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Can Foreign Partners Now Exit Partnerships Tax Free?

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In *Grecian Magnesite Mining v. Commissioner*[1] ("*Grecian Magnesite*") the Tax Court held that a non-U.S. partner's gain from the redemption of its partnership interest was neither U.S. source income nor income effectively connected with a U.S. trade or business ("ECI"), despite the partnership's conduct of a trade or business in the United States. The foreign partner was "therefore not liable for U.S. income tax on the disputed gain." This taxpayer victory is significant primarily because the Tax Court's decision rejects longstanding Internal Revenue Service ("Service") guidance and addresses ambiguities in the rules governing partnership and international taxation.

In 1991, the Service published Revenue Ruling 91-32,[2] in which it stated its position that non-U.S. persons may be subject to U.S. tax on certain gain from sales of interests in certain partnerships; in 2012, the Service released Field Attorney Advice 20123903F,[3] in which it essentially reiterated its position in Revenue Ruling 91-32. But now, in *Grecian Magnesite*, the Tax Court has held that the Service does not have the right to simply treat the sale of a partnership interest (including a limited liability company ("LLC") that is treated as a partnership for U.S. federal income tax purposes) by a foreign partner as a sale of the partner's share of the partnership's underlying assets in order to tax all or part of the gain as ECI – and that Revenue Ruling 91-32 is not a correct statement of the law.

Since 1991, a non-U.S. partner that sold its interest in a partnership that conducts a U.S. trade or business (and has a U.S. office or fixed place of business) commonly was advised to file a U.S. federal income tax return and pay income tax on any gain from such sale of a partnership interest that would be effectively connected with the partnership's U.S. business, at least to avoid a potential challenge by the Service. As of now, the Tax Court decision does not alter the Service's position, and the Service may continue to advance its position in the future.

In rendering its decision in *Grecian Magnesite*, the Tax Court supported the "entity" view of partnership taxation in this context, which essentially treats a partner's interest in a partnership entity as distinct from any rights related to the property owned or held by the partnership itself, rather than the "aggregate" view, which essentially treats a partnership as an aggregation of individuals rather than a distinct legal entity and could treat partners as owning their proportionate shares of the partnership's underlying property. The *Grecian Magnesite* decision notes that the Code reflects both the entity and aggregate approaches, depending on the context, and further states that "[t]he entity approach . . . predominates in the treatment of transfers of partnership interests as transfers of interests in a separate entity rather than in the assets of the partnership."[4] The tension between the entity and aggregate views is at its strongest when addressing the sale by a non-U.S. partner of an interest in a partnership that owns U.S. trade or business assets (or interests in U.S. real property), and the case reignites the debate as to the better approach in this context.

As a basic principle of international taxation, the United States only imposes tax on certain income earned by foreign persons. A foreign person generally is subject to U.S. federal income tax on income or gain that is either (a) received from sources within the United States ("U.S. source" income) and that is non-business or passive type income (i.e., "fixed or determinable annual or periodic" ("FDAP" income)),[5] or (b) income from domestic business activities (i.e., income that is "effectively connected" with the conduct of a trade or business conducted by the foreign corporation in the United States during the taxable year, or "ECI").[6] In *Grecian Magnesite*, the specific issue was whether the gain was ECI (there was no contention that the gain was FDAP).

Further, as some would characterize as a basic principle of partnership taxation, under Section 741 of the Internal Revenue Code (the "Code"), a partner's sale of a partnership interest generally is treated as the sale of a capital asset, and, as described by the Tax Court, under these general rules, "a partner pays tax on the sale of its partnership interest, in a manner broadly similar to the manner in which it might pay tax on the sale of an interest in a corporation" unless a specific exception applies.[7] Congress has enacted specific exceptions to the general rule that treats the sale of an interest in a partnership as the sale of a capital asset, such as under the Foreign Investment in Real Property Tax Act ("FIRPTA"), which applies to the sale of an interest in a partnership that owns United States real property interests ("USRPIs"). Notably, even to the extent that *Grecian Magnesite* is upheld or unchallenged, FIRPTA would subject a partner to U.S. federal income tax on the sale of interests in certain partnerships holding USRPIs; in fact, the FIRPTA exception was followed in the case, and the taxpayer conceded that it could be subject to tax on certain gain pursuant to the FIRPTA rules.[8] The disputed gain in the case was explicitly gain that was not attributable to real property.[9]

The Service has taken the position that the Code and Treasury Regulations ("Regulations") authorize the United States to tax non-U.S. partners on certain gain from sales of interests in partnerships as ECI by treating the selling partner as realizing gain as if the partnership had sold such partner's share of the underlying trade or business assets (to the extent the partnership has an office or fixed place of business in the United States and the gain is attributable to such office or fixed place of business).[10]

Since the Service published its position in 1991, commentators have argued that the position as asserted by the Service neither was authorized by the Code nor a logical interpretation of the Regulations. Further, there have been legislative proposals to amend the Code to codify the result of Revenue Ruling 91-32 and impose withholding obligations.[11]

Against this history, the Tax Court in *Grecian Magnesite* criticizes and declines to follow the Service's ruling, stating that "Rev. Rul. 91-32 is not simply an interpretation of the IRS's own ambiguous regulations, and we find that it lacks the power to persuade" and, further that the Service's "treatment of the partnership provisions . . . is cursory in the extreme."

While the case has generated intense interest in large part due to its rejection of the Service's position in Revenue Ruling 91-32, the balance of its analysis, i.e., whether gain or income is U.S. source (and thus would be ECI on the facts of the case) or foreign source is equally worth noting. As the Tax Court states, "[t]here is no Code section that specifically provides the source of a foreign partner's income from the sale or liquidation of its interest in a partnership."[12] Ultimately, the Tax Court concluded that the gain in this case should be sourced under the general rule of Section 865 of the Code, pursuant to which gain from the sale of personal property by a non-U.S. person is foreign source.[13]

That said, the Tax Court considered the Commissioner's contention that the sale of a partnership interest could be subject to an exception and sourced to the United States where a non-U.S. person has a U.S. office or fixed place of business to which the gain is attributable. Specifically, Code Section 865(e)(2) provides that "if a nonresident maintains an office or other fixed place of business in the United States, income from any sale of personal property (including inventory property) attributable to such office or other fixed place of business shall be sourced in the United States." The Tax Court's analysis progresses by considering that the disputed gain might be taxable as U.S. source ECI under the U.S. office exception if the gain was attributable to the *partnership's* U.S. office, which the Tax Court assumed should be deemed to have been the *partner's* U.S. office.[14]

After assuming that the U.S. office of the partnership should be attributed to the partner, the Tax Court addressed the tests for determining whether the gain could be attributable to such an office or fixed place of business. Since attribution of gain to an office results only where (a) the U.S. office is a "material factor" in the production of the income and (b) and the office "regularly carries on" the type of activities from which the gain is derived, the Tax Court concluded that on the facts of the case the gain from the redemption could not meet these tests, and as such would not be attributable to a U.S. office or fixed place of business. Specifically, as to the material factor analysis, the Tax Court distinguished between an office that would be simply a material factor in the ongoing distributive share income from regular business operations of the partnership (in the case, the trade or business of mining for natural resources, specifically, magnesite), and an office that would be a material factor in the partnership interest sale or redemption transaction itself and any gain realized from such transaction. As to the analysis of whether the office regularly carried on the type of activities from which the gain was derived, the Tax Court found that the redemption of the partnership interest was an extraordinary event not in the ordinary course of business of the trade or business carried on through the partnership's U.S. office, noting that the partnership had only engaged in two such transactions over the course of seven years.

While this would seem to be the likely result for many partnership interest sales, care should be taken to ensure that the attribution rules do not apply to treat gain as attributable to a U.S. office or fixed place of business when planning the sale of a partnership interest. The decision notes that the specific taxpayer in *Grecian Magnesite* was a foreign corporation that had activities and an office and Greece, and that the taxpayer had no office, employees or business operations in the United States other than its interest in the partnership that specifically was addressed in the case.

As noted above, *Grecian Magnesite* separately addresses a portion of the gain from the partnership interest sale that was attributable to the partnership's USRPIs. While the taxpayer conceded the application of FIRPTA to the deemed sale of the USRPIs, the Tax Court took the opportunity to note that Section 897(g) of the Code, which operates to tax foreign partners by a "look-through" to the assets of the partnership, would be "superfluous" if Congress had intended Section 741 of the Code (treating the sale of a partnership interest as the sale of a capital asset) to be a "look-through" provision in general. Thus, while partners in real estate ventures and oil and gas partnerships may not reap the benefits of this case because such partnerships generally hold USRPIs, the same FIRPTA provisions that apply to these partnership interest sale transactions serve as a basis to illustrate that (absent a specific Code provision on point) the sale of partnership interests otherwise should be treated as the sale of an interest in an entity by the partner – and not its underlying assets.

While the *Grecian Magnesite* decision is a welcome development in the international tax community, it remains to be seen what might happen on appeal, assuming the Service will appeal the case. Also, the Service has yet to indicate whether it will continue to follow Revenue Ruling 91-32 and thus could continue challenging taxpayers taking a contrary position.

Even if the case is not overturned, planning considerations will remain for partnerships with non-U.S. partners that hold USRPIs. Furthermore, this case addresses gain or loss from the sale of a partnership interest – only a partner's exit transaction – and *not* the taxation of a partner's distributive share income from a partnership conducting U.S. business activities, and the status of such distributive share income as ECI is not affected by *Grecian Magnesite*. The case does not challenge the rules pursuant to which if an operating partnership is engaged in a trade or business, its partners are treated as being engaged in that business – and non-U.S. partners generally would be subject to tax on their share of a partnership's U.S. business income as ECI. Furthermore, since such partners then would be treated as having a U.S. trade or business, income from other sources could be treated as effectively connected thereto, resulting in more taxation. In fact, *Grecian Magnesite* addresses the general rule, that a partner in a partnership is treated as engaged in the trade or business in which such partnership is engaged, but in the case, the relevant business that could potentially be attributed to the partners was a mining business – and imputing the partnership’s trade or business to its partners is different than imputing ownership of the assets to partners.

Moreover, this taxpayer victory is also notable because, as a general principle, efficient tax laws should not impose tax differently if taxpayers' activities are economically similar. In this case, it appears undisputed that a foreign partner in a partnership that has appreciated U.S. business assets would be subject to U.S. federal income tax if the partnership sold the assets and allocated the proceeds to the foreign partner, but under the facts of the case, such foreign partner may escape U.S. federal income tax liability if the partner exits the investment by selling its interest in the partnership, even if the amount of the proceeds from the disposition of the partnership interest reflects the value of the economic appreciation of the partnership’s business assets. If one were to follow the Tax Court's analysis, the sale by the partnership of the assets and the sale by the partner of the partnership interest would be subject to entirely different tax treatment.

Private equity funds and their investors may welcome the result of this case, but should realize its limitations even under the best case scenarios (e.g., the Service does not appeal or loses on appeal and Congress does not intervene). Indeed, private equity fund structures often employ the use of so called "blocker corporations" for foreign investors to hold interests in operating partnerships that earn ECI. These blocker corporations do not reduce the taxation of the ECI allocated from the partnership, but rather contain the "taint" of being engaged in a trade or business so that the foreign investor is not treated as having a U.S. trade or business – thereby protecting such non-U.S. investor's other investments from U.S. tax and eliminating the obligation to file U.S. federal income tax returns. As private equity funds consider the implication of this case and any subsequent developments, to the extent they are investing in partnerships engaging in U.S. trades or businesses, blocker corporations likely still will be necessary to "block" ultimate investors from being treated as being engaged in a U.S. trade or business. However, even to the extent that blocker corporations are needed to protect against ECI from operations, often the value of an investment – especially for fund investors – lies at exit. The *Grecian Magnesite* case thus is a welcome development to such investors as well as practitioners required to take Revenue Ruling 91-32 under advisement despite the apparent flaws behind the reasoning and result. That said, even if upheld, *Grecian Magnesite* will not apply to every partnership exit transaction, and thus selling partners need to be mindful of the limitations of the decision. At the same time, discussions may turn to revisit the current construct of U.S. international taxation, including FIRPTA. Perhaps the case will foster broader discussion – especially as the nation's leaders turn to tax reform.

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1 Grecian Magnesite Mining, Indus. & Shipping Co. v. Commissioner, No. 19215-12, 149 T.C. No. 3 (July 13, 2017), available ***here***.

2 Revenue Ruling 91-32, 1991-1 C.B. 107.

3 Field Attorney Advice Memorandum 20123903F (Sept. 28, 2012).

[4] *See Grecian Magnesite*, at *6.

[5] *See* Section 881 of the Code.

[6] *See* Section 882 of the Code.

[7] *See Grecian Magnesite*, at *6; *see also* Sections 741 and 751 of the Code.

[8] *See* Section 897(g) of the Code.

[9] *See Grecian Magnesite*, at *2.

[10] *See* Revenue Ruling 91-32, 1991-1 C.B. 107.

[11] *See* Department of the Treasury, General Explanation of the Administration's Fiscal Year 2017 Revenue Proposals, at 29 (Feb. 2016); Department of the Treasury, General Explanation of the Administration's Fiscal Year 2016 Revenue Proposals, at 40 (Feb. 2015); Department of the Treasury, General Explanation of the Administration's Fiscal Year 2015 Revenue Proposals, at 65 (March 2014); Department of the Treasury, General Explanation of the Administration's Fiscal Year 2015 Revenue Proposals, at 67 (April 2013); Department of the Treasury, General Explanation of the Administration's Fiscal Year 2013 Revenue Proposals, at 96 (Feb. 2012).

[12] *See Grecian Magnesite*, at *13.

13 *See* Section 865(a)(2) of the Code.

14 Note that the parties disputed whether the partnership's U.S. office should be deemed to be the partner's U.S. office, but the Tax Court explicitly did not resolve this dispute and stated that "[b]ecause we hold that in any event the disputed gain was not 'attributable to' any such office, we need not resolve this dispute." *See Grecian Magnesite*, at FN 19.