Executive summary

The United States (US) Treasury and the Internal Revenue Service (IRS) have issued proposed regulations (REG-113604-18) under Internal Revenue Code Section 864(c)(8) with guidance on the treatment of gain or loss recognized by foreign persons from the sale or exchange of an interest in a partnership that is engaged in a trade or business in the US. The proposed regulations include:

1. Rules for determining gain or loss under Section 864(c)(8)(A) and the corresponding limitation under Section 864(c)(8)(B), including the applicability of the “hot asset” rules of Section 751
2. Guidance on coordinating Section 864(c)(8) with the “FIRPTA” rules of Section 897
3. Clarifications with respect to tiered partnerships
4. Guidance on treaties
5. An “anti-stuffing rule” applicable to the Section 864(c)(8) regulations and Section 897

The proposed regulations do not include withholding guidance under Section 1446(f), which will be issued separately. (For certain interim guidance under Section 1446(f), as well as interim guidance issued under Section 864(c)(8) before the issuance of the proposed regulations.)
The proposed regulations, which to some extent are consistent with the IRS’s prior guidance in Revenue Ruling 90-12, are proposed to apply to transfers occurring on or after 27 November 2017, the enactment date of Section 864(c)(8). If any provision of the proposed regulations is finalized after 22 June 2019, however, Treasury and the IRS expect that provision to apply only to transfers occurring on or after 27 December 2018 (i.e., the date of publication of the proposed regulations in the Federal Register). (Section 7805(b)(2) provides a special rule allowing regulations to be effective earlier than permitted under Section 7805(b)(1) when the regulation is filed or issued within 18 months of the enactment of the relevant statutory provision. 22 June 2019 appears to be the expiration of the period.)

**Proposed regulations**

### Gain or loss on the transfer of a partnership interest

Under Section 864(c)(8)(A), if a non-US partner transfers an interest in a partnership that is engaged in a US trade or business, the gain (or loss) may be treated as ECI. Section 864(c)(8)(B), however, limits the amount of gain treated as ECI to what the foreign transferor’s distributive share of gain or loss would have been ECI if the partnership had sold all its assets at fair market value.

The proposed regulations would apply Section 864(c)(8) to transfers, defined as sales, exchanges and other dispositions, including a 731(a) distribution from a partnership to a partner, to the extent that gain or loss is recognized. The proposed regulations also provide that Section 864(c) does not override otherwise applicable nonrecognition provisions. Thus, to the extent that the gain or loss were not recognized as a result of one or more nonrecognition provisions, the foreign transferor would not recognize gain under Section 864(c)(8). The Preamble, however, requests comments on whether other Code provisions adequately address transactions that rely on Section 731 partnership distributions to reduce the scope of assets subject to US federal income taxation and notes that Treasury and IRS may propose rules addressing these types of transactions.

**Determination of gain or loss under Section 864(c)(8)(A)**

Under the proposed regulations, to determine the amount of gain or loss under Section 864(c)(8)(A), a foreign transferor generally must first determine its “overall” gain or loss on the transfer of a partnership interest (outside gain or loss). This determination is made using all relevant provisions of the Code and regulations and, for example, may include gain resulting from liability relief.

Although a partnership interest is generally a capital asset and Section 741 provides that gain or loss on a sale of a partnership interest is generally capital gain or loss, the “hot asset” rules of Section 751 can treat a portion of the outside gain or loss as ordinary income or loss to the extent attributable to inventory or various types of assets with “built-in” ordinary income, such as cash-basis accounts receivable and depreciable assets subject to recapture on sale. The proposed regulations would require the foreign transferor to separately apply Section 864(c)(8) to its capital gain or loss and its ordinary income or loss.
Determination of deemed sale gain or loss and the Section 864(c)(8)(B) limitation

After a foreign transferor determines outside gain or loss (the amount of capital gain/loss and the amount of ordinary gain/loss), the proposed regulations specify a three-step process to derive the limitation in Section 864(c)(8)(B) against which the outside gain or loss is compared:

1. For each asset of the partnership, determine the amount of gain or loss that the partnership would recognize in connection with a deemed sale for fair market value (determined immediately before the partner's transfer of its partnership interest) to an unrelated party in a fully taxable transaction for cash (the deemed sale gain and loss).

2. Determine the amount of that gain or loss that would be treated as effectively connected gain or loss (deemed sale EC gain or loss).

3. Determine the foreign transferor's distributive share of the ordinary and capital components of any deemed sale EC gain and deemed sale EC loss.

The Section 864(c)(8)(B) limitation would be determined by comparing (1) the foreign transferor's outside gain or loss that is treated as capital with the relevant “aggregate deemed sale EC capital gain or loss” (i.e., the sum of the foreign transferor's distributive shares of the capital components of deemed sale EC gain and deemed sale EC loss items for all relevant assets); and (2) the foreign transferor's outside gain or loss that is treated as ordinary with the relevant “aggregate deemed sale EC ordinary gain or loss” (i.e., the sum of the foreign transferor's distributive shares of the ordinary components of deemed sale EC gain and deemed sale EC loss items for all relevant assets). This determination would be separately made for capital gain/loss and ordinary income/loss.

For purposes of the second step, the proposed regulations include rules for determining whether gain or loss that would arise in a deemed asset sale would be treated as effectively connected gain or loss. For Section 864(c)(8) to potentially apply, the partnership would have to be engaged in a US trade or business; thus this provision of the regulations would effectively cause income from the deemed sale to be per se treated as ECI, except for investment assets without a sufficient connection with the US business. More precisely, the deemed asset sale by the partnership would be treated as attributable to an office or fixed place of business in the US maintained by the partnership, causing any gain to be US-source under Section 865(e)(2)(A). The Section 865(e)(2)(B) exception from US-source treatment for property sold for use, disposition, or consumption outside the US, in a sale in which an office or other fixed place of business outside the US materially participates, would not apply. The proposed regulations however, provide an exception to this general rule if, during the 10-year period ending on the date of transfer:

(1) no income or gain previously produced by the asset was taxable as effectively connected with the conduct of a trade or business within the US by the partnership (or a predecessor of the partnership), and (2) the asset was not used, or held for use, in the conduct of a trade or business within the US by the partnership (or a predecessor of the partnership).

After the amount of deemed sale EC gain or loss is determined for each asset, the deemed sale EC gain and loss from each asset would be aggregated to determine the aggregate deemed sale EC ordinary income or loss and the aggregate deemed sale EC capital gain or loss. The amount of the outside ordinary income or loss treated as ECI would be limited to the aggregate deemed sale EC ordinary income or loss. Similarly, the amount of the outside capital gain treated as ECI would be limited to the aggregate deemed sale EC capital gain or loss. As a result of this methodology, both outside gain (or loss) and aggregate deemed sale EC gain (or loss) may act as a “ceiling.” For example, suppose a foreign partner sells an interest in a partnership, all of whose assets are US business assets, and that, under Section 751(a), the partner has ordinary income of 100 from the sale and capital gain of 10. Assume further that the partner's total ordinary deemed sale EC gain is 120 and total capital deemed sale ECI gain is 5. Under the proposed regulations, the partner would recognize ordinary ECI of 100 (the lesser of the outside ordinary gain of 100 and the total ordinary deemed sale EC gain of 120) and capital ECI of 5 (the lesser of the outside capital gain of 10 and the total capital deemed sale EC gain of 5).

If a foreign transferor transferred an interest in the partnership that is less than all the partner's interest in the partnership, the partner's distributive share of the deemed sale EC gain and loss would be determined based on the transferred interest.

Source of gain or loss

The proposed regulations do not specifically address the source of gain or loss from the transfer of a partnership interest, but Treasury and the IRS request comments on whether any additional guidance is needed regarding the source of gain or loss subject to Section 864(c)(8).
Provision is non-exclusive

The proposed regulations specify that the rules therein do not prevent any portion of gain or loss recognized on the transfer of a partnership interest from being treated as effectively connected gain or loss under other sections of the Code (subject to the rule, described next, coordinating Section 864(c)(8) and Section 897).

Coordination with Section 897

The FIRPTA rules of Section 897 provide that gain on the sale of US real estate, and interests in US entities that predominantly own US real estate (collectively, US real property interests), is per se ECI. The proposed regulations include a rule to coordinate the taxation of US real property interests under Section 864(c)(8) and Section 897(g). Under Section 897(g), the amount realized by a nonresident alien individual or foreign corporation in exchange for all or part of an interest in a partnership generally is, to the extent attributable to US real property interests, considered an amount received from the sale or exchange in the US of such property. The proposed regulations state that, when a partnership holds US real property interests and is also subject to Section 864(c)(8) because it is engaged in the conduct of a trade or business within the US without regard to Section 897, the amount of the foreign transferor’s effectively connected gain or loss will be determined under Section 864(c)(8) and not under Section 897(g). As a result, the proposed regulations state that Section 864(c)(8)(C) does not reduce the amount of gain or loss treated as effectively connected under the general rule.

Tiered partnerships

Consistent with Notice 2018-29, the proposed regulations include guidance that applies to a foreign transferor transferring an interest in an upper-tier partnership that owns, directly or indirectly, an interest in one or more lower-tier partnerships that are engaged in the conduct of a trade or business within the US. The proposed regulations would require the deemed sale gain or loss to be computed for each lower-tier partnership (starting from the lowest-tier partnership that is engaged in a US trade or business). They also include rules for determining the amount of effectively connected gain or loss that would be allocated to the upper-tier partnership and the amount of gain or loss recognized by a foreign transferor that is treated as effectively connected gain or loss.

When a foreign transferor is a direct or indirect partner in an upper-tier partnership and the upper-tier partnership transfers an interest in a lower-tier partnership that is engaged in the conduct of a trade or business within the US, the proposed regulations would require the upper-tier partnership to determine its effectively connected gain or loss by applying the principles of the proposed regulations.

Treaties

The proposed regulations stipulate that treaty relief generally will not apply. US tax treaties typically provide that gains from the sale of property forming part of a permanent establishment in the US can be subject to US tax. The proposed regulations would extend this principle to the disposition of a foreign partner’s interest in a partnership with a permanent establishment in the US. Under case law, a partnership’s permanent establishment is attributed to all the partners, including limited partners; thus, US tax treaties generally do not provide relief from Section 864(e)(8). The one exception applies for certain ships and aircraft. Many US tax treaties exempt gain from the sale of ships and aircraft used in international traffic from US tax, even if attributable to a US permanent establishment. The proposed regulations provide that Section 864(e)(8) does not apply to the extent gain on sale of a partnership interest is allocable to gain from such ships or aircraft.

Anti-stuffing rule

An anti-stuffing rule would prevent inappropriate reductions in amounts characterized as effectively connected gain when a foreign partner (or related person) transfers property to a partnership with a principal purpose of reducing the amount of gain treated as effectively connected gain (or increasing the amount of loss treated as effectively connected loss) under Section 864(c)(8) or Section 897.

Implications

The proposed regulations would implement a formulaic approach to calculating the amount of gain or loss that is treated as effectively connected with a US trade or business upon a foreign partner’s sale of a partnership interest. Certain aspects of the methodology, however, appear to place a significant burden on partnerships with foreign partners. For example, as deemed sale gain and loss is calculated on an asset-by-asset basis, an affected partnership would have to determine the fair market value of each of its assets every time a foreign partner sells an interest.
The proposed regulations, moreover, appear to be overly broad in determining the amount of gain or loss that is treated as deemed EC gain or loss in the second step of the Section 864(c)(8)(B) calculation. Specifically, by providing that gain or loss in the deemed sale “is treated as attributable to an office or other fixed place of business maintained by the partnership in the US...,” the proposed regulations would seemingly treat all gains and losses (other than gains or losses with respect to (a) investment assets with no factual connection to the US business and (b) US real property interests under Section 897) that do not fit within the 10-year exception as effectively connected gains and losses. The examples provided suggest, however, that the proposed regulations may not be intended to be so broad in this respect.

The proposed regulations’ rule coordinating its provisions with Section 897 appears to override Section 864(c)(8)(C), which generally reduces effectively connected gain or loss determined under Section 864(c)(8)(A) by any amount treated as effectively connected gain or loss under the US real property interest rules of Section 897. The Preamble states that “the reduction called for by [Section] 864(c)(8)(C) is not necessary” because the proposed regulations provide that the effectively connected gain or loss is determined under Section 864(c)(8) rather than Section 897(g). It is unclear why the Treasury and IRS chose a different method of coordination than that in the statute.

Transfers of partnership interests covered by the proposed regulations include distributions to a partner to the extent Section 731(a) gain or loss is recognized. The application of Section 864(c)(8) and the proposed regulations to distributions taxable under Section 731(a) raises several questions. For example, consideration will need to be given to coordinating the application of other partnership tax rules, such as Section 751(b), with the proposed regulations’ methodology for determining the amount of capital and ordinary gain or loss subject to Section 864(c)(8). In addition, it is not clear what percentage (if any) of a partner’s interest is treated as “transferred” when Section 731(a) gain results solely from a reduction in the partner’s share of partnership liabilities. Taxpayers will need to consider the proposed regulations’ application to partnership distributions carefully.

Endnotes

1. All “Section” references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. See EY Global Tax Alerts, US IRS issues interim guidance under new Section 1446(f) for sales of interests in non-publicly traded partnerships, dated 12 April 2018 and US IRS suspends application of new Section 1446(f) withholding requirement on dispositions of publicly traded partnership interests, dated 12 January 2018.
4. This determination is made under all applicable Code provisions (including Section 704), taking into account allocations of tax items under the principles of Section 704(c), including any remedial allocations, and any Section 743 basis adjustment. The Preamble, however, states that the IRS is considering whether further guidance is needed.
5. This is a consequence of the “limited force of attraction” rule of Section 864(c), which treats the US-source income of a non-US person engaged in a US trade or business as ECI, except for income from certain investment assets. Income from such assets is ECI only if the assets have a sufficient connection with the US business.
6. Compare the 10-year lookback rule of Section 864(e)(7).
7. The examples provided in the proposed regulations create some uncertainty about the scope of the deemed ECI rule and the 10-year exception.
8. The proposed regulations do not discuss how Section 864(e)(8) interacts with Section 883, which provides for a reciprocal exemption from shipping and aircraft income, including gains from the sale of ships and aircraft, in certain situations in which no tax treaty applies.
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