The equalization mechanism is intended to align the interests of all of the investors with the fund sponsor and to avoid conflicts of interest that might arise where different investors have divergent interests in fund investments. Once the payments have been made under the equalization mechanism, all investors are treated for purposes of the fund's economics as having invested as of the initial closing.

In the example above, Investor C's capital contribution of $400 is determined solely by reference to Investor C's share of the capital required to purchase the $1,200 investment and does not in any way take account of any appreciation or depreciation in the value of the investment over the six-month period.[54] For that reason, Investor C could be getting the benefit of a bargain purchase or could be funding losses — although in most real-world cases, because the investment is relatively illiquid, it would be difficult to detect significant shifts in the investment's value over a period as short as six months.[55] Conversely, with regard to Investor C's share of the investment that Investors A and B funded initially, Investors A and B are entitled only to a time-value-of-money return (the terms of which were set out in the fund agreement). They usually would not be expected to retain any economic exposure to Investor C's one-third stake in the investment.

The tax characterization of such equalization provisions over the course of multiple fund closings is uncertain. On the one hand, the arrangement described above has put Investors A and B in an economic position similar to where they would be if they had each loaned $200 to Investor C for six months. Of course, Investors A and B are not really Investor C's creditors. They do not have a creditor claim against Investor C, and they have no means of compelling Investor C to be admitted to the fund in order to trigger the equalization procedure in the first place. Some practitioners have suggested that Investors A and B should be viewed as having written an at-the-money call option to Investor C to purchase one third of the investment for a fixed price. However, the equalization provision does more than merely afford Investor C with the ability to purchase pre-existing assets at a fixed price. Undergoing the equalization procedure is a condition for Investor C's admission to the fund overall (including a larger capital commitment to be drawn down over time), and as discussed above, could work out to Investor C's advantage or detriment depending on the actual value of the $1,200 investment at the time of Investor C's admission. Also, the call option under this view would not have been written to

[54] In certain funds, the initial investors may negotiate to retain the benefit of certain extraordinary gains in cases where they expect such gains for one reason or another, but such transactions do not represent the market norm.

[55] It is the fact that these fund investments are illiquid and unlikely to change significantly in value over a short period of time that makes equalization acceptable as a commercial matter to fund investors. Funds with liquid assets that are more volatile and easily valued, such as hedge funds, generally require new investors to buy into the fund based on the then-current value of the fund assets.

Investor C specifically, but to any subsequent closer, and the amount subject to the option would vary depending on the size of the subsequent closer's capital commitment, the size of the initial investment, etc.

Of particular relevance to section 1446(f) is the question of whether Investors A and B could be viewed as having engaged in a disguised sale of partnership interests to Investor C upon Investor C's admission to the fund. That question raises numerous complicated issues that are beyond the scope of this Report, but practitioners advising funds have been concerned that, if the subsequent closing mechanics and equalization procedures were to be viewed as disguised sales of partnership interests, then Investor C would be required to withhold 10% of the $400 contribution to the fund unless Investors A and B, or the fund itself, provided appropriate certifications establishing an exception from section 1446(f) withholding. In the simplified example we have provided, the procedures for complying with section 1446(f) would be manageable, but in the case of a fund-raise in the real world, there would be numerous investors coming in through multiple closings. Every closing after the initial closing would present a new set of potential withholding obligations under section 1446(f), and each closing would be more complicated than the one preceding it, as the number of investors potentially subject to withholding increases and as the same early closers are subject to potential section 1446(f) withholding multiple times over the course of several months.

Regardless of whether the closing mechanics discussed above are properly viewed as disguised sales, we do not believe that the equalization provisions described above constitute an appropriate occasion for the imposition of withholding under section 1446(f) or the requirement of the full certification procedures contained in proposed Treasury regulation section 1.1446(f)-2. First, as discussed above, any "gain" realized by an investor through the subsequent closing mechanics (at least in the cases of a market-standard equalization provision) would be attributable to a time-value-of-money return pursuant to a formula contained in the fund documents, and would not be a function of any built-in gain that might exist in any fund assets. In fact, because the assets involved in most cases are likely to be illiquid, they are unlikely to generate a significant amount of easily-determinable gain or loss within a few months of the fund's initial investment. For that reason, it is unlikely that the value of the relevant investments on the fund's books will have changed, and the fund likely would value the investments at cost if it were required to provide a certification to establish an exemption from withholding.

Second, because of the various covenants and structures put in place in most funds in order to prevent non-U.S. investors from realizing ECI directly, the chances that a fund would generate ECI for non-U.S. investors — within the first few months of the fund's inception and before the completion of a capital raise — is likely to be quite low.

Even though exceptions are likely to be available (*e.g.*, the Non-Foreign Status Exception for all U.S. transferees or the Less-Than-10% ECG Exception), the complexity of complying with the procedures of section 1446(f) for numerous investors repeatedly over a period of few months in such a case strikes us as unwarranted. For the reasons discussed above, we recommend that Treasury and the IRS provide an exception from withholding for any income realized by an investor pursuant to such an equalization procedure of the sort discussed above, to the extent such income is attributable solely to a fixed, pre-determined return provided under the fund documents at the time of the fund's inception. If such an approach is adopted, we also recommend that the relevant language be drafted so as to avoid taking a view on the question of whether an equalization procedure such as the one described above constitutes a disguised sale giving rise to a substantive tax liability under section 864(c)(8), at least until Treasury and the IRS have reached a definitive view on that question.

Alternatively, Treasury and the IRS might consider whether it would be useful to provide a procedure whereby the fund can certify that it is in the process of raising funds and that it does not believe that a sale of its investments made to date would generate significant ECI for non-U.S. investors. Whatever certification procedure is adopted, it should allow for partnerships to provide information in a streamlined fashion, rather than requiring a separate set of documents each time a partner receives an equalization payment.

### *F. The Non-Foreign Status Exception: Should Include Transferors Holding Partnership Interests in Connection with a U.S. Trade or Business*

We recommend a regulatory exception from section 1446(f) withholding if the relevant partnership interest is held by the non-U.S. transferor in connection with a U.S. trade or business — for example, if the transferor is a securities dealer operating in the United States and holds a PTP interest in connection with those activities. In such a case, any gain or loss realized by the transferor should be included on the transferor's U.S. federal income tax return filed in the ordinary course, and withholding in such circumstances would be unnecessary. One way of effecting such an exception would be to expand the Non-Foreign Status Exception to include transferors that provide a valid Form W-8 ECI.

## V. Valuation Issues

This Section V discusses issues arising in situations where the partners and the partnership value partnership assets differently. Specifically, section 864(c)(8) establishes a non-U.S. transferor's liability in connection with the transfer of a partnership interest by looking to the amount of ECG that would be realized upon a hypothetical disposition by the partnership of all of its assets. For purposes of the Less-Than-10% ECG Exception and the determination of a transferor's maximum tax liability under proposed Treasury regulation section 1.1446(f)-2(c)(4), the fair market value of the partnership's assets as of a specified "determination date" is presumed to be their current fair market value.[56] For these purposes, the Proposed Regulations appear to assume, reasonably, that the determination would be made by the partnership.

However, consider the case of a non-U.S. person transferring a 10% interest in a partnership to a third-party purchaser. The partnership values its net assets at $2,000, which would imply that the 10% interest should be sold for $200. However, none of the Proposed Regulations, the recently proposed regulations under section 864(c)(8) or Revenue Ruling 91-32 consider the case where the amount realized in respect of the transfer is not $200, but instead is only, say, $175. This mismatch could be the result of a "minority discount", or the result of the fact that the transferor and transferee ascribe a different value to the partnership's assets than the partnership itself does. The price of $175 in this example represents an arm's-length market

[56] Proposed Treasury regulation section 1.1446(f)-1(c)(4) contains the rules for establishing a determination date in connection with a transfer of a partnership interest.

transaction, and accordingly is arguably a more reliable means of valuing the partner's interest and gain related to effectively connected assets than the numbers produced by the partnership in respect of a hypothetical transaction. Accordingly, at least to the two parties transacting in this example, the partnership's assets are more appropriately valued at $1,750, and we believe that $1,750 is the appropriate value to use in determining the transferor's ultimate liability under section 864(c)(8). Furthermore, if another transferor also sells a different 10% interest in the same partnership to another purchaser for $180, we believe that it is appropriate to value partnership assets at $1,800 for purposes of determining that second transferor's ECG — illiquid assets defy precise valuation, and the second transferor has in fact realized $5 more than the first transferor as an economic matter.

In making these observations, we acknowledge that the valuations provided by a partnership without reference to the actual transaction price play an important role where the partnership may be asked to produce a certification before a transfer has in fact occurred in a situation where the partnership may not even know the amount realized (and where the final amount realized may not have been determined with finality). In addition, even if the amount realized by a transferor is known to the partnership, it is likely more efficient for a partnership to be able to produce a single certification using a single set of asset values where there are multiple transfers of partnership interests on the same date at different prices. For ease of accounting, many investment partnerships allow transfers of partnership interests only at the end of a fiscal quarter, and so it is not uncommon, for example, for several transactions in interests in the same partnership to occur on the same date but potentially with transaction prices that imply different values for the partnership as a whole. In such a case, it would be cumbersome to require a partnership to value assets separately by reference to the value implied by the amount realized in each separate transaction.

Notwithstanding the potential utility of determining ECG by reference to a partnership's valuation of its assets as of a specified determination date, we believe that it would be appropriate for partnerships and transferors of partnership interests to be given the option to value assets by reference to the actual amount realized by the transferor to the extent the transferor and the partnership are able and willing to make such calculations in a timely manner.[57] In this regard, proposed Treasury regulation section 1.1446(f)-1(c)(4)(i)(A) provides that the determination date in respect of a transfer can be the actual date of the transfer, which in turn suggests that the valuation implied by a transaction price may in fact be the value utilized on that date. Because the Proposed Regulations do not currently contemplate the case where different transactions imply different values for partnership assets, however, we recommend that they be clarified to allow different valuations for different transfers, so long as each valuation is supported by an arm's-length price on which a transferor and transferee have agreed to execute a transaction.

Similarly, in cases where, for withholding tax purposes, a partnership provides ECG amounts that are not derived from the amount realized by the relevant transferor, it would

[57] This position is not an abandonment of our skepticism regarding the ability of partnerships to provide the relevant information quickly, but rather an acknowledgement that valuations based on the actual transfer price are superior and should be used in those cases where the taxpayers have made the relevant information available within the necessary timeframe.

nonetheless be appropriate to require that valuations based on the actual amount realized be used for purposes of determining a transferor's substantive liability under section 864(c)(8) and all related purposes.

## VI. No Harm, No Foul

We believe that it would be appropriate to provide that, if a transferor transfers an interest in a partnership and fails to provide a certification for exemption from withholding, the transferee and the partnership may be excused from liability for withholding tax (including from any penalties) under section 1446(f) if they later demonstrate that the transfer resulted in no ECG as a substantive matter under section 864(c)(8). We believe that it would also be appropriate to allow the transferee and the partnership the opportunity to prove, after the transfer, what the transferor's maximum tax liability would have been under proposed Treasury regulation section 1.1446(f)-2(c)(4) and limit the transferee's and partnership's withholding liability to that amount. Although we recognize the importance of bolstering the withholding regime so that it serves its intended purpose, we also believe that transferees and partnerships should not be burdened with liability for withholding tax when there is no substantive underlying tax.

The Proposed Regulations reference sections 1461 and 1463, which provide that a tax that is actually paid by the taxpayer shall not be recollected from a withholding agent that failed to withhold.[58] By its terms, the rule carries an implicit assumption that a substantive tax is due. If the obligation to pay the tax did not exist, the withholding agent would not be able to demonstrate that the tax has been paid.

The rules under section 1445 with respect to withholding of tax on dispositions of U.S. real property interests ("USRPIs") within the meaning of section 897 provide a form of "no harm, no foul" rule for transfers of USRPIs by foreign persons and, by analogy, support the notion that some form of "no harm, no foul" rule should be adopted in the case of section 1446(f).[59] The specifics of the section 1445 rules are not apposite, however, in the case of section 1446(f), as discussed below. A withholding agent failing to withhold under section 1445 as required is nonetheless excused of liability for withholding tax if either: (i) the transferor of the USRPI files a tax return and pays the necessary tax, or (ii) the IRS issues a withholding certification establishing that the transferor's maximum tax liability is zero.[60] The implicit assumption that a tax return is due makes sense in the context of section 1445 because any non-U.S. transferor of a USRPI will be treated as having recognized ECI or ECL from a U.S. trade or business, and thus would be expected to file a return. Exempting transferees from a withholding

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[58] However, the withholding agent is not entirely relieved of liability, as it remains liable under section 1463 for interest or any penalties or additions to the tax otherwise applicable.

[59] Sections 897 and 1445 were enacted as part of the "Foreign Investment in Real Property Tax Act of 1980," colloquially known as "FIRPTA," and these Code sections and the regulatory rules promulgated under them are referred to in this Report by that name.

[60] Treas. Reg. § 1.1445-1(e)(3)(i). The withholding agent is also excused from penalties, but not interest. Interest is payable "with respect to the entire amount that is required to be deducted and withheld". Treas. Reg. § 1.1445-1(e)(3)(ii). In the section 1441 context, if a withholding agent fails to deduct and withhold any tax imposed under section 1441 and the tax is paid, then the withholding agent is relieved of its liability for the withholding tax, but is not relieved from liability for interest or penalties. Treas. Reg. § 1.1441-1(b)(7)(iii).

obligation where the transferor can provide a tax return stating that the transferor's liability is zero is therefore a workable solution in the context of section 1445.

By contrast, with respect to liability under section 1446(f), in the case of a non-U.S. transferor of a partnership interest, it is not always the case that the transferor would be required to file a tax return or that any substantive tax in fact is due. Consider the case of an investment fund formed as a Cayman Islands limited partnership that invests exclusively in non-U.S. portfolio companies and that has generated no ECI over its term. This fund files a Form 1065, due to the fact that it has U.S. limited partners and receives U.S. source income from temporary investments in Treasury securities.[61] Despite the limited nexus with the United States, such a fund might be subject to the withholding rules of section 1446(f) as a theoretical matter (depending on how the IRS responds to our recommendations contained in Section IV). If a non-U.S. investor in the fund transfers an interest in the fund, say, to another non-U.S. party, it is easy to imagine the non-U.S. investor not knowing that a U.S. withholding certificate was required.[62]

Although we acknowledge the IRS's legitimate concern in ensuring that the fund in fact has no ECI and that the transferor in fact would have realized no ECG, we believe that the drafters of the Proposed Regulations would agree that this transfer is not an appropriate occasion to collect withholding tax, in spite of the two non-U.S. persons' failure to comply with U.S. tax regulations of which they were understandably unaware. While section 1446(f) appears to borrow many of its principles from the section 1445 withholding regime, a rule modeled on the section 1445 regime and exempting transferees and partnerships from withholding where they can present a tax return serves no purpose in this context. In contrast to the case where a USRPI is sold, where there is necessarily a nexus between the transferor and the United States due to the nature of the property being transferred, there is no nexus between the transferor and the United States in the current example, and no requirement under U.S. federal income tax law that the transferor file a U.S. tax return. We do, however, agree with the outcome of the analogous section 1445 rule — that if there is no underlying substantive liability, the withholding agent should be relieved of withholding liability and applicable penalties for having failed to withhold.[63]

In the event a transferee and non-U.S. transferor were to find themselves needing to justify the lack of withholding to the IRS at some later date (or to some third party creditor or regulator), they could do so by demonstrating that the fund in question in fact had no direct interest in assets connected to a U.S. trade or business at the time of the transfer. This could be achieved by a retroactive application of the Less-Than-10% Exception, the Three Year Rule or the maximum tax liability rule contained in proposed Treasury regulation section 1.1446(f)-2(c)(4) — effectively allowing the parties to provide certifications after the fact as needed.

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[61] *See* Treas. Reg. §1.6031(a)-1(b)(2).

[62] In fact, under Treasury regulation section 1.6031(a)-1(b)(3)(iii), the partnership is not required to provide non-U.S. partners with Schedule K-1s.

[63] See Treas. Reg. § 1.1445-1(e)(3). As noted in footnote 60, the FIRPTA rule does not exempt the withholding agent from interest. We do not take a position on whether, for purposes of section 1446(f), a withholding agent should be liable for interest on an amount that is not, in fact, required to be paid as a tax (because there is no underlying liability) where the withholding agent has not complied with a technical withholding obligation.

The same concern is also salient for U.S. transferors. Consider the example of a U.S.-based corporation that transfers a partnership interest to another U.S. resident, but fails to provide a Form W-9. Without the Form W-9 (or another certification under the Proposed Regulations), by the terms of section 1446(f), the transferee has a withholding obligation despite the clear inapplicability of section 864(c)(8) to the transferor. The reality, unfortunately, is that not every transferee will obtain a Form W-9. If the IRS later asserts withholding liability on the transferee or partnership, the parties should be excused from liability given that there was no substantive tax liability. Similar to the suggestion with respect to non-U.S. transferors, this could be achieved through retroactive application of the Non-Foreign Status Exception.

We believe that, without some form of "no harm, no foul" rule in cases where parties fail to withhold on transferors (whether non-U.S. or U.S) in situations similar to the ones described above, the regime contained in the Proposed Regulations is likely to become unworkable, particularly given the significant volume of secondary market transfers to which section 1446(f) would apply.

## VII. Application of Section 1446(f) Withholding Rules to Transfers of PTP Interests

### *A. Overview*

The Preamble acknowledges that broker-intermediated transactions in PTP interests may not involve a direct funds flow or information exchange between the transferor and transferee, and that accordingly the brokers that participate in the transaction may be best positioned to carry out the withholding obligations that would otherwise fall on the transferee and the partnership.[64] For that reason, the Proposed Regulations provide special withholding rules for transfers of PTP interests occurring through one or more brokers.[65] The following discussion addresses the limitations of the Proposed Regulations and proposes certain recommendations intended to carry out the goals of section 1446(f) without adversely impacting the market for PTP equity.

#### i. PTP Secondary Withholding

This Section VII.A.i discusses the rules under which distributions by a PTP are subject to secondary withholding. As discussed above, the transferee of a PTP interest in a broker-intermediated transaction may be subject to secondary withholding in respect of future distributions by the PTP, but only in cases where the failure to withhold was due to a faulty qualified notice that stated incorrectly that either the 10% PTP Exception or the Qualified Current Income Exception was available.

[64] Preamble at Section V.A ("A transfer of a PTP interest raises unique issues for withholding under section 1446(f). For example, when a transfer of a PTP interest is effected through one or more brokers, the transferee will generally not know the identity of the transferor. Accordingly, the Conference Report for the Act acknowledged that transfers involving PTP interests could require withholding rules different from those that apply to transfers involving non-PTP interests.").

[65] Prop. Treas. Reg. § 1.1446(f)-1(b) ("broker" includes any person, foreign or domestic, that in the ordinary course of a trade or business during the calendar year stands ready to effect sales made by others, and that, in connection with a transfer of a PTP interest, receives all or a portion of the amount realized on behalf of the transferor).

Our first recommendation concerning the PTP secondary withholding rules relates to the time at which the PTP is required to withhold on its distributions. Under the Proposed Regulations, secondary withholding liability applies in this context on the later of the date that is 30 days after the date of the transfer or 15 days after the date that the PTP has actual knowledge that the transfer has occurred. However, despite that rule, the Preamble notes that the PTP's obligation to withhold commences when the PTP "makes the determination" that a faulty qualified notice has been provided (including having been notified thereof by the IRS). We believe the rule in the Proposed Regulations should be changed, consistent with the Preamble, to reference the time at which the PTP becomes aware of the fact that a qualified notice is faulty, because that is the point at which the PTP could reasonably be expected to be aware of its withholding obligation. Thus, the deadline for beginning to withhold should reference the date that is 15 days after the PTP has actual knowledge of the fact that a qualified notice is faulty, rather than 15 days after the date that the partnership has actual knowledge of the transfer

Second, we recommend that final regulations remove the requirement that secondary withholding liability remain with a PTP interest after the initial transferee has disposed of the interest. We question the choice of allowing a withholding liability to follow a PTP interest and penalize transferees that may have complied fully with their own requirements under section 1446(f). The Preamble justifies the continuation of withholding liability by noting that the proposed rules are intended to "[t]o ensure that publicly traded partnerships exercise due diligence when publishing these qualified notices … ." However, we are concerned that, under the Proposed Regulations as currently drafted, the consequences of publishing a faulty qualified notice instead may serve merely to prevent many PTPs from ever undertaking to publish a qualified notice and incur the potential liability that could arise from a mistake.

Whatever the justification for the rule as currently drafted, it creates a troublesome consequence for a PTP that files a faulty qualified notice. Consider the case where a PTP files a qualified notice that is discovered to be incorrect two months after it is posted on the PTP's website. All transferees that acquired PTP interests during that two-month period relying on the qualified notice would be subject to secondary withholding. In addition so would everyone else that purchased PTP interests in subsequent transfers. In a liquid market, a purchaser likely would have no way of knowing exactly who the transferor of a PTP interest was (especially if the interest is transferred over an exchange), and almost certainly would not be able to trace the ownership chain of the particular PTP interest it just acquired back over a two-month period. In fact, the PTP itself may not have access to such information, as noted in the language from the Preamble quoted above. Furthermore, if a PTP interest is transferred several times in the course of the month and some number of the transferees relied on the qualified notice, then the PTP interest would be subject to liability for multiple withholding amounts – and again the final transferee in the chain would have no ready way of ascertaining that fact upon acquisition.

Furthermore, even if a qualified notice produced by a PTP has not been declared faulty yet, the transferee of a PTP interest would have to accept the risk that distributions in respect of that interest could be dramatically reduced (or eliminated for the foreseeable future) in the event that a fault is found with a qualified notice at some time in the future. This situation in turn strikes us as potentially causing market participants to assume that PTP interests are subject to withholding liabilities in any case where the relevant PTP has filed a qualified notice. While it is difficult to predict how the possibility of an incorrect qualified notice would affect market values, it undoubtedly would be negative.

Given the potential exposure to the PTP, the rule may strongly disincentivize PTPs from issuing qualified notices in the first place. Of course, the rule could be justified on the grounds that it incentivizes PTPs to be extremely conservative and to post qualified notices only in cases where they are certain that one of the withholding exceptions applies with a high margin of error. Given the stakes of making an error in this regard, there is a chance that many PTPs simply would adopt stated policies of never filing qualified notices; such policies may be the only means available to be absolutely sure of avoiding secondary withholding and a potentially unfavorable situation. Such policies in turn would lead to situations where PTPs that generate no or little ECI are unwilling to provide qualified notices out of an abundance of caution and thus subject their non-U.S. transferors to needless withholding. We do not believe such an outcome was intended by the drafters of the Proposed Regulations, and we strongly urge Treasury and the IRS to consider other means of ensuring the integrity of qualified notices that do not risk such extreme consequences for all of the PTP equity holders. For example, penalties for preparers of qualified notices that act in bad faith or without a requisite of care might be designed to achieve an appropriate set of incentives.

ii. Cascading Liability

As mentioned, a broker is obligated to withhold from an amount realized on the transfer of a PTP interest unless an exception applies. Although there are coordination rules intended to avoid over-withholding where there are multiple brokers in a payment chain, there is no clear mechanism to allow a broker to rely on specific documents in order to assume that withholding has been satisfied by another responsible party. The Preamble suggests that parties will in practice arrive at an appropriate mechanism to address withholding liabilities for market transactions[66] but in the absence of certainty, and given the strict liability standard that applies for the failure to withhold, we recommend that specific rules be promulgated setting out exactly what kind of evidence is sufficient for a broker to forego withholding. In this regard, the Preamble states that the Treasury Department and the IRS intend to modify the Qualified Intermediary ("QI") agreement provided in Rev. Proc. 2017-15 to allow QIs to assume primary withholding responsibility on the amount realized. We agree with this proposed modification. In situations where one foreign broker in the chain has paid the withholding tax, the Proposed Regulations might provide the specific form of certification that is required in order to allow a broker to rely on the "no withholding if someone else has withheld" exemption.

## VIII. PTP Distributions: Coordination between Section 1446(a) and Section 1446(f)

This Section VIII discusses the need for coordination between the withholding regime under section 1446(a) (which requires a partnership to withhold where a non-U.S. partner's distributive share contains ECI) and the regime under section 1446(f) in respect of distributions made by PTPs that are treated as acquisitions by the PTP of partnership interests. As explained below, we believe that section 1446(f) should not apply to any PTP distribution that also is subject to withholding under section 1446(a).

[66] Preamble at V.A ("While comments have stated that clearing organizations may not have the capability to complete the withholding required under § 1446(f), the Treasury Department and the IRS anticipate that clearing organizations will make arrangements to ensure that, when effecting the transfer of a PTP interest on behalf of foreign brokers, they act on behalf of brokers that assume withholding responsibility when clearing sales of PTP interests (such as a qualified intermediary).").

By way of background, the Proposed Regulations address potential overlap between withholding obligations under section 1446(f) and other sections of the Code as follows:

- If a transferee has withholding obligations under both section 1445 and section 1446(f), then section 1445 withholding controls (except to the extent the transferor has applied for a withholding certificate to exempt it from the section 1445 withholding obligations, in which case the transferee withholds the greater of the amount required under section 1445(e)(5) or section 1446(f)(1)).[67]

- Where an upper-tier partnership transfers an interest in a lower-tier partnership, the transferor partnership's gain on disposition of the interest, if any, is potentially subject to withholding under section 1446(a), to the extent that it gives rise to ECI allocable to a non-U.S. partner in the upper-tier partnership, and could also give rise to withholding under section 1446(f). Accordingly, proposed Treasury regulation section 1.1446-3(c)(4) provides that the upper-tier partnership/transferor may credit the amount withheld under section 1446(f)(1) against its withholding tax obligations under section 1446(a) for the relevant taxable year, to the extent the amount is allocable to foreign partners.

- If a partnership has a secondary withholding obligation (because a transferee of a partnership interest failed to withhold as required under section 1446(f)), any amount required to be withheld on a distribution under any other withholding provision of the Code is not also required to be withheld under section 1446(f)(4).[68]

- Where the transferee of a PTP interest is a broker remitting the amount realized to a foreign person, the broker is relieved of its withholding obligation under section 1446(f) if the amount realized is subject to gross proceeds backup withholding under section 3406.[69]

None of the foregoing, however, coordinates the section 1446(f) withholding obligation with the section 1446(a) withholding obligation that might arise on a distribution made by a PTP. One possible reason for the lack of a coordination rule is that section 1446(a) generally applies to items of partnership income at the time such income is *allocated* to a non-U.S. partner, whereas withholding in respect of section 1446(f) occurs only where a distribution to a partner is in excess of the partner's basis in the partnership interest, thereby causing the partner to recognize gain under section 731(a) and thus be treated as having disposed of a partnership interest.[70] Normally, at least in the case of a partner that does not sell its partnership interest, if a partner receives an allocation of ECI subject to section 1446(a) withholding, the partner's basis in the partnership would be expected to increase correspondingly, with the result that a subsequent distribution of the ECI would not be expected to be in excess of basis or to trigger withholding under section 1446(f).

[67] Prop. Treas. Reg. § 1.1446(f)-1(d).
[68] Prop. Treas. Reg. § 1.1446(f)-3(c)(3).
[69] Prop. Treas. Reg. § 1.1446(f)-4(b)(5). See also Preamble at V.B.4 ("To prevent withholding twice on the same payment, proposed Treasury regulation § 1.1446(f)-4(b)(5) provides an exception to withholding under section 1446(f)(1) if the amount realized is subject to withholding under section 3406.").
[70] Treas. Reg. § 1.1446-3(b)(2)(i)(A)

Proposed Treasury regulation section 1.1446(f)-4, however, provides a special withholding regime for PTPs, under which actual distributions to foreign partners (as opposed to mere allocations of income) are subject to section 1446(a) withholding to the extent the relevant distribution is deemed to be made out of ECI realized by the partnership. For these purposes, proposed Treasury regulation section 1.1446-4(f)(3) contains a "waterfall" under which distributions are allocated to various types of partnership income, one of which is ECI subject to section 1446(a) withholding.[71]

Similarly, proposed Treasury regulation section 1.1446(f)-4(b)(4) provides that *all* distributions made by a PTP in a broker-intermediated transaction (*i.e.*, where the PTP makes the distribution to a broker that is holding the interest for an account holder) are in excess of the transferee's basis,[72] and thus subject to section 1446(f) withholding, except to the extent the distribution is not in excess of the PTP net income for the current year (the "Current Year Income Exception"). The Current Year Income Exception appears to be an attempt to acknowledge that allocations of partnership income should increase a partner's basis in its partnership interest and thus allow for distributions in respect of which no section 1446(f) withholding is required — at least to the extent of current year income. However, PTP interests trade in public markets at prices that may be higher or lower than the basis a partner would have if it invested in the PTP at inception and continually adjusted its basis to take account of inclusions of income and loss and distributions. That fact may explain why the Current Year Income Exception is limited only to the partnership's current-year net income — in other words, the exception makes certain assumptions in an attempt to reach "rough justice" in a situation where the PTP cannot be expected to have accurate information about a partner's basis in a PTP interest.

However, it appears possible under the rules as currently drafted that a broker-intermediated distribution from a PTP could be subject to withholding both (i) under section 1446(a), on the grounds that it is treated as a distribution of ECI previously realized by the partnership, and (ii) under section 1446(f) on the grounds that the Proposed Regulations deem the distribution to be in excess of the partner's basis. In other words, the same distribution is deemed to constitute ECI under two separate rules, both of which require withholding. We believe this result was unintended and is a case of over-withholding.

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[71] Specifically, under the existing Treasury regulation section 1.1446-4(f)(3) a PTP distribution is treated as paid out of income as follows: FDAP that is not ECI and is subject to withholding (without regard to available treaty exemptions); ECI that is not subject to withholding; ECI that is subject to withholding under section 1446; and finally anything else. The Proposed Regulations modify this to provide greater specificity, separately providing for FDAP that is subject to withholding and FDAP that is not subject to withholding. Specifically, proposed Treasury regulation section 1.1446-4(f)(3) treats PTP distributions as paid out of income as follows: FDAP that is subject to withholding; FDAP that is not subject to withholding; ECI that is not subject to withholding; ECI that is subject to withholding under Treasury regulation sections 1.1446-1 through 1.1446-6; all other types of income.

[72] The coordination rule between sections 1441 and 1445 makes a similar assumption and ignores that a portion of a distribution might be treated as return of capital. Proposed Treasury regulation section 1.1441-3(c)(4) allows that a USRPHC making a distribution may withhold only under section 1441 and not under section 1445 – the USRPHC must "withhold under section 1441 on the full amount of the distribution, whether or not any portion of the distribution represents a return of basis or capital gain." Alternatively, the USRPHC can withhold under both section 1441 and section 1445 by making a reasonable estimate of the portion of the distribution that is a dividend and withholding under section 1441 on that portion and then withholding "under section 1445(e)(3) and § 1.1445-5(e) on the remainder of the distribution or on such smaller portion based on a withholding certificate." Thus the coordination rules do not take into account that some portion of the distribution might be return of basis.

For that reason, we recommend the adoption of a coordination rule under which distributions of ECI taxed under section 1446(a) are not subject to additional withholding under section1446(f). One approach might be modeled on the rule in proposed Treasury regulations section 1.1446-3(c)(4) that, when an upper-tier partnership transfers an interest in a lower-tier partnership, the upper tier partnership is allowed to credit the amount withheld under section 1446(f)(1) against its withholding obligation under section 1446(a) to the extent the amount is allocable to non-U.S. partners: in other words, the upper tier partnership does not face a double withholding in respect of its allocable share of the lower tier partnership's ECI that is allocable to foreign partners. Under this approach, sections 1446(a) and 1446(f) both are potentially applicable to a distribution, but amounts withheld under 1446(f) reduce liabilities under section 1446(a) dollar-for-dollar. Alternatively, another approach might be a rule under which distributions by a PTP are exempt from withholding under section 1446(f) to the extent they are subject to withholding under section 1446(a) (or vice versa).

It is also possible to develop a rule under which section 1446(f) withholding does not apply to broker-intermediated PTP distributions to the extent that cumulative distributions by a PTP are not in excess of cumulative net income earned by the PTP over time (regardless of whether the income was treated as ECI). Such a rule would follow the "rough justice" of assuming that income inclusions allocable to a partnership interest over time are reflected in the basis of the partner currently holding that interest – to the extent not reduced by prior distributions and prior allocations of loss– and would carry that approach to its logical conclusion. Although we recognize that it might create administrative burdens to keep what amounts to a running account of a PTP's income and distributions on an ongoing basis, we recommend that Treasury and the IRS consider whether this approach might also be justified in spite of the administrative complexities.

## IX. Miscellaneous

### *A. Partnership Basis May Not Be Knowable Mid-Year*

It is often difficult or impossible for the transferor of a partnership interest to know its basis in the transferred partnership interest at the time of transfer. Specifically, a transferor's basis in a partnership interest is increased and decreased to take account of (i) allocations to that transferor of items of income, gain, loss and deduction— including amounts making up the transferor's distributive share for the relevant portion of the year of transfer under section 706, and (ii) variations in liabilities allocated to the transferor under section 752. If the partnership allocates items to the transferor using the proration method (*i.e.*, by reference to a day-count fraction applied to the entirety of a partnership item realized over the course of the entire taxable year), the information necessary to determine the transferor's basis may not exist at the time of the transfer. Even if the partnership allocates items according to an interim closing of the books, however, the accurate calculation of a transferor's basis in a partnership interest will require the partnership to complete an interim closing of the books as of the time of the transfer, a task that may take time following the transfer.[73] A transferor typically will have to wait until it receives its Schedule K-1 for the taxable year of transfer before it can calculate its basis accurately.

[73] Many partners and partnerships require transfers of partnership interests to be "effective" as of the end of a fiscal quarter or other relevant accounting period, enabling the partnership to allocate distributive shares among transferors and transferees in accordance with section 706 without having to create special "stub" accounting periods. Even

The No Gain Exception and the computation of Maximum Tax Liability pursuant to proposed Treasury regulation section 1.1446(f)-2(c)(4) both require a transferor to be able to calculate its basis in the partnership interest at the time of the transfer. Consider the case of a transferor of an interest in a partnership that is undergoing financial difficulty and generating significant losses. The transferor may expect that it will qualify for the No Gain Exception upon a transfer of the partnership interest, but may not know for certain, because the transferor cannot be certain of the amount of partnership current-year losses that will be allocable to it and reduce the partner's basis.

We urge Treasury and the IRS to consider addressing the uncertainty inherent in determining partnership basis through a safe harbor that would allow transferors and transferees to calculate the basis of a partnership interest (solely for purposes of section 1446(f)) by reference to reasonable assumptions that can be made with confidence at the time of the transfer.

*B. Disguised Sales That Occur Over Time*

Disguised sales that might occur over a period of time raise an issue under section 1446(f). Consider the case of an investment partnership where a limited partner ("LP 1") would like to exit, and where the general partner seeks to accommodate this wish, but currently is in need of LP 1's capital and is not required to redeem LP 1 for some period of time. A new investor ("LP 2") —completely unaware of this state of affairs — makes a new investment in the partnership, which investment could be used to fund a full redemption of LP 1. The general partner is cautious about redeeming LP 1, but becomes convinced after a year that it no longer needs LP 1's capital and redeems LP 1's interest.

Currently, the law is unclear as to whether that fact pattern gives rise to a disguised sale of LP 1's partnership interest to LP 2. LP 2 is not aware of the likelihood of a redemption of LP 1, but perhaps the intentions or plans of the general partner and LP 1 are sufficient to treat LP 1 as having sold a partnership interest, especially if the partnership were merely to hold LP 2's capital in a short-term investment prior to LP 1's redemption. Treasury regulation section 1.707-7, relating to disguised sales of partnership interests, currently is reserved.

If LP 2 were considered to be a transferee of a partnership interest from LP 1 by virtue of the disguised sale rule, then presumably LP 2 would have been required to withhold on the contribution of capital to the partnership absent an exception to withholding.[74] LP 2 might then find itself subject to secondary withholding on its partnership distributions. A similar result could arise in cases where one partnership interest is contributed to another partnership in a transaction that later is deemed to be a disguised sale of property to the second partnership under section 707(b).

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where the task of closing the partnership books has been simplified in such manner, however, a partnership may well not be able to provide accurate information based on a closing of the books by the time the actual transfer has been completed.

[74] We assume for this purpose that the disguised sale is deemed to occur once the money is transferred to the partnership, but acknowledge that a different rule could apply. *Cf.* Treas. Reg. § 1.707-3(a)(2)(a disguised sale of property to a partnership is deemed to occur at the time the partnership becomes the owner of the property for tax purposes).

Given the uncertainty concerning disguised sales of partnership interests, we believe it might be appropriate to consider providing relief from the withholding tax rules for taxpayers inadvertently participating in such a disguised sale.[75]

*C. Certification of Maximum Tax Liability and Tiered Partnerships*

As discussed above, proposed Treasury regulation section 1.1446(f)-2(c)(4) provides that, in determining the amount of withholding required in respect of a partnership transfer, the transferee may determine its withholding liability by reference to the Maximum Tax Liability that the transferor would owe under section 864(c)(8). For these purposes, however, proposed Treasury regulation section 1.1446(f)-2(c)(4)(i) states that "[a] transferor that is a foreign partnership is treated as a nonresident alien individual for purposes of determining the transferor's maximum tax liability." Accordingly, it appears that the rules do not allow an aggregate approach to apply to foreign partnerships in this context, and that a foreign partnership therefore is presumed to be liable for tax on its full allocable share of ECI at individual tax rates, regardless of whether any of the partners in the partnership are corporations or U.S. persons.

By contrast, proposed Treasury regulation section 1.1446(f)-2(c)(2)(iv) provides that, for purposes of measuring the amount realized in respect of the transfer of a partnership interest, the U.S. partners in a foreign partnership may certify as to their "non-foreign status." Once those certifications are made, only the portion of the amount realized allocable to partners that have not provided such a certification is subject to withholding under section 1446(f).

The policy rationale for treating foreign partnerships on a look-through basis for purposes of determining the amount realized that is subject to section 1446(f) withholding would seem to apply equally for purposes of determining the transferor's maximum tax liability. For example, consider the case of a foreign partnership that is 90% owned by U.S. individuals and 10% owned by non-U.S. individuals, with all partnership items allocated among the partners *pro rata* in accordance with their respective ownership percentages. If such foreign partnership sells an interest in another partnership for $1000 (realizing $200 of ECG that is ordinary income and $200 non-effectively connected gain) and all the U.S. partners provide appropriate certifications, then under proposed Treasury regulation section 1.1446(f)-2(c)(2)(iv), only $100 would be treated as an amount realized subject to section 1446(f) withholding. Under section 864(c)(8), the non-U.S. individuals owning 10% would recognize ECG of $20 which, assuming a tax rate of 37%, would result in a $7.40 tax liability. For purposes of calculating the transferor's maximum tax liability, however, the language quoted above appears to say that the full $200 of ECG would be treated as realized by a nonresident alien individual, subject to tax at 37%.[76] Since the tax on $200 of gain at a 37% would be $74, the maximum tax liability would substantially exceed both the substantive tax liability under section 864(c)(8) and the withholding required by section 1446(f) without application of the maximum tax liability

[75] This recommendation is narrower than the recommendation contained in our Prior Report of August 10, 2018, which was to limit withholding liability in the case of a disguised sale only to the partnership, and which appears to have been rejected.

[76] Prop. Treas. Reg. § 1.1446(f)-2(b)(4). The maximum tax liability is determined by reference to Treasury regulation section 1.1446-3(a)(2), which requires the transferor to use the highest relevant tax rate.

mechanism ($10, or the product of 10% and the $100 realized). We do not believe that this is a sensible result or that it was intended by the drafters of the Proposed Regulations.

We recommend that proposed Treasury regulation section 1.1446(f)-2(c)(4) be amended to allow a foreign partnership to be treated as U.S. person to the extent that its partners have provided certifications of their non-foreign status meeting the requirements of proposed Treasury regulation section 1.1446(f)-2(c)(2)(iv). A look-though approach also should be adopted for claims of eligibility for treaty benefits, to the extent such benefits otherwise would be available.

*D. Coordination with FIRPTA Rules*

i. Qualified Foreign Pension Fund

As noted in our Prior Report of August 10, 2018, section 897(l) treats a qualified foreign pension fund as a non-foreign person for purposes of FIRPTA. Proposed Treasury regulation section 1.1445-2(b)(2)(i) permits a qualified foreign pension fund, as described in section 897(l), to provide the same certification as a domestic entity would use to certify that it is a non-foreign entity. We reiterate our recommendation contained in the Prior Report that the regulations should make clear that qualified foreign pension funds may only provide such a certification for purposes of section 1445, and not for purposes of section 1446.

ii. Ascertaining Non-Foreign Status

The FIRPTA regulations allow a transferee of a USRPI to rely on a certification of non-foreign person status, as in proposed Treasury regulation section 1.1446(f)-2(b). However, if the transferee cannot obtain a certification, it can still "rely upon other means to ascertain the non-foreign status of the transferor" pursuant to Treasury regulation section 1.1445-2(b). The regulations applicable to section 1446(a) withholding also provide that the presumption of non-foreign status does not apply to "the extent that the partnership relies on other means to ascertain the non-foreign status of a partner and the partnership is correct in its determination that such partner is a U.S. person".[77] We recommend that Treasury and the IRS include an analogous provision in the final section 1446(f) regulations.

*E. Refunds of Amounts Withheld by Partnerships on Distributions to Transferees*

If a transferee fails to withhold any amount as required section 1446(f), the partnership has an obligation to withhold such amounts, plus interest, from distributions to the transferee under section 1446(f)(4). Treasury requested comments on proposed Treasury regulation section 1.446(f)-3(e)(2), which states "A transferee may not obtain a refund when the amount of tax withheld under this section exceeds the transferee's withholding tax liability under § 1.1446(f)-2. Instead, only the partnership may claim a refund on behalf of the transferee for the excess amount under this section."

We acknowledge the partnership may have better access to information with respect to the transferee's liability (which is based on the transferor's liability), and thus whether an excess

[77] Treas. Reg. § 1.1446-1(c)(3).

amount was withheld on distributions to the transferee. We also believe, however, that the transferee is capable of obtaining information should it wish to.

Partnerships may not have an incentive to apply for a refund, as the transferee and partnership would likely not enter into a contractual arrangement requiring that the transferee be reimbursed for excess withholding, as suggested by Treasury in the Preamble.[78] On the other hand, if the partnership does seek and obtain the refund, the partnership likely would be required to turn over all or a portion of the cash to the transferee.

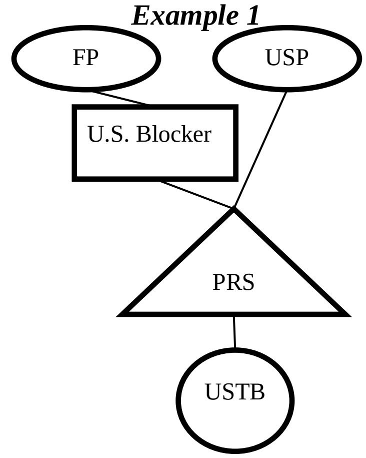
Therefore, we believe the transferee should be given the opportunity to demonstrate, without the assistance of the partnership, that excess amounts were withheld and it is owed a refund. If Treasury or the IRS is concerned that the partnership and the transferee might both file refund claims, one option is to require the partnership to delegate authority to collect the refund to the partner (for example, by providing the transferee with a certification, to be sent to the IRS along with the claim, that the partnership will not also file a claim). A second option is to require the party claiming the refund to provide sufficient information about the transfer or the tax imposed so that the IRS is able to confirm that the claim is not duplicative using its existing computer systems.

[78] Preamble at IV.D.

## Appendix A—Blocker Corporation Structures

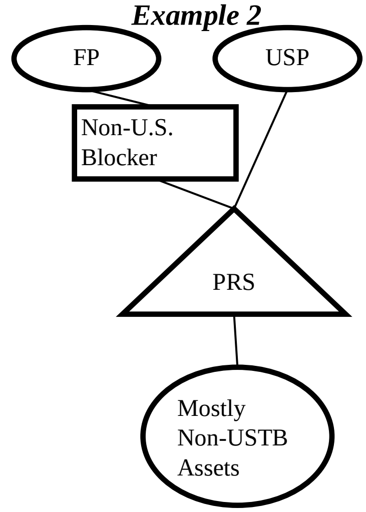
*Example 1: Above-the-fund U.S. blocker – USTB Only*. A foreign person ("FP") and a U.S. person ("USP") want to form a 50/50 partnership ("PRS") to invest in a USTB. As FP does not wish to recognize ECI directly, FP invests indirectly in PRS through U.S. blocker and USP invests directly in PRS. PRS allocates 50% of the income/loss from the USTB to the U.S. blocker and 50% to USP. The U.S. blocker and USP are both subject to U.S. tax on the income from the USTB on a net basis.

***Example 1***



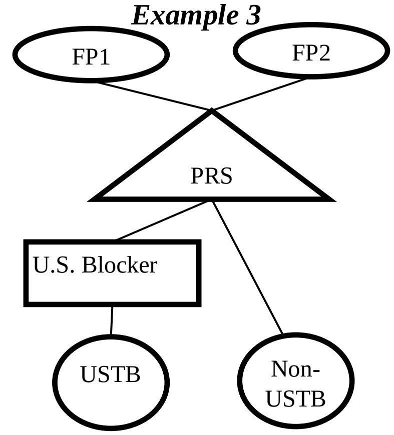

*Example 2: Above-the-fund foreign blocker – Mostly Non-USTB.* A foreign person ("FP") and a U.S. person ("USP") want to form a 50/50 partnership ("PRS") to invest primarily in assets that are not related to a USTB ("Non-USTB Assets"). While significant amounts of ECI are not expected, FP does not want direct exposure to the risk that some of the investments could give rise to ECI (e.g., the risk of FIRPTA gains, the risk of an investment in a lower-tier partnership interest that generates ECI, or the risk that some activity is found to constitute a USTB, against the expectations of PRS and the partners). FP also does not want to invest through a U.S. blocker, because that would subject all of the blocker's income (whether or not related to a USTB) to U.S. tax. Accordingly, FP chooses to invest through a non-U.S. blocker, which will be subject to: (i) U.S. corporate income tax and branch profits tax (as well as the applicable filing requirements) on its ECI, and (ii) U.S. withholding tax on certain payments of U.S. source dividends, interest, etc., but generally will *not* be subject to U.S. tax on its investments in Non-USTB Assets.

***Example 2***



*Example 3: Below-the-fund U.S. blocker – USTB and Non-USTB Assets – FP Only.* Two foreign persons ("FP1" and "FP2") form PRS to invest 50/50 in both a USTB and in Non-USTB Assets. As FP1 and FP2 do not wish to recognize ECI directly, PRS invests in the USTB indirectly through a U.S. blocker, which will pay U.S. corporate-level tax on income from the USTB. As FP1 and FP2 do not have any sensitivity to income attributable to Non-USTB Assets, PRS invests directly in the Non-USTB Assets. FP1 and FP2, indirectly through PRS, each have a 50% interest in the U.S. blocker and a 50% interest in a Non-USTB, neither of which will cause PRS (or FP1 or FP2) to recognize ECI.

***Example 3***




If PRS were a foreign partnership, because it has only non-U.S partners and no ECI, it generally would not be obligated to file a Form 1065 to the IRS or deliver Schedule K-1s to FP1 and FP2.

*Example 4: Below-the-fund U.S. blocker – USTB and Non-USTB Assets – FP and USP.* FP and USP form PRS to invest 50/50 in both a USTB and Non-USTB Assets. Because FP does not wish to realize ECI, but USP does not have the same sensitivity, PRS makes 50% of the investment in the USTB through a U.S. blocker and 50% of the investment in the USTB directly. In accordance with the PRS partnership agreement, all PRS's income/loss from the U.S. blocker is specially allocated to FP and all PRS's income/loss from PRS's direct investment in USTB is specially allocated to USP. As both FP and USP do not have any sensitivity to income attributable to Non-USTB Assets, PRS holds it entire investment in the Non-USTB Assets directly. All of PRS's income from the Non-USTB Assets is allocated 50/50 among FP and USP. Assuming that the allocations are respected for tax purposes and have substantial economic effect, the result is that FP does not recognize ECI or ECL directly, but would be required under Treasury regulation section 1.875-1 to file a U.S. tax return (because it nonetheless is deemed to be engaged in a USTB by virtue of being a partner in a partnership that has a direct interest in a USTB).

***Example 4***