30 September 2020

# Global Tax Alert

# US: Final regulations largely adopt proposed characterization of foreign persons' gain or loss from sale or exchange of interests in certain partnerships, with some welcome changes

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## Executive summary


On 21 September 2020, the United States (US) Treasury Department and the Internal Revenue Service (IRS) released final regulations (T.D. 9919) under Internal Revenue Code[1] Section 864(c)(8) that provide guidance for determining the treatment of gain or loss recognized by a foreign person on the sale of an interest in a partnership that is engaged in the conduct of a trade or business within the United States (US trade or business). The final regulations largely adopt proposed regulations that were issued on 20 December 2018 (REG-113604-08), with certain modifications.

The final regulations generally retain the proposed regulations' three-step approach for determining effectively connected gain or loss, in part by reference to a "deemed sale" of the partnership's assets. They also adopt favorable "asset-specific rules" for determining, by reference to existing sourcing rules, the foreign-source portion of gain or loss on the deemed sale of the partnership's assets. Additionally, they clarify the application of the deemed sale rule to assets that would be exempt from US tax under an applicable US income tax treaty if disposed by a partnership.

The final regulations do not, however, provide withholding and reporting guidance. On 13 May 2019, the Treasury Department and the IRS published proposed regulations (REG-105476-18) in the Federal Register on information

reporting and withholding of tax for dispositions of an interest in a partnership. Although those proposed regulations were not included in the final Section 864(c)(8) regulations as expected, the Treasury Department and the IRS indicated that they plan to publish final withholding and information reporting regulations later.

## Detailed discussion

### Section 864(c)(8) overview

Section 864(c)(8) treats gain or loss from the disposition by a nonresident alien individual or foreign corporation (i.e., a foreign transferor) of an interest in a partnership that is engaged in a trade or business within the United States (US trade or business) as effectively connected with the conduct of that US trade or business (EC gain or EC loss). This gain or loss, however, is EC gain or EC loss only to the extent that the foreign transferor's distributive share of gain or loss from a deemed sale of the underlying partnership assets for fair market value on the date of the transfer would be treated as effectively connected with the partnership's US trade or business.

### Section 864(c)(8)(A) gain or loss

Section 864(c)(8)(A) treats as EC gain or EC loss any gain or loss recognized on the sale or exchange by a foreign transferor of any interest, direct or indirect, in a partnership engaged in a US trade or business, subject to a limitation in Section 864(c)(8)(B). The final regulations implement Section 864(c)(8)(A) by requiring a foreign transferor to determine gain or loss recognized on the transfer of a partnership interest under all relevant Code provisions, including Sections 741 and 751. Section 741 defines gain or loss on a sale of a partnership interest as generally capital gain or loss. Under the "hot asset" rules of Section 751, however, the sale or exchange of a partnership interest may be treated as ordinary income or loss to the extent attributable to a transferring partner's share of certain assets that would give rise to ordinary income or loss. To determine the portion of such capital gain or loss, and ordinary income or loss, that is treated as EC gain or EC loss, the final regulations require the foreign transferor to determine gain or loss according to four categories: (1) outside capital gain, (2) outside capital loss, (3) outside ordinary gain and (4) outside ordinary loss. In each case, the respective amount of gain or loss is treated as EC gain or EC loss, subject to the applicable Section 864(c)(8)(B) limitation.

#### Interaction with nonrecognition provisions

The final regulations specify that Section 864(c)(8) does not override any applicable nonrecognition provision under the Code or regulations that defers gain or loss recognition. Consistent with the proposed regulations, however, the final regulations generally do not include detailed guidance on the interaction of these nonrecognition provisions with Section 864(c)(8), notwithstanding Treasury's authorization under Section 864(c)(8)(E) to issue such rules.

The final regulations also coordinate rules on the interaction of Section 864(c)(8) with the *Foreign Investment in Real Property Tax Act* (FIRPTA) and with US income tax treaties, respectively, as described in more detail later.

### Section 864(c)(8)(B) limitation

Section 864(c)(8)(B) limits the amount of effectively connected gain or loss that would be recognized by the foreign transferor under Section 864(c)(8)(A). As under the proposed regulations, the final regulations generally adopt a "deemed sale" approach to determine this limitation. Under the final regulations, a separate limitation applies for each of the four categories previously identified: (1) outside capital gain, (2) outside capital loss, (3) outside ordinary gain and (4) outside ordinary loss.

#### Three-step process to determine Section 864(c)(8) gain or loss

To compute the Section 864(c)(8)(B) limitation, the final regulations generally retain the three-step process articulated by the proposed regulations for determining effectively connected gain or loss in the "deemed sale." The three steps are as follows:

1. Determine on an asset-by-asset basis the amount of gain or loss that the partnership would recognize on a fully taxable deemed sale of its assets for their fair market value on the date of the transfer of the partnership interest
2. Determine the amount of gain or loss from each asset in the deemed sale in Step 1 that would be treated as EC gain or EC loss, applying Section 864 principles and modified sourcing rules provided in the final regulations
3. Determine the foreign transferor's distributive share of the effectively connected gain or loss as determined in Step 2, particularly by reference to the ordinary and capital components of that gain or loss

A detailed discussion of each of these steps follows.

### Step 1: Determine deemed sale gain or loss on an asset-by-asset basis

The first step to compute the Section 864(c)(8)(B) limitation is to determine the gain or loss that the partnership would recognize on a deemed sale of the partnership's assets on the date of the transfer of the partnership interest (deemed sale gain or deemed sale loss). The deemed sale is treated as a fully taxable transaction based on a deemed sale of each asset (tangible and intangible) for its fair market value.

### Step 2: Determine deemed sale EC gain or loss on an asset-by-asset basis

After determining deemed sale gain or loss in Step 1, the next step requires a determination of the amount of deemed sale gain or loss that would be treated as effectively connected gain (deemed sale EC gain) or effectively connected loss (deemed sale EC loss). As in Step 1, this determination is made on an asset-by-asset basis. Subject to certain special rules, described in more detail below, Section 864 and its regulations apply for purposes of determining deemed sale EC gain or loss.

For purposes of determining whether deemed sale gain or loss would be from sources within or outside the United States, and thus whether that gain or loss would be treated as deemed sale EC gain or deemed sale EC loss, the final regulations deem the asset sale to be attributable to an office or other fixed place of business that the partnership maintains in the United States. Whether gain or loss from a partnership's sale of an asset gives rise to US-source gain or loss generally depends on certain facts about the nature of the asset and the manner in which the sale took place. For example, a sale of property (including inventory) may be attributable to a US office or other fixed place of business, and therefore generate US-source gain or loss, if a US office or other fixed place of business materially participated in the sale of the property. In the context of a deemed asset sale, the facts necessary to determine the source of the deemed sale gain or loss may not exist.

To address this, the proposed regulations included a broad presumption for purposes of determining whether deemed sale gain or loss would be from sources within or outside the United States, and thus whether that income would be treated as deemed sale EC gain or deemed sale EC loss. Under this presumption, a deemed asset sale would be treated as attributable to an office or other fixed place of business that the partnership maintained in the United States. In certain cases, this broad presumption would have effectively treated, as deemed sale EC gain or deemed sale EC loss, built-in gain or loss in assets that, if actually sold, would not be US-source gain or loss treated as effectively connected with a US trade or business.

To address this, the final regulations retain the "10-year exception" included in the proposed regulations and adopt a series of new factual tests limiting application of the presumption that a deemed sale would be attributable to a US office or other fixed place of business. In the Preamble to the final regulations, Treasury and the IRS explain that these new rules are intended to "provide fair, administrable rules" that, by reference to existing sourcing principles, are less likely to overstate the amount of gain or loss on the deemed sale that is attributable to a US office or other fixed place of business.

*10-year exception*

Under the 10-year exception, the deemed sale of an asset is not treated as giving rise to deemed sale EC gain or deemed sale EC loss if the asset satisfies two conditions. First, the asset must not have produced effectively connected income for the partnership or the foreign transferor (or predecessor to either person) during the prior 10-year period or, if less than 10 years, the period during which the partnership or foreign transferor (or predecessor to either person) held the asset. Second, the asset must not have been used, or held for use, in the conduct of a US trade or business by the partnership or foreign transferor (or either's predecessor) during the same period.

*Asset-specific rules*

The final regulations include new asset-specific rules that leverage facts from a partnership's earlier tax years as a proxy for determining the source of deemed sale gain or loss. These asset-specific rules apply to three categories of assets: inventory property, intangibles and depreciable personal property. In each case, the foreign-source portion of property within each category is exempt from the final regulations' presumption treating the deemed sale of such property as being attributable to a US office, reducing the extent to which deemed sale gain or loss from that property must be treated as deemed sale EC gain or deemed sale EC loss.

The asset-specific rule for inventory property determines the foreign-source inventory gain or loss by multiplying deemed sale gain or loss attributable to inventory property by the partnership's "foreign-source inventory ratio." The foreign-source inventory ratio is the ratio, for the three tax years immediately preceding the deemed sale, of the partnership's gross income from inventory sales that was foreign-source income to all of the partnership's gross income from inventory sales over the same period. If the partnership has not existed for three tax years, the look-back period is the period from the partnership's (or its predecessors') formation until the close of its immediately preceding tax year.

The asset-specific rule for intangibles adopts a similar approach, treating as foreign-source intangible gain or loss an amount equal to deemed sale gain or loss on intangibles (within the meaning of Section 865(d)(2)) multiplied by the "foreign-source intangible ratio." The foreign-source intangible ratio is the ratio, for the three tax years immediately preceding the deemed sale, of a partnership's gross ordinary income (other than from dispositions of depreciable or amortizable property) that was not effectively connected with a US trade or business to all of the partnership's gross ordinary income (other than from such dispositions). The Preamble to the final regulations indicates that Treasury and the IRS based the foreign-source intangible ratio on a partnership's ordinary gross income, rather than all of its gross income, because they considered ordinary income to be a reliable proxy for a partnership's use of intangibles in the ordinary course of its trade or business. Similar to the inventory asset-specific rule, the look-back period may be shorter if a partnership has not existed for three tax years.

Lastly, the asset-specific rule for depreciable personal property provides two rules for determining the foreign-source portion of deemed sale gain or loss from depreciable personal property. First, the final regulations treat deemed sale gain from such property as foreign-source to the extent that gain would be treated as foreign-source under Section 865(c)(1) in the event of an actual sale. Under Section 865(c)(1), a portion of the gain from depreciable property may be treated as foreign-source to the extent that previous depreciation deductions were allocated and apportioned to foreign-source income. Second, gain in excess of previous depreciation adjustments is sourced by reference to the location of the depreciable property.

*Material-change-in-circumstances rule*

The final regulations also include a "material change in circumstances rule" to complement the asset-specific rules. As the name implies, this rule applies when a material change in circumstances occurs that would produce a "materially different" sourcing result than the result that would have been reached using the asset-specific rules. A materially different result only occurs when the change in circumstances results in at least a 30 percentage point difference compared with the result that otherwise would have been reached under the relevant asset-specific rule. This is measured based on a "modified look-back period," defined as the period that began on the date that the material change in circumstances occurred (a factual determination) and ended on the last day of the partnership's tax year immediately preceding the year of the deemed sale. Thus, for example, a partnership that significantly expands its foreign business activities (relative to its US trade or business) during the three-year look-back period may have a lower proportion of deemed sale EC gain (or deemed sale EC loss) under this rule than would otherwise be determined under the more mechanical exceptions described in the preceding paragraphs.

### Step 3: Determine the foreign transferor's distributive share of deemed sale EC gain or loss

The final step is to determine the foreign transferor's distributive share of the deemed sale EC gain or deemed sale EC loss identified in Step 2 that would have been allocated to the foreign transferor by the partnership. The final regulations state that all applicable Internal Revenue Code provisions apply when determining the foreign transferor's distributive share, and this determination should take into account allocations under the principles of Section 704(c), including remedial allocations under Treas. Reg. Section 1.704-3(d), and basis adjustments under Section 743(b).

## Additional considerations

### Coordination with Section 897

The final regulations generally adopt the proposed regulations' coordination rules between Section 864(c)(8) and the FIRPTA rules of Section 897. The FIRPTA rules generally take a foreign transferor's gain or loss on the sale of a US real property interest into account as though the foreign transferor were engaged in a US trade or business, meaning the gain or loss is subject to tax in the United States. When a foreign transferor receives an amount of money or property in exchange for all or a part of its interest in a partnership, Section 897(g) treats that amount as received from the sale or exchange of the US real property interests to the extent attributable to US real property interests held by the partnership.

The final regulations coordinate the application of Section 864(c)(8) and Section 897(g), both of which would otherwise apply to tax gain or loss recognized by a foreign transferor upon the disposition of an interest in a partnership that was both engaged in a US trade or business and held one or more US real property interests. If a foreign transferor's transfer of a partnership interest is subject to Section 864(c)(8) and the foreign partnership also owns one or more US real property interests, the coordination rule determines effectively connected gain or loss under Section 864(c)(8) rather than Section 897(g). A partnership that holds US real property interests but does not conduct a US trade or business would be subject to Section 897(g).

When a foreign transferor does not recognize gain or loss on its transfer of a partnership interest under Section 864(c)(8), either by reason of a nonrecognition provision or an applicable US income tax treaty, the final regulations clarify that Section 897(g) may nonetheless apply, causing a foreign transferor to recognize FIRPTA gain or loss. The final regulations include no guidance, however, as to how Section 864(c)(8) and Section 897(g) interact when gain on the transfer of a partnership is partially recognized (for example, when a foreign transferor recognizes gain due to the receipt of money or other property in connection with a Section 351 contribution).

### Coordination with treaties

The final regulations also include more detailed rules for coordinating Section 864(c)(8) when a US income tax treaty applies. First, the final regulations clarify that the computation of a foreign transferor's deemed sale EC gain or deemed sale EC loss is determined by reference to whether the partnership had a permanent establishment in the United States under the terms of an applicable US income tax treaty at the time of the transfer. As a result, the assets of a US trade or business are not taken into account in determining deemed sale EC gain or deemed sale EC loss if (1) a partnership conducts a US trade or business that does not qualify as a permanent establishment in the United States, and (2) the foreign transferor is eligible to claim the benefits of an applicable US income tax treaty. This treatment does not apply if gain or loss from the sale of the assets would otherwise be subject to tax in the United States, as would be the case, for example, for certain real property.

The final regulations also clarify that a foreign transferor may claim benefits of a US income tax treaty in determining its EC gain or EC loss only to the extent that the foreign transferor satisfies the requirements of the US income tax treaty's limitation-on-benefits article, if any.

### Tiered partnerships

Special rules apply to tiered partnerships. Generally, the final regulations require an upper-tier partnership to determine the deemed sale gain or loss for each lower-tier partnership (starting from the lowest-tier partnership that is engaged in a US trade or business), along with its distributive share of such gain or loss. Similar principles apply when an upper-tier partnership transfers an interest in a lower-tier partnership that is engaged in a US trade or business.

## Effective dates

The final regulations apply to transfers occurring on or after 26 December 2018. Although the final regulations do not apply to transfers occurring before 26 December 2018, Section 864(c)(8) is self-executing, so all transfers occurring on or after 27 November 2017, but before 26 December 2018, are subject to Section 864(c)(8). Amounts taken into account on or after 26 December 2018, under an installment sale are subject to the final regulations.

# Implications

Section 864(c)(8) has broad applicability. In addition to sales of partnership interests, Section 864(c)(8) may apply to redemptions of a partner's interest, distributions in excess of basis and a rebalancing of partnership interests in which Section 731(a) gain or loss is recognized. In many cases, foreign partners and the partnerships in which they invest are surprised by the variety of circumstances under which compliance with Section 864(c)(8) may be necessary. Those compliance obligations will increase substantially when final withholding rules under Section 1446(f) are issued.

The final regulations do not include final reporting rules that would require a partnership to provide information to a foreign transferor regarding its distributive share of any deemed sale gain or loss. In the absence of applicable reporting requirements, it is often challenging for a foreign transferor to determine its liability under Section 864(c)(8). The Preamble to the final regulations indicates that Treasury and the IRS expect to finalize these reporting rules in the future. Partnerships that are engaged in a US trade or business should be prepared to implement those rules, which can require the determination of deemed sale EC gain or deemed sale EC loss by a partnership on any date in which a foreign transferor (including an indirect foreign transferor in an upper-tier partnership) transfers its partnership interest.

Finally, the final regulations provide welcome relief by clarifying the rules on determining the source of deemed sale gain or loss from certain assets, limiting the extent to which such gains and losses should be treated as giving rise to deemed sale EC gain and deemed sale EC loss. The effect of those rules will be to limit the extent to which "outside" gain or loss on the transfer of a partnership interest will give rise to EC gain or EC loss for a foreign transferor.

## Endnote

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.

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