TAX COURT GIVETH AND CONGRESS TAKETH AWAY: TAXATION OF SALE OF U.S. PARTNERSHIP INTERESTS BY FOREIGN PERSONS AND IMPACT ON M&A TRANSACTIONS

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The Tax Cuts and Jobs Act (H.R. 1) (the "Act"), signed by President Trump on December 22, 2017, implemented the most comprehensive overhall of the Internal Revenue Code of 1986, as amended (the "Code") in decades. In particular, the Act overturned a 2017 Tax Court case, Grecian Magnesite Mining, Indus. & Shipping Co. v. Commissioner, 149 T.C. No. 3 (2017), in which the Tax Court generally held that the proceeds received by a foreign corporation upon redemption of its interest in a U.S. partnership with effectively connected U.S. income is properly treated as capital gain (other than to the extent attributable to U.S. real estate) and, as such, is not U.S. source income and not subject to U.S. income taxes. In so holding, the Tax Court in Grecian declined to follow the long-standing position of the IRS set forth in Rev. Rul. 91-32 that gain or loss of a foreign partner that disposes of its interest in a partnership that is engaged in a trade or business through a fixed place of business in the United States will be United States source effectively connected income. Grecian was a welcome relief to taxpayers and practitioners alike.

But what the Tax Court giveth, Congress taketh away. In passing the Act, Congress amended Section 864(c) of the Code, dealing with a nonresident alien and a foreign corporation's effectively connected U.S. income, by adding a new subsection (8) which generally provides that, where a nonresident alien or foreign corporation has gain or loss on the sale of an interest in a partnership that is engaged in a trade or business in the U.S., such gain or loss shall be treated as U.S. source effectively connected income. This amendment adopts the aggregate theory of partnerships by determining the amount of a foreign partner's effectively connected U.S. gain or loss based on a deemed sale of the partnership assets and such partner's distributive share of any resulting effectively connected income. This amendment is effective for sales, exchanges, and dispositions of partnership interests on or after November 27, 2017.

In addition, the Act revised subsection (f) to Section 1446 of the Code to now require the transferee of a partnership interest to withholding 10% of the amount realized on the sale of partnership interest to the extent treated as effectively connected U.S. income pursuant to the Section 864(c)(8) of the Code described above. If a transferee fails to withhold any amount required to be withheld, the partnership shall be required to deduct and withhold from distributions to such transferee a tax in an amount equal to the amount such transferee failed to withhold plus interest thereon. Similar to FIRPTA, withholding is not required where the transferor provides a non-foreign affidavit and the 10% withholding requirement may be reduced at the discretion of the IRS upon request. Such withholding is required for sales, exchanges and dispositions of partnership interests after December 31, 2017.

The import of Section 864(c)(8) and 1446(f) on M&A transactions is significant. Buyers of partnership interests (including LLCs taxed as partnerships), as well as the applicable partnership and other partners, should be

mindful in their diligence and in structuring their deals to ensure compliance with these new Code provisions. Importantly, unlike FIRPTA, where the transferee becomes obligated to pay any amounts that were not properly withheld, Section 1446(f) of the Code obligates the partnership itself where the transferee is required and fails to withhold on the sale of partnership interest by a foreign partner. Such a failure would impact not only the transferee but the partnership and other partners as well. As such, the definitive deal documents, including but not limited to the applicable purchase and sale agreement as well as the partnership (or LLC) agreement to which the transferee becomes a party, should address these issues.

If you have any questions on this topic, please contact the author, Mitchell W. Goldberg, on the firm's Business, Finance & Tax Team.

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