SALE OF AN INTEREST BY A FOREIGN PARTNER – IS REV. RUL. 91-32 BASED ON LAW OR ADMINISTRATIVE WISHES?

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Tags
Code §741
Code $751
Code §897
Code §1445
Exchange
F.I.R.P.T.A.
L.L.C.
Partnership
Sale

INTRODUCTION

In Rev. Rul. 91-32, the I.R.S. announced its view that foreign partners in partnerships operating in the U.S. (including foreign members of L.L.C.'s) are properly taxed on their capital gains under a look-thru rule to the assets owned by the partnership. Without much justification other than an acknowledgement that any other approach would prevent the I.R.S. from collecting tax, the I.R.S. claims that the rules for taxing partners on gains from the disposal of an interest in a partnership simply are different when the partner is not a U.S. person – a doubtful proposition in light of specific provisions of the Internal Revenue Code and case law. This article addresses the r the U.S. tax rules for determining when gain derived by a non-U.S. person is taxed in the U.S., the facts in Rev. Rul. 91-32, and a Tax Court case awaiting decision in which the validity of Rev. Rul. 91-32 is squarely in issue.

BACKGROUND

In general, U.S. tax law provides that an interest in a partnership is treated as a capital asset, and a sale of a partnership interest is treated as the sale of that asset. This is commonly referred to as the "entity theory" of partnerships.[1]

Notwithstanding such entity treatment for a partnership interest, when income, gain, loss, or credit is recognized by a partnership, its partners are treated as if they received their distributive shares of such income, gain, loss, or credit directly from the source.[2] This is commonly referred to as the "aggregate theory" of partnerships, meaning that a partnership is nothing more than a contractual arrangement among the partners.

If the aggregate treatment applied when a partner disposed of a share of a partnership interest, a sale of that interest would in effect be treated as a sale of an undivided interest in each asset owned by the partnership, including inventory, investments, cash, and fixed assets. To the extent sales proceeds related to inventory, income would be recognized presumably based on the difference between the portion of the sales price allocated to the inventory and the carrying value of the inventory. Ordinary income would be produced for the seller of the partnership interest. Similarly, to the extent sales proceeds related to fixed assets, the difference between the portion of the sales price allocated to each fixed asset and the adjusted basis of that asset would produce capital gain, under Code §1231, except for the depreciation recapture.

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1 Code §741.

2 Code §702(b).

In order to achieve roughly comparable results in the division between capital gains subject to favorable tax rates for individuals and ordinary income taxed at regular tax rates of up to 39.6% at the Federal level, U.S. tax law either expressly adopts the aggregate approach, which is limited to F.I.R.P.T.A. treatment of foreign investors in real estate partnerships and Subpart F inclusions when a C.F.C. sells a partnership interest,[3] or treats the gain as if it produced ordinary income, which is accomplished by honoring the entity theory but increasing the rates of tax for some or all of the gain.[4]

Rev. Rul. 91-32 involves a foreign investor in a partnership that engages in a U.S. business but does not invest in real estate. In that fact pattern, the carefully devised tests that are applied to distinguish between effectively connected capital gains that are taxable and capital gains that are not taxable lead to only one conclusion – under the law as written, the gain is a capital gain, and in most circumstances, that gain is free of tax for a non-U.S. partner.

TEST FOR DETERMINING EFFECTIVELY CONNECTED GAINS

U.S.-Source Income

The general source of income rule is set forth in Code §865(a), which provides that income from the sale of personal property by a non-U.S. person is treated as foreign-source income unless provided otherwise in Code §865.

A special source rule in Code §865(e) applies if (i) the foreign person maintains an office or other fixed place of business in the U.S., and (ii) the sale of personal property is "attributable" to the U.S. office or other fixed place of business.[5] Under Code §864(c)(5)(B), a taxpayer's gain is not attributable to a U.S. office or other fixed place of business unless the office or fixed place of business is a "material factor" in the production of the gain and "regularly carries on activities of the type from which such gain . . . is derived." If applicable, this special rule would make the income from the sale of personal property U.S. source.

Effectively Connected Income

Relevant income tax regulations[6] issued by the I.R.S. provide that for the purposes of determining whether any income or gain from sources within the U.S. arising from the sale or exchange of capital assets is effectively connected income for the taxable year, the principal tests to be applied are (i) the "asset-use test" and (ii) the "business-activity test." The asset-use test measures whether the income, gain, or loss is derived from assets used in, or held for use in, the conduct of a trade or business in the U.S. The business-activity test measures whether the activities of the trade or business conducted in the U.S. were a material factor in the realization of the income, gain, or loss.

The asset-use test is of primary significance where, for example, interest income

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3 Code §897(c)(4). See also Code §954(c)(4)(A).

4 Code §751.

5 Code §865(e)(2)(A).

6 Treas. Reg. §1.864-4(c)(1)(i).

is derived from sources within the U.S. by a nonresident alien individual or foreign corporation that is engaged in the business of manufacturing or selling goods in the U.S., or the asset that is sold was held in a direct relationship to the trade or business conducted in the U.S. A direct relationship exists where the asset was held to meet the present needs of the trade or business and not its anticipated future needs. For example, if an asset is held to meet the operating expenses of a U.S. trade or business, a direct relationship is deemed to exist. In comparison, no direct relationship exists to the U.S. trade or business if the asset is held for the purpose of providing

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- future diversification into a new trade or business,
- expansion of trade or business activities conducted outside of the U.S.,
- future plant replacement, or
- future business contingencies.[7]

In comparison, an asset will generally be treated as held in a direct relationship to a U.S. trade or business if

- the asset was acquired with funds generated by that trade or business,
- the income from the asset is retained or reinvested in that trade or business, or
- personnel who are present in the U.S. and actively involved in the conduct of that trade or business exercise significant management and control over the investment of such asset.[8]

The business-activity test ordinarily applies to income or gain that is generally passive but arises directly from the active conduct of the taxpayer's trade or business in the U.S.[9] The business-activity test is of primary significance where (i) dividends or interest are derived by a dealer in stocks or securities, (ii) gain or loss is derived from the sale or exchange of capital assets held in the active conduct of a trade or business by an investment company, (iii) royalties are derived in the active conduct of a business consisting of the licensing of patents or similar intangible property, or (iv) service fees are derived in the active conduct of a servicing business.

Treatment of Partnership Interests

To determine whether the gain from the disposition of the partnership interest is U.S. source and, if so, whether it is effectively connected income, the key inquiry is whether the partnership interest is properly treated as an asset that is separate and distinct from the underlying assets of the partnership.

Under U.S. tax law, a partnership is viewed at times to be a separate entity and at other times to be an aggregate of the partners, thereby having no separate legal identity for U.S. income tax purposes.

For purposes of computing ongoing operating income, the Code generally adopts

7 Treas. Reg. §1.864-4(c)(2)(iv)(a).

8 Treas. Reg. §1.864-4(c)(2)(iv)(b).

9 Treas. Reg. §1.864-4(c)(3)(i).

the aggregate approach and the partners are deemed to recognize their distributive shares of partnership income, deductions, and losses as if received directly from the source, thereby ignoring the partnership.[10] Similarly, a partner increases the basis in its partnership interest by its distributive share of partnership income.[11] Distributions of cash to a partner generally are not treated as income, but rather reduce the partner's basis in the partnership interest.[12]

However, for other purposes, the partnership is treated as an entity. Thus, for purposes of computing gain, a partner's interest in the partnership is treated as a capital asset. Therefore, upon a sale of a partnership interest, the partner realizes a capital gain or capital loss.[13] Similarly, a partnership's method of accounting may be different from the method of accounting used by the partners individually. This is acceptable only if the partnership is a separate entity. Consequently, if a partnership computes income under the accrual method of accounting, income is recognized when it sends out a bill. That income is reported by the partnership and passed through for reporting to each partner, even though payment has not been received and each partner uses the cash method of accounting to compute income.[14]

In further illustration, where the partnership is foreign and a partner is a controlled foreign corporation ("C.F.C."), a sale to the partnership of personal property by a party related to the C.F.C. has been held not to be the same as a sale of personal property to the C.F.C. It does not result in the creation of "foreign base company income," which is taxable to a U.S. shareholder of the C.F.C. under Subpart F[15] of domestic tax law except to the extent expressly provided in U.S. tax law or regulations.[16] Such a provision is now expressly provided for in the U.S. income tax regulations.[17] Finally, if a C.F.C. sells an interest in a partnership, the gain is generally treated as an item of "foreign personal holding company income" because the partnership interest is considered to be a passive asset separate and apart from the underlying assets of the partnership.[18] An exception is provided for when the C.F.C. owns 25% or more of the capital or profits interest in the partnership.[19]

At times, the separate entity approach provides for inappropriate treatment for gains derived from the sale of a partnership interest. Examples include (i) gains from the sale of a partnership interest where the partnership assets consist of U.S. real property interests or (ii) inventory assets that have appreciated or depreciable assets that would produce recapture income if they were sold by the partnership. In those circumstances, U.S. tax law either expressly adopts the aggregate approach[20] or

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10 Code §702(b).

11 Code §705(a)(1).

12 Code §733.

13 Code §741.

14 Treas. Reg. §1.703-1(b)(1).

15 Code §§951 to 963.

16 *Brown Group v. Commr.*, 77 F3d 217, (8th Cir. 1996), revg. 104 T.C. 105 (1995).

17 Treas. Reg. §1.954-1(g)(1), effective for years beginning on or after July 23, 2002.

18 Code §954(c)(1)(B)(ii).

19 Code §954(c)(4)(A).

20 Code §897(c)(4). See also Code §954(c)(4)(A), id.

treats the gain as if it produced ordinary income.[21]

The foregoing provisions of U.S. tax law lead to the following conclusion: When a non-U.S. person sells an interest in a partnership that does not own U.S. real property, the gain is covered by the general rule of U.S. tax law that a partnership interest is a capital asset. U.S. law adopts no general rule applicable to all taxpayers or any specific rule applicable to foreign persons under which the partner is treated as if it disposed of its share in the underlying assets of the partnership. Consequently, the gain should not be considered to produce effectively connected income.

VALIDITY OF REV. RUL. 91-32

The I.R.S. Position

"When a non-U.S. person sells an interest in a partnership that does not own U.S. real property, the gain is covered by the general rule . . . that a partnership interest is a capital asset."

Notwithstanding the foregoing provisions of U.S. law, the I.R.S. has issued several rulings, in the international context, in which it applied a strict look-thru rule for sales of interests in partnerships. The first, Rev. Rul. 89-85, 1989-2 C.B. 218, involves a C.F.C. that was a partner of a foreign partnership engaged in transactions with a party related to the C.F.C. The ruling holds that a look-thru approach must be adopted under the general principles of U.S. tax law applicable to partnerships and, as a result, the derived foreign base company income that was taxable to the U.S. shareholder of the C.F.C. The fact pattern is identical with the those in *Brown Group v. Commr*.[22] This ruling has no validity in light of the holding in *Brown Group*.

The second, Rev. Rul. 91-32, addressed the taxation of a foreign person who disposed of a partnership interest where the partnership owned assets in the U.S. The ruling considered the gain or loss to be attributable to the global property owned by the L.L.C. This means that to the extent the assets of the U.S. office of the partnership are indirectly sold, the gain from the sale of the partnership interest would be U.S.-source gain considered to be effectively connected income and therefore subject to U.S. Federal income tax. On the other hand, to the extent that the partnership's assets are located outside the U.S., the gain from the sale of the partnership interest would be foreign-source gain that is not effectively connected income. The same conclusion would be reached in the context of an income tax treaty or simply in the context of U.S. domestic tax law. In sum, the I.R.S. applied the aggregate theory of partnerships and looked to Rev. Rul. 89-85 for justification of its application in determining the source and character of partner gain. As a result, the classification of the character of the gain as effectively connected income and the source of the gain as U.S. source would be controlled by the character and source that would be derived by the underlying partnership in a hypothetical sale of all its assets.[23]

In the context of income tax treaties, the I.R.S. has applied the same approach, reasoning that in determining a partner's gain from the disposition of interests in a partnership, it is appropriate to look to a foreign partner's interest in the assets of the partnership. Under this approach, gain or loss realized by a non-U.S. partner upon the disposition of its interest in a partnership that has a U.S. permanent establishment is gain or loss that is attributable to the permanent establishment.

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21 Code §751.

22 *Supra* note 16.

23 Code §§865(e)(2) and (3) in conjunction with the look-thru principle under Code §875.

Is the I.R.S. Position a Correct Interpretation of the Law?

While a revenue ruling will be respected by the I.R.S., it is not binding precedent on a court of law. It represents the I.R.S. interpretation of the law, but that interpretation may not be correct.[24] This is illustrated by a case before the U.S. Tax Court, *Grecian Magnesite Mining, Industrial & Shipping Co., SA, v. Commr*.[25] in which the validity of Rev. Rul. 91-32 is the principal issue. The case was tried and briefed in 2014, but no decision has been rendered as of the date of this article.

Rev. Rul. 91-32 Analysis Relies on Cases that Have Not Addressed the Issue

The I.R.S. position expressed in Rev. Rul. 91-32 is unsupported by applicable provisions of U.S. tax law and the case law. The cases cited simply do not make the point hoped for by the I.R.S.

In Rev. Rul. 91-32, the I.R.S. referred to *Unger v. Commr*.[26] in support of the proposition that income from the disposition of a partnership interest by the foreign partner should be attributable to the foreign partner's fixed place of business in the U.S. However, *Unger* did not address that issue. *Unger* addressed the issue of whether gain that is derived by a resident of Canada from a sale of U.S.-situs property by a U.S. partnership engaged in a U.S. business, where the sale is negotiated by the general partner, is taxable to a Canadian resident individual who is a limited partner of the U.S. partnership. That transaction bears no similarity to the transaction considered in Rev. Rul. 91-32 beyond the presence of a Canadian resident and the existence of a U.S. partnership or the equivalent.

Unger involved the application of Code §875, under which a foreign person is considered to be engaged in a trade or business within the U.S. if the partnership of which the foreign person is a member is so engaged. In Unger, the U.S. partnership actively participated in arranging sales and did so on a regular basis. Thus, the U.S. office of the partnership met the material factor test and the ordinary course requirement for the partnership income to be considered effectively connected income from the sale of personal property.

Rev. Rul. 91-32 Is Inconsistent with Code §741

In Rev. Rul. 91-32, the I.R.S. ignores the plain meaning of Code §741, which codifies the separate entity approach when evaluating the character of gain from the sale of a partnership interest. Code §741 provides as follows:

> In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items).

The clear meaning of Code §741 is that a partnership interest is an asset that is separate and apart from an indirect interest in partnership assets.

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[24] See, generally, Linda Galler, "Judicial Deference to Revenue Rulings: Reconciling Divergent Standards," *Ohio State Law Journal* 4 (1995).

[25] Docket No. 19215-12.

[26] T.C. Memo 1990-15.

In *Pollack v. Commr.*,[27] the Tax Court addressed the application of Code §741 to the sale of a partnership interest. In the case, a management consultant invested $50,000 to become a limited partner in a venture capital business. The management consultant anticipated that he would get a considerable amount of consulting work out of the fledgling and troubled businesses with which the venture capital firm would be dealing. However, things did not work out as hoped, and the management consultant sold his interest for $23,000, incurring a loss. He claimed that the loss was an ordinary loss because it related to the underlying business of the partnership. The I.R.S. contended that except in the limited circumstances set forth in Code §751 (and also for F.I.R.P.T.A. purposes), the underlying assets are not relevant in determining the character of the gain derived from the sale of the partnership interest. The court explained that Code §741 was a codification of the partnership entity theory embodied in several pre-1954 cases. The only exception to the separate entity approach was the cross-reference to Code §751, which merely converts capital gain treatment into ordinary income but does not otherwise provide flow-thru treatment for the assets of the partnership to the partners.[28]

Code §751 sets forth the specific partnership items that can cause a capital gain from the sale of a partnership interest to be converted into ordinary income. None of these items are relevant for Rev. Rul. 91-32 purposes. They involve the following:

- Partnership receivables if a partnership reports income under the cash method of accounting and has not reported the profits from the sale
- Recapture under Code §617 of partnership mining exploration expenditures that were previously deducted against ordinary operating income
- Recapture of deferral embedded in shares of stock in a domestic international sales corporation (a "D.I.S.C."), a form of export subsidy in the U.S.
- Recapture of depreciation under Code §1245 on items of depreciable personal property
- Recapture under Code §1248 of the earnings of a foreign corporation that is a C.F.C.
- Recapture of depreciation under Code §1250 for depreciable real property
- Recapture of soil and water conservation deductions under Code §1252
- Recapture of interests in franchises, trademarks, and trade names under Code §1253 if the selling partner retains certain rights in the intangible property
- Recapture of oil and gas, geothermal, and other mineral properties under Code §1254(a)
- Recapture of market discounts that would be treated as interest income pursuant to Code §1276 in connection with market discount bonds and short-term obligations
- Recapture of deferred rental income under Code §467(c) for economically

[27] 69 T.C. 142 (1977).

[28] Treas. Reg. §1.751-1(a)(2).

accrued but deferred rent

The amount of the gain from the sale of a partnership interest that is treated as ordinary income is based on the recapture that would be mandated under the foregoing provisions as if the listed assets were sold at fair market value in a fully taxable transaction for cash.[29] However, the actual transaction of the taxpayer is not treated as anything other than a sale of the partnership interest.

As a result, Code §741 supports the application of the entity theory of partnerships when dealing with a sale of a partnership interest. Accordingly, whether the gain is effectively connected income is dependent on the activity that gives rise to the sale, not the assets owned by the partnership. The source of the gain will be dependent on the residence of the seller and not the income generated by the assets of the partnership.

Aggregate Approach is Applied Only When Expressly Mandated by Congress

In comparison to the approach taken by Code §751 – a measuring device for determining the amount of capital gain from the sale of a partnership interest that is converted into ordinary income – Code §897(g) provides a direct look-thru rule when a partnership holds a "U.S. real property interest" and a foreign partner sells or otherwise disposes of an interest in the partnership. Code §897(g) provides as follows:

> Under regulations prescribed by the Secretary, the amount of any money, and the fair market value of any property, received by a nonresident alien individual or foreign corporation in exchange for all or part of its interest in a partnership, trust, or estate shall, to the extent attributable to United States real property interests, be considered as an amount received from the sale or exchange in the United States of such property.

The regulations appear at Treas. Reg. §1.897-7T(a).

Enactment of Code §897(g) would not have been necessary if the aggregate theory of partnerships were applicable to a sale of a partnership interest, as proposed in Rev. Rul. 91-32. Where Congress believed an exception to the general entity treatment under Code §741 was appropriate, it enacted a specific exception to the entity theory. Because Congress provided for a look-thru rule when it wanted to address a certain problem, it is clear that the absence of a specific aggregate rule for determining source and character of gain on sale of a partnership interest by a foreign partner is intentional. Consequently, the general entity rule of Code §741 should apply to a sale by a foreign partner.

Rev. Rul. 91-32 Fails to Address Case Law Reaching Opposite Conclusion

There are several cases addressing the aggregate versus entity theory in general. In the absence of abusive tax planning, they hold that the separate entity approach prevails in connection with the treatment of a partnership interest.

Pollack v. Commr. has already been discussed. In that case, the I.R.S. argued, and the court confirmed, that the underlying assets of a partnership are not relevant in

[29] *Id.*

determining the character of the gain derived from the sale of the partnership interest. Code §741 codified the holdings in several cases that pre-dated the Internal Revenue Code of 1954.

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Petroleum Corp. of Texas Inc. v. United States[30] involved the sale of a partnership interest. In that case, the taxpayer corporation distributed partnership interests to its shareholders in a complete liquidation that was then tax free under the version of Code §336 enacted prior to the 1986 Tax Reform Act. The partnership owned several assets that had been depreciated and would have been subject to depreciation recapture if sold by the partnership.

The taxpayer argued that partnership interests were not listed in the applicable Code sections that dealt with recapture, and therefore, no recapture was required. By contrast, the I.R.S. applied a look-thru approach to impose recapture taxation. The Fifth Circuit adopted the taxpayer's position:

> We find it significant that not until well after Taxpayers' liquidating distributions had been made did Congress enact Code Section 386, specifically requiring a corporation which, after March 31, 1984, distributes an interest in a partnership holding recapture property, to recognize its share of gain attributable to such property. Had the enactment of Code Section 386 been merely a codification of existing law, there would have been no reason for Congress to specify, as it did, that the new provision would only be applied prospectively. Thus, the Code provisions were applicable when Taxpayers made the 1983 liquidating distributions of interests in partnerships holding recapture property simply do not support the district court's finding that, for tax purposes, Taxpayers were deemed to have distributed property subject to the Code's recapture provisions. If anything, the enactment of Code Section 386 in its 1984 form, and the way it was enacted with prospective applicability only, confirm Taxpayers' contention that before the subject amendment the law was not as urged by the government.

Another case, *Holiday Village Shopping Center v. United States*,[31] involved a recapture issue very similar to that presented in *Petroleum Corp*. In *Holiday Village*, the taxpayer corporation owned a 99% interest in a partnership that owned and operated residential real property. The partnership had taken accelerated depreciation deductions. The corporation distributed the 99% partnership interest to its shareholders as part of a complete liquidation that qualified for tax-free treatment under the law then in effect, and the taxpayer asserted the depreciation recapture rules then in effect did not apply. By contrast, the I.R.S. asserted a look-thru rule applied so that recapture was required.

The Court of Appeals for the Federal Circuit held for the I.R.S. and applied a look-thru rule, but with an important caveat. The court noted as follows:

> Holiday Village also informed us that there were only two partners. The *99 percent interest* in the partnership that Holiday Village had, realistically gave it an *owner's interest in the partnership property*

[30] 939 F.2d 1165 (5th Cir. 1991).

[31] 773 F.2d 276 (Fed. Cir. 1985).

> *as effectively as if it had owned the property directly*. *Under these circumstances* the partnership should not be viewed as an independent taxable entity wholly separate from and independent of its two partners. [Emphasis added].[32]

The court's holding in *Holiday Village* was fact-specific and dependent upon the court's determination that the taxpayer's 99% partnership interest was tantamount to complete ownership of the underlying property. The Court of Appeals for the Fifth Circuit in *Petroleum Corp.*, previously discussed, reached a contrary conclusion, distinguishing it from the facts in *Holiday Village* as follows:

> We do not intend to create a conflict between this circuit and the Federal circuit when we find *Holiday Village* inapposite to the instant case. Rather, we distinguish this case from *Holiday Village* on the facts. Here, as conceded by the government, all transactions had valid business purposes and were not conceived or entered into in avoidance of taxes. That cannot be said with regard to facts of *Holiday Village*.[33]

The Court of Appeals for the Eleventh Circuit in *Coggin Automotive Corp. v. Commr*.[34] agreed that *Holiday Village* was properly distinguished on the basis of control. In *Coggin*, the taxpayer was a C-corporation that operated as a holding company. *Coggin*, the taxpayer, owned varying majority interests in five subsidiary C-corporations. The five subsidiaries owned six automobile dealerships.

As part of a plan to create six separately controlled businesses, the shareholder of the taxpayer formed six S-corporations, each of which became the general partner of a separate limited partnership. Each of the existing subsidiaries contributed its business assets and liabilities to a separate partnership on the basis of one business to one partnership. Each subsidiary received an interest as a limited partner. The restructuring served several purposes: (i) It assisted in the succession planning for the shareholder; (ii) it supported efforts to retain qualified general managers and key employees of the automobile dealerships by providing ownership incentives; and (iii) it afforded the general managers greater flexibility than the corporate form.

As part of the plan, the subsidiaries were liquidated into the taxpayer, Coggin. The partnerships continued to operate and continued to use the L.I.F.O. (last in, first out) method of accounting. Coggin then made an S-election, and the I.R.S. argued that the L.I.F.O. reserve in the partnerships was subject to recapture under Code §1363(d). The I.R.S. position was posited on two factors: (i) Coggin converted into an S-corporation, and (ii) in the year preceding the election, the partnerships valued inventory under the L.I.F.O. method of accounting.

The I.R.S. argued that the assets of the partnerships were attributed to Coggin, the limited partner, under the aggregate theory of accounting. The Court of Appeals disagreed. According to the court, the partnership owned inventory and Coggin owned partnership interests and no look-thru rule was applicable. In reaching its decision, the Court of Appeals chose to follow the holding in *Petroleum Corp.* over the contrary ruling in *Holiday Village*, stating as follows:

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32 *Id.*, at 279-280.

33 *Petroleum Corp.*, 939 F.2d at 1167 n.1.

34 292 F.3d 1326 (11th Cir. 2002).

> Although the Federal Circuit reached a contrary conclusion on the recapture issue in *Holiday Village*, 773 F.2d at 279, the Fifth Circuit in *Petroleum Corporation* distinguished Holiday Village on the basis that there was no legitimate business purpose present in Holiday Village, therefore the application of substance-over-form principles was appropriate. *Petroleum Corp.* 939 F.2d at 1167 n.1. We agree.
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> It is undisputed that the . . . restructuring transaction had economic substance and a valid business purpose. The aggregate theory does not override the clear language of the statute. In accordance with *Petroleum Corporation*, we must follow the statute and not extend it by using judicially-created look-through principles.[35]

In *PDB Sports Ltd. v. Commr.*,[36] the taxpayer was a partnership that owned a professional sports franchise including, among other assets, professional football player contracts. An interest in the partnership had been sold and, following the sale, the partnership adjusted its tax basis in its assets, including the player contracts, pursuant to Code §732(d). The issue presented was whether Code §1056 applied to preclude the basis step-up with respect to the player contracts.

The taxpayer argued that Code §1056 was inapplicable because that provision applies only to sales or exchanges of a sports franchise, and no sports franchise had been sold. The I.R.S. argued for a look-thru of the partnership interest, as if the partnership sold a portion of the interests. The Tax Court declined to apply a look-thru approach, stating as follows:

> The absence of express provisions in Code §1056 to address partnership transactions more likely indicates that it does not apply to basis adjustments available to partners who purchase partnership interests.[37]

In *George Edward Quick Trust v. Commr.*,[38] the taxpayer was a trust that had acquired a one-half interest in a partnership from the estate of the decedent who had been a partner in the partnership. The question presented was whether the trust could obtain a step-up in the basis of the partnership interest by reason of Code §1014(a) relating to the fair market value of assets received from a decedent. If the step-up in basis could be obtained, the partnership could elect to have that stepped-up basis pushed down to certain receivables. Since the partnership followed the cash method of accounting, without the step-up, the basis in the receivable was zero.

Code §1014(a) is subject to a limitation relating to income received from a decedent. Pursuant to Code §1014(c), the basis step-up rule of Code §1014 does not apply to the extent the inherited property includes a right to receive an item of income in respect of a decedent (an "I.R.D. item"). The I.R.S. argued that the taxpayer's right to a share of the partnership's unrealized receivables constituted an I.R.D. item, thereby causing Code §1014(c) to apply. The taxpayer argued that Code §1014(c) did not apply, because the decedent died owning a partnership interest, rather than

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35 *Id.*, at 1333.

36 109 T.C. 423 (1997).

37 *Id.*, at 437-438.

38 54 T.C. 1336 (1970).

directly owning the partnership's unrealized receivables.[39] The Tax Court agreed with the I.R.S.

According to the court, the trust received a partnership interest which included rights to receive partnership income at such time as the receivables were settled by payment. To the court, this was the essence of the stepped-up value and was a classic I.R.D. item. The court also found additional statutory support for its conclusion in Code §751, previously discussed, which converts gain from the sale of a partnership interest into ordinary income to the extent it is attributable to unrealized receivables of the partnership.

"Domestic U.S. tax law mandates entity treatment for sales of partnership interests. Where Congress intended to modify the tax treatment of the sale of a partnership interest, it either broadened the scope of Code §751 or specifically provided for other treatment."

<u>*Partnership Anti-Abuse Regulations*</u>

In 1995, the I.R.S. adopted certain anti-abuse regulations in the partnership context. These regulations provide that the I.R.S. may treat a partnership as an aggregate if that treatment would carry out the policy of domestic tax law.[40] However, if a clearly articulated policy of the law mandates entity treatment, the anti-abuse rules will not apply. For the reasons expressed above, domestic U.S. tax law mandates entity treatment for sales of partnership interests. Where Congress intended to modify the tax treatment of the sale of a partnership interest, it either broadened the scope of Code §751 or specifically provided for other treatment. Because no express policy has been enacted to limit the scope of entity treatment for the sale of partnership interests, the anti-abuse rules should not mandate a conclusion different from the one mentioned above.

There are strong reasons to apply the separate entity approach:

- It is supported by the plain meaning of Code §741.
- It is supported by the standard under which gains that are effectively connected income are distinguished from gains that are not effectively connected income.
- It is supported by the problem that was addressed by the enactment of Code §897(g) and the limited scope of the solution.
- It is supported by the cases that almost uniformly recognize that a partnership interest is a separate asset.

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[39] *Id.*, at 1342.

[40] Treas. Reg. §1.701-2 provides in pertinent part as follows:

> (e) Abuse of entity treatment.
>
> (1) General rule. The Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder.
>
> (2) Clearly contemplated entity treatment. Paragraph (e)(1) of this section does not apply to the extent that – (i) A provision of the Internal Revenue Code or the regulations promulgated thereunder prescribes the treatment of a partnership as an entity, in whole or in part, and (ii) That treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.

GRECIAN MAGNESITE CASE

The validity of the I.R.S. position has been presented to the I.R.S. in *Grecian Magnesite, Mining, Industrial & Shipping Co., SA v. Commr.*, a case that was tried and briefed in 2014. A final decision has not been issued.

The facts in the case are relatively straightforward:

- Grecian Mining is a privately-owned corporation organized under the laws of Greece.
- From 2001 through 2008, it was a member of a U.S. L.L.C. that was engaged in the business of extracting, producing, and distributing magnesite.
- The business operations were carried on in the U.S.
- In 2008, Grecian Mining's interest in the L.L.C. was completely redeemed, a transaction treated as a sale or exchange of the membership interest.
- Although there were no negotiations as such, whatever discussions took place with the L.L.C. were carried on by officers of Grecian Mining based in Greece.
- The decision to proceed with the redemption was made in Greece, and all documents were signed in Greece.
- Grecian Mining did not maintain an office of its own in the U.S. and did employ individuals located in the U.S.

A portion of the redemption proceeds was properly allocable to appreciation of U.S. real property. The balance related to active business operations that appreciated in value during the period in which Grecian Mining was a member of the L.L.C. Grecian Mining was examined by the I.R.S. and a notice of deficiency was issued by the I.R.S. in 2012 – about the time that an I.R.S. field service advice was issued asserting the validity of the Rev. Rul. 91-32. The I.R.S. asserted that the capital gain was properly treated as effectively connected income because Grecian Mining was engaged in a trade or business as a result of its investment in the L.L.C. Grecian Mining's position is that the assets of the L.L.C. do not control the character of the gain from a disposition of an interest in the L.L.C. Even if it did, the gain is not treated as U.S.-source gain under U.S. tax law[41] and cannot be taxed in the U.S. as effectively connected income under the general rule that foreign-source income cannot be effectively connected income[42] except in three instances[43] that are not relevant to the facts of the case. After almost three years from submission of briefs, the Tax Court has yet to rule on the matter.

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[41] Code §865(a)(2). An exception that applies to sales attributable to a U.S. office that materially participates in a sale is not applicable as no such office existed and could not have engaged in material participation. See Code §865(e)(2)(A).

[42] Code §864(c)(4)(A).

[43] Code §864(c)(4)(B). The exceptions relate to foreign source (i) royalties derived in a licensing business, (ii) dividends, interest, and guarantee fees of a banking, financing, or similar business, and (iii) sales of inventory. In each instance, an office in the U.S. must materially participate in the income-generating transaction.

CONCLUSION

In Rev. Rul. 91-32, the I.R.S. adopted a view that the rules for characterizing gains from the sale of a partnership interest are different when the partner is not a U.S. person. In so doing, it ignored the clear policy behind Code §741, and asserted that, for a foreign partner, the sale involves a disposition of an indirect share in the underlying assets of the partnership. The weakness in the I.R.S. position is that when Congress enacted Code §897(g) and limited the provision to sales of interests in a partnership owning U.S. real property, it effectively acknowledged that the general rule of Code §741 continued to apply to all other sales. Indeed, when a partnership owns real property and other business property, Code §897(g) affects the real property. The matter will be decided when the Tax Court issues its opinion in *Grecian Magnesite Mining Industrial and Shipping Co SA v. Commr*.