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Federal Tax & International Tax ADVISORY ■

JULY 24, 2017

Big Tax Court Win for Foreign Investors in U.S. Partnerships

A foreign investor, not engaged in a U.S. trade or business, can sell stock in a U.S. corporation without fear of U.S. tax liability (with the notable exception of stock in certain U.S. corporations heavily invested in U.S. real property). For decades, however, the Internal Revenue Service's (IRS) position, as expressed in Rev. Rul. 91-32, has been to deny that foreign investors in U.S. partnerships (including LLCs taxed as partnerships) are entitled to comparable freedom from tax. The first reported court test of the IRS's reading of the law, though long in coming, is being welcomed by taxpayers as a thorough repudiation of the IRS's position. The new court decision, *Grecian Magnesite Mining, Industrial & Shipping Co., SA, v. Commissioner*, 149 T.C. No. 3 (July 13, 2017), affirms that, with some exceptions, gain on disposition of a partnership interest, like gain on the sale of stock, does not create a tax liability for foreign investors. Grecian is not the last word on the subject, but it may have a real impact on how foreign investments into the U.S. are made.

Facts

Grecian Magnesite Mining (GMM), a Greek corporation, held a 12.6% interest in Premier Chemicals, LLC (Premier), a U.S. limited liability company that was treated as a partnership for U.S. federal income tax purposes. Premier, with a headquarters in Pennsylvania, mined magnesite in the United States. Except for its investment in Premier, GMM was more or less a stranger to the United States: it had no office, employees, or business operations of its own in this country.

After holding its interest for several years, GMM was redeemed in full by Premier for $10.6 million. GMM reported none of the resulting $6.2 million gain to the IRS. GMM eventually conceded that $2.2 million of gain was attributable to U.S. real property. But GMM observed that Congress carved out gain attributable to U.S. real property as a specific exception to the general rule. The IRS's position was that taxability was the general rule; GMM should have paid tax on all $6.2 million. According to the IRS, consistent with Rev. Rul. 91-32, all of GMM's gain was taxable as U.S.-source income effectively connected with a U.S. trade or business. The gain in *Grecian* happened to arise from a redemption, but the issue would have been the same if GMM had instead recognized $6.2 million on selling its entire interest to a third party.

"Entity" vs. "Aggregate"

The case can be understood as a battle between two ways of viewing partnerships. A partnership can be seen as an "entity," like a corporation. From this perspective, a partnership interest, like corporate stock, is a separate asset – a partnership is not merely a collection of the assets that the partnership owns. Another way to look at a partnership is as an "aggregate" of its members. From that point of view, when a member sells an interest in the partnership, it is essentially as if the member had been engaging in the business of the partnership and sold its share of the business's assets. The IRS insisted on looking at GMM as an "aggregate" of its members.

Which of the two viewpoints is correct? The answer is that it depends on the particular issue. Under the Code, partnerships are entities in some respects and aggregates in others, and in some instances it may be uncertain which viewpoint the Code embodies. Unfortunately for the IRS in *Grecian*, the Tax Court demonstrated that there is really no uncertainty about the issue at hand.

Section 741 of the Code is an example of the entity perspective: gain or loss on the sale or exchange of a partnership interest "shall be considered as gain or loss from the sale or exchange of a capital asset…" Thus the general rule of Section 741 is that gain on the sale of a partnership interest is gain on the sale of a single capital asset, not determined as if the partner sold its pro rata share of the assets held by the partnership. Section 751, which deals with inventory and unrealized receivables, is an exception to the general rule, as is Section 897(g) concerning U.S. real property, but those exceptions do not undercut the general rule. The court conscientiously navigated a number of other provisions of the Code and Treasury regulations, including key international tax rules. However, Code Section 741 appears to lie at the heart of the analysis.

Having determined that the "entity" approach should apply to the redemption of GMM's partnership interest, the court then turned to the international tax rules to determine whether the disputed gain was taxable as U.S.-source effectively-connected income (ECI). Although the IRS argued that the court should give Rev. Rul. 91-32 "appropriate deference" since it involves facts similar to *Grecian*, the Tax Court declined to do so. To the delight of taxpayers and practitioners who criticized Rev. Rul. 91-32 for decades, the court stated that the ruling "is not simply an interpretation of the IRS's own ambiguous Regulations, and we find that it lacks the power to persuade."

Rather than basing its determination on Rev. Rul. 91-32, the court looked to the Code and Treasury regulations. The IRS argued that the disputed gain falls under the "U.S. office rule" (an exception to the default rule for determining the source of income from sales of personal property) because the activities in that office were a "material factor" in the production of the increased value of GMM's partnership interest. The court, again, was not persuaded by the IRS. Based on its interpretation of the regulations, the court concluded that Premiere's actions to increase its overall value were not "an essential economic element in the realization of the income" that GMM received when it redeemed its interest, and the disputed gain was not realized in the "ordinary course" of Premier's business conducted through its U.S. office. The court held that the disputed gain from the redemption was not taxable as U.S.-source ECI.

Will this be the Last Word on the Issue?

This opinion has been long-awaited by many international tax practitioners. For decades practitioners have criticized Rev. Rul. 91-32, questioning the IRS's authority for the conclusions made in the ruling. To the dismay of those who celebrate this decision, it may not be the last word on the issue. It is possible that the IRS will appeal, and a legislative response is also not out of the question. During the Obama Administration, the U.S. Treasury Department proposed on several occasions to effectively codify Rev. Rul. 91-32, and the joint Treasury/IRS 2013-2014 priority guidance plan included 'guidance' for implementing the revenue ruling. Although the Trump Administration has not yet addressed the issue, it has clearly been important to the government in the past.

In part because of Rev. Rul. 91-32, foreign investors shy away from holding direct interests in U.S. partnership operating businesses. GMM, a Greek corporation, held an interest directly in a U.S. partnership, but many foreign investors choose a somewhat more roundabout ownership structure. A foreign corporation might set up a U.S. corporation as a subsidiary, so that the U.S. subsidiary – commonly known as a "blocker" – rather than the foreign corporation would acquire the U.S. partnership interest. *Grecian* will not lead to a wholesale abandonment of "blocker" structures. However, at least in some cases *Grecian* may tip the balance in favor of the kind of unblocked investment that seems to have served GMM well.

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