

# KIRKLAND & ELLIS

KirklandPEN

## Proposed IRS Regulations Impose Withholding Tax on Funds when a Partner Sells or Transfers its Interest

03 June 2019

On May 7, 2019, the Internal Revenue Service ("IRS") issued proposed regulations under the 2017 Tax Cuts and Jobs Act<sup>1</sup> ("TCJA") to implement a new withholding tax imposed on partnerships<sup>2</sup> and buyers when a partnership interest is sold or transferred. If finalized as drafted, the rules would have a meaningful and potentially adverse impact on secondary market sales and other transfers of interests in private equity and other investment funds, as well as portfolio companies taxed as partnerships. While the proposed regulations do not take effect until 60 days after finalization, fund sponsors (as well as buyers and sellers of partnership interests) should be aware that the proposed regulations may be finalized as drafted with little advance notice.

Under current, interim IRS guidance, subject to several exceptions, the TCJA requires the buyer of a partnership interest to withhold 10% of the amount realized if two conditions are met. First, there is a non-U.S. seller and second, the partnership is engaged in a U.S. trade or business or owns (directly or indirectly) an interest in another partnership engaged in a U.S. trade or business.

If finalized as drafted, the proposed regulations would:

- Require the buyer to withhold on the transfer of any partnership interest unless the transfer qualifies for one of several listed exceptions, each of which requires a certification signed under penalties of perjury;<sup>3</sup>
- Require the partnership to withhold tax from distributions (including in-kind distributions) to the buyer if the buyer has failed to withhold the proper amount, creating a new potential liability for both the fund and the fund sponsor;

- Impose an obligation on certain sellers to notify the partnership of the secondary sale or transfer of a partnership interest and require the partnership to provide substantial information to the notifying seller; and
- Reduce the *de minimis* exception threshold (for avoiding these withholding obligations) from 25% to 10%, such that either (1) the seller must certify that less than 10% of its income from such partnership consisted of ECI in each of the three most recent taxable years or (2) the partnership must certify that less than 10% of the partnership's gain would be ECI on a hypothetical sale of all partnership assets at fair market value.

The proposed regulations would also terminate the current suspension of withholding on the sale or transfer of an interest in a publicly traded partnership ("PTP") taxed as a partnership<sup>4</sup> and generally shift the withholding obligation from the buyer to the broker(s) who effectuate the transfer.

If finalized as drafted, the proposed regulations would materially increase the costs and burdens of secondary market transactions on fund sponsors, sellers and buyers of partnership interests.

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1. See prior [KirklandPEN](#) describing the TCJA legislation that created the 10% withholding tax regime. See also prior [KirklandPEN](#) describing the IRS' interim guidance.↩

2. These rules apply to any entity taxed as a partnership for U.S. tax purposes. The word "partnership" in this *KirklandPEN* thus includes an LLC, a PTP taxed as a partnership, and other incorporated and unincorporated entities taxed as partnerships.↩

3. The seller or transferor may provide certification of its non-foreign status or income tax treaty exemption, or that it has not realized any gain or that it qualifies for nonrecognition. The transferor or the partnership itself may provide certification of a *de minimis* exception further described in the text.↩

4. This new withholding tax is not imposed on trading of interests in a PTP taxed as a corporation.↩

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