

IRS Temporarily Eases Withholding Regime for Secondary Sales of Partnership Interests

PENpoints

The notice (1) provides for several situations in which the new 10% withholding regime is either suspended or is not required in the case of a non-U.S. partner's transfer or disposition of a partnership that holds ECI-producing assets and (2) clarifies certain rules on how to compute the required withholding.

In an April 2, 2018, notice,¹ the U.S. Department of Treasury published guidance with respect to provisions of the 2017 tax legislation (the "Tax Bill") that impose a new 10 percent withholding tax on certain sales of partnership interests, including secondary sales of limited partner interests in hedge funds and private equity funds. Under the Tax Bill, withholding is now required on sales and exchanges of partnership interests by non-U.S. partners, if the underlying partnership holds assets that are "effectively connected" with the conduct of a trade or business within the United States under U.S. tax laws ("ECI"). The Tax Bill first requires the transferee to withhold at the source and secondarily requires the underlying partnership to withhold to the extent the transferee has not withheld the required amounts. A full description of these new requirements was provided in a prior [KirklandPEN](#).

Guidance on Exceptions to Withholding and How to Compute Withholding

The April 2 notice provides interim answers to many of the critical questions that remained after enactment of the Tax Bill, pending publication of final Treasury Regulations. In particular, the notice (1) while not providing for an across the board suspension of withholding for non-publicly traded partnership interests, does provide for several situations in which withholding is either suspended or is not required² and (2) clarifies certain rules on how to compute the required withholding.

Suspension and Exceptions to Withholding

- *Suspension of Secondary (Fund) Withholding.* One key rule benefitting private equity and hedge funds is that the notice immediately suspends until further guidance is provided the requirement that the underlying partnership is required to withhold in situations in which the transferee does not fully withhold and pay the appropriate amount of tax over to the U.S. Internal Revenue Service ("IRS").

- *Suspension of Withholding on Nonrecognition Transaction.* The notice immediately suspends until further guidance is provided any withholding for transactions that would be eligible for "non-recognition" treatment under existing law (e.g. certain contributions to partnerships or distributions from partnerships that are not treated as taxable sales).
- *No Withholding based on FIRPTA Certificate or W-9.* The notice clarifies that the transferee does not need to withhold when the transferor provides evidence of its non-foreign status for U.S. tax purposes, including by providing an appropriate IRS Form W-9 (or an affidavit meeting the existing requirements to avoid withholding under the rules of the "Foreign Investment in Real Property Tax Act" (also known as "FIRPTA")).
- *No Withholding based on Certificate that No Gain is Realized.* The notice provides that the transferee does not need to withhold if the transferor provides an affidavit that the transfer will not result in realized gain for U.S. federal income tax purposes, so long as the transferee has no knowledge that the affidavit is false.
- *No Withholding based on Certificate that Less than 25 Percent of Income/Gain is ECI.* The notice provides that the transferee does not need to withhold if either (1) the transferor provides the transferee an affidavit stating that less than 25 percent of the income allocated with respect to transferred interest in the three most recent taxable years (determined under rules specified in the notice) constituted ECI

INSIDE KIRKLANDPEN

<i>PENbriefs</i>	3
<i>Upcoming Events</i>	3

¹ IRS Notice 2018-29.

² The IRS previously suspended withholding on sales of interests in publicly traded partnerships. IRS Notice 2018-08, 2018-7 I.R.B. 352. The new notice does not impact this previous suspension.

(including certain income treated as ECI under the FIRPTA rules), or (2) the partnership provides the transferee an affidavit stating that if the partnership sold all of its assets for fair market value, less than 25 percent of the total gain would be treated as ECI (including gain treated as ECI under the FIRPTA rules). The IRS provided that it expects the 25 percent threshold to be reduced when final guidance is issued.

Guidance on Determining the Withholding of any Withheld Amounts

- *Treatment of Liabilities.* The amount of withholding required under the Tax Bill is based on the amount realized by the transferor on the disposition of the partnership interest (including any reduction in the share of the partnership's liabilities). The notice permits transferring partners to establish their share of the partnership's liabilities based on the amounts reported on their most recent Schedule K-1 from the partnership (determined under rules specified in the notice and assuming they have no actual knowledge of subsequent events that would materially change a partner's share of the partnership's liabilities). The notice also permits the underlying partnership to establish a transferring partner's share of liabilities.
- *Caps Withholding at Amount Paid by Transferee.* Because the withholding under the Tax Bill is based on amount realized (including any reduction in share of liabilities), there was a concern that the withholding required could exceed the cash purchase price paid. The notice provides that the maximum amount of withholding tax that can be imposed on a transfer is the amount realized on the transfer less the decrease in the transferor's share of partnership liabilities resulting from the transfer. In most cir-

cumstances, this cap on withholding should not exceed the cash portion of the purchase price paid by the transferee to the transferor.

- *Redemptions.* In situations where a partnership is making a distribution to a partner, the amount distributed can be subject to withholding under the Tax Bill if the distribution exceeds the partner's "outside" basis in the partnership. The notice permits a partnership making a distribution to a non-U.S. partner to rely on its own books and records in determining a partner's "outside" basis in its partnership interest when calculating whether a distribution to a partner would be a taxable distribution.

Other Guidance Still Required

The notice provides helpful practical guidance for investors and purchasers of partnership interests who seek to implement the new withholding rules, building upon the prior IRS Notice that suspended these new withholding rules entirely for transfers of publicly traded partnership interests. However, further guidance is still necessary to establish:

- procedures to establish reduced withholding tax liabilities for transfers that are subject to a reduced (but not eliminated) rate of ECI withholding;
- coordination of the new withholding rules with the existing FIRPTA rules to ensure no duplicative or overlapping withholding upon sale of a partnership interest that holds both assets that would produce ECI upon sale as well as U.S. real estate assets;
- implementing the new withholding rules in the case of tiered partnerships that hold assets that would generate ECI upon sale; and
- providing mechanics for collecting refunds of over-withheld or improperly withheld amounts.

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PENbriefs

Singapore Introduces Deferred Prosecution Agreements

Singapore recently passed legislation introducing the concept of the deferred prosecution agreement (DPA) to the jurisdiction. Corporations (but not individuals) facing prosecution for corruption, money laundering or receipt of stolen property may now attempt to negotiate the terms of a DPA with prosecuting authorities. With the introduction of DPAs, Singapore joins the U.S., Brazil, the U.K. and France, which form the vanguard of an increasingly consistent global approach to corporate criminal resolutions. To learn more, see our recent [Alert](#).

PENnotes

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. Kirkland partner Richard Campbell will moderate a panel on “Add-On Acquisitions as a Source of Value.” Click [here](#) for more information.

PEI Private Fund Compliance Forum 2018 New York, NY, May 8-9, 2018

This event will examine critical changes in the regulations governing private equity and the impact on compliance processes, and provide the latest approaches for managing firms’ compliance programs. Kirkland is a sponsor of the event, and partner Alpa Patel will be a panelist on “Identifying conflicts at your firm.” Click [here](#) for more information.

LPGP Women in Private Debt Conference New York, NY, May 23, 2018

The first annual LPGP Women in Private Debt Conference will bring together 100 LPs and GPs from the global private debt community to analyze the latest trends in the market, discover new investment opportunities and build meaningful business relationships for long-term growth. Kirkland partner Stephanie Berdik will be a panelist on “Why are investors opting to allocate to private debt vs. other asset classes?” and partner Erica Berthou will lead the fireside chat. Click [here](#) for more information.

2018 SuperReturn Energy Boston, MA, June 18-19, 2018

Kirkland is a sponsor of this specialized energy private equity event. Bringing LPs and GPs together, SuperReturn Energy provides a platform for energy investors to share expertise, build partnerships and do deals. Kirkland partner John Pitts will participate on the “Private Equity Oil & Gas Deal Sourcing” panel. Click [here](#) for more information.

Private Debt Investor CFOs & COOs Forum 2018 New York, NY, June 20-21, 2018

Kirkland is a sponsor of this event, which will delve into the complexities of managing the finance and operations of firms that invest across the capital structure, including senior secured loans, subordinated debt, hybrid financing and more. Kirkland partner Stephanie Berdik will address how LPs evaluate private debt and credit funds, and partner Norm Champ will discuss the before and after of an SEC exam. Click [here](#) for more information.

PLI Annual Private Equity Forum New York, NY, July 16-17, 2018

This annual event is designed to provide an overview of the legal issues that need to be considered in marketing a private equity fund, current regulatory and compliance hot buttons, issues in negotiating the terms of private equity funds, GP-led fund restructurings, sponsor stake sales, and other developments. Kirkland partner Andrew Wright will speak on “General Partner Arrangements: Structure and Terms.” Click [here](#) for more information.

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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 seven 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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