

CLIENT ALERT

Tax Reform in Small Bites: New Withholding Taxes on Sales of Fund Interests

Feb.12.2018

This is one in a series of articles analyzing the impact of tax reform on investment funds and their portfolio companies. [Click here](#) to see all articles in the series.

The Tax Cuts & Jobs Act (TCJA) codified the IRS's longstanding position¹ that a non-US partner's gain from the sale of a partnership interest may be subject to US federal income tax where the partnership is engaged in a US trade or business. Taxpayers had challenged the IRS's position—and even won a case in the Tax Court in 2017²—but the TCJA effectively overrules that case for sales of partnership interests after November 27, 2017. The rule applies whether the partnership in question is organized within or outside the United States. The TCJA also imposes a new withholding tax on purchasers of partnership interests (or on the partnership if the purchaser does not withhold). These rules will impact investment funds structured as partnerships.

Under the TCJA, if a non-US investor sells an interest in an investment fund, the investor's gain or loss will be treated as "effectively connected income" (ECI) to the extent the investor would have had a distributive share of ECI if the fund had sold all of its assets at fair market value and allocated the gain or loss to the partners. ECI can arise for a foreign investor either because the fund itself is engaged in a trade or business (which is not common for PE or VC funds but may be more common for liquid strategies) or because the fund invests in a portfolio company treated as a partnership for federal income tax purposes. In the latter case, the portfolio company's business is attributed to the fund. Often foreign investors structure their investments in funds through blocker corporations in order to avoid ECI.

However, the TCJA also imposes a new withholding obligation. Specifically, the buyer (which likely would include the fund, in the case of a redemption) is required to withhold 10 percent of the total amount realized by the non-US seller on the sale or exchange of the interest. It is not clear how the buyer would know whether the fund has ECI or the total amount realized (which would include the purchase price as well as the seller's share of fund debt). If the buyer does not withhold, the fund is required to withhold. We would expect such an expense to be charged back to the buyer, but general partners should ensure that the fund documents cover this issue. With the increase in the secondary market for transfers of interests, general partners should consider this point before approving any transfer of interests.

The new withholding requirement applies even if no amount of gain would actually be recharacterized as ECI because, for example, the fund has "blocked" the ECI on behalf of the foreign investor. The only exception provided by the statute is that no withholding applies if the seller provides a certificate that it is not a foreign person. Although the IRS has the authority to prescribe a reduced withholding amount, as a practical matter, that process could take months and would likely not be complete

by the time of sale. We believe it would be helpful for the IRS to allow the fund to provide a certificate to the buyer providing, for example, that no amount of ECI would be allocated to the seller and therefore allowing the buyer not to withhold.

To the extent the withholding tax exceeds the foreign investor's actual liability for US federal income tax, the foreign investor can file a US federal income tax return to obtain a refund.

¹ Rev. Rul. 91-32.

² *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner*, 149 T.C. No. 3 (2017).

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