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What Is the Government's Appeal in 'Grecian' About?

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As by now everyone knows, the IRS appealed its loss in *Grecian Magnesite Mining*[1] ("GMM") in the Tax Court up to the D.C. Circuit. What no one seems to know is why. Given the relatively small amount of tax at issue, there must be something more going on here. And in terms of the merits of the case, the IRS already "won" when Congress enacted a new tax on the sale of certain partnership interests by foreign persons.[2] So why bother?

You won't get an answer to that question simply by reading the IRS's appeal brief. The basic approach of that brief is to express amazement that the Tax Court could get things so wrong, making sweeping statements about how the tax law supposedly "works." Perhaps the Circuit Court will buy this, but for anyone versed in the nuances of §864, the IRS's brief is an exercise in cleverly undermining the entire structure of the regulations under that section. And therein, I think, lies the real reason for the appeal.

First, some background. In its brief, the IRS pretty much abandoned the entity-aggregate battlefield that many thought was the whole point of the argument, and a good part of its original sally in Rev. Rul. 91-32. That is, one could read the brief as conceding that the sale of a partnership interest is a sale of an interest in a separate entity and not the sale of the partner's share of the partnership's assets. This was a wise decision. As I wrote a long time ago, and still believe, §741 and its evil cousin §751 are uber-entity rues not admitting of aggregate analysis. And when Congress decided to "overrule" the result in GMM and "codify" Rev. Rul. 91-32 (neither of which they did, exactly), it did so in a way that renders moot the aggregate-entity distinction.

A foreign person who sells an interest in a partnership conducting a U.S. trade or business has sold a capital asset, being the partnership interest. Section 751 does not apply to recast any portion of the gain as ordinary income, because nothing in that section mentions gain that would be effectively connected income if the partner or the partnership had sold assets. And even if §751 did apply, it wouldn't get the IRS to where it wants to go, because the source of the ordinary income would still be foreign unless the source rules can be monkeyed with.

So the appeal in *Grecian* is all about source.[3] The IRS had to find an exception to the default source rule for sales of personal property by foreign persons, §865(a)(2), which is based on residence and thus foreign source. The IRS brief tips its hand early on, in the section purporting to describe the proceedings in the Tax Court: "Under the income-sourcing rules of the Code, the disputed gain is subject to U.S. tax if it is attributable to an office or other fixed place of business maintained by Grecian in the United States." This is a reference to the exception set out at §865(e)(2)(A), referred to in the case as the "U.S. office rule."

Section 865(e) actually contains two mirror-image source rules, which I think is important. It is titled "special rules for sales through offices or fixed places of business." Section 865(e)(1) deals with sales by U.S. persons, whereas §865(e)(2) deals with sales by

[1] 149 T.C. No. 3 (2017), *on appeal*, D.C. Cir. No. 17-1268 (2018).

[2] §864(c)(8), §1446(f), as added by the 2017 tax act, Pub. L. No. 115-97 (Dec. 22, 2017). All section references are to the Internal Revenue Code, as amended.

[3] Interestingly, §864(c)(8) is the opposite — that section says nothing about source. Instead, it merely declares gain to be ECI without bothering to run it through the source rules first.

foreign persons. In each case, a person resident in one state (the residence state) who maintains an office in the other state (the source state) and sells personal property will have income based on source if the sale is attributable to that office.[4]

Section 865(e)(3) provides that for purposes of both §865(e)(1) and §865(e)(2), to determine whether a person has an office in the other state, and to determine whether a sale is attributable to such office, the principles of §864(c)(5) apply. The focus of the present case is on §865(c)(5)(B). In order for sales income to be attributable to an office in the other state, such office must be a *material factor* in the production of the income *and* such office must *regularly carry on* activities of the type from which such income is derived.

This is a high bar, and was intended as such. The fact that a foreign person happens to have a U.S. office (as the taxpayer in GMM admitted it had by attribution from the partnership) will not be enough to create U.S.-source income on a sale; the office must materially participate in the activity pertinent to the sale, and must do so on a regular basis. A foreign person could have a U.S. office engaged in nothing but accounting, with all sales being made through an office outside the United States, and that would not be enough to cause the sales income to be sourced to the United States. Moreover, even if the U.S. office did everything necessary to cause the sale to occur, it won't be enough to find U.S.-source income unless the office does that regularly. The same is true in reverse under §865(e)(1).

The high bar presented by §865(e)(1) prevents U.S. multinationals from easily creating foreign-source income in order to efficiently utilize their foreign tax credits. In order to have income from personal property sales sourced by other than residence (the default rule), one really needs to have one's boots on the ground in the source jurisdiction. The IRS faithfully implemented congressional intent in writing the regulations under §865(c)(5)(B). But because the rule is exactly the same when the shoe is on the other foot, the IRS may not be entirely happy with those regulations when the goal is to seek to tax foreign persons.

I think it's been clear for a long time now that the IRS dislikes the narrow constraints of the U.S. office rule when it applies to foreign persons. This dislike comes through loud and clear in the IRS's appeal brief in GMM, and even the taxpayer's reply brief did not fail to notice it. The IRS in GMM is trying to fudge the words of its own regulations to convince the court that the U.S. office rule can apply even when the foreign taxpayer did nothing to effect the sale, and even when the partnership did nothing to effect the sale. The IRS argument ignores the words of its own regulations in order to argue that the question of source comes down to where value is created by the partnership's business activities.[5]

This is ironic. The United States government has eaten through a great deal of international goodwill, in the BEPS project and in other venues, vociferously arguing that value creation is not a proper standard for sourcing income. And in fact the U.S. rules, including the U.S. office rule at issue in GMM, do not incorporate a value creation principle. It is too fuzzy, and too easy for taxpayers and governments to game.

The question is why, if the IRS doesn't like its own regulations as applied by the Tax Court in its GMM decision, it doesn't rewrite the regulations. The statute gives the IRS a fair amount of interpretive leeway here. I think it is because the IRS needs these regulations to deter foreign-source income creation by U.S. persons. But because the IRS wants to have its cake and eat it too, it is trying to do by litigation under §865(e)(2) what it can't or won't do by regulation.

I don't think the IRS strategy here is limited to sales of partnership interests. Very little is at stake. Practically no foreign person invests directly in partnerships conducting a U.S. trade or business. To avoid having to file a U.S. tax return and, where the foreign person is a corporation, to avoid becoming subject to the branch tax, most foreign persons invest in operating partnerships through U.S. corporations (often referred to as ''blockers''). I believe this explains why the IRS dropped the aggregate theory on appeal in GMM; it wasn't what the fighting was about.

Whether the issue is sales of property or engaging in activities that the IRS would like to call a business when conducted by foreign persons, the IRS has been trying for quite some time now to substitute broad general theories of value creation for the old-fashioned §864 regulations. Any time you see a GLAM or other IRS pronouncement that mentions the stupifyingly byzantine *InverWorld* case,[6] you know that this is what is going on.

On the other hand, it is quite common for U.S. persons to invest outside the United States through entities treated as partnerships, including by checking boxes open. For the IRS, keeping the foreign office

[4] Sales of inventory are subject to special rules and are not covered here.

[5] Even that argument looks like a loser. Given that this was a natural resources business, it seems much more likely that the increase in the value of the taxpayer's partnership interest was attributable to market forces than to any value-creating activities of the partnership.

[6] *InverWorld Inc. v. Commissioner*, T.C. Memo 1997-226, and related cases. The case is so prolix it can be cited for almost any conceivable proposition.

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rule narrow makes sense, because the outbound stakes are much higher. However, it will be interesting to see whether the calculus changes as a result of tax reform and the repeal of indirect foreign tax credits for all foreign income, other than subpart F income and GILTI, earned by U.S. multinationals. If the IRS decides, after all, that the easy creation of foreign-source income is not such a big deal, it may finally decide to rewrite the §864 regulations to make it easier to go after foreign taxpayers.

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