Partnership Disposition Regulations Usher in New Age of Complexity

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"There is an ancient belief that the gods love the obscure and hate the obvious. Without benefit of divinity, modern men of similar persuasion draft provisions of the Internal Revenue Code. Section 341 is their triumph." That quote is from an article written by Martin D. Ginsburg (late husband of recently deceased Justice Ruth Bader Ginsburg) in the 1970s. Section 341 was repealed in 2003. But its offering to the gods has been replaced by the many subsequent efforts by Congress at "simplification." The Tax Cuts and Jobs Act of 2017 (the TCJA) is their most recent triumph.

Unfortunately, new code section 864(c)(8), which was enacted as part of the TCJA, is no exception, as exemplified by Monday's release of regulations which govern the taxation of a foreign person on the disposition of an interest in a partnership that is engaged in the conduct of a trade or business in the United States (section 864(c)(8)). This alert provides a brief historical background leading up to the enactment of 864(c)(8), explains the regulation at a high level and then highlights some of the complexities associated with the regulations.

BACKGROUND

Prior to 1991, the conventional wisdom was that foreign persons were simply not subject to U.S. tax on gains from the disposition of a partnership interest (except to the extent that the partnership held U.S. real property). That changed dramatically when the IRS issued Rev. Rul. 91-32, which applied the aggregate theory of partnership taxation to, in essence, treat the foreign seller of a partnership interest as having sold a proportionate interest in each and every asset of the partnership. As a result, if the partnership was engaged in a U.S. trade or business, a proportionate part of the foreign partner's gain became subject to U.S. tax.

For years, more than a few practitioners and taxpayers took the position that Rev. Rul. 91-32 was incorrect. In July 2017, the Tax Court overturned it [1], eliminating (seemingly forever) the unnecessary complexity that the Service conjured up back in 1991. However, approximately five months later, Congress reincarnated Rev. Rul. 91-32, as part of the TCJA, in the form of new Internal Revenue Code sections 864(c)(8) and 1446(f) (dealing with a transferee's obligation to withhold tax, at the rate of 10%, on the amount realized on the disposition of a partnership interest by a foreign person).

On Monday, the final regulations under section 864(c)(8) were released. Proposed regulations under section 1446(f), which were published in May of 2019, still have not been finalized.

SECTION 864(C)(8) AND THE FINAL REGULATIONS IN A NUTSHELL

Similar to Rev. Rul. 91-32, section 864(c)(8) operates to treat all or a portion of a foreign partner's gain or loss on the sale or exchange of a partnership interest as income that is "effectively connected" with the conduct of a trade or business in the U.S.

(ECI) if the partnership is engaged in trade or business in the U.S.

Helpfully, the regulations clarify that section 861(c)(8) only applies to the amount of gain or loss recognized by the foreign transferor under all relevant provisions of the code and regulations. As a result, it does not apply to gains that are realized, but not recognized, including gains that occur upon dispositions at death.

> A&M Insight: Prior to this clarification, there was concern that section 864(c)(8) applied even to realized gains, regardless of whether the gain was recognized. As a result of this clarification, foreign persons may seek to structure their dispositions of partnership interests in a manner that does not cause them to recognize any gain on the partnership interest (e.g., rollover or other tax-free transactions).

To determine the extent to which the foreign person's gain or loss is recharacterized as ECI, the regulations provide the following 3-step process to determine the maximum amount that is recharacterized:

1. Determine the partnership's gain or loss from a hypothetical sale of all of its assets as of the date of the transfer of the partnership interest;

2. Determine the amount of gain or loss from the deemed sale that would be treated as ECI; and

3. Determine the foreign transferor's distributive share of the deemed sale ECI gain or ECI loss.

> *A&M Insight:* In finalizing the regulations, Treasury and the IRS chose not to adopt a comment that a foreign partner that does not own a controlling interest in a partnership should be allowed to estimate the portion of their gain or loss that is ECI. As a result, in order to apply Step 1, foreign persons will need to actually value all of the partnership's underlying assets when they sell their partnership interest. In some circumstances, the partners may have contractually agreed as to how assets should be valued or the partnership as a whole may need to value its assets (e.g., due it dispositions by U.S. partners) and so this may not be a challenge. However, in other circumstances, partnerships may not be willing to provide this information, in which case it is unclear how the partner should make the requisite determinations; or partnerships may be willing to provide the information, but the parties will have to negotiate who bears the cost. With that said, in circumstances in which a valuation is now necessary, it will be easier for partnerships to make a section 754 basis adjustment for the sale of the partnership interest, because the requisite valuation has already been performed.
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> Additionally, it is noteworthy that the determination in step 2 will generally require knowledge of the actual facts and circumstances associated with the sale, including the use of the assets being sold. In order to address this, because the sale is hypothetical, the regulations provide rules that generally maximize the amount of the partnership's gain or loss which would be treated as ECI, thereby increasing the amount of the foreign partner's gain or loss that would be characterized as ECI.

Additionally, the regulations contain rules dealing with the following issues:

- The determination of how much of the foreign transferor's gain or loss is treated as capital gain or ordinary income;
- Transfers of less than all of the foreign partner's interest in the partnership;
- Coordination with the rules dealing with foreign investment in U.S. real property;
- Tiered partnerships; and
- Coordination with provisions of tax treaties.

A&M TAXAND SAYS

These final regulations may apply in a private equity context as well as in other contexts. However, their applicability to private equity transactions may be limited if foreign investors participate through US blocker corporations. If these rules may apply, taxpayers will need to consider them, and if they apply, consider the ramifications, including potential withholding obligations for buyers. A&M Taxand is happy to discuss whether the regulations could have the effect of taxing you or your company as a foreign transferor of a partnership interest, or impose a withholding obligation on you or your company as the transferee of the partnership interest.

[1] Grecian Magnesite Mining, Industrial & Shipping Co v. Commissioner, 149 T.C. 63 (2017), aff'd 926 F.3d 819 (D.C. Cir. 2019).

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