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# Global View

## *Withholding Procedures on the Purchase of a U.S. Partnership Interest*

By Robert Misey

**W**hen counseling foreign businesses who enter the United States on their choice of entity, I often recommend the formation of a U.S. C corporation. I prefer a U.S. C corporation because a foreign person generally does not incur U.S. income tax on the disposition of shares of the U.S. C corporation.<sup>1</sup> In contrast, a foreign person who sells an interest in a U.S. partnership interest always incurs gain on the sale.<sup>2</sup> The foreign person's gain is the share of income from a hypothetical sale of the partnership's assets.<sup>3</sup>

**Example 1.** ForCo, a foreign corporation, and USCo, a U.S. corporation, each own 50% of an LLC taxed as a U.S. partnership ("USP"). USP has assets of \$4 million of cash and \$6 million fair market value of inventory that has an adjusted basis of only \$1 million. Joe, a U.S. person, buys ForCo's 50% interest for \$5 million. ForCo's gain on the sale is \$2.5 million [50% of (\$6 million less \$1 million)] and ForCo will have to pay U.S. tax on that gain (see Figure 1).

To ensure the collection of tax on any gain from a sale, the Code requires purchasers of a U.S. partnership interest to withhold 10% of the purchase price.<sup>4</sup> Unfortunately, most purchasers do not realize they have a withholding/compliance obligation.

**Example 2.** ForCo, a foreign corporation, and USCo, a U.S. corporation, each own 50% of an LLC taxed as a U.S. partnership ("USP"). USP has assets of \$4 million of cash and \$6 million fair market value of inventory that has an adjusted basis of only \$1 million. Joe, a U.S. person, buys ForCo's 50% interest for \$5 million. ForCo's gain on the sale is \$2.5 million [50% of (\$6 million less \$1 million)]. Because ForCo is a foreign corporation, Joe must withhold \$500,000 for the IRS (10% of the \$5 million). When filing its return, ForCo pays tax at a 21% rate on the \$2.5 million of income for \$525,000, and ForCo will pay the IRS \$25,000 in addition to the \$500,000 that Joe withheld (see Figure 2).

FIGURE 1.

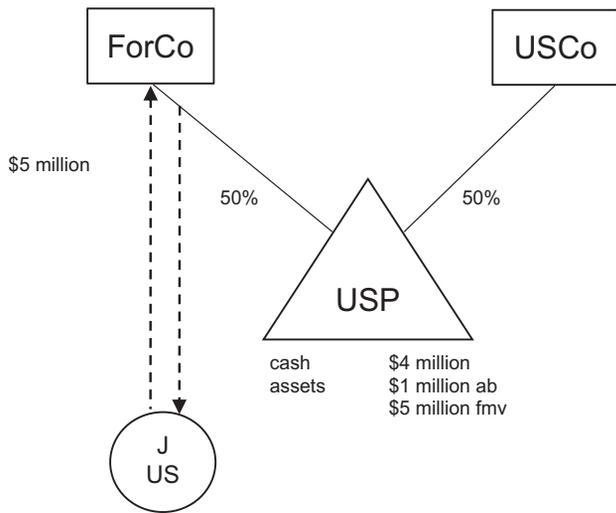
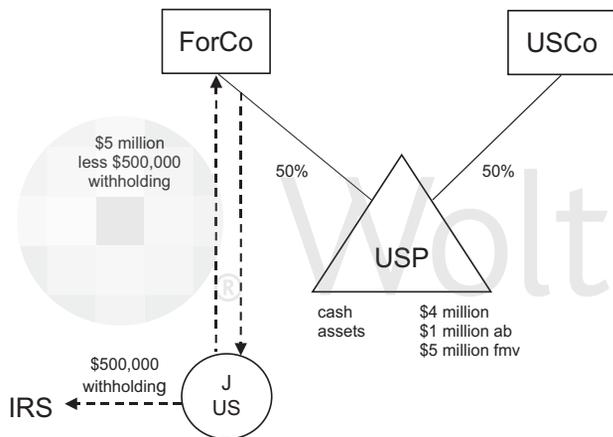


FIGURE 2.



If the purchaser fails to withhold, the U.S. Partnership also assumes liability for the withholding.<sup>5</sup>

To ease administrative burdens on the purchaser, the Code provides that the following situations do not require withholding: (i) the partnership is a publicly-traded partnership;<sup>6</sup> (ii) the purchaser receives an affidavit from the seller that states, under penalty of perjury, that the seller is not a foreign person,<sup>7</sup> or (iii) at the request of the seller, the IRS prescribes a reduced amount of withholding.<sup>8</sup>

**Example 3.** LLC is a publicly traded partnership, some of whose interests are owned by Norman Ray Allen

(“NRA”). Joe, a U.S. individual, purchases interests of LLC (previously owned by NRA) that trade on a financial market. Because the interests of the LLC are publicly-traded, Joe does not have to withhold.

The rationale behind the publicly traded-partnership exception is similar to the exception for publicly-traded corporations from withholding under the Foreign Investment in Real Property Tax Act (“FIRPTA”). Without the exception, the trading of interests in the financial markets would slow to an unacceptable inefficiency.

In Notice 2018-29,<sup>9</sup> the IRS stated that taxpayers should follow the rules regarding FIRPTA withholding on sales of U.S. real property interests until the IRS provides guidance with respect to withholding on the purchase of U.S. partnership interests. These rules would include, for example, the use of Forms 8288 (*U.S. withholding tax return*) and 8288-A (*statement of withholding*). Moreover, Notice 2018-29 provides rules for an affidavit (exception (ii) above) that are similar to the FIRPTA rules.<sup>10</sup> However, despite the Code section’s authority of the IRS to prescribe a reduced amount of withholding,<sup>11</sup> Notice 2018-29 appears to abdicate this responsibility of the IRS to issue certification (exception (iii) above) and transfers the burden to the seller.<sup>12</sup>

In addition to the three aforementioned exceptions from withholding, Notice 2018-29 goes beyond the language of Code Sec. 1446 by allowing additional exceptions for the following: (i) the seller certifies that, for each of the last three years, the seller’s allocable share of effectively connected income was less than 25% of the seller’s total allocable share of income for the year;<sup>13</sup> (ii) the partnership certifies that, if it had sold all of its assets at fair market value, the amount of gain that would have been effectively connected with the conduct of a U.S. trade or business would be less than 25% of the total gain;<sup>14</sup> or (iii) a nonrecognition provision applies.<sup>15</sup>

The guidance offered by Notice 2018-29, along with its foreshadowing of future regulations, appears to be a good start on the rules for withholding. Nevertheless, despite the publicity accorded the Tax Cut and Jobs Act of 2017, the withholding and these procedures seem to be a potential trap for the unwary. It is easy to envision many circumstances where relatively unsophisticated taxpayers will purchase U.S. partnership interests from foreign persons without obtaining the appropriate certification to avoid withholding.

ENDNOTES

<sup>1</sup> Code Sec. 865(a), Reg. §11441-2(b)(2). An exception taxes gain if over 50% of the U.S. C corporation’s value constitutes U.S. real estate. Code Sec. 897.  
<sup>2</sup> Code Sec. 864(c)(8)(A).

<sup>3</sup> Code Sec. 864(c)(8)(B). A branch profits tax may also apply. Code Sec. 884(a).  
<sup>4</sup> Code Sec. 1446(f)(1). The exact language is “...10% of the amount realized on the disposition.”

<sup>5</sup> Code Sec. 1446(f)(4).  
<sup>6</sup> Code Sec. 1446(g)(1); Notice 2018-29 §4.05.  
<sup>7</sup> Code Sec. 1446(f)(2).  
<sup>8</sup> Code Sec. 1446(f)(3).

<sup>9</sup> Notice 2018-29, 2018-6 IRB 495.

<sup>10</sup> Reg. §1.1445-2(b).

<sup>11</sup> Code Sec. 1446(f)(3).

<sup>12</sup> Notice 2018-29 §6.02. This seems comparable to Reg. §1.1445-2(b)(3).

<sup>13</sup> Notice 2018-29 §6.03.

<sup>14</sup> Notice 2018-29 §6.04.

<sup>15</sup> Notice 2018-29 §6.05, which incorporates the requirements of Reg. §1.1445-2(d)(2).

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