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KIRKLANDPEN
Private Equity Newsletter

January 16, 2018

Secondaries Beware: New Withholding Requirements for Transfers of Partnership Interests

PENpoints

Recent U.S. tax legislation may obligate a purchaser of a private equity fund interest, and potentially even the fund itself, to withhold a portion of the purchase price.

U.S. tax legislation, enacted on December 22, 2017, includes provisions regarding sales and exchanges of partnership interests that impact private equity and hedge fund sponsors, as well as transferors and transferees of limited partner interests, and likely also non-U.S. partners whose partnership interests are redeemed. The legislation applies where the partnership (1) generates income "effectively connected" with the conduct of a U.S. trade or business ("ECI") or (2) owns (directly or indirectly through another entity classified as a partnership or disregarded entity for U.S. tax purposes) assets that are used in the conduct of a U.S. trade or business.

The new legislation introduces a new U.S. tax withholding requirement that will affect secondary market purchase and sale agreements, as well as fund transfer agreements. In connection with such transactions, participants are likely to require additional representations and indemnities concerning the new withholding tax, and fund managers are expected to seek comfort that withholding is not required or that the applicable tax will be withheld.

Specific Reporting and Withholding Rules. More specifically, the new rules require:

- a non-U.S. corporation or individual transferor (including a non-U.S. corporation or individual who holds a partnership interest indirectly through one or more pass-through entities) of an interest in a partnership to report and pay U.S. tax on the portion of the gain (if any) recognized on the disposition that is treated as ECI (the "ECI Reporting Provision");
- the acquiror (i.e., the transferee) of such a partnership interest to withhold U.S. tax equal to 10% of the gross amount realized by a non-U.S. transferor on the disposition (the "10% tax amount"), irrespective of the portion of the partnership's assets and income that generate ECI or are used in the conduct of a U.S. trade or business;
- a partnership that is the subject of a transfer to withhold the 10% tax amount from subsequent distributions to the acquiror if the acquiror fails to withhold the 10% tax amount; and
- apparently, a partnership that redeems the interest of a non-U.S. individual or corporate partner to withhold the 10% tax amount out of the partner's redemption proceeds.

In effect, the new legislation (a) codifies the longstanding position of the Internal Revenue Service (expressed in Revenue Ruling 91-32) that some or all of the gain recognized by a non-U.S. partner on the sale of a partnership interest generally should be treated as ECI (and thus subject to U.S. taxation) if the partnership is engaged in a U.S. trade or business, and (b) overrides the recent U.S. Tax Court decision in *Grecian Magnesite Mining Co. v. Commissioner*,[1] which suggested that some or all of the gain recognized upon the transfer or redemption of such an interest may not be subject to U.S. taxation.

Applicable Non-U.S. Transferors and Tax Rates. Although the legislation specifically refers to non-U.S. individuals and corporations, other types of non-U.S. transferors are subject to the new rules, including most non-U.S. pensions (which are generally treated as either individuals or as corporations for U.S. tax purposes) and sovereign wealth funds, whether investing directly in a partnership or indirectly through one or more pass-through entities.

Under the legislation, a foreign corporation generally would be subject to regular U.S. corporate tax rates with respect to gain reported pursuant to the ECI

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Reporting Provision. The maximum U.S. federal income tax applicable to corporations has been reduced to 21%, effective for taxable years beginning after December 31, 2017.

A non-U.S. individual transferor would be subject to the U.S. tax rates applicable to individuals, which will depend on the type of assets held by the partnership and on the amount of the individual's overall U.S. income. The maximum marginal U.S. federal income tax rate for individuals is 37%, effective for taxable years beginning after December 31, 2017.

A transferor generally should be entitled to credit the amount of any withholding tax against its U.S. federal income tax amount due as a result of the ECI Reporting Provision.

Effective Dates. The ECI Reporting Provision is effective for transfers occurring on or after November 27, 2017. The withholding requirement is effective for transfers occurring after December 31, 2017. However, the IRS already has issued guidance temporarily suspending the withholding requirement (but not the ECI Reporting Provision) for transfers of publicly traded partnership interests. In that guidance, the IRS requested input on whether the withholding requirement also should be suspended for transfers of nonpublic partnership interests.

Unclear Impact of New Legislation. Several aspects of the new provisions are unclear and will require guidance from the IRS. These include:

- procedures for requesting a reduced withholding amount, which will be relevant in cases where the 10% withholding amount significantly exceeds the amount of tax ultimately due from the transferor pursuant to the ECI Reporting Provision;
- coordination of the new ECI withholding requirement with the existing "FIRPTA" withholding requirements applicable to partnerships holding U.S. real property interests (particularly with respect to qualified foreign pension funds, which are exempt from "FIRPTA" tax with respect to transfers of certain U.S. real property interests but are subject to the new ECI Reporting and 10% withholding tax with respect to transfers of partnership interests that fall within the scope of the legislation);
- procedures enabling the partnership to determine whether the correct amount was withheld by the acquiror of the partnership interest;
- guidance concerning application of the provision to intermediaries and transferors that are partnerships;
- procedures for a transferor to indicate that it is not subject to the new provisions (i.e., because the transferor is not a non-U.S. corporation or individual); and
- rules clarifying whether various types of transfers that are otherwise "nonrecognition" events and generally non-taxable for U.S. tax purposes are (or are not) now taxable for foreign transferors as a result of the new provisions.

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1 Discussed in a prior *KirklandPEN*.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

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New Local Laws Prohibit Employers From Asking About Prior Salary

Numerous states, cities and localities have recently passed legislation banning all employers from asking a typical question of prospective workers: How much did you make in your last job?

Effective January 1, 2018, California state law now prohibits an employer from asking a job applicant about his or her salary history, unless the candidate discloses such information voluntarily and without prompting or the information is obtained pursuant to a federal or state government open records request. The California law also prohibits employers from relying on salary history in determining whether to extend an offer of employment to an applicant or as a factor in determining the salary of the applicant (unless one of the exceptions applies). California joins several other states which enacted similar bans in 2017, including New York City (effective October 31, 2017), Puerto Rico (effective March 8, 2017), Oregon (effective October 6, 2017), Delaware (effective December 14, 2017), and the city of Philadelphia (pending legal challenge). Laws in Massachusetts and the city of San Francisco will become effective July 1, 2018.

Why These New Laws Matter. Employers who violate these laws may face financial penalties. For instance, under the New York City law, employees can pursue compensatory damages, back-pay, and attorneys' fees if a lower salary was offered or paid based on salary history. If enforced by the New York City Commission on Human Rights, a civil penalty of up to $125,000 can be assessed for an unintentional violation and up to $250,000 for a willful, wanton or malicious violation of the law. While California's new law does not contain a specific penalty provision, it is likely that as case law develops, damages will still be pursued through the California Private Attorneys General Act (PAGA), which authorizes aggrieved employees to file lawsuits to recover civil penalties on behalf of themselves and other employees for California Labor Code violations.

To ensure compliance with these laws, a private equity firm and its portfolio companies in these states, cities and localities should revise their employment applications to remove any questions asking for salary history, as well as review their recruitment and hiring processes to avoid asking about applicants' salary history.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

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PENbriefs

KirklandAIM Update

Recently in our *KirklandAIM* newsletter, which is directed towards Chief Compliance Officers and other compliance professionals, we discussed the upcoming year's key filing and compliance deadlines for private fund managers with a December 31 fiscal year end. Click here to access this edition of *KirklandAIM*.

PENnotes

PLI Drafting and Negotiating Corporate Agreements 2018
New York NY, January 18, 2018
Chicago, IL, January 31, 2018

This PLI seminar will teach the basics of drafting and negotiating corporate agreements — from how the provisions of an agreement fit together, to the fundamental drafting and negotiating principles common to all corporate agreements. Kirkland partners Jonathan Davis and Keith Crow will be panelists at the New York and Chicago events, respectively. Click here for more information or to register.

45th Annual Securities Regulation Institute
Coronado, CA, January 22-24, 2018

Hosted by Northwestern Law, the 43rd Annual Securities Regulation Institute will take place in Coronado, California. One of the most visible and highly regarded securities and corporate law conferences in the country, the Securities Regulation Institute reaches prominent attorneys from both firm and in-house practices. Kirkland partner Scott Falk is on the planning committee and will be a panel member for the Mergers & Acquisitions session. Click here for more information or to register.

24th Annual Harvard Business School Venture Capital Private Equity Conference
Boston, MA, January 27, 2018

Kirkland is a sponsor of the 24th Annual Harvard Business School Venture Capital and Private Equity Conference, which will address a range of today's most relevant topics. Keynote speakers at this year's event are Kewsong Lee, deputy CIO of private equity and head of global market strategies at The Carlyle Group; Sean Klimczak, global head of infrastructure at Blackstone; and Paul Maeder, co-founder and managing general partner at Highland Capital Partners. Click here for more details or to register.

17th Annual Beecken Petty O'Keefe & Company Private Equity Conference
Chicago, IL, February 23, 2018

Kirkland is a sponsor of this annual event, which brings together financiers, students and entrepreneurs to network and share insights into the dynamics of investing in a constantly changing economy. This year's conference is themed "Remaining Nimble and Achieving Returns While Facing Uncertainty and Volatility." Click here for more information.

25th Annual Columbia Business School Private Equity Conference
New York, NY, February 23, 2018

Kirkland will partner with Columbia Business School to sponsor its annual Columbia Business School Private Equity Conference. The event will focus on the emerging challenges and opportunities facing the private equity and venture capital industries in the coming year. The conference will bring together industry professionals, students, alumni and faculty to share their knowledge and experiences. Click here for more information or to register.

13th Annual Stern Private Equity Conference
New York, NY, March 2, 2018

Kirkland will sponsor New York University's Stern School of Business' 13th Annual Stern Private Equity Conference. The conference will provide a forum for industry leaders to discuss the opportunities and risks of today's private equity and venture capital environment, including how tepid global growth, regulatory dynamics, political pressure and financial market conditions are posing challenges to fundraising, deal financing and operations. More information to follow.

Wharton Private Equity & Venture Capital Conference
New York, NY, March 16, 2018

The Wharton School's Private Equity and Venture Capital Conference will showcase several keynote speeches and panel discussions on the state of the private equity and venture capital industries. Kirkland partner Robert Blaustein will moderate the Funds panel and partner Stephen Hessler will moderate the Distressed Opportunities panel. Click here for more information or to register.

2018 Kellogg Private Equity and Venture Capital Conference
Chicago, IL, April 25, 2018

Kirkland is a sponsor of this annual student-led conference, which brings industry professionals, alumni, students and Kellogg faculty together for a day of discussion on the current state of the industry and its most pressing issues. More information to follow.

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Kirkland & Ellis' nearly 500 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and fund formations on behalf of more than 400 private equity firms and hedge funds around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in each of the last six years by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. U.S. News Media Group and Best Lawyers have ranked Kirkland as a Tier 1 law firm for Leveraged Buyouts and Private Equity Law for seven consecutive years and as a top-tier firm for Private Funds/Hedge Funds Law since 2012. The Firm was recognized as the #1 law firm for private equity in the 2018 Vault 100 rankings, and, in 2016, Private Equity International named the Firm "Law Firm of the Year in North America: Fund Formation" for the third year in a row.

In 2012-2017, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011-2016*, and has consistently received top rankings among law firms in Private Equity by The Legal 500, the Practical Law Company and IFLR, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite," having noted that the Firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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