

Client Update

Tax Court Rejects Controversial IRS Ruling Taxing Foreign Investors on Sales of Partnership Interests

On July 13, 2017, the United States Tax Court [ruled](#) that Grecian Magnesite Mining, Industrial & Shipping Co., S.A. (“GMM”) did not have to pay U.S. federal income tax on gain realized on the redemption of its interest in a partnership engaged in a U.S. business. The tax court’s ruling rejected the IRS position, set out in a 1991 ruling, that gains of foreign investors on the sale of interests in such partnerships are treated as income effectively connected with a U.S. trade or business (“ECI”) under an “aggregate theory”. If sustained, the GMM case creates a pathway for foreign investors to sell interests in operating LLCs and partnerships without paying U.S. federal income taxes. The Tax Court did not base its decision on any tax treaty; its decision is an interpretation of domestic law.

REVENUE RULING 91-32

The United States taxes foreign investors on U.S.-source ECI, such as income allocated from a partnership engaged in a U.S. trade or business. In 1991, the IRS issued Revenue Ruling 91-32, analyzing when gain on the disposition of such a partnership interest will be treated as ECI. The IRS’s view, set out in the ruling, is that the character of such gain is determined under an “aggregate theory” by reference to the character of gain that would have been realized had the partnership sold its assets.

The ruling has been controversial since publication. Commentators criticized the ruling as lacking support in the Internal Revenue Code or the Treasury Regulations, reflecting IRS policy rather than legal analysis. Despite this controversy, the IRS has affirmed its position repeatedly since the ruling’s publication. However, the Obama administration signaled some weakness in the analysis by proposing to codify the ruling.

TAX COURT RULING

GMM owned an interest in Premier Chemicals, LLC (“Premier”), a tax partnership engaged in the business of extracting, producing and distributing magnesite in the United States. In 2008, Premier redeemed GMM’s interest. GMM realized approximately \$6 million of gain, which it

did not report as ECI.¹ The IRS asserted that GMM's gain was ECI to the extent attributable to Premier's underlying assets and that all such gain was attributable to ECI assets. GMM disagreed and filed a petition with the Tax Court.

The Tax Court declined to follow Revenue Ruling 91-32, finding the revenue ruling's analysis "lacks the power to persuade." The Tax Court instead ruled that the gain is characterized, under an "entity theory", as gain from the sale of an "indivisible capital asset" rather than the sale of the partnership's underlying assets. The court concluded that the gain was attributable to GMM's disposition of its interest in Premier, and not to Premier's business, and so was properly not treated as ECI.

The court went on to determine that GMM's gain on the sale of the partnership interest was not U.S. source under general tax principles.

WHAT DOES THIS MEAN FOR YOU?

The Tax Court's decision rejects the controversial analysis of Revenue Ruling 91-32, and if sustained will give comfort to foreign investors selling interests in partnerships operating in the United States. However, even if the Tax Court's ruling is sustained, foreign investors in U.S. operating businesses will still recognize ECI from partnership operations and may therefore prefer to set up "blocker structures" shielding them from current tax on ongoing partnership income. As a result of the case, foreign blockers may be more attractive for owning investments in operating LLCs and partnerships.

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Please do not hesitate to contact us with any questions.

¹ GMM later conceded that a portion of its gain was attributable to Premier's U.S. real property assets and subject to U.S. federal income tax.

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