July 28, 2017

Tax Court Rejects IRS Attempt to Tax Non-U.S. Investor on Sale of Partnership Interest

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INTRODUCTION

In a recent case, the U.S. Tax Court rejected the IRS's longstanding and controversial position adopted in a 1991 ruling. In the 1991 ruling, the IRS took the position that a non-U.S. partner's gain on the sale of an interest in a partnership is treated as income effectively connected with a U.S. trade or business ("ECI") to the extent such gain is attributable to the partnership's assets held for use in the partnership's U.S. trade or business. Contrary to the IRS's position in the ruling, the tax court held that a non-U.S. corporate taxpayer was not subject to U.S. federal income tax on the gain realized from the redemption of the taxpayer's interest in a U.S. operating LLC taxed as a partnership, unless such gain was attributable to the LLC's U.S. real property interests ("USRPIs"). The tax court's decision, if sustained on appeal (it is widely expected that the IRS will appeal), may have structuring implications for a non-U.S. investor's investment in a partnership engaged in a U.S. trade or business. For example, it may permit a non-U.S. investor to sell its interest in such partnership without paying U.S. federal income tax to the extent the partnership does not own a USRPI.

REVENUE RULING 91-32

A non-U.S. partner in a partnership is generally subject to U.S. federal income tax on its share of ECI allocated from the partnership. If a non-U.S. partner sells an interest in a partnership, the IRS has taken the position that, pursuant to Revenue Ruling 91-32, any gain on such sale should also be treated as ECI to the extent attributable to the partnership's assets used in a U.S. trade or business. This "aggregate" approach in the IRS ruling has been criticized as inconsistent with the "entity" approach expressly contemplated under the Internal Revenue Code (the "Code") regarding the sale of a partnership interest. The Code provides that the sale of a partnership interest is generally treated as the sale of a distinct capital asset without requiring the taxpayer to look through the partnership to its assets except to the extent that the partnership owns a USRPI or certain ordinary income assets. In response to such criticism, prior Administrations proposed codifying the IRS ruling to provide statutory support, yet nothing has been enacted into law.

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TAX COURT'S *GRECIAN* RULING

Grecian Magnesite Mining, Industrial & Shipping Co., S.A. ("Grecian"), a Greek company treated as a corporation for U.S. federal income tax purposes, held an interest in Premier Chemicals, LLC ("Premier"), an entity engaged in a U.S. magnesite mining business and taxed as a partnership for U.S. federal income tax purposes. Premier redeemed Grecian's interest, with payments to be made over two years, resulting in approximately $6.2 million of total gain to Grecian. Grecian did not report the gain as ECI. The IRS, based on Revenue Ruling 91-32, asserted that some of the gain should be reported as ECI as such gain was attributable to Premier's assets used in a U.S. trade or business.

The tax court refused to look through Premier to its assets as it determined that the IRS's "aggregate" approach improperly interpreted the text of the relevant statutes. Instead, the tax court held that Grecian should be treated as selling a distinct capital asset, the source of income of which should be determined based on the residency of the seller, unless such gain was attributable to Grecian's fixed place of business in the United States. Grecian did not have a fixed place of business in the United States. The tax court also refused to attribute Premier's U.S. office to Grecian because Premier's U.S. office was not a material factor in Grecian's realization of the redemption gain and even if it was, the redemption was not in the ordinary course of activities that Premier's U.S. office regularly carried on. With Grecian having no U.S. fixed place of business, the tax court concluded that the disputed gain was foreign-source income that was not ECI (the taxpayer and the IRS agreed that the portion of the gain attributable to USRPIs held by Premier was subject to tax as ECI).

OBSERVATIONS

The *Grecian* decision does not change the rule that non-U.S. partners will be subject to U.S. federal income tax on their shares of ECI allocated from the partnership and ECI-sensitive investors will generally want to hold their interests in a U.S. operating partnership through a blocker. However, if the Grecian decision is upheld, a non-U.S. investor may benefit from structuring its investment in an ECI-generating partnership through a non-U.S. blocker under certain circumstances.

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