Executive summary

In *Grecian Magnesite*,¹ the United States (US) Tax Court overturned Revenue Ruling 91-32² in which the Internal Revenue Service (IRS) applied the aggregate theory of partnerships to treat non-US persons disposing of investments in partnerships as disposing of the underlying assets, thereby generating effectively connected income (ECI).

Under the Court’s conclusion in *Grecian*, non-US taxpayers’ gain from dispositions of ECI-generating partnership interests may entirely escape US tax (except to the extent partnerships make US real estate investments). The Tax Court ruling has broad implications and non-US persons should review their current and proposed investment structures and also evaluate the potential for seeking refund claims for historic transactions.

Detailed discussion

**Background**

In Revenue Ruling 91-32,³ the IRS treated a non-US partner that sold its partnership interest as having sold proportionate pieces of the partnership’s underlying property for purposes of determining whether the gain was ECI by reasoning as follows:
... it is appropriate to treat a foreign partner’s disposition of its interest in a partnership that is engaged in a trade or business through a fixed place of business in the United States as a disposition of an aggregate interest in the partnership’s underlying property for purposes of determining the source and ECI character of the gain or loss realized by the foreign partner.

Some commentators criticized this position because it conflicts with the entity theory of partnerships that Section 741 requires for certain purposes and with the treatment of gain/loss for personal property sales in the hands of a non-US person under Section 865. Of particular concern to these critics has been the IRS’s blurring of the lines between subchapter K’s aggregate and entity rules for partnerships and their partners to reach, in the critics’ view, a potentially inappropriate result. Such concerns have existed notwithstanding references in Treasury Explanations and Senate Finance Reports to numerous treaties citing Revenue Ruling 91-32 as a correct interpretation of law.

**Tax Court holding on tax treatment of non-US person’s disposition of partnership interest**

The case at issue involves Grecian Magnesite Mining (GMM), a Greek corporation that had invested in Premier Chemicals, LLC (Premier), a limited liability company treated as a partnership for US federal income tax purposes. Premier held various assets that generated ECI in multiple US states, including real estate and other assets related to the extraction, production and distribution of magnesite. In 2008 and 2009, Premier redeemed GMM’s interest and GMM realized gain totaling US$6.2 million, of which US$2.2 million was attributable to real estate assets and US$4 million arose from other business operating assets. GMM did not treat any of the realized gain as ECI on its originally filed Form 1120-F for the 2008 tax year.

Aside from the real estate assets held by Premier, the Tax Court ruled that GMM was not subject to US tax on the redemption of its partnership interest because the associated gain was not US-source and not effectively connected. The Court explicitly rejected the IRS’s position in Revenue Ruling 91-32 and held that the ruling neither interpreted the IRS’s own ambiguous regulations nor provided a persuasive interpretation of the statute in analyzing the tax consequences of a sale of a partnership interest.

Based on a strict reading of the applicable statutory provisions, the Tax Court reasoned that the use of the singular when referring to a “capital asset” in Section 741, rather than the plural use of “assets,” reflected Congress’ intent to govern the sale of a partnership interest under an entity theory, except to the extent of explicit exceptions such as those in Sections 751 and 897(g). Because a partnership interest is a capital asset distinct from the assets held by the partnership, it further held that the gain from the sale of such an asset is to be sourced to the country of residence of the non-US partner unless an exception applies.

The Tax Court also held that Premier’s US offices were not attributed to GMM for purposes of sourcing the gain under Section 865(e), which attribution would have been necessary for the gain to have been treated as US-source and ECI under Section 864(c). The Court’s contrary holding focused on the IRS’s conflation of the level at which the ongoing value of a business operation occurs with the level at which the gain from the sale of an interest in that business occurs. Only the latter was germane to the Court’s ruling. Because Premier was not in the business of selling and redeeming partnership interests, the Tax Court did not find that the redemption of GMM’s interest in Premier was realized in the ordinary course of Premier’s business of producing and selling magnesite products in the US.

**Implications**

Many practitioners will view the Grecian holding as affirmation of a belief they have held for some time, i.e., that Revenue Ruling 91-32 was inconsistent with the statutory construction of subchapter K. The Tax Court’s decision creates additional flexibility for taxpayers to invest in US, non-FIRPTA operating partnerships without creating potential US tax exposure on the future exit. The conclusion might change, and at the least the analysis is more complicated, if there is an upper-tier partnership selling interests in a lower-tier partnership, when the upper-tier partnership has a US office. Grecian dealt with a somewhat unusual case of a Section 732 redemption from a partnership, when the partner was not in the US. Accordingly, different factual patterns need to be analyzed to determine the extent to which they fall under the conclusion of Grecian.
It may be possible to seek refunds for gains previously realized that were reported as taxable under the reasoning of Revenue Ruling 91-32. Financial statement accruals related to potential exposures in this area may also warrant revisiting.

On the other hand, there are some taxpayers who reported losses on sales of partnerships engaged in US business activities. Taxpayers who followed Revenue Ruling 91-32 are potentially harmed by the Court’s ruling in Grecian and should evaluate their filing positions accordingly.

The Government may appeal the case. Additionally, the Trump Administration may view the last Green Book proposal from the Obama Administration on Revenue Ruling as a revenue-raising opportunity that would be favorably viewed by those seeking to enact other tax law changes that would reduce the tax burden of US persons. On the other hand, the Trump Administration may wish to encourage foreign investment in the US by not advocating for a law change in this area, so the Grecian holding could become a permanent statutory provision.

Endnotes

3. Id.
4. All “Section” references are to the Internal Revenue Code of 1986 (the Code) and its underlying Treasury regulations.
   In general, the appropriate taxation of a non-US person’s disposition of a partnership interest requires coordinating multiple Code Sections, including, but not limited to, Sections 741, 864, 865, and 875. A non-US person investing in a partnership that is engaged in a US trade or business will be treated as engaged in the same US trade or business. Income and gains of non-US persons are generally subject to federal income tax only if they are effectively connected with the conduct of a trade or business in the US, whether directly or through a partnership investment. To be considered effectively connected, income first will generally need to be treated as US-source. Section 864 provides rules for when an item of income is considered effectively connected, while Section 865 provides source rules for the sale of personal property (such as partnership interests), and Section 741 addresses the character and general entity-level taxation approach to sales or exchanges of partnership interests. Section 741 provides that, except as provided in Section 751, a partner treats gain or loss from its disposition of a partnership interest as gain or loss from the sale or exchange of a capital asset. Section 897(g) provides a look-through rule treating gain or loss from the sale of a partnership interest as an amount received from a sale or exchange of property in the United States to the extent attributable to such property held by the partnership.
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