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Legal Update
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Redemption of Interest in US Partnership Not Taxable to Foreign Investor; Tax Court Refuses to Follow Revenue Ruling 91-32

In general, a non-US person is not subject to US federal income tax when he sells stock of a US corporation.[1] The US Internal Revenue Service ("IRS"), in Revenue Ruling 91-32,[2] however, held that US tax was due when a non-US person sold an interest in a partnership, if the partnership is engaged in the conduct of a trade or business in the United States. Although many taxpayers and tax professionals believe that the sale of the stock and the sale of the partnership interest should both be tax-exempt, the rule espoused in Revenue Ruling 91-32 has had a chilling effect on many transactions. Many foreign taxpayers, unwilling to take a position contrary to the ruling, often structured their transactions in a manner that incurred a significant tax burden to avoid the application of the ruling. In a case of first impression, the Tax Court has declined to follow Revenue Ruling 91-32 and held that a disposition of an interest in a US partnership did not give rise to a US tax liability.

On July 13, 2017, the Tax Court released its decision in *Grecian Magnesite Mining v. Commissioner*,[3] in which it held that gain recognized by a foreign corporation (Grecian Magnesite Mining, "GMM") on the disposition of its interests in a US partnership ("Premier") was not taxable in the United States, except to the extent that the gain was attributable to United States real property interests held by Premier. In so holding, the Tax Court rejected the IRS's questionable position in Revenue Ruling 91-32 that gain recognized by a foreign partner upon disposing of its interest in a US partnership conducting a US trade or business is treated as gain from the sale of the partnership's underlying assets for purposes of determining whether such gain is subject to US federal income tax.

Summary of *Grecian Magnesite Mining*

GMM is a Greek corporation engaged in mining activities in Greece. Other than its interest in Premier, GMM had no office, employees, or business operations in the United States. In 2001, GMM purchased an interest in Premier, an entity treated as a partnership for US federal income tax purposes that was engaged in mining activities in the United States. In 2008, Premier and GMM entered into an agreement for Premier to redeem GMM's interest in exchange for two cash payments. As a result of the redemption, GMM recognized a gain of approximately $6.2 million, which it did not report to the IRS. On audit, the IRS and GMM agreed that $2.2m of the gain was attributable to US property interests and therefore taxable in the United States. The IRS and GMM, however, disagreed on whether the remaining $4 million of gain (the "disputed gain") was taxable in the United States.

I. AGGREGATE VS. ENTITY TREATMENT

The critical issue in *Grecian Magnesite Mining* was whether the "aggregate theory" or the "entity theory" of partnerships applies to the disposition of a partnership interest. The aggregate theory treats a partnership as an aggregation of its owners rather than as a discrete legal entity. Thus, under the aggregate theory, a partnership interest is merely an interest in the partnership's assets rather than an interest in a distinct entity. In contrast, the entity theory treats a partnership as a discrete entity that is separate from its owners. Under the entity theory, a partnership interest is an interest in the partnership entity itself. Subchapter K of the Code, which governs partnership taxation, is an amalgam of entity and aggregate treatment for partnerships.

Under the Code, a liquidating payment by a partnership to a partner is considered a distribution by the partnership. Any gain or loss on such distribution is considered as gain or loss from the sale of the partnership interest by the distributee partner. The Code provides that gain from the sale of a partnership interest is, subject to certain limited exceptions, treated as gain from the sale of a capital asset.

In *Grecian Magnesite Mining*, the IRS argued, consistent with its conclusion in Revenue Ruling 91-32, that the aggregate theory should apply to GMM's redemption of its interest in Premier. Consequently, GMM's gain from the redemption should be taxed as if it had resulted from the taxable disposition of Premier's underlying assets. Because Premier's underlying assets were used in a US trade or business, any gain from the disposition of those assets would be effectively connected income.

The IRS pointed to Revenue Ruling 91-32 to support its position that the redemption of GMM's interest in Premier should be analyzed under an aggregate theory. The Tax Court, however, noted that the Revenue Ruling was "not simply an interpretation of the IRS's own regulations, and we find that it lacks the power to persuade." In particular, the Tax Court criticized Revenue Ruling 91-32's "cursory in the extreme" discussion of the partnership provisions governing the disposition of partnership interests. Consequently, the Tax Court declined to follow Revenue Ruling 91-32.

According to the Tax Court, the Code embraces the entity theory as the general principle governing the disposition of a partnership interest. Section 731 of the Code provides that gain from a distribution made in redemption of a partner's interest in a partnership is treated as gain from the sale or exchange of such partnership interest. Section 741 of the Code provides that the sale or exchange of a partnership interest is generally treated as the sale or exchange of a capital asset. The Tax Court noted that the reference in Section 741 of the Code to a singular capital asset demonstrates that what is being sold or exchanged is the partnership interest itself, and not an interest in all of the partnership's underlying assets. The exceptions to this general rule (for example, in Sections 351 and 897(g) of the Code) offer further support for the Tax Court's position that the entity theory generally controls. Accordingly, the Tax Court held that GMM's redemption gain should be treated as gain from the sale of GMM's interest in Premier rather than as gain from the sale of Premier's assets.

II. EFFECTIVELY CONNECTED INCOME

After determining that the redemption of GMM's partnership interest by Premier was properly viewed as a sale of GMM's partnership interest in Premier, the Tax Court turned its focus to Subchapter N of the Code, which addresses the taxation of international transactions. Subchapter N provides for US taxation of a foreign corporation's income if either (i) the income is received from sources within the United States (i.e., "U.S.-source income") and is one of several types of income, including "fixed or determinable annual or periodic" income (i.e., "FDAP income") or (ii) the foreign corporation is engaged in a

trade or business within the United States (a "U.S. trade or business") and the income is "effectively connected" with the foreign corporation's conduct of its US trade or business. GMM and the IRS agreed that the disputed gain was not the type of income taxable under (i) above. The question, therefore, was whether the disputed gain was US-source income effectively connected with Premier's US business.

Section 865(a) of the Code provides a general rule that income realized by a taxpayer from the sale of personal property is sourced within or without the United States based on the residency of the taxpayer. GMM was a Greek corporation and had no other connections to the United States that would support its being treated as a United States resident. Its partnership interest in Premier was personal property. Hence, the disputed gain was not US-source income under the general rule of Section 865.

However, Subchapter N provides certain exceptions to this general rule. The IRS seized onto one exception in particular: income, gain, or loss attributable to a US office or fixed place of business of a nonresident is considered US-source income. Income, gain, or loss 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, gain, or loss is derived. The IRS presented two arguments in support of its contention that the activities of Premier's office were "material" in the production of the disputed gain.

First, the IRS argued that Premier's office was material to the deemed sale of GMM's partnership interest because Premier's redemption of GMM's partnership was economically equivalent to Premier's selling its underlying assets and distributing to each partner its pro rata share of the proceeds. The Tax Court found this argument to be a mere restatement of the IRS's earlier argument that the aggregate theory governs the sale of partnership interests. Moreover, the Tax Court noted that Premier's activities in actually effecting the redemption (i.e., paying out cash to GMM) were merely "clerical functions incident to the sale or exchange," and therefore not a material factor in GMM's realization of the disputed gain.

Second, the IRS argued that the activities of Premier's office in running Premier's business were responsible for the increased value of GMM's partnership interest in Premier. Hence, the gain realized by GMM was economically attributable to the activities of Premier's US office. The Tax Court dismissed this argument as well, noting that GMM's gain from the redemption was not realized from Premier's US mining activities but rather was realized as a result of Premier redeeming GMM's partnership interest. Although it was true that Premier's activities added value to GMM's partnership interests, the Tax Court noted that analogous Treasury Regulations provide that adding value alone is not a material factor in the realization of gain. Thus, the Tax Court found that the activities of Premier's US office were not "material" in the production of the disputed gain. Moreover, the Tax Court held that, even if the activities of Premier's US office had been material in the production of the disputed gain, the redemption of GMM's interest in Premier was not undertaken in the ordinary course of Premier's US trade or business (Premier had only engaged in two such redemptions in seven years). Accordingly, GMM's disputed gain was not attributable to Premier's US office. Therefore, the disputed gain was foreign-source income not subject to US federal income tax.

Federal Tax Implications

We note that the Tax Court's holding remains subject to appeal. However, if the ruling stands, *Grecian Magnesite Mining* could have a significant impact on tax planning by foreign investors in US partnerships. Although the foreign partners would remain subject to US tax on current income allocated to them by the partnership, upon exit they would be able to avoid US tax by selling their interest in the partnership rather than having the partnership

sell assets and distribute the proceeds to them. Thus, *Grecian Magnesite Mining* may make investing in certain US investment vehicles (e.g., funds that do not hold US real property) more attractive to foreign investors, as doing so will allow them to avoid some of the tax leakage attendant in investing through corporations.

State Tax Implications

Many states limit taxable income to a corporation's effectively connected income (either by express statute or by virtue of using the corporation's federal form 1120, line 28 as the starting point for state income tax computations). Thus, *Grecian Magnesite Mining* would arguably prevent those states from taxing gain from the sale of a partnership where the gain is not subject to US federal income tax. However, not all states apply that limitation. Some states deem a corporate partner to be directly taxable wherever the partnership does business (different rules apply for general partnerships and limited partners, but both involve this risk) and then determine the portion of income that could be taxed by the state either by an entity or aggregate approach. Because these states' rules are not necessarily tied to federal treatment and instead are based on the state's own statutory regimes, the holding in *Grecian Magnesite Mining* may have little or no impact. Companies are, therefore, reminded to separately consider the state tax consequences of structures and transactions even where the structure or transaction does not result in federal tax.

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Endnotes

1 Treas. Reg. § 1.871-7(a)(1). This rule does not apply to sales of stock if the stock is held in connection with the conduct of a US trade or business.

2 1991-1 C.B. 107

3 149 T.C. 3.

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