

# U.S. Partnerships With Foreign Partners: Navigating Withholding, Informational Reporting, and Payment Requirements

TUESDAY, JUNE 15, 2021, 1:00-2:50 pm Eastern

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June 15, 2021

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Joshua S. Kaplan  
Managing Director  
KPMG US  
[jskaplan@kpmg.com](mailto:jskaplan@kpmg.com)

Danielle Nishida  
Principal, Information Reporting & Withholding  
Tax  
KPMG US  
[daniellenishida@kpmg.com](mailto:daniellenishida@kpmg.com)

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# U.S. Partnerships With Foreign Partners:

## Navigating Withholding, Informational Reporting, and Payment Requirements

- June 15, 2021
- [tax.kpmg.us](https://tax.kpmg.us)



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# Speakers

## **Danielle Nishida**

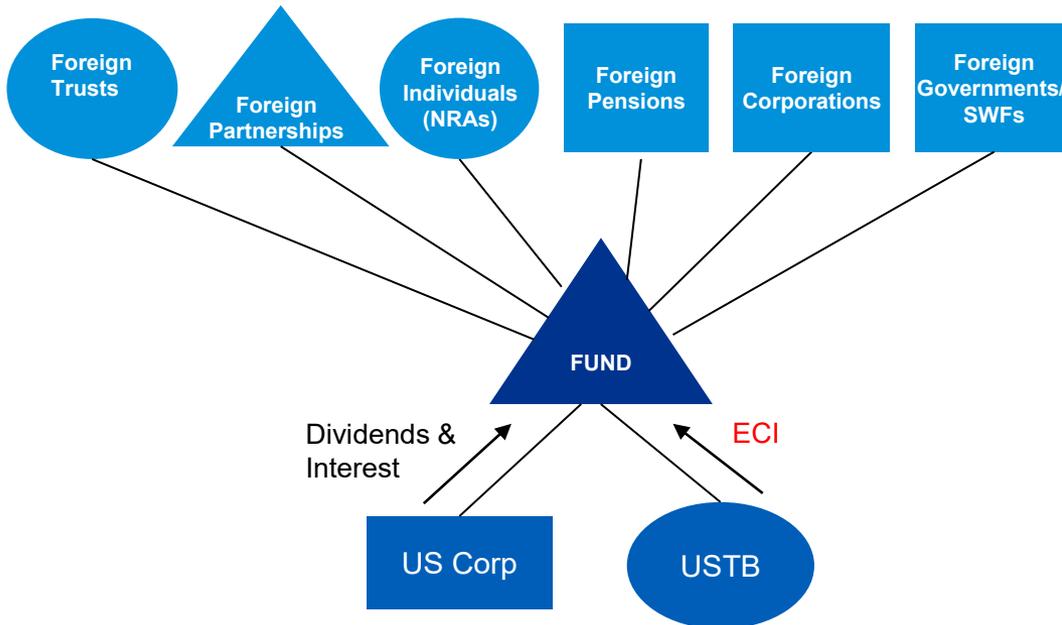
Principal, Information Reporting & Withholding  
Tax, Washington National Tax

## **Josh Kaplan**

Managing Director, International  
Washington National Tax



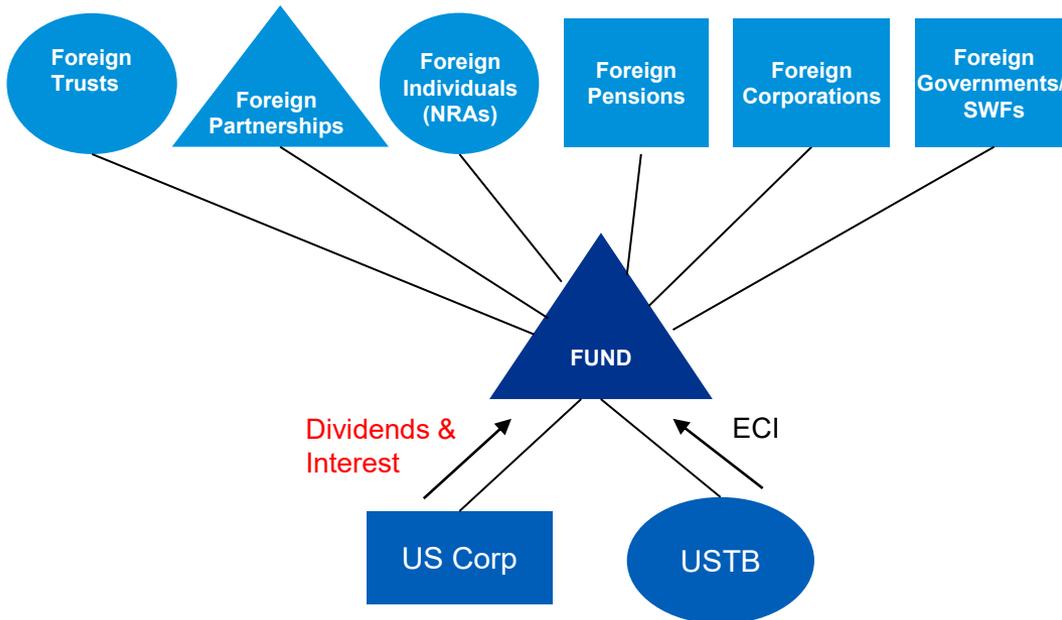
# Overview of US Taxation of Foreign Investors



## Taxation of active business income (ECI)

- Income effectively connected with the conduct of a US trade or business (ECI) taxed on net basis at the regular graduated US rates applicable to type of taxpayer.
- FIRPTA gain treated as ECI.
- US trade or business and permanent establishment of a partnership is attributed to its foreign partners.
- Foreign corporations may be subject to 30% branch profits tax, unless reduced by treaty.
- **US federal income tax return requirement.**
- Partnership withholds on ECI allocable to foreign partners.

# Overview of US Taxation of Foreign Investors (cont'd)



## Taxation of passive US income (FDAP)

- US source fixed or determinable annual or periodical income (FDAP) taxed at 30% statutory rate, unless reduced by treaty, or specific statutory exception (e.g., section 892, portfolio interest).
- FDAP includes interest, dividends, rents, royalties
- Gross basis taxation.
- US source capital gains generally not taxable, unless ECI or FIRPTA applies.
- Generally no US return filing for foreign partner
- Tax generally collected by withholding



# Taxation and Withholding on ECI Earned by Partnership

# Taxation of Active Business Income

## Code

- Foreign person must be engaged in a US trade or business (USTB);
- Must have US source income effectively connected with the USTB.
  - Foreign source income may be ECI in limited circumstances.

## Treaty

- Foreign person must have US permanent establishment (PE);
- Must have US source business profits attributable to the US PE.

## USTB and PE of partnership attributed to partners

### Return filing requirement

- Foreign person engaged in USTB must file US tax return, even if no tax liability
- Foreign person exempt from tax under treaty (because no US PE) must file return to report treaty position

### **Always determine taxation under the Code before considering whether there is a PE; if no tax under the Code, PE not relevant**

- Generally easier to have USTB than PE

# US Trade or Business

## Generally “facts and circumstances” test

- Whether active profit-oriented activities of a foreign person in the United States are “considerable, continuous and regular”
- Generally, a low threshold
- Foreign person may be engaged in a USTB through its own activities or activities conducted through an agent (express or implied)

## Partnership/partner activities

- If partnership (US or foreign) is engaged in USTB, a foreign person that is a partner in such partnership is also considered to be engaged in a USTB (section 875(1))

## Net election for real property activities

- Foreign investors may elect to treat US real property activities as USTB even if not USTB under general principles (section 871(d), section 882(d))
- Election made by partners, not partnership

# What Does ECI Include?

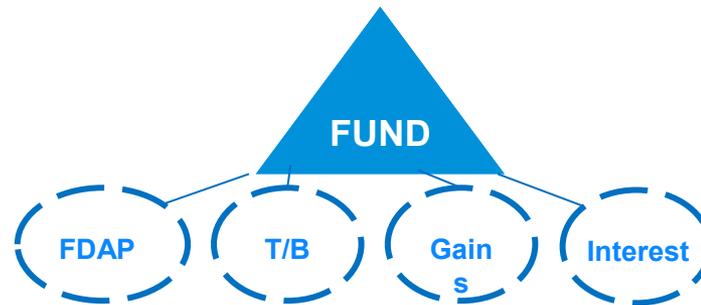
## General Rule – “limited force of attraction”

- If a foreign person is engaged in a USTB, all US source income that is not FDAP income or capital gain income is treated as ECI, regardless whether the income is attributable to the activities of the USTB (section 864(c)(3))

## US source FDAP income and US source capital gain or loss is ECI if meet one of two tests:

- Asset use test (income derived from asset used in USTB); or
- Business activities test (activities of USTB are “material factor” in generating income). Reg. §1.864-4(c)
- Both tests aimed at ECI treatment for generally passive-type income that might be viewed as business income for certain taxpayers (e.g., interest on trade receivables and working capital, dividends for securities dealers, rents and royalties from active leasing or licensing business)

# Sourcing Rules – General Partnership-level Determination



**Generally, source of income derived by a partnership is determined at the partnership level; partner's distributive share of the partnership's income retains that source**

**Exception for sales of personal property (e.g., stock) by a partnership**

**Interest income is sourced to residence of debtor.**

# Partnership Withholding on ECI – Section 1446(a)

## General Rule

- Partnership (US or foreign) that is engaged in a USTB—directly or indirectly through another partnership—must withhold on effectively connected taxable income (ECTI) allocable to foreign partners, regardless whether the income is distributed.
  - These rules also apply to US LLCs that are treated as partnerships for USFIT purposes and foreign entities that are treated (or have elected to be treated) as partnerships for USFIT purposes

## Amount and Timing of Withholding

- Partnership generally must withhold at highest marginal rate applicable to type of partner (i.e., 21% for foreign corporations and 37% for NRAs and foreign entities taxed as individuals)
  - Long term capital gain rate may be available for LTCG allocable to NRAs
- Partnership generally makes quarterly withholding payments
- ECTI calculated at partnership level similarly to calculation of net ECI, but regulations provide special rules for certain items (e.g., treatment of capital losses)
  - Section 1446(a) can result in over withholding if partner has effectively connected losses from other sources (foreign partners can certify partner-level losses in certain situations by providing Form 8804-C)
  - Application of BPT to foreign corporate partner not considered

# Partnership Withholding on ECI – Section 1446(a) (cont'd)

## Amount and Timing of Withholding (cont'd)

- Foreign partnership generally can credit withholding under section 1445(a) or section 1446(f)(1) against section 1446(a) withholding obligation
- Amount withheld is credited against tax due on foreign partner's tax return, and amount withheld is treated as distributed to partner in cash on last day of partnership's taxable year
  - **Withholding by partnership does not relieve foreign partner's obligation to file tax return**

## Partner Documentation

- Partnership generally must assume partner is foreign person unless partner provides Form W-9
- Foreign partners must provide relevant W-8 Form certifying classification and, if applicable, entitlement to benefits under treaty (Form W-8BEN-E) or section 892 (Form W-8EXP)
- Generally can look through foreign partnership that provides W-8IMY and documentation for its partners
- Foreign partners that make net ECI election for real property activities provide Form W-8ECI

## Partnership Reporting

- Form 8804 used to report partnership's total section 1446(a) withholding liability (required if gross ECI, even if no withholding because no net ECI)
- Form 8805 provided to IRS and foreign partners to report withholding w/r/t particular foreign partner
- Partnership pays withholding with Form 8813

# FIRPTA Tax and Withholding

# FIRPTA – General Overview

**Section 897(a) treats a foreign person’s gain or loss from the sale of a US real property interest (“USRPI”) as gain or loss that is effectively connected with a USTB.**

- FIRPTA gain thus subject to tax at regular US tax rates and foreign investor required to file tax return

**A USRPI generally includes real property located in the US and stock in a US corporation that was a US real property holding corporation (“USRPHC”) during the shorter of the shareholder’s holding period of the prior 5 years.**

- A corporation is a USRPHC if the FMV of its USRPI’s equals or exceeds 50% of the sum of the FMV of its USRPIs, foreign real property interests, and other trade or business assets.

**FIRPTA also applies to gain from the sale of an interest in a partnership that holds USRPIs.**

- Gain on sale of partnership engaged in a USTB may also be ECI under section 864(c)(8).

**Corresponding withholding regime in section 1445 for disposition of USRPIs.**

# FIRPTA – General Overview

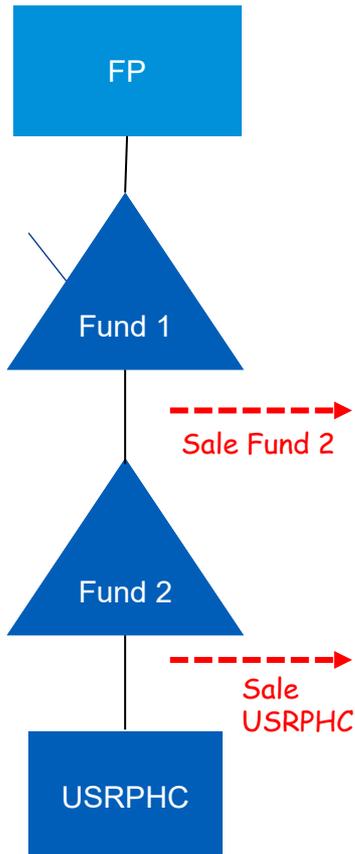
**FIRPTA overrides tax treaties; investor cannot rely on capital gains article to avoid FIRPTA tax.**

**Foreign corporations generally subject to BPT on FIRPTA gain from disposition of direct USRPIs (e.g., land or buildings); BPT does not apply to gain from disposition of USRPHC stock.**

**Various exceptions to FIRPTA, include**

- Domestically controlled REITS
- Qualified foreign pension funds
- Public REITs
- Section 892 investors
- Qualified shareholders of REITs
- Cleansing Exception
  - Stock in US corporation not a USRPI if the US corporation sells all USRPIs in fully taxable transactions

# Sale of USRPI by Partnership With Foreign Partner



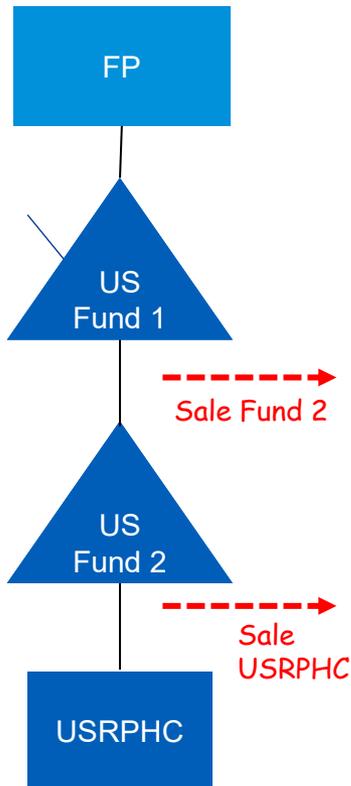
## Sale of USRPHC stock by Fund 2

- Section 897 does not specifically address the consequences of a sale/disposition of a USRPI by a partnership with foreign partners. Rather, the consequences to the partner are determined under the general partnership rules in subchapter K
- Under section 702 principles, a foreign partner's distributive share of gain from the sale of a USRPI by a partnership is subject to tax under section 897
- Note: the section 897 consequences to FP are the same regardless whether the partnership is US or foreign, but the withholding consequences may differ

## Sale of Fund 2 by Fund 1

- Section 897(g) generally treats gain on the disposition of a partnership interest as FIRPTA gain to the extent attributable to gain in the partnership's USRPIs
- Coordination with new section 864(c)(8)

# Sale of USRPI by US Partnership – Withholding



## Section 1445(a) Withholding

- Transferee of USRPI not required to withhold under section 1445(a) if receives certification that partnership not a foreign person

## Section 1445(e)(1) Withholding

- A US partnership generally must withhold 21% of gain from disposition of USRPI allocable to its foreign partners

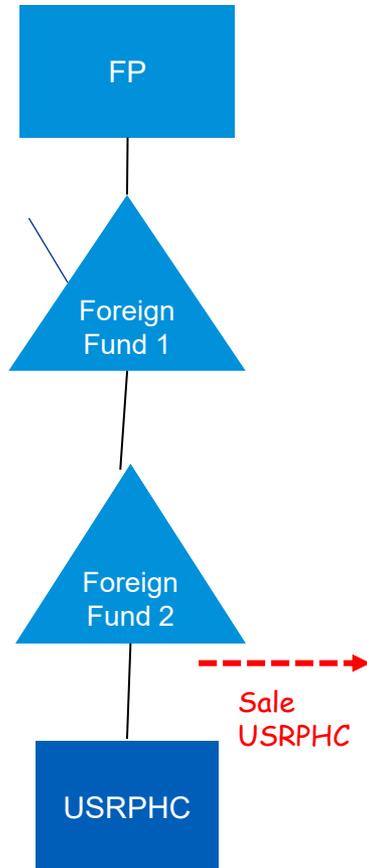
## Section 1446(a) Withholding

- A partnership (US or foreign) with foreign partners generally must withhold on ECTI allocable to foreign partners. FIRPTA gain generally included in ECTI

## Section 1446(a) / Section 1445(e) Overlap

- Because a foreign person's gain from the disposition of a USRPI is treated as ECI under section 897(a), the disposition of a USRPI by a partnership may trigger withholding under both section 1445(e)(1) and section 1446(a)
- Compliance with section 1446(a) generally satisfies US partnership withholding requirements under section 1445. Reg. §1.1446-3(c)(2)

# Sale of USRPI by Foreign Partnership – Withholding



## Section 1445(a) Withholding

- Transferee of USRPI must withhold under section 1445(a) unless exception applies (because Foreign Fund 2 is foreign person for purposes of section 1445)

## Section 1446(a) Withholding

- Same as with domestic partnership;
- Foreign Fund 2 generally must withhold on the amount of FIRPTA gain allocable to foreign partners

## Section 1446(a) / Section 1445(a) Overlap

- Foreign partnership may credit amount withheld under section 1445(a) during the taxable year against the amount of its section 1446(a) withholding tax liability to the extent the amount withheld under section 1445(a) is allocable to its foreign partners

# Withholding on Non-ECI FDAP Income Earned by Partnership

# Chapter 3 (NRA) Withholding

- Chapter 3 is a substantive tax regime that requires collection of 30% tax at source
- Payments of U.S. source FDAP income made to non-U.S. persons is subject to 30% withholding unless exception applies
- Notable Exceptions:
  - Portfolio Interest
  - Short Term Interest/OID
  - ECI
  - Bank Deposit Interest
  - Treaty Claims
- Withholding applies to all non-U.S. payees subject to a few exceptions (e.g., tax exempt entities, governments, central bank, etc.)

# FATCA Withholding

- FATCA is a punitive withholding regime
- FATCA withholding applies before chapter 3
  - Therefore, if FATCA withholding applies then no chapter 3 withholding is required
  - If FATCA withholding does not apply, then test for chapter 3 withholding
- A withholding agent that makes a “withholdable payment” is required to determine the FATCA status of the payee and withhold 30% tax if the payee has a noncompliant FATCA status (i.e., Nonparticipating FFIs and passive NFFEs that do not provided requisite owner information)
- Withholdable payment means any payment of U.S. source FDAP income unless an exception applies
- Notable Exceptions
  - Short term interest/OID
  - ECI
  - Non-financial payments (includes rent, royalties, and non-financial services)
  - Grandfathered Obligations

# FATCA Withholding (cont.)

- FATCA Withholding only applies to the following payees:
  - Nonparticipating FFIs (NPFFIs)
  - Passive Nonfinancial Foreign Entities (Passive NFFEs) that do not provide required owner certification
  - Entities presumed to be NPFFIs under FATCA presumption rules
  - Foreign financial institutions that pass up withholding
  - Recalcitrant account holders of participating FFIs

# Step 1: Determine whether payment is in scope

- All U.S. source FDAP income is potentially subject to NRA and/or FATCA withholding and reporting.
- Character and sourcing of the payment is the responsibility of the withholding agent
- FDAP is all income other than gain from sale of property, market discount and option premiums.
  - Includes compensation (including expense reimbursement if not under an accountable plan), royalties, rents, directors fees, interest on accounts payable, prizes/awards
  - Generally, payments for goods, products, or supplies are not FDAP.
    - Exception: Gains from sale/exchange of intangible assets such as copyrights and patents, to extent gains are from payments contingent on productivity, use, or disposition
  - Note that carried interest is currently not treated as FDAP but Biden Administration proposal may change that
- Sourcing rules generally determined under IRC Sections 861-865
  - For income not explicitly addressed in regulations or guidance, generally source by analogy to identified sourcing rules (BOA Case)
  - Important to obtain sufficient written support for sourcing determination when depending on facts provided by payee
  - **If cannot determine source, regulations presume U.S. source**

## Step 2: Determine payee's status

- **Documentation is key to determining withholding**
- Identifies whether payee is a U.S. or non-U.S. person
- Provides FATCA status of person
- Provides information necessary for reporting
- Determines withholding rate:
  - Classification of payee/beneficial owner (i.e., individual, corporation, partnership)
  - Whether withholding agent can apply reduced rate of withholding
- Documents should be on file before payment is made
  - Otherwise withholding agent must apply presumption rules (presumption rules tend to apply maximum withholding rates)
  - Affidavits permitted for Forms W-8 only, not W-9

# Types of documentation

## — Different forms based on type of payee

- Form W-9: U.S. payees
- Form W-8BEN (Individuals): Beneficial owner certification to claim non-U.S. status and treaty benefits for individuals
- Form W-8BEN-E: Beneficial owner certification to claim non-U.S. status and treaty benefits for entities
- Form W-8ECI: Effectively connected income (not applicable to partners earning ECI through partnership)
- Form 8233: Individual – Independent personal services & treaty claims for services income
- Form W-8EXP: Foreign governments, tax-exempts, etc.
- Form W-8IMY: Intermediaries and flow-through entities

## — All forms must be validated for tax purposes (this means more than just checking to make sure form is complete and signed).

# Form W-8BEN (Individuals)

Form W-8BEN used for –

- Foreign individual for income other than independent personal services or ECI
  - Foreign TIN generally required
- Individual may make treaty claim on Form W-8BEN
  - U.S. TIN or foreign TIN required for individuals claiming treaty benefits
  - Exception: No TIN required for dividends and interest from stock and debt obligations that are actively traded

# Form W-8BEN-E

Form W-8BEN-E used for –

- Foreign entities that are not flow-through entities (whether or not claiming treaty benefit) if income is not ECI
  - Foreign TIN generally required
- Flow through entities that are hybrids claiming treaty benefits
  - U.S. or foreign TIN required for foreign corporation claiming treaty benefits
  - Exception: No TIN required for dividends and interest from stock and debt obligations that are actively traded
- FATCA status must be provided if making in scope payment for FATCA (i.e., withholdable payment)
- Treaty Claims
  - Line 14b now requires the entity to certify as to how it meets the Limitation of Benefits Article in the treaty
  - Actual knowledge test applies to LOB provision only



# Form W-8IMY

Form W-8IMY used for –

- Foreign intermediary or flow-through entity (e.g., partnership), QSL/QDD
- Must provide underlying tax documentation for underlying owners and a withholding statement that allocates income to each owner (in addition to other required information)
- Unless entity is a withholding entity (e.g., QI assuming primary withholding or withholding partnership/trust)
- If Form W-8IMY is provided without owner-level documentation or withholding statement when required, withholding is generally required at 30 percent rate
- Exception: Amounts not subject to NRA withholding
- Withholding Statements
  - **General Rule:** Withholding statement must contain all fields designated in the form instructions (approx. 15 fields)
    - Regulations make it clear that as of 2017, these fields must be on withholding statement even if they are already on the form (e.g., addresses, TINs, statuses)
  - **Alternative Withholding Statement**
    - Permits simplified withholding statement
    - Only required to include data not contained on withholding certificates if the entity certifies that it has no information in its files that conflicts with the withholding certificates
    - However, if any conflicting data on file, complete withholding statement must be used

# Form 8233

- Form 8233 would apply to a partner if the partner was receiving income in exchange for performing services for the partnership **and** the partner was making a treaty claim
- ITIN required on form
  - The IRS has indicated they may consider allowing foreign TINs instead of U.S. TINs for treaty claims made on the Form 8233 in the future but right now a U.S. TIN is required.
- Must provide new Form 8233 each year (Identify tax year on form)
- Withholding agent must file Form 8233 with the IRS within 5 days of receipt and cannot grant treaty exemption for 10 days
- If the IRS does not object within 10 days, treaty benefits apply retroactively to the date of the first payment covered by the certificate

# Documentation for Hybrids

- Generally, flow-through entities may not use a Form W-8BEN-E.
  - Partnerships, grantor trusts, simple trusts should generally use a Form W-8IMY and pass up information regarding owners.
  - Disregarded entities should submit the appropriate form for their owners.
- However, hybrid entities may use Form W-8BEN-E to make treaty claims for Chapter 3 purposes.
  - In such case, entity must indicate in entity line that it is a hybrid making a treaty claim.
  - Line 5 (Chapter 4 status) is left blank.
  - A separate Form W-8IMY with withholding statements and underlying documentation would need to be provided to claim exemption under FATCA.

# Documentation for Reverse Hybrids

## — Reverse hybrids

- Reverse hybrid is an entity that is a corporation for U.S. tax purposes but that is a pass-through entity or a branch under the laws of the foreign country where the entity resides and is taxed.
- A reverse hybrid should only use Form W-8BEN-E for payments that it is not claiming treaty benefits on behalf of its owners.
- If the entity wants to claim treaty on behalf of its owners, it must provide a Form W-8IMY along with a withholding statement and W-8BEN/W-8BEN-E for its owners.
  - Entity would need to be viewed as a flow-through entity from perspective of treaty country in order for owners to claim treaty benefits

# Form 1042-S reporting

- U.S. source income paid to non-U.S. persons (“NRAs”) generally subject to Form 1042-S Reporting
- Form 1042-S Reporting applies to:
  - All payments that *have* been withheld upon (whether necessary or not)
  - All payments that *should have* been withheld upon (even if they weren’t)
  - Amounts subject to withholding under Chapter 3 (which includes most U.S. source FDAP payments) unless specifically excepted
- Year-end reporting to IRS and payee on Form 1042-S.
- Annual Form 1042 reports gross income paid and withholding tax liability

# Form 1042-S and 1042 filing requirements

## — Due Date for Forms 1042-S and 1042

- March 15 following the year of the payment

## — Extensions

- Automatic *30-day* extension available for Forms 1042-S (IRS Copies) by filing Form 8809 prior to due date
- Additional *30-day* extension may be available for Forms 1042-S (IRS Copies) by filing Form 8809 again prior to end of extension period
- Max. *30-day* extensions for Forms 1042-S (Recipient copies) by writing letter to IRS including a reason for delay and postmarked by the due date
- Automatic *6-month* extension available for Form 1042 (Form 7004 prior to due date)

## — Forms 1042-S extension due date confusion

- The 30-day extension due date is 4/14, NOT 4/15

## — Electronic filing requirement

- Financial institutions must now file electronically through the IRS FIRE System
- All other withholding agents must file electronically through the IRS FIRE System if they file 250 or more Forms 1042-S per year
- Lower threshold had applied for partnerships and may again when final regulations issued

# Reminders for Form 1042-S Completion

- Requirement to provide Chapter 3 and Chapter 4 status (when making a withholdable payment) for recipient, withholding agent, and intermediary (if applicable).
- Withholding Agent must provide chap 3 status instead of code 01 or 02 (US Withholding Agent Financial Institution or US Withholding Agent Other)
- Requirement to indicate whether form is being provided for Chapter 3 or Chapter 4 purposes and indicate exemption code.
- Account-by-account reporting requirement for USFIs
- USFIs must enter an account number for all financial accounts
  - Partnership interests in a partnership that is a financial institution is generally a financial account
  - If no account number on file, one should be assigned
- Nonwithholding foreign partnerships are not beneficial owners of income
  - Nonwithholding foreign partnerships (chapter 3 status code 08) should not be listed as a beneficial owner in Box 13. If you do not know who the beneficial owner is, the form should be issued to an “Unknown Recipient,” with the partnership listed as an intermediary in Box 15
  - Leave Box 13b (Recipient's country code) blank and enter “Unknown Recipient” in Box 13a (Recipient's name)

# Reporting for Partnership Distributions: Lag Method

Prior to 2019 partnerships were required to follow the lag method of reporting

- **Payments are reported for year in which payment (deemed or actual) occurs**
  - Lag method of reporting splits the reporting of partnership income included in a partner's distributive share for a year into two different reporting years based on the date the payments (actual or deemed) are made to the partner
  - Therefore, when the partnership distributes in a subsequent year for income earned by the partnership in the prior year, the deposit and payment must be treated as made for the subsequent year
  
- **Withholding & depositing under lag method:**
  - Withholding under the lag method occurs at the time of payment
  - Income earned by a partnership in Year 1 that is not distributed during Year 1 will be treated as paid to the non-U.S. partners on the earlier of the distribution date or the partnership's K-1 reporting date (typically Sept 15th deadline)
  - Timing of deposit occurs according to regular chapter 3 deposit schedule (generally at end of quarter monthly period following date of withholding)
  - Deposits of amount withheld are deposited to IRS account for year in which withholding took place
    - IRS deposit accounts should match 1042 reporting

# Reporting Partnership Distributions: Prop. Reg. Method

**Proposed Burden Reduction Regulations issued in December 2018 and 2019 Form 1042-S instructions provide a new method for partnership reporting (Prop Reg Method)**

**Prop Reg Method generally reverses the lag method for partnership reporting purposes**

- Under Prop Reg Method, all income included in a foreign partner's distributive share for the year will be reported on a Form 1042-S for that same year
  - Payments are reported for year income is earned by partnership, even if withholding occurs in subsequent year
  - Goal is to better match up Form 1042-S reporting to K-1s

**Change to Prop Reg Method does NOT impact withholding or timing of deposit**

- Withholding still occurs at the time of payment (actual or deemed)
- Timing of deposits continues to occur according to regular chapter 3 deposit schedule (generally at end of quarter monthly period following date of withholding)
- However, because IRS deposit accounts must match Form 1042, deposits must be attributed to the year income is earned by partnership
  - Therefore deposit withholding taxes to Year 1 account, regardless of when withholding occurred

# Reporting Partnership Distributions: Prop. Reg Method (cont.)

- **Prop Reg Method extends due date for Form 1042-S to Sept 15th of Year 2 for all payments made *after March 15<sup>th</sup>* of Year 2 when the Prop. Reg. Method is followed**
  - Extended deadline only applies when reporting payment as a Year 1 payment and attributing deposited tax to Year 1 account
  - Partnership must check box 7c on Form 1042-S to indicate that qualifies for the Sept 15th due date
  - Distributions made between 1/1 and 3/15 of Year 2 must be reported by 3/15 of Year 2 (Apr 14th extended DL)
    - Therefore, extended deadline would not apply if partnership is issuing K-1 by March 15th
    - Will be very difficult to manage distributions made between 1/1 & 3/15 as it allows minimal shut down time between payments and reporting deadline
    - Partnership will definitely want to utilize 30-day extension in this case
- **Adoption of Prop Reg Method is optional for all partnerships until regulations are finalized**
  - However, the new method is expected to become mandatory for calendar year partnerships once final regulations are issued
  - Fiscal year partnerships will be able to elect whether to transition to Prop Reg Method or remain on traditional lag method of reporting

# What stays the same? Distribution in year earned

## Scenario 1: Partnership earns income in 2019 and distributes that income to partners during 2019

	Traditional lag method	Prop. reg. method
Payment Date	Date of actual distribution (2019)	
Withholding	Withhold on date of actual distribution (2019)	
Deposits	Deposit applied to 2019 Year	
Reporting	Report income on Form 1042-S for 2019 Year Deadline: Mar 15, 2020 (Apr 14, 2020 with extension)	

# Differences – Distribution after year earned

## Scenario 2: Partnership earns income in 2019 and distributes that income to partners between Jan 1, 2020, and Mar 15, 2020

	Traditional lag method	Prop. reg. method
Payment Date	Date of actual distribution (2020)	
Withholding	Withhold on date of actual distribution (2020)	
Deposits	Deposit applied to 2020 Year	Deposit applied to 2019 Year
Reporting	<ul style="list-style-type: none"> <li>— Report income on Form 1042-S for 2020 Year</li> <li>— Deadline: Mar 15, 2021 (Apr 14, 2021 with extension)</li> </ul>	<ul style="list-style-type: none"> <li>— Report income on Form 1042-S for 2019 Year</li> <li>— Deadline: Mar 15, 2020 (Apr 14, 2020 with extension)</li> <li>— <i>NOTE: Deadline is an entire year earlier</i></li> <li>— Check Box 7c</li> </ul>

# Differences – Distribution after year earned (cont.)

**Scenario 3: Partnership earns income in 2019 and either distributes that income to partners between Mar 15, 2020, and Sept 15, 2020 (or doesn't distribute income and is deemed to distribute on extended K-1 deadline)**

	Traditional lag method	Prop. reg. method
Payment Date	Date of actual distribution (2020)	
Withholding	Withhold on date of actual distribution (2020)	
Deposits	Deposit applied to 2020 Year	Deposit applied to 2019 Year
Reporting	<ul style="list-style-type: none"> <li>— Report income on Form 1042-S for 2020 Year</li> <li>— Deadline: Mar 15, 2021 (Apr 14, 2021 with extension)</li> </ul>	<ul style="list-style-type: none"> <li>— Report income on Form 1042-S for 2019 Year</li> <li>— Deadline: Sept 15, 2020</li> <li>— Check Box 7c</li> </ul>



# Partnership Draft Schedules K-2 and K-3

# Draft Form 1065 Schedules K-2 & K-3

On July 14, 2020, the IRS released new international reporting forms for tax year 2021 (filing season 2022)

Intended to replace portions of the current Form 1065, Schedules K and K-1

- Schedule K, Line 16 → Schedule K-2
- Schedule K-1, Line 16 (*and related footnotes*) → Schedule K-3

## Expected benefits:

- Standardized format aligns the information provided by partnerships to the international tax forms used by partners
- Consistent information should allow partners to more easily prepare their tax returns
- Better and more consistent data should allow the IRS to more efficiently verify taxpayer compliance



# Impact

## The new schedules shall result in voluminous reporting

- Schedule K-2 is 20 pages
- Schedule K-3 is 22 pages
- Note, however, the instructions contain various other statements and schedules that may be required as additional attachments

## Other observations

- The IRS noted in its press release that all of the information reported on the new schedules is already necessary for the partnership to provide to its partners or is available to the partnership
- No estimate of the time required to complete these forms was included with the draft forms or instructions
- Similar forms are expected for Form 1120-S and Form 8865
- Requirement to include information with Form 1065 seemingly makes information subject to the new partnership audit regime.



# Schedule K-2 is Organized Into Nine Parts

**Part 1: Partnership's Share of Current Year International Transaction Information**

**Part 2: Foreign Tax Credit Limitation**

**Part 3: Other Information for Preparation of Forms 1116 or 1118**

**Part 4: Other Foreign Transaction Information for US Partners**

**Part 5: Information on Partners' Section 951(a)(1) and Section 951A Inclusions**

**Part 6: Information to Complete Form 8621**

**Part 7: Partnership's Interest in Foreign Corporation Income (Section 960)**

**Part 8: Partners' Information for Base Erosion and Anti-Abuse Tax (Section 59A)**

- Foreign related parties of each partner must be identified, subject to the exception for certain small partners.

**Part 9: Foreign Partners' Character and Source of Income and Deductions**

- Section 1 – Gross Income
- Section 2 – Deductions, Losses, and Net Income
- Section 3 – Allocation and Apportionment Methods for Deductions

# Schedule K-3 Layout

**Schedule K-3 is completed for each partner in the partnership**

**Reports each partner's share of the items reported on Schedule K-2**

**Adds one additional reporting section:**

- Part 10: Foreign Partner's Distributive Share of Deemed Sale Items on Transfer of Partnership Interest
  - Section 864(c)(8) information to provide effectively connected gain or loss information for a direct or indirect foreign partner

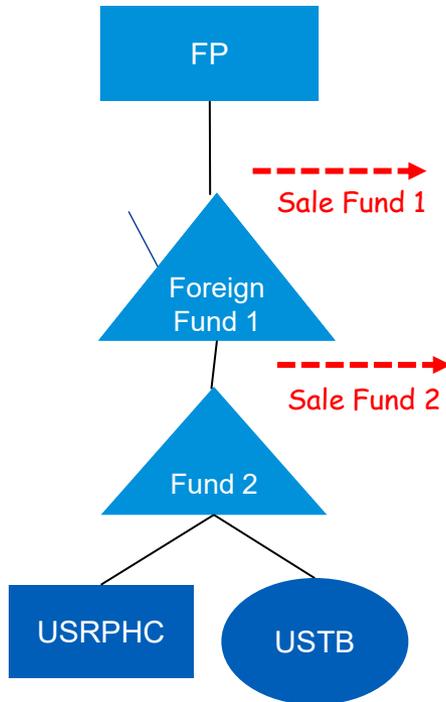


Sales of Partnership  
Interests – FIRPTA,  
Section 864(c)(8), and  
Section 1446(f)

# Sale of Partnership Interest by Foreign Partner – FIRPTA

## Substantive FIRPTA Tax

- Under section 897(g), gain on sale of Fund 1 or Fund 2 interests treated as FIRPTA gain to the extent attributable to gain in the partnership's USRPIs
- Coordination with new section 864(c)(8)



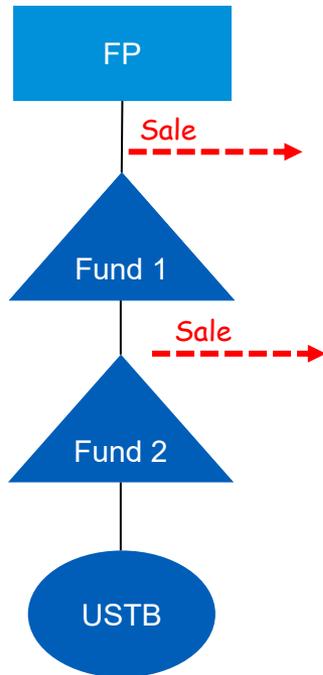
## Section 1445(a) Withholding

- An interest in a partnership is treated as a USRPI for section 1445 w/h purposes if 50% or more of the value of the partnership's gross assets consist of USRPIs and 90% or more of the value of its gross assets consist of USRPIs and cash/cash equivalents (a "50/90 partnership")
- Buyer must withhold 15% of amount realized by seller on acquisition of interest in 50/90 partnership, unless reduced by w/h certificate
- No section 1445 withholding required on acquisition of interest in non-50/90 partnership, even if seller has FIRPTA tax

## Section 1446 Withholding

- Section 1446(a) withholding same as prior slide.
- Coordination with new section 1446(f) withholding.

# Transfers of USTB Partnership Interests – Section 864(c)(8)



**Gain from the sale or exchange by a foreign person of an interest in a partnership that is engaged in a USTB is characterized as ECI to the extent the foreign partner would be allocated ECI if the partnership sold all of its assets for FMV on the date of the sale or exchange.**

- Under regulations, if partnership that is engaged in USTB holds USRPIs, section 864(c)(8) trumps section 897(g).
  - Regulations inconsistent with statutory language
- Provision codifies historic IRS position in Rev. Rul. 91-32 and reverses 2017 *Grecian Magnesite* Tax Court decision

## **Section 864(c)(8):**

- Applies to sales, exchanges, contributions, redemption distributions
- Applies to tiered structures
- Takes into account section 751(a) gain

**Section 864(c)(8) Is effective for sales and exchanges occurring after November 27, 2017**

# Calculation of EC Gain or Loss

## Proposed and final section 864(c)(8) regulations both retain a “gain limitation” approach, but with modification to incorporate section 751(a)

- Recognition of deemed EC gain or loss limited to “outside” capital gain or loss
- Recognition of deemed EC ordinary gain or loss limited to “outside” ordinary gain or loss

## Regular partnership tax rules apply in determining partner’s outside gain or loss

- Partner computes its adjusted basis in its partnership interest pursuant to section 705, including its share of partnership liabilities allocable to its interest under section 752
- The partner’s gain on sale is capital under section 741, except to the extent section 751(a) applies
- Section 751(a) results in the partner recognizing ordinary income to the extent of its share of ordinary income from “unrealized receivables” and “inventory” that would be allocated to the interest sold on a hypothetical sale of all assets on the date of the transfer of the interest

TIP



*It is possible for a partner to have an overall gain or loss on the sale of its interest, but following application of section 751(a) to recognize an ordinary gain and a capital loss.*

# FIRPTA Coordination and Nonrecognition Transfers

## FIRPTA Coordination rule

- Statute provides that gain that is ECI under section 864(c)(8)(A) is reduced by the amount of gain that is treated as ECI under section 897(g).
- Final regulations follow proposed regulations in providing that when a partnership is engaged in a USTB and holds USRPIs, the amount of the transferor's EC gain or loss is determined under section 864(c)(8) and not section 897(g).
- Section 897(g) continues to apply to transfers of interests in partnerships that holds USRPIs but are not engaged in a USTB (e.g., investment holding of land or stock in a USRPHC).

## Nonrecognition transfers

- Nonrecognition transfers are not subject to section 864(c)(8); no special section 864(c)(8) rules
- Section 897(g) (FIRPTA) continues to apply to the transfer if the partnership holds one or more USRPIs.

# Transferor Notice Requirements

**A “notifying transferor” that transfers an interest in a specified partnership must generally notify the partnership of the transfer:**

- In writing, within 30 days of the transfer
- Notice must include: Names and addresses of the transferor and transferee(s); TIN of the transferor and transferee(s) (if known); and the date of the transfer.
- Exception – statement not required for transfers of PTP Interests, or for if the transfer is due to receiving a distribution from a partnership

**A partnership receiving notice of a transfer must report to the notifying transferor the transferor’s ECI from the deemed sale of assets under Reg. §1.864(c)(8)-1(c)(3)(ii).**

- Determined as of the actual transfer date
- On or before the due date for issuing Schedule K-1s for the taxable year that includes the transfer.
- The proposed regulations clarify that the partnership is required to provide a transferor partner with the necessary information to determine the transferor partner’s section 751(a) ordinary income, and its impact on the partner’s capital gain or loss.

# Section 1446(f) overview

- Section 1446(f) states that if any portion of the gain (if any) on any disposition of an interest in a partnership would be treated under section 864(c)(8) as effectively connected with the conduct of a trade or business within the United States, the Transferee shall be required to deduct and withhold a tax equal to 10 percent of the amount realized on the disposition.
- **Transferee** means any person, U.S. or foreign, that acquires a partnership interest through a transfer.
  - Transferee includes a partnership that makes a distribution
- **Transferor** means any person, U.S. or foreign, that transfers a partnership interest.
  - In the case of a grantor trust, the term transferor means the grantor or other owner of the trust.

# Components of Section 1446(f)

- **Applies to any sale or exchange of a partnership interest (including redemptions)**
  - U.S. or foreign partnership
  - Direct or indirect transfer
  - Any partner unless partner is a *documented* U.S. person
  - Unless an exception can be established
- **2 Different sets of rules apply depending on whether the partnership is publicly traded or not**
  - 10% withholding applies consistently but different party has primary withholding obligation in each case
  - If party with primary withholding obligation does not withhold as required, the partnership will have secondary withholding liability
  - Exceptions vary under each set of rules but generally pertain to establishing either that the payee is not subject to withholding or that the transfer does not result in a sufficient amount of gain or ECI to trigger the withholding obligation
- **For any sale or exchange of a partnership interest, proper documentation is critical if withholding is not being applied**



# Section 1446(f) for Non-Publicly Traded Partnerships

# Non-Publicly Traded Partnerships (non-PTPs) – General Rule

- A transferee is required to withhold 10% of the amount realized on any transfer of a partnership interest unless an exception applies
  - A transfer includes a sale or exchange or other disposition
  - A transfer also includes any distribution from a partnership to a partner
    - In this case, the partnership is the transferee
- The regulations generally are effective for transfers on or after Jan.29, 2021
  - For rules applicable before that date transferees can rely on the proposed regulations or Notice 2018-29

# Exceptions – Certification of Transferor’s Status (Withholding Certificates)

## — Certification of Non-foreign Status by Transferor

- The certification must:
  - State that the transferor is not a foreign person (i.e., is a U.S. person);
  - Provide the transferor’s name;
  - Provide the transferor’s U.S. taxpayer identification number (U.S. TIN);
  - Provide the transferor’s address; and
  - Be signed under penalties of perjury.

• **A valid Form W-9 may be relied on as a certification of non-foreign status.**

## • **Valid Form W-8BEN/BEN-E With Treaty Claim**

- No withholding is required if the transferor certifies that the transferor is not subject to tax on any gain from the transfer pursuant to an income tax treaty.
- If only a portion of the gain from the transfer is not subject to tax, the transferee may rely on a certification of maximum tax liability to avoid overwithholding.
- The transferee may rely on the certification only if it mails a copy to the IRS within 30-days after the transfer.

# Exceptions – Certification by Transferor

## • Certification of No Realized Gain by Transferor

- The certification must state that the transfer of the partnership interest would not result in any realized gain (including ordinary income arising from application of section 751) to the transferor as of the determination date.
- A partnership that is a transferee because it makes a distribution may rely on its books and records, or on a certification from the transferor, to determine that the distribution would not result in any realized gain to the transferor as of the determination date.

## • Certification of Non-recognition by Transferor

- The transferor certifies that the transfer of the partnership interest is subject, in whole or in part, to a non-recognition provision.
- If only a portion of the gain from the transfer is subject to a non-recognition, the transferee may rely on a certification of maximum tax liability to avoid overwithholding (see, below).
- The certification must briefly describe the transfer and provide the relevant law and facts.

# Exceptions – Certification by Transferor (cont.)

- **Less than 10% Effectively Connected Income**
  - **Transferor certifies that:**
    - (1)It was a partner during each year in a 3-year testing period;
    - (2)Its distributive share of gross effectively connected income was less than \$1 million for each year;
    - (3)Its distributive share of gross effectively connected income was less than 10% of its total distributive share of gross income; and
    - (4)Its distributive share was timely reported on a tax return and any tax due was timely paid.
  - **The Schedule K-1 is used to determine the \$1 million and 10% thresholds.**
  - **Other criteria apply**
  - **A partnership that makes a distribution may rely on its books and records to make the determinations, but it must also receive certifications from the transferor regarding the timely filing of returns and payment of tax.**

# Exception – Certification from Partnership

- **Certification by Partnership that Less than 10% Effectively Connected Gain**
  - **Certification must states that:**
    - 1) If the partnership sold all of its assets at fair market value as of the determination date any of the following would apply:
      - The partnership would have no gain that would have been effectively connected with a U.S. trade or business;
      - The amount of the partnership’s net gain that would have been effectively connected with a U.S. trade or business would be less than 10% of the total gain;
      - The transferor would not have a distributive share of net gain from the partnership that would have been effectively connected with U.S. trade or business;
      - If the transferor would have a distributive share of such gain from the partnership, the transferor's distributive share that would be less than 10 percent of the transferor's distributive share of the total net gain from the partnership; or
    - 2) The partnership was not engaged in a trade or business within the United States at any time during the taxable year of the partnership through the date of transfer.

# Amount Realized

- **For a transfer other than a distribution, the amount realized is the sum of:**
  - The amount of cash paid to the transferor;
  - The fair market value of property transferred to the transferor;
  - The amount of any liabilities assumed by the transferee or to which the partnership interest is subject; and
  - The reduction in the transferor's share of partnership liabilities.
  
- **For a transfer that arises from a distribution, the amount realized is the sum of:**
  - The amount of cash distributed to the transferor;
  - The fair market value of property distributed to the transferor; and
  - The reduction in the transferor's share of partnership liabilities.
  
- **Modified Amount Realized**
  - If the transferor is a foreign partnership, the transferee may apply 10% withholding to the modified amount realized under the procedures similar to those specified in the PTP section

# Maximum Tax Liability

- **For a transfer (other than a transfer arising from a distribution), a transferee may rely on a certification of transferor's maximum tax liability to determine the amount to withhold.**
- **For a transfer that arises as a result of a distribution, a partnership may rely on its books and records if they contain all of the information below.**
- **A foreign partnership or a foreign trust that is a transferor is treated as a non-resident alien individual for the purpose of making the maximum tax liability computation.**
  - The maximum tax liability computation does not apply to foreign partners with interests in a foreign partnership.
- **Maximum tax liability means the amount of the transferors effectively connected gain multiplied by the applicable percentage.**
  - The applicable percentage for foreign corporations is the highest rate of tax under section 11(b)(1) (currently 21%) and for non-corporations the highest rate under section 1 (currently 37%).

# Reporting and Paying Tax

- **Transferee must report and pay tax withheld by 20th day after the date of distribution**
  - Tax Return Form 8288
  - Information Return Form 8288-A
  - Requires TINs of both transferor and transferee
- **IRS will stamp and return copy of Form 8288-A to transferor so that transferor can obtain credit or refund as required**

# Partnership Residual Withholding Obligation

- **A partnership has an obligation to withhold on distributions to a transferee when the required transferee certification establishes only partial satisfaction of the required amount, is not provided, or cannot be relied upon.**
  - Partnership must begin withholding on distributions occurring beginning on the later of 30 days after the transfer or 15 days after the date in which the partnership acquires knowledge that the transfer has occurred.
  - An interest charge is also imposed on the amount of withholding the partnership is required to impose on the transferee.
- **A partnership also has an obligation to withhold on distributions to a transferee when it receives a notice from the IRS indicating that transferee has provided incorrect information regarding the amount realized or withheld or has failed to pay the tax.**
- **The partnership will have a residual obligation to withhold on distributions to the transferee when it has reason to know that the exception claimed by the transferor is not correct, even if the transferee had no knowledge that the exception claimed by the transferor was not correct.**

Note: The partnership's residual withholding obligation discussed above does not go into effect until Jan. 1, 2022.

# Section 1446(f) for Publicly Traded Partnerships

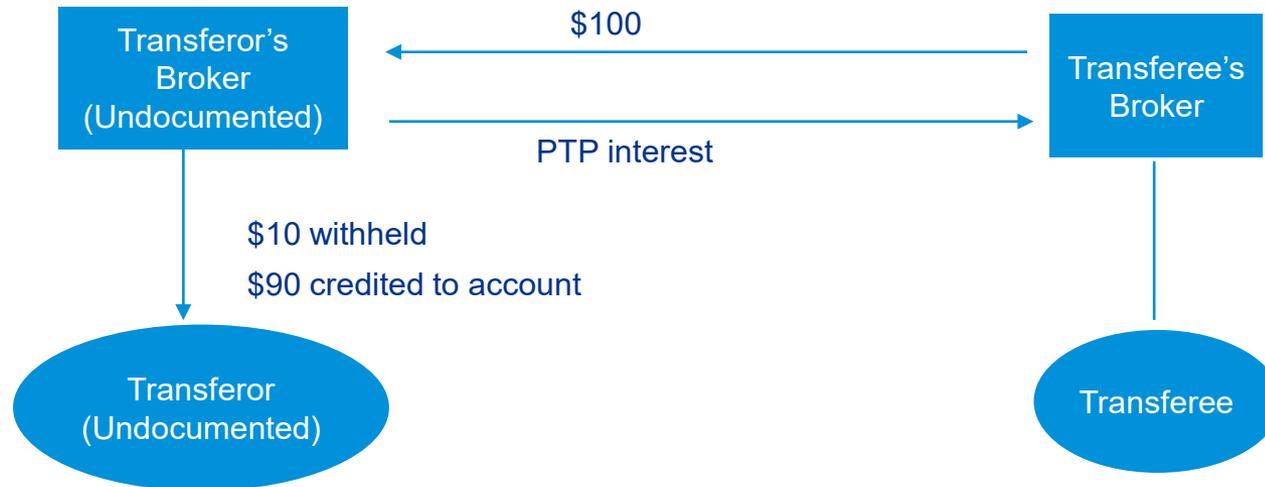
# Publicly Traded Partnerships (PTPs) – General

- **A broker must withhold 10% of the amount realized on the transfer of a PTP interest unless an exception applies**
  - A “broker” is a U.S. or non-U.S. person that, in the ordinary course of a trade or business, stands ready to effect sales made by others, and that receives all or a portion of the amount realized from the transfer of a PTP interest on behalf of the transferor (e.g., seller or recipient of a distribution).
    - A broker includes a clearing organization, but the clearing organization is not required to withhold.
    - The definition excludes brokers acting exclusively on behalf of the transferee.
  - A “PTP interest” is an interest in a partnership that is publicly traded on an established securities market (e.g., an exchange) or is readily tradable on a secondary market.
  - A transfer includes a sale or exchange, a distribution, or other disposition.
  - Generally, the amount realized is the amount of cash received (but see exceptions for modified amount realized and a distribution of cumulative net income).
- **Effective for transfers on or after Jan. 1, 2022**

# Withholding Events

- **A broker must withhold 10% of the amount realized on the transfer of a PTP interest unless an exception applies**
  - A broker that pays an amount realized to a transferor that is its customer is required to withhold unless an exception applies.
  - A broker that pays an amount realized to another broker is required to withhold unless an exception applies.
    - No withholding is required when the payee broker is documented as a U.S. person.
  - Absent documentation, any person paid by a broker is presumed to be a non-U.S. person and subject to withholding.

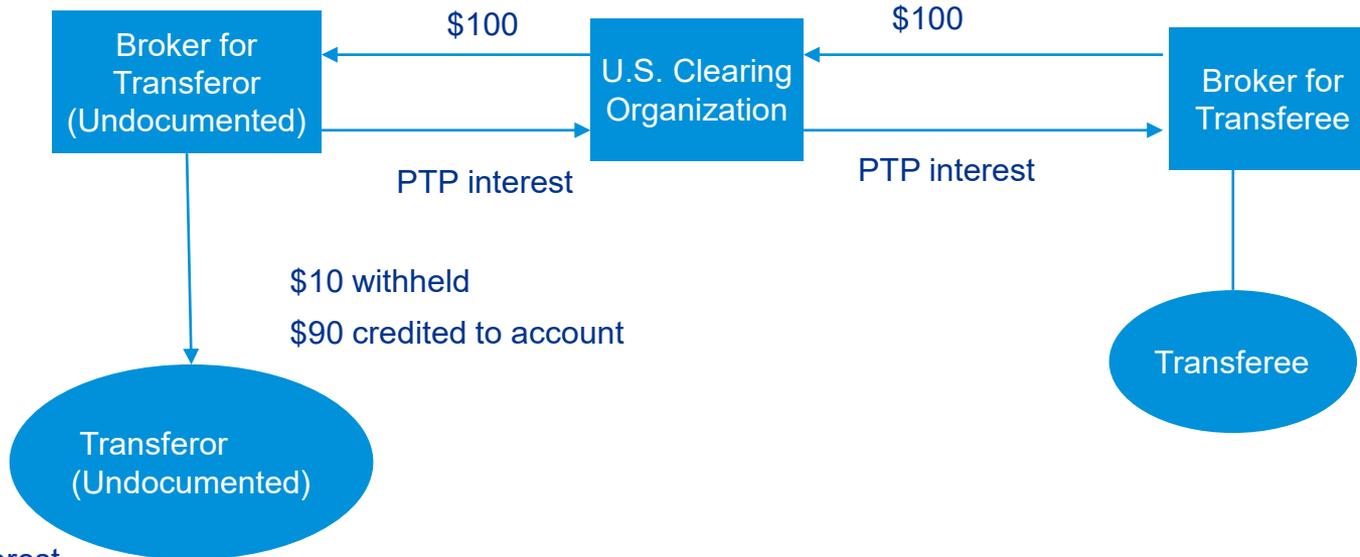
# Example 1 – Transaction Without Clearing Organization



PTP interest  
FMV = \$100  
Basis = \$100

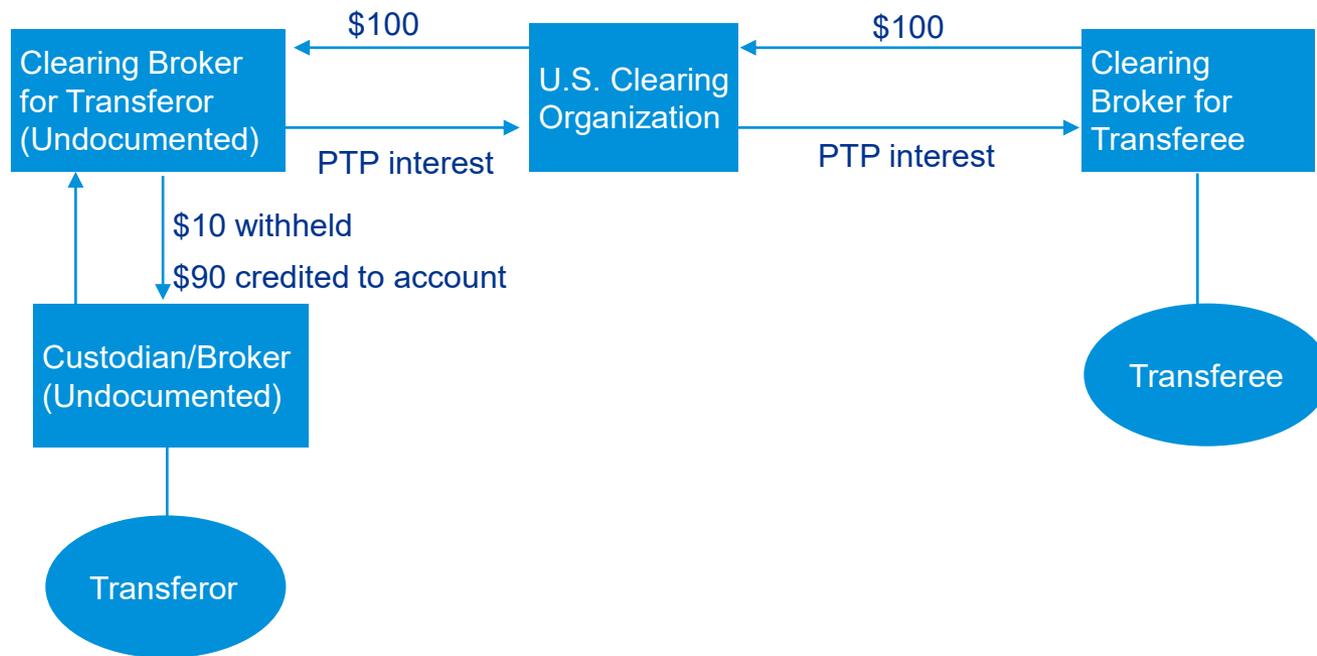
Transferor's broker must withhold \$10 (10% x \$100 of amount realized). The amount of gain is not relevant. The broker must presume transferor is a non-U.S. person unless it has documentation establishing otherwise.

# Example 2 – U.S. Clearing Organization



PTP interest  
FMV = \$100  
Basis = \$100

# Example 3 – Withholding on Another Broker – No DVP/RVP Rule



# Withholding Exceptions

## A broker is not required to withhold if:

- **Form W-9 or other documentation of non-foreign status:**
  - The broker pays a transferor that is its customer and the customer has provided a Form W-9;
  - The broker pays a transferor and receives a certification of the transferor's non-foreign status from another broker acting as an agent for the transferor (other broker must not receive payment, must have collected transferor's Form W-9, and must pass up transferor's TIN); or
  - The broker pays the amount realized to another broker that has provided a Form W-9.
- **Form W-8 establishes no withholding required:**
  - The broker pays another broker that has provided a Form W-8IMY stating that it is a qualified intermediary (QI) that assumes primary withholding responsibility for the payment;
  - The broker pays a U.S. branch of a foreign bank or insurance company that has provided a valid Form W-8IMY (without regard to the requirement that the amount is not effectively connected income) that states the U.S. branch agrees to act as a U.S. person with respect to the payment;
  - Transferor provides a Form W-8BEN or Form W-8BEN-E claiming a treaty exception from withholding; or
  - Transferor provides a Form W-8ECI certifying that it is a dealer in securities and that gain from the transfer of PTP interest is ECI

**Note:** No exception for payee broker that is a non-qualified intermediary

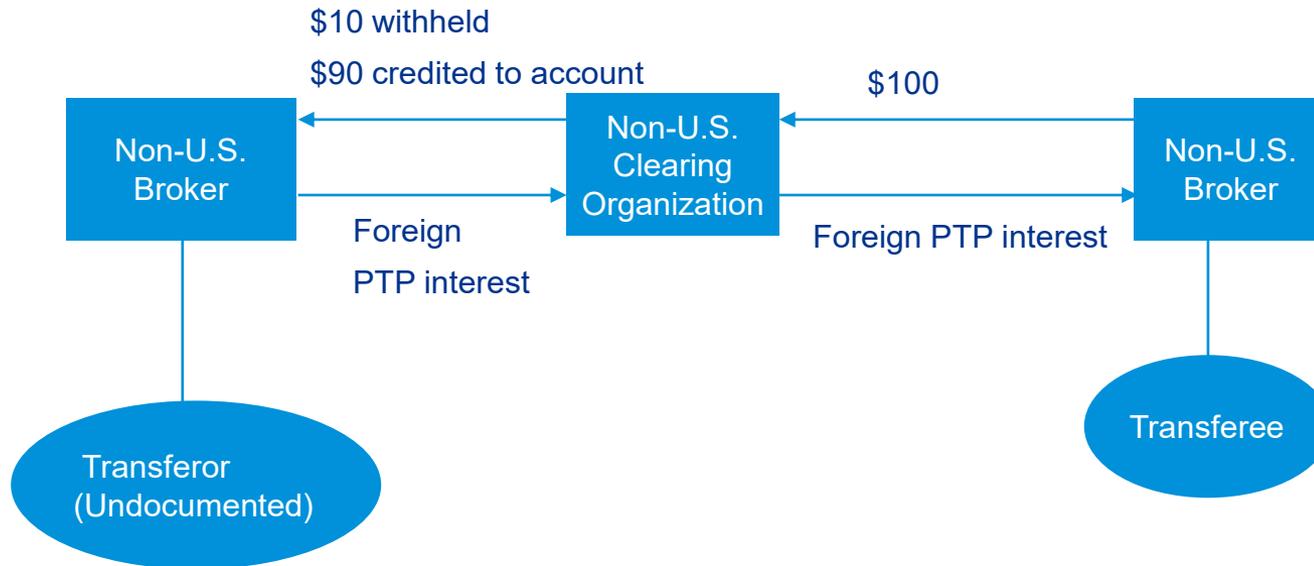
# Withholding Exceptions (cont.)

- **Withholding tax already applied or backup withholding applies.**
  - A broker receives a payment from another broker and the first-mentioned broker withheld the full amount required.
  - A broker is not required to withhold under section 1446(f) if the transferor is subject to backup withholding, i.e., has already been determined to be a U.S. non-exempt recipient for Form 1099 reporting purposes.

# Withholding Exceptions – Qualified Notice

- **A broker may rely on a qualified notice from a PTP that states one of the following:**
  - If the PTP sold all of its assets at fair market value on the PTP designated date:
    - The amount of the net gain that would have been effectively connected with the conduct of a U.S. trade or business would be less than 10% of the total net gain; or
    - No gain would have been effectively connected with a U.S. trade or business.
  - The partnership was not engaged in a U.S. trade or business at any time during the taxable year of the partnership through the PTP designated date.
- **The PTP designated date for a transfer is any date that is designated by the PTP in a qualified notice, provided that the PTP designated date occurs on or after the date that is 92 days before the date on which the PTP posted the qualified notice.**
- **A qualified notice is the recent notice given by a PTP regarding a distribution that is attributable to effectively connected income, gain, or loss of the partnership, but only if the PTP has posted it within the 92-day period ending on the date of the transfer.**
  - In the case of a transfer resulting from a distribution, a notice is a qualified notice only if it is posted with respect to the distribution.

# No Offshore Exception Provided



PTP interest  
FMV = \$100  
Basis = \$100

— No Qualified Notice published within past 92 days indicating that a section 1446(f) exemption applies

# Determining the Amount to Withhold

- **Broker must withhold 10% of the amount realized.**
  - For a transfer other than a distribution, the amount realized is the amount of gross proceeds paid or credited to the customer or other broker.
  - For a distribution, the amount realized is the amount of the distribution reduced by the portion of the distribution attributable to the PTP's cumulative net income.
    - Cumulative net income is the net income earned by the PTP since its formation that has not been previously distributed.
    - The excess of a distribution over cumulative net income is identified on a qualified notice posted with respect to the distribution.
- **Broker may rely upon qualified notice for purposes of determining the amount to withhold on a PTP distribution (presuming qualified notice designates the excess amount over cumulative net income)**
  - If PTP issues an incorrect qualified notice, PTP has obligation to make up the underwithholding instead of the broker.

# Determining the Amount To Withhold – Modified Amount Realized

- **If a transferor is a foreign (i.e., non-U.S.) partnership, a broker may apply 10% withholding to the modified amount realized.**
  - The modified amount realized is the amount realized multiplied by the aggregate percentage determined on the determination date
    - Determination date is one of: (i) the date of the transfer; (ii) any day not more than 60 days before the transfer; or (iii) for a partner other than a controlling partner, the date that is the later of the first day of the partnership's taxable year or the date before the transfer of the most recent reevaluation event under certain sections of the §704(b) regulations).
  - The aggregate percentage is the percentage of gain (if any) arising from the transfer that is allocated to presumed foreign (i.e., non-U.S.) persons.
  - A presumed foreign person is any direct or indirect partner that has not provided a Form W-9 or a Form W-8BEN/ BEN-E that states that the partner is not subject to any tax on any gain under an income tax treaty.
- The non-U.S. partnership must provide:
  - Form W-8IMY that includes a withholding statement that allocates the percentage of gain to each direct or indirect partner and that provides whether each partner is a U.S. person, a foreign partner eligible for treaty benefits, or a presumed foreign taxable person; and
  - The Forms W-9 of U.S. partners & Forms W-8BEN/BEN-E of foreign partners entitled to treaty benefits.

# Determining the Time to Withhold and Deposit

- **Timing of Withholding**

- Withholding on a transfer other than a distribution is required on the settlement date.
- Withholding on a distribution is required on the distribution date.

- **Deposits**

- Deposits are done in accordance with the normal deposit rules that apply to NRA withholding.
- Where undeposited tax is \$2,000 or more, depositing will be done at end of any quarter-monthly period (i.e., the 7th, 15th, 22nd, and the last day of the month).

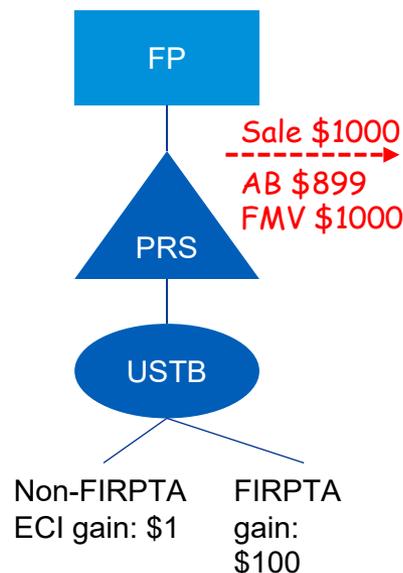
# Reporting

- **Must report on Form 1042-S a distribution made by PTP that is:**
  - An amount subject to withholding, or
  - Paid to a QI or U.S. branch that agrees to be treated as a U.S. person.
- **Must report amount realized on transfer of a PTP interest on Form 1042-S:**
  - ***Unless*** withholding did not apply due to:
    - Transferor being documented as a U.S. person;
    - Transferor being subject to backup withholding; or
    - Reliance on a qualified notice.
  - **Exception**: A U.S. clearing organization is only required to report amount realized on the sale of a PTP interest cleared and settled through a net settlement system maintained by the clearing organization acting as a central counterparty in the sale (with reporting on the non-netted amount).

# PTP's Liability

- **Final regulations removed the residual withholding obligation on a PTP that publishes a false qualified notice.**
- **Instead, the final regulations, impose direct liability on the PTP for an underwithholding that results from false qualified notices issued by the PTP.**
- **PTP is only liable for underwithholding in the following circumstances:**
  - PTP issues a qualified notice incorrectly stating that a withholding exception applies and the PTP had failed to make a reasonable estimate of the amounts required for determining the exception contained in the qualified notice; or
  - PTP issues a qualified notice incorrectly stating the portion of the distribution attributable to the amount in excess of the cumulative net income of the partnership
    - There does not appear to be limitation on the PTP's liability if the PTP makes a reasonable estimate

# Sale of 50/90 Partnership Engaged in USTB



## FIRPTA Withholding

- PRS is a 50/90 partnership. Buyer therefore must withhold \$150 (15% of amount realized), unless reduced by a w/h certificate
- Seller could apply for a w/h certificate to reduce FIRPTA withholding to \$21 (21% tax on \$100 of FIRPTA gain)

## §1446(f) Withholding

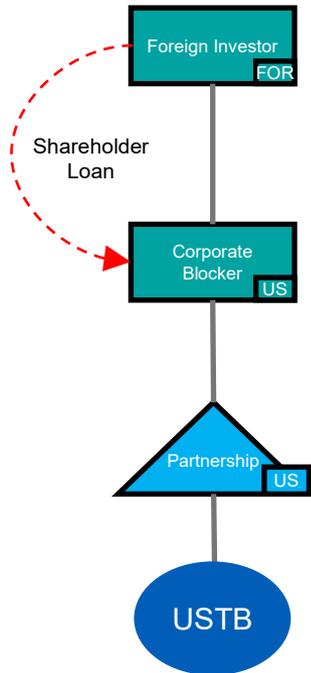
- Buyer must withhold \$100 (10% of amount realized), unless an exception applies

## §1445/1446(f) Coordination

- If buyer withholds \$150 under §1445, buyer not required to withhold under §1446(f)
- If seller applies for FIRPTA withholding certificate, buyer must withhold greater of \$21 FIRPTA w/h or \$100 §1446(f) w/h, unless exception applies to reduce or eliminate §1446(f) withholding
- Seller may provide max tax liability certificate to limit §1446(f) withholding

# Use of Blockers

# Leveraged US Blocker



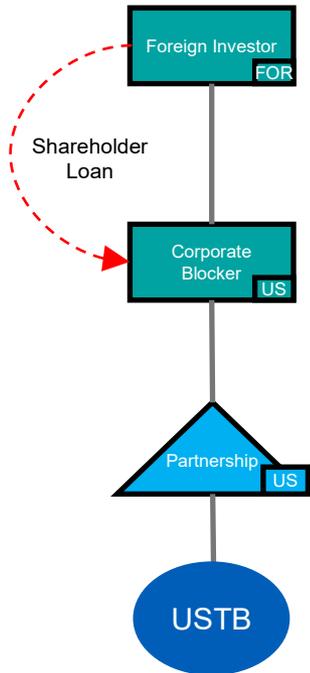
## Advantages

- US Blocker prevents investor from being engaged in a USTB
- Generally, no annual US return filing requirement for foreign investor; Corporate Blocker files the US tax return
- US Blocker not subject to BPT
- Generally, ability to use leverage to reduce US Blocker's US taxable income
- Goal for interest payments on shareholder loans to qualify for treaty reduction or exemption, or portfolio interest exemption ("PIE")
- Section 892 investors exempt from tax on income from US blocker/gain from sale of blocker stock as long as US blocker is not a controlled entity

## Disadvantages

- Potentially two levels of US tax
  - US Blocker subject to 21% USFIT (plus state tax) on net income/gain
  - Foreign investor subject to 30% withholding tax on dividends and interest from US Blocker, unless reduced or eliminated by treaty or section 892
- US blocker may be subject to the BEAT if >50% foreign owner

# Leveraged US Blocker



## Debt considerations

- Blocker debt capacity and transfer pricing for interest rate
- Thin-capitalization” or earnings stripping rules (e.g., section 163(j)) may apply to limit US Blocker’s interest expense deduction
- Interest expense deduction generally limited to 30% of EBITDA (EBIT for taxable years beginning after 2021), subject to potential election out.
- Applicability of section 385 regulations
- Special disallowance rules for “hybrid” debt instruments
- AHYDO
- Interest/OID may not be deductible until actually paid

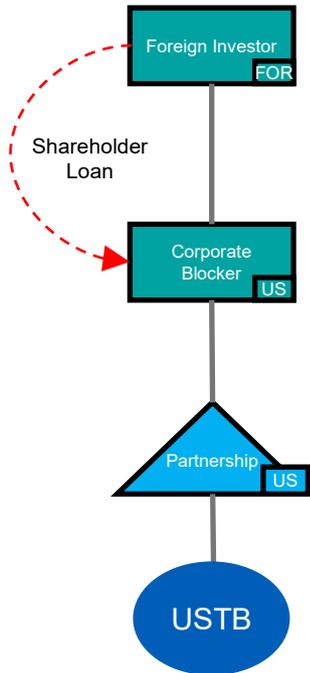
# US Blockers – Exit Strategy

## Sale of Blocker Stock

- Gain generally not subject to US tax, unless FIRPTA applies, but difficult to find buyers
- If US Blocker stock is USRPI (because US Blocker is a current or former USRPHC), foreign investor subject to FIRPTA tax on gain and buyer generally required to withhold 15% of foreign seller's amount realized under section 1445(a)

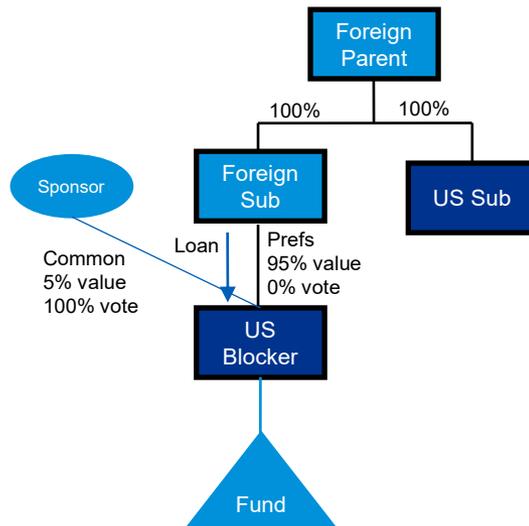
## Liquidation of Blocker

- Blocker sells all assets (or partnership sells all assets), pays tax on any gain, and distributes cash in liquidation.
- If US Blocker stock is not a USRPI, foreign investor will not be subject to tax or withholding on receipt of liquidating distribution
  - Should adopt plan of liquidation prior to making distribution
- If US Blocker stock is a USRPI, foreign investor will not be subject to FIRPTA tax or withholding if US Blocker satisfies “cleansing exception”
  - If blocker disposes of all USRPIs, taxable asset sale “cleanses” the FIRPTA taint and blocker stock ceases to be a USRPI



# Portfolio Interest & Section 958(b)(4) Repeal

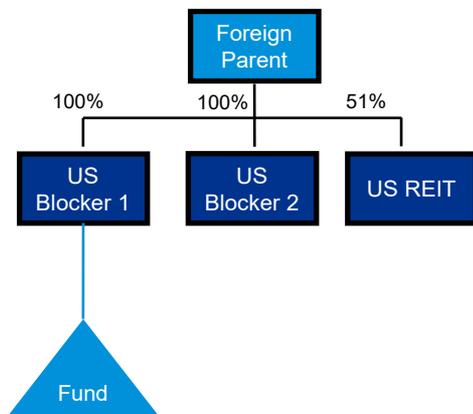
- Under the “portfolio interest exemption,” Foreign Sub may be exempt from USFIT on interest received from US Blocker if Foreign Sub holds less than 10% of the voting power of US Blocker and certain additional requirements are satisfied
- However, PIE not available for income received by a controlled foreign corporation (“CFC”) from a related person
- Due to repeal of section 958(b)(4), US Sub is treated as owning all of the stock of Foreign Sub, causing Foreign Sub to be a CFC
- US Blocker is related to Foreign Sub because Foreign Sub owns 95% of the value of US Blocker
- Interest from US Blocker to Foreign Sub therefore not eligible for PIE
- Note: recent regulations under section 958(b)(4) do not provide relief for this fact pattern



# BEAT and US Blockers

## US Blocker 1

- For purposes of determining whether US Blocker 1 meets the \$500m average annual gross receipts test to be a BEAT taxpayer, must aggregate:
  - Total gross receipts of all US corporations in which Foreign Parent directly/indirect holds >50% vote or value;
  - ECI of Foreign Parent;
  - ECI of any foreign corporation in which Foreign Parent directly/indirectly holds >50% vote or value



## Compliance

- US Blocker 1 required to file Form 8991 and complete Line 1 (gross receipts information) if the aggregate group had \$500m US gross receipts during any of the prior 3 years
- US Blocker 1 required to complete Line 2 of the Form 8991 if the aggregate group had \$500m average annual gross receipts for the prior 3 taxable years

# Q&A

— If you submitted a question, someone from KPMG may contact you via phone or email. Or, you may contact one of today's presenters directly:

<b>Danielle Nishida</b>	<b><a href="mailto:daniellenishida@kpmg.com">daniellenishida@kpmg.com</a></b>
<b>Josh Kaplan</b>	<b><a href="mailto:jskaplan@kpmg.com">jskaplan@kpmg.com</a></b>



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