FOREIGN PARTNER NOT SUBJECT TO U.S. TAX ON GAIN FROM REDEMPTION OF U.S. PARTNERSHIP INTEREST

Authors
Neha Rastogi
Elizabeth Zanet
Nina Krauthamer

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In *Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commr.,*[1] the U.S. Tax Court recently held that a foreign partner was not subject to U.S. Federal tax when it redeemed its interest in a U.S. partnership and that the capital gain realized was not "U.S.-source income" and not "effectively connected to a U.S. trade or business" (discussed in detail below). In so holding, the Tax Court rejected the I.R.S. analysis in Revenue Ruling 91-32.[2]

This case represents a significant victory for the taxpayer. In addition to rejecting the I.R.S.'s "aggregate" approach to the taxation of a disposition of partnership interests by foreign partners, it arguably bolsters the Tax Court's holding in *Pierre v. Commr.*,[3] a case in which it determined that a transfer of interests in a limited liability company ("L.L.C.") that was a disregarded entity for U.S. Federal tax purposes was a transfer of the interests in the entity, and not a transfer of the entity's underlying assets, for U.S. Federal gift tax purposes.

BRIEF FACTS

Grecian Magnesite Mining, Industrial & Shipping Co., S.A. ("Grecian") was a foreign corporation in the business of extracting, producing, and selling magnesite. Grecian directly owned an interest in Premier Chemicals L.L.C. ("Premier"), a Delaware L.L.C. in the business of extracting, producing, and selling magnesite in the U.S. For U.S. Federal tax purposes, Premier was treated as a partnership. Other than through its ownership of Premier, Grecian had no office, employees, nor business operations in the U.S.

Grecian entered into an agreement to redeem its entire interest, of 12.6%, in Premier for $10.6 million in cash. The redemption was effectuated in two payments in which Grecian realized total gain of $6.2 million. The parties agreed that $2.2 million of the realized gain was attributable to Premier's U.S. real property.

Though initially Grecian took the position that the full $6.2 million of gain was not U.S.-source income – and thus not subject to U.S. Federal income tax – it later conceded that the $2.2 million of gain attributable to the U.S. real property was subject to income tax under Internal Revenue Code ("Code") §897(g) (discussed in detail below) and filed a U.S. Federal corporate income tax return to report and pay the tax. The dispute that reached the Tax Court was whether the remaining $4 million was U.S.-source income that is effectively connected with a trade or business in the U.S.

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[1] 149 T.C. 3 (2017).

[2] 1991-1 C.B.107.

[3] 133 T.C. 24 (2009).

Foreign persons, including foreign corporations such as Grecian, generally are subject to U.S. Federal income tax on "U.S.-source income," which generally consists of two broad categories of income:

- Investment income such as dividends, interest, rents, and royalties, which is referred to as fixed or determinable annual or periodic ("F.D.A.P.") income
- Income that is effectively connected with a trade or business in the U.S.

In the case at hand, the I.R.S. did not assert that the disputed gain was F.D.A.P. income. Premier was an operating company, thus most of its income likely was from the active operation of its mining business and not investment income. Accordingly, the court stated it would only consider whether the disputed gain was income effectively connected with a U.S. trade or business.

AGGREGATE V. ENTITY APPROACH

The court noted that the rules of partnership taxation (found in Subchapter K of the Code) at times treat partnerships as an aggregate of partners and under other circumstances treat partnerships as entities in their own right. An example of the aggregate approach is when a partner determines its distributive share of the partnership's taxable income or loss. In this context, the partnership as an entity with a distinct legal existence is ignored. Instead, it is considered an aggregation of partners, with each partner reporting its distributive share of the partnership's taxable income or loss.

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In the context of a redemption of a partnership interest, the court determined that the entity approach (with some exceptions discussed below) must be followed. The court's analysis was as follows:

- Code §736(b)(1) provides the general rule for liquidating payments made to a partner in redemption of its partnership interest, and states that such liquidating payments be considered as **a distribution by the partnership**.
- Code §731 governs the taxation of distributions by a partnership to a partner, and states that in such case "any gain or loss recognized under this subsection shall be considered as gain or loss from the **sale or exchange of the partnership interest of the distributee partner** (emphasis added)."
- Code §741 provides the general rule for sales or exchanges of a partnership interest, and states that gain or loss must be recognized by the transferor partner, and that such gain or loss will be considered as gain or loss from **the sale or exchange of a capital asset**.

The court noted that under the above analysis, the partnership is conceived of as an entity distinct from its partners, and a partner pays tax on a 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." It rejected the aggregate approach argument asserted by the I.R.S., which would have required treating the partner's redemption of a partnership interest as the partner's deemed sale of separate interests in each asset owned by the partnership.

The court acknowledged that Congress explicitly carved out exceptions to Code

§741 and that, when such an exception applies, the aggregation approach is required so that the sale of the partnership interest may be treated (at least in part) as a sale of the partnership's underlying assets. By its own terms, Code §741 acknowledges one such exception because it is a general rule that applies "except as otherwise provided in Code § 751," which applies when a partnership's underlying assets include unrealized receivables or inventory items (so-called hot assets).

Code §751(a) recharacterizes gain from a sale or exchange of a partnership interest attributable to the partnership's hot assets as ordinary income rather than capital gain. Code §751(b) provides for recharacterization of distributions (including liquidating distributions) from a partnership to a partner to the extent the partner receives a disproportionate share of hot assets, or other partnership property for the partner's share of the partnership's hot assets. The court specifically stated that since the I.R.S. did not assert that Code §751(b) was applicable, it would not consider it. Nonetheless, footnote 16 of the opinion suggests that, Code §751(b), might be an exception to Code §741 in appropriate circumstances, in the same manner as Code §897(g). It is much less clear that Code §751(a) can be read the same way.

Code §897(g) states that the amount realized by a foreign person, such as a foreign corporation, in exchange for a partnership interest, to the extent attributable to U.S. real property, will be considered as an amount received from the sale or exchange of in the U.S. of such property. Thus, under Code §897(g), the amount realized by Grecian attributable to Premier's U.S. real property was U.S.-source income that was effectively connected to a U.S. trade or business, and thus, subject to U.S. Federal income tax.

In the end, the court stated that if the I.R.S.'s aggregation approach was correct, the exceptions to Code §741 in Code §§751 and 897(g) would be superfluous.

FOREIGN PARTNER'S GAIN FROM REDEMPTION OF U.S. PARTNERSHIP INTEREST WAS NOT U.S.-SOURCE INCOME

After it established that the disputed gain constituted income from the sale of personal property in the form of an indivisible capital asset, the court turned to the question of whether that gain was subject to tax under the rules governing international transactions (found in Subchapter N of the Code).

The Tax Court declined to defer to the I.R.S.'s holding in Revenue Ruling 91-32, which determined that gains realized by foreign partners on the dispositions of interests in U.S. partnerships should be analyzed asset by asset and that, to the extent that the assets of the partnerships would give rise to effectively connected income ("E.C.I.") if sold by the partnerships, the departing partners' *pro rata* shares of such gains should be treated as E.C.I. The court stated that the ruling was incorrect because it essentially imposed a Code §751-type analysis for all partnership assets that generate E.C.I. and such an exception is not supported by the Code.

The court began its analysis with Code §882, which states that a foreign corporation engaged in a trade or business in the U.S. is taxable on taxable income which is **effectively connected with the conduct of a trade or business in the U.S.**[4]

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[4] Under Code §881, a foreign corporation may also be taxable on U.S.-source

Under Code §875(1), Premier's U.S. trade or business was attributable to Grecian because a foreign corporation is considered engaged in a U.S. trade or business if the partnership of which such corporation is a partner is so engaged.

Since Grecian was engaged in a U.S. trade or business by virtue of its Premier partnership interest, the next question was whether the gain from the redemption of the partnership interest was income effectively connected with the conduct of Premier's U.S. trade or business, which, as discussed above, was mining for magnesite.

E.C.I. is defined under the rules of in Code § 864(c). Code §864(c)(3) states that if a foreign partner is engaged in a U.S. trade or business, all income gain or loss from sources within the U.S. (other than F.D.A.P. income) is treated as effectively connected with the conduct of a trade or business within the U.S. As previously discussed, the I.R.S. did not assert that the disputed gain was F.D.A.P. income. Thus, if the disputed gain was U.S.-source income, then Code §864(c)(3) would treat it as effectively connected with Premier's U.S. trade or business. Accordingly, the next question addressed by the court was whether the disputed gain was U.S.-source income.

Code §§861 to 863 and 865 provide the income sourcing rules. The court noted that there is no Code provision that governs the source of a foreign partner's income from a sale or liquidation of its interest in a partnership. However, the general rule for gain realized from the sale of personal property, such as Grecian's partnership interest, is found in Code §865(a). Under that section, if the amount is realized by a nonresident, such as a foreign corporation, the gain is sourced outside the U.S. and, thus, is not U.S.-source income. Under this analysis, unless an exception to Code §865(a) applied, the source of the disputed gain would be non-U.S. and, thus, not subject to U.S. Federal income tax in the hands of Grecian.

The I.R.S. argued that an exception to Code §865(a), referred to in the decision as the "U.S. office rule" exception, applied. The court proceeded to analyze – and dismantle – the I.R.S. argument.

The U.S. office rule exception for nonresidents is found in Code §865(e)(2)(A), and generally states:

> If a nonresident maintains an office or other fixed place of business in the United States, then the income from a sale of personal property attributable to such office or other fixed place of business shall be sourced in the United States.

The sales income will be attributable to the U.S. office or fixed place of business, if the U.S. office

- is a material factor in the production of such income, and
- regularly carries on activities of the type from which such income, gain, or loss is derived.[5]

F.D.A.P. income. However, as discussed above, the I.R.S. did not assert that F.D.A.P. income was present in this case, so the analysis was confined to Code §882.

[5] Code §864(c)(5)(B). (Under §865(e)(3), the U.S. office rule exception must be determined under the principles of Code §864(c)(5).)

Further, the regulations state that "regularly carries on" means realized in the ordinary course.[6]

The I.R.S. argued (and the court assumed) that Premier's U.S. office is deemed to be Grecian's U.S. office. In trying to show that the disputed gain was attributable to Premier's U.S. office, the I.R.S. argued that Premier's U.S. office was material to the deemed sale of Grecian's portion of the partnership's assets and material to the increased value of Grecian's partnership interest during Grecian's tenure as partner. The court dismissed the first argument because it hinged on the aggregation approach, which it already had determined was not the correct analysis. As to the second argument, the court stated that the I.R.S. was conflating the ongoing value of a business with gain from the sale of an interest in that business. That is, the disputed gain was not realized from Premier's mining business (*i.e.*, activities at the partnership level) but rather at the partner level, from the distinct sale of Grecian's partnership interest. Further, the regulations state that adding substantial value to intangible property (in this case, the going concern value of Premier) is not a material factor.[7] Finally, since Premier's business was mining, and not buying and selling partnership interests, the redemption was not in the ordinary course but rather an extraordinary event.

In summary, the court determined that since the disputed gain was not attributable to a U.S. office or other fixed place of business, it was not U.S.-source income. Consequently, the disputed gain was not E.C.I. and, therefore, not taxable in the U.S.

COMPARISON TO THE *PIERRE* CASE

In *Pierre*, the taxpayer, Suzanne Pierre, had $10 million in cash that she wanted to use to provide for her son and granddaughter. She entered into a plan under which she formed Pierre L.L.C., a single member limited liability company ("S.M.L.L.C.") validly formed under New York law and disregarded for Federal tax purposes under the Treasury entity classification regulations (the "Regulations"). She then created two trusts, one for her son and one for her granddaughter. Approximately two months later, she transferred cash and securities worth $4.25 million to Pierre L.L.C. Shortly after funding Pierre L.L.C. with the cash and securities, she transferred the entire interest in Pierre L.L.C. to the trusts as follows: (i) a gift transfer of a 9.5% membership interest to each trust (to use a portion of her available gift tax-related credit/exemption amounts) and (ii) a sale to each trust of a 40.5% membership interest in exchange for a secured note. The notes each had a face amount of $1.092 million, which was determined by valuing a 1% non-managing interest valued at $26,965, after applying a 36.55% discount. Pierre filed a gift tax return to report each gift of a 9.5% interest in Pierre L.L.C.

The I.R.S. argued that the transfers of the Pierre L.L.C. interests to the trusts were actually transfers of the proportionate shares of the underlying assets of Pierre L.L.C. because the entity was disregarded for Federal tax purposes under the Regulations. If the transfers were treated as transfers of the proportionate shares of Pierre L.L.C.'s underlying assets, a gift tax underpayment would arise because the discount applied to the transfers of the Pierre L.L.C. interests would not apply.

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[6] Treas. Reg. §1.864-6(b).

[7] Treas. Reg. §1.864-6(b)(2)(i).

The Tax Court disagreed with the I.R.S. and determined that the transfers were transfers of interests in Pierre L.L.C. It stated that under U.S. Supreme Court precedent, state law creates property rights and Federal tax law then defines the tax treatment of those property rights. In this case, New York law created no property rights in the underlying assets of Pierre L.L.C. because it recognized the entity as separate and apart from its owners.

The court stated that the Regulations do not disturb this long-established manner of (i) determining the nature of the gift (*i.e.*, the property interest) under state law, (ii) determining the arm's length value of the gift, and (iii) then calculating the gift tax under the Federal gift tax provisions. The Regulations determine whether an S.M.L.L.C. should be taxed as a separate entity or disregarded so that tax on its operations is borne by its owner.

"The Grecian case is an exciting judicial precedent, arising at the intersection of two highly complex areas of the U.S. tax law: partnership taxation and taxation of international transactions."

Pierre is similar to *Grecian* in that the Tax Court respected the transfer of an interest in an L.L.C. as a transfer of an interest in the entity, rather than a transfer of the L.L.C.'s underlying assets. The court in *Grecian* followed the logic of Subchapter K to determine that the aggregation approach should not apply to characterize a redemption of an L.L.C. interest as a deemed sale of the L.L.C.'s underlying assets. The court in *Pierre* arguably went further because it found that an S.M.L.L.C., disregarded for Federal tax purposes, should be respected as an entity for the purpose of valuing a transfer of an interest in an S.M.L.L.C. for Federal gift tax purposes.

CONCLUSION

The *Grecian* case is an exciting judicial precedent, arising at the intersection of two highly complex areas of the U.S. tax law: partnership taxation and taxation of international transactions. The case offers the Tax Court's step-by-step analysis of the application of and interplay between those sets of rules. Importantly, it is a pro-taxpayer determination of an issue previously interpreted under an I.R.S. ruling that was unfavorable to a foreign partner disposing of an interest in a U.S. partnership. It remains to be seen whether the I.R.S. will appeal the case or whether it will continue to litigate the issue on similar or alternative grounds.

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