

## US: Final regulations under Section 1446(f) set forth rules on withholding on transfers of partnership interests

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The United States (US) Internal Revenue Service (IRS) has released final regulations ([TD 9926](#)) under Internal Revenue Code<sup>1</sup> Section 1446(f), which imposes a new withholding tax on transfers by non-US persons of interests in partnerships that are engaged in a US trade or business. The final regulations retain the basic approach of the proposed regulations issued in May 2019 but make numerous changes to specific rules in response to comments received.

### Background

The *Tax Cuts and Jobs Act* (TCJA) settled an ongoing dispute about whether nonresident aliens and foreign corporations not otherwise engaged in a US trade or business were subject to US tax on gains on sales of interests in partnerships engaged in a US trade or business. Section 864(c)(8) treats gain on the sale of interests in those partnerships as effectively connected with the conduct of a US trade or business (ECI), and subject to tax in the hands of the non-US partners, to the extent the gain was allocable to the partnership's US business assets. Section 1446(f) is an enforcement mechanism for Section 864(c)(8), which requires transferees purchasing interests in such partnerships from non-US transferors to deduct and withhold a 10% tax from the amount realized. Section 1446(f)(4) requires partnerships to withhold tax from future distributions (backstop withholding) to transferees that were previously required to withhold tax on the amount realized by the non-US transferor but did not do so. Backstop withholding would continue until the amount not withheld, plus interest, was recovered.

Although Section 1446(f) was effective for transfers after 2017, the TCJA was enacted so late in 2017 that it was impossible for the IRS to provide guidance before 2018. On 29 December 2017, Treasury and the IRS issued Notice 2018-08, which suspended withholding (but not the substantive tax) for dispositions of publicly traded partnership (PTP) interests until the issuance of regulations (or other guidance). A similar delay was not provided for non-PTP interests. Notice 2018-29 was released on 12 April 2018, to provide temporary procedures for withholding and paying over the tax on non-PTP interests and to provide exceptions and limitations under certain circumstances.

On 7 May 2019, the IRS issued proposed regulations under Section 1446(f). See EY Global Tax Alert, [US proposed regulations under Section 1446\(f\) would clarify scope of withholding on transfers of partnership interests](#), dated 15 May 2019, for a detailed discussion of the proposed rules.

On 21 September, 2020, the IRS released final regulations (T.D. 9919) under Section 864(c)(8) with guidance for determining the treatment of gain or loss recognized by a foreign person on the sale of an interest in a partnership that is engaged in a US trade or business. The final regulations largely adopted proposed rules issued in December 2018. See EY Global Tax Alert, [US: Final regulations largely adopt proposed characterization of foreign persons' gain or loss from sale or exchange of interests in certain partnerships, with some welcome changes](#), dated 30 September 2020.

## Final regulations

The final regulations under Section 1446(f) retain the overall approach and structure of the proposed rules but add modifications throughout, as described below.

### Information on transfer

Consistent with the proposed regulations, the final regulations require non-US persons and certain domestic partnerships with non-US direct or indirect partners that transfer an interest in a partnership covered by Section 864(c)(8) to provide a statement to that partnership within 30 days of the transfer. In turn, the partnership that receives such a statement (or otherwise knows that a transfer has occurred) generally must provide information to the transferor partner so that partner may comply with Section 864(c)(8) if that transferor would have had a distributive share of the gain or loss from a deemed sale of the effectively connected assets.

The final regulations add that a specified partnership must include in the statement provided to the notifying transferor information on whether the transferor's deemed sale "EC gain" or "EC loss" was determined under the material-change-in-circumstances rule provided in the final regulations under Section 864(c)(8). Under the material-change-in-circumstances rule, the relevant foreign-source portion of deemed sale gain or loss may be determined, in certain cases, by reference to the source of the partnership's income occurring after the date, if any, on which a material-change-in-circumstances occurs, rather than under the general three-year lookback period.

### Scope of withholding obligation under Section 1446(f)

Like the proposed regulations, the final regulations require withholding on the transfer of a partnership interest unless an exception or adjustment to withholding applies. In response to comments, however, the final regulations add a rule specifying that any person required to withhold under Section 1446(f) is not liable for failure to withhold, or any interest, penalties or additions to tax, if it establishes to the satisfaction of the Commissioner that the transferor had no gain under Section 864(c)(8) subject to tax on the transfer. In addition, the final regulations add an exception to withholding for a partnership that certifies to the transferee that it is not engaged in a trade or business within the US.

### Exceptions to withholding on transfers of non-PTP interests

The final regulations, like the proposed regulations, require a transferee to withhold under Section 1446(f)(1) a tax equal to 10% of the amount realized on any transfer of a partnership interest (other than a PTP interest) unless an exception to withholding, or an adjustment to the amount to withhold, applies. The final regulations, however, modify some of the exceptions to withholding included in the proposed regulations.

#### No Gain Exception

Under the proposed regulations, an exception to withholding would apply if the transferee relies on a certification from the transferor stating that the transfer of the partnership interest would not result in any realized gain, including ordinary income arising from the application of Section 751 and Treas. Reg. Section 1.751-1 (the No Gain Exception). The final regulations retain the No Gain Exception but amend

the rule in response to comments that a transferor may be unable to use the exception due to not having necessary information from the partnership. The amended rule states that a transferor may rely on a certification from the partnership stating that, as of the determination date, the transfer of the partnership interest would not result in any ordinary income arising from the application of Section 751 and Treas. Reg. Section 1.751-1. The final regulations add that this certification, in turn, is attached to, and forms part of, the general certification provided by the transferor to the transferee as part of the No Gain Exception.

### Effectively Connected (EC) Gain Exception

The proposed regulations included a rule under which an exception to withholding would apply if the transferee relied on a certification from the partnership stating that, if the partnership sold all of its assets at fair market value on the determination date, the amount of net EC gain resulting from the deemed sale would be less than 10% of the total net gain from the deemed sale (the EC Gain Exception). The final regulations modify the rule, in part. Under the final rule, a transferee may rely on a certification from the partnership stating that, if the partnership sold all of its assets at fair market value on the determination date in the manner described in Treas. Reg. Section 1.864(c)(8)-1(c), the transferor's distributive share of net EC gain from the partnership would be either zero or less than 10% of the transferor's distributive share of the total net gain from the partnership.

Agreeing with a comment that a transfer of an interest in a partnership that is not engaged in a trade or business in the US is not subject to Section 864(c)(8) and, therefore, should be excepted from withholding under Section 1446(f), the IRS further modified the EC Gain Exception rule in the final regulations. The modified rule states that the transferee may rely on a certification from the partnership stating that the partnership was not engaged in a trade or business within the US at any time during the tax year of the partnership through the date of transfer.

### Effectively Connected Income (ECI) Exception

The proposed regulations included an exception (ECI Exception) to withholding for a transferee relying on a certification from the transferor that (1) the transferor was a partner in the partnership for the immediately prior tax year and the preceding two tax years and (2) in each of those years, the transferor's allocable share of effectively

connected taxable income (ECTI) was less than 10% of the transferor's total distributive share of net income received from the partnership, and less than \$1 million.

The final regulations modify the ECI Exception to refer to a transferor's share of gross effectively connected income (as reported on a Schedule K-1 or other statement furnished to the partner), rather than its allocable share of ECTI. As a result, because this exception looks to the transferor's share of ECI as reported on a Schedule K-1 (or similar statement) rather than its allocable share of ECTI, a transferor that is not allocated any effectively connected income or loss in any relevant year can still use the exception even if it has not received a Form 8805 for that year.

The final regulations further modify the ECI Exception to look to gross amounts of income, rather than net amounts of income, for purposes of determining whether the transferor's distributive share of ECI was less than 10% of the transferor's total distributive share of income from the partnership.

### Claim for treaty benefits

The proposed regulations would allow a transferor to claim an exception or adjustment to withholding when it qualifies for treaty benefits with respect to a transfer of a partnership interest (including a transfer of a PTP interest). To make this rule more administrable, the final regulations allow a transferor to use the applicable withholding certificate – i.e., Form W-8BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)*, or Form W-8BEN-E, *Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)* – as the certification for making a claim for benefits under an income tax treaty. The Preamble provides that the instructions to the form will be updated to include the information required for a valid treaty claim on the gain realized upon the transfer of a partnership interest. The final regulations, however, prohibit this exception from applying if the treaty benefits apply to only a portion of the gain from the transfer.

### Determining the amount to withhold

The final regulations, like the proposed regulations, include guidance for determining the amount to withhold, and they also include certain procedures that allow for adjustments to the amount to withhold that are intended to better reflect the transferor's tax liability on any gain under Section 864(c)(8).

Among these rules, the proposed regulations included a procedure for determining the amount realized when the transferor of a partnership interest is a foreign partnership. Under this procedure, when a foreign partnership transfers an interest in a partnership, the transferee of the interest could rely on a certification provided by the transferor partnership that provides a modified amount realized. The IRS agreed with a comment suggesting expansion of this approach when a foreign partner in the transferor partnership is eligible for treaty benefits. Accordingly, the final regulations allow for a reduction of the amount realized when a transferor that is a foreign partnership has a direct or indirect partner that is not subject to tax on gain from a transfer under an applicable US income tax treaty. Additionally, another change to the final regulation provides that the amount-realized calculation does not need to include the transferor's reduction in partnership liabilities if the amount otherwise required to be withheld would exceed the amount realized (determined without regard to any decrease in the transferor's share of partnership liabilities).

The proposed regulations also included a procedure allowing a transferee to withhold based on a certification received from the transferor containing certain information relating to the transferor and the transfer, including the transferor's maximum tax liability on the transfer. The final regulations modify this rule to allow transferors that are foreign trusts to use the maximum tax liability procedure in Treas. Reg. Section 1.1446(f)-2(c)(4) to reduce the amount to be withheld.

### **Partnership's requirement to withhold under Section 1446(f)(4)**

Under Section 1446(f)(4), if a transferee fails to withhold any amount required to be withheld under Section 1446(f)(1), the partnership must deduct and withhold from distributions to the transferee a tax equal to the amount that the transferee failed to withhold (plus interest). The final regulations generally adopt the proposed rules for implementing this requirement on a partnership to withhold.

The final regulations amend these rules to limit the instances of withholding under Section 1446(f)(4) on certain transferees, and to reduce the compliance burden on those transferees. The amended rules allow a partnership to determine that it does not have a withholding obligation in certain circumstances (i.e., the partnership knows the transferor is a US person because it already possesses a Form W-9, *Request for Taxpayer Identification Number*

*and Certification*, from the transferor that meets Treas. Reg. Section 1.1446(f)2(b)(2)'s requirements for non-foreign status (even if the transferee does not provide a certification of withholding to the partnership under Treas. Reg. Section 1.1446(f)-2(d)(2))).

The final regulations also modify the proposed rules to allow the transferee, rather than the partnership, to obtain a refund of over withholding for amounts withheld under Section 1446(f)(4).

### **Withholding under Section 1446(f)(4) by PTPs**

Responding to comments, the IRS stated that it has determined that a PTP should not be required to withhold under Section 1446(f)(4). The final regulations remove the requirement in the proposed regulations that a PTP withhold on a transferee under Treas. Reg. Section 1.1446(f)-3 and add instead provisions imposing liability for underwithholding under Section 1461 if the partnership issued an incorrect qualified notice upon which brokers relied to not perform the required withholding.

### **Credits and refunds for amount withheld under Section 1446(f)(4)**

In response to comments, the IRS modified the final regulations to allow a transferee to directly claim and obtain a refund for any excess amount withheld under Treas. Reg. Section 1.1446(f)-3. Accordingly, under the final regulations, the partnership may not claim a refund on behalf of the transferee for any excess amount withheld under Treas. Reg. Section 1.1446(f)-3.

The final regulations also clarify that the excess amount withheld under Treas. Reg. Section 1.1446(f)-3 is the amount of tax and interest withheld under Treas. Reg. Section 1.1446(f)-3 that exceeds the transferee's withholding tax liability under Treas. Reg. Section 1.1446(f)-2 and any interest owed by the transferee with respect to such liability.

### **Withholding on transfer of PTP interest by a foreign person**

Under the final regulations implementing Section 1446(f) withholding on transfers of PTP interests, brokers that effect a transfer of a PTP interest on behalf of a foreign partner and pay the amount realized to a foreign transferor that is their customer (or to another broker they are required to treat as a foreign person) must generally withhold a tax equal to 10% of the amount realized, subject to certain exceptions. The final regulations include rules for determining the amount

realized for purposes of withholding on a transfer of a PTP interest. These rules go into effect on 1 January 2022 – in other words, in less than 15 months, not the 18 months that the securities industry had requested (prior to the pandemic) to implement this new regime.

### Qualified Intermediaries

In the Preamble to the proposed regulations, the IRS stated that it intended to modify the Qualified Intermediary (QI) agreement set forth in Revenue Procedure 2017-15 to allow QIs to assume primary withholding responsibilities on amounts realized under Section 1446(f) and on PTP distributions under Section 1446(a). The IRS stated that the QI-related provisions of these final regulations will be incorporated into a revised QI agreement effective for the 2023 calendar year. Because relevant provisions of the final regulations apply to QIs starting 1 January 2022, the IRS added that Section 1446(a) and (f) requirements for QIs for the 2022 calendar year will be set forth in a rider to the current QI agreement.

Under the final regulations, a QI may assume primary withholding responsibility under Section 1446(f) on a payment-by-payment basis. In addition, a QI may assume (or not assume) primary withholding responsibility under Section 1446(f) on a sale of a PTP interest regardless of whether the QI assumes primary withholding responsibilities under Sections 1441 and 1442. However, the final regulations require a QI that assumes withholding responsibilities on any portion of a distribution from a PTP to assume withholding responsibilities for the entire distribution, including when Section 1446(f) treats the distribution as a disposition.

In response to comments, the final regulations allow a broker to determine the amount to withhold under Section 1446(f) on an amount realized and paid to a QI that does not assume primary withholding responsibility under Section 1446(f) based on aggregate information about its account holders that are transferring PTP interests.

QIs may report Section 1446 withholding on a pooled basis rather than issuing Forms 1042-S to each customer. The collective refund procedure, which allows QIs to obtain refunds of over withholding on behalf of customers, will not be available for Section 1446 withholding. The QI Agreement will incorporate the requirements for nominee reporting of PTP interests under Treas. Reg. Section 1.6031(c)-1T.

### Clearing organizations

The final regulations, like the proposed regulations, define a broker to include a clearing organization for purposes of the rules governing withholding on a foreign person's transfers of PTP interests. The final regulations do not, however, require a broker that is a US clearing organization to withhold on an amount realized on trades of PTP interests that (1) are netted and (2) have a US clearing organization as the central counterparty. The final regulations require a US clearing organization to report, on a non-netted basis, sales of PTP interests that have undergone a netting process at a US clearing organization for each direct clearing member on Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, unless an exception applies.

The final regulations also do not require a US clearing organization to withhold on and report its transfers of cash and securities, on a gross basis, at the instruction of its members to settle a trade of a PTP interest.

Therefore, on sales of PTP interests, the clearing broker of the transferor would be required to withhold on any amount realized and paid to the transferor's custodian unless an exception applies.

### Documentation of non-foreign status of broker

The proposed regulations included a rule requiring a broker to treat another broker as a foreign person unless it obtains documentation (including a certification of non-foreign status, such as a Form W-9) establishing that the other broker is a US person. To allow flexibility in existing relationships, the final regulations permit a broker to rely on documentation that it already possesses from the payee broker, rather than requiring new documentation for each transaction when the same payee broker is used. As a result, brokers that have never before been required to collect tax documentation from other brokers for delivery-versus-payment transactions will need to obtain it. The regulations permit (but do not require) a US clearing organization to provide its members copies of the documentation it has collected. The final regulations retain the presumption that, in the absence of documentation, the broker will be presumed foreign.

### Broker's determination of prior broker withholding

The proposed regulations included a rule under which a broker would not be required to withhold on an amount realized from the sale of a PTP interest when it knows that the withholding obligation has been satisfied by another broker. The final regulations expand this rule so that a broker acting as an intermediary for an amount realized is not required to withhold when it receives the amount from another broker unless it knows, or has reason to know, that the paying broker did not withhold the full amount required.

### Exceptions to withholding on a foreign person's transfer of a PTP interest

In response to comments, the final regulations add an exception to withholding if a valid Form W-8ECI, *Certificate of Foreign Person's Claim that Income is Effectively Connected with the Conduct of Trade or Business in the United States*, is provided and certifies that (1) the transferor is a dealer in securities (as defined in Section 475(c)(1)) and (2) any gain from the transfer of a PTP interest is effectively connected with the conduct of a trade or business within the US without regard to Section 864(c)(8).

The final regulations retain the allowance for a modified amount realized when a foreign partnership provides gain allocations. Despite industry requests, however, such allowance was not extended to nonqualified intermediaries; consequently, any amount realized and paid to a nonqualified intermediary will be subject to 10% withholding, even if the intermediary acts on behalf of US persons or other persons entitled to a zero rate.

The final regulations retain the exception provided in the proposed regulations that withholding is not required if the qualified notice provides that the net gain that would be effectively connected gain in a hypothetical sale of the PTP's asset would be less than 10% of the total gain. The final regulations further provide that withholding is not required if the PTP provides in the qualified notice that it is not engaged in a US trade or business. Finally, the final regulations provide (as did the proposed regulations) that a qualified notice including these exceptions can only be relied upon if it was issued no more than 92 days before the transfer.

### Determining the amount to withhold on distributions

The proposed regulations included rules for a broker to determine the amount realized for purposes of computing the amount to withhold on the transfer of a PTP interest. Under the proposed regulations, in the event of a PTP

distribution that is treated as a transfer for purposes of Section 1446(f), the entire distribution was treated as the amount realized. The proposed regulations included an exception to a broker's requirement to withhold on a PTP distribution if the entire distribution is designated on the PTP's qualified notice as a qualified current income distribution.

The final regulations retain the rule requiring withholding under Section 1446(f) on a distribution made with respect to a PTP interest. They replace, however, the exception for a qualified current income distribution with a procedure for adjusting the amount realized to the amount of a distribution that exceeds cumulative net income minus cumulative distributions. To the extent a distribution is not out such excess, it must be withheld upon – even if the distribution is also subject to withholding under Sections 1441 or 1446(a). These two layers of potential withholding are unique to the Section 1446(f) regime. As previously mentioned, the PTP may be liable for any underwithholding by brokers if a qualified notice misstates the amount attributable to cumulative net income.

### Amendments to existing Section 1446 regulations governing PTP distributions

The final regulations require a PTP to provide a qualified notice to any registered holder that is a nominee for a distribution.

The proposed regulations included a default withholding rule for when a qualified notice fails to provide sufficient detail for a nominee to determine the amounts subject to withholding on a PTP distribution. The final regulations amend this rule to add the following: if a nominee cannot determine a partner's status as a corporation, for purposes of the default withholding rule, the nominee must use the higher of the following rates: (1) the rate of withholding applicable to a foreign person that is a corporation and (2) the rate of withholding applicable to a foreign person that is not a corporation, without regard to any available treaty reduction.

To address situations in which a distribution by a PTP is paid through multiple nominees that might otherwise each be required to withhold, the final regulations add an exception to withholding for a nominee paying the distribution to a QI or US branch that is also a nominee for the distribution. The final regulations also allow a broker to withhold under Section 1446(a) based on specific payee documentation provided by a QI.

## Applicability dates

The final regulations generally apply to transfers that occur on or after the date that is 60 days after their date of publication in the Federal Register. However, different applicability dates apply for specific provisions. Certain provisions, including those applicable to transfers of PTP interests and secondary withholding tax liability of a partnership when a transferee fails to withhold, apply to transfers that occur on or after 1 January 2022. Other specified provisions, consistent with their proposed applicability dates, apply to transfers occurring on or after the date of publication of the final regulations in the Federal Register.

## Implications

With respect to the PTP provisions, PTPs and the securities industry face a number of challenges, including:

- ▶ Considerably less time to implement Section 1446(f) withholding and reporting than requested, coupled with a more challenging work environment due to the pandemic

- ▶ The need to implement a new withholding regime on gross proceeds paid to foreign persons
- ▶ The need to potentially withhold twice on the same distribution from a PTP
- ▶ The need to obtain documentation and potentially withhold in a delivery versus payment (DVP) transaction

Asset managers for non-PTP interests should be establishing policies and procedures to manage requests for information to determine amounts realized and other relevant information. Additionally, for the partnership interest transferred, asset managers will want to have a process in place to manage receipt of notifications from the transferee that the withholding obligation has been satisfied. If a transferee fails to perform its Section 1446(f) withholding obligation, the partnership is responsible for backstop withholding.

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## Endnote

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.

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