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Major Tax Court Decision Creates Opportunities for Non-US Investors

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On July 13, 2017, the US Tax Court issued its decision, *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner of Internal Revenue* (149 T.C. No 3), which dealt with the taxability of gains derived by a non-US corporation from the redemption of its interest in a partnership engaged in a US trade or business. In refusing to give deference to Rev. Rul. 91-32, the Tax Court adopted an "entity approach," treating the redemption as a distribution in exchange for a single, indivisible capital asset (the partnership interest).

This is contrast to the "aggregate approach" adopted in Rev. Rul. 91-32, where the Internal Revenue Service (IRS) treated the sale or exchange of a partnership interest as a disposition of the taxpayer's interest in each of the partnership's underlying assets. Accordingly, the Tax Court held that Grecian Magnesite Mining, Industrial & Shipping Co., SA (GMM) was not subject to US federal income tax on gain derived from the disposition of its partnership interest, except with respect to the portion of the gain that was attributable to US real property interests held by the partnership.

Background

GMM, a Greek corporation, acquired an interest in Premier Chemicals, LLC, an entity treated as a partnership for US federal income tax purposes (the "partnership"). The partnership was engaged in the conduct of a US trade or business. GMM did not have any offices, employees or business operations in the US, other than through its interest in the partnership. From 2001 to 2008, GMM was subject to tax on its allocable share of the partnership's income. On 2008, GMM realized gain from the redemption of its partnership interest, part of which was attributable to US real property held by the partnership. GMM did not report such gain in its US federal income tax returns. The IRS asserted that the entirety of the gain was taxable as US source effectively connected income (ECI), whereas GMM contended that solely the portion of the gain attributable to US real property held by the partnership was taxable in the US.

Analysis

Subchapter K of the Internal Revenue Code (IRC) adopts a blend of aggregate and entity treatment for partners and partnerships, depending on the context of each pertinent transaction. Under the entity approach, the partnership is respected as a separate and distinct entity, whereas the aggregate theory treats the partnership as an aggregation of its partners who each own an undivided interest in the underlying assets, liabilities and operations. The entity approach is reflected in IRC Sec. 741, which generally provides that the gain of a transferor partner from the sale or exchange of a partnership interest shall be considered as gain from the sale or exchange

of a capital asset, i.e. the partnership interest.[1] Conversely, IRC Sec. 897(g) adopts an aggregate approach, treating the portion of any gain that is attributable to such partner's share of any underlying US real property interests held by the partnership as a direct sale thereof, resulting in US source ECI.

In Rev. Rul. 91-32, the IRS articulated the position that a non-US partner's gain on the sale or exchange of its partnership interest is ECI and subject to US federal income tax to the extent attributable to property of the partnership that is held or used in the partnership's US trade or business, effectively treating the sale of the partnership interest as a sale of its underlying assets.

With respect to the portion of GMM's gain that was attributable to US real property interests held by the partnership, the parties agreed that IRC Sec. 897(g) governed, resulting in that portion of the gain being subject to tax as US-source ECI. However, in regards to the taxability of the residual gain, the Tax Court refused to give deference to Rev. Rul. 91-32 on the grounds that IRC Sec. 741 treats the sale or exchange of a partnership interest as the sale or exchange of a single, indivisible capital asset, subject to certain exceptions, such as IRC Sections 897(g) and 751 (relating to unrealized receivables and inventory items). The Tax Court noted in multiple instances that the existence of these exceptions proved the general rule that the sale or exchange of a partnership interest should be treated as a sale or exchange of a single capital asset (the partnership interest) and not as a sale or exchange of each of the partnership's underlying assets; if such transaction was intended to be treated as a sale of each of the partnership's underlying assets, there would be no need for special rules dictating such treatment with respect to particular assets (i.e., IRC Sections 897(g) and 751). Accordingly, the taxpayer's gain other than gain attributable to the underlying real property was treated as gain from the sale of a single capital asset, the partnership interest.

Having determined that the disputed gain was gain with respect to the sale of the partnership interest, the next step in the Tax Court's analysis was to consider whether such gain should be treated as US source, and thereby subject to tax as ECI or as foreign source and not subject to US federal income tax.

Pursuant to IRC Sec. 865(a), gain from the sale of personal property (such as the partnership interest at issue) is sourced by reference to the residence of the seller. Under an exception to the foregoing rule, if the income from the sale of personal property is attributable to the nonresident seller's office or other fixed place of business in the US, it will be treated as US source. The Code goes on to clarify that gain is attributable to a US office only if: (a) the US office is a material factor in the production of such income, and (b) the US office regularly carries on activities of the type from which such income is derived. Activities of the US office are considered to be a material factor in the production of income if they provide a significant contribution to, by being an essential economic element in, the realization of the income. Consistent with the entity approach espoused by IRC Sec. 741, the Court held that the relevant transaction for purposes of the analysis was the redemption of the partnership interest (instead of the hypothetical sale of GMM's pro rata share of the underlying assets of the partnership) and, therefore, the value-enhancing activities of the partnership with respect to its underlying assets were to be disregarded. In addition, the redemption of GMM's interest was found to be a one-time, extraordinary event, and, as such, it was not deemed to have been undertaken in the ordinary course of the partnership's business.

Finally, in regards to the portion of the gain that was taxable in the US under IRC Sec. 897(g), the Court held that GMM was not liable for accuracy-related penalties or additions to tax for failure to file a tax return and failure to pay tax, because it reasonably relied on the erroneous advice of an experienced certified public accountant.

[1] GMM's interest was redeemed by the partnership. Per IRC Sec. 736(b)(1) and 731(a), payments in liquidation of a partnership interest are treated as a distribution by the partnership. Any gain or loss recognized by the partner in a distribution is treated as gain or loss from the sale or exchange of a partnership interest.

Conclusion

This is an important decision as it provides much needed guidance regarding the US tax treatment of gains derived by non-US persons from the taxable exchange or disposition of interests in partnerships engaged in a US trade or business. This judicial override of Rev. Rul. 91-32 might leave open the possibility of refund claims for taxes imposed thereunder. It should be noted, however, that the IRS might appeal the decision, and Congress might seek to override the Tax Court through legislation. Inbound investors should carefully assess the impact of this decision on their structuring determinations.

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