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Report No. 1414
March 22, 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: *Section 864(c)(8) Proposed Regulations*

Dear Messrs. Kautter, Rettig, and Desmond:

This letter ("**Letter**") of the New York State Bar Association Tax Section comments on proposed regulations (the **"Proposed Regulations"**) issued by the Internal Revenue Service ("**IRS**") and the Department of the Treasury ("**Treasury**") to implement Section 864(c)(8)[1] as amended by "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97.[2]

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1 Unless otherwise indicated, all Section (and §) references are to the Internal Revenue Code of 1986, as amended (the "**Code**"), or the Treasury Regulations promulgated thereunder.

2 The principal drafters of this Letter are Lee E. Allison and Robert Cassanos with helpful comments from Kimberly S. Blanchard, Andrew H. Braiterman, Peter J. Connors, Meyer H. Fedida, Phillip J. Gall, Andrew W. Needham, Richard Nugent, Deborah L. Paul, Richard L. Reinhold, Michael L. Schler, Stephen E. Shay, Chris Shim, Michael A. Shulman, Michael B. Shulman, Eric B. Sloan and Dana L. Trier. This Letter reflects solely the views of the Tax Section of the New York State Bar Association and not those of the Executive Committee or House of Delegates of the New York State Bar Association.

This Letter supplements our prior report (the "**Prior Report**") dated August 10, 2018, which requested guidance under Section 864(c)(8)[3]. We commend the IRS and Treasury for their efforts in drafting the Proposed Regulations, as Section 864(c)(8) is a new statutory provision and the Proposed Regulations are thoughtful and comprehensive. Given the extensiveness of the Prior Report and the detail contained in the Proposed Regulations (and the preamble thereto (the "**Preamble**")), this Letter comments only on (i) Section 731 nonrecognition transactions, (ii) the U.S. office attribution rule, (iii) the role of treaties and (iv) the ten-year exception.

A. Section 731 Nonrecognition Transactions.

Proposed Regulations Section 1.864(c)(8)-1(b)(2)(ii) provides that a foreign transferor will not recognize gain or loss under Section 864(c)(8) to the extent that such gain or loss is not recognized by reason of a non-recognition provision of the Code. However, the Preamble to the Proposed Regulations notes that Treasury and the IRS:

> continue to consider, and comments are requested regarding, whether other Code provisions adequately address transactions that rely on section 731 distributions to reduce the scope of assets subject to U.S. federal income taxation . . . .

The Prior Letter and Prior Report contain detailed discussions of nonrecognition transactions in general and Section 731 transactions in particular[4] but did not discuss the specific subject as to which the Preamble requested comments. Thus, we turn to that subject below.

Several provisions of current law could have potential application to the Section 731 fact pattern discussed in the Preamble. We discuss below the partnership anti-abuse rule, judicial doctrines (such as substance over form and step transaction), and Section 864(c)(7). As noted below, application of each of these provisions of current law presents challenges.[5]

1. Partnership Anti-Abuse Rule (§1.701-2).

The partnership anti-abuse rule has two main prongs. First, a transaction may be recast if the results obtained are inconsistent with the intent of Subchapter K.[6] Second, even if not inconsistent with Subchapter K, a partnership transaction may be treated as an aggregate rather than an entity if aggregate treatment is more appropriate unless there is a statutory or regulatory provision requiring entity treatment.[7]

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3 The Prior Report supplemented our prior letter (the "**Prior Letter**") to the IRS and Treasury, dated February 2, 2018 requesting immediate guidance under Section 864(c)(8). The Prior Letter and Prior Report are attached to this Letter as Appendices. 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).

4 See pages 9-11 of the Prior Letter and pages 12-18 of the Prior Report.

5 We note that Subchapter K includes several provisions governing partnership distributions that could also be pertinent depending on the facts, such as Sections 704(c)(1)(B), 707 and 737.

6 Treas. Reg. §1.701-2(b).

7 Treas. Reg. §1.701-2(e).

Turning to the examples contained in the Prior Report, there were three main fact patterns outlined, each involving a partnership ("**PRS**") having partners that included at least one U.S. person ("**USP**") and one foreign person ("**FP**") where PRS contained both U.S. trade or business ("**USTB**") assets and non-USTB assets. The Prior Report assumed that all of the assets of PRS had a zero tax basis.

First, the partners could change their business arrangement in a way which resulted in greater amounts of effectively connected income ("**ECI**") being allocated to USP and lower amounts of ECI being allocated to FP, assuming compliance with Section 704(b) (including the rules applicable to so-called "reverse Section 704(c) allocations"). Second, USP could be redeemed out of PRS for USTB assets, leaving FP as a partner in PRS with a greater allocation of non-USTB items. Third, FP could be redeemed out of PRS for non-USTB assets, leaving USP as a partner in PRS with a greater allocation of USTB items.

The Prior Report observed that, unlike the first two fact patterns, the third fact pattern was clearly subject to Section 864(c)(8) as a jurisdictional matter because FP exchanged its interest in PRS for non-USTB assets. Accordingly the balance of our comments below are focused on this fact pattern, the fact pattern raised in the Preamble. The Prior Report also noted that in none of the three fact patterns did the amount of ECI subject to tax by the U.S. diminish. In all three fact patterns, 100% of the income, gain or loss attributable to the USTB remained in the U.S. tax net. But, in all three fact patterns, some or all of the income, gain or loss attributable to the non-USTB assets was shifted from USP to FP and therefore removed from the U.S. tax net. Thus, a question is whether any of these fact patterns violates the policies underlying Section 864(c)(8) which appear centered on protecting the USTB tax base. The Prior Report also noted, but did not discuss, that the stakes could potentially be different if the assets of PRS have substantial tax basis.

In terms of the partnership anti-abuse rule, it does not appear that the fact patterns fall squarely within either prong of the rule, at least on the facts presented in the Prior Report. As to the first prong, Treasury Regulations Section 1.701-2(a) states that implicit in the intent of subchapter K are the following requirements: (i) the partnership must be bona fide and each transaction must be entered into for a substantial business purpose, (ii) the form of each partnership transaction must be respected under substance over form principles and (iii) the tax consequences under subchapter K to each partner must accurately reflect the partners' economic agreement and clearly reflect the partner's income. The first two requirements are discussed below in our discussion of common law doctrines. It is arguably difficult to see how the third requirement is implicated in this fact pattern. Both USP and FP continue to recognize the proper amount of income at the proper time—it is just that the income recognized by FP is not ECI. An arguably analogous scenario would involve a tax-exempt partner receiving in a Section 731 transaction assets that do not give rise to unrelated business taxable income ("**UBTI**") from a partnership containing both UBTI and non-UBTI assets. Assuming strong business purpose and economic substance, it is arguably difficult to see how such a transaction violates the clear reflection of income requirement of the anti-abuse prong of the anti-abuse rule.

The second prong of the anti-abuse rule (aggregate treatment) would appear to be governed by Sections 741 and 864(c)(8). These sections already prescribe a specific and unique amalgam of aggregate and entity concepts and would therefore appear to preempt invocation of this prong of the anti-abuse rule as it stands currently. That is, it is difficult to see how this prong of the anti-abuse rule under current law could compel a treatment not otherwise required under Section 864(c)(8) and the regulations thereto.

We also considered whether the arguments above could change if one assumed, contrary to the Prior Report, that PRS had substantial tax basis in its assets. To take the "worst" fact pattern, assume that the USTB assets have zero basis and the non-USTB assets have full basis and that FP has a zero basis in its interest in PRS. In the third fact pattern, where FP is redeemed for non-USTB assets, it would appear that FP would take the distributed non-USTB assets with a zero basis under Section 732(a)(2) or (b) and that, if PRS has a Section 754 election in effect, PRS would increase its basis in the retained USTB assets under Section 734(b)(1)(B). This increased basis arguably represents erosion of the tax base attributable to the USTB if the increased basis is depreciable or amortizable or the USTB is subsequently sold in a taxable transaction. In other words, not only is the income producing potential of the non-USTB asset removed from the U.S. tax net (because USP no longer has an interest in the USTB assets) but the remaining tax base of the USTB may also be reduced (because basis in those assets has been increased). This result does not appear as likely in the first two fact patterns—where the re-alignment occurs as a result of a change in partnership allocations there is no shift in basis and where a shift in basis occurs as a result of the distribution of USTB assets (which may be an unusual case) it is likely to be from USTB assets to non-USTB assets, in effect a form of reverse base erosion.

Thus, the analysis whether this specific fact pattern involves an abuse of Subchapter K may differ from the analysis in a case that does not involve increasing basis in USTB assets, especially if one believes that the focus of Section 864(c)(8) is protecting the ECI tax base from erosion as opposed to a broader anti-base erosion principle. However, in this regard we note that this basis-shifting result is by no means unique to this fact pattern. For example, the same result could occur in the example above involving taxable and tax-exempt partners, or if PRS had two foreign partners. Thus even this basis-shifting fact pattern might not represent an abuse of Subchapter K as distinguished from a general result flowing from the present Subchapter K rules which could perhaps be the subject of a separate inquiry.

2. Judicial Doctrines.

Judicial doctrines such as the step-transaction doctrine[8] and the *Court Holding* doctrine[9] could have potential application depending on the facts. For example, one could posit a case in which PRS has low basis USTB assets and recently acquired high basis non-USTB assets and uses its high basis non-USTB assets to redeem FP. Perhaps the non-USTB assets were acquired at FP's direction in order to facilitate a tax efficient redemption of FP. While each case must be considered on its own facts, the Service recently raised step transaction and economic substance arguments in a similar case without success.[10]

By the same token, judicial doctrines could potentially be invoked in a case in which USP and FP wanted to sell all the assets of PRS and attempted to minimize tax under Section 864(c)(8) by distributing the USTB assets to USP and the non-USTB assets to FP. In one case, USP and FP might then sell the respective assets distributed to each of them to the same third party. Alternatively, in a less extreme case, USP and FP could sell their respective assets to different parties without any pooling of consideration or crossing of indemnities. Taxpayers who have a mix of business and non-business motives may be able to structure their transactions to avoid application of judicial doctrines. Thus, while judicial

8 *Waterman S.S. Corp. v. Commissioner*, 430 F.2d 1185 (5th Cir. 1970), *cert. denied*, 401 US. 939 (1971).

9 *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

10 *Countryside Ltd. P'ship v. Comm'r*, T.C. Memo 2008-3 (Jan. 2, 2008)

doctrines may well have application in some fact patterns involving Section 731 distributions which implicate the policies behind Section 864(c)(8), such doctrines may be inapplicable in other cases.

3. Section 864(c)(7).

Section 864(c)(7) states that if any property ceases to be used or held for use in connection with the conduct of a USTB, and is sold within ten years, then the determination whether the sale proceeds are taxable as ECI is made as if the sale occurred immediately before the cessation. Therefore, a foreign taxpayer who withdraws assets from a USTB and sells such assets within ten years will generally recognize gain or loss upon the sale. Although a full analysis of Section 864(c)(7) is beyond the scope of this Letter, we do not believe that Section 864(c)(7) should apply to transactions with respect to partnership interests (including Section 731 distributions).

The partnership interest is not actually held for use or used in a trade or business. The partnership's assets are so used and held for use. To the extent either Section 864(c)(8) or Revenue Ruling 91-32 requires gain or loss on a sale of the partnership interest to be treated as ECI, that is the result of a specific statutory or administrative treatment. It does not change the actual nature or use of the assets in question. Thus, as a technical matter, the provision does not appear to apply to a sale of a partnership interest.

Moreover, as a substantive matter, it does not appear appropriate that Section 864(c)(7) should apply to partnership interests as doing so would cause disparities between the treatment of sales of partnership interests and assets. For example, suppose a partnership dropped its USTB into a domestic corporation (not a United States real property holding corporation) in a Section 351 transaction and then a foreign partner sold the foreign partner's partnership interest within the next ten years. If Section 864(c)(7) applied to partnership interests, then the sale by the foreign partner would apparently be subject to tax even though no tax would be due under Section 864(c)(7) if the partnership sold its stock in the corporation (assuming no step transaction). That inconsistency is directly contrary to the branch consistency approach advocated in the Prior Report and implicitly adopted in the Proposed Regulations. It is also inconsistent with Section 864(c)(8)(B)(i)(I) (the "**Limiter**" rule discussed more fully below in our discussion of the USOAR, as defined below). The purpose of Section 864(c)(8) is to "level the playing field" by promoting greater parity between partnership asset and partnership interest sales. Applying Section 864(c)(7) to partnership interests creates the opposite result, namely, increasing the potential differences between asset and interest transfers.

Assuming then that Section 864(c)(7) should not apply to partnership interests as a general matter, the remaining question is whether Treasury could somehow apply Section 864(c)(7) on a "rifle shot" basis to Section 731 transactions. Even assuming Section 864(c)(7) can reach this case, we do not believe it should be so applied because doing so would either increase disparities between sales of partnership interests and assets, result in significant complexity, or both. We believe that such a "rifle shot" approach would if anything be more complex than regulations which could instead be promulgated under the authority of Section 864(c)(8) addressing the issue directly.

B. U.S. Office Attribution Rule.

Under Section 864(c)(8), gain or loss on a sale by a foreign partner of an interest in a partnership that has a USTB is treated as ECI, subject to Section 864(c)(8)(B), the Limiter rule. The Limiter rule limits the amount of gain or loss treated as ECI to the foreign partner's allocable share of such gain or loss that would be so treated if the partnership had actually sold all of its assets. The Proposed Regulations, for purposes of determining this deemed effectively connected gain or loss upon a sale of an asset, treat such deemed asset sale gain or loss as attributable to "an office or other fixed place of business maintained by the partnership in the United States" (a "**U.S. Office**"), and the assets deemed sold are not treated as sold for use, disposition or consumption outside the United States in a sale in which an office or other fixed place of business maintained by the partnership in a foreign country materially participated in the sale (the "**USOAR**"), unless (i) no income or gain previously produced by the asset was taxable as ECI by the partnership during the ten-year period ending on the date of the transfer, and (ii) the asset was not used, or held for use, in the conduct of a trade or business within the United States by the partnership during the ten-year period ending on the date of transfer (the "**Ten-Year Exception**").[11] The general effect of the USOAR is to treat all such deemed asset sales as U.S. source except to the extent that the Ten-Year Exception applies.[12] The Preamble requested comments as to whether additional guidance is needed regarding the "source of gain or loss resulting from a deemed sale by the partnership, including rules coordinating this rule with Section 865(e)(2)(B)."

We believe that the guiding principle should be that the sale of a partnership interest by the foreign partner should not produce a better or worse result than if PRS had actually sold its assets. This principle is consistent with the wording of Section 864(c)(8)(B), limiting the gain or loss calculation to that gain or loss that would result if actual assets were sold. It is also consistent with the general principle of Section 864(c)(8) to promote greater parity between partnership asset and partnership interest sales. In light of this overarching principle, as well as the statutory language of the Limiter rule, we believe the USOAR is over-inclusive as discussed below.

As background, under Section 864(c)(3), all U.S. source income that is not covered by Section 864(c)(2) (so-called "FDAP" income and capital gain) is classified as ECI. Section 865 generally provides that, except as otherwise provided in Section 865, income from the sale of personal property by a nonresident is sourced outside the United States.[13] These source rules for sales of personal property by partnerships are applied at the partner level, except as provided in regulations.[14] Section 865(e)(2) treats income from the sale of personal property (including inventory) by a nonresident that is attributable to a U.S. office as U.S. source, unless, in the case of inventory, such inventory is sold for foreign use, disposition or consumption with material participation of a foreign office. The relevant regulations regarding office attribution require that to be "attributable" to a U.S. office, the office must have been "a material factor in the realization of the income, gain or loss" in question and that such income, gain or loss must be realized "in the ordinary course of the trade or business carried on through that office".[15] Thus, for example, if an item of income,

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11 Prop. Reg. §§1.864(c)(8)-1(c)(2)(i) and 1.864(c)(8)-1(c)(2)(ii).

12 Other exceptions could arise, for example, to the extent the assets in question consisted of non-U.S. real property.

13 Section 865(a).

14 Section 865(i)(5). No such regulations have been issued.

15 Treas. Reg. §1.864-6(b)(1). For purposes of Section 865, Section 865(e)(3) provides that the principles of Section 864(c)(5) shall apply. Treas. Reg. 1.864-6(b)(1) defines those principles for purposes of Section 864(c)(5). No regulations have been promulgated implementing those principles specifically for purposes of Section 865.

gain, or loss is of a type whose source is affected by the office to which the sale is attributable, the effect of the USOAR appears to be to turn the deemed gain or loss from that asset into U.S. source gain or loss regardless of what would have occurred had the asset in question actually been sold, unless the Ten-Year Exception applies. The U.S. source gain in turn would then appear to be ECI in many if not all cases unless it is capital gain (in which case it would still be ECI if either the so-called "asset use" or "business activities" test of Section 864(c)(2)(A) and (B), respectively, were satisfied with respect to such asset).

To illustrate the potential reach of the USOAR, consider an example whose facts are substantially similar to those set forth in Treasury Regulations Section 1.864-4(b), Example (3), except that S is a partnership, rather than a foreign corporation. S has two businesses, a business with a U.S. Office engaged in dealing in electronic equipment and a foreign business (without any U.S. Office) engaged in selling vintage wines, some of which are sold to customers in the United States The example concludes that under the so-called "force of attraction" principle of Treasury Regulations Section 1.864-4(b), the U.S. source wine sales are ECI.[16] Assume that both businesses have inventories, goodwill, and other intangible assets (trademark, workforce in place, customers' lists, etc.).

Now suppose a partner in S sells its interest. Consider first the effect of the USOAR on the deemed sale of the inventory of the wine business. Under the USOAR, the wine inventory would be treated as having been sold by a U.S. Office, presumably the one handling the electronics sales, even though an actual sale of the wine inventory as part of a bulk sale of the vintage wine business might not meet the test for attribution to a U.S. Office under Treasury Regulations Section 1.864-6(b)(1). Further, under the USOAR, the sale would be treated as for use and consumption in the United States without material participation by the foreign office. Thus, unless the Ten-Year Exception applied it would appear that the entire inventory of the vintage wine business could be treated as giving rise to deemed ECI, while in the case of an actual sale, assuming that title and risk of loss passed outside the United States, and no U.S. office materially participated in the sale, presumably none of the gain would have been U.S. source or ECI.[17]

As to the Ten-Year Exception in respect of the wine inventory, it is not at all clear how the Ten-Year Exception applies, given that there were sales of wine inventory to U.S. customers in the last ten years. If the Ten-Year Exception were applied on a "bottle by bottle" or "case by case" basis, then the Ten-Year Exception would always seem to apply, because, by definition, the individual bottles or cases that were the subject of the deemed sale had never actually been sold (leaving aside the very rare occasions of a reacquisition within the ten year period). On the other hand, perhaps the wine inventory should be viewed as a single unitary "mass" asset for this purpose. In that case, because some of the gain from that asset had been treated as ECI within the past ten years presumably the entire inventory would now be tainted. It is not clear this interpretation was intended either.[18] However if that is the proper interpretation of the USOAR, then, although the vintage wine business had no real U.S. nexus other than sales to U.S. customers, it appears that the

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[16] Section 861(a)(6) treats income from the purchase of inventory property outside the United States and its sale within the United States as U.S. source.

[17] Sections 861(a)(6) and 864 (c)(4)(B)(iii).

[18] Note that many types of inventory are even more readily viewed as a mass asset than vintage wine and thus may be even more susceptible to failing the Ten-Year Exception under facts similar to those in the example in the text if inventory is treated as a mass asset for purposes of the Ten-Year Exception.

USOAR could treat the deemed sale of the entire vintage wine business inventory as giving rise to ECI, a result that might not apply if S actually sold its assets.

Turning now to the intangibles, including the goodwill, customer list, and so forth, presumably some value (perhaps a great deal of value) would be attributed to these types of assets. Although not entirely clear, if the intangibles are Section 1231 assets, commentators appear to believe they should be subject to the full "force of attraction" principle even if the gain resulting from a sale of such intangibles would be capital gain. This is because the intangible assets themselves are not necessarily capital assets, but rather they are assets described in section 1231 whose sale may give rise to capital gain.[19] If that analysis is correct, then it appears that the deemed sale of these intangibles (goodwill, customer list, etc.) would be U.S. source[20] and fully subject to force of attraction.[21] Therefore that gain will also be deemed ECI unless the Ten-Year Exception applies.

The Ten-Year Exception requires *inter alia* that no income or gain previously produced by the asset was taxable as ECI during the ten-year period ending on the date of the transfer. This business has had some ECI during the last ten years. If any portion of this ECI was "produced" by any or all of these intangible assets, are those assets now also tainted? For example, suppose the customer list includes the address of the U.S. customer whose sale gave rise to ECI. Has the customer list therefore "produced" ECI? If so, is the entire customer list now tainted? Or is the status of the list unaffected by the prior ECI? As was the case with the discussion of inventory, the test seems to be susceptible of two interpretations, one of which is clearly over-inclusive, one of which may be under-inclusive. Perhaps only the portion of the value of the list properly allocable to U.S. customers should not be eligible for the Ten-Year Exception. While this approach might be the most theoretically precise, it would be very difficult to apply even in an actual asset sale. By contrast, we would expect in an actual asset sale of the vintage wine business that the sale may well have been negotiated from an office outside the United States and none of the gain may have been U.S. source or ECI except for the portion of the goodwill (if any) of the business which arose in the United States.[22]

Note that the foregoing analysis is of a very simplified and extreme case. In practice, multi-branch or multi-business partnerships are likely to present more complex fact patterns, which could be more difficult to resolve. Thus, while the foregoing example relies on the force of attraction principle, we do not believe the issues involving the USOAR are limited to fact patterns involving that principle. For example, the same

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[19] One commentator has noted that, while ambiguous, language in the legislative history under H.R. Rep. No. 1450, 89th Cong., 2d. Sess. 58 (1966) providing that gain or loss must be "derived from the sale or exchange of property which is a capital asset (as defined in sec. 1221 of the code)" may support the proposition that 864(c)(2) focuses on the type of asset being sold, rather than the character of the gain. See Harvey Dale, Effectively Connected Income, 42 Tax L. Rev. 689, 700; see also Yaron Reich, U.S. Federal Income Taxation of U.S. Branches of Foreign Banks: Selected Issues and Perspectives, 2 Fla. Tax Rev. 1, 7.

[20] The gain would be U.S. source even in the case of goodwill because of the deemed participation under the USOAR by the U.S. office making the goodwill attributable to such deemed office. Section 865(e)(2)(A).

[21] Section 864(c)(3).

[22] In the case of intangibles other than goodwill, assuming consideration was not based on productivity or use, gain would be sourced to the partner's residence unless attributable to a U.S. office. Sections 865(d) and 865(e)(2). With respect to goodwill, the gain would have been sourced to the country where it arose unless attributable to a U.S. office. Sections 865(d)(3) and 865(e)(2).

considerations would be relevant and the same concerns could arise if S's U.S. business was also a vintage wine selling business and each office handled customers in different geographic locations but they occasionally fulfilled orders for each other.

We believe that the foregoing discussion indicates that the USOAR is too blunt an instrument to solve an admittedly difficult problem. While the necessity of determining source in the case of a hypothetical transaction is a daunting task, we believe the basic problem arises not because of Section 864(c)(8) but because the underlying source rules are in large part dependent on fact-specific determinations which can readily be made if at all only in the context of an actual sale. This reality makes it difficult to resort to "facts and circumstances" as a backstop--there are none. Moreover, in the case of an actual asset sale, the relevant facts may in many cases be within the control of the taxpayer. Thus, ironically, if one were to resort to a presumption which was most likely to conform to the reality of an actual asset sale, then the "realistic" presumption should be one of tax minimization to the extent within the taxpayer's control. But, this approach may not be satisfactory either. Another approach would be to look to relevant assets whose sourcing is not based on residency to any extent. For example, goodwill is sourced to the country where it arose unless the office attribution rule applies.[23] Thus, using the source of gain or loss on the sale of goodwill (without a hypothetical office participation) as a proxy for the source of goodwill and other deemed asset sale gain or loss may be a reasonable approach to what would otherwise seem to be either a very complex or very one-sided determination (possibly both). If desired, a separate rule could be adopted for inventory sales which rule could look to past sources of inventory sales on some sort of average basis over some period of time, although this could require more information than might be readily obtainable in some cases. Special rules could be imagined for other types of assets, although all of these rules would seem to be subject in many cases to the same issues about obtaining relevant historical facts.

C. Treaties.

The Proposed Regulations provide that for purposes of applying Section 864(c)(8) to gain of a treaty resident on a sale of a partnership interest, treaty provisions applicable to gains from the alienation of property forming part of a permanent establishment ("**PE**"), including gains from the alienation of a PE in the United States, apply to the transfer by a foreign partner of an interest in a partnership with a PE in the United States. It is unclear whether this rule switches off the USOAR. As mentioned, we believe that a guiding principle is to "level the playing field" between partnership asset sales and partnership interest sales. Thus, since the USOAR would not apply to a treaty-eligible partner in the case of an actual sale of assets by the partnership, the same result should apply in the case of a treaty-eligible partner that sells its partnership interest. Indeed, even if final regulations replace the USOAR with another approach, we believe treaty principles should apply instead in the case of a treaty-eligible partner.

Further, consider a foreign hybrid (a partnership for U.S. tax purposes, but a corporation for purposes of the tax regime of the hybrid's jurisdiction of residence) which has a USTB with ECI that is exempt from U.S. tax because the foreign hybrid has no U.S. PE. If the foreign hybrid sold its assets, none of its owners would be subject to U.S. tax

[23] Sections 865(d)(3) and 865(e)(2).

because of the treaty between the United States and the hybrid's jurisdiction.[24] The same result should apply if a foreign owner of the hybrid entity sells its interest in the entity. By the same token, if the hybrid has a U.S. PE but the gain attributable to that U.S. PE differs from that which would be attributable to its USTB if it were not treaty-eligible, then in the case of an actual sale of assets, only the gain attributable to the PE under the treaty would be taxable. In all these cases, the tax results on sale of partnership interests should be conformed to those which would arise had assets been sold unless there is some good reason for the departure.

Further, to the extent that similar rules apply under Section 883 or other Sections of the Code to foreign hybrid entities which are the beneficiaries of a mutual agreement other than a bilateral income tax treaty or are otherwise entitled to a particular benefit under the Code which would have the effect of limiting the U.S. tax on the sale of their assets, the same principles should apply in the case of a sale of interests in the entity. This result is not dependent on the specific agreement in question. Rather it stems from the principles of Section 864(c)(8) itself and the application of the Limiter rule.

Finally, we repeat the recommendations in the Prior Letter and the Prior Report that (i) the final regulations provide explicit guidance for treaty-based holders which are treated as having ECI but have no PE in the United States that they are exempt from Section 864(c)(8), and (ii) future treaties make clear that gains on a sale of a partnership interest, to the extent the partner's share of unrealized gain in the partnership's assets is properly attributable to a PE of the partnership in the United States, should be subject to tax and that attribution should be governed by typical treaty rules. For instance, if a partnership sold an asset, and gain or loss was not "attributable to" a U.S. PE, under a treaty provision similar to Article 7(1) of the U.S. Model Income Tax Convention, the treaty should not allow the gain to be taxed in the United States, and to the extent that was the case, in the case of a partnership interest sale, any portion of the seller's gain attributable to that asset should similarly be treaty-protected (leaving aside the unusual case where the sale was attributable to a PE maintained by the foreign partner in the United States, for example the foreign partner was a dealer in partnership interests and the sale was connected to a dealing business carried on by a U.S. PE).

D. Ten-Year Exception.

We ask that the final regulations clarify that if an asset would otherwise qualify for the Ten-Year Exception but was held by PRS for less than ten years, such asset would qualify for the Ten-Year Exception.

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[24] This result would apply even with respect to partners who are not themselves treaty residents. See generally New York State Bar Association Tax Section Report No. 1373, *Report on Application of Section 894 to Effectively Connected Income of Hybrid Entities* (June 13, 2017).

We appreciate your consideration of our Letter. 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. 1387
February 2, 2018

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

Dear Messrs. Kautter and Paul:

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

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

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

I. Background

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

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

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

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

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

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

II. <u>Recommendations Regarding Section 1446(f)</u>

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

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

[2] *See* N.Y. St. Ba. Ass'n, Tax Sec., *Report on Guidance Implementing Revenue Ruling 91-32* (Jan. 21, 2014).

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

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

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

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

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

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

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

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

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

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

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

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

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

2. Allow Transferees to Rely on Certifications

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

IV. Other Issues to be Addressed

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

- the fact that the mechanical application of Section 864(c)(8) may result in the taxation of the same items of unrealized gain in USTB assets more than once in the case of partial transfers of a partner's interest or multiple transfers of the same partnership interest,

- the effect, if any, of special allocations of income, gain, loss or deduction on the application of Section 864(c)(8), including the intended effect of the flush language following Section 864(c)(8)(B),

- how to make determinations necessary to apply the Provisions when partnership interest transfers occur during the middle of a tax accounting period,

- the manner of determining the source of effectively connected gain or loss recognized under Section 864(c)(8),

- the interaction of the Provisions with the FIRPTA tax and withholding regime of Sections 897 and 1445,

- the interaction of the Provisions with the partnership audit rules of the Bipartisan Budget Act of 2015,

- the application of the Provisions to tiered partnership arrangements,

- the effect of a shift in a foreign partner's share of USTB assets in a transaction not otherwise resulting in the recognition of gain or loss,

- the application of Section 1446(f) where proceeds are received by a partner in connection with a transaction treated as a disguised sale of a partnership interest,

- whether the secondary liability of a partnership to withhold tax under Section 1446(f) where the transferee failed to do so continues to apply after the transferee transfers the acquired interest to another party,

- the manner in which tax should be withheld under Section 1446(f) in the case of transfers of PTP interests,

- the manner in which a partnership with a USTB may confirm that tax has been withheld on a transfer of a partnership interest in order to eliminate its secondary obligation to withhold on distributions to the transferee, and

- definitional issues with respect to the defined terms provided in Section 1446(f), including the fact that (i) the "transferor" and "transferee" as used in Section 1446(f), by virtue of its cross-reference to Section 1445, appear to be limited to the persons who transfer or receive a "U.S. real property interest" (rather than the partnership interest) and (ii) a "qualified foreign pension fund" is apparently permitted to avoid withholding by providing a nonforeign affidavit (even though such a fund would still be subject to tax on a partnership interest transfer).

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

* * *

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

Respectfully submitted,

Karen G. Sowell

Karen Gilbreath Sowell
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NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON SECTIONS 864(c)(8) and 1446(f)

August 10, 2018

CONTENTS

The New York State Bar Association Tax Section (the "***Tax Section***") is submitting this report (the "***Report***")[1] to request guidance under Sections 864(c)(8) and 1446(f) (collectively, the "***Provisions***") of the Internal Revenue Code of 1986, as amended (the "***Code***"), which were added to the Code pursuant to P.L. 115-97 (the "***Act***") on December 22, 2017.[2] This report supplements our letter (the "***Prior Letter***")[3] to the Internal Revenue Service (the "***Service***") and the Department of the Treasury ("***Treasury***") dated February 2, 2018 requesting immediate guidance with respect to the Provisions in order to allow affected transactions to proceed in a workable manner while the government considers how to address the broader set of issues raised by the Provisions.

I. Background

Section 864(c)(8) provides that gain or loss of a nonresident alien individual or foreign corporation from the sale, exchange or disposition of a directly or indirectly held partnership interest generally is treated as effectively connected with the conduct of a U.S. trade or business (a "***USTB***") to the extent that such gain or loss does not exceed the gain or loss such person would have recognized as effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the transfer. Section 1446(f) provides that a transferee of such a partnership interest generally must withhold tax equal to 10% of the amount realized upon the disposition of a partnership interest if any gain on the transfer of such interest would be treated as effectively connected with the conduct of a USTB under Section 864(c)(8).

The enactment of Section 864(c)(8) was intended to override the result in *Grecian Magnesite Mining Co. v. Commissioner*, 149 T.C. No. 3 (July 13, 2017), *appeal docketed*, No. 17-1268 (D.C. Cir. December 18, 2017) ("***GMM***"). In *GMM*, the Tax Court held that gain recognized on a sale or exchange by a foreign person of an interest in a partnership that is engaged in a USTB generally does not constitute income that is effectively connected with a USTB ("***ECI***"). In *GMM*, the court rejected the position of the Service in Rev. Rul. 91-32, 1991-1 C.B. 107, that gain or loss recognized by a foreign person upon its disposition of a partnership interest generally constitutes ECI or effectively connected loss ("***ECL***") to the extent of the foreign person's distributive share of unrealized gain or loss of the partnership attributable to effectively connected property of the partnership.

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1 The principal drafters of this Report were Robert Cassanos and Michael Shulman. Substantial assistance was provided by Ze'ev Deutsch and Adam Sternberg. Helpful comments were received from Stanley A. Barsky, Kimberly S. Blanchard, Peter H. Blessing, Andrew H. Braiterman, Peter J. Connors, Charles W. Cope, Timothy J. Devetski, Phillip J. Gall, Rafael Kariyev, Michael Karlin, Abraham Leitner, Michael Miller, Erika W. Nijenhuis, Harsha Reddy, Tyler Robbins, David R. Sicular, Michael L. Schler, David H. Schnabel, Eric B. Sloan, Karen G. Sowell, Chaim Stern, and Gordon E. Warnke. This letter reflects solely the views of the Tax Section of the New York State Bar Association ("***NYSBA***") and not those of the NYSBA Executive Committee or the House of Delegates.

2 All Section references herein are to the Code unless otherwise indicated.

3 *See* N.Y. ST. BA. ASS'N, TAX SEC., *Request for Immediate Guidance under Sections 864(c)(8) and 1446(f)* (Feb. 2, 2018).

Section 864(c)(8) differs in certain important respects from the holding in Rev. Rul. 91-32 and is ambiguous in many respects. Moreover, Rev. Rul. 91-32 itself raised numerous interpretative questions, resulting in substantial commentary from practitioners, the issuance of a prior report by the Tax Section[4] and the initiation of a project at the Treasury and the Service regarding the implementation of the ruling.[5] Most of these questions continue to apply to the application of Section 864(c)(8). In addition to overriding the result in *GMM* in Section 864(c)(8), Section 1446(f) imposes a new withholding regime on transfers of partnership interests.

On January 2, 2018, Treasury and the Service issued Notice 2018-8, 2018-7 I.R.B. 352 (Jan. 2, 2018), which suspended all withholding in connection with the sale or other disposition of publicly traded partnership ("***PTP***") interests under Section 1446(f) until regulations or other guidance under such section are issued. Notice 2018-8 also requested comments on whether a temporary suspension of Section 1446(f) withholding for partnership interests other than PTP interests is needed and what additional guidance may be needed to assist taxpayers in applying the Provisions.

In response to requests for immediate guidance and temporary relief from certain aspects of the Provisions (including the Prior Letter), Treasury and the Service issued Notice 2018-29, 2018-16 I.R.B. 495 (Apr. 2, 2018) (the "***Notice***"). The Notice provided, among other things that:

- until regulations are issued, transferees required to withhold under Section 1446(f)(1) must use the rules in Section 1445 and the regulations thereunder for purposes of reporting and paying over the tax;

- Treasury and the Service intend to issue regulations providing that:

    - if the transferee receives a certification issued by the transferor stating that the transfer of its partnership interest will not result in realized gain, a transferee may generally rely on the certification and be relieved from liability for withholding under Section 1446(f);

    - no withholding is required under Section 1446(f)(1) upon the transfer of a partnership interest if the transferee receives from the transferor a certification that for the transferor's immediately prior taxable year and the two taxable years that precede it (i) the transferor was a partner in the partnership for the entirety of each of those years, and (ii) the transferor's allocable share of ECI for each of those taxable years was less than 25% of the transferor's total distributive share of income for that year;

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

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

- o no withholding is required under Section 1446(f)(1) upon the transfer of a partnership interest if the transferee is provided a certification certifying that if the partnership had sold all of its assets at their fair market value, the amount of gain that would have been ECI would be less than 25% of the total gain;

- o no withholding is required under Section 1446(f)(1) upon the transfer of a partnership interest if the transferee receives from the transferor a notice that satisfies the requirements of Treas. Reg. § 1.1445-2(d)(2);

- o a transferee generally may rely upon a certification in determining the amount of liabilities of the partnership that are included in the amount realized on a transfer for purposes of Section 1446(f); and

- o if a partnership makes a distribution to a partner, the partnership generally may rely on its books and records, or on a certification received from the distributee partner, to determine whether the distribution exceeds the partner's basis in its partnership interest.

The Notice also requested comments on several issues, including the following:

- rules for determining the amount realized, including when the amount of required withholding may exceed the proceeds of a sale of a partnership interest;

- procedures for reducing the amount required to be withheld, such as limiting the withholding to the tax on the gain recognized (if determinable);

- rules implementing the requirement for a partnership to withhold under Section 1446(f)(4) on distributions to a transferee that fails to withhold under Section 1446(f)(1); and

- rules that should apply under Sections 864(c)(8), 897, 1445, and 1446(f) when a partner disposes of an interest in a partnership that holds both U.S. real property interests ("***USRPIs***") and other property used in the conduct of a USTB.

II. Summary of Proposed Recommendations and Requests for Guidance

A. <u>Nonrecognition Transactions</u>

- Regulations should confirm the Provisions do not override normal nonrecognition provisions except in cases in which either (a) a similar transaction engaged in by a foreign partner with a U.S. branch would not be entitled to nonrecognition or (b) in cases where there is no similar or analogous branch transaction (for example, in certain Section 731 transactions) and there is substantial base erosion. In the case of situations described in clause (b) of the preceding sentence, consideration should be given to conditioning the override of normal nonrecognition principles on whether the transaction is deemed abusive in nature taking into account the particular facts and circumstances, rather than applying a mechanical override rule.

B. Acceleration and Duplication of Effectively Connected Gain and Loss

- Regulations should adopt a "proportionality" rule similar to that set forth in Rev. Rul. 91-32 to minimize the likelihood of accelerating and double counting of ECI and ECL.

- Alternatively, regulations should prevent the double-counting of the same unrealized gains and losses in assets used in a USTB in multiple transfers by the same foreign person.

C. Treatment of Partnership Distributions

- Regulations should confirm that distributions within basis are not subject to withholding at all and that absent disguised sale treatment, withholding applies only to the amount of money distributed (if any) which exceeds basis.

- If desired, consideration could be given to imposing withholding on the entire amount of distributions in excess of basis, but allowing partnerships to make an election to withhold on only the effectively connected portion of the amount of a distribution in excess of basis, but at the maximum applicable statutory rate rather than at a 10% rate.

D. Application of the Provisions to Tiered Partnerships

- Regulations should confirm that sales of interests in upper-tier partnerships are subject to the Provisions even where the only assets held by such upper-tier partnership are interests in lower-tier partnerships holding USTB assets.

E. Limitation of Gain/Loss Under Section 864(c)(8)

- Regulations should clarify that a foreign partner first must determine how much gain or loss it recognizes in connection with a partnership interest sale (including by virtue of Section 751(a)), and then apply Section 864(c)(8) to determine whether any of such gain or loss should be recharacterized as ECI or ECL.

F. Partnership Determinations of Fair Market Value

- In applying the hypothetical allocation regime of Section 864(c)(8), regulations should require the partnership to assign an aggregate value to its assets such that, if the partnership were to sell all of its assets for that aggregate value, it would result in the partnership (after payment of its liabilities) distributing an amount in respect of the transferred interest that is equal to the amount paid to the foreign partner for such interest.

G. Effect of Distributive Share Provision

- Regulations should confirm that the hypothetical allocation regime of Section 864(c)(8) should take into account any special allocations of the partnership.

H. Source of Gain Recognized Under Section 864(c)(8)

- Regulations should confirm that (a) Section 864(c)(8) has no bearing or impact on source; and (b) the source of gain or loss derived from the sale of a partnership interest subject to Section 864(c)(8) has no bearing or impact on whether it is ECI or ECL.

- To the extent it is desired to promulgate a special source rule for partnership interest sales, consideration should be given to whether a residence-based source rule would better mitigate double taxation than an activity-based rule.

I. Interaction with Bilateral Income Tax Treaties

- Regulations should confirm the approach taken in Situation 3 of Rev. Rul. 91-32, but adding or using a rationale not inconsistent with the decision in *GMM*. In addition, consideration could be given to amending the Code and/or our treaties to confirm this result.

J. Coordination of the Provisions with the FIRPTA Provisions

- Regulations should provide that a foreign partner's reduction of ECI or ECL recognized under Section 864(c)(8) for gain or loss recognized under FIRPTA may result in the creation of ECI or ECL, even where the foreign partner recognizes no overall gain or loss, respectively, in connection with the disposition.

- Regulations should provide that, in determining whether either of the 25% Exceptions (as defined below) is applicable, income and gains with respect to USRPIs should be ignored.

K. Exception from Withholding Where Effectively Connected Gain Is Less Than Threshold Percentage of Total Gain

- While it is not clear that the 25% threshold for the 25% Exceptions contained in the Notice should be reduced, we recommend that any reduction of such threshold be to a level no lower than 10%.

- With respect to the limitation on using the 25% ECI Exception (as defined below) where the foreign partner has been allocated no income during the three years preceding the sale, regulations should clarify that this restriction should apply only where during each of the three preceding taxable years the transferor was allocated no income.

L. Secondary Liability of a Partnership to Withhold Under Section 1446(f)(4)

- Regulations should provide that a partnership that receives proper certification of compliance with Section 1446(f) is exempt from secondary withholding.

- Regulations should provide that secondary withholding does not apply to publicly traded partnerships.

- In the case of successive transfers of a single partnership interest, regulations should not impose secondary withholding on distributions to a purchaser with respect to an unrelated transferee's failure to withhold on a prior transfer of the same interest, except possibly in narrowly tailored abusive cases.

M. Application of Section 1446(f) Where There Are Insufficient Funds to Withhold

- Regulations should adopt the approach taken in the Notice, pursuant to which the amount of withholding under Section 1446(f) is limited to the entire amount realized (determined without regard to the decrease in the transferor partner's share of partnership liabilities).

N. Withholding in Connection with Disguised Sales of Partnership Interests

- In the case of a disguised sale of a partnership interest, regulations should provide that:

    - the partnership (rather than the contributing partner) is responsible for withholding amounts required to be withheld under Section 1446(f), and

    - the "transferee" partner should not be subject to secondary withholding for an under-withholding in connection with the transfer.

O. Withholding in Connection with a Transaction Described in Revenue Ruling 99-6

- Regulations under Section 1446(f) should provide that where a person acquires interests in an existing partnership from one or more partners and the partnership becomes a disregarded entity as a result of such acquisition, the acquirer is treated as acquiring partnership interests for purposes of Section 1446(f), and thus is required to withhold under Section 1446(f) if an exemption from withholding is not available.

P. Withholding on the Disposition of a Publicly Traded Partnership Interest

- Regulations should provide that the broker through which publicly traded partnership interests are transferred should be responsible for withholding and reporting under Section 1446(f).

- Any broker withholding and reporting with respect to publicly traded partnership interests should be required no earlier than the date that is one year following the date on which regulations under Section 1446(f) addressing the manner in which tax is to be withheld in connection with the transfer of PTP units are finalized.

Q. Manner for Depositing Withheld Tax and Filing Forms Relating to Withholding

- Regulations should memorialize the interim approach set forth in the Notice for depositing tax withheld under Section 1446(f) and filing of forms relating to such withholding (*i.e.*, to use the procedures set forth under Section 1445 and the regulations thereunder), subject to certain modifications (including providing new forms specific to Section 1446(f) withholding).

- Regulations should specifically permit, and a new form comparable to Form 8288-B should be released to facilitate, the issuance of withholding certificates enabling a lower amount of withholding under Section 1446(f).

R. Provision of Information by Partnerships to Partners

- Regulations should provide that upon request by a foreign selling partner, a partnership must provide (i) the amount of liabilities attributable under Section 752 to the transferred interest, (ii) the amount of ECI or ECL that the transferor would have recognized with respect to the transferred interest had all of the partnership's assets been sold for their fair market value, and (iii) any other information reasonably needed by such partner in order to calculate the amount of ECI or ECL recognized by virtue of the application of Section 864(c)(8).

- With respect to any calculations required to be made under Section 864(c)(8) or Section 1446(f) (including (i) whether the 25% threshold is exceeded, (ii) the amount of ECI or ECL attributable to the transferor, and (iii) the amount of liabilities attributable to the transferred interest), regulations should provide that a partnership may elect to perform such calculations as of the last day of its most recent taxable year, but only where the partnership reasonably determines that its use of such end of the year convention will not significantly affect any calculation to be made under the Provisions.

S. Section 1446(f) Definitions

- Regulations should properly define terms such as "transferor," "transferee" and "nonforeign person" for purposes of Section 1446(f), rather than defining such terms by cross-reference to Section 1445.

III. Discussion

A. Treatment of Non-Recognition Transactions and Transactions that Shift a Foreign Partner's Share of U.S. Trade or Business Assets

In the Prior Letter we considered whether Section 864(c)(8) applies to transactions eligible for nonrecognition treatment. We concluded that:

1. Although not entirely clear, Section 864(c)(8) did not by its terms purport to override any nonrecognition provisions. Rather, it merely characterized any gain or loss arising from a transaction within its scope as ECI or ECL to the extent therein provided. In other words, it is best read as a characterization provision, not a recognition provision.

2. While there is no explicit authority in Section 864(c)(8) to override nonrecognition provisions, the grant of regulatory authority contained therein is quite broad and explicitly references a number of nonrecognition provisions (although none we think relevant, for reasons set forth in the Prior Letter and below). From this we concluded that the government has the implicit authority to override nonrecognition provisions involving sales, exchanges or other dispositions of partnership interests by foreign persons and that that authority was not limited to the enumerated nonrecognition provisions set forth in the statute.[6]

Although the Notice did not address the application of Section 864(c)(8) to nonrecognition transactions, it did permit transferors to avoid withholding on a temporary basis by certifying that their transactions qualify for nonrecognition treatment under the Code.[7] While the withholding tax relief provided in the Notice is temporary, it is consistent with the conclusions above, namely that the default rule should be to respect the nonrecognition provisions of the Code except to the extent provided in future guidance.

We believe that regardless of whether the statute is read to exclude or to include transactions made pursuant to nonrecognition provisions, the ultimate result should be the same

[6] *See also* AM. BA. ASS'N TAX SEC., *Comments on the Need for Guidance Under Sections 864(c)(8) and 1446(f)* at 6 (Mar. 19, 2018) (the "***ABA Report***").

[7] Notice, Section 6.05.

in either case – the result should not depend on the default rule, but on what better reflects sound tax policy.

The Prior Letter identified a potential approach to determining when a nonrecognition provision should be overridden by Section 864(c)(8), which we called the "Branch Consistency Approach" ("***BCA***"). We believe the overriding principle of Section 864(c)(8) is aligning more closely the taxation of partnership interest transfers and asset transfers. The BCA explicitly seeks to align the tax treatment of asset and interest transfers because it looks in the first instance to whether the transaction in question would have been accorded nonrecognition treatment had the partnership assets been held directly by the foreign person.[8] For that reason, we think the BCA provides the best framework for determining when nonrecognition provisions should be overridden, and thus believe it should be adopted. The BCA would not override nonrecognition treatment except in cases where either (i) nonrecognition treatment is already overridden for branch transfers or (ii) there is no closely analogous branch transaction (as in certain Subchapter K transactions) and there is a suitable avoidance potential by reason of the manner in which the transaction was structured. To the extent the BCA would not override nonrecognition provisions, as a general rule this is not because this approach is inherently pro- (or anti-) taxpayer, but rather because under the Code, the same treatment applies for branch transactions generally. Consequently, as discussed in the Prior Letter, under the BCA Section 864(c)(8) would not override nonrecognition treatment under Sections 351 and 721, and it would also exempt, for example, Section 332 liquidations of foreign partners into their parent entities and foreign-to-foreign or inbound mergers of foreign partners to the same extent those transactions would have been exempt had they been undertaken by a foreign person that was conducting a USTB directly through a branch.[9]

The balance of this section deals with the application of the BCA in cases where there is no close analogy to a branch transaction, but a nonrecognition provision would otherwise be applicable. The Prior Letter contained the following example:

> *Section 731(a) Distributions*. Foreign partner ("***FP***") and a U.S. person ("***USP***") hold interests in PRS. PRS has a USTB and also holds non-USTB assets. In a transaction ordinarily qualifying as a nonrecognition transaction, PRS distributes the non-USTB assets to FP in complete redemption of its interest in

8 Where assets are held by a partnership and the partnership engages in the transaction in question, this would be an "asset" transaction, not an "interest" transaction, from the perspective of applying the BCA.

9 The other approach considered in the Prior Letter, the Transferor Gain Approach ("***TGA***"), would not seek to align the taxation of asset and interest transfers more closely, but rather would look to whether the same foreign person would remain liable for the same amount of tax after the nonrecognition transaction as before the transaction should the property received in the transaction subsequently be disposed of. In contrast to the BCA, this approach, if carried to its logical conclusion, would override virtually all nonrecognition provisions, with the possible exception of certain Section 721 and Section 731 transactions. The Committee did not endorse the TGA principally because it leads to disparate results from the results that would have obtained had the foreign person conducted the USTB directly. The Committee felt that such a result was inconsistent with the overall intention of Section 864(c)(8), which was to align more closely the tax treatment of these two types of transactions, not to drive them further apart.

> PRS. In such a case, while USP remains fully subject to tax, FP has gone from partially subject to U.S. tax (because it indirectly held a share of the USTB through PRS) to not being subject to U.S. tax because it no longer holds any interest in PRS. In such case, under either approach [that is, under either the BCA or TGA], nonrecognition treatment may not be appropriate. Nevertheless, depending on the factual circumstances (e.g., where the parties have a strong business purpose for causing FP to be redeemed for non-USTB assets), there may be situations where nonrecognition may still be appropriate. We believe further study is warranted to determine the circumstances in which it is necessary to override the nonrecognition rule in Section 731, as we believe the determination may not be susceptible to a hard and fast rule.

By way of background, one reason nonrecognition treatment may not be appropriate in the facts of the example is because even though all of the USTB assets remain fully subject to tax, FP has essentially "swapped" its share of the USTB assets for a share of non-USTB assets on which it will not pay tax. For example, if all of the assets of PRS consisted of two different USTBs, each with zero basis, and FP was redeemed out for the assets of one USTB, it would be "escaping" gain on the assets of the USTB left behind, but would be fully subject to tax on the USTB assets it has acquired, with the result that there should not be any base erosion (assuming no inside-outside basis differential). In this case, since there would appear to be no base erosion potential, there would be no reason to override nonrecognition. On the other hand, where PRS's assets consist of both USTB assets and non-USTB assets, and such assets are not being divided proportionately, then there is at least potential for base erosion and a different question is presented. This potential is independent of the respective bases of the USTB assets and the non-USTB assets. To illustrate the principle more clearly, assume that PRS's basis in its assets is zero. In the base case – where PRS disposes of all of its assets in a taxable transaction – USP would pay tax on all of its gain, while FP would pay tax only on its ECI. After the Section 731 distribution however, while USP remains fully subject to tax in the event PRS disposes of the remaining assets, FP would not be subject to tax at all if it disposed of the assets it received in the distribution. Thus, even though a disposition of the USTB remains fully subject to tax, there is less tax paid in the aggregate because FP has gone from partly taxable to wholly nontaxable and USP cannot pay tax on more than 100% of its gain. It is the shifting of the non-USTB assets, not the USTB assets, that creates the potential base erosion. However, if USP was also a foreign person and the facts were otherwise identical (including as to basis), there would be no base erosion potential and accordingly, no reason to override nonrecognition, because the entire built-in gain of the USTB would generally remain fully subject to tax.[10]

Imposing tax in this fact pattern where base erosion potential arises is somewhat "result driven," but not necessarily inappropriately so. When USP is a taxable domestic person, there is or may be a permanent removal of taxable assets from the U.S. tax base. In such a case, overriding nonrecognition treatment could be said to be the "last clear chance" to keep the U.S.

[10] The same type of base erosion could result where a partnership redeems a U.S. tax-exempt partner in exchange for assets that do not generate unrelated business taxable income ("***UBTI***") and the partnership retains gain assets that do generate UBTI.

tax base from being eroded. When USP is not a U.S. person, absent other indicia of abuse, there may be no base erosion potential merely on account of the character of the assets being distributed on the facts presented, and therefore little if any reason to override normal nonrecognition rules.

In that regard, it should be noted that the facts of the example given in our Prior Letter represent a very extreme (and conceptually simple) fact pattern. Consider the following variations on the example:

1. PRS might have multiple partners, some of which might be partnerships, such as funds that have both U.S. and foreign partners. If nonrecognition is overridden in this case, presumably such an override would be done on a "look through" basis. For example, if FP is a Cayman partnership all of whose partners are U.S. persons, presumably Section 864(c)(8) does not apply, and there is nothing to override. But if some of the partners are U.S. and some are foreign, do the U.S. partners get taken into account, and if so, how? Conversely, if USP is a Delaware partnership with foreign partners, is the increased interest of those foreign partners to be taken into account in analyzing whether there is, in fact, base erosion? Presumably, this "look through" rule goes up indefinitely until one reaches an individual, non-grantor trust or taxable corporation. That might require FP and USP to understand each other's ownership structure to a very exact degree in order to determine whether the interest in the USTB held by foreign indirect partners is actually increased or decreased.

2. Now assume that PRS conducts two businesses, A and B, both of which have USTBs of different sizes (relative to the overall size of the business). If FP is redeemed out for business A, its interest in the USTB conducted by business B ("***BUSTB***") has been reduced, but its interest in the USTB conduct by business A ("***AUSTB***") has increased. If nonrecognition is overridden in this case, is A simply taxed on the gross decrease in its share of the gain inherent in BUSTB, or on the delta, if any, between its share of the unrealized gain in AUSTB and that in BUSTB?[11] If the latter, how would that be computed? What responsibilities would PRS have, if any, to compute the value of the relative components of each business?

3. There may be fact patterns where the distribution is in the nature of a rescission, although not technically qualifying as such. For example, suppose FP and USP both contribute IP to PRS to exploit the IP, but if for any reason PRS is liquidated or one partner redeemed, the redeemed partner gets back its contributed IP. In

[11] In the case discussed above, where the assets of PRS consist solely of two different USTBs, we noted that there did not seem to be a principled basis to override nonrecognition under either the BCA or the TGA approach merely because FP had effectively "swapped" its interest in AUSTB for an interest in BUSTB, where the net result was to keep the amount of FP's built-in ECI or ECL constant. Assuming this is correct, then it points strongly if not inevitably to a "netting" approach which would be complex to implement in cases involving the fact pattern in the text or variations thereof.

> such a case, does it matter if each partner is getting back the property it contributed, and if so, whether that was hard-wired into the partnership agreement from inception?

We think these varying fact patterns, which are merely illustrative, should be borne in mind when trying to craft a rule dealing with potential overrides of Section 731 nonrecognition. The Prior Letter's example is intended to illustrate a concern, but in the real world the facts (in many cases) are likely to be much messier than those in that example.

With that in mind, focusing on the fact pattern in which the assets of a partnership containing USTB and non-USTB assets are divided asymmetrically between foreign and domestic partners, it is not clear that overriding Section 731 mechanically in all cases is appropriate. The discussion that follows is intended to outline some of the considerations that may be relevant in analyzing this issue. Assume for purposes of this discussion that the variations of the divisive transaction we are considering are motivated by a bona fide business purpose, for example, a desire on the part of the partners of PRS to divide the economic benefits and burdens of PRS's assets in a manner different from the current division. In other words, the "division" is not intended as a precursor to a sale of the property distributed or a down-the-road "recombination" of PRS's assets through a joint sale to a third party. Assume further that the value of the USTB and non-USTB assets is equal, and that FP and USP are currently equal partners with a "straight up and down" allocation of all items of income gain or loss.

There are a number of ways that division or re-division could be accomplished. One way to effect a division of the business would be to redeem out one of the partners for its "desired" business. This is essentially the fact pattern presented in the Prior Letter: FP and USP desire to go their separate ways, and that is accomplished by redeeming FP for non-USTB assets. If anything, it would not be surprising if the non-USTB assets in the case of a split up would go to the non-U.S. partner. The partners have a desire to part ways and there is nothing necessarily untoward about the fact that, for example, the assets located in a particular jurisdiction go to the partner resident in such jurisdiction. While this may have a base erosion result, it is not clear from the facts presented that it had a base erosion motive.[12]

On the other hand, the same result could also be achieved under current law by redeeming USP's interest in exchange for the USTB assets, an equally logical and straightforward approach. So long as there is at least one other partner left in PRS besides FP after the redemption, this transaction is not a sale, exchange or other disposition of FP's interest in PRS, and therefore is not subject to Section 864(c)(8), even though the economic results may be similar (if not identical) to those obtained in the case of a redemption of FP's interest in PRS.[13] In this fact pattern, because Section 864(c)(8) has no application, the scope of the

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[12] For example, PRS may have contingent liabilities associated with the USTB, and one purpose for the divisive transaction may be to effect the parties' intention that responsibility for those liabilities remain with PRS and USP. Absent some non-tax "friction" like this, presumably the transaction could have been structured as described in the next paragraph (*i.e.*, as a redemption of USP for USTB assets).

[13] Again, the form chosen may not be tax-motivated – the contingent liabilities could be associated with the non-USTB business, and the form chosen more closely aligns those liabilities with the proper parties.

nonrecognition override rule is irrelevant since there is no relevant nonrecognition provision to override from FP's perspective.[14]

We note that in many cases FP and USP may be able to achieve an economic outcome somewhat similar (although perhaps not identical) to that in the examples above without any distribution of assets in a case in which there was a reallocation of partnership items of income, gain, or loss. This could arise in a variety of fact patterns, ranging from cases where the shift was pre-negotiated (for example, FP's share of the profits of the USTB could increase or decrease based on hitting certain targeted thresholds), as the result of "ordinary course" reallocation of profits, or as (in the more extreme variants) a permanent but not pre-negotiated shift of the profits of the partnership. Assuming that the allocations chosen by FP and USP would not cause the arrangement to be recharacterized under general principles (for example as a deemed distribution of partnership assets), a reallocation of partnership items of income, gain, or loss (other than possibly a capital shift for services), whether arising from a pre-negotiated shift or from a mid-stream reallocation, should not ordinarily be viewed as a sale, exchange, or other disposition of partnership interests. To the extent this is correct, it should not give rise to a deemed sale or exchange of such interests. The flexible nature of partnership arrangements permits the partners to vary their economic deal in myriad ways without triggering dispositions or deemed dispositions of partnership interests.[13] As a result, such a shift of the economic sharing should not result in a sale, exchange, or other disposition of a partnership interest to which Section 864(c)(8) could apply.[15]

Regardless of motive, a similar issue could arise where a partnership makes a non-liquidating, in kind distribution of non-USTB assets to a continuing foreign partner.

14 We think changing this result would require a statutory change. While beyond the scope of this Report, any such change would appear to require FP to recognize and pay tax on a transaction in which FP does not appear to have a realization event, which we think may be challenging. Presumably, such a change would require an approach similar to that of Section 751(b).

15 Not only is this the correct result technically, we believe it is also consistent with the fundamental policy of Section 864(c)(8), which is to align more closely the taxation of partnership interest and asset transfers. Assume for the moment that after the reallocation, USP and FP decide to exit their investments by causing PRS to sell all of its assets. To the extent the reallocation was respected under Section 704(b), the reallocation could presumably have the effect of shifting the amount of ECI gain allocated to FP on exit. Since the purpose of Section 864(c)(8) is to harmonize the result in the asset sale case with that in the interest sale case, presumably the same result should occur if instead FP were to sell its interest in PRS, at least assuming, as recommended in Part G below, that the "flush" language regarding nonseparately stated items in the calculation of the Cap (as defined below) is not interpreted in such a way as to create a discontinuity between interest and asset transfers. In that regard, we note that such adjustments to partnership allocations will often be accompanied by so-called "book ups" which require application of Section 704(c) principles to the built-in gains and built-in losses existing on the adjustment date. Under current law, however, such "book ups" are not required – and in some cases may arguably not even be permitted – in the case of allocation adjustments among existing partners (*i.e.*, where new partners are not admitted and there are no contributions or distributions by or to the existing partners). Proposed regulations would, however, address the issue of book ups in certain partnership recapitalizations. *See* Prop. Reg. § 1.704-1(b)(2)(iv)(f)(5)(v). These regulations should mitigate any concerns that such adjustments could result in an "end run" around the principles outlined above, since they should align more closely the results arising from such transactions and Section 721 transactions.

To summarize thus far, there are a number of ways that partners may choose to divide or re-divide their economic arrangements, some of which may effect something akin to a split-up or demerger. Most of these do not involve potential for base erosion, as indicated above, but some do. In the cases that do there are a variety of ways such transactions might be effected. Of the three identified here, two do not appear in most cases to trigger Section 864(c)(8). The third way – the one set forth in the example in the Prior Letter quoted above – has base eroding potential and also potentially implicates the statute, and so could result in an override of Section 731 in appropriate cases.

Given that the transaction in question may not have a base erosion motive, we would suggest that consideration be given to basing the override of normal nonrecognition provisions in this type of case on an anti-abuse approach which looks at taxpayer motivations and weighs them against the tax result obtained.[16] In effect, this exercise would not be dissimilar to that utilized in Section 355 transactions where the device potential of a spin off transaction is weighed against the business purpose and other relevant aspects of the transaction.[17] In this context, one might look at similar factors (including, for example, whether the assets distributed are historic assets or were acquired for the purpose of making the distribution, and whether the distributed assets were sold soon after the distribution) to determine whether it is more appropriate on balance to override generally-applicable nonrecognition principles. If desired, consideration could be given to the relief of PRS's liability as withholding agent. Under the Notice, it appears that PRS does not need to withhold as long as it believes the distribution is entitled to nonrecognition treatment.[18] However, in a case like this it may be appropriate to condition relief from withholding on a certain level of care on the part of PRS. This could give PRS an incentive to "police" the transaction and make an independent assessment of the factors involved. While not entirely satisfactory, we think this approach may provide a reasonable framework in this case.

[16] In looking at the tax results obtained, a number of factors could be considered, including possible basis shifts within the partnership as the result of the distribution. Note that, for the reasons set forth above, it may in many cases not be possible to readily determine whether the result of any such transaction actually erodes the tax base to any meaningful extent.

[17] *See* Section 355(a)(1)(B); Treas. Reg. § 1.355-2(d). Note, however, that in a Section 355 transaction, the tax base is preserved in the sense that a subsequent asset sale by the distributing or controlled corporation would normally be subject to full tax; however, because such taxable asset sales rarely occur, this difference may be more theoretical than it appears, especially since a foreign holder of either corporation can simply dispose of its stock in most cases without further U.S. tax (other than any tax imposed under FIRPTA), assuming neither corporation is a U.S. real property holding corporation ("***USRPHC***").

[18] Notice, Section 6.05 ("When a partnership is a transferee by reason of making a distribution in which no gain is recognized, the transferee partnership is not required to withhold and the transferor is not required to provide a notice to the transferee partnership").

B. Acceleration and Duplication of Effectively Connected Gain and Loss

1. Partial Dispositions of a Partnership Interest

The basic characterization rule of Rev. Rul. 91-32 is that the amount of a foreign partner's gain or loss treated as effectively connected upon the partner's disposition of its partnership interest is proportional to the amount of the partner's distributive share of gain or loss that would be treated as effectively connected upon a hypothetical liquidation of the partnership. In a partnership where all tax allocations are pro rata, and assuming the partnership has no USRPIs, the foreign partner would pay U.S. federal income tax only on the portion of its gain attributable to the unrealized gain in the partnership's USTB. Assuming the objective of Rev. Rul. 91-32 (and Section 864(c)(8)) is to align the taxation of partnership asset and partnership interest transfers more closely, this would appear to be the correct approach from a policy perspective.

By contrast, the basic characterization rule of Section 864(c)(8) is that all of the foreign partner's gain or loss is treated as ECI or ECL, subject to a cap (the "***Cap***"). Section 864(c)(8)(A) provides: "gain or loss on the sale or exchange of all (or any portion of) such interest shall be treated as effectively connected with the conduct of such trade or business to the extent such gain or loss does not exceed the amount determined under subparagraph (B)." The Cap is found in Section 864(c)(8)(B), which provides:

> The amount determined under this subparagraph with respect to any partnership interest sold or exchanged—
>
> (i) in the case of any gain on the sale or exchange of the partnership interest, is—
>
> (I) the portion of the partner's distributive share of the amount of gain which would have been effectively connected with the conduct of a trade or business within the United States if the partnership had sold all of its assets at their fair market value as of the date of the sale or exchange of such interest, or
>
> (II) zero if no gain on such deemed sale would have been so effectively connected.

(The Code provides a parallel formula for determining the Cap on ECL a foreign partner is required to recognize.)[19] Thus, Section 864(c)(8) generally adopts the characterization rule of Rev. Rul. 91-32, but without the proportionality concept embedded in Rev. Rul. 91-32.

The Code's approach produces the same results as Rev. Rul. 91-32 in cases where the foreign partner disposes of its entire partnership interest.

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19 Section 864(c)(8)(B)(ii).

Example 1.[20] FP holds a 50% interest in PRS, with a $0 basis. All of PRS's items are shared on a pro rata basis. PRS has unrealized gain of $200 in its assets: $100 in a USTB which has no USRPIs, and $100 in assets unrelated to the USTB, in each case with a basis of $0. If FP sells its interest for $100, FP will realize gain of $100. Under the rule of Rev. Rul. 91-32, because 50% of FP's distributive share of PRS's gain upon a hypothetical liquidation of its assets would be considered ECI, 50% of FP's gain on the disposition of its interest in PRS would be considered ECI. Because FP realized a gain of $100, $50 of such gain would be considered ECI. Under Section 864(c)(8)(A), all of FP's gain ($100) is considered ECI, subject to the Cap. The Cap is the amount of FP's distributive share of ECI upon a hypothetical liquidation of PRS, which is $50. Thus, only $50 of the gain is considered ECI – the same result reached by Rev. Rul. 91-32.

The Code's approach appears to arrive at a different result, however, in cases where the foreign partner disposes of only a portion of its partnership interest.

Example 2. The facts are the same as in Example 1, except that FP sells only half of its interest for $50. FP realizes $50 of gain on the sale. Under Rev. Rul. 91-32, because 50% of FP's distributive share of PRS's gain upon a hypothetical liquidation of its assets would be considered ECI, 50% of FP's gain is treated as ECI, and FP thus recognizes $25 of ECI. Under Section 864(c)(8)(A), however, all of FP's gain ($50) is considered ECI, subject to the Cap. The Cap is the amount of FP's distributive share of ECI upon a hypothetical liquidation, which, as discussed above, is $50. Thus, all $50 of the gain FP realizes is apparently considered ECI. In effect, in the case of a partial sale, under this interpretation, FP is required to recognize the same amount of ECI as if it had sold its entire interest. Similarly, if FP sells a portion of its interest at a loss, FP is able to recognize the entire ECL associated with its PRS interest. It is theoretically possible that this approach reflected a Congressional intention that recognition of both ECI and ECL should be accelerated in the case of partial transfers. As a policy matter, however, there does not appear to be a good reason to do either, which leads to the conclusion that the outcome may be the result of inartful drafting rather than intention.

However, this is not the entire story. More serious problems arise where a foreign partner disposes of the remainder of its interest in a subsequent transaction.

Example 3. In the previous example, assume that after disposing of half of its interest, FP then disposes of the other half of its interest in PRS for $50. Again, FP realizes $50 of gain on the sale. Under the approach taken in Rev. Rul. 91-32, because 50% of FP's distributive share of PRS's gain upon a hypothetical liquidation of its assets would be considered ECI, 50% of FP's gain is again treated as ECI, and FP recognizes $25 of ECI. Under Rev. Rul. 91-32, then, FP realizes in the aggregate a total of $50 of ECI gain, exactly equal to FP's share of the total amount of unrealized gain in PRS's USTB assets. By contrast, under Section 864(c)(8)(A), all of FP's gain ($50) is once again considered ECI, subject to the Cap. The Cap is the amount of FP's distributive share of ECI upon a hypothetical liquidation, which (since FP is now a 25% shareholder) is $25. Even though FP already paid tax on all $50 of unrealized gain in the

[20] Except where noted otherwise, we assume that PRS in each example in this Report has no liabilities.

partnership's USTB assets, FP must nevertheless pay tax on an additional $25 of ECI. Unlike the timing detriment presented in the first leg of the transaction, this is a permanent detriment. Foreign partners could presumably use the same interpretation of Section 864(c)(8) to partially duplicate their ECLs as well, thus turning a timing benefit into a permanent benefit.[21] Thus, in a universe of voluntary transfers, where partial gain transfers result in duplication of gains and partial loss transfers result in duplication of losses, it may be the case that the number of partial gain and partial loss transactions will not be proportional to the total of built-in ECI and ECL in that universe and that the fisc will be the net loser from the resulting whipsaw.[22]

We therefore recommend that the government issue regulations interpreting Sections 864(c)(8)(A) and (B) as implicitly embodying a consistent proportionality rule, for both gains and losses, effectively replicating the rule of Rev. Rul. 91-32. This would eliminate the accelerated recognition of ECI and ECL and, more importantly, the potential duplication of ECI and ECL, each of which is artificial and unwarranted. We believe there is room for such an interpretation, because the Cap contained in Section 864(c)(8)(B) refers to "the portion of the partner's distributive share of the amount of gain" that would be treated as ECI or ECL in a hypothetical liquidation, suggesting that percentages, not dollar amounts, are at issue. This interpretation, however, is not the most natural reading of the statute, which otherwise appears to be based on the amount, and not percentage, of gain or loss. All of this raises the question why Section 864(c)(8) did not track the language of Rev. Rul. 91-32 more closely. Thus, there is some risk that such an interpretation may be challenged by a foreign partner looking to accelerate or duplicate its losses from a USTB it holds through a partnership. While we think this risk is relatively small given the obvious policy issues associated with the more literal reading of the statute, the safest way to eliminate this risk would be through a technical correction.

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21 This effect appears to magnify as the number of sales increases. If FP disposes of its interest over three sales, the amount of gain (or loss) treated as ECI (or ECL) increases; if FP disposes of its interest over four sales, it increases further. Although we have not provided an example, this problem of over-inclusion of ECI also applies to successive distributions by a partnership to a foreign partner in excess of basis.

22 Consider a case where FP holds interests in PRS1 (which has a built-in ECI) and PRS2 (which has a built-in ECL). FP wishes to sell its interests in PRS1 and PRS2 to Secondary Fund, a family of funds which has an onshore and offshore parallel fund structure. Presumably, if all of the interests in PRS1 are sold in a single transaction to a single buyer (for example, an aggregating vehicle formed by Onshore Secondary Fund and Offshore Secondary Fund), then the "right" result would be obtained and FP would be taxed on the proper amount of ECI (that is, the amount prescribed by Rev. Rul. 91-32). By contrast, if FP sells a partial interest in PRS2 to Onshore Secondary Fund and the remainder in a separate transaction to Offshore Secondary Fund, there does not appear to be a technical rule to prevent the result described above, with the net result that FP can use its "excess" ECL recognized on the sale of PRS2 to offset a portion of its (correctly calculated) ECI on PRS1. There does not appear to be any policy justification for such duplication of gain or loss and it is difficult to conceive of a Congressional intent to permit the duplication of either gains or losses to result in permanent under- or over-taxation. FP should not have to induce Secondary Fund to form an aggregating vehicle solely to mitigate this result, nor should it be able to benefit from duplication of losses in the case of partial sales (whether or not linked). While this example may seem somewhat extreme, it is just one illustration of the potential risks of not addressing the partial sale issue.

As an alternative, if the government is concerned that it lacks the authority to promulgate the rule suggested, it could consider promulgating a regulation preventing unrealized gain or loss in a USTB that was previously used to treat gain or loss of the foreign partner as ECI or ECL under Section 864(c)(8) from being used for calculating the partner's Cap in the future, with appropriate adjustments for intervening changes in the partner's proportional interest in the partnership. Such a solution would not solve the acceleration of gain and loss issue described above, but it would mitigate the duplication problem at the cost of considerable incremental complexity. However, advocates of this approach believe that it could arguably be viewed as more faithful to the statutory language.[23]

2. Multiple Transfers of a Single Partnership Interest

Foreign partners may also over-count their gains and losses in a situation where a single partnership interest is transferred multiple times by multiple foreign transferors.

Example 4. In Example 1 above, suppose that FP sells its entire interest to FP2 for \$100. FP must recognize \$50 of ECI, the entirety of the unrealized gain in its share of PRS's USTB assets, in connection with the transfer. FP2's basis in its 50% partnership interest is \$100. Now suppose PRS's non-USTB assets increase in value so that they are worth \$200. FP2 now sells its interest in PRS to FP3 for \$150, realizing a gain of \$50. Under Section 864(c)(8)(A), all of FP2's gain (\$50) is considered ECI, subject to the Cap. As discussed above, the Cap is the amount of FP's distributive share of ECI upon a hypothetical liquidation. If PRS had a Section 754 election in place when FP sold its interest, PRS's basis in the USTB assets would have received a step-up on the sale of FP's interest to FP2,[24] and the Cap would be \$0 – FP would not recognize any ECI on the disposition. If, however, PRS did not have a Section 754 election in effect at the time FP sold its interest, the Cap at the time FP2 sold its interest would be \$50, and FP2 would be required to recognize \$50 of ECI (due to the unrealized gain in the USTB assets) despite the fact that FP already recognized as ECI all of such unrealized gain.[25] ECI recognition corresponding to the unrealized ECI gain is effectively duplicated.[26] If

23 The Service could take the position that it is simply interpreting Section 864(c)(8)(B) as providing the method for calculating the Cap in the case of a foreign partner's first disposition (partial or complete) of its partnership interest, and that another rule applies on subsequent dispositions of the remainder of such interest.

24 Section 743(b).

25 If, instead of the non-USTB assets increasing in value by \$100, the USTB assets increased in value by \$100, the Cap would be \$150, and all \$50 of gain realized by FP2 upon its sale of the PRS interest would be treated as ECI. This is the correct result – because FP2 owns 50% of PRS, FP should recognize ECI with respect to half of the \$100 of post-acquisition gain in the USTB assets, or \$50.

26 Using Rev. Rul. 91-32's formula, because 33% of FP2's distributive share of PRS's gain upon a hypothetical liquidation of its assets would be considered ECI, 33% of FP2's gain is treated as ECI, and FP2 realizes \$13.33 of ECI gain. This mitigates, but does not solve, the problem of duplication of ECI recognition. Moreover, if, as in the previous note, it was the USTB that increased in value, Rev. Rul. 91-32 would dictate that 66% of FP2's gain, or \$26.66, is ECI – allowing FP2 to underpay on its 50% share of the \$100 gain in the value of the USTB assets.

the non-USTB assets increased in value by another $100, and FP3 sold its interest to FP4 for $200, FP3 would be required to recognize again all of the unrealized ECI gain in the USTB assets, effectively triple-counting such gain. Foreign partners could use this technique to double- or triple-count an ECL as well, with a significant caveat. Under Section 743(b), a partnership with a "substantial built-in loss"[27] is required to adjust downward its basis in its assets upon a partner's disposition of its interest, as if a Section 754 election was in effect. The problem of ECL duplication therefore only exists with respect to a relatively small amount of losses.

A similar situation arises in the context of U.S. partners. In that context, however, recognition of gain on a subsequent asset sale is more likely to produce a usable offsetting loss than in the foreign partner context. In either case, partnerships that wish to avoid double-counting gain may make a Section 754 election, while the mandatory step down in partnership basis where there is a "substantial built-in loss" should prevent significant harm to the fisc from FP's double-counting ECLs. Should the government decide to address the issue, however, our recommendation above for a regulation excluding already-utilized unrealized gain from future calculation of the Cap could be expanded to include the scenario reflected in Example 4, thereby preventing duplication of ECI and ECL.

C. <u>Treatment of Partnership Distributions</u>

A distribution by a partnership to a partner generally does not result in the recognition of gain or loss. Specifically, Section 731(a) provides that a partner generally does not recognize gain or loss on receipt of non-liquidating distributions from a partnership. An exception is provided in the case of distributions of "money" (defined to include cash and in certain cases marketable securities) in excess of such partner's adjusted basis in its partnership interest, in which case gain is recognized in an amount equal to the excess of such distribution over the partner's adjusted basis in its partnership interest.[28] Loss may be recognized by a partner in connection with a distribution only in the case of a liquidating distribution of money. The flush language at the end of Section 731(a) provides that "[a]ny gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner." This language appears to bring gain recognized on distributions in excess of basis, and losses recognized on liquidation, within the potential ambit of Section 864(c)(8), which applies to "gain or loss on the sale or exchange of all (or any portion

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27 A partnership is treated as having a "substantial built-in loss" if either (i) the partnership has an unrealized loss of $250,000 or more in its assets or (ii) the transferee partner would be allocated a loss of more than $250,000 if the partnership assets were sold for their fair market value. Section 743(d).

28 In the case of a mixed distribution, containing both money and other property, the distributee partner recognizes gain only to the extent the money received exceeds its adjusted basis immediately prior to the distribution. Treas. Reg. § 1.731-1(a)(1)(i). Throughout this discussion, the term "distribution in excess of basis" refers to a distribution containing an amount of money greater than the distributee partner's adjusted basis in its partnership interest. A "distribution not in excess of basis" refers to either (i) a distribution of money equal to or less than the distributee partner's adjusted basis in its partnership interest or (ii) a distribution that does not include money, in each case even though the value of property distributed may exceed the partner's adjusted basis in its partnership interest.

of) such interest,"[29] and Section 1446(f), which applies to "any portion of the gain (if any) on any disposition of an interest."[30] Presumably, in such a case, the partnership is the "transferee," and thus the withholding agent, for Section 1446(f) purposes.

Under Section 6.05 of the Notice, no withholding is required under Section 1446(f) on distributions not in excess of basis. Section 9 of the Notice, in turn, provides procedures on which the partnership may rely to determine a foreign partner's basis. The approach of the Notice is consistent with the concept that Section 864(c)(8) does not apply to partnership distributions not in excess of basis. We recommend that regulations retain this approach.

As drafted, however, the Notice appears to be silent concerning the amount of withholding required where a distribution exceeds the distributee partner's basis. Under Section 1446(f), withholding is required in an amount "equal to 10 percent of the amount realized on the disposition." In the case of a distribution in excess of basis, it is arguably unclear what "the amount realized on the disposition" refers to. It could refer to the distribution in its entirety, or to the portion of the distribution in excess of basis. Technically, Section 731(a) only recharacterizes "*gain*… recognized under this subsection" as gain on a disposition. The more appropriate reading, therefore, might be that "the amount realized on the disposition" for purposes of Section 1446(f) is the amount of gain recognized under Section 731(a) (*i.e.*, the excess of the distribution over basis). However, an argument could be made that gain recognized under Section 731(a) is treated as gain from a disposition because Section 731(a) recharacterizes the entire distribution as a disposition. Were such a reading to be adopted, 10% of the amount realized on the disposition would be equal to 10% of the entire distribution. Depending on the answer, the partnership could have dramatically different withholding tax obligations.

Example 5. To take an extreme case, suppose FP has a $50,000,000 adjusted basis in its partnership interest, and receives a non-liquidating cash distribution of $50,001,000. If withholding is required on 10% of the entire distribution, the partnership must withhold $5,000,100; by contrast, if withholding is only required on 10% of the amount distributed in excess of basis, or if the cash were distributed in two separately-respected distributions of $50,000,000 and $1,000, the partnership must withhold only $100. A requirement to withhold on 10% of the entire distribution would therefore create a cliff effect, leading to large amounts of over-withholding and therefore giving partnerships a strong incentive to split up distributions to foreign partners that would otherwise exceed basis in order to decrease the amount required to be withheld. As a matter of policy, there does not seem to be any benefit to creating such a cliff effect, nor to treating two smaller distributions differently from one larger one. Moreover, as pointed out above, absent a disguised sale, there is no sale or exchange except to the extent one is deemed to occur under Section 731(a), and that deeming rule applies in the case of a gain transaction only to the portion of the distribution that exceeds basis. Thus, we think both technical and policy considerations favor withholding only on the amount distributed in excess of basis.

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[29] Section 864(c)(8)(A).

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

It could nevertheless be argued that, in the example above, while withholding on $1,000 is the right target *amount* as a policy matter, 10% is the wrong *rate*, and withholding should be imposed on the excess distribution at the actual rate (or perhaps the top rate) applicable to a partner of that status. The reason Section 1446(f) prescribes a 10% withholding tax rate in the case of a disposition is presumably because withholding is based on the amount realized, not on the amount of gain that is subject to tax. In the ordinary case, the transferee does not know FP's basis in its partnership interest, and therefore cannot withhold based on the exact amount of FP's gain. A 10% rate might be viewed simply as "rough justice." In the case of a distribution, however, the partnership is expected to know FP's basis in its partnership interest, as well as the portion of the gain which is ECI, and can more easily withhold the amount of FP's exact tax liability, similar to "regular" Section 1446 withholding. The statute, however, does not appear to contemplate this option.

One possible approach, if the government believes it has the authority to do so, would be to impose withholding at a 10% rate on the entire distribution if the aggregate amount of money distributed exceeded the partner's basis, but allow partnerships to elect into a regime that would impose withholding solely on the effectively connected amount distributed in excess of the partner's basis at the applicable statutory tax rates on net income, rather than at a 10% rate. The election could be conditioned on following the certification procedures for establishing basis in the case of distributions within basis,[31] and could be irrevocable once made. This could, if desired, be an "all or nothing" election that would apply to all distributions by the partnership to foreign partners in excess of such foreign partners' basis. If the election was made, the withholding rate would be (under current law) 20% or 37%, depending on the type of income (for nonresident aliens) or 21% (for foreign corporations) on the amount in excess of FP's adjusted basis, as determined by the partnership's books and records or by a certification by the foreign partner, properly treated as ECI.[32]

For this purpose, distributions that are treated as in complete liquidation of a partner's interest would be aggregated, as would distributions that were intentionally disaggregated or broken up for purposes of avoiding this rule. Treasury and the IRS may also find it desirable to consider an aggregation rule that would presume distributions that are made within a given time period (*e.g.*, two or three years) are made with an intention to disaggregate (and thus impose aggregation for purposes of this rule unless the partnership can rebut the presumption).[33]

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31 *See* Notice, Section 7.

32 In the case of a partner that is a partnership, principles similar to those of Treas. Reg. § 1.1446-5(c) could apply.

33 Where a series of distributions are aggregated, it is possible that the amount of tax required to be withheld (absent a partnership election to withhold at a higher rate on only the excess distribution) by the partnership may exceed the amount of cash actually distributed in the distribution which ultimately caused the distribution in excess of basis (for example, such an issue would arise if the two distributions of $50,000,000 and $1,000 in Example 5 above were aggregated). In order to mitigate the adverse consequences to a partnership of such an outcome, we suggest that the government consider adopting a position that it will not seek to collect from a partnership, as withholding agent, an amount of tax greater than the amount of tax that would have been withheld had the election described above been made. We

We recognize that this approach, subject to possible aggregation, still leaves open the possibility that a non-electing partnership could make multiple distributions over a period of time and that the earlier distributions within basis would not be subject to withholding and the later distributions that include amounts in excess of basis would be subject to only a 10% rate of withholding. But this is what the statute appears to contemplate.

D. Application of the Provisions to Tiered Partnerships

The application of the Provisions to transactions involving tiered partnerships needs clarification and is uncertain in certain respects. To illustrate the basic issue, suppose that FP owns an interest in a holding partnership ("***HP***"), which owns an interest in an operating partnership ("***OP***"). Section 864(c)(8)(A) provides:

> [I]f a nonresident alien individual or foreign corporation owns, *directly or indirectly*, an interest in a partnership which is engaged in any trade or business within the United States, gain or loss on the sale or exchange of all (or any portion of) *such interest* shall be treated as effectively connected with the conduct of such trade or business to the extent such gain or loss does not exceed the amount determined under subparagraph (B).[34]

If HP sells its interest in OP, that appears to fall cleanly within the ambit of the statute – FP indirectly owns an interest in OP, and such interest is being sold.[35] If, on the other hand, FP sells its interest in HP, the application of Section 864(c)(8) to such a sale is less clear. By its terms, the statute contemplates cases where an interest in a partnership that is engaged in a USTB ("such interest") is sold; the statute includes situations where an interest in the operating partnership is indirectly *owned* prior to being sold, but does not directly address situations where an interest in the operating partnership is indirectly *sold*. Arguably, the statute intended to say something along these lines: "[I]f a nonresident alien individual or foreign corporation owns, directly or indirectly, an interest in a partnership which is engaged in any trade or business within the United States, gain or loss on the *direct or indirect* sale or exchange of all (or any portion of) such interest shall be treated as effectively connected with the conduct of such trade or business to the extent such gain or loss does not exceed the amount determined under subparagraph (B)." (suggested addition in italics). However, it did not use such language.

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also note that certain aspects of the tax treatment of multi-year liquidating distributions raise well-known, and unanswered, questions under Subchapter K that are beyond the scope of this Report but that ultimately impact the tax treatment of such distributions under Sections 864(c)(8) and 1446(f).

34 Emphasis added.

35 Note that if HP is a domestic partnership, no Section 1446(f) withholding would arise on the sale, because HP is not a foreign person. However, "regular" Section 1446 withholding would presumably apply. We recommend that guidance confirm this result.

From a policy perspective, the sale of an interest in HP should fall within the ambit of the statute. The alternative, that FP recognizes no ECI or ECL upon its sale of an interest in HP, could allow a foreign person to avoid paying U.S. federal income tax on the disposition of its interest in an operating partnership by investing in the operating partnership through an aggregator or holding partnership and then selling its interest in such an upper-tier partnership. This is not an appropriate result.[36]

While the wording in the statute is not optimal, we think the most straightforward approach to treating gain or loss on such a sale as ECI or ECL is to treat HP as being engaged in a USTB by reason of its interest in OP. In this regard, Section 875(1) provides that "a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged." We recognize that HP is neither an individual nor a foreign corporation, and HP is not in fact engaged in a trade or business, except indirectly through OP. Presumably, the argument would be that Section 875(1) should be applied through tiers of partnerships to treat FP as engaged in a USTB, and it should therefore implicitly be read to treat HP as engaged in a USTB as well. In other words, at least for this purpose, HP is treated as directly being engaged in a trade or business. It could be argued that if this is correct then the reference to "directly or indirectly" in the statute would presumably have been unnecessary, because FP would meet the test automatically so long as HP is a partner in OP. But in the case where HP disposes of its interest in OP, that language might have some meaning.[37] Having said that, this is a very convoluted way to arrive at a conclusion that could have been said much more simply had the statute included the second "directly or indirectly" where indicated above. We think the government should provide guidance on this fact pattern and confirm that the transaction in the example is taxable, and the reasons therefor, while also pursuing a technical correction along the lines suggested above to eliminate any doubt in this regard.

E. Limitation of Gain/Loss Under Section 864(c)(8)

By its terms, Section 864(c)(8) causes only gain or loss otherwise recognized to be recharacterized as ECI or ECL. Specifically, Section 864(c)(8)(A) states:

> if a nonresident alien individual or foreign corporation owns, directly or indirectly, an interest in a partnership which is engaged in any trade or business within the United States, gain or loss on the sale or exchange of all (or any portion of) such interest shall be treated as effectively connected with the conduct of such

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36 *But see* ABA Report, *supra* note 6 at 21.

37 Another alternative interpretation, that the words "directly or indirectly" could be interpreted in this context to refer only to looking through record ownership to beneficial ownership rather than looking through tiers of entities, does not seem appropriate here. The more natural reading of the term, especially in the case where HP sells its interest in OP, is an entity look-through concept. But Cf. Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders (Thomson Reuters/Tax & Accounting, 7th ed. 2015 with updates through July 2018) (accessed on Checkpoint (www.checkpoint.riag.com) July 2, 2018), Section 9.02, text and note at note 31 (arguing that "directly or indirectly" as used in Section 318 refers to beneficial rather than record ownership, not to looking through tiers if indirect entity ownership).

trade or business to the extent such gain or loss does not exceed the amount determined under subparagraph (B).

Thus, because Section 864(c)(8) starts by calculating the amount of gain or loss with respect to the sale or exchange, and then potentially reduces the amount of such gain or loss recharacterized as ECI or ECL by applying the Cap, it seems clear that, consistent with the approach taken in Rev. Rul. 91-32, the provision is intended to recharacterize, in applicable cases, recognized gain or loss as ECI or ECL, respectively, but that the provision should not cause a foreign partner that recognized a loss on the relevant sale to be treated as recognizing ECI (or vice versa).

Example 6. FP has a tax basis of $110 in its interest in PRS and sells such interest for $100. Therefore, FP recognizes a loss of $10 in connection with the sale. Assume that if PRS had sold all of its underlying assets, FP would have been allocated $10 of ECI and $20 of loss that would not have been ECL, and that none of PRS's assets are "hot assets" for purposes of Section 751. In such a case, FP should recognize a $10 loss that should not be an ECL in connection with the sale of its interest, and FP should not recognize any ECI because, even though FP would have been allocated $10 of ECI upon a sale of all of FP's assets, the amount that may be recharacterized as ECI under Section 864(c)(8) cannot exceed (by virtue of the Cap) the amount of gain actually recognized, which in this case is zero.

It is not entirely clear, however, how the application of Section 751(a) to a foreign partner's sale of its partnership interest might affect this "gain limitation" feature. Section 751(a) and the Treasury regulations promulgated thereunder may cause the seller of a partnership interest that otherwise would recognize a loss upon the sale to instead recognize ordinary income in respect of its share of gain in the partnership's unrealized receivables and inventory items and a correspondingly greater amount of capital loss in connection with the sale. If Section 751(a) applies first, before the application of Section 864(c)(8), any ordinary gain triggered by Section 751(a) would seemingly be eligible for potential recharacterization as ECI under Section 864(c)(8), even though the seller may have an overall loss in its partnership interest.

Example 7. Facts are the same as Example 6, except that all $10 of ECI that FP would have recognized upon a sale of PRS's assets relates to unrealized receivables of PRS. Thus, upon the sale of FP's PRS interest, Section 751(a) causes FP to recognize $10 of ordinary gain and $20 of capital loss. In such a case, if Section 751(a) applies before determining potential recharacterization under Section 864(c)(8), then all $10 of the ordinary gain recognized due to the application of Section 751(a) would be recharacterized as ECI.[38]

While the statute is not clear on this point, we believe that the better reading is that a foreign partner first must determine how much gain or loss it recognizes in connection with a partnership interest sale (including by virtue of Section 751(a)), and then apply Section 864(c)(8)

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38 For a discussion of a similar issue arising under Rev. Rul. 91-32, *see* N.Y. ST. BA. ASS'N, TAX SEC., *Report on Guidance Implementing Revenue Ruling 91-32* at n. 19 (Jan. 21, 2014).

to determine whether any of such gain or loss should be recharacterized as ECI or ECL.[39] In any event, we recommend that regulations clarify whether Section 864(c)(8) applies before or after the application of Section 751(a).

F. Partnership Determinations of Fair Market Value

In order to determine the amount (if any) of gain or loss recognized by the foreign transferor of a partnership interest that is treated as ECI or ECL under Section 864(c)(8), it must be determined how much ECI or ECL would be recognized by such partner upon the partnership's sale of all of its assets on the date of transfer at their fair market value. The statute does not clearly indicate whether fair market value of a partnership's assets under this hypothetical sale approach should be based on (i) normal principles for determining the fair market value of assets (*i.e.*, the willing buyer-willing seller standard) or (ii) the extrapolated value of the partnership's assets based on the purchase price for the partnership interest being transferred.

Example 8. PRS believes that the total fair market value of its assets is $100, and reflects that value in determining its net asset value. PRS further believes that half of its assets ($50) constitute USTB assets and the other half of its assets ($50) are non-USTB assets. FP owns a 10% interest in PRS with a $0 basis and sells such interest on the secondary market for $85. The purchase price reflects a discount to the interest's net asset value due to the lack of a market for the interests in PRS. PRS has a $0 basis in its assets, and FP has a $0 basis in its PRS interest. FP recognizes $85 of gain on the sale of its PRS interest. As a technical matter, Section 864(c)(8) requires that such gain be treated as ECI up to the Cap, which looks to how much ECI would be allocated to FP if all of PRS's assets were sold for their fair market value (or $50 as viewed from PRS's perspective). This is in contrast with the proportionality approach taken in Rev. Rul. 91-32, which would cause 50% of FP's gain (or $42.50) to be treated as ECI because 50% of the built-in gain at PRS relates to USTB assets.

Treatment of $50 of FP's gain as ECI, even though only 50% of the underlying gain relates to USTB assets, seems questionable from a policy perspective. Further, a requirement for a partnership to determine the total fair market value of its assets in a manner that is not simply a function of the purchase price paid to the foreign selling partner would require certain partnerships (*i.e.*, those that do not otherwise routinely calculate fair market value) to undertake additional (and potentially costly) work. As a result, we recommend that regulations require that, in applying the hypothetical allocation regime of Section 864(c)(8), a partnership should assign an aggregate value to its assets that, if the partnership were to sell all of its assets for that aggregate value, would result in the partnership (after payment of its liabilities) distributing an amount in respect of the transferred interest that is equal to the amount paid to the foreign partner for such interest.[40] As applied to Example 8, this approach would cause FP to recognize $42.50

[39] *But see* ABA Report, *supra* note 6 at 11 (stating: "We note, however, that although section 751 normally can result in ordinary gain or loss in excess of the total outside gain or loss in certain cases [citation omitted], that possibility appears to be foreclosed for a foreign partner that is taxed only on ECI").

[40] This approach would be similar to that provided in Treas. Reg. § 1.755-1(a)(4) in connection with determining the amount of basis adjustments under Section 743(b).

of ECI because the assets of PRS would be treated as having an aggregate value sufficient to cause the transferred interest to receive $85 upon a sale of PRS's assets followed by its immediate liquidation.[41]

G. Effect of the Distributive Share Provision

In determining the amount of gain or loss from the sale or exchange of a partnership interest that is treated as ECI or ECL, the flush language following Section 864(c)(8)(B)(ii)(II) provides that "a partner's distributive share of gain or loss on the deemed sale shall be determined in the same manner as such partner's distributive share of the non-separately stated taxable income or loss of such partnership." The Committee Report provides no indication regarding the intent of this distributive share provision. As described below, while the intent of this provision is unclear, we have considered three potential interpretations of such provision.

First, the language might be interpreted as providing that Section 864(c)(8) is applied by ignoring any special allocations made by a partnership. We believe that it is unlikely that the language was intended to produce such a result and strongly recommend that regulations do not implement such an approach. As a general matter, Section 864(c)(8) is intended to produce a tax result for a selling partner that is generally consistent with a sale by the underlying partnership of its assets and the allocation of gain or loss from such a sale to its partners. Taxable gain or loss from an actual sale of partnership assets would be allocated among its partners based on their economic sharing of profits or losses from the sale. Such economic sharing would reflect any special allocation of specific items of income, gain, loss or deduction, such that a special allocation of such items as an economic matter generally would also result in an allocation of the corresponding tax items among the partners (assuming such allocations are respected under Section 704(b)). If special allocations were ignored for purposes of applying Section 864(c)(8), a sale of a partnership interest could result in dramatically different tax consequences from a sale by the partnership of its underlying assets.

Example 9. PRS has two partners, FP and USP. PRS has two businesses, one that constitutes a USTB and the other that does not constitute a USTB. PRS has a $0 basis in each business. Each business has a fair market value of $100. PRS generally allocates all of its items 50% each to FP and USP, but specially allocates 90% of its items from its USTB to FP (with the remaining 10% of such items allocated to USP). If PRS were to sell all of its assets, FP would be allocated $140 of gain ($90 of ECI from the USTB and $50 of non-ECI gain from the non-USTB). If instead FP were to sell its PRS interest for $140, it would recognize $140 of gain (assuming it has a $0 basis in its interest). If regulations were to adopt an approach that would ignore special allocations, FP might recognize only $70 of ECI, rather than the $90 it would have recognized upon a sale by PRS of its assets. Such a result would be inconsistent with the general purpose behind the enactment of Section 864(c)(8), which was to better align the treatment of a foreign partner's partnership interest sale with that of a sale of underlying assets.

41 The converse would also be true; in the case in which an interest was sold at a premium, this approach would preclude ignoring the premium on calculation of ECI and ECL.

Second, the provision could be interpreted as providing that the hypothetical ECI or ECL from the deemed sale must be treated as allocable to each partner in the same proportion as its share of ordinary business income or loss of the partnership as shown in Box 1 of the partner's Schedule K-1.[42] We believe that such interpretation is misguided and should be dismissed for the same reasons as the first interpretation. That is, a partner's share of ordinary business income or loss (as shown in Box 1 of Schedule K-1) may bear little correlation to how such partner would share ECI or ECL if the partnership sold its assets, and thus would often produce highly distortive results. The distortive effect of this interpretation may be particularly pronounced in the case of Section 704(c) gain or loss.

Example 10. FP and USP form PRS, with FP contributing USTB assets (that would give rise to long-term capital gain upon sale) with a fair market value of $100 and a basis of $0 and USP contributing $100 of cash. FP and USP share all profits and losses equally. If PRS were to sell the assets contributed by FP for $100, all $100 of capital gain would be allocated to FP under Section 704(c), which would appear in Box 9a (net long-term capital gain (loss)) of FP's Schedule K-1. Assume instead that FP sold its partnership interest for $100. Under the second interpretation, upon the hypothetical deemed sale transaction FP would be allocated only $50 of the $100 of ECI recognized by PRS (*i.e.*, its share of Box 1 income or loss) and thus would recognize only $50 of ECI upon the sale of its partnership interest. As illustrated by this example, if this interpretation were to be adopted, a partner having Section 704(c) gain that sells its partnership interest may recognize dramatically different tax consequences as compared to a direct sale of the same assets by the partnership.[43]

The third interpretation of the provision is that it reflects Congressional concern about the use of special allocations to distort the application of Section 864(c)(8) in a manner that reduces or eliminates its impact. We believe that the principles of Section 704(b), together with the operation of Section 704(c) and reverse Section 704(c), generally should prevent the use of special allocations to cause inappropriate results under Section 864(c)(8). Nevertheless, in order to give effect to this interpretation of the distributive share language, the government could consider including in regulations an anti-abuse rule that would ignore the effect of any special allocation a principal purpose of which was to reduce the amount of ECI (or increase the amount of ECL) recognized by a foreign partner upon a sale of its partnership interest.[44] Although we

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42 In this regard, we note that the Committee Report, in its discussion of a similar provision in Section 163(j) concerning nonseparately stated income, described nonseparately stated income as:

> This amount is the "Ordinary business income or loss" reflected on Form 1065 (U.S. Return of Partnership Income). The partner's distributive share is reflected in Box 1 of Schedule K-1 (Form 1065).

Committee Report, p. 229.

43 Similar distortions could arise with respect to reverse Section 704(c) allocations. To the extent one views either type of allocation as "special," similar distortions would arise under the first interpretation as well.

44 For example, such a result could apply in cases where an adjustment is made to partnership allocations for the purpose of reducing the amount of ECI allocable to a foreign partner in anticipation of an interest transfer, where there is no "book up" of assets in connection with such adjustment. *See* note 15 above

feel that such an anti-abuse rule may be unnecessary, its inclusion in regulations should have limited impact in light of the points made above.[45]

We note, however, that in light of the confusion regarding the proper application of the distributive share provision, the government may wish to consider a legislative correction in order to avoid the possibility that taxpayers attempt to apply the provision in an inappropriate manner (*e.g.*, by asserting that, pursuant to the statutory provision, special allocations of a partnership must be disregarded for purposes of applying Sections 864(c)(8) and 1446(f)).

H. Source of Gain Recognized Under Section 864(c)(8)

This section discusses how gain or loss which is treated as ECI or ECL under Section 864(c)(8) should be sourced. By way of background, for purposes of the sourcing rules, a partnership interest is treated as personal property except to the extent that FIRPTA applies.[46] Section 865(a) provides that "except as otherwise provided in this section, income from the sale of personal property… by a nonresident shall be sourced outside the United States."

Assuming that a partnership interest is not inventory in the hands of a nonresident seller, the only relevant exception to the above rule arises if the sale is "attributable" to a U.S. office maintained by the nonresident. For this purpose, Section 865(e)(2) provides that "the principles of Section 864(c)(5) shall apply in determining whether a taxpayer has an office or other fixed place of business and whether a sale is attributable to such an office or other fixed place of business."

Section 864(c)(5)(B) provides that "income, gain, or loss shall not be considered as attributable to an office or other fixed place of business within the United States unless such office or fixed place of business is a material factor in the production of such income, gain, or loss and such office or fixed place of business regularly carries on activities of the type from which such income, gain, or loss is derived." The regulations thereunder provide that "the activities of the office or other fixed place of business shall not be considered to be a material factor in the realization of the income, gain, or loss unless they provide a significant contribution to, by being an essential economic element in, the realization of the income, gain, or loss."[47]

(discussing the potential for distortions where no "book up" occurs in connection with an adjustment to partnership allocations).

45 This interpretation is generally consistent with the Tax Section's recommendations concerning substantially similar language contained in Section 163(j). *See* N.Y. ST. BA. ASS'N, TAX SEC., *Report on Section 163(j)* (May 28, 2018) (suggesting that the language in Section 163(j) requiring a partner's distributive share of excess taxable income be allocated in the same manner as its share of the partnership's non-separately stated income or loss should be read as preventing a partnership from allocating "Post-Calculation Items" disproportionately (relative to their sharing of income generally) among the partners).

46 *See* Blessing and Lubkin, 905-2nd T.M., *Source of Income Rules* (accessed on Bloomberg Law (www.bloomberglaw.com) 7/6/18), VII.A.2.l.1.

47 Treas. Reg. § 1.864-6(b)(1).

The foregoing is the general rule. No specific rule is provided for the sourcing of sales of partnership interests. Treas. Reg. § 1.864-6(b)(2)(i) provides a specific rule for sourcing gains and losses arising from intangible property including patents, copyrights, franchises, trademarks, trade names, goodwill, "and other like properties."[48] This regulation provides that the material factor test is not met "merely because the office or other fixed place of business conducts one or more of the following activities: (a) Develops, creates, produces, or acquires and adds substantial value to, the property which is leased, licensed, or sold, or exchanged…" Rather, the regulation explicitly requires that the U.S. office actively participate in the sale itself in order for gain to be treated as U.S. source income.

Prior to the enactment of Section 864(c)(8), source was critical to the determination of ECI and ECL. This is because Section 864(c)(4)(A) provides that, with exceptions not relevant hereto, no foreign source gain or loss shall be treated as effectively connected. Thus, gains and losses from the sale of partnership interests could not be treated as ECI or ECL by reason of Section 864(c)(4)(B) if such gains or losses were treated as foreign source. Based on the regulations discussed above, it could be argued that such gains and losses also could not be treated as U.S. source by reason of Section 865(e)(2), unless the selling nonresident partner maintained an office in the United States that regularly engaged in the sale of such interests (for example, if the nonresident was a dealer in such interests).

Rev. Rul. 91-32 addressed this issue directly, providing for ECI or ECL treatment in appropriate cases, by treating the partnership's office as attributable to the partner, and then treating the participation of that office in the development of the partnership's property as fulfilling the materiality factor, thereby making gain or loss on sale of a partnership interest U.S. source. The Tax Court, citing the regulations on sourcing the sale of an intangible discussed above, rejected this argument in *GMM*,[49] holding that gain or loss on a foreign partner's sale of its partnership interest is treated as foreign source unless the U.S. office of the foreign partner materially participates in the sale in the ordinary course of its business.

Section 864(c)(8) does not address source at all. It does not refer to the source of the gain or loss realized on the sale of a partnership interest treated as ECI or ECL under its provisions; nor did the Act substantively amend Section 865 or any of the other relevant source rules in the Code. Instead, Section 864(c)(8) simply provides that gain or loss from the sale of an interest in a partnership that has a USTB is treated as ECI or ECL if certain requirements are met. This approach raises the question: how, in the absence of an explicit source rule, is the ECI or ECL from the sale of such a partnership interest to be sourced?

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48 This regulation applies to intangible property "located outside the United States." Section 864(c)(5) elaborates on Section 864(c)(4)(B), which in turn is concerned only with foreign source income treated as ECI by reason of its attribution to a U.S. office. Presumably the principles of Section 865(c)(5) do not depend on the location of the property in question. However, it appears that the Service, at least, does not believe this is the case. Brief for Respondent-Appellant, *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner* (D.C. Cir. *brief filed* June 8, 2018) (No. 17-1268), at *27-*29.

49 *Grecian Magnesite*, 149 T.C. No. 3 at *37-*47.

One approach would be to read the statute as written, and to therefore view it as having no impact on sourcing. This approach would follow the form of a sale of a partnership interest and apply Section 865(a) to source the gain or loss, because there are no relevant sourcing rules contained in Section 864 and no correlative changes were made to the Code sections that do deal with source. For comparison, when Congress enacted FIRPTA, it was careful to amend the source rule for real property in Section 861(a)(5) so that gain from the disposition of any asset treated as a USRPI (and therefore treated as ECI under FIRPTA) would be treated as U.S. source, thereby conforming source and ECI treatment for USRPIs. No such sentiment appears to have animated the drafters of Section 864(c)(8). This does not mean that gain or loss treated as ECI or ECL under Section 864(c)(8) is necessarily foreign or U.S. source; it simply means that the source of such income or gain has no bearing on its status as effectively connected (or vice versa), but must be determined independently.

This conclusion, however, leads to the following conundrum: Section 864(c)(4)(A) was not amended by the Act, and therefore still provides that, with exceptions not relevant hereto, no foreign source gain or loss shall be treated as ECI or ECL. Read literally, this could be construed to mean that, to the extent the gain arising from the sale of a partnership interest is foreign source, it cannot be treated as ECI under Section 864(c)(8). However, this reading could negate Section 864(c)(8) in whole or in part, a result that presumably was not intended by the drafters of the Act. Moreover, given that Section 864(c)(8) is both more specific and later in time than Section 864(c)(4)(A), and was written in response to *GMM* holding the gain to be foreign source, it would seem that the former provision should trump the latter even if the result is that foreign source gain would be treated as ECI under Section 864(c)(8). Nonetheless, it would be helpful if the government issued guidance to the effect that gain arising under Section 864(c)(8) would still be treated as ECI even if properly classified as foreign source, if only to prevent the Service from being whipsawed by taxpayers taking different positions on this issue.[50]

[50] The contrary argument (i.e., that Section 864(c)(8) does not trump Section 864(c)(4)(A)) places the vitality of Section 864(c)(8) at risk by gambling that the Service's appeal in GMM will succeed. But even if the Service prevails on appeal in GMM, presumably the Tax Court would defer to its own decision in GMM in any case not appealable to the D.C. Circuit. Golsen v. Commissioner, 54 T.C. 742 (1970), *aff'd on other grounds*, 445 F.2d 985 (10th Cir. 1971). There does not appear to be a strong argument that the mere enactment of Section 864(c)(8) changed the source rules. An entirely new source provision cannot easily be conjured from a subsection that nowhere mentions source. This mode of reasoning would also render provisions such as Section 861(a)(5) mere surplusage, because the enactment of Section 897 itself (under this reasoning) and the need to reconcile Section 897 with Section 864(c)(4)(A) would have sufficed to convert the source of gain on the sale of, say, stock of a USRPHC from foreign source to U.S. source. There appears to be little if any commentary on the interaction between Section 864(c)(8) and the source rules. However, the ABA Report, *supra* note 6 at 12, which does not explicitly deal with source, argues in the context of treaties that the fact that Section 864(c)(8)(B) uses a hypothetical liquidation to calculate the Cap "could be read as indicative that such deemed asset sale character be applied in testing eligibility for treaty protection." Presumably, a similar argument could be made in the source context as well. However, it is not entirely clear how this would affect source. For example, under the approach taken by the Tax Court in *GMM*, presumably the source rules would still be the same, namely that the gain would be sourced by reference to the partner's residence, unless a U.S. office participated in the sale itself. Of course, here there is no sale (other than the sale of the partnership interest itself), so source would presumably be determined based either on the partner's actual office (the path taken by the Tax Court in *GMM*) or on the hypothetical participation of the partnership office in a hypothetical sale. It is not clear what the basis for

Assuming that the government adopts the position that Section 864(c)(8) applies regardless of how source is determined, the question arises whether there is anything at stake on the source issue. The main impact of treating ECI gain arising under Section 864(c)(8) as foreign source would be to make it easier for the foreign partner to credit any foreign taxes imposed on such gain against the taxes imposed by reason of Section 864(c)(8). Conversely, making such ECI U.S. source would make it more challenging for the foreign partner to credit such foreign taxes against the tax liability imposed by virtue of Section 864(c)(8). The facts of *GMM* are instructive in this regard. Grecian Magnesite paid tax in Greece on the gain triggered by the sale of its interest in the U.S. partnership.[51] To treat that gain as U.S. source ECI – the result mandated on the facts of that case by Rev. Rul. 91-32 – could have resulted in double taxation of the same gain. This potential outcome arises because the gain would be re-sourced away from the country of residence of the seller.[52] On the other hand, adopting the rule articulated by the Tax Court in *GMM* – which would generally leave source aligned with residence – could mitigate double taxation. It could be argued that adopting a rule which decreases double taxation would be a desirable result from a policy perspective, at least once the statute requires treating the gain as ECI regardless of source.

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an interpretation using a hypothetical office participation would be. On the other hand, it could be argued that the method of calculating the Cap itself presupposes such a hypothetical exercise. *See* note 55 below. But it is one thing to presume office participation for purposes of calculating the Cap, as the Cap is really an exception (or a relief valve) from the basic rule that all of the gain or loss is ECI or ECL. It is another thing to use a hypothetical office participation to reverse the basic source rule (which is residence of the seller) where no such participation actually occurred.

51 *See* Petitioner's Reply Brief at 11, *Grecian Magnesite, Mining, Industrial & Shipping Co., SA v. Comm'r*, 149 T.C. No. 3 (2017) (No. 19215-12).

52 Were a rule similar to that of Section 864(c)(8) become the international norm, double and even triple taxation of gains could become even more likely without a residence-based source rule. Consider the following example:

Example 10. PRS does business and has offices in three countries (the United States, Canada and Mexico). FP is a Mexican resident. FP's share of the built-in gain of the three branches is as follows: US: +$25X; Canada: +25X (USD); Mexico: -$25X (USD). Assume FP's overall gain on the sale of its partnership interest is therefore $25X (USD). Presumably, all of this gain is treated as ECI for U.S. federal income tax purposes (total gain = $25X; amount of allocated ECI in a hypothetical asset sale = $25X), and assume that such ECI is treated as U.S. source income. However, should Canada adopt a similar rule, then not only would all of the gain be fully subject to tax in Canada as well, for the same reason, but Canada would also presumably consider all of the gain to be Canadian source. Finally, it stands to reason that Mexico, the state of residence, would also seek to tax the gain and might logically consider the gain to be Mexican source. That would mean three jurisdictions would impose tax on the same amount of economic gain, with no foreign tax credits available in any country. On the other hand, should all three countries treat the gain as being Mexican source, then the triple taxation problem would be potentially eliminated. Note that Section 865(e)(2)(B) actually provides for a limited "tie breaker" rule where offices located in the U.S. and abroad both materially participate in the transaction; however, its scope is limited to sales of inventory property for use or distribution outside the United States.

Assuming one wishes to deviate from a residence-based source rule, however, there are a number of other ways to mitigate double taxation if desired, at least in theory. For one, Greece could have re-sourced the gain even though it was derived by a Greek resident from the sale of an interest in a business entity which sale was negotiated exclusively in Greece. This does not seem likely, although we note that under Section 865(e)(1) presumably that result would have arisen in the "mirror" case had Greek tax of 10% or more been imposed on the sale of a partnership interest by a U.S. resident so long as the partnership had an office in Greece which had contributed in some way to the growth of the business.[53]

Assuming Greece would not re-source the gain, another way to mitigate double taxation would be to resort to treaty provisions. Treaties could address the issue by barring imposition of tax by the nonresident state. The taxpayer in *GMM* made precisely such a claim, but the issue was not reached by the Tax Court which held for the taxpayer on purely statutory grounds. This approach would eliminate double taxation but at the cost of also eliminating the tax base of the nonresident state entirely when the sale of the branch is effected by a sale of partnership interests.[54]

In short, neither approach to mitigating double taxation appears very satisfactory or very practical, at least when compared to residence-based sourcing, if ECI and ECL status is de-coupled from source.

To summarize, applying pre-Act law, the Tax Court in *GMM* held gain of the type subject to tax under Section 864(c)(8) to be foreign source income; to the extent that result is correct, nothing in the Act expressly changes that result. We have set forth certain considerations above that may be considered in determining the appropriate source rule in this context. In this context, we think consideration could be given, if desired, to the implications for double taxation when considering the source of ECI and ECL arising from sales of partnership interests by

[53] Presumably, the office attribution rule of Section 865(e)(1) in the partnership context should operate in the same way it operates in Section 865(e)(2), which is addressed in Rev. Rul. 91-32. Thus, the hypothetical U.S. partner in the Greek partnership would be attributed the Greek office of the partnership. Deviating from a residence-based source rule based on the partnership's activities (as opposed to those of the partner) could have .consequences other potentially unintendedEven assuming, on the facts of *GMM*, that Greece would have adopted a rule akin to Section 865(e)(1), it is not clear how such a rule would apply where Greece (the residence state) views the partnership as fiscally opaque or views it as fiscally transparent but interprets the office attribution rule as the Tax Court did in *GMM*. For example, on the facts in *GMM*, if Greece had treated the partnership involved therein as fiscally opaque and had therefore treated the sale of partnership interests as a sale of stock, double taxation would presumably have arisen. And of course the same double taxation would also apply in the mirror case, where (for example) the U.S. treated a Greek partnership as a corporation while Greece taxed the sale because (in Greece) the corporation was a partnership. The rule of Section 864(c)(8) is not hybrid-sensitive, and the office attribution rule employed in Rev. Rul. 91-32 is a Code-based rule. The point is that a number of stars must align rather precisely to mitigate double taxation on sales of partnership interests once one departs from residence-based sourcing. The two countries must each have some version of Section 865(e)(1), they must have congruent rules concerning hybridity, and they must apply the office attribution rules in a similar, if not identical, manner.

[54] The application of treaties to transactions otherwise subject to Section 864(c)(8) is analyzed in Part I below.

foreign persons in a post-Act world, which points towards adoption or retention of residence-based sourcing.[55]

I. Interaction with Bilateral Income Tax Treaties

As a general rule, the U.S. does not tax gains of foreign persons unless such gains are or are deemed to be effectively connected with the conduct of a USTB. Bilateral income tax treaties generally operate to limit the taxes imposed by one jurisdiction on the residents of the other jurisdiction, usually to avoid or minimize double taxation of the same income. In particular, the "Gains" and "Business Profits" articles of most U.S. bilateral income tax treaties generally operate to shield any gains derived by a resident of one jurisdiction from taxation by the other jurisdiction unless such gains arise from the alienation of a permanent establishment (a "***PE***") or of personal property forming part of the business property of a PE in the other jurisdiction, or are derived from real property (as defined) situated in the other jurisdiction. Because, leaving USRPIs aside, the U.S. generally only taxes "effectively connected" gains of foreign persons to begin with, the impact of treaties on the U.S. federal income taxation of a foreign person's gains is generally limited to exempting from tax such ECI which does not arise from the alienation of personal property forming part of a PE.

While a Code provision which is later in time may override a treaty provision, in order to do so it ordinarily must address or relate to the treaty provision it is overriding.[56] Neither the Act in general nor Section 864(c)(8) in particular, by its terms, purports to affect the application of

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55 We note that there may be other considerations. For example, adopting residence-based sourcing would de-couple in many cases the source results in interest transfers from asset transfers. While the statute indicates a desire to align more closely the taxation of interest and asset transfers, it is silent as to alignment on source. Under the approach suggested in the text, arguably the desired alignment has been accomplished by making the "right" amount of income effectively connected. In addition, we think implementation of a look through source rule could be very complicated since it could be necessary to determine the source of a myriad of hypothetical asset transfers. For example, Section 865(e)(2)(B) re-sources gain or loss on sales of inventory property by a nonresident from foreign to U.S. if the gain is attributable to a U.S. office of the nonresident and then re-sources the gain back to foreign source if a foreign office materially participated in the sale and the sale is for use, disposition or consumption outside the United States. It is unclear how the participation of either the U.S. or foreign office would be determined in the case of a hypothetical sale, much less whether the hypothetical buyer of the inventory would be foreign. The difficulty could increase further if one takes the broader view of office attribution advanced by the Service in *GMM*, since that would require a potential inquiry into other activity not directly related to the hypothetical sale. This is only one issue of many, as the sourcing rules are complex. Adoption of a partner-level sourcing rule could be much simpler in this respect, although given the linkage between source and the determination of ECI, it could be argued that many of the same issues would arise in determining the Cap in any event.

56 *TWA v. Franklin Mint Corp.*, 466 U.S. 243, 252 (1984) ("There is, first, a firm and obviously sound canon of construction against finding implicit repeal of a treaty in ambiguous congressional action"); *Cook v. U.S.*, 288 U.S. 102, 120 (1933) ("A treaty will not be deemed to have been abrogated or modified by a later statute unless such purpose on the part of Congress has been clearly expressed"); *Amaral v. Commissioner*, 90 T.C. 802, 812 fn. 12 (1988), *nonacq.* 1988-2 C.B. 1 ("Congress may terminate or modify a treaty by a later statute, [citation omitted] but we will not deem a treaty to have been so modified or terminated unless we find that Congress has clearly expressed its purpose to do so.")

treaties. This approach can be contrasted with that taken by Congress with respect to FIRPTA, which specifically provided for treaty overrides.[57] Section 864(c)(8) simply treats as ECI or ECL certain gains or losses derived by foreign persons on sales of partnership interests. As pointed out above, this is neutral from a treaty perspective, because the gains provision of U.S. bilateral income tax treaties by definition can only apply to precisely such gains – for if there is no tax, the treaty has no application. Accordingly, our view is that Section 864(c)(8) was not intended to override any U.S. bilateral income tax treaty. That this result was intended can, we think, be gleaned from the text and legislative history of the Act, which nowhere mention treaties.

However, this does not end the inquiry. It is still necessary to determine whether and in what circumstances gain on the sale of a partnership interest would constitute gain from the alienation of personal property forming part of the business property of a PE in the United States under the provisions of a given treaty. In this regard, Rev. Rul. 91-32, Situation 3, directly addresses this issue, and we think it therefore provides helpful guidance. It states as follows (emphasis added):

> *Situation 3*
>
> …the Draft United States Model Income Tax Treaty (June 16, 1981) (the Treaty)…. generally exempts from United States tax gain from the disposition of movable property by a resident of the United States treaty partner. *See* Article 13(3) (Gains) of the Treaty. However, this rule does not apply if such gain is from the alienation of movable property that are assets of a permanent establishment in the United States.
>
> A foreign partner of a partnership that has a permanent establishment in the United States is treated as itself having a permanent establishment. *Donroy, Ltd. v. United States,* 301 F.2d 200 (9th Cir. 1962); *see* Rev. Rul. 85-60, 1985-1 C.B. 187. More particularly, "the office or permanent establishment of a partnership is the office of each of its partners, whether general or limited." *Unger v. Commissioner, T. C.* Memo. 1990-15, 58 TCM 1157, 1159, citing *Donroy, Ltd. v. United States, supra.* Accordingly, *FP2* is considered to have a permanent establishment in the United States because he is a partner in PS2.
>
> <u>The determination whether gain from the alienation of movable property is attributable to a permanent establishment in the United States is generally made</u>

[57] Section 1122(c) of P.L. 96-499 (as amended by Sec. 831(h) of P.L. 97-34), which added Section 897 to the Code, specifically provided that "except as provided in paragraph (2) [concerning certain renegotiated treaties], after December 31, 1984, nothing in section 894(a) or 7852(d) of the Internal Revenue Code of 1954 or in any other provision of law shall be treated as requiring, by reason of any treaty obligation of the United States, an exemption from (or reduction of) any tax imposed by section 871 or 882 of such Code on a gain described in section 897 of such Code."

by applying principles analogous to those governing whether an item is effectively connected with the conduct of a trade or business in the United States, though the "attributable to" concept of the Treaty is more limited in its scope than the "effectively connected" concept of the Code. *See* Rev. Rul. 81-78, 1981-1 C.B. 604. The principles applied are substantially similar, however, when the amounts at issue are those that would be described in section 864(c)(2) of the Code if the Treaty were not applied. Accordingly, for the reasons discussed in *Situation* 1, a disposition of an interest in a partnership that has a permanent establishment in the United States will be treated as resulting in gain that is attributable to the permanent establishment to the extent provided below.

It is appropriate under the Treaty to look to a foreign partner's interest in the assets of the partnership to determine the amount of the foreign partner's gain from the disposition of its partnership interest that is attributable to a United States permanent establishment. *Cf*. Commentary on Article 1 of the OECD Model Double Taxation Convention on Income and Capital, paragraphs 2-5 (1977). Gain of *FP2* from the disposition of its interest in PS2 will thus be subject to United States tax only to the extent such gain is attributable to the unrealized gain of the partnership's assets attributable to the partnership's permanent establishment, and loss will be allocable to *FP2's* gain from sources within the United States that is attributable to a permanent establishment of *FP2*. Such gain or loss is to be determined in the manner described in *Situation 1*.

Holdings

...

Situation 3

Under the Treaty, gain of a foreign partner that disposes of its interest in a partnership that has a United States permanent establishment is gain that is attributable to a permanent establishment and is subject to United States tax under the Treaty, to the extent that the partner's potential distributive share of unrealized gain of the partnership is attributable to the partnership's permanent establishment.

The analysis contained in Situation 3 leads to at least three conclusions.

First, if a partnership has no PE, then a treaty-based foreign partner is clearly protected from taxation under a typical U.S. bilateral income tax treaty upon a disposition of its partnership interest, and nothing in Section 864(c)(8) adversely affects that protection, even if the partnership in question has a USTB.

Second, even if the partnership has a PE, the amount of gain under the treaty in question would be limited to the amount of gain “attributable” to that PE, which, as Rev. Rul. 91-32 notes, can be different (usually lower) than the amount which would be treated as effectively connected under the Code.[58]

Third, where the partnership has a PE, the analysis critically depends on "exporting" the Code-based analysis of Situations 1 and 2 to a treaty context (see underscored language). It was this exact "look through" analysis, however, that the Tax Court rejected in *GMM*.

The facts in *GMM* involved a redemption of a partnership interest and, accordingly, the operative section was Section 731. *GMM* stated as follows:

> …section 731(a)…makes explicit that the "entity theory" generally applies to a partner's gain from a distribution:
>
> > Any gain or loss recognized under this subsection shall be considered as gain or loss *from the sale or exchange of the partnership interest* of the distributee partner.
>
> Sec. 731(a) (emphasis added). This wording could hardly be clearer. The partnership provisions in subchapter K of the Code provide a general rule that the "entity theory" applies to sales and liquidating distributions of partnership interests-i.e., that such sales are treated not as sales of underlying assets but as sales of the partnership interest….
>
> The Commissioner has not convinced us to reconsider the argument that we rejected 38 years ago when it was advanced by the taxpayer in Pollack. Addressing ourselves to the statutory text, we conclude that subchapter K mandates treating the disputed gain as capital gain from the disposition of a single asset….

To summarize thus far, the method employed in Rev. Rul. 91-32 to treat sales of partnership interests as sales of business property of a PE owned by the partnership seems to be exactly the same as the "aggregate" method used in that Ruling to treat such sales as taxable under the Code. That aggregate method was rejected by the Tax Court in *GMM*.[59] Using that

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58 It would be helpful to have guidance as to how these rules apply in hybrid situations. Consider the following example: FP, a foreign corporation resident in Country A, is a partner in Hybrid, a Country B LLC that holds a USTB but no PE and is treated as a partnership for U.S. federal income tax purposes and as a corporation for Country B purposes. Country A does not have an income tax treaty with the United States, while Country B does. If Hybrid sold its USTB and would be able to claim benefits under the Country B treaty, because Country B does not regard Hybrid as fiscally transparent, presumably FP would therefore not have any income tax liability on the sale. On the other hand, if FP sold its interest in Hybrid, Section 864(c)(8) would presumably treat such gain as ECI. Guidance as to whether FP would be eligible to claim any treaty benefits in this situation under the logic of Rev. Rul. 91-32 would be useful.

59 *Grecian Magnesite*, 149 T.C. No. 3 at *25-*31. While *GMM* is currently on appeal, based on the brief filed by the Commissioner, it does not appear that the aforementioned conclusion is being challenged by the government. Brief for Respondent-Appellant, *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner* (D.C. Cir. *brief filed* June 8, 2018), (No. 17-1268). Rather, the Commissioner's brief concentrates solely on the holding in *GMM* that the gain derived by the taxpayer in that case on the redemption of its partnership interest was foreign source.

common law "aggregate" approach, and assuming no challenge to the holding of *GMM* on the "aggregate versus entity" issue is successful, it is not clear how one could directly apply Situation 3 to subject to U.S. tax a treaty-based foreign selling partner on the grounds that the partnership interest being sold was in fact the PE itself or "business property" of the PE of the partnership itself once it is conceded that the partnership interest is itself a separate unitary asset and not some sort of amalgam of interests in the underlying assets. The analysis in Situation 3 was explicitly based on the approach in Situation 1, the same approach which was rejected by the Tax Court in *GMM*. It is difficult to see how a common law aggregate approach could be applied for purposes of applying a treaty if it does not apply for purposes of applying Code provisions generally. Absent such an approach, it is also not intuitively obvious on what grounds a partnership interest is "business property" of the PE owned by the partnership (much less that it is the PE itself). The contrary interpretation if anything seems more logical, as well as consistent with the reasoning of *GMM*.

We note that while Rev. Rul. 91-32 uses the words "attributable to a PE" in the underscored passage above, it is not entirely clear that the attribution concept found in the business profits article of most treaties is germane here. The 2016 United States Model Income Tax Convention (the "***Model Treaty***"), as well as most U.S. income tax treaties in general, expressly subordinates the provisions of the Business Profits article to any other article (such as the Gains article) which deals with a specific category of income.[60] Thus the question of whether a gain is "attributable" to a PE is generally relevant only where the treaty permits taxation of the gains in the first place. In the case of personal or movable property, this property generally must be the PE itself or form part of the "business property" of the PE before it can be taxed, and before the question of "attribution" arises.[61] Rev. Rul. 91-32 in effect avoided or elided this issue by adopting an aggregate approach to partnership interests, but *GMM* rejected that approach.[62]

Nor are the words of the Gains article of the Model Treaty themselves conducive to aggregate argument on their face. In the treaty context, the question is whether the assets sold consisted of "business property" of the PE, not whether the gain on the sale of interests is

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60 Model Treaty, Article 7(4): "Where profits include items of income that are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article."

61 It should be noted that some treaties use concepts other than "business property" of a PE. For instance, the Romanian treaty (Article 13(1)(a)) and the South Korean treaty (Article 16(1)(b)) each provide for taxation in the state where the PE is located if "the property giving rise to the gain is <u>effectively connected</u> with such permanent establishment," which may suggest a different (perhaps broader) test. In addition, a few treaties do not contain a "Gains" article, and some give broader scope to taxing gains generally than the Model Treaty does.

62 If, however, one were to take the position that the attribution concept should govern the taxability of the gain, we note that the technical explanations of many treaties explain "attribution" in the treaty context as "analogous but not entirely equivalent to the 'effectively connected' concept in Code section 864(c)" (*see, e.g.*, the Technical Explanation to Article 7(2) of the United Kingdom treaty), and that one could argue that once Section 864(c)(8) has recharacterized the gain as ECI in the domestic context, the gain is "attributable to" a PE in the treaty context.

"attributable" to the PE. This is a different and arguably narrower test that whether the gain is "attributable" to a PE, just as it also seems to be a different and narrower test than the connection required to be effectively connected under the Code. In addition, the typical U.S. bilateral income tax treaty provides an explicit look-through rule for partnerships where real property is concerned.[63] In other words, a partnership interest can be treated as a real estate interest to the extent (and only to the extent) its assets consist of real property interests. It is not necessary to make this rule bilateral (although at least one treaty previously did) because of the incorporation of the Code definition of a USRPI in the case of the United States, thereby incorporating Section 897(g) directly into the treaty.[64] But it suffices to show that the treaty itself does not presume a generic "look through" rule for partnership interests. For example, the analogous provision for gains derived from the sale of movable property provides as follows:

> Gains from the alienation of movable property forming part of the business property of a permanent establishment that an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other Contracting State.[65]

While not dispositive, the structure of the Model Treaty provision appears to indicate that if an "aggregate" approach to taxation of gains arising from sales of partnership interests is

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63 For example, Article 13 of the Model Treaty provides in relevant part concerning gains derived from real estate:

> 1. Gains derived by a resident of a Contracting State from the alienation of real property (immovable property) situated in the other Contracting State may be taxed in that other Contracting State.
>
> 2. For the purposes of this Article the term "real property (immovable property) situated in the other Contracting State" shall include:
>
> > a) real property (immovable property) referred to in Article 6 (Income from Real Property (Immovable Property));
> >
> > b) where that other Contracting State is the United States, a United States real property interest; and
> >
> > c) where that other Contracting State is __________, …
> >
> > > ii) an interest in a partnership or trust to the extent that the assets of the partnership or trust consist of real property situated in __________, …

64 *See, e.g.*, the original Article 13(3)(b) of the 1980 U.S.-Canada treaty (*available at* https://www.irs.gov/businesses/international-businesses/canada-tax-treaty-documents), establishing a bilateral rule, which was later replaced under Article 6(1) of the 1983 protocol to the treaty, which incorporated the concept of a USRPI.

65 Article 13(3) of the Model Treaty.

appropriate, such approach should be found in the domestic law of the country in which the PE was located, if at all.

In fact, one treaty that explicitly addresses this issue in the text of the treaty appears to take precisely this approach. The Protocol to the German treaty, with respect to its Gain article (which is otherwise similar to the Model Treaty provisions quoted above), provides that "Nothing in [Article 13(3)] shall prevent gains from the alienation by a resident of a Contracting State of an interest in a partnership, trust, or estate that has a permanent establishment situated in the other Contracting State from being treated as gain under paragraph 3."[66] The technical explanations to the treaties with Austria, the Netherlands, Sweden, Turkey, and Ukraine (at least) each contain a somewhat similar, though arguably broader, statement (although the treaties themselves do not).[67] The legislative history to other treaties often will contain a reference to Rev. Rul. 91-32, but typically this is in the context of explaining why asset sales by a partnership are attributable to a foreign partner's PE.[68] Aside from these references, there appears to be little if any authority on point in any treaty, in contrast to the treatment of gains derived from real property, where the "look through" treatment in the case of partnership interest sales is usually quite explicit.

This leaves open the question of whether the German Protocol was intended to confirm an interpretation of its Gains article or to expand it. The "nothing" language suggests the latter. Even if one takes the view that the Protocol is intended as an "in furtherance of" provision, it still leaves the taxation to domestic law and, as pointed out above, it is not entirely clear where this stands when the statutory provision in question has no reference to PEs and the administrative guidance uses reasoning which has been rejected by the only judicial decision on

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66 Protocol Amending the Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, Signed on 29th August 1989, Paragraph 13.

67 *See*, *e.g.*, Treasury Department Technical Explanation of U.S.-Netherlands income tax treaty, signed December 18, 1992, and the protocol amending the treaty, signed October 13, 1993, Article 14 ("[Paragraph 3] permits gains from the alienation by a resident of a State of an interest in a partnership, trust or estate that has a permanent establishment situated in the other State to be taxed as gains attributable to such permanent establishment under paragraph 3. Thus, for example, the United States may tax gains derived from the disposition of an interest in a partnership that has a permanent establishment in the United States, regardless of whether the assets of such partnership consist of personal property as defined in Article 14.").

68 *See*, *e.g.*, Treasury Department Technical Explanation of U.S.-United Kingdom income tax treaty, signed July 24, 2001 ("A resident of the United Kingdom that is a partner in a partnership doing business in the United States generally will have a permanent establishment in the United States as a result of the activities of the partnership, assuming that the activities of the partnership rise to the level of a permanent establishment. Rev. Rul. 91-32, 1991-1 C.B. 107. Further, under paragraph 3, the United States generally may tax a partner's distributive share of income realized by a partnership on the disposition of personal (movable) property forming part of the business property of the partnership in the United States."). The question presented by these references to Rev. Rul. 91-32 is whether they represent some sort of an implicit understanding between the contracting states that aggregate treatment in this case was appropriate. Whatever the strength of this argument, it clearly seems weaker where the reference to Rev. Rul. 91-32 makes no mention of partnership interest sales.

point to date. In the interim, regardless of the scope of the gains provision, Rev. Rul. 91-32 has not been withdrawn and accordingly, taxpayers can still rely on it whether or not it binds them.[69]

To summarize, taxpayers appear to remain protected by Rev. Rul. 91-32 in the treaty context, while there is doubt as to the degree to which the Service can continue to use its method of analysis in that context. To the extent the Service cannot use the reasoning of Rev. Rul. 91-32, Section 864(c)(8) may not provide assistance in treaty interpretation for the reasons set forth above.

This state of affairs could benefit from further guidance. The Prior Letter urged the government to endorse the approach of Rev. Rul. 91-32, which at least would have the virtue of putting taxpayers on notice that they cannot assume the Ruling is now a one-way street in their favor.[70] However, even if such an announcement is made, the theoretical basis for its conclusions may remain uncertain unless either (a) *GMM* or a successor case is overturned in a situation in which the aggregate versus entity conclusion is revisited, or (b) the conclusion of the analysis rests at least partly on a different theoretical basis than the common law "aggregate" approach of Rev. Rul. 91-32. For example, the ABA Report argues that the fact that Section 864(c)(8)(B) uses a hypothetical liquidation to calculate the Cap "could be read as indicative of an intention that such deemed asset sale character be applied in testing eligibility for treaty protection."[71] This argument could potentially provide a statutory basis for the conclusion in Situation 3. In any event, the Model Treaty language appears to require that the partnership interest constitute either the permanent establishment the partnership owns or business property thereof in order to align with the approach taken in Rev. Rul. 91-32 and subject the sale of that asset to tax.

Given these considerations, in addition to confirmation of the result in Situation 3 of Rev. Rul. 91-32 by administrative guidance, if desired consideration could also be given to amending the Code to explicitly adopt the holding of that Ruling, as well as amending our treaties to resolve or clarify this issue. These various approaches are not necessarily mutually exclusive.[72]

For example, the wording of the Model Treaty could be amended to create a corollary set of provisions to those found in the Model Treaty for partnerships owning real estate and that change could be introduced into protocols as the occasion arose.

For example, a typical treaty provision might say:

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69 *Rauenhorst v. Commissioner*, 119 T.C. 157, 171 (2002) (holding that the Commissioner is bound by a revenue ruling that has not been revoked, even when a court has arguably ruled against it).

70 Prior Letter at 11.

71 ABA Report, *supra* note 6 at 12.

72 The ability of a foreign partner to claim foreign tax credits for any taxes it pays in its jurisdiction of tax residence, discussed above in Section H, may also be relevant in this context. *See* text accompanying note 54 above.

> Gains from the alienation of movable property forming part of the business property of a permanent establishment that an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other Contracting State. For this purpose, the business property of a permanent establishment shall include interests in a partnership, trust or estate to the extent the [value of such interest is derived from] [gain or loss (if any) realized on such alienation is attributable to] a permanent establishment situated in the other state.

To the extent such a corollary set of provisions could not readily be added, consideration should be given to at least adding to existing treaties as the occasion arises a provision comparable to the Protocol to the German treaty.

J. Coordination of the Provisions with the FIRPTA Provisions

1. Coordination of Section 864(c)(8) with Section 897(g)

Section 864(c)(8)(C) provides that the amount of gain or loss potentially treated as ECI or ECL under Section 864(c)(8)(A) is reduced by the amount of gain or loss so treated under Section 897. Thus, in order to calculate the amount of gain or loss treated as ECI or ECL under Section 864(c)(8) upon the disposition of an interest in a partnership that holds both USRPIs and other USTB assets, the transferor must first determine the portion of the gain or loss treated as ECI or ECL under Section 897.

Where a foreign partner recognizes a gain (or loss) on its disposition of its partnership interest, and the partnership has built-in gain (or built-in loss) in both its USRPIs and its other USTB assets, the application of the FIRPTA coordination rule in Section 864(c)(8)(C) is relatively straightforward. It is unclear, however, how Section 864(c)(8)(C) should apply where a foreign partner recognizes gain or loss on its disposition of its partnership interest and the partnership has built-in gain in its USRPIs and a built-in loss in other USTB assets or vice versa.

Example 11. FP sells its interest in PRS for $100. FP's adjusted tax basis in its PRS interest is $100. Therefore, FP recognizes no gain or loss in connection with the disposition (assuming that Section 751 does not apply to cause FP to recognize any ordinary items). Of the $100 of proceeds, (i) $20 is attributable to a USRPI, in which FP's indirect basis is $10 and (ii) $80 is attributable to other USTB assets in which FP's indirect basis is $90. FP recognizes $10 of ECI gain relating to the USRPI under Section 897(g). Section 864(c)(8)(C) then directs FP to reduce the amount of ECI otherwise recognized under Section 864(c)(8) by $10. Because FP otherwise recognizes no gain or loss in connection with the disposition, it is unclear whether Section 864(c)(8)(C) should cause FP to recognize a $10 ECL (because its gain of zero was reduced by $10 to result in a $10 ECL) or whether the direction to reduce gain or loss by gain or loss recognized under Section 897(g) should be limited to reducing the amount to zero, but not creating an ECL where FP otherwise recognized ECI. While the language is unclear, we believe that sound tax policy should allow FP to recognize a $10 ECL in this case. Specifically, if PRS were to sell all of its assets, FP would recognize no net ECI or ECL because its share of ECI with respect to PRS's USRPI would be offset by its share of ECL with respect to PRS's non-USRPI

USTB assets. It is difficult to see the policy justification to require FP to recognize ECI with respect to the USRPI and deny it the ECL with respect to the other assets. Accordingly, we recommend that regulations provide that FP's reduction of ECI or ECL recognized under Section 864(c)(8) for gain or loss recognized under FIRPTA may result in the creation of ECI or ECL, even where FP recognizes no overall gain or loss, respectively, in connection with the disposition.

2. Coordination of Section 1446(f) with Section 1445

As discussed above, the Notice states that Treasury and the Service intend to issue regulations that Section 1446(f) withholding is not required if upon the transfer of a partnership interest the transferee is provided a certification that either:

- for the transferor's immediately prior taxable year and the two taxable years that precede it (i) the transferor was a partner in the partnership for the entirety of each of those years, and (ii) the transferor's allocable share of ECI for each of those taxable years was less than 25% of the transferor's total distributive share of income for that year (a "***25% ECI Exception***"),[73] or

- if the partnership had sold all of its assets for their fair market value, the amount of ECI recognized by the partnership would be less than 25% of the partnership's total gain recognized (a "***25% Gain Exception***" and, together with the 25% ECI Certification, the "***25% Exceptions***").[74]

For purposes of each of these exceptions, the Notice does not distinguish between ECI from the disposition of a USRPI under Section 897 and ECI from the disposition of other USTB assets. With respect to the transfer of a partnership interest in a partnership holding USRPIs, Treas. Reg. § 1.1445-11T(d)(1) requires the withholding of tax under Section 1445 only if (i) 50% or more of the value of the gross assets consist of USPRIs, and (ii) 90% or more of the value of the gross assets consist of USPRIs plus any cash or cash equivalents (the "***50/90 Rule***").

We consider below three alternative approaches for taking into account USRPIs in applying the 25% Exceptions:

- treat FIRPTA gains as ECI for purposes of determining the amount of ECI and include such gains in determining the total amount of income and gains,

- ignore FIRPTA gains in determining the amount of ECI, but include such gains in determining the total amount of income and gains, and

- ignore FIRPTA gain in determining both the amount of ECI and the total amount of income and gains.

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73 Notice, Section 6.03.

74 Notice, Section 6.04.

Under the first approach, where FIRPTA gains would count both for determining the amount of ECI and for determining total income and gains, the disposition of an interest in a partnership with no USTB assets other than USRPIs could be ineligible for the 25% Gain Exception even though such partnership interest would not be subject to withholding under Section 1445 under the 50/90 Rule. For example, assume that PRS holds two assets, a USRPI with a basis of zero and a fair market value of $25 and a non-USTB asset with a basis of zero and a fair market value of $75. Assume further that the 25% ECI Exception does not apply. FP's sale of its interest in PRS would not be eligible for the 25% Gain Exception, even though PRS holds no USTB assets other than a USRPI.

Read literally, the 25% Exceptions look to how much ECI has been, or upon an asset sale would be, recognized and does not distinguish between ECI recognized under Section 897 and other types of ECI, which is consistent with the first approach. If the 25% Exceptions were interpreted in such a manner, however, it would substantially change the manner in which withholding upon the sale of partnership interests in partnerships holding real property would be applied, effectively replacing in most cases the 50/90 Rule with the 25% Exceptions. There is no suggestion in the Committee Report or otherwise that the Provisions were intended to alter the current substantive or withholding tax treatment under Section 897 and 1445 of transfers of partnership interests in real property partnerships. This view is consistent with Rev. Rul. 91-32, which was intended to address the treatment of gain attributable to USTB assets of a partnership other than USRPIs. Furthermore, given that the amount of overall gain or loss potentially treated as ECI or ECL under Section 864(c)(8) is reduced by the amount of ECI or ECL recognized under Section 897(g), it would seem odd that FIRPTA gains would nevertheless be counted in applying the 25% Exceptions.

Under the second approach, where FIRPTA gains would not count in determining the amount of ECI recognized but would count in determining total income and gains, the result could be highly distortive, particularly where most of the partnership's assets are either USRPIs or USTB assets other than USRPIs. For example, assume that PRS holds two assets, a USRPI with a basis of zero and a fair market value of $76 and non-USTB assets with a basis of zero and a fair market value of $24. If the second approach applied to treat PRS as having $100 of built-in gain, only $24 of which would produce ECI (because the built-in FIRPTA gain is ignored), FP's transfer of its PRS interest would not be subject to Section 1446(f) withholding under the 25% Gain Exception, even though all of PRS's gain would be treated as ECI.

The third approach, where FIRPTA gains would be ignored for both determining ECI and determining total income and gains, appears to be the most reasonable approach. In effect, it would apply the 25% Exceptions only to the non-USRPI assets held by the partnership and would look to the percentage of total income and gain that is (or upon an asset sale would be) derived with respect to those non-USRPI assets that would be ECI. This seems to be in keeping with the overall framework of the Provisions, which focus on non-FIRPTA ECI. Therefore, we recommend that regulations provide that in applying the 25% Exceptions, recognized or built-in gains with respect to USRPIs held by the partnership are ignored.

K. Exception from Withholding Where Effectively Connected Gain is Less Than Threshold Percentage of Total Gain

As described above, the Notice provides for two exceptions – the 25% Exceptions – from withholding under Section 1446(f) where ECI is less than a threshold percentage of the total gain.

1. Level of the Threshold

The Notice states that the government intends "to provide future guidance that will reduce the threshold for withholding below 25 percent for both of these rules." It is not clear why the Notice would use a 25% threshold but then indicate its intention to use a lower threshold in future guidance. First, the 25% threshold is already substantially lower than the current 50/90 Test used for FIRPTA withholding. Second, because withholding under Section 1446(f) is generally an all-or-nothing approach (unless the government permits the issuance of withholding certificates allowing for a reduced amount of withholding), the full 10% of the amount realized in connection with a partnership interest transfer will need to be withheld so long as the relevant threshold is exceeded. Further lowering the threshold would increase the likelihood that the amount withheld will be substantially disproportionate to the amount of tax actually owed by the foreign partner. While it is not clear that the 25% threshold contained in the Notice should be reduced, we recommend that any reduction of such threshold be to a level no lower than 10% in light of the concerns discussed above.

2. Use of the 25% ECI Exception

We also note that ambiguity exists regarding the inapplicability of the 25% ECI Exception where a transferor "did not have a distributive share of income in any of its three immediately prior taxable years during which the partnership had effectively connected income." Specifically, it is unclear whether this provision applies where, in *any one* of such years, the transferor had no distributive share of income or, alternatively, only where, in *all* of such years, the transferor had no distributive share of income. While the language is unclear, we think that the better approach would be for the 25% ECI Exception to be inapplicable only where the transferor had no distributive share of ECI during the entire three-year period. As a result, we recommend that regulations clarify the application of the 25% ECI Exception in this regard.

We also note that because the 25% ECI Exception looks to whether the ECI allocated to the foreign partner was less than 25% of the partner's total distributive share of income for that year, it is unclear whether the exception may be applicable, and if so, how it should be applied, where for a particular taxable year the foreign partner was allocated ECL (rather than ECI) and/or where the foreign partner was allocated overall net loss.

L. Secondary Liability of a Partnership to Withhold Under Section 1446(f)(4)

Section 1446(f)(4) introduces a new regime of secondary withholding: If the buyer of a partnership interest ("***B***") does not properly withhold on FP in connection with the disposition of its interest in PRS, then PRS itself must withhold tax from future distributions to B in the same amount that B failed to withhold on PRS, plus interest. This withholding requirement was temporarily suspended under Section 11 of the Notice "until regulations or other guidance have been issued under [Section 1446(f)(4)]."

The operation of Section 1446(f)(4) raises several issues that should be addressed through guidance. The first issue is that Section 1446(f)(4) does not, by its terms, permit B to certify to PRS that it withheld properly in a manner that relieves PRS of the obligation to withhold on distributions to B. As the law presently stands, absent the Notice, when FP disposes of its PRS interest, the only way for PRS to be sure that it will avoid interest and penalties for not fulfilling its secondary withholding obligation is to withhold on future distributions to B and allow B to file for a refund. Although PRS may have information regarding the sales price and other details of the transaction, nothing in Section 1446(f)(4) or the Notice would allow PRS to rely on that knowledge in order to limit its secondary withholding obligation (including interest and penalties thereon).

Typically, the PRS partnership agreement will give PRS the right to deduct from distributions otherwise payable to any partner the amount of any withholding taxes properly charged to that partner. Such agreements may also include a contribution right, whereby partners must contribute any shortfall to PRS in the event that any future distributions payable to such partner are not sufficient to cover the withholding liability, and this right may survive even if the partner in question ceases to be a partner. Whether or not such provisions are included in the PRS agreement, and whether or not they explicitly reference Section 1446(f), PRS's general partner or managing member will often have at least a reasonable consent right over transfers of partnership interests, except in the case of PTP unit transfers. The general partner or managing member would be expected to require an indemnity from both B and FP for any secondary withholding liability imposed on PRS. While both of these types of "self-help" can mitigate the problem, absent a procedure which allows for certification and reliance, because the secondary liability is strict in nature, PRS is still technically liable unless it withholds the entirety of every future distribution it would make to B, including any liquidating distribution, until the potential exposure is satisfied, in which case B would need to file for a refund.[75]

For example, consider a case in which an interest in PRS is sold as part of a much larger transaction. PRS may know what portion of the purchase price is allocated to the interests in PRS being transferred by FP and whether that allocated amount has been properly withheld upon. However, the portion of the purchase price allocated to the interest in PRS could be revised – for example, by reason of an audit, which could occur as long as FP's statute of limitations for the year of transfer stays open.

Accordingly, we recommend that regulations provide that PRS may rely on a certification by B that it fulfilled its requirement to withhold under Section 1446(f)(1) with respect to its acquisition of its PRS interest so long as PRS does not know or have reason to know the information contained in the certification is incorrect. Such certification could, if desired, include the basis on which B calculated the amount withheld. Exemption could be conditioned on PRS's cooperation in certifying as to FP's share of any PRS partnership liabilities under the

[75] Note that, to the extent that primary withholding is relieved because of a certification safe harbor, there is presumably no secondary withholding – PRS would be liable only for amounts that B should have, but did not, withhold.

procedures set forth in the Notice or any similar future guidance, if such cooperation is not otherwise made obligatory.[76]

The second issue raised is the application of secondary withholding to PTP units. PTP units are traded on exchanges. Thus, the buyer of the interest does not know who the seller is, or vice versa. For this reason, we recommend in Part P below that any withholding required under Section 1446(f) be undertaken by the broker through which a PTP unit transfer is executed. For the same reason that it is impractical for the buyer of PTP units to withhold on the purchase price, it is also impractical for PRS to be responsible for determining whether proper withholding under Section 1446(f) was effected with respect to a PTP unit transfer and to be made liable for withholding on distributions to the buyer of such a unit where there was under-withholding. We would recommend that a corollary provision of a broker withholding regime would be to exempt the PTP from all secondary liability for exchange-traded sales of PTP units. Such an exemption should apply whether or not the relevant broker discharged its own withholding responsibility properly, at least in cases where the PTP did not know or have reason to know that such broker did not properly discharge its responsibilities.

Another issue is the scope of the secondary withholding requirement in the case of multiple transfers of a single partnership interest. Suppose FP transfers its interest in PRS to USP, who fails to withhold as required under Section 1446(f)(1) (the "***first transfer***"). PRS now has an obligation under Section 1446(f)(4) to withhold on future distributions to USP. Suppose further that, before PRS fully satisfies its secondary withholding obligation, USP transfers its interest to FP2, who is not required to withhold under Section 1446(f)(1) because USP can certify it is a U.S. person (the "***second transfer***"). By the terms of the statute, it would appear that PRS has no obligation to withhold on future distributions to FP2. PRS's obligation to withhold in connection with a transfer only extends to "distributions to the transferee." In the case of the first transfer, therefore, PRS's secondary withholding obligation only applies to mandate withholding from distributions to USP. USP is no longer a partner and no longer expects to receive any distributions from PRS. And if USP properly certified as to its U.S. status during the second transfer, PRS has no secondary obligation to withhold on FP2 in connection with the second transfer.

This result is sound from a policy perspective, as well. The contrary result, that USP's failure to withhold "taints" the interest it acquired such that PRS must withhold on whoever currently owns the tainted interest, would be impractical. Every potential purchaser of any partnership interest (including potential U.S. buyers of partnership interests from U.S. sellers) would need to diligence the history of transfers of the partnership interest going back to January 1, 2018 to ensure that in every prior transfer of that PRS interest (or any predecessor interest in a prior partnership which PRS succeeded to, for example, by reason of a merger or continuation) any withholding obligations were properly discharged. Applying secondary withholding in this manner would make persons who were only remotely or tangentially related to the under-withholding the persons who would bear the burden of that under-withholding. Partnerships, for

[76] If such cooperation is made obligatory, then it also stands to reason that PRS should be entitled to rely on the certification.

their part, would be required to track their secondary withholding obligations on various interests as they were sold and resold. If complex rights in a tainted partnership interest were sold, or if a partner who holds both tainted and untainted interests in a partnership were to sell a portion of its aggregate interests to a third party, it could create uncertainty as to the partnership's withholding liability. The amount of work needed to "pedigree" every partnership interest transfer would be extensive and would only grow over time. In short, the statute does not provide for this sort of "successor" withholding regime and for the reasons set forth herein, even if there were authority to impose such a regime, we do not think it would be advisable to do so.

However, consider a case where FP and USP are under common control, or where the first transfer and the second transfer were part of the same plan and/or are close in time. In the most extreme case, USP's status as a bona fide partner might be open to question. In such a situation, exempting PRS from secondary withholding on distributions to FP2 may appear to blunt the deterrent effect of secondary withholding, which we assume is to motivate the parties to the transaction to withhold properly in the first place. Having said that, however, we think that any anti-abuse rule should in the first instance focus on FP, USP and FP2 (rather than PRS). For example, FP2 may know or have reason to know that USP is serving as FP's agent or intermediary. FP2 is better positioned to make this assessment, as opposed to PRS, which is (as pointed out above) a stranger to the transaction. In appropriate cases, FP2 should presumably not be permitted to rely on USP's nonforeign certification. On the other hand, if no anti-abuse rule applies to the primary withholding liability, none should apply to the secondary withholding liability either. PRS's secondary withholding liability is supposed to be derivative of a primary withholding liability, and is to be satisfied only out of future distributions to a person who did not discharge that responsibility properly. Where, for example, USP is a bona fide partner, neither condition obtains, because FP2 will be entitled to rely on USP's certification of nonforeign status and will therefore be exempt from primary withholding, and there are no future distributions to be made to USP from which secondary withholding can be satisfied.

Balancing all of the various factors, we think that an anti-abuse rule, if one is imposed, should be very narrowly targeted and apply if and only if (a) either (i) FP2 is not entitled to exemption from its obligation to withhold on the purchase from USP[77] (for example, because it knows or has reason to know that USP is acting as FP's agent), or (ii) under general tax principles, USP would not be treated as the beneficial owner of the interest in PRS, but rather would be treated as an agent or intermediary of either FP or FP2 and (b) PRS knows or has reason to know the condition described in (a)(i) or (ii) is present.

M. Application of Section 1446(f) Where There Are Insufficient Funds to Withhold

Section 8 of the Notice addresses a situation where 10% of the amount realized by a foreign partner upon its disposition of its partnership interest is greater than the amount of money or other property paid by the transferee. Such a situation could arise, for example, when the partnership's assets are heavily levered, or when the foreign partner cannot establish its share of

77 We recognize that it may be appropriate to apply the anti-abuse rule in appropriate cases where USP is a foreign person.

partnership liabilities. Section 8 provides that the transferee's withholding liability is limited to "the entire amount realized, determined without regard to the decrease in the transferor partner's share of partnership liabilities" (*i.e.*, "the amount that the transferor would, but for the transferee remitting it as withholding under Section 1446(f), receive from the transferee"). This limiting rule does not apply to withholding on a partnership distribution in excess of basis, or if the transferee is related to the transferor within the meaning of Section 267(b) or Section 707(b)(1).

The FIRPTA withholding regulations take a different approach, requiring that the transferee apply to the Secretary for a certificate of reduced withholding in a case where the amount paid is insufficient to cover the transferee's withholding obligation.[78] Thus, while the FIRPTA regulations require Treasury's blessing to attain reduced withholding, the Notice allows for automatic reduced withholding in certain circumstances.[79]

We believe that the approach taken by the government in Section 8 of the Notice is appropriate. We recognize that automatically reducing withholding may leave open some possibility of abuse, but we think the administrative burden placed on both Treasury and the taxpayers would be too heavy if Treasury were to be required to issue a withholding certificate for every transfer of an interest in a heavily levered partnership. Moreover, the fact that the automatic reduction rule does not apply in the case of a related transferee deals effectively with certain types of potential abuse. We do believe, however, that where the transferor and transferee are related, they should be able to apply to Treasury for a reduction in withholding, as provided in Section 1446(f)(3).

N. Withholding in Connection with Disguised Sales of Partnership Interests

In 1984, Congress enacted Section 707(a)(2)(B),[80] which authorized the issuance of regulations permitting the recharacterization of related transfers of property to and from a partnership as a sale of a partnership interest where the transfers, "when viewed together, are properly characterized as a sale or exchange of property." While proposed regulations attempting to implement this provision were withdrawn in 2009, the Service announced at the time of such withdrawal that "until new guidance is issued, any determination of whether transfers between a partner or partners and a partnership is a transfer of a partnership interest will be based on the statutory language, guidance provided in legislative history, and case law."[81] Thus, even in the absence of regulations regarding disguised sales of partnership interests, a contribution to a partnership and a related distribution by the partnership may in appropriate

[78] Treas. Reg. § 1.1445-1(b)(5).

[79] Section 1446(f)(3) also provides for Treasury-approved, case-by-case reduced withholding: "At the request of the transferor or transferee, the Secretary may prescribe a reduced amount to be withheld under this section if the Secretary determines that to substitute such reduced amount will not jeopardize the collection of the tax imposed under this title with respect to gain treated under section 864(c)(8) as effectively connected with the conduct of a trade or business with in the United States."

[80] H.R. Rep. No. 98-432, pt. 2, at 883-884 (1984).

[81] Announcement 2009-4, 2009-8 I.R.B. 597.

circumstances be treated as a disguised sale of a partnership interest by the distributee partner to the contributing partner.

Where a disguised sale of a partnership interest results from a contribution of property and a related distribution of property, the partner receiving the distribution is treated as selling its partnership interest to the partner making the contribution. Under this construct, the contributing partner would be the "transferee" (as defined in the Notice) of the partnership interest, and thus generally would be required to withhold tax under Section 1446(f). Because, however, the contributing partner will not actually be making a payment to the distributee partner, it could prove to be logistically difficult to impose the withholding tax responsibility on the contributing partner. The partnership, as the party actually making the payment to the partner deemed to be selling its interest, would be in a better position to effect any required withholding. Therefore, we recommend that regulations provide that the partnership (rather than the contributing partner) be responsible for withholding any amount required to be withheld under Section 1446(f) in connection with a disguised sale of a partnership interest. The government should be indifferent as to which party is responsible for withholding so long as that party is clearly identified.

If the partnership is made responsible for withholding under Section 1446(f) in the case of disguised sales of partnership interests, we further recommend that the partnership not be required to withhold any under-withheld amounts from distributions to the "transferee" partner under Section 1446(f)(4). The rationale for the partnership being required to withhold on distributions to the transferee is to penalize the party responsible for withholding for failing to do so. If the partnership, and not the "transferee" partner, is responsible for withholding, there is no reason to reduce future distributions to such partner. Instead, the partnership is already liable for any under-withholding in connection with the transactions and should be the party against whom the government should have recourse.

O. <u>Withholding in Connection with a Transaction Described in Revenue Ruling 99-6</u>

Rev. Rul. 99-6 addresses two situations in which the acquisition of partnership interests causes a partnership to become a disregarded entity for tax purposes. In the first situation, one of two partners in a partnership buys all of the other partner's interest in the partnership, causing the partnership to be treated as a disregarded entity. In the second situation, a single purchaser acquires all of the interests in an existing partnership from its partners, causing the partnership to be treated as a disregarded entity. In each situation, the ruling holds that the selling partner or partners are treated as selling partnership interests (thus implicating the provisions of Section 864(c)(8) if the partnership holds USTB assets). But in each situation, the purchaser is treated as acquiring all (in situation 2) or part (in situation 1) of the partnership's underlying assets.

Section 1446(f) by its terms requires withholding by any "transferee" of a partnership interest. The Notice defines the term "transferee" to mean "any person that acquires a partnership interest by transfer, and includes a partnership that makes a distribution."[82] As a

[82] Notice, Section 3.04.

result, the acquirer of a partnership interest in a transaction described in Rev. Rul. 99-6 is not considered a transferee based on such definition. Consequently, without further guidance, a transfer described in Rev. Rul. 99-6 would appear not to be subject to withholding. This is the case even though (i) a transfer of the same partnership interests in a transaction that did not result in the partnership becoming a disregarded entity would have been subject to withholding under Section 1446(f) and (ii) a transfer of the partnership's assets in a transaction causing the recognition of ECI would have triggered the partnership's requirement to withhold on its foreign partners under "regular" Section 1446.

We believe that it would be inappropriate for the transfer of interests in a partnership holding USTB assets to escape withholding tax solely by virtue of the fact that the partnership becomes a disregarded entity as a result of the transfer. Accordingly, we recommend that regulations under Section 1446(f) provide that where a person acquires interests in an existing partnership from one or more partners and the partnership becomes a disregarded entity as a result of such acquisition, the acquirer is treated as acquiring partnership interests for purposes of Section 1446(f),[83] and thus is required to withhold under Section 1446(f) if an exemption from withholding is not available.

P. Withholding on the Disposition of a Publicly Traded Partnership Interests

After enactment of the Act, many practitioners and industry members expressed concern that a transferee of units in PTPs would be technically required to withhold tax under Section 1446(f) upon its acquisition of such units, even though the transferee would not have privity with the seller of such units, or the means or sophistication in withholding, in order to be able to effect the required withholding properly. In this regard, the Committee Report indicated that, in the case of a foreign partner's transfer of PTP units through a broker, the broker might be required to withhold tax under Section 1446(f) on behalf of the transferee.[84] Further, given the volume and manner of execution of the trading of PTP units, any withholding of tax with respect to such trading, even by the brokers through which such trades are executed, would require the building of systems in order to effect the withholding and to make proper reporting to the Service in connection with such withholding. The building of such withholding tax systems would take a meaningful amount of time.

As noted above, in response to these concerns, Treasury and the Service issued Notice 2018-8, 2018-7 I.R.B. 352, which suspended all withholding in connection with the sale or other disposition of PTP interests under Section 1446(f) until regulations or other guidance under such section are issued. We believe that, consistent with the Committee Report, the broker through which PTP unit trades are executed should be responsible for withholding and information

[83] The government may also wish to modify Rev. Rul. 99-6 to make clear that this treatment under Section 1446(f) overrides the ruling's general treatment of such a transaction as the acquisition of assets.

[84] H.R. Rep. No. 115-466 at 369 ("the Secretary may provide guidance permitting a broker, as agent of the transferee, to deduct and withhold the tax equal to 10 percent of the amount realized on the disposition of a partnership interest to which the provision applies. For example, such guidance may provide that if an interest in a publicly traded partnership is sold by a foreign partner through a broker, the broker may deduct and withhold the 10-percent tax on behalf of the transferee").

reporting under Section 1446(f) to the extent withholding is required. However, in order to permit brokers to build systems to enable them to withhold and report under Section 1446(f) in an appropriate manner and without undue burden, any broker withholding and reporting with respect to publicly traded partnership interests should be required no earlier than the date that is one year following the date on which regulations under Section 1446(f) addressing the manner in which tax is to be withheld in connection with the transfer of PTP units are finalized.[85]

Q. Manner for Depositing Withheld Tax and Filing Forms Relating to Withholding

Section 5 of the Notice provides that until regulations, other guidance, or forms and instructions have been issued under Section 1446(f), transferees required to withhold under that provision generally must use the rules in Section 1445 and the regulations thereunder for purposes of reporting and paying over the tax. Those provisions currently include the use of Form 8288 (U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests) and Form 8288-A (Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests) – and the Notice directs the transferee to include the statement "Section 1446(f)(1) withholding" at the top of each such form.

We think that the interim approach set forth in the Notice (*i.e.*, to use the procedures set forth under Section 1445 and the regulations thereunder) generally is a workable starting point, and recommend that regulations memorialize that approach, subject to certain modifications. New forms should be released relating to Section 1446(f) withholding, corresponding to Form 8288 and Form 8288-A, with appropriate modifications that specifically contemplate that the transferred property is a partnership interest and that the underlying assets consist of USTB assets other than USRPIs.

Section 5 of the Notice also provides: "At this time, the IRS will not issue withholding certificates under section 1446(f)(3), such as those provided on Form 8288-B, Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests." It is not clear why a foreign partner's transfer of a partnership interest should not be eligible for a withholding certificate providing for a lower amount of withholding when a comparable transfer of a USRPI would be so eligible. As a result, we recommend that regulations specifically permit, and a new form comparable to Form 8288-B be released to facilitate, the issuance of withholding certificates enabling a lower amount of withholding under Section 1446(f).

R. Provision of Information by Partnerships to Partners

Upon a foreign partner's transfer of a partnership interest, in order to determine whether Section 864(c)(8) will apply to recharacterize a recognized gain or loss as ECI or ECL, the foreign partner will need to know (i) the amount of liabilities attributable under Section 752 to the transferred interest and (ii) the amount of ECI or ECL that the transferor would have recognized with respect to the transferred interest had all of the partnership's assets been sold for their fair market value. In the case of a non-controlling partner without contractual rights to such

[85] *See also* SEC. INDUST. AND FIN. MKTS. ASS'N, *Recommendations on Implementation of Section 1446(f)* (Aug. 2, 2018) (addressing certain Section 1446(f) considerations in the case of PTPs).

information, the partner may not have sufficient information to file its return in the manner required by Section 864(c)(8). As a result, we recommend that regulations provide that upon request by a foreign selling partner, a partnership will be required to provide the information described above, and any other information reasonably needed by such partner in order to calculate the amount of ECI or ECL recognized by virtue of the application of Section 864(c)(8). We recognize that compelling a partnership to provide such information might impose a significant burden on the partnership by requiring it to make determinations, some of which may be very complicated, that it would otherwise not have to make. Nevertheless, we believe that the needs of the foreign selling partner to obtain such information, and the untenable position that such a partner could be in if the partnership did not provide the information, should outweigh the burden placed on the partnership in being required to comply with such an information request.

We have considered whether Treasury has the regulatory authority (without a specific legislative grant of authority) to promulgate regulations that would require the provision by a partnership of the information described above to a foreign selling partner. While the answer to this question is not entirely clear, we note that in the FIRPTA context a domestic corporation is *required* by the regulations under Section 897 to provide information to a requesting foreign shareholder with respect to the corporation's status as a USRPHC.[86] Neither Section 897 nor Section 1445 requires a corporation to provide such information, and neither contains a specific grant of regulatory authority that would permit such a requirement.[87] Much like Section 864(c)(8) in the context of ECI or ECL, absent a requirement on the part of a domestic corporation to provide information with respect to its status as a USRPHC, a selling foreign shareholder would not be able to establish that the shares of the corporation were not a USRPI.[88] As a result, there is some precedent for regulations to be issued, even in the absence of a specific grant of regulatory authority, to require the provision of information to a taxpayer by an entity, if in the absence of such requirement, the taxpayer would be unable to determine its tax liability.

We also note that the partnership's cooperation would be required in order for the transfer of a partnership interest to benefit from the 25% Gain Exception because the relevant certification must be provided by the partnership whose interest is transferred. In this regard, we believe it is less critical that the partnership cooperate in providing the relevant certification than it is that the partnership comply with respect to Section 864(c)(8), because any tax withheld would be credited against the tax liability of the foreign selling partner. Thus, so long as the partnership provides the information necessary for the foreign selling partner to determine how much ECI or ECL it recognized in connection with the sale, the partner should be able to obtain

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86 Treas. Reg. § 1.897-2(h).

87 We note that while Section 897(c)(1)(A)(ii) states that the taxpayer must establish that the domestic corporation is not a USRPHC "at such time and in such manner as the Secretary by regulations prescribes," this grant of authority relates to the requirement of the taxpayer to establish non-USRPHC status and not to the corporation whose shares are transferred to establish such status.

88 *See* Section 897(c)(1)(A)(ii) which, subject to certain exceptions, generally treats any interest (other than an interest solely as a creditor) in a domestic corporation as a USRPI unless the taxpayer establishes that such domestic corporation was not a USRPHC during the applicable period.

a refund of any over-withheld tax. As a result, we believe that the burden that would be borne by the partnership if it were required to provide a certification relating to the 25% Gain Exception outweighs the needs of the foreign selling partner and, therefore, do not recommend that a partnership be compelled to provide such a certification.

Where, however, a partnership does provide a certification that the 25% Gain Exception is applicable with respect to a particular transfer, it is unclear whether the partnership might be secondarily liable under Section 1446(f)(4) for any under-withholding if it were ultimately determined that the 25% Gain Exception was unavailable (*e.g.*, if the partnership's calculation of built-in gain relating to USTB assets was found to be understated). Under the Notice, no withholding is due if such a certification is received, apparently regardless of whether the certification is ultimately determined to be correct. Because no withholding is due, the partnership arguably should not be secondarily liable for any under-withholding. We recommend that regulations make clear that this is the case by providing that a partnership that provides a certification that the 25% Gain Exception applies to a partnership interest transfer will not be secondarily liable under Section 1446(f)(4) so long as it prepared such certification reasonably and in good faith.[89]

Because the requirement for a partnership to provide information to foreign selling partners may impose a significant burden on the partnership, we recommend that a partnership be permitted to use certain simplifying conventions. Specifically, for any calculations required to be made under Section 864(c)(8) or Section 1446(f) (including (i) whether the 25% Gain Exception applies, (ii) the amount of built-in ECI or ECL attributable to the transferor and (iii) the amount of liabilities attributable to the transferred interest), the partnership should be permitted to elect to perform such calculations as of the last day of its most recent taxable year. We recognize, however, that in certain cases, such as where the relevant facts have changed significantly between the end of the prior taxable year and the date of the relevant determination, use of such a simplifying convention might be distortive. As a result, we recommend that the use of such a simplifying convention be available only where the partnership reasonably determines that its use will not significantly affect any calculation to be made under the Provisions.

S. Section 1446(f) Definitions

Section 1446(f)(5) provides that any term used in Section 1446(f) which is also used in Section 1445 shall have the same meaning as when used in Section 1445. "Transferor," "transferee" and "foreign person" appear to be the only terms that are specifically defined for purposes of Section 1445 and are relevant for purposes of Section 1446(f). Section 1445(f) defines "transferor" as "the person disposing of the United States real property interest," "transferee" as "the person acquiring the United States real property interest," and "foreign person" as "any person other than a United States person, and except as otherwise provided by

[89] Providing such a rule would prevent partnerships from being unwilling to provide such certifications, even where the exception should be applicable, for fear that they could be held liable if their determinations were ultimately determined to be incorrect.

the Secretary, an entity with respect to which section 897 does not apply by reason of subsection (l) thereof." Section 897(l) excludes qualified foreign pension funds ("***QFPFs***") from the application of Section 897, and thus a QFPF generally is not considered a foreign person for purposes of Section 1445.

The definitions of "transferor" and "transferee" provided in Section 1445 would appear to limit the application of Section 1446(f) to cases where the partnership whose interest is being transferred happens to hold a USRPI, in addition to non-USRPI USTB assets. It appears unlikely that this effect was intended. In Sections 3.02 and 3.03 of the Notice, "transferor" was defined as "any person that transfers a partnership interest, [including] a person that receives a distribution from a partnership," and "transferee" was defined as "any person that acquires a partnership interest by any sale, exchange or other disposition, [including] a partnership that makes a distribution." We recommend that the Secretary promulgate regulations adopting definitions similar to those provided in the Notice for transferor and transferee for purposes of Section 1446(f), taking into account our recommendation in Section O above dealing with Rev. Rul. 99-6 transactions. It is possible, however, that such definitions may be challenged as being inconsistent with the statutory language.[90]

Similarly, defining "foreign person" for purposes of Section 1446(f) in accordance with Section 1445 results in a QFPF not being considered a foreign person for purposes of Section 1446(f). A QFPF could, therefore, theoretically avoid Section 1446(f) withholding by providing a valid nonforeign affidavit under Section 1446(f)(2). It is difficult to discern a policy reason for QFPFs to be exempt from Section 1446(f) withholding upon the disposition of an interest in a partnership that is engaged in a non-FIRPTA USTB. Compounding the policy issue, QFPFs are exempt from withholding tax in the FIRPTA context because they are exempt from the substantive FIRPTA tax.[91] Treatment of a QFPF as a non-foreign person, however, would only exempt such QFPF from Section 1446(f) withholding; it would still be liable for substantive tax under Section 864(c)(8).

Section 1445(f)(3)(B) authorizes the Secretary to limit the situations in which a QFPF is not considered a "foreign person" for purposes of Section 1445 (and presumably, by extension, Section 1446(f)). We recommend that the Secretary promulgate regulations pursuant to this authority providing that a QFPF is considered a foreign person for purposes of Section 1446(f).

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[90] In this regard, it should be noted that the definitions of transferor and transferee in Section 1445(f) specify that a transferor disposes, and a transferee acquires, "*the* United States real property interest." Section 1446(f) does not refer to a USRPI, leaving an unspecified referent. An argument could therefore be made that Section 1446(f)(5) was not intended to apply the *exact* definitions of transferor and transferee in Section 1445(f) to Section 1446(f), but that it was intended to apply its definitions to Section 1446(f) with appropriate conforming changes, such as replacing "the United States real property interest" with "a partnership interest."

[91] *See* Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 2015 at 155 (March 2016).

Ultimately, it would be helpful if Section 1446(f)(5) were stricken entirely in technical corrections, because it appears to apply explicitly to only three terms, and defines each of them incorrectly for purposes of Section 1446(f).

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