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Beware! Foreign Partners in Partnerships Located in the US

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Foreign companies must consider many issues in their tax planning if they are in partnership with companies based in the United States and want to sell shares.

IRC (Internal Revenue Code) section 1446(a) imposes a US withholding tax on foreign partner's distributive share of income from the partnership (foreign or US domestic partnership), if the partnership is considered engaged in US trade or business ("partnership"). The tax is withheld by the partnership at the foreign partner's marginal tax rate – 21% for corporations and 37% for individuals ["1446(a) tax"].

If foreign entities or persons want to invest in partnerships located in the US or sell their interest in these partnerships, various tax aspects must be considered. Talk to us in advance of your planning.

Ragini Subramanian, Tax Manager, Marcum LLP, Greenwich, Connecticut, USA

Effective as of 2018, IRC Sections 1446(f) and 864(c)(8) codified the tax treatment of a gain on a sale of partnership interest by a foreign partner. Section 1446(f) requires the transferee to withhold, report, and pay to the IRS 10% tax on the amount realised by the foreign partner upon disposition of his/its partnership interest ["1446(f) tax"] (unless an exception applies or the transferor certifies as to lower maximum tax liability on the gain). The amount realised (to which

the 10% withholding applies) includes cash and fair market value (FMV) of property received, liabilities of the foreign partner assumed by the transferee and reduction in the foreign partner's share of partnership liabilities. If the transferee does not withhold such amount, the partnership is responsible for this tax, Marcum tax manager Ragini Subramanian explains.

If an exception applies, and if the transferor foreign partner (in some cases partnership) provides certification as to the applicability of a given exception, the 1446(f) tax need not be withheld. The exceptions include:

1. Transferor did not realise any gain on the sale.
2. If all assets of the partnership were sold, the amount of net gain that would have been effectively connected with the conduct of a US trade or business would be less than 25% (or 10% subject to finalisation of proposed regulations) of the total net gain or that no gain would have been effectively connected.
3. In three prior years, the transferor's allocable share of ECTI was less than 10% of the total distributive share of the transferor's net income.
4. No gain was recognised under a non-recognition provision of the Internal Revenue Code.
5. Treaty exemption.

If the transferee does not have information as to the total amount realised, or the certification as to an exception is not provided by the transferor, the transferee pays nothing to the transferor and sends 100% of the purchase price to the IRS. The transferee is also required to provide the partnership with the exception certification or certification as to its payment of 1446(f) tax to the IRS; failing which, the liability to withhold, report and pay this tax (with interest) falls on the partnership. In turn, the partnership satisfies this liability by withholding from the distributions to the transferee.

Section 1446(f) has added a layer of compliance complexity for foreign partners and their partnerships. The selling foreign partner is at risk of not receiving any funds (e.g., in the event the full amount realised is not known) upon disposition of his/its partnership interest. The time required for various certifications and compliance associated with 1446(a) and/or 1446(f) withholdings also adds to the cost of the foreign partner's ownership of the partnership interest. The partnership is also exposed due to increased compliance requirements and should consider amending its operating agreements to provide for adequate exchange of information, to allow for proper withholding and preparation of certifications in the event of the transfer of a partnership interest, says the expert.

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