

Client Alert

Tax Practice Group

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Tax Court Overrides Key Revenue Ruling on the Tax Treatment of the Sale of U.S. Partnership Interest by Foreign Persons

In a July 13, 2017 opinion, the United States Tax Court in *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner*ⁱ refused to follow the long-held IRS position found in Revenue Ruling 91-32ⁱⁱ (“the “Revenue Ruling”) that a foreign person’s gain from the sale of an interest in a partnership engaged in a U.S. business is itself treated as effectively connected income (“ECI”), causing the foreign person to be subject to U.S. federal income tax on such gain. The court’s decision may prove to be very significant, as the Revenue Ruling has loomed large in the structuring of inbound investments in U.S. operating partnerships. The court determined that the ruling lacked the power to persuade and was entitled to no deference at all. The court’s decision treats the Revenue Ruling as representing the IRS’s litigating position but not as an authoritative interpretation of the law. While the decision is expected to be appealed, it could mark a significant shift in the tax law and lead to planning opportunities in the structuring of foreign investments in U.S. non-real estate operating businesses.

Background

The U.S. federal income tax treatment of a foreign person’s sale of a partnership interest depends in large part on whether the partnership is respected as an entity separate from its partners (the “entity approach”) or, alternatively, viewed as an aggregation of its partners (the “aggregate approach”). Under the entity approach, a partnership interest is a distinct asset, separate and apart from the assets of the partnership, and accordingly the sale of the interest is treated as the sale of a capital asset, generating non-taxable foreign source income under section 865ⁱⁱⁱ in the case of a foreign seller that does not maintain an office or other fixed place of business in the U.S. On the other hand, under the aggregate approach, the sale would be viewed as though the partner sold its proportionate share of the property held by the partnership. That would cause a foreign seller’s gain to be subject to U.S. tax if the underlying property is used in a U.S. trade or business. It should be noted that any real estate held by the partnership is explicitly accorded “aggregate” treatment under section 897(g), so the questions raised by the Revenue Ruling and *Grecian Magnesite* are limited to non-real estate business assets.

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Depending on the context, the partnership rules at times employ an entity approach and at other times employ an aggregate approach. For example, under section 703(b) a partnership is regarded as an entity for purposes of electing an accounting method. Under section 741, a partnership interest is treated as a capital asset for purposes of computing gain or loss on a sale of the interest. On the other hand, section 751 uses an aggregate approach to exclude from capital gain or loss treatment the portion of the proceeds of a sale of a partnership interest that is attributable to “unrealized receivables” and substantially appreciated inventory items. More fundamentally, the Code adopts the aggregate approach for purposes of allocating tax items of the partnership, which result in adjustments to partners’ outside tax basis.

In the context of the sale of a partnership interest by a foreign person, the IRS adopted the aggregate view in the Revenue Ruling. The Revenue Ruling has been widely criticized because of its deviation from the entity approach without the support of any statutory or regulatory authority.

Grecian Magnesite v. Commissioner

In 2001, Grecian Magnesite, a foreign corporation organized under the laws of Greece, purchased interests in Premier Chemicals, LLC (“Premier”), a tax partnership. In 2008, Premier offered to redeem Grecian Magnesite’s interest in the partnership for cash. Grecian Magnesite accepted and its interest was fully redeemed. On the advice of its accountant, Grecian Magnesite did not report any of the gain from the redemption as ECI.

Upon audit, the IRS, presumably relying on the Revenue Ruling, issued a statutory notice of deficiency assessing tax on the gain from the redemption. It also asserted various penalties for both years. Grecian Magnesite conceded that a portion of the gain was attributable to U.S. realty and accordingly that such amount was subject to tax under section 897(g).

At issue before the court was whether the gain that was not attributable to a U.S. real property interest was effectively connected with a U.S. trade or business and thus subject to U.S. federal income tax. The court acknowledged that the Code predominantly applies the entity theory to the transfer of partnership interests, citing sections 731, 736, and 741 in support. While specific exceptions exist, such as in section 897(g), no exception applied in this case to the gain that was not attributable to U.S. real property. As to that gain, the court found that the entity approach should control so that the redemption of the Premier interest was actually the sale of an interest in an entity (and not its underlying assets) by a nonresident. As a result, the gain recognized was foreign source income under the default rule of section 865 and was not ECI.^{iv} The court further held that Grecian Magnesite was not liable for any penalties because it reasonably relied on the advice of its accountant that none of the gain was ECI.

Insights

The court’s holding in *Grecian Magnesite* validates the long-held view by many tax practitioners that the Revenue Ruling was poorly reasoned. The court harshly criticized the ruling, finding its reasoning “cursory in the extreme” and concluding that it was entitled to no deference at all. It is likely that the IRS will appeal the decision, and may also issue informal guidance to reflect its non-acquiescence with the decision and to reaffirm its litigating position. It is also possible that the policy makers will enact legislation or promulgate regulations that would implement the aggregate approach of the Revenue Ruling in order to backstop section 875.

In light of the potential for an appeal and possible administrative and/or legislative efforts to reverse the Tax Court’s decision, or its effect, it is unlikely that *Grecian Magnesite* will cause much change in the way that inbound investments are structured in the short run. If the *Grecian Magnesite* decision stands, however, it may prove to have a profound impact on structuring of foreign investment in U.S. partnerships, including flow-through structures in which private

equity and venture capital funds often invest. Traditionally, private equity and venture capital fund structures insert a U.S. “blocker corporation” between a U.S. partnership and the foreign investors to block ECI, thereby preventing attribution of a U.S. trade or business up the chain and relieving the investor of any U.S. tax reporting obligations. However, the blocker structure comes with some tax inefficiency, as tax is reported and paid by the corporation on its income. *Grecian Magnesite* opens the door to direct investment in a U.S. partnership without the use of a blocker (or with a foreign blocker) where the anticipated gain or loss on the partnership interest will not be attributable to U.S. real property. Note, however, that the decision only affects the treatment of gain on exit. It does not have any impact on the tax treatment of a distributive share of operating profits, which would still subject a foreign investor to U.S. federal income tax and associated reporting requirements (and a branch profits tax if a foreign blocker is used). The case will be closely watched while it awaits final resolution.

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ⁱ 149 T.C. No. 3, Docket No. 19215-12.

ⁱⁱ 1991-1 C.B. 107.

ⁱⁱⁱ Unless otherwise noted, all references herein to a “section” are references to a section of the Internal Revenue Code of 1986, as amended (the “Code”).

^{iv} The court rejected the Commissioner’s position in the Revenue Ruling that the foreign partner’s gain from the sale of the interest was attributable to the partnership’s U.S. office. That rejection, too, is consistent with the entity approach.