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Philippe Benedict focuses his practice on the tax aspects of investment funds, mergers and acquisitions, international transactions, real estate transactions and financial instruments. He has advised on many major transactions involving sales or spinoffs of investment fund managers. Philippe advises on the tax aspects of securitizations, including his recent representation of affiliates of Fortress Investment Group LLC and affiliates of AGL in the securitization of their leveraged facilities. He has also advised multiple alternative asset managers on the formation and structuring of funds, including Bardin Hill, Dendur, Force Hill and Kize with the launch of new funds. Philippe's real estate transactions include advising the Related/Oxford joint venture developing Hudson Yards on closing nearly $1.4 billion in equity investments and debt financing for the center's first tower, advising Oxford on over $5 billion in financing; and advising Arel Capital on a number of equity investments.

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Recognized by *The Legal 500 US* as a leading tax lawyer, David has spoken on tax issues related to running investment management firms and their funds, as well as hedge fund tax considerations and compensation structures. He contributed to “Hedge Fund Employee Compensation” (Practical Law) and *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). David has presented on the topic of “Hedge Funds” at PLI’s Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances Conference for several years. He is a member of the American Bar Association and the New York State Bar Association. David received his LL.M. and J.D., *magna cum laude*, from NYU School of Law, and his A.B., *cum laude*, from Harvard University.

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Christine Harlow focuses on the tax aspects of investment funds, private equity funds, joint ventures and registered investment companies. She provides advice with respect to structuring and formation of such entities as well as ongoing operations. Her practice also includes providing advice to lenders and borrowers in financing transactions and advising on transactions involving sales of investment fund managers. A rising star in the industry, Christine is a contributor to *Private Equity Funds: Formation and Operation* (Practising Law Institute) and co-authored "Year-End FATCA Action Items for Investment Funds That Are Sponsored Entities or Have Investors that Are Sponsored Entities," an *SRZ Alert*. Christine received her J.D. from Cornell Law School and her B.S. from Cornell University.

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Shlomo has been recognized as a leader in his field by *Chambers USA, The Best Lawyers in America*, *The Legal 500 US*, *New York Super Lawyers* and the *Tax Directors Handbook.* He is a member of the Tax Section of the New York State Bar Association and regularly speaks at industry conferences and events. In addition, he has published on a range of topics, including FATCA provisions, FIRPTA and REIT rules, and compliance requirements for hedge funds. Most recently, he co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). Shlomo received his J.D. from Hofstra University School of Law.

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Elie Zolty focuses his practice on the tax aspects of onshore and offshore investment funds, private equity partnerships, real estate investment trusts (REITs) and real estate joint ventures. He represents investment managers in connection with the formation of funds and their ongoing operations, as well as sales of their investment management businesses. He also represents real estate sponsors in connection with operations, restructurings and workouts.

A published author, Elie recently contributed to “United States Fundraising” in *The Private Equity Review*, published by Law Business Research and he co-authored “PATH Act: Recently Enacted Legislation Modifies the FIRPTA and REIT Rules,” an *SRZ Alert*. Elie received his LL.M. in taxation from NYU School of Law, his J.D. from Osgoode Hall Law School and his B.A., with distinction, from York University.

Tax

I. Qualified Opportunity Zones

A. Congress enacted, at the end of 2017, significant tax incentives for investments in Qualified Opportunity Zones ("QOZs"). The QOZ legislation was intended to spur investment in lower-income communities by allowing for the reinvestment of capital gain into a QOZ on a tax-favored basis, thus encouraging economic growth in such communities.

1. On Dec. 19, 2019, the U.S. Treasury Department issued Final Regulations under sections 1400Z-1 and 1400Z-2 to provide clarification on the legislation and to settle open questions.

B. A QOZ is a low-income area that has been certified by the Secretary of the Treasury. As of this time, all QOZs have been certified. The QOZ designations expire on Dec. 31, 2028. However, for taxpayers with properly deferred gains generated prior to Dec. 31, 2026, the QOZ tax benefits remain available through Dec. 31, 2047.

C. Investment in a QOZ provides a taxpayer with three major benefits.

1. Deferral of tax on eligible capital gain until the earlier of the date the investor disposes of their interest in the QOZ investment, experiences an inclusion event or Dec. 31, 2026.

(a) If the investment is held through Dec. 31, 2026 or the investor experiences certain inclusion events, there will be a tax on the deferred gain without corresponding cash available to pay the liability.

(b) Upon realization, the deferred gain will generally have the same tax attributes in the year of inclusion that it would have had if it had not been deferred under the QOZ rules.

2. A step-up in the basis of the QOZ investment in the amount of 10% of the amount of gain deferred if the interest is held for five years, and an additional 5% if held for seven years. Thus, only 85% of the initial deferred amount will be subject to tax.

(a) Given that the deferred gain will be realized, at the latest, on Dec. 31, 2026, in order to obtain the step-up in basis, the five- and seven-year holding periods need to be met before such date.

3. If the QOF interest is held for 10 years or more, the exclusion from taxation of any additional gain over the initial deferred amount upon (i) the disposition of a QOF (as defined below) interest, (ii) the disposition of qualified opportunity zone property (QOZ stock, QOZ partnership interests or QOZ business property, each as defined below) or (iii) for QOFs that are pass-through entities, the disposition of an underlying asset (other than inventory).

D. An investor makes an investment in a QOZ by investing qualifying capital gain into a qualified opportunity fund ("QOF").

1. A QOF may be organized as a corporation or partnership for federal income tax purposes, and may be an existing entity.

2. Only equity interests in a QOF are eligible, although a QOF equity interest may be pledged as collateral to obtain debt financing.

3. Deemed contributions due to allocations of partnership liabilities under Section 752 do not constitute investments in a QOF.

4. A QOF must hold 90% of its assets in "QOZ Property" as defined below ("90-Percent Assets Test"). This is measured at the end of the first six months of the fund's taxable year and semiannually thereafter.

(a) For purposes of the 90-Percent Assets Test, the value of the QOF's assets should generally be the value reflected on the QOF's applicable financial statements. If the QOF has no such statements, alternative valuation methods described in the final regulations may be used.

(b) If a QOF fails to satisfy the 90-Percent Assets Test for any month, (subject to a cure period), the QOF will be subject to a penalty equal to the dollar amount by which it fails multiplied by the then-effective IRS underpayment rate. The penalty calculation uses the yearly underpayment rate divided by 12.

5. A fund self-certifies as a QOF by filing a Form 8996 with its federal income tax return.

E. Any person that may recognize capital gain is eligible to invest in a QOF, including individuals, entities treated as partnerships, entities treated as corporations (including S corporations, regulated investment companies ("RICs") and real estate investment trusts ("REITs")), trusts and estates.

1. To qualify, capital gains must arise from a transaction with a person unrelated to the taxpayer.

2. Amounts other than qualifying capital gain may be invested, but the rules state that the investment will be bifurcated and such other amounts will not be subject to favorable tax treatment.

3. Capital gain recognized from Section 1256 contracts (e.g., regulated futures contracts, foreign currency contracts, non-equity options) is only eligible for the QOZ tax benefits to the extent of net gain from all of the investor's Section 1256 contracts.

4. Capital gain recognized from a position that is or has been part of a "straddle" (within the meaning of section 1092, applying only to actively-traded property) during (i) the current taxable year or (ii) a prior taxable year in the event losses arising from such arrangement have been carried over to the current taxable year is not eligible for the QOZ tax benefits under the QOZ rules (special rules apply to identified straddles).

F. Capital gain must be invested within 180 days of the date on which the investor would otherwise recognize the gain for federal income tax purposes.

1. In the case of a sale or exchange, this period generally begins on the date of the transaction.

2. In the case of a capital gain dividend received by a RIC or REIT shareholder, this period begins on the date the dividend is received, even if the RIC or REIT does not designate the dividend as a capital gain dividend until later. Alternatively, a shareholder may elect to begin its 180-day investment period on the last day of such shareholder's taxable year.

3. If a RIC or REIT shareholder is required under the Code to include an undistributed amount as capital gain, the shareholder's period begins, at the shareholder's election, on the last day of the RIC or REIT's taxable year or the last day of the shareholder's taxable year in which the amount would otherwise be recognized as long-term capital gain by the shareholder.

4. If a partnership derives capital gain from a sale or exchange, the partnership may elect to defer the gain within 180 days of the transaction. If the partnership so elects, the gain will not be allocated to the partnership's partners. Instead, the gain will be allocated to the partners when the partnership recognizes it.

5. The partnership may instead allocate the gain to its partners, who then may choose to elect to defer the gain. In this instance, the partners' 180-day period begins on one of three dates: (i) the date on which the gain is realized, (ii) the last day of the partnership's taxable year in which the gain is realized or (iii) the due date (without extensions) of the partnership's tax return for the year in which the gain is realized.

(a) Gain that is allocated to a partner by a partnership is only eligible for deferral if the gain arose from a transaction with a person unrelated to both the partner and the partnership.

(b) The QOZ rules provide parallel treatment for other pass-through entities and their owners, including LLCs, S corporations, trusts and estates.

(c) Partnerships with partners who are interested in investing in QOFs may be asked for faster processing of Schedules K-1 and side letters or other agreements that the partnership will not elect to defer gain in a QOZ investment without the consent of the partners.

G. The assets that qualify for the 90-Percent Asset Test are QOZ stock, QOZ partnership interests and QOZ business property (together, "QOZ property").

1. QOZ stock means any stock in a domestic corporation if:
   (a) Such stock is acquired by the QOF after Dec. 31, 2017 at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash;
   (b) At the time the stock was issued, the corporation qualified as a QOZ business (as defined below) or was formed for such purpose; and
   (c) During substantially all of the QOF's holding period for such stock, such corporation qualified as a QOZ business.
2. QOZ partnership interest means any capital or profits interest in a domestic partnership if:
   (a) Such interest was acquired by the QOF after Dec. 31, 2017 from the partnership solely in exchange for cash;
   (b) At the time the interest was acquired, the partnership qualified as a QOZ business or was formed for such purpose; and
   (c) During substantially all of the QOF's holding period for such interest, such partnership qualified as a QOZ business.
3. QOZ business property means tangible property used in a trade or business of the QOF if:
   (a) Such property was acquired by the QOF by purchase from an unrelated person after Dec. 31, 2017;
   (b) The original use of such property in the QOZ commences with the QOF or the QOF substantially improves the property (as defined below); and
   (c) During all of the fund's holding period for such property, substantially all of the use of such property was in a QOZ.

H. A QOZ business, as described above, means a business in which:
1. Substantially all of the tangible assets held by the business are QOZ business property;
2. At least 50% of the total gross income of the business is derived from the active conduct of a trade or business;
3. A substantial portion of any intangible property owned by the business must be used in the active conduct of a trade or business;
4. Less than 5% of the average of the aggregated unadjusted bases of the property in the business is attributable to "nonqualified financial property" (which includes debt, stock, partnership interests, derivatives, etc.); and
5. The underlying business is not a: private or commercial golf course; country club; massage parlor; hot tub facility; suntan facility; racetrack or other gambling facility; or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

I. Original Use or Substantial Improvement of QOZ Business Property
1. "Original use" is defined differently for different types of property, but generally provides that property must first be used in the QOZ or may be previously used if vacant for a period of time. Given the permanence of land, the original use of land can never commence with a QOF in a QOZ and, thus, the QOZ rules do not require land to meet the original use requirement.
2. Under the QOZ rules, property is considered to be substantially improved by a QOF if, during the 30-month period following the date the property is acquired, the QOF makes additions to the basis of the property equal to the acquisition cost of such property. In short, the QOF must double its basis in the property after purchasing it. If a QOF purchases a plot of land with an existing building on the land, the determination of whether a QOF has substantially improved land is made only with respect to the adjusted basis of the building (without regard to the basis allocable to the land) and separate improvements to the land are not required.

(a) The QOZ rules provide for the aggregation of capital expended to improve property for purposes of determining whether this requirement has been met.

J. Realizing that developing businesses will have difficulty meeting some of the requirements under the QOZ rules, the rules provide a safe harbor for amounts deemed to be reasonable working capital.

1. The safe harbor applies to cash and other financial property held by a QOZ business if the QOZ business:

(a) Keeps written records that designate the use of the working capital for development of a trade or business in a QOZ (including the acquisition, construction or improvement of QOZ business property in the QOZ);

(b) Provides a reasonable schedule consistent with the ordinary startup of a trade or business for the use of the working capital in the QOZ business within 31 months; and

(c) Actually uses the working capital in a manner that is substantially consistent with the written plan.

(i) The 31-month period for the use of working capital may generally be extended by an additional 31 months with respect to each item of tangible property. The second 31-month period must be pursuant to a plan and schedule that is compliant with the above requirements.

2. Several benefits apply to the use of working capital that fits within the safe harbor:

(a) Tangible property that is purchased, leased or improved pursuant to the working capital plan and schedule is treated as QOZ business property for purposes of meeting the requirement that a QOZ business hold substantially all of its assets as QOZ business property;

(b) Income derived from safe-harbored working capital will be counted toward the requirement that 50% of the total gross income of the business be derived from the active conduct of a trade or business;

(c) Intangible property purchased or licensed by a business pursuant to the reasonable written plan with a written schedule for the expenditure of the working capital will be deemed to be used in the active conduct of a trade or business during the period of time that the business satisfies the three requirements in clause 1 above; and

(d) Property that is deemed to be safe-harbored working capital will be excepted from the requirement that less than 5% of the business property be attributable to nonqualified financial property.

II. Section 752

A. In October 2019, Treasury issued final regulations under Section 752 of the Code providing guidance, among other things, on when a partnership's liabilities should be treated as recourse for purposes of being included in a partner's outside tax basis in its partnership interest.

B. Generally, recourse liabilities are apportioned to the partners, if any, that bear the economic risk of loss with respect to such liabilities (i.e., the obligation to repay the partnership's liabilities if the partnership becomes worthless).

C. The final regulations change the analysis for determining this risk of loss ("Changes"). The Changes apply to liabilities assumed or incurred by a partnership on or after Oct. 9, 2019, other than those assumed or incurred pursuant to a binding written contract entered into prior to Oct. 9, 2019.

D. For transactions grandfathered from the Changes, generally, the partners' actual ability to repay the liabilities is disregarded (i.e., there was a presumption that, barring a plan to avoid the obligation to repay, partners would fulfill their obligations).

E. Responsibility for repaying the partnership's recourse liabilities (e.g., short sales) will generally fall exclusively to the general partner regardless of the general partner's external financial status, except where another partner has assumed such liabilities. Historically, the general partner would receive an increase in its outside tax basis corresponding to most (if not all) of such liabilities.

F. Under the Changes, a partnership must determine whether there exists a commercially reasonable expectation that the partner(s) with the risk of loss for a liability will have the ability to repay such liability under the terms of the obligation if the obligation becomes due. The Changes further explain that among the facts and circumstances considered in making such determination are the factors a third-party creditor would take into account in deciding whether to extend credit to the partner.

G. Additionally, the Changes include an anti-abuse mechanism that considers whether the facts and circumstances surrounding allocations indicate a principal purpose of eliminating partners' economic risk of loss or creating the appearance of an applicable economic risk of loss when the substance of the arrangement indicates otherwise.

H. Additionally, the Changes may operate to limit the recourse liabilities under what can be termed as a "cliff effect" (i.e., if a liability in its entirety cannot be supported by the net worth of a partner, even if a portion of such liability can be supported by the net worth of the partner, the liability will not be considered recourse to the partner at all). There is some uncertainty as to how the cliff effect will apply when there are multiple liabilities.

I. Liabilities for which no partner bears the economic risk of loss under the Changes will be treated as nonrecourse. Regulations Section 1.752-3 apportions basis from nonrecourse liabilities in the following order: (i) according to the partners' shares of partnership minimum gain; (ii) according to the amount of any taxable gain that would be allocated to the partners under Section 704(c) of the Code and the principles of reverse 704(c); and (iii) in a manner consistent with allocations of partnership profits or allocations on amounts related to a significant item of income or gain.

J. It is important to note that the Changes do not distinguish between new liabilities and those assumed or incurred prior to Oct. 9, 2019 that are replaced with new ones on or after Oct. 9, 2019 (e.g., an existing liability extinguished under a facility entered into prior to Oct. 9, 2019 and a new liability taken out in the same amount under the same facility on or after Oct. 9, 2019).

III. Limitation on Deductibility of Business Interest Expense

A. Section 163(j) of the Code limits the deduction of business interest expense attributable to a trade or business generally to the sum of the taxpayer's (x) business interest income and (y) 30% of adjusted taxable income relating to a trade or business (unreduced by business interest expense and excluding business interest income). For these purposes, business interest expense and business interest income do not include "investment interest" or "investment income," respectively, within the meaning of Section 163(d) of the Code. For tax years beginning before January 2022, adjusted taxable income is generally equivalent to EBITDA. For tax years beginning on or after January 2022, adjusted taxable income is generally equivalent to EBIT.

B. Generally, Section 163(j) applies after the application of provisions that subject interest expense to disallowance, deferral, capitalization or other limitation but applies before the operation of the at-risk loss limitations, passive activity loss limitations and the limitation on excess business losses.[1]

C. Any business interest expense not deductible pursuant to the foregoing limitation is treated as business interest expense of an eligible taxpayer that carries forward to succeeding taxable years, subject to the same limitation.

D. The limitation on the deductibility of business interest expense does not apply to interest attributable to an electing real property trade or business and certain other businesses. Such activities, including the performance of services as an employee, are excluded from the meaning of trade or business for purposes of Section 163(j). Adjusted taxable income is computed without regard to income not properly allocable to a trade or business.

E. Proposed regulations released in November 2018 ("November 2018 Proposed Regulations") provide an expansive definition of "interest" and an anti-avoidance rule for amounts associated with the time value of money. This includes guaranteed payments for use of capital, a portion of the payments on swaps with significant nonperiodic payments, substitute interest payments on securities lending transactions, income from hedging transactions in which the underlying security is an interest-bearing instrument, commitment fees, debt issuance costs and factoring income.

[1] *See* Prop. Reg. § 1.163(j)-3(b)(3).

F. Application to Partnerships

1. In the case of a partnership, the limitation is determined at the partnership level. To the extent the limitation applies at the partnership level to reduce the business interest expense deductible for a year, such excess shall carry forward to succeeding years and, subject to certain limitations, may be deducted by an eligible partner to the extent the partnership has sufficient excess taxable income that was not offset by business interest expense in such year. Any amount not utilized will form part of the investor's adjusted basis in its interest in the partnership only at the time such investor disposes of its interest.

2. Partner-level adjustments (e.g., Section 743 adjustments, remedial allocations, etc.) are not taken into account when determining the partnership's adjusted taxable income. Rather, they are taken into account at the partner level.

3. As described above, Section 163(j) only applies to business interest expense and not to other types of interest expense such as investment interest expense. Notwithstanding the foregoing, the preamble to the November 2018 Proposed Regulations indicates that for partnerships that are engaged in a trade or business, a partner that does not materially participate may be subject to the interest limitations under both Section 163(j) and 163(d).

4. Business interest expense of a partnership disallowed as a deduction by the operation of Section 163(j) is allocated to the partners ("disallowed business interest"). Such amounts are carried forward and treated as paid in subsequent years, subject to certain limitations.

5. Under the November 2018 Proposed Regulations, a partner may deduct its share of such disallowed business interest in a subsequent year to the extent of:

   (a) Its allocated excess business interest income from such partnership and

   (b) Its allocated excess taxable income from such partnership (with the deduction of the amounts otherwise allowable under this clause (b) capped at 30% of the sum of the partner's share of the excess taxable income from the partnership and adjusted taxable income from other sources). However, the Blue Book states that a partner can deduct its share of such disallowed business interest in a subsequent year only to the extent of its allocated excess business interest income and 30% of its share of the excess taxable income from the partnership).

6. If non-business interest expense of a partnership is allocated to a corporate partner, 163(j) limitations would apply at the corporate partner level because all interest expense and income of a corporation is treated as business interest expense and income.

7. Computation of a corporation's E&P does not take into account the application of 163(j). As a result, the limitations under 163(j) may not adversely impact investors in offshore feeder funds under certain circumstances.

8. The November 2018 Proposed Regulations explicitly reserve on the application of 163(j) to tiered partnerships, partnership mergers and divisions and self-charged interest.

G. Taxpayers may rely on the November 2018 Proposed Regulations before they are finalized so long as the taxpayer consistently applies all the rules of such proposed regulations.

IV. Sale of Partnership Interests by Foreign Partners

A. The IRS held in a 1991 Revenue Ruling[2] that gain on the sale of a partnership interest by a foreign partner was subject to tax in the U.S. to the extent of such partner's share of unrealized net gain in any "effectively connected income" assets held by the partnership.

B. In 2017, the Tax Court held in Grecian Magnesite[3] that a foreign partner was not subject to U.S. federal income tax on gain from the sale of a partnership interest in a partnership conducting business in the U.S., except for gain

[2] *See* Rev. Rul. 91-32.
[3] *See Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (July 13, 2017).

attributable to the partnership's United States real property interests. The IRS has appealed the decision of the Tax Court.

C. Section 864(c)(8) of the Code effectively reverses Grecian Magnesite by providing that gain or loss realized by a foreign partner from the sale or exchange of a partnership interest occurring on or after Nov. 27, 2017 is treated as effectively connected with a U.S. trade or business to the extent that the seller of such interest would have had effectively connected gain or loss had the partnership sold all of its assets for their fair market value as of the date of the sale or exchange.

D. In addition, Code Section 1446(f) requires the buyer of a partnership interest to withhold 10% tax on the amount realized by the seller on the sale or exchange of a partnership interest occurring after Dec. 31, 2017 if any portion of the seller's gain on the sale of the interest would be effectively connected income under Code Section 864(c)(8), unless the seller certifies that the seller is non-foreign. In the event the buyer fails to withhold the correct amount of tax, the partnership shall deduct and withhold from distributions to the buyer an amount equal to the tax that the buyer failed to withhold from the seller.

E. The IRS issued Notice 2018-08 on Dec. 29, 2017, which suspends withholding under Code Section 1446(f) on the transfer of any interest in a PTP as defined in Code Section 7704(b) until regulations or other guidance has been issued under Code Section 1446(f).

F. On April 2, 2018, the IRS issued Notice 2018-29, providing interim guidance upon which taxpayers may rely (pending the issuance of regulations or other guidance).

1. The Notice outlines methods to certify that Section 1446(f) withholding is not necessary.

(a) No Section 1446(f) withholding is required if the transferor certifies to its non-foreign status. Transferors may use a modified FIRPTA certificate or a Form W-9 (so long as such Form W-9 contains the name and taxpayer identification number of the transferor, and is signed and dated under penalties of perjury). A transferee may rely on a previously obtained Form W-9.

(b) No Section 1446(f) withholding is required if the transferor provides a certification that the transfer will not result in gain.

(c) No Section 1446(f) withholding is required if, within 30 days prior to a transfer, the transferor provides a certification that transferor's allocable share of "effectively connected taxable income" ("ECTI") in each of the three taxable years prior to such transfer was less than 25% of its entire distributive share of partnership income in each such year. It should be noted that this exception does not apply when the transferor is disposing of the interest to the partnership (e.g., through a withdrawal).

(d) No Section 1446(f) withholding is required if the partnership provides a certification that a hypothetical sale of all of its assets at fair market value would generate less than 25% effectively connected gain (including, for these purposes, FIRPTA gain).

2. The Notice suspends withholding under Section 1446(f) for nonrecognition transactions if the transferor provides a notification of a nonrecognition transaction to the transferee, signed under penalties of perjury, containing the transferor's name, TIN, address, a brief description of the transfer and an explanation of why gain or loss is not recognized in such transaction.

3. The Notice also suspends withholding in situations in which the partnership would be required to withhold under Section 1446(f) due to a transferee's failure to withhold as required.

G. On May 7, 2019, the IRS released proposed regulations providing guidance on Section 1446(f), adding to and modifying some of the exceptions to withholding provided in Notice 2018-29.

1. The proposed regulations require the transferee to report and pay any tax withheld by the 20th day after the date of the transfer.

2. The proposed regulations provide six exceptions to withholding that a transferee can rely on, unless the transferee has actual knowledge that the certifications are incorrect or unreliable:

(a) The transferor can certify non-foreign status with a Form W-9.

(i) The proposed regulations also clarify that a Form W-9 may be used to establish non-foreign status of a transferor for purposes of Section 1445 (FIRPTA withholding).

(b) The transferor can certify that there will be no gain realized by the transferor. Unlike Notice 2018-29, the proposed regulations clarify that this certification must take into account any ordinary income arising from application of Section 751(a) and the regulations thereunder (e.g., income from unrealized receivables). Therefore, a transferor may not provide such certification if Section 751(a) and the regulations thereunder would require the transferor to realize ordinary income, even if the transferor would realize an overall loss on the transfer.

(c) No withholding is required if the transferee receives a certification from the partnership that, in a hypothetical sale of all of the partnership's assets at fair market value, the amount of net effectively connected gain resulting from the deemed sale would be less than 10% of the total net gain, instead of the 25% threshold in Notice 2018-29.

(d) Consistent with Notice 2018-29, no withholding is required if the transferor certifies that its distributive share of ECTI during the previous three years was below a certain threshold; however, the proposed regulations reduce the 25% threshold provided in the Notice to 10%. The transferor must certify that it was a partner in the partnership at all times during the immediately prior taxable year and the two years preceding it, and that its (and certain related parties') allocable share of ECTI for each of those taxable years was less than 10% of the transferor's total distributive share of the partnership's net income for that year. In addition, the transferor must certify that, in such taxable years, the transferor's allocable share of ECTI was less than $1 million.

(i) The proposed regulations expand this exception beyond Notice 2018-29, by allowing a partnership to use this exception when the transferor is disposing of the interest to the partnership (e.g., through a withdrawal).

(e) The transferee may rely on a certification from the transferor that a nonrecognition provision of the Code applies to the transfer, consistent with Notice 2018-29.

(i) If only a portion of the gain realized on the transfer would be subject to the nonrecognition provision, an adjustment to the amount required to be withheld may be permitted.

(f) An additional exception to withholding, which is not contained in Notice 2018-29, exists if the transferor certifies that it is not subject to tax on any gain based on a claim of treaty benefits. The certification must include a valid Form W-8BEN or Form W-8BEN-E that contains the information required to support the claim of treaty benefits, and the transferee must mail a copy, along with certain additional information, to the IRS by the 30th day after the transfer date in order to rely on it.

(i) This exception does not apply to a transferor that is a flow-through entity (e.g., a partnership), even if all of its partners qualify for an exemption under a treaty.

(g) The exceptions described above apply to transfers that occur on or after the date that is 60 days after the date these proposed regulations are finalized. For transfers that occur before such 60th day, taxpayers may apply the rules described in either Notice 2018-29 or the proposed regulations' exceptions described above.

3. Under Section 1446(f)(4), if a transferee fails to withhold any amount required to be withheld under section 1446(f)(1), the partnership must deduct and withhold from distributions to such transferee a tax equal to the amount the transferee failed to withhold, plus interest.

(a) To prevent such secondary withholding obligation, a transferee must furnish, within 10 days of the transfer, a certification to the partnership that includes, among other things, underlying certifications that the transferee relies on to claim an exception or adjustment to the withholding.

(b) These rules apply to transfers that occur 60 days after the date of the finalization of these proposed regulations.

(c) If the partnership does not receive a certification that the proper amount was withheld or that there was an exception to withholding, it must begin to withhold on distributions made to the transferee on the later of the date that is 30 days after the transfer or 15 days after the partnership acquires actual knowledge of the transfer.

V. Dividend Equivalent Payments: Section 871(m)

A. Introduction

1. In 2010, Section 871(m) of the Code was enacted to treat as U.S. source dividends for U.S. withholding tax purposes:

   (a) "Dividend equivalent payments" on "specified notional principal contracts" that are based on a four-factor statutory definition; and

   (b) Substitute dividend payments on securities lending or sale-repurchase transactions.

2. On Sept. 17, 2015, the Treasury issued final and temporary regulations ("2015 Final Regulations" and "2015 Temporary Regulations," respectively, and, together, the "2015 Regulations") implementing Section 871(m) of the Code.

3. On Dec. 2, 2016, the IRS released Notice 2016-76, which indicated the Treasury's intent to phase in the applicability of the 2015 Regulations differently for transactions entered into each of: (i) calendar year 2017; and (ii) calendar year 2018 and subsequent calendar years.

4. On Jan. 19, 2017, the Treasury issued final and temporary regulations ("Final Regulations" and "Temporary Regulations," respectively, and, together, the "2017 Regulations") that adopted, with some modifications, the 2015 Regulations.

5. On Aug. 4, 2017, the IRS released Notice 2017-42, which further extends the phase in and delays the effective dates of certain provisions of the 2017 Regulations.

6. On Sept. 20, 2018, the IRS released Notice 2018-72, which further extends the phase in and delays the effective dates of certain provisions of the 2017 Regulations.

7. On Dec. 16, 2019, the IRS (i) finalized certain proposed regulations ("2019 Regulations") and (ii) released Notice 2020-2, which further extends the phase-in and delays the effective dates of certain provisions of the 2017 Regulations.

B. Statutory Provision

1. Under Section 871(m) of the Code, a notional principal contract ("NPC") (generally, an equity swap) is a "Specified NPC" subject to withholding under Section 871(m) if the NPC provides for one or more amounts that may be contingent upon, or determined by reference to, U.S.-source dividends and at least one of the following four factors is present:

   (a) In connection with entering into the NPC, a long party to the NPC transfers the underlying security to a short party to the NPC (known as "crossing in");

   (b) In connection with the termination of the NPC, a short party to the NPC transfers the underlying security to a long party to the NPC (known as "crossing out");

   (c) The underlying security is not readily tradable on an established securities market; or

   (d) The underlying security is posted as collateral by a short party to the NPC with a long party to the NPC.

2. Section 871(m) of the Code authorizes the Treasury to specify other transactions as being "Specified NPCs" or otherwise substantially similar to a transaction yielding a dividend equivalent payment. The 2017 Regulations, as modified by IRS Notice 2018-72, expand the universe of transactions subject to Section 871(m) of the Code, if such transactions are entered into (or significantly modified) after 2016 or 2020, as applicable.

C. The 2017 Regulations

1. Transactions that Can Give Rise to "Dividend Equivalent Payments" ("Section 871(m) Transactions")

   (a) A "dividend equivalent" is any of:

(i) A substitute dividend that references a U.S.-source dividend made pursuant to a securities lending or sale-repurchase transaction;

(ii) A specified NPC;

(iii) A payment that references a U.S.-source dividend made pursuant to a specified equity-linked instrument ("specified ELI"); or

(iv) Another substantially similar payment.

(b) An NPC for purposes of Section 871(m) generally means an equity swap.

(c) An equity-linked instrument ("ELI") for purposes of Section 871(m) generally means any financial transaction that references the value of one or more underlying equity securities, potentially including: forward contracts, futures contracts, swaps, options, convertible preferred stock, convertible debt instruments and debt instruments linked to underlying equity securities.

The "portfolio interest" exception to interest withholding will not apply to any dividend equivalent payment under a debt instrument.

2. Miscellaneous Issues Regarding Dividend Equivalent Amounts

(a) Any gross amount that references the payment of a U.S.-source dividend, whether actual or estimated, explicit or implicit, is treated as a dividend equivalent to the extent of the amount determined under the 2017 Regulations.

For example, the 2017 Final Regulations treat a price return swap as a transaction that provides for the payment of a dividend equivalent because the anticipated dividend payments are presumed to be taken into account in determining the other terms of the NPC.

(b) A dividend equivalent with respect to a Section 871(m) transaction is reduced by the amount of any deemed dividend arising from adjustments of convertible debt instruments and other ELIs under Section 305 of the Code, such as a change to the conversion ratio or conversion price of a convertible debt instrument. Such a deemed dividend may still be subject to withholding under other Code sections.

(c) A payment referencing a distribution on an underlying security is not a dividend equivalent subject to Section 871(m) to the extent that the distribution would not be subject to U.S. withholding if the long party owned the underlying security directly.

3. The "Delta" and "Substantial Equivalence" Tests

(a) An NPC or an ELI is a specified NPC or specified ELI subject to Section 871(m) if the instrument has a "delta" of 0.8 or greater in the case of a "simple contract," or if a "substantial equivalence" test is satisfied in the case of a "complex contract," which is in each case determined at the time of the instrument's "issuance."

(i) A "simple contract" is a contract that: (i) references a fixed number of shares (that is known when the contract is issued) of one or more issuers to determine the payments under the contract; and (ii) has a single maturity or exercise date on which all amounts are required to be calculated.

(ii) A contract can still be a simple contract if it has a range of potential exercise dates (such as an option) as long as amounts due under the contract are determined by reference to a single, fixed number of shares on the exercise date.

(iii) A "complex contract" is any contract that is not a simple contract (e.g., if the number of shares of stock referenced by the contract is not fixed, but, rather, varies based on the payoff amount, time of payout or some other factor).

(b) The "delta" of a simple contract is generally a measure of how sensitive the fair market value of an instrument is to changes in the fair market value of the underlying security, generally ranging from one (completely dependent on the value of the underlying security) to zero (completely independent of the value of the underlying security).

(c) For a complex contract, "substantial equivalence" generally measures the correlation between the value of the contract and the value of the shares used to hedge the contract at various testing prices. If this correlation is greater than the equivalent calculations performed for a simple contract specified ELI or a specified NPC, then the complex contract is a specified ELI or a specified NPC, as applicable. The Treasury has invited comments to the "substantial equivalence" test.

4. Determining Delta/Substantial Equivalence

(a) The determination of whether an instrument is a specified ELI or a specified NPC is made only on the date the instrument is "issued."

An instrument is treated as issued when it is issued, entered into, purchased or otherwise acquired at its inception or original issuance, including an issuance that results from a deemed exchange pursuant to Section 1001 of the Code.

(b) If one of the parties to a transaction subject to Section 871(m) is a broker or dealer, that party is required to determine whether a potential Section 871(m) transaction is a Section 871(m) transaction and report the timing and amount of any dividend equivalent to the other party.

(c) If neither or both parties are dealers or brokers, then the short party must make such determination and provide such reporting.

5. Time of Withholding

Withholding is required at the later of:

(a) The time the amount of the dividend equivalent is determined, which is the later of: (i) the day prior to the ex-dividend date; and (ii) the record date; and

(b) The time a payment occurs. A payment is deemed to occur:

(i) If money or other property is paid to the long party, which includes the economic benefit to the long party of netted payments within the contract that would otherwise have been made at such time; or

(ii) The long party sells or disposes of the contract, including by virtue of termination of the contract, lapse of the contract, offsets or otherwise.

6. Baskets, Indices and Miscellaneous Situations

(a) *Baskets*. If a short party issues a contract that references a basket of 10 or more underlying securities and hedges the contract with an exchange-traded security that references substantially the same underlying securities, then the short party may use the hedge security to determine the delta of the contract it is issuing.

(b) *Combined Transactions*. If a long party (or a related person) enters into two or more transactions that reference the same underlying security and the transactions were entered into in connection with each other, then the transactions are combined and treated as a single transaction for purposes of Section 871(m).

(i) If a broker does not have actual knowledge that multiple transactions were entered into in connection with each other, the broker may generally presume the transactions were not entered in connection with each other if either: (i) the transactions were entered into two or more business days apart; or (ii) the transactions are held in different accounts.

(ii) The 2017 Final Regulations do not provide for the netting of a taxpayer's long and short positions, though the preamble to the 2015 Final Regulations leaves open the possibility of more expansive rules in the future.

(c) *Transactions Referenced to Partnership Interests*. Section 871(m) only applies to payments on an NPC or ELI that references a payment on a partnership interest when the partnership: (i) is a trader or dealer in securities; (ii) holds significant investments in securities; or (iii) holds an interest in a lower-tier partnership described in (i) or (ii).

A partnership is considered to hold significant investments in securities if either 25% or more of the value of the partnership's assets consist of underlying securities or potential Section 871(m) transactions, or the value of the underlying securities or potential Section 871(m) transactions equals or exceeds $25 million. In this case, dividend equivalent payments are determined by looking through to such partnership's underlying assets.

This affects swaps on "master limited partnerships." Fund managers should have upfront communications with their brokers to understand how they intend to apply this set of rules, including whether they may be over-withholding on a swap if they cannot get sufficient comfort that the particular master limited partnership referenced under the swap is not a covered partnership.

(d) *Indices*. Transactions that reference a qualified index are generally excepted from Section 871(m). The qualified index exception is designed to provide a safe harbor for widely used passive indices that reference a diversified portfolio of long positions, and is not intended to apply to any index that: (i) is customized or reflects a trading strategy; (ii) is not generally available (i.e., the exception does not apply to over-the-counter transactions); or (iii) targets dividends. Entering into a short position that references component security of a qualified index may invalidate a qualified index Section 871(m) transaction. There is a "*de minimis*" safe harbor for a short position that reduces the exposure to referenced components securities of a qualified index by 5% or less of the value of the long positions in component securities in the qualified index.

(e) *Anti-Abuse Rule*. The IRS Commissioner may treat any payment on a transaction as a dividend equivalent if the taxpayer entered into or acquired the transaction with a principal purpose of avoiding Section 871(m). The IRS may also avail itself of general common law and statutory rules in order to challenge transactions that are designed to avoid the application of Section 871(m).

D. Notices 2016-76, 2017-42, 2018-72 and 2020-2

1. Transactions Entered into During Calendar Years 2017-2022

(a) "Delta One" Transactions

(i) The term "delta one" was not defined in any of the notices. However, the language of the notices supports that only simple contracts can be "delta one" transactions.

(ii) A transaction is a Section 871(m) Transaction if it has a delta of 1.0 on the date of issuance.

(b) Combined transactions (as described above) that have a delta of 1.0 are within the scope of the Notices. However, a broker acting as a short party will only need to combine over-the-counter transactions that are priced, marketed or sold in connection with each other. Long parties would still be responsible for the substantive tax for transactions that are combined under the 2017 Regulations, even if the short party is not responsible for withholding any tax.

(c) The IRS will apply a good faith standard to determine whether long and/or short parties applied the combination, withholding and other rules during 2017-2022.

(d) "Qualified derivatives dealers" ("QDDs") will not be subject to tax on dividends and dividend equivalents received in 2017-2022 in their equity derivatives dealer capacity or withholding on dividends (including deemed dividends). QDDs must use good faith efforts to comply with the 2017 Regulations through the end of 2022.

2. Transactions Entered into After 2022

(a) All other transactions entered into after 2022 (or significantly modified after 2022) that are considered Section 871(m) Transactions under the 2017 Regulations will be subject to the withholding and substantive tax provisions.

(b) The IRS will apply a good faith standard for actions taken by taxpayers during 2023 for Section 871(m) Transactions entered into during 2023 that are not "delta one" transactions, including whether taxpayers are properly applying the "substantial equivalence" test.

E. Possible Further Changes

1. A Treasury official announced publicly in November 2017 that the government is considering whether or not to implement the 2017 Regulations for transactions that are "non-delta one" transactions.
2. The Treasury and the IRS announced on Dec. 16, 2019 (the same date as Notice 2020-2 was issued) that they are continuing to evaluate the 2017 Regulations to "consider possible agency actions that may reduce unnecessary burdens imposed by the regulations" in accordance with Executive Order 13777.

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