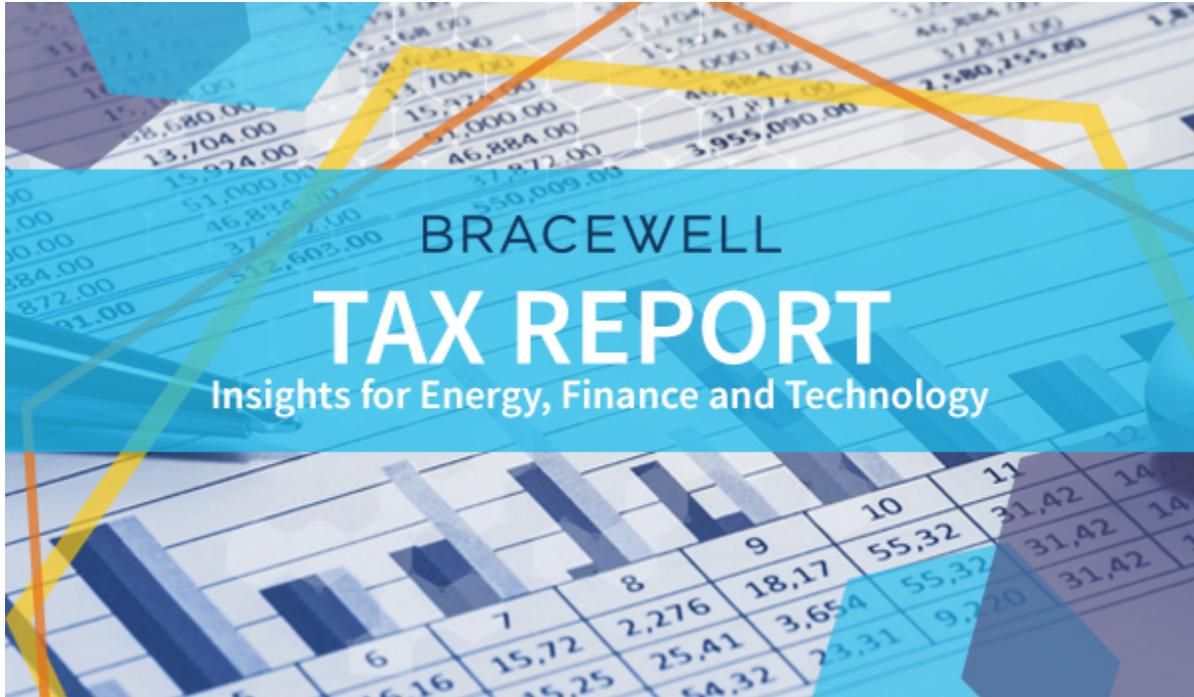


Tax Reform and the Foreign Partner

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While much has been made about international tax reform contained in the Tax Cuts and Jobs Act ("TCJA") that modifies the taxation of U.S. taxpayers with multinational holdings and operations, the new law did not leave inbound investment untouched. Notably, the TCJA codified a published ruling in a fairly controversial area of partnership tax law, in a potential disappointment to non-U.S. investors in domestic partnerships and practitioners who questioned the authority for issuing the ruling in the first place.

By way of background, foreign persons generally are subject to tax on income effectively connected with the conduct of a trade or business within the United States ("ECI") in the same manner as U.S. persons. ECI generally is not subject to withholding, but special rules require partnerships to withhold with respect to allocations of ECI to their non-U.S. partners. In Revenue Ruling 91-32 (the "Ruling"), the IRS held that a foreign partner has ECI to the extent the gain is attributable to ECI-producing assets. ECI-producing assets were defined as those belonging to a partnership that is carrying on a trade or business in the United States through a fixed place of business.

While practitioners and taxpayers alike typically rely on published rulings, this one was controversial from the start.¹ The uncharacteristic amount of opposition to the ruling was due to disagreement over whether the Treasury had the authority to treat such gain as ECI; otherwise, under the Internal Revenue Code (the "Code"), the sale of a partnership interest generally was treated as the sale of a capital asset (with the only exceptions in the Code being for receivables and so-called "hot" assets), and before the TCJA there arguably had been no path in the Code for the IRS to add other exceptions. While there often is tension in partnership taxation between treating the partnership as an entity versus an aggregate of its partners, practitioners opposing the ruling argued (rather persuasively) that the IRS could not rule in a manner that was inconsistent with a Code Section and treat the sale of a partnership interest as anything other than the sale of a unitary capital asset, no different than stock in a corporation (except to the extent the Code *already provided* grounds to "look through" to the underlying assets, such as hot assets).

The TCJA codification likely was sparked by the Tax Court ruling in *Grecian Magnesite* which, in a direct repudiation of the Ruling, stated that the gain from a foreign partner's sale of a capital asset should be sourced to such partner's country of residence (click [here](#) for more). Under the TCJA, new Code Section 864(c) states that ECI is to be treated in the same manner as if the partnership had sold the assets generating ECI and allocated the gain to the partner. Moreover, in calculating the taxable gain of a foreign partner of a partnership that is engaged in a U.S. trade or business, the new provision states that any gain on the disposition of a partnership interest will be presumed to be U.S. source ECI gain and any loss will be presumed to be foreign source non-ECI, unless the partner is able to produce evidence demonstrating otherwise.

Significantly, the new law also imposes a withholding tax at a flat 10% rate on the amount realized on the sale or disposition of the interests. The new provision (Code Section 1446(f)) allows the IRS, at the request of the transferor or transferee, to reduce the amount of withholding if it will not jeopardize the collection of the tax imposed, though notably there is no specific procedure yet in place for foreign partners to obtain such a reduction. What's more, if the purchaser of the interest in question fails to withhold the proper amount of tax, the responsibility falls to the partnership itself.

Arguably, the enactment of new Code Section 864(c) resolves the primary concern of those who opposed the ruling, as Congress has the power to create new tax law on par with Section 741, and to create an exception to the treatment provided for therein. However, even for those who agree with the substance of the ruling, the withholding obligation, which currently provides little guidance as to the procedure the seller must follow in order to avoid or mitigate, will cause practical concerns, as will the burden to prove the nature of losses. Compare this to the process outlined in the Foreign Investment in Real Property Tax Act ("FIRPTA"), which Treasury should consider when working on procedures (if any) for collecting and remitting the new ECI withholding tax. That process allows the seller to apply for a withholding certificate in order to reduce the required withholding to the foreign investor's actual tax liability – or provide a notice of nonrecognition transfer to prevent withholding entirely in certain reorganizations and contribution transactions. Even if the withholding certificate is not received in time, the buyer does not have to remit the withheld amounts if the application is filed before closing/sale. Moreover, the notice of nonrecognition need only be presented before the closing and a copy filed with the IRS within 20 days of the transfer. Presumably, Code Section 1446(f)(3) will provide the IRS with the authority to promulgate similar procedures for new Code Section

864(c). Otherwise, foreign investors may be forced to file federal income tax returns to obtain a refund of amounts withheld in excess of their actual tax liability. Many foreign investors are reluctant to file tax returns in the United States revealing personal identifying information where their only connections are, in some cases, isolated investments. This may drive foreign investors to invest in partnerships that are expected to generate ECI through so-called blocker corporations in order to be protected from the taint of ECI as well as the need to personally file tax returns.

As we discussed ([here](#)), blocker corporations cleanse the "taint" of ECI, but at the cost of entity-level tax. However, the entity-level tax on blockers is now less onerous with the new 21% rate (a 40% reduction from the prior corporate rate of 35%), and blockers now have more flexibility to leverage with related party debt following the repeal of the so-called "earnings stripping" rules (see [here](#)), though they likely would be impacted by the new limit on interest deductions (generally, to the sum of interest income and 30% of taxable income (see [here](#))). This may be particularly attractive to investors in private equity type investments who tend not to rely on the payment of dividends (which creates a second level of tax), but rather realize their full return on investment upon exit.

To the extent that the Act ever was touted as a way to level the playing field for inbound investors, the codification of the Ruling – coupled with the way in which FIRPTA was left completely intact despite sweeping international tax reform otherwise – signals that making the United States a more attractive investment opportunity was not as high of a priority for lawmakers as was previously believed. Interestingly, even though many of the significant international tax law changes in the TCJA addressed OECD concerns on base erosion, they mostly were targeted at preventing U.S. companies from artificially reducing U.S. federal tax – and the new so-called "territorial" tax system only benefits U.S. corporations. Given the current administration's "America First" slogan, it may not be a coincidence that the only change directed at non-U.S. investors put them at a competitive and practical disadvantage to domestic investors.

¹ See Blanchard, "Rev. Rul. 91-32: Extrastatutory Attribution of Partnership Activities to Partners," 76 Tax Notes 1331 (9/8/97).