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Tax | Alert

July 2017

Welcome News for Non-U.S. Persons Investing into U.S. Businesses: U.S. Tax Court Rejects Long-Standing IRS Ruling

On July 13, 2017, the U.S. Tax Court, in *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner*,[1] rejected the long-standing Internal Revenue Service (IRS) position that a non-U.S. person is taxed on the sale of an interest in an entity that is a "partnership" for U.S. federal income tax purposes (hereinafter, a partnership) that is engaged in business in the United States.

Under the Tax Court's holding in *Grecian*, if a non-U.S. person sells an interest in a partnership or is completely redeemed from a partnership that is engaged in a "trade or business in the United States" the non-U.S. seller is, in general, not subject to U.S. federal income tax on the gain from the sale. (As noted below, one exception to this is that the non-U.S. seller is subject to U.S. federal income tax under the Foreign Investment in Real Property Tax Act of 1980, as amended (FIRPTA) to the extent that the gain is attributable to the non-U.S. seller's share of United States real property interests (USRPIs) owned by the partnership.)

This Tax Court holding has major implications for non-U.S. persons who invest in the United States. Non-U.S. persons who have invested or are considering investing into the United States may wish to reassess their structures and non-U.S. persons who previously paid tax in accordance with the IRS position that was rejected by the Tax Court in *Grecian* should consider filing refund claims.

[1] 149 TC No. 3.

Background of the Case

Grecian Magnesite Mining, a Greek corporation (Non-U.S. Co.), owned an interest in Premier Chemicals LLC, a Delaware limited liability company classified as a partnership for U.S. federal income tax purposes (the Partnership). The Partnership was engaged in the business of extracting, producing, and distributing magnesite. The Delaware Partnership's headquarters was in Pennsylvania, and it owned industrial properties and mines in various states, including Nevada, Florida, and Pennsylvania.

The Partnership completely redeemed Non-U.S. Co.'s interest in the Partnership for $10.6 million. Non-U.S. Co. realized a gain of $6.2 million on the redemption. $2.2 million of that gain was attributable to Non-U.S. Co.'s share of the Partnership's USRPIs, and the remaining $4 million of the Partnership's gain was attributable to Non-U.S. Co.'s share of the other business assets of the Partnership.

Non-U.S. Co. did not pay tax on any of the $6.2 million of gain. By the time the Tax Court heard the case, however, the parties had agreed that, under FIRPTA, Non-U.S. Co. was subject to U.S. federal income tax on its $2.2 million of gain attributable to the Partnership's USRPIs. The issue in *Grecian* therefore was whether Non-U.S. Co.'s remaining $4 million of gain was subject to U.S. federal income tax.

IRS's Position

A non-U.S. person is subject to U.S. federal income tax on its income that is effectively connected with a trade or business in the United States (often referred to as *effectively connected income*). Under current law, a non-U.S. individual is subject to U.S. federal income tax on *effectively connected income* at rates of up to 39.6 percent, and a non-U.S. corporation is subject to U.S. federal income tax on *effectively connected income* at rates of up to 35 percent. A non-U.S. corporation may also be subject to an additional branch profits tax on *effectively connected income* which is not reinvested in a U.S. trade or business (unless such tax is reduced or eliminated by a tax treaty).

If a non-U.S. person is a partner in a partnership that is engaged in a *trade or business in the United States* and earns *effectively connected income*, there is no question that the non-U.S. partner is subject to U.S. federal income tax on its share of the partnership's *effectively connected income*. Therefore, if the Partnership were to earn *effectively connected income* from its U.S. operating business, Non-U.S. Co. would be subject to U.S. federal income tax on its share of the Partnership's *effectively connected income*. Furthermore, if the Partnership were to sell assets that produce *effectively connected income*, Non-U.S. Co. would have been subject to U.S. federal income tax on its share of that gain.

The question at issue in *Grecian*, however, was whether a non-U.S. person is subject to U.S. federal income tax on its gain from the redemption or sale of an interest in a partnership that is engaged in a *trade or business in the United States*.

The IRS's position in Revenue Ruling 91-32, and the position that it took in the *Grecian* litigation, is that the gain realized by a non-U.S. partner on the redemption or sale of an interest in a partnership engaged in a *trade or business in the United States* should be analyzed on a partnership asset-by-partnership asset basis. To the extent the non-U.S. partner would have realized *effectively connected income* if the partnership had sold an asset, the non-U.S. partner's corresponding share of its gain from the redemption or sale of an interest in the partnership likewise is *effectively connected income*.

The Tax Court's Analysis and Holding

Over the years, many practitioners and academics have expressed the view that the reasoning of Revenue Ruling 91-32 is not correct, but the IRS clung to its position. Until this case, the validity of Revenue Ruling 91-32 has never been directly addressed by any court.

Not surprisingly, the Tax Court in *Grecian* stated that it would not follow the IRS's approach in Revenue Ruling 91-32, which it criticized as "cursory in the extreme" and lacking in "the power to persuade."

Instead of following Revenue Ruling 91-32, the Tax Court engaged in a detailed and methodical analysis of the Internal Revenue Code (the Code) and the Treasury Regulations (the Regulations). The Tax Court began by addressing the general partnership tax rules applicable to the redemption of an interest in a partnership. Under the Code, the amount a partner receives in a redemption that exceeds the partner's basis in its interest in the partnership is treated as gain from the sale or exchange of the partner's interest.

The Code provides a general rule that, in the case of a sale or exchange of an interest in a partnership, gain or loss is treated as gain or loss from the sale or exchange of a capital asset. (There are, however, exceptions that apply, such as to the extent that the partnership's assets consist of unrealized receivables, or substantially appreciated inventory items.) Based on the statutory language and structure of the partnership tax rules, the Tax Court took an "entity" approach, and held that a partner's redemption gain should be treated as gain from the sale or exchange of "a singular capital asset."

The court then analyzed whether a non-U.S. partner is subject to U.S. federal income tax on its gain from the sale of its interest in a partnership. Under the provisions of the Code applicable to non-U.S. persons, a non-U.S. partner's gain from the sale of an asset such as an interest in a partnership is only *effectively connected income* if the gain is "U.S. source income." Under the general rule of the Code, income from the sale of personal property by a nonresident is non-U.S. source income. Therefore, under this general rule, Non-U.S. Co. would not be subject to U.S. federal income tax on its gain from the sale of its interest in the Partnership (except, under FIRPTA, to the extent attributable to its share of appreciation in the Partnership's USRPIs).

The IRS argued, however, that a special exception in the Code applied. That exception provides that if a nonresident maintains an "office or other fixed place of business" in the United States, income from a sale of personal property attributable to that office or other fixed place of business is U.S. source income. Under the Code, income, gain, or loss is attributable to a U.S. office or other fixed place of business only if the U.S. office or other fixed place of business is "a material factor in the production of such income" and the U.S. office "regularly carries on activities of the type from which such income, gain, or loss is derived."

The IRS argued that Non-U.S. Co.'s gain from the redemption was attributable to Non-U.S. Co.'s office (which, according to the IRS, was the Partnership's office), because the activities of that office were ultimately responsible for the increased value of Non-U.S. Co.'s interest in the Partnership.

Based on its interpretation of the Regulations, however, the Tax Court concluded that, for the disputed gain to be attributable to a U.S. office or other fixed place of business, that office or other fixed place of business's activities "must be material to the redemption transaction itself and the gain realized therein, rather than simply being a material factor in ongoing, distributive share income from regular business operations." Furthermore, the court concluded that the gain was not realized in the "ordinary course" of business conducted through the U.S. office or other place of business because the redemption transaction was not part of the Partnership's ordinary business but rather a "one-time, extraordinary event."

Conclusion

Under *Grecian*, a non-U.S. partner's gain from the sale or redemption of its interest in a partnership that is engaged in business in a *trade or business in the United States* is not subject to U.S. federal income taxation (except, under FIRPTA, to the extent attributable to USRPIs owned by the partnership).

The Tax Court's well-reasoned analysis rejects an IRS position that many have long considered to be technically incorrect. It is possible, however, that the IRS may appeal this decision, and it is also possible that there may in the future be legislative or regulatory changes or developments that override this decision. Nonetheless, non-U.S. persons investing in the United States should carefully consider the effects of *Grecian* on their U.S. tax planning.

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