KPMG report: Initial impressions of final regulations, withholding and reporting obligations on dispositions of certain partnership interests

October 15, 2020

kpmg.com

The IRS on October 7, 2020, posted on its website a version of **final regulations** [PDF 601 KB] (156 pages) (T.D. 9926) ("Final Regulations") regarding withholding and reporting obligations with respect to dispositions of certain partnership interests under section 1446 and related sections of the Code.

Sections 864(c)(8) and 1446(f) were added to the Code by the 2017 U.S. tax law (Pub. L. No. 115-97), the law that is often referred to as the "Tax Cuts and Jobs Act" (TCJA). Sections 864(c)(8) provides rules for determining the amount of gain or loss that is treated as effectively connected with a U.S. trade or business when a non-U.S. person sells an interest in a partnership that is engaged in a trade or business in the United States. Section 1446(f) provides withholding and reporting rules applicable to the transfer of partnership interests described in section 864(c).

Treasury and the IRS on December 29, 2017, released Notice 2018-08, which provided a temporary suspension of the requirement to withhold on amounts realized in connection with dispositions by a foreign person of certain interests in publicly traded partnerships. On April 2, 2018, Treasury and the IRS released Notice 2018-29, which generally provided temporary guidance with respect to dispositions by a foreign person of interests in non-publicly traded partnerships.

Proposed regulations under section 1446(f) were published on May 13, 2019 ("Proposed Regulations"), which generally set forth guidance related to withholding and reporting obligations with respect to dispositions by a foreign person of interests in partnerships (both publicly traded and non-publicly traded) that are engaged in a trade or business in the United States.

The Final Regulations retain the basic approach and structure of the Proposed Regulations but include several modifications and clarifications based on industry comments received.

Below is a summary of the key modifications addressed by the Final Regulations, based on the version released by the IRS. Modifications affecting interests in non-publicly traded partnerships are addressed first, followed by modifications affecting interests in publicly traded partnerships ("PTPs").

Contents

Background 2
Withholding obligations under section 1446(f) 2
In general 2
Applicability dates 2
Limitation on section 1446(f) liability where no tax due under section 864(c)(8) 3
Partnerships, trusts, and estates claiming credits for section 1446(f) withholding 3
Certifications provided by grantor trusts 4
Withholding on transfers of non-PTP interests 4
Exceptions to withholding 4
No realized gain exception updated to accommodate 751 property 4
Updates to the 10% effectively connected gain exception 5
10% effectively connected income exception 6
Documentation for treaty exemptions 6
Determining the amount to withhold 7
Modified amount realized to account for treaty benefits 7
Certification of maximum tax liability for trusts 7
Partnership's residual withholding liability 8
No relief from partnership residual withholding when partnership has reason to know certification relied upon was not correct 8
Certifications of non-foreign status for the transferor 8

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Refunds for overwithholding ... 9
Residual liability for related parties ... 10
Withholding on transfers of PTP interests ... 10
Qualified intermediaries (QIs) ... 10
QI agreement ... 10
Additional flexibility for qualified intermediaries ... 11
Nonqualified intermediaries (NQIs) ... 11
Clearing organizations and DVP transactions ... 12
Limited obligations for clearing organizations ... 12
No DVP exception ... 13
General rules ... 13
Withholding satisfied by another broker ... 13
Relevant withholding date for sales of PTPs interests ... 13
Clarification of broker 1042-S reporting ... 14
Exceptions to withholding ... 14
New exception for dealers in securities ... 14
Updates to the 10% effectively connected gain exception ... 14
Removal of qualified current income exception ... 14
Elimination of residual withholding requirements for PTPs ... 14
Determining the amount to withhold ... 15
Modified amount realized to account for treaty benefits ... 15
Updated amount realized on PTP distributions & removal of qualified current income exception ... 15
Delivery of qualified notices for PTP distributions ... 16

Background

Certain transferors that transfer an interest in a partnership in a transaction described in section 864(c)(8) are required to notify the partnership within 30 days of the transfer and, in turn, the partnership is required to provide the notifying transferor with information needed to comply with 864(c)(8). Some of the information needed to comply, namely the foreign source portion of certain deemed sale gain or loss, generally covers a three-year lookback period. In certain cases, however, a modified lookback period may be used that covers the period after a material change in circumstances occurs.

Accordingly, the Final Regulations require that the partnership's statement to the notifying transferor to state whether the information being provided was determined under the alternate material change in circumstances rule.

Withholding obligations under section 1446(f)

In general

Applicability dates

The provisions of the Final Regulations generally have an applicability date of 60 days after the Final Regulations are published in the Federal Register. However, certain provisions, in particular those

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

pertaining to PTPs and a partnership's residual withholding obligation, go into effect for transfers taking place on or after January 1, 2022.

KPMG observation

This timeline for implementing the rules regarding PTP interests and a partnership's residual withholding obligation may prove to be very challenging for the industry as this provides brokers and partnerships less than 15 months to update systems to enable compliance. The short timeline to the commencement of broker withholding exacerbates an already difficult issue brokers face of trying to establish a process for the collection of documentation and withholding for DVP transactions for the first time.

Limitation on section 1446(f) liability where no tax due under section 864(c)(8)

The Final Regulations retain the general rule requiring withholding on the transfer of a partnership interest unless an exception applies. Therefore, a transferee must presume that a transfer is subject to withholding unless it obtains a certification from the transferor establishing that no withholding is required. In the partnership distribution context, the partnership may also rely on its books and records to establish that no withholding is required.

The Final Regulations provide, however, that regardless of the general requirement to withhold, a person that fails to withhold as required under section 1446(f) will not be liable for a failure to withhold if it can establish to the satisfaction of the IRS that no gain on the transfer is effectively connected with the conduct of a U.S. trade or business under section 864(c)(8). This rule applies with respect to transfers of both PTP and non-PTP interests and applies to any person required to withhold under section 1446(f) (e.g., a transferee, partnership, or broker).

KPMG observation

This change helps limit potential liability to those situations that the section 1446(f) withholding rules were designed to target, namely those transactions that result in a substantive tax liability under section 864(c)(8). This change will be particularly welcomed by a partnership that knows, based on the nature of its activities, that no transfer of a partnership interest would create effectively connected gain under section 864(c)(8) and, therefore, it shouldn't be subject to a withholding liability (noting, of course, that the partnership would need to expend the time and effort to assert this defense). However, because this modification does not create an outright exception to withholding but, rather, a process under which a person can provide evidence to the IRS to establish withholding wasn't required, this relief is entirely within the discretion of the IRS. For that reason, reliance on this limitation of liability rule should only be done as a last resort.

Partnerships, trusts, and estates claiming credits for section 1446(f) withholding

The Final Regulations allow transferors that are foreign partnerships to claim credits for withholding imposed under section 1446(f) by crediting such amounts against the partnership's section 1446(a) tax liability with respect to amounts allocable to foreign partners. The Final Regulations also allow foreign trusts and foreign estates to claim credits for withholding imposed under section 1446(f) to the extent the trust or estate is liable for tax under section 864(c)(8). In each case, the transferor claiming the credits

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

should generally attach the stamped copy of the Form 8288-A received from the IRS to the applicable return containing the claim for credit.

If the transferor does not receive the stamped Form 8288-A from the IRS, it should attach to the applicable return a statement that includes all information that would have been provided on the Form 8288-A, along with substantial evidence of the amount withheld.

The IRS and Treasury plan to update the instructions for Forms 8804, 8805, and 8813 accordingly.

Certifications provided by grantor trusts

The Proposed Regulations provided that a certification by a transferor that is a grantor or other owner of a grantor trust must identify the portion of the amount realized that is attributable to such grantor or other owner. The Final Regulations expand this rule by allowing the grantor trust to provide the grantor's certification to the transferee as part of a Form W-8IMY package (*i.e.*, a Form W-8IMY, withholding statement, and underlying owner certification). A domestic grantor trust providing a certification on behalf of a foreign grantor or owner may provide a statement containing the information that a flow-through entity would provide on a Form W-8IMY, withholding statement, and underlying owner certification.

Withholding on transfers of non-PTP interests

Exceptions to withholding

Note that all withholding exceptions under section 1446(f), other than exceptions pertaining to distributions, require the reliance on a certification. Therefore, even though the focus of section 1446(f) is on non-U.S. partners who transfer their interests in a partnership engaged in a U.S. trade or business, in the absence of adequate documentation, section 1446(f) has the potential to impact the transfer of any partnership interest.

No realized gain exception updated to accommodate 751 property

The "No Realized Gain Exception" generally provides an exception to withholding if the transferee relies on a certification from the transferor stating that the transfer of the partnership interest would not result in any realized gain, including any ordinary income arising from the application of section 751 and Reg. section 1.751-1 (which includes items such as unrealized receivables or inventory items). Under the Proposed Regulations, a partnership was generally required to provide the transferor with the information necessary to determine whether the certification of no realized gain was appropriate, but was not required to do so until the deadline for submission of Form 8308 (generally, January 31st of the calendar year following the calendar year of transfer). Accordingly, under the Proposed Regulations, transferors would often lack the information necessary to make use of the No Realized Gain Exception until the opportunity to apply the exception had passed.

The Final Regulations provide that a transferor may rely on a certification ("751 Certification") from the partnership stating that, as of the determination date, the transfer of the partnership interest would not result in any ordinary income under section 751 and Reg. section 1.751-1. The 751 Certification is attached to, and forms part of, the general certification provided by the transferor to establish that the No Realized Gain Exception applies.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

KPMG observation

The solution provided in the Final Regulations provides a more administrable method of obtaining the necessary information from the partnership in sufficient time to utilize the No Realized Gain Exception. However, the partnership is not obligated to provide the transferor with the 751 Certification. Therefore, while the partnership may have an incentive to provide the 751 Certification as a matter of furthering partner relationships, transferors may continue to have limited ability to use the No Realized Gain Exception if partnerships do not provide the necessary information on a voluntary basis.

Updates to the 10% effectively connected gain exception

The Proposed Regulations included a 10% Effectively Connected Gain ("EC Gain") exception providing an exception to withholding if the transferee relies on a certification from the partnership stating that if the partnership sold all of its assets at fair market value ("FMV") on the determination date, the amount of net effectively connected gain resulting from the deemed sale would be less than 10% of the total net gain from the deemed sale, or that the partnership would not have any gain that was effectively connected income. In the partnership distribution context, the partnership may also rely on its books and records to establish that the EC Gain exception applies.

The Final Regulations update the EC Gain exception to allow the transferee to take into account its distributive share of EC Gain to compute the 10% EC Gain exception. Specifically, in addition to the certifications permitted in the Proposed Regulations, a transferee may now rely on a certification from the partnership that upon a deemed sale of the partnership's assets, the transferor's distributive share of net EC Gain would be zero or not exceed 10% of total net gain.

The Final Regulations also retain the exception of the Proposed Regulations allowing the partnership to determine the applicability of the 10% EC Gain exception at the partnership level without regard to a partner's distributive share.

The Final Regulations also expand the EC Gain exception to apply to transfers of interests in partnerships not engaged in a U.S. trade or business. Accordingly, apart from any deemed sale analysis, a transferee may rely on a certification from the partnership stating that the partnership was not engaged in trade or business within the United States any at time during the partnership's tax year through the date of the transfer.

KPMG observation

The additional options for the EC Gain exception provide additional flexibility for transferees to establish that no withholding should apply. In particular, the outright exception for partnerships not engaged in any trade or business in the United States provides a straight-forward exception without extensive calculation on the part of the transferor or partnership. However, given the increase to the number of variations, it becomes even more important that persons involved in the frequent transfers of partnership interests create a template (or checklist) for completing the certifications for each exception to ensure that the certifications are complete and accurate.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

10% effectively connected income exception

Under the Proposed Regulations, a transferee was not required to withhold to the extent it relied on a certification from the transferor providing, in relevant part, that the transferring partner's allocable share of effectively connected taxable income ("ECTI") for the immediately prior tax year and two preceding tax years was less than 10% of the transferor's total distributive share of *net* income received from the partnership, and less than $1 million in each of those years (the "10% ECTI exception"). The Proposed Regulations provided that the transferor's allocable share of ECTI was determined by reference to Form 8805 (other than when the transferor was allocated an effectively connected loss or had deductions allocated and apportioned to effectively connected income and could treat its ECTI as zero). As a result, the ECTI Exception was only available to a transferor that was either allocated a positive amount of ECTI that was reported on Form 8805, or an effectively connected loss, and the ECTI exception, accordingly, was not available to a partner that had no effectively connected income or loss.

In response to comments requesting that the calculations for the exception be done on a gross basis rather than net basis, and that the exception should be available to transferring partners that were not allocated any effectively connected income or loss, the Final Regulations change the 10% ECTI exception to a 10% effectively connected income ("ECI") exception. Under the 10% ECI exception in the Final Regulations, a transferor calculates the $1 million threshold based on the transferor's distributive share of *gross effectively connected income* (rather than ECTI), and measures the 10% threshold by comparing the transferor's distributive share of *gross effectively connected income* against the transferor's total distributive share of *gross income* from the partnership for such period (rather than net income). For this purpose, the transferor's distributive shares of effectively connected income and gross income are determined by reference to Schedule K-1, rather than Form 8805. The rule in the Proposed Regulations limiting availability of the 10% ECI exception to transferors having a distributive share of effectively connected taxable income has accordingly been updated to require only that transferors have a distributive share of gross income.

KPMG observation

The modifications to this exception, particularly the reliance on only on a Schedule K-1 instead of both Schedule K-1 and a Form 8805, as was previously required under the Proposed Regulations, should make this exception more available and practical to transferors.

Documentation for treaty exemptions

The Proposed Regulations allowed a transferee to rely on a certification from the transferor stating the that transferor is fully exempt from tax under an applicable tax treaty, provided that the transferor includes with the certification a valid Form W-8BEN or W-8BEN-E, as applicable, supporting the claim for treaty benefits. The Final Regulations streamline the requirements for this exception in providing that the treaty claim on the Form W-8 constitutes the required certification. The instructions for both Forms W-8 will be updated to include instructions for using the forms to satisfy the treaty exception.

KPMG observation

The comments in the preamble to the Final Regulations indicate that at a minimum, the instructions to Forms W-8BEN and W-8BEN-E will be updated to accommodate the section 1446 treaty exemption. As with all Form W-8 modifications, unless the IRS specifically provides

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

otherwise, practitioners should be prepared to transition to the new form versions, even if the practitioner has no section 1446(f) transactions.

Note that, in contrast to traditional treaty claims made on Forms W-8BEN and W-8BEN-E for section 1441 and 1442 purposes, the treaty claim for section 1446(f) purposes requires that the transferee mail a copy of the certification to the IRS within 30 days of the date of the transfer. As a result of this obligation to mail the certification within 30 days of the transfer, the ability to reduce section 1446(f) withholding by obtaining a treaty certification retroactively with an affidavit appears to be limited.

The section 1446(f) regulations do provide that a person required to withhold may establish that a reduced rate of withholding was appropriate in order to reduce the person's own liability for failing to withhold, however, the IRS can still impose interest and penalties even when the liability for the underlying tax is reduced. Therefore, taxpayers need to consider that Forms W-8 containing treaty claims for section 1446(f) purposes are obtained in a timely manner.

Determining the amount to withhold

Modified amount realized to account for treaty benefits

When the transferor of a partnership interest is a foreign partnership, the regulations allow the transferee to withhold on the "modified amount realized" rather than the full amount realized on the transfer. Under the Proposed Regulations, the modified amount generally equaled the portion of the amount realized allocable to direct or indirect partners of the transferring partnership that did not provide certifications of U.S. status, as indicated in the tax documentation (i.e., Form W-8IMY, withholding statement, and certifications of U.S. status) provided to the transferee.

The Final Regulations update the modified amount realized to also exclude amounts allocable to direct or indirect partners of the transferor partnership that are foreign persons but exempt from tax under an applicable tax treaty. Any such exclusions must be supported by a certification of treaty benefits made on a Form W-8BEN or W-8BEN-E, as applicable, included in the documentation provided to the transferee.

Therefore, under the Final Regulations, the modified amount realized subject to section 1446(f) withholding will be the amount realized on the transfer, less amounts allocable to either certified U.S. persons or foreign persons with certified treaty exemptions.

Certification of maximum tax liability for trusts

The Proposed Regulations allowed a transferee to limit withholding based on a certification of maximum tax liability provided by a transferor that is foreign corporation, a foreign individual, or a foreign partnership. When such certification of maximum tax liability is obtained, if the transferor's maximum tax liability is less than 10% of the amount realized, the transferee can instead withhold the maximum tax liability.

In response to comments received, the Final Regulations include foreign trusts in the types of transferors eligible to provide, and be withheld on in accordance with, a certification of maximum tax liability.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Partnership's residual withholding liability

No relief from partnership residual withholding when partnership has reason to know certification relied upon was not correct

The Proposed Regulations required a partnership to withhold on future distributions to a transferee when the partnership has reason to know that the transferor's certification supporting a reduction or exception to withholding was incorrect or unreliable, even if the transferee reasonably relied on the certification. This "residual withholding obligation" applies even when the reason to know is caused by information contained in the partnership's books and records that was not visible to the transferee. Commentators pointed out that the application of this rule can result in the imposition of withholding on a transferee who has appropriately relied upon a certification for which the transferee had no reason to know was unreliable. For this reason, commentators requested that this rule be modified to eliminate a partnership's residual withholding when the transferee properly relied upon a transferor certification, even if the partnership has information in its files that conflicts with the certification provided.

The Final Regulations decline to adopt this comment. In the preamble to the Final Regulations, Treasury and the IRS state that they believe the partnership residual withholding is appropriate, even if the transferee had no knowledge or reason to know the documentation was incorrect or unreliable. To minimize a risk of being withheld upon, the preamble suggests that the partnership should initially withhold on transfers of partnership interests while the transferee confirms that the partnership has no reason to know that the certification obtained by the transferee is incorrect or unreliable.

KPMG observation

The imposition of strict liability on the transferee for relying on certifications that turn out to be incorrect or unreliable based on information not possessed by the transferee poses substantial risk to transferees. The suggestion presented in the preamble that the transferee initially withhold on all transfers while the transferee consults with the partnership within the 20 days between the time the transfer occurs and the deposit is due with the IRS, while effective in reducing this risk, may pose substantial administrative challenges for transferees as this approach requires transferees to manage large amounts of withholding and to not only provide the required certifications to the partnerships but obtain a response from the partnership prior to the deposit deadline. If a response cannot be obtained from the partnership in time, the transferee is faced with the choice of depositing the, likely, excessive withholding or risking late deposit penalties.

For this reason, transferees may wish to consider limiting the withholding exceptions upon which they rely to those that pose minimal risk, such as certifications that are provided directly by the partnerships or Forms W-9 from the transferor. In addition, when transferees do rely upon transferor certifications, the transferees should establish a process to withhold, escrow the amounts withheld temporarily, submit the certification to the partnership, set up a process to manage responses from the partnership, and deposit or refund the amounts withheld, as appropriate, before the end of the 20-day window.

Certifications of non-foreign status for the transferor

The Proposed Regulations generally required partnerships to withhold on distributions to a transferee if the transferee failed to withhold as required on the transfer. In determining whether a residual withholding obligation exists, the partnership can generally rely on a certification of withholding provided

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

by the transferee (the transferee certification) unless the partnership knows or has reason to know the certification is unreliable.

The Final Regulations retain this general rule but also provide an exception to a partnership's residual withholding obligation when the partnership has a certification of non-foreign status for the transferor on file, provided the partnership has no reason to know the certification is unreliable. When the partnership has a reliable certification of non-foreign status on file for the transferor, the partnership will not be required to withhold, even when the transferee has failed to provide the transferee certification.

KPMG observation

The availability of this exception provides partnerships a strong incentive to collect certifications of non-foreign status from all U.S. persons entering the partnership regardless of any regulatory requirement to do so, as those partners will presumably become transferors at some point. Given that there is no limitation on how the certification of non-foreign status is obtained, there may be opportunities to avoid the residual withholding obligation by obtaining transferor certifications from third parties.

Refunds for overwithholding

Under the Proposed Regulations, a partnership that imposed residual withholding on distributions to a transferee was the only party allowed to claim a refund for amounts withheld in excess of the transferee's withholding obligation on the transfer from which the transferee obtained the interest. The Final Regulations shift the claim for refund entirely: rather than having to rely on the partnership to make the claim on the transferee's behalf, the transferee is now the only party that can claim a refund for residual withholding imposed by the partnership in excess of the transferee's withholding liability on the initial transfer.

A transferee may claim a refund for the excess amount of payments that have been made to the IRS (either by the transferee or the partnership) in excess of the tax which is properly due by the transferee for the tax period. However, the Final Regulations provide that a transferee's withholding tax liability is not satisfied if a partnership has actual knowledge or reason to know that the certification relied upon by the transferee to reduce or eliminate withholding is incorrect or unreliable.

The Final Regulations further clarify that the "excess" amount available for refund, both the transferee's original withholding liability and the residual withholding imposed on the transferee by the partnership should be calculated with interest.

KPMG observation

Shifting the refund claim responsibility for excess withholding applied to distributions made to the transferee from the partnership to the transferee will enable transferees to ensure that a refund claim is filed when appropriate, as they will no longer be reliant on the partnership to decide whether to make the claim on their behalf. This method of permitting transferees to file their own refund claims is much more practical and consistent with other withholding regimes.

However, the language stating that the transferee's withholding tax liability is not satisfied if a partnership has actual knowledge or reason to know that the certification relied upon is incorrect or unreliable appears to limit the transferee's ability to claim a refund for amounts withheld by the

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

partnership when the partnership had information that called into question the reliability of the certification but the transferee did not. Therefore, even when the transferee has withheld correctly based on the information available to the transferee, if the partnership has additional contradicting information, the withholding tax is then imposed on the transferee and the transferee appears unable to claim a refund for this amount.

The Final Regulations do not elaborate, however, on the process for the claiming the refund and it is unclear how the IRS will know that the partnership withheld based on contradicting information in its files when the transferee applies for a refund (i.e., if the transferee is merely providing the certification upon which it relied to establish that no withholding was required and that certification appears to be facially valid, it may not be apparent when a partnership has withheld based on additional information not visible on the certification or when the partnership has simply overwithheld in error). In fact, the transferee itself may not know the reason that the partnership withheld or whether the partnership's assessment of the contradicting information was reasonable.

Residual liability for related parties

The Proposed Regulations generally required that a partnership with a residual withholding liability stop withholding when the transferee subject to residual withholding transfers their interest to another party (the subsequent transferee). Notwithstanding this general rule, however, a partnership was required to continue withholding on the subsequent transferee if the partnership had actual knowledge that the subsequent transferee is related (as defined under section 267(b) or section 707(b)(1)) to either the initial transferee that was subject to residual withholding or the original transferor from which the initial transferee received its interest.

The Final Regulations retain this rule and further clarify that a related person that becomes a subsequent transferee is liable for tax under section 1461 to the same extent the initial transferee was subject to residual withholding. This modification does not have any substantive impact on the operation of the section 1446(f) rules but rather closes a loophole that could otherwise allow the new transferee to claim a refund for withholding imposed.

Withholding on transfers of PTP interests

Qualified intermediaries (QIs)

QI agreement

The IRS and Treasury plan to update the Qualified Intermediary agreement ("QI agreement") to allows QIs to assume primary withholding obligations under section 1446(f) as well as on distributions by publicly traded partnerships under section 1446(a). While the current QI agreement is in effect through calendar year 2022, the Final Regulations provide guidance on the changes expected to go into effect with the new QI agreement in 2023.

The Final Regulations also note that a rider to the current QI agreement will set forth QI obligations under sections 1446(a) and 1446(f) for calendar year 2022. However, QIs will not be required to conduct periodic reviews with respect to section 1446(a) or 1446(f) compliance for the 2022 calendar year. Therefore, the rider for 2022 will not include any review procedures for these sections.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Additional flexibility for qualified intermediaries

Under the Proposed Regulations, QIs that assume primary withholding under chapter 3 were generally exempt from withholding under 1446(f). The Final Regulations further allow QIs to assume primary withholding for 1446(f) purposes on a payment-by-payment basis. Accordingly, a QI may now assume primary withholding with respect to the sale of a PTP interest but not on a PTP distribution, or vice versa. To the extent a QI does not assume primary withholding, it can choose to pass up information for specific underlying owners or instead provide pooled information (i.e., pools of foreign persons subject to 10% withholding, foreign persons exempt from withholding, or U.S. persons exempt from withholding). If a QI chooses to pass up specific payee information, the broker (or nominee) making the payment must treat each person identified by the QI as a recipient for Form 1042-S reporting purposes, and the QI is relieved of reporting obligations with respect to those payees.

The Final Regulations also allow a QI to assume primary 1446(f) withholding with respect to sales of PTP interests regardless of whether the QI has assumed primary withholding under sections 1441 and 1442. With respect to a PTP distribution, however, a QI that assumes primary withholding for any purpose must assume primary withholding for all purposes.

QIs will be able to complete their own Form 1042-S reporting with respect to amounts subject to withholding under 1446(a) or 1446(f) on a pooled basis to the same extent generally permitted under the QI agreement for other purposes. However, QIs will not be able to use the collective refund procedures for amounts withheld under section 1446(a) or 1446(f). Therefore, the QI will be required to provide a recipient specific Form 1042-S upon request. In addition, the preamble provides that the updated QI agreement will require the QI to comply with the nominee reporting rules in Reg. section 1.6031(c)-1T.

KPMG observation

The option permitting the QI to pass up payee specific information achieves the same result that a QI would normally get when it elects to be treated as an NQI with respect to a payment for purposes of sections 1441 and 1442. However, since NQIs are subject to 10% withholding on the amount realized under section 1446(f), the Final Regulations permit a QI that does not assume primary withholding under section 1446(f) to pass up payee specific information in its capacity as a QI.

Nonqualified intermediaries (NQIs)

The Final Regulations clarify that brokers will be required to withhold the full 10% of the amount realized on transfers of PTP interests when paid to an NQI, even if the NQI is acting on behalf of a U.S. person or foreign person that is eligible for treaty relief.

Treasury and the IRS have explained that this determination reflects the view that NQIs are not required to account to the IRS with respect to their compliance with the withholding and reporting requirements of section 1446(f).

Partners that are account holders of the NQI may be entitled to claim a credit for the withholding imposed at the NQI level and allocated to their share of the amount realized; however, the NQI will need to issue a Form 1042-S to the partner supporting the claim.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

KPMG observation

The decision to impose withholding on the full amount realized when paid to an NQI is inconsistent with the treatment of NQIs generally under chapter 3 and is inconsistent with the rules under section 1446(f) governing payments to nonwithholding partnerships (NWPs). Both NQIs and NWPs are foreign entities that have no special relationship with the IRS under which they agree to comply with U.S. tax law and are, accordingly, treated as entities that cannot be relied upon to comply with the obligations imposed on withholding agents. For that reason, both entities are given a look-through treatment for withholding and reporting purposes, under which such entities are required to pass up documentation from underlying payees to an upstream withholding agent that will perform the withholding based on the documentation provided and will report directly to the payee (i.e., the person on whose behalf the NQI or NWP receives the payment). This process enables the correct withholding to be applied based on the rates applicable to the underlying payees, enables the payees to receive the information returns necessary for refund claims, and places the responsibility for compliance with an upstream withholding agent that has some accountability to the IRS.

This look-thru method has been applied by the section 1446(f) regulations with respect to NWPs through the modified amount realized calculation which allows the NWP to pass up documentation and allocation information to support a reduced amount of withholding with respect to the portions of the payment allocated to U.S. persons or foreign persons eligible for treaty relief. As an NWP is similarly situated to an NQI, it appears unduly punitive and arbitrary to permit an NWP to utilize a look thru method in the calculation of a modified amount realized, while imposing the maximum withholding on an NQI. While this method may serve to encourage more intermediaries to register as QIs, that option is not available to all intermediaries since not all jurisdictions are QI-eligible jurisdictions. Additionally, the same argument could be made for incentivizing NWPs to register as withholding partnerships, however, the government has not deemed that necessary.

The method under the Final Regulations of requiring the maximum withholding on payments to NQIs creates an inefficient process under which NQIs, who are generally unfamiliar with the Form 1042-S process, will be required to issue Forms 1042-S to customers that are eligible for refund claims and those customers will need to make refund claims to recover the excessive withholding, which only serves to further slow down an already lethargic refund process.

Clearing organizations and DVP transactions

Limited obligations for clearing organizations

A clearing organization that effects transfers of PTP interests on behalf of a transferor qualifies as a "broker" under both the Proposed and Final Regulations. However, the Final Regulations exempt U.S. clearing organizations from withholding requirements with respect to trades of PTP interests where the trades are settled through a net settlement system under which the U.S. clearing organization is the central counterparty. Notwithstanding the relief from withholding, the U.S. clearing organization will be required to report its gross payments to the clearing members on each leg of the transaction (i.e., on a non-netted basis) on Forms 1042-S.

A U.S. clearing organization that makes payments on a gross basis to settle a trade of a PTP interest at the direction of a member is not required to perform any withholding or reporting with respect to the transaction.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

No DVP exception

Industry comments had asked for an exception from the obligation to withhold on "delivery versus payment" ("DVP") for all parties other than the custodian for the seller. Treasury and the IRS declined to follow the recommendations made in the comments due to concerns that some custodians will be nonqualified intermediaries (NQIs) who have no accountability to the IRS and, therefore, cannot be relied upon to withhold and report as required. Therefore, under the Final Regulations, brokers are generally required to withhold on payments of amounts realized on PTP transfers to foreign custodians, including payments made with respect to DVP transactions. This process ensures that when the custodian for the seller is an NQI, withholding will be assessed by the US broker at the NQI's level such that the receipt of section 1446(f) withholding will not be contingent on the compliance of an NQI.

In order to help facilitate the transfer of documentation that could support an exception to withholding, the Final Regulations allow a U.S. clearing organization to provide tax documentation received from one member broker (including a member custodian) to another member broker, so long as the member whose documentation is being provided is notified and has the option to opt out.

KPMG observation

Many brokers were hoping for a complete exception from withholding on DVP transactions so the lack of such an exception in the Final Regulations will require substantial adjustments to their processes in order to comply with this new requirement. In accordance with the permission granted by the Final Regulations to share documentation of its members, U.S. clearing organizations could reduce some of the burden caused by these new documentation requirements by utilizing a central repository to house and share withholding certificates of member brokers and custodians. An automated repository could enable the documentation process to be done instantaneously in many circumstances and could reduce instances where withholding would be necessary.

General rules

Withholding satisfied by another broker

The Proposed and Final Regulations both provide that a broker is not required to withhold on amounts realized on the transfer of a PTP interest when it knows the withholding has already been fully satisfied. The Final Regulations further clarify that a broker acting as an intermediary is not required to withhold on amounts received from another broker (the upstream broker) unless it has reason to know that the upstream broker did not withhold as required. Accordingly, a broker acting as an intermediary that passes up valid documentation indicating that it does not assume primary withholding responsibility for section 1446(f) purposes and has no reason to know the documentation is unreliable, will generally not have any section 1446(f) withholding obligation. This standard mirrors the standard generally applicable for section 1441 purposes.

Relevant withholding date for sales of PTPs interests

The Final Regulations clarify that with respect to sales of PTP interests, the relevant date for withholding is the settlement date, not the trade date. This aligns with a broker's backup withholding requirements with respect to proceeds subject to reporting under section 6045.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Clarification of broker 1042-S reporting

The Proposed Regulations generally required brokers to report on Forms 1042-S payments to foreign transferors or foreign brokers of amounts realized on the transfer of a PTP interest. The Final Regulations clarify that the broker's Form 1042-S reporting should be completed on an aggregate basis for each transferor. The IRS intends to update the Form 1042-S instructions accordingly.

In addition, Treasury and the IRS have confirmed that a foreign partnership that has been withheld upon by a broker for section 1446(f) purposes will be required to attach a Form 1042-S received from the broker in order to obtain a credit against its liability under section 1446(a).

Exceptions to withholding

New exception for dealers in securities

The Final Regulations add a new exception to withholding for foreign securities dealers. Specifically, a transferor will be exempt from withholding if it provides the broker a valid Form W-8ECI certifying that the transferor is a dealer in securities and that any gain on the transfer is effectively connected with the conduct of a U.S. trade or business without regard to the provisions of section 864(c)(8). A broker may generally rely on a form satisfying these requirements that it already has on file for the transferor rather than obtaining a new form for each specific transfer.

Updates to the 10% effectively connected gain exception

Under the Proposed Regulations, the 10% Effectively Connected Gain ("EC Gain") exception generally provided that a broker is not required to withhold on the transfer of a PTP interest to the extent it appropriately relies on a qualified notice from the PTP that establishes that upon a deemed sale of the partnership's assets, less than 10% of the gain (or none of the gain) would constitute gain effectively connected with a U.S. trade or business. The Final Regulations update this exception by providing that a broker may also rely on a qualified notice stating that the PTP was not engaged in trade or business within the United States any at time during the partnership's tax year through the designated date for the qualified notice.

Removal of qualified current income exception

The Final Regulations also removed the qualified current income exception and replaced it with a modification to the determination of the amount realized. See the discussion regarding the Updated Amount Realized on PTP Distributions, below, for further details.

Elimination of residual withholding requirements for PTPs

Under the Proposed Regulations, a PTP that posted a false qualified notice on which a broker relied to avoid withholding had a residual obligation to withhold on subsequent distributions to the transferee. Under the Final Regulations, PTPs no longer have any residual withholding requirement, even where a broker fails to withhold based on a false qualified notice posted by the partnership. Rather than requiring withholding on future distributions to the transferee as a result of a compliance error made by the PTP, the Final Regulations impose direct liability for the underwithheld tax on the PTP itself pursuant to section 1461. However, with respect to qualified notices that indicate that an exception to withholding applies, the Final Regulations provide that a PTP will only be liable for the underwithheld tax when it has failed to make a reasonable estimate of the relevant amounts contained in the qualified notice.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

KPMG observation

The relaxation of a PTP's liability under section 1461 when the error made on the qualified notice was made based on reasonable calculations, should have a significant impact on the feasibility of these rules. Without this relief, PTPs would likely have been unwilling to accept the liability for errors contained in qualified notices and may have elected simply to not issue them. However, it is also significant that while the rules regarding a PTP's liability for qualified notices that contain representations as to the applicability of the 10% ECI exception absolve a PTP of liability when the determination of the applicability of the exception is based on a reasonable estimate, there appears to be no corresponding relief provided when a PTP, based on reasonable calculations, issues a qualified notice incorrectly representing the portion of the distribution that is attributable to cumulative net income. It is unclear if this inconsistency is merely a drafting error or an intentional distinction.

In response to comments stating that a PTP would lack sufficient information to determine the underwithholding that occurred as a result of a broker's reliance on a qualified notice, the Preamble to the Final Regulations states that PTPs should be able to rely upon nominee reporting under Reg. section 1.6031(c)-1T (which generally includes reporting on transfers of partnership interests).

Determining the amount to withhold

Modified amount realized to account for treaty benefits

Where the transferor of a PTP interest is a foreign partnership, the regulations allow a broker to withhold on the "modified amount realized" rather than the full amount realized on the transfer. Under the Proposed Regulations, the modified amount generally equaled the portion of the amount realized allocable to direct or indirect partners of the transferring partnership that did not provide certifications of U.S. status, as indicated in the tax documentation (i.e., Form W-8IMY, withholding statement, and certifications of U.S. status) provided to the transferee.

The Final Regulations update the modified amount realized to also exclude amounts allocable to direct or indirect partners of the transferring partnership that are foreign persons but exempt from tax under an applicable tax treaty. Any such exclusions must be supported by a certification of treaty benefits made on a Form W-8BEN or W-8BEN-E, as applicable, included in the documentation provided to the transferee.

Thus, the modified amount realized subject to section 1446(f) withholding will be the amount realized on the transfer, less amounts allocable to either certified U.S. persons or foreign persons with certified treaty exemptions.

Updated amount realized on PTP distributions and removal of qualified current income exception

Under the Proposed Regulations, the amount realized on a PTP distribution generally included the amount of cash and the fair market value of property to be distributed, however, brokers were not required to withhold if they relied on a qualified notice establishing that the entire distribution was qualified current income. The qualified current income exception provided an all or nothing standard which did not allow for any flexibility when only a portion of the distribution was made up of current net income. Additionally, the qualified current income exception only took into account current net income but not cumulative net income.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

In response to comments requesting more flexibility in the test, the Final Regulations removed the qualified current income exception entirely and replaced it with a modification to the calculation of the amount realized that provided a carve out for cumulative net income. Specifically, the Final Regulations now define the amount realized on a PTP distribution as the amount of the distribution less the portion of the distribution that is attributable to the cumulative net income of the partnership (i.e., the partnership's cumulative net income since formation that has yet to be distributed). This amount realized will be provided on the PTP's qualified notice, which the broker can then rely upon when determining the amount to withhold.

Delivery of qualified notices for PTP distributions

Under the Proposed Regulations, a PTP producing a qualified notice was generally required to post the qualified notice in a readily accessible format on a portion of the PTP's primary public website dedicated to this purpose; however, there was no requirement to directly provide the qualified notice to any particular party. The Final Regulations keep this general posting requirement but further require PTPs to provide a qualified notice directly to any registered holder of a PTP interest that is a nominee for PTP distributions.

The Final Regulations also clarify that if a PTP fails to issue a sufficient qualified notice, a nominee must apply the default withholding rule under Reg. section 1.1446-6(4)(b)(4), which assigns specific withholding rates to corporate and non-corporate partners. The Final Regulations further clarify that if a nominee cannot establish the status of a partner (i.e., corporate or non-corporate), it must apply whatever rate is higher.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Contact us

For more information, contact a KPMG tax professional:

Laurie Hatten-Boyd
T: +1 206 213 4001
E: lhattenboyd@kpmg.com

Danielle Nishida
T: +1 212 954 2774
E: daniellenishida@kpmg.com

Phil Garlett
T: +1 408 367 5764
E: pgarlett@kpmg.com

Carson Le
T: +1 212 954 7465
E: carsonle@kpmg.com

www.kpmg.com
kpmg.com/socialmedia

The information contained herein is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

KPMG is a global network of professional services firms providing Audit, Tax and Advisory services. We operate in 147 countries and territories and have more than 219,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization. NDPPS 811721