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International Tax ADVISORY ■

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Gain on Sale of Partnership Interest by Nonresident Alien Taxable as Effectively Connected Income

In recently released Field Attorney Advice, the IRS reaffirmed its position that gain on the sale of a partnership interest by a nonresident alien may be subject to U.S. tax as effectively connected income (ECI). The taxpayer was also liable for annually assessed interest on the deferred tax on the sale under the installment sale rules.

Factual Background

The taxpayer, a nonresident alien, was a partner in a U.S. partnership that develops and markets consumer products. The partnership was headquartered in the United States, and strategic operational decisions were made in the United States. Prior to selling her interest in the partnership, the taxpayer had filed nonresident individual U.S. income tax returns, reporting income or loss from the partnership. In Year 1, the taxpayer disposed of her interest in exchange for a promissory note. The taxpayer did not file a U.S. tax return in Year 1 or thereafter.

The IRS issued a Notice of Proposed Adjustment (NOPA), concluding that the taxpayer's gain from the sale of her partnership interest constituted ECI, according to Revenue Ruling 91-32. Additionally, the NOPA determined that the installment sale rules applied to the sale: although tax was deferred until a principal payment was made on the promissory note (after Year 1), Section 453A requires the taxpayer to pay interest on the deferred tax.

The taxpayer protested, arguing that, under Section 741, gain on the sale of a partnership interest is a capital asset and that, as a nonresident alien, she is not taxable on capital gains unless she is present in the United States for at least 183 days. The taxpayer further contended that the 183-day rule applies even if the Revenue Ruling's treatment of the gain as ECI is proper. Because she was not present in the United States for 183 days or more, taxpayer claimed that she was not subject to tax. Lastly, the taxpayer disputed the application of Section 453A to a nonresident alien.

Revenue Ruling 91-32

Under Section 741, a provision based on the entity theory of partnership taxation, gain on the sale of a partnership interest is generally capital gain. Nonresident aliens typically are not subject to U.S. tax on capital gains under Section 871(b) unless they are present in the United States for 183 days or more. Revenue Ruling 91-32 presents an exception to the general rules where a nonresident alien partner disposes of an interest in a partnership that is engaged in a trade or business through a fixed place of business in the United States by applying the aggregate theory of partnership taxation to treat disposition of the partnership interest as a disposition of a share of the underlying partnership assets. Thus, the ruling concludes that gain or loss from a foreign partner's disposition of an interest in a partnership engaged in a trade or business through a fixed place of business in the United States will be ECI to the extent that the partner's distributive share of unrealized gain or loss of the partnership would be attributable to "ECI property" of the partnership.

Revenue Ruling 91-32 relies on the attribution and sourcing rules of Code Sections 875, 865(e) and 864(c) to reach its conclusion. Under Section 875, a nonresident alien partner is considered engaged in a trade or business in the United States if his/her partnership is so engaged. Section 865(e) provides that income from the sale of personal property by a nonresident is U.S. source if the nonresident has a fixed place of business in the United States and the income is attributable to that fixed place of business under Section 864(c) principles. Among other things, Section 864(c)(2) provides that certain capital gain or loss from U.S. sources may be ECI if the gain or loss is derived from assets used or held for use in a trade or business in the United States (i.e., ECI property).

Field Attorney Advice

In the Field Attorney Advice, the IRS restates its reasoning in Revenue Ruling 91-32, asserting that the ruling's analysis is "consistent with current law." The Advice dismisses as baseless the taxpayer's argument that the "aggregate approach" is improper. The IRS also rejects the taxpayer's likening of ownership of partnership interests to ownership of corporate stock because partnerships, unlike corporations, are generally taxable only at the owner level through the attribution and imputation of partnership income, gain, loss, deduction and credit to the partners. Notably, the IRS fails to connect the dots between applying the attribution rule of Section 875 in the context of partners' distributive shares and applying that provision to treat income on the sale of a partnership interest as ECI. In rebuffing the taxpayer's contention that the 183-day rule precludes taxation even of ECI of a nonresident alien, the IRS points to Section 871(b)(1) as providing a "general imposition of tax" on such income with no qualification based on the individual's presence in the United States.

Finally, the Field Attorney Advice concludes that the installment sale method in Section 453 and interest on deferred tax rule in Section 453A apply to the taxpayer's sale of her partnership interest for a promissory note. The IRS observes that the installment method may apply to an installment sale "throughout Subtitle A," which encompasses the Code provisions relating to taxation of nonresident aliens. Citing Section 864(c)(6), the IRS states that the taxability of income or gain of a nonresident alien taken into account in one year, but attributable to a sale or exchange in a different year, is determined as if the income or gain were accounted for in the year of the sale or exchange. The IRS further notes that the Protocol to the U.S.-India tax treaty incorporates a similar principle by treating income attributable to a permanent establishment (PE) in the

United States as taxable in the United States even if payments occur after the PE no longer exists. Therefore, to the extent the taxpayer's gain on the sale of her partnership interest is treated as ECI but payments are deferred until a later year, the taxpayer is subject to U.S. tax on those payments.

Conclusion

Many commentators disagree with the analysis and conclusion of Revenue Ruling 91-32. In spite of the IRS' selective cobbling together of provisions in Sections 864, 865 and 875, there does not seem to be apparent authority in the Code for the ruling's carve-out to the entity theory-based provision of Section 741. Several of the ruling's critics have pointed to the language of Section 741 itself, as well as the existence of specific statutory exceptions, such as Section 751 (treating certain income from the sale of a partnership interest as ordinary if attributable to unrealized receivables and inventory of the partnership) and Section 897 (treating certain income from the sale of a partnership interest as ECI if attributable to a U.S. real property interest), as indicating the need for a specific Code provision to override capital gain treatment for the sale of a partnership interest. And practically speaking, allocation of a foreign partner's gain or loss on the sale of his/her partnership interest between capital gain or loss and ECI raises definitional and valuation issues not fully addressed in the ruling or elsewhere. Administrative enforceability presents another concern since a foreign person's sale of a partnership interest typically would not trigger entity-level reporting.

Notwithstanding these and other criticisms, however, the Field Attorney Advice reflects the IRS' commitment to its position in Revenue Ruling 91-32. Nonresident alien taxpayers who are partners in partnerships engaged in a trade or business through a fixed place of business in the United States should be mindful of the IRS' stance (although the position has yet to be challenged in court, at least in a published opinion). If one accepts the arguably flawed main premise that the sale of a foreign partner's partnership interest may produce ECI subject to U.S. tax, the IRS' views in the Advice regarding the 183-day rule and installment method do not appear unreasonable.

Interestingly, the Field Attorney Advice does not invoke the anti-abuse rule in Section 1.701-2(e) of the Regulations, added in 1994, which permits the Commissioner to "treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose" of any Code or regulatory provision. As application of the aggregate theory underlies the IRS' primary contention in Revenue Ruling 91-32 and the Advice, this omission seems odd. Also, it is worth noting that the language of paragraph 2 of Section 1.701-2(e) limits aggregate treatment when a Code or regulatory provision "prescribes the treatment of a partnership as an entity, in whole or in part, and that treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision." Perhaps the IRS did not want to base its conclusions on an "anti-abuse rule," especially where it seems unclear which specific statutory or regulatory provision furnishes a basis for its application to contravene Section 741, a Code provision that clearly adopts the entity approach subject to otherwise limited statutory exceptions.

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