TAX

U.S TAX COURT BOUNCES REV. RUL. 91-32: SALES OF PARTNERSHIP INTERESTS BY FOREIGN PARTNERS MAY NOT BE SUBJECT TO U.S. TAX

by Peter J. Kulick

The practice of tax law is an exercise of statutory interpretation. A recent opinion of the U.S. Tax Court, *Grecian Magnesite Mining, Indust. & Ship. Co. v. C.I.R.*, 149 T.C. No. 3 (July 13, 2017), is illustrative. *Grecian Magnesite* is also a highly anticipated decision that resolves a lingering debate over the proper U.S. tax treatment of the sale of a U.S. domestic partnership interest by a foreign partner.[1] *Grecian Magnesite* held that a foreign partner's sale or exchange of an interest in a U.S. domestic partnership may (mostly) be excluded from U.S. income tax. In arriving at its conclusion, the Tax Court rejected a controversial Revenue Ruling, Rev. Rul. 91-32, 1991-1 C.B. 107.

Grecian Magnesite involved the redemption of a foreign partner's interest in a Delaware limited liability company, Premier Chemicals, LLC ("Premier"). Grecian Magnesite Mining ("GMM"), the foreign partner, was domiciled in Greece and engaged in foreign mining activities. Its sole U.S. activity consisted of owning a membership interest in Premier. Premier was engaged in the business of mining magnesite at mines located throughout the U.S. In 2008, Premier agreed to redeem GMM's membership interest in a transaction that ultimately produced $6.2 million in gain. Taking the position that the gain was not U.S. sourced or effectively connected income ("ECI") of a U.S. trade or business, GMM neither reported the gain nor paid U.S. tax on the gain.

A foreign business can be subject to U.S. taxation if it either has U.S. sourced income that is "fixed or determinable annual or periodic" income (so-called "FDAP income"), or the foreign business is engaged in a U.S. trade or business during a taxable year and has ECI of the U.S. trade or business.[2]

Rev. Rul. 91-32 and its Controversy

Rev. Rul. 91-32 was controversial since the date it was released some 26-years ago. The controversy stemmed from the Internal Revenue Service's position to treat a domestic partnership as an aggregate, rather than an entity. By applying an aggregate approach, the Service treated a foreign partner's sale or disposition of an interest in the partnership as if the foreign partner sold a portion of each asset owned by the partnership. As a result, when turning to the income-sourcing rules of the Internal Revenue Code of 1986, as amended (the "Code"), the Service concluded that any gain was U.S. sourced and subject to U.S. tax.

For the astute partnership tax attorneys, the Service's argument in Rev. Rul. 91-32 harkened back the historic policy debate of whether an entity or aggregate approach should be used in determining the U.S. tax of partnership activities. Under an entity approach, the partnership is treated as an entity on to itself. In contrast, the aggregate approach views each partner as a co-owner of the partnership assets. With the enactment of Subchapter K of the Code,[3] Congress opted to mostly apply an entity approach to partnership taxation, however, limited exceptions exist to the entity approach. The exceptions force the application of an aggregate approach to certain items of partnership taxation. The treatment of unrealized receivables and inventory items under Section 751 of the Code is one example where the aggregate approach predominates.

To understand why applying the aggregate approach to a foreign partner was controversial, it is helpful to understand how Subchapter K treats the sale or exchange of a partnership interest. Code Section 741 offers a general rule that a sale or exchange of a partnership interest "shall be considered as gain or loss from the sale or exchange of a capital asset."[4]

Payments received upon a redemption and liquidation of a partnership are treated the same as a sale or exchange; however, the legal analysis requires weaving through three separate Code sections. First, Code Section 736(b) addresses the treatment of payments received by a partner upon liquidation of the interest. That section provides that liquidating payments are considered a distribution by the partnership. Second, the flush language of Section 731(a) provides that any gain or loss recognized upon a distribution shall be treated "as gain or loss from the sale or exchange of the partnership interest of the distributee partner." Third, since Section 731(a) directs that a distribution is to be treated as a sale or exchange of a partnership interest, Code Section 741 is operable. As noted above, Section 741 directs that a sale or exchange of a partnership interest is treated as a sale of a capital asset.

Turning back to Rev. Rul. 91-32, the Service's decision to apply an aggregate approach meant that the source and ECI character of the gain on the foreign partner's deemed sale of the partnership's assets was U.S. source income of a U.S. trade or business with a fixed place of business in the U.S. According to the Service, since the gain was U.S. sourced income of a U.S. trade or business, the gain recognized by the foreign partner was subject to U.S. tax.[5]

The *Grecian Magnesite* Decision

Rev. Rul. 91-32 had long been the bane to many tax attorneys. Not only did most tax lawyers disagree with the Service's strained interpretation of the tax law, there were several practical concerns. Most foreign partners exiting a U.S. trade or business were unlikely to willingly comply with Rev. Rul. 91-32. From the foreign partner's perspective, it was questionable whether the Service had jurisdiction to enforce payment of the purported tax. From the U.S. partnership perspective, it could face back-up withholding obligations and concerns with respect to its own consequences if it failed to comply with a back-up withholding obligation.[6]

From a partnership tax perspective, *Grecian Magnesite* confirms that the entity approach applies to the sale or redemption of a partnership interest -- even if the selling partner is a non-U.S. partner. From a

statutory interpretation perspective, the court's conclusion is not surprising. As outlined above, the plain language of the Code would seem to dictate the exact outcome reached by the Tax Court.

After concluding the redemption of the partnership interest was a sale of a capital asset, the Service's path to taxing GMM's gain was to convince the Tax Court that the gain was ECI of a U.S. trade or business of *Premier*.[7] What was the trade or business of Premier? Was GMM's gain on the sale of its membership *effectively connected* with Premier's trade or business? Whether the gain was ECI ultimately turned on the proper income sourcing of the gain.

The Code default rule sources a gain arising from the sale of personal property to outside the U.S. if the gain is recognized by a non-U.S. resident. Alternatively, gain can be sourced to a U.S. office if the U.S. office is a material factor in the production of income and the U.S. office regularly carries on activities of the type from which such gain is derived. While engaging in a technical application of the Code's income sourcing rules, the important take-away is that the Tax Court concluded GMM's gain from the sale of an interest in a U.S. partnership was foreign-sourced. Thus, the gain was not subject to U.S. tax, unless another specific tax law exception applied.

An exception did applying to a portion of GMM's gain -- which GMM conceded during trial -- that caused a portion of the gain to be subject to U.S. tax. The exception dealt with the Foreign Investment in Real Property Tax of 1980 (so-called "FIRPTA") rules, which cause the direct or indirect sale of U.S. real property interests to be subject to U.S. taxation.

Planning Opportunities

Grecian Magnesite settles the debate with regard to the proper U.S. tax treatment of a foreign partner's sale of an interest in a U.S. partnership. In many instances, any gain may properly be characterized as foreign-sourced income.

Grecian Magnesite also demonstrates traps for the unwary remain. The entity approach to partnership taxation can be called-off in some instances, with the consequence is that all or a portion portion of a gain derived from the sale of a partnership interest would be subject to U.S. taxation. For example, the FIRPTA rules cause a direct or indirect sale of a U.S. real property interest to be subject to U.S. income tax. For those structuring a foreign partner's sale of its interest in a U.S. partnership, *Grecian Magnesite* provides certainty with respect to whether the gain can be taxed in the U.S. and also warns the tax planner that individual assets of a partnership still need to be examined to assess whether there is , and the extent of, any U.S. tax exposure.

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[1] A "partnership" as used in this article refers to entities classified as a partnership for federal tax purposes, including multi-member limited liability companies. The terms "partnership" and "LLC" are used interchangeably.

[2] It is noteworthy to stress that the second mechanism for a foreign business to have U.S. tax exposure is tested on an annual tax year basis and is not a permanent taint.

[3] The mostly entity approach was originally adopted by Congress with the enactment of the 1954 version of the Internal Revenue Code. The entity approach continued with subsequent enactment of the 1986 Code.

[4] Code Section 741 continues by acknowledging a caveat to the capital asset treatment of a sale of a partnership: "except as otherwise provided in section 751 (relating to unrealized receivables and inventory items." The Tax Court in *Grecian Magnesite* did point to this caveat in rejecting the Commissioner's argument that the aggregate approach should apply to a foreign partner's sale of a partnership interest by pointing out that Congress could have called off the entity approach by specifically directing an aggregate approach to apply such as was done by cross-referencing Code Section 751.

[5] The courts and the Service both agreed that a different result is reached if the entity is a C corporation. In the context of the sale of stock of a C corporation by a foreign partner, the Service had conceded that gain would not be U.S. sourced and, thus, not subject to U.S. taxation.

[6] There was likely not a basis under the U.S. tax law to impose a withholding tax on proceeds paid to a foreign partner that sold its interest in a U.S. partnership.

[7] The Code attributes the trade or business of a partnership to the foreign partners. Thus, a foreign partner is treated as if it directly conducts the trade or business of the partnership.

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