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INVESTMENT FUNDS | M&A | EXECUTIVE COMPENSATION

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US Tax Withholding Considerations for LP Secondary Transactions

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Introduction

When a non-US person sells an interest in an entity that is treated as a partnership for US tax purposes, such as a private investment fund, the buyer may be required to withhold and remit to the US Internal Revenue Service a portion of the purchase price, unless the buyer receives from either the seller or the partnership a certification that no withholding is required by reason of an exemption. A buyer that fails to withhold may be liable for the underlying tax, and in some cases the partnership may be required to withhold from future distributions to the buyer or be liable for the underlying tax. This article provides an overview of the two applicable withholding regimes in the context of LP secondary transactions.

Overview of US Taxation of Non-US Persons

To better understand the rationale behind these withholding regimes, it may help to first review how non-US persons are subject to US federal income tax on their US-source income. In general, the US tax treatment depends on whether the income is categorized as capital gains, passive income (e.g., interest, dividends, royalties), or "ECI" (including "FIRPTA" gains).

Capital Gains

Non-US persons generally are not subject to US federal income tax on US-source capital gains attributable to the sale of investment securities, provided that the gains are not FIRPTA gains or otherwise considered ECI, as described below. The receipt by a non-US person of such US-source capital gains income does not trigger a US tax filing obligation.

Passive Income

Non-US persons generally are subject to a gross 30% withholding tax on US-source dividends, certain types of interest, and other "fixed or determinable, annual or periodical" (FDAP) income. This 30% withholding tax does not apply to "portfolio interest," which generally includes interest on debt instruments in registered form, provided that the non-US lender owns less than 10% of the US borrower. Income tax treaties frequently reduce the withholding rate on dividends to 15% (or less) and eliminate the withholding on non-portfolio interest. The receipt by a non-US person of US-source FDAP income does not trigger a US tax filing obligation, provided that the appropriate taxes are withheld.

ECI and FIRPTA

A non-US person that is engaged (or is deemed to be engaged) in trade or business in the United States will be subject to US federal income tax on any income that is "effectively connected" with that trade or business, even if the income otherwise would not have been subject to US federal income tax or would have been considered FDAP income. Such taxable income commonly is referred to as "effectively connected income," or "ECI." The tax is levied on the net ECI at the same graduated rates that normally apply to US persons: up to 37% for individuals and 21% for corporations. While ECI generally is not subject to withholding, a US partnership that realizes ECI is required to withhold tax against any such ECI that is allocated to its non-US partners, even if not distributed. Importantly, a non-US person that realizes ECI will be required to file a US federal income tax return annually. For this reason, non-US investors generally want to avoid all ECI.

A non-US corporation that realizes ECI also will be subject to a 30% "branch profits" tax on it net after-tax ECI (unless such tax rate is reduced by a treaty), resulting in an effective tax rate of up to 47.5%. The purpose of the branch profits tax is to equalize the tax treatment between non-US corporations that conduct business in the United States through a US subsidiary corporation versus an unincorporated branch office. If a non-US corporation were to conduct business in the United States through a US subsidiary corporation, then there would be two levels of tax: first, the US subsidiary corporation would be subject to US federal income tax on all of its income, then then the non-US parent corporation would be subject to a 30% withholding tax on any dividends that it received from its subsidiary (unless such tax is reduced by a treaty). If a non-US corporation instead were to conduct business in the United States through an unincorporated branch, then, without a branch profits tax, the non-US corporation would be subject to only a single level of tax on the branch's income. Accordingly, to create a rough parity between these two arrangements, a non-US corporation with an unincorporated US branch would be subject to a 30% branch

profits tax on the deemed remittance of profits from its US branch.

While non-US persons generally are not subject to US federal income tax on non-ECI capital gains, gain on the sale of a "United States real property interest," or "USRPI," is treated as ECI under rules added by legislation known as The Foreign Investment in Real Property Tax Act of 1980, or "FIRPTA." A USRPI is defined to include an interest in real property located in the United States, including certain leasehold interests, options to acquire real property, and "associated personal property," such as movable walls and furnishings. A USRPI does not include an interest solely as a creditor in real property. In some instances, the stock of a US corporation will be considered a USRPI if the corporation is deemed to be a "United States real property holding company" by holding 50% or more of specified assets in the form of US real property.

Under the ECI rules, a partner in a partnership is treated as directly realizing the partner's proportionate share of any ECI that is realized by the partnership. Accordingly, certain common activities of investment funds can result in ECI for their non-US investors:

1. Loan origination activities in the United States;

2. The receipt by the investment fund of certain types of fees from US sources (such as commitment fees, transaction fees, break-up fees or consulting fees);

3. Direct, indirect or derivative investments in US real estate, including an interest in a corporation that holds substantial US real estate; and

4. Investments in US portfolio companies that are structured as partnerships or limited liability companies that are taxed as partnerships.

FIRPTA Withholding / Section 1445

Under FIRPTA – specifically, Section 1445[1] – if a non-US person sells a USRPI, the buyer generally is required to withhold 15% of the gross amount realized. The amount realized includes cash paid, the fair market value of property transferred, and the amount of any liability assumed by the buyer or to which the USRPI is subject. A partnership interest is treated as a USRPI in its entirety if both (1) 50% or more of the value of the partnership's gross assets consists of USRPIs, and (2) 90% or more of the value of the partnership's gross assets consists of USRPIs plus any cash or cash equivalents (the "50/90 test"). A buyer that is required to withhold under FIRPTA but fails to do so may be held liable for the underlying tax. However, a buyer is shielded from such liability if it reasonably relies on the seller's certification that is not a non-US person (or is a non-US person but is a "qualified foreign pension fund") or the partnership's certification that it does not satisfy the 50/90 test.

In the case of a secondary transaction, the buyer is required to withhold under FIRPTA only if both (1) the seller is a non-US person (and not a qualified foreign pension fund), and (2) the partnership interest is a USRPI (i.e., the partnership satisfies the 50/90 test). In other words, if the seller is a US person, or if the fund does not satisfy the 50/90 test, the buyer is not required to withhold under FIRPTA, even if the buyer does not receive a withholding certification. However, absent a certification, the buyer could be held liable for the underlying tax if it was later determined that the buyer should have withheld.

In practice, fund sponsors historically have resisted providing FIRPTA certifications in connection with LP-led secondary transactions. This is because, unlike ECI withholding, FIRPTA does not impose secondary withholding liability on the partnership, and therefore fund sponsors don't have an incentive to take on possible liability by providing a certification that must be signed under penalties of perjury. This isn't a problem when the seller is a US person and can provide a certification of non-foreign status. But when the seller is a non-US person, the buyer is faced with a dilemma. If the buyer insists on withholding 15% of the gross purchase price, the seller could decide to walk away from the deal. Instead, the buyer must get comfortable through its own due diligence that the partnership does not satisfy the 50/90 test. Fortunately, fund sponsors appear more willing to provide FIRPTA certifications following the introduction of ECI withholding.

ECI Withholding / Section 1446(f)

In addition to possible FIRPTA withholding under Section 1445, the sale of a partnership interest by a non-US person can trigger ECI withholding under Section 1446(f). If a non-US person realizes gain on the sale of a partnership interest, Section 864(c)(8) provides that such gain will be considered ECI to the extent the non-US person would have been allocated ECI if the partnership sold all its assets at their respective fair market values. Section 1446(f), in turn, provides that if a non-US person would realize even just $1 of ECI on the sale of a partnership interest pursuant to Section 864(c)(8), the buyer must withhold 10% of the amount realized. Amount realized includes cash paid, debt assumed and reduction in the seller's share of the partnership's liabilities. If the buyer fails to withhold any amount required to be withheld, the partnership must deduct and withhold from future distributions to the buyer the amount the buyer failed to withhold (plus interest).

Although Section 1446(f) provides that withholding is required only if ECI is recognized under Section 864(c)(8), the US Treasury Regulations that interpret and implement

[1] All "Section" references are to the US Internal Revenue Code of 1986, as amended, unless otherwise indicated.

Section 1446(f) go a step further and provide that a buyer is required to withhold unless it receives from either the seller or the partnership one of several possible certifications that withholding is not required by reason of an exemption. Those certifications are summarized below. The US Treasury regulations also provide that the partnership is required to withhold from future distributions to the buyer unless the partnership receives from the buyer a certification that it has complied with its withholding obligation or is not required to withhold because it received from either the seller or the partnership an appropriate certification. However, the US Treasury regulations also provide that neither the buyer nor the partnership will be held liable for the failure to withhold if the sale does not generate ECI under Section 864(c)(8).

US-based fund sponsors (and non-US based fund sponsors with US counsel) almost always will require a buyer to provide a certification that it has either complied with its withholding obligation or is not required to withhold because it has received from either the seller or the fund an appropriate certification. (Yes, that can be circular). And US buyers almost always will insist on withholding if they do not receive from either the seller or the fund an appropriate certification. Unfortunately, sometimes this can result in a non-US seller being subject to ECI withholding, even if the sale does not generate ECI under Section 864(c)(8). In that case, the seller would need to file a US tax return to claim a refund.

Possible ECI Withholding Certifications

As mentioned above, the US Treasury Regulations provide that a buyer of a partnership interest is required to withhold under Section 1446(f) unless it receives from either the seller or the partnership a certification that withholding is not required by reason of an exemption. The six possible certifications are summarized below. Detailed requirements for these certifications are included in US Treasury Regulations Section 1.1446(f)-2(b).

Seller Certification of Non-Foreign Status

A buyer is not required to withhold if the seller provides either an IRS Form W-9 or a certification stating that the seller is not a non-US person.

Seller Certification of No Gain on Sale

A buyer is not required to withhold if the seller provides a certification stating that the seller will not realize any gain on the sale of the partnership interest. This certification is uncommon for a typical LP secondary.

Seller Certification of Treaty Benefits

A buyer is not required to withhold if the seller provides a certification stating that the seller is not subject to tax on any gain from on the sale of the partnership interest pursuant to an income tax treaty. This certification is uncommon for a typical LP secondary.

Seller Certification of Nonrecognition Treatment

A buyer is not required to withhold if the seller provides a certification stating that the seller will not recognize any gain or loss on the sale of the partnership interest pursuant to a nonrecognition provision, e.g., because the seller is contributing the interest to another partnership in a tax-free Section 721 transaction. This certification is uncommon for a typical LP secondary because a sale to a third party generally is not eligible for nonrecognition treatment.

Seller Certification of Less than 10% ECI

A buyer is not required to withhold if the seller provides a certification stating all the following:

1. The seller was a partner of the partnership during the entirety of the seller's immediately prior taxable year and the two preceding taxable years (the "look-back period");
2. The seller's allocable share of ECI for each of the taxable years within the look-back period, as reported on Schedule K-1 or other statement required to be furnished to partners, was less than $1 million;
3. The seller's allocable share of ECI for each of the taxable years within the look-back period, as reported on Schedule K-1 or other statement required to be furnished to partners, was less than 10% of the seller's total distributive share of income for that year; and
4. If the seller had an allocable share of ECI in any of the taxable years within the look-back period, such ECI was reported on a federal tax return by the seller on or before the due date (including extensions), and all taxes due have been timely paid.

For purposes of this less-than-10%-ECI certification, the seller's immediately prior taxable year is the most recent taxable year of the seller that includes the partnership's taxable year that ends with or within the seller's taxable year and for which both an IRS Form 8805 (Foreign Partner's Information Statement of Section 1446 Withholding Tax) and a Schedule K-1 were due (including extensions) or filed (if earlier) by the time of the transfer. Schedule K-1 must be filed with the partnership's US federal income tax return (Form 1065), which generally must be filed by March 15 of the following year. A partnership can request an automatic extension to September 15. Thus, if a secondary transaction will close in May 2025 but the partnership has not yet filed its 2024 Form 1065 or provided Schedule K-1s (because it requested a six-month extension), the relevant 3 years are 2021, 2022, and 2023.

Unfortunately, because of a couple of technical requirements in the US Treasury Regulations, sellers frequently are unable to provide this less-than-10%-ECI certification, even if they have never received any ECI from the fund. One of these technical requirements is that the fund must have filed a Form 1065 and Schedule K-1s with the IRS during each of the years within the look-back period. In

other words, "pro forma" Schedule K-1s won't suffice. The other technical requirement is that the seller must have had a distributive share of gross income during each of the years within the look-back period. In other words, a seller cannot provide this certification if the fund didn't have any income during any of the years within the look-back period.

Partnership Certification of Less than 10% Effectively Connected Gain

A buyer is not required to withhold if the partnership provides a certification stating that the partnership was not engaged in a trade or business within the US at any time during the taxable year of the partnership through the date of the sale, or, if the partnership sold all its assets at fair market value as of the "determination date," either:

1. None of the gain would have been ECI, or, if some of the gain would have been ECI, such ECI would have been less than 10% of the total net gain; or
2. The seller would not have been allocated any ECI from the hypothetical sale, or, if the seller would have been allocated ECI from the hypothetical sale, such ECI would have been less than 10% of the seller's share of the total net gain.

For this purpose, the "determination date" can be (i) the date of the sale, (ii) any other date that is no more than 60 days before the date of the sale; or (iii) the date that is the later of (a) the first day of the fund's tax year in which the transfer occurs, or (b) the date of the most recent revaluation event before the date of the sale.

FIRPTA and ECI Withholding Checklist

FIRPTA and ECI withholding should be addressed early in the process of a secondary transaction. Specifically, when a selling LP is a non-US person, the following questions should be answered as soon as possible:

1. To avoid FIRPTA withholding under Section 1445, will the partnership provide a certification that the partnership interest is not a USRPI because the partnership does not satisfy the 50/90 test?

2. If the partnership is not willing to provide a FIRPTA certification, is the buyer comfortable through its own due diligence that FIRPTA withholding nevertheless is not required because the partnership likely does not satisfy the 50/90 test?

3. To avoid ECI withholding under Section 1446(f), will the partnership provide a less-than-10%-effectively-connected-gain certification described above?

4. If the partnership will not provide a less-than-10%-effectively-connected-gain certification, can the selling LP provide a less-than-10%-ECI certification described above? (Note that, among other things, this would require the partnership to have filed a Form 1065 and Schedule K-1s with the IRS during each of the years within the look-back period, and the selling LP must have received a distributive share of gross income during each of the years within the look-back period.)

5. If the partnership will not provide a less-than-10%-effectively-connected-gain certification, and if the selling LP cannot provide a less-than-10%-ECI certification (or any of the other certifications described above), is the buyer comfortable through its own due diligence that ECI withholding nevertheless is not required because the selling LP will not recognize any ECI on the sale of the partnership interest? (Note that a buyer may insist on withholding in the absence of an ECI certification, even if the selling LP will not recognize any ECI on the sale of the partnership interest.)

6. If the partnership will not provide a less-than-10%-effectively-connected-gain certification, and if the selling LP cannot provide a less-than-10%-ECI certification (or any of the other certifications described above), but the buyer is comfortable through its own due diligence that ECI withholding nevertheless is not required because the selling LP will not recognize any ECI on the sale of the partnership interest, will the partnership agree to not withhold from future distributions to the buyer?

In addition to determining whether FIRPTA or ECI withholding is required, the parties also will need to decide on how such withholding is addressed in the purchase agreement. For example, a purchase agreement typically will permit the buyer to withhold from the purchase price any required taxes. However, a selling LP may want to request advance notice of any withholding. Further, a selling LP may want the buyer to expressly agree not to withhold under Sections 1445 or 1446(f) if the seller provides an IRS Form W-9 (if the seller is a US person) or an appropriate certification (if the seller is a non-US person). As another example, a purchase agreement typically will require the seller to indemnify the buyer for any taxes. A buyer may want such indemnification to specifically include any withholding taxes under Sections 1445 or 1446(f). A buyer also may want to ensure that any indemnification for taxes is not subject to any thresholds or caps. And as a final example, a buyer may want the list of closing deliverables to include an IRS Form W-9 (if the seller is a US person) or the applicable ECI withholding certification (if the seller is a non-US person).

Finally, to the extent a FIRPTA or ECI withholding certification will be provided at closing, the parties should have their respective US tax counsel sign off on the form of any such certification well in advance of closing to avoid any possible delays. Note, however, that a FIRPTA or ECI certification must be signed and dated within 30 days prior to the sale.

About Bird Tax Law

Chris has been practicing tax law for over 15 years, with much of that time at AM Law 100 firms. His practice encompasses investment funds, M&A and executive compensation. As part of his investment fund practice, Chris advises non-US fund sponsors and investors on the US tax aspects of fund formations and secondary transactions.

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