

CLIENT ALERT

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Proposed Income Tax Regulations May Affect Private Equity Funds and Other Partnerships that Have Direct or Indirect Foreign Investors

To Our Clients and Friends:

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On May 7, 2019, the U.S. Treasury proposed new federal income tax regulations (REG-105476-18) to provide additional guidance on a new partnership rule enacted in the Tax Cuts and Jobs Act of 2017. This could potentially affect partnerships (or limited liability companies taxed as partnerships) doing business in the U.S. (“ETB Partnerships”) as well as private equity funds that have direct or indirect foreign investors.

The new law, provided under Sections 864(c)(8) and 1446(f) of the Internal Revenue Code, is designed to ensure that foreign investors in partnerships that are engaged in a U.S. trade or business will pay U.S. taxes when their direct or indirect interests in the partnerships are disposed of. The new law achieves this goal primarily by imposing a tax withholding obligation on the transferee of such an interest. The newly proposed regulations provide reporting rules that facilitate the transfer of information between the relevant parties, as well as details of how the withholding regime (and the applicable exceptions thereto) will be implemented.

Notably, when applied to tiered partnerships, the new law may lead to less obvious results. For example, suppose a foreign person (including

any corporate entity organized outside the U.S.) owns an interest in a private equity fund that is formed as a U.S. partnership which invests in portfolio companies that are ETB Partnerships. If the fund sells its interest in an ETB Partnership for a gain, under the new law the foreign partner’s allocable share of the gain would be taxable to the foreign partner to the extent such gain is effectively connected with a U.S. trade or business, determined as if the underlying ETB Partnership had sold all of its assets.¹ In addition, it appears that the proposed regulations would generally require the fund to withhold an amount of tax, at the highest applicable income tax rate, with respect to the foreign partner’s share of the gain. A failure to withhold and pay over the required amount of tax to the IRS would generally cause the fund to be subject to interest and potential penalties.

As a result, the determination of the foreign partner’s substantive tax liabilities and the U.S. fund’s tax withholding obligation would depend largely on an analysis of a deemed sale treatment at the underlying ETB Partnership level, and this information would then have to

¹ This discussion assumes the ETB Partnership does not have any “U.S. real property interest” as defined under the “FIRPTA” rules.

be passed on through the chain of ownership. Under the proposed regulations, when the U.S. fund disposes of its investment in the ETB Partnership, the fund generally will have an obligation to notify the ETB Partnership, and the ETB Partnership in turn will generally have an obligation to provide the fund, on or before the due date (with extensions) for issuing K-1's, with a statement that includes the fund's share of gain or loss on a deemed sale of assets (determined in the manner required under the new law), regardless of the fact that the ETB Partnership is not actually selling its assets. These additional obligations would also generally arise if the fund holds an interest in the ETB Partnership indirectly through other holding partnerships or LLCs. This could theoretically have a cascading effect if there are multiple tiers of pass-through entities involved.

Furthermore, under the new law, if a foreign partner sells its interest in a partnership that holds an interest directly or indirectly in an ETB Partnership, the foreign partner should also generally be subject to U.S. tax on the gain to the extent effectively connected with a U.S. trade or business, determined as if the underlying ETB Partnership had sold all of its assets, and the person who purchases the partnership interest from the foreign partner would have an obligation to withhold a tax of 10 percent of the "amount realized" on the sale, subject to some important exceptions that may apply under certain circumstances. If the purchaser fails to withhold any amount required to be withheld, the partnership would generally be required to withhold the full amount of each distribution made to the purchaser until it has withheld a tax of 10 percent of the "amount realized" on the sale, reduced by the amount (if any) that was withheld by the purchaser, plus certain required interest. As provided in the proposed regulations, the amount realized is generally

the sum of (1) the amount of cash paid (or to be paid) to the seller, (2) the fair market value of any other property transferred (or to be transferred) to the seller, (3) the amount of any liabilities assumed by the purchaser or to which the partnership interest is subject, and (4) the reduction in the seller's share of partnership liabilities. Therefore, when a foreign partner sells its interest in a partnership that is or holds an interest (directly or indirectly) in an ETB Partnership, the partnership under the new law generally would have to be clearly aware, and even require, that the purchaser has withheld the full amount of taxes that are required to be withheld on the sale.

Although these proposed regulations are subject to change until finalized, partnerships that may be affected, such as private equity funds and their portfolio companies, should consider taking appropriate steps to ensure proper compliance. Please call your primary contact at Golenbock Eiseman Assor Bell & Peskoe LLP or a member of our Tax Department with any questions.

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