GRECIAN MAGNESITE PUT TO BED: TAX COURT RULING AFFIRMED ON APPEAL

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INTRODUCTION

Recently, the Court of Appeals for the D.C. Circuit affirmed the 2017 Tax Court ruling in the matter of Grecian Magnesite *Mining v. Commr.*,[1] which held that a foreign corporation was not liable for U.S. tax on the gain from a redemption of its membership interest in a U.S. limited liability company ("L.L.C.") treated as a partnership where the L.L.C. was engaged in a U.S. trade or business. Gain attributable to U.S. real property was not at issue in the initial decision or the appeal. In so holding, it affirmed the entity view of partnerships for U.S. tax purposes as it relates to the character of the interest owned by a member.

BACKGROUND

The I.R.S. has a long history in misapplying U.S. tax rules applicable to a sale of a partnership interest. For U.S. tax purposes, a partnership interest is treated as an asset separate and apart from an indirect interest in partnership assets. In Rev. Rul. 91-32, the I.R.S. misinterpreted case law and Code provisions to conclude that gains derived by foreign investors in U.S. partnerships are subject to tax.[2] No one thought the I.R.S. position was correct, but then, in a field advice to an agent setting up an adjustment, the I.R.S. publicly stated that the ruling was a proper application of U.S. law when issued.[3]

The validity of the I.R.S. position was presented to the Tax Court in *Grecian Magnesite, Mining, Industrial & Shipping Co., SA v. Commr.*, a case that was tried and briefed in 2014. The facts in the case are relatively straightforward. Grecian Magnesite was 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 Magnesite'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 Magnesite based in Greece. The decision to proceed with the redemption was made in Greece, and all documents were signed in Greece. Grecian Magnesite did not maintain an office of its own in the U.S. but did employ individuals located in the U.S.

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

[2] For a full discussion of the validity of Rev. Rul. 91-32 prior to the holdings in the *Grecian Magnesite* decisions in the Tax Court and the Court of Appeals, see "Sale of a Partnership Interest by a Foreign Partner – Is Rev. Rul. 91-32 Based on Law or Administrative Wishes?" *Insights* 6 (2017).

[3] FAA 20123903F.

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 Magnesite was a member of the L.L.C. Grecian Magnesite was examined by the I.R.S., and a notice of deficiency was issued in 2012 – about the time that the 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 ("E.C.I.") because Grecian Magnesite was engaged in a trade or business as a result of its investment in the L.L.C. Grecian Magnesite's position on audit was that the assets of the L.L.C. did not control the character of the gain from a disposition of an interest in the L.L.C. Even if it did, the gain was not treated as U.S.-source gain under U.S. tax law[4] and cannot be taxed in the U.S. as E.C.I. under the general rule that foreign-source income cannot be E.C.I.[5] except in three instances that are not relevant to the facts of the case. After almost three years from submission of briefs, the Tax Court ruled in favor of Grecian Magnesite.

TAX COURT DECISION

At the level of the Tax Court, the I.R.S. argued that the aggregate theory of partnerships should prevail. Under this view, the redemption of the partnership interest is properly viewed as a sale of the partner's indirect interest in all the underlying assets that make up the business of the partnership. Because those assets produced E.C.I. for the foreign partner, the I.R.S. argued that the redemption gain is characterized as E.C.I. In broad terms, the I.R.S. argued that whether the L.L.C. sold the assets or the foreign partner sold a partnership interest, the tax result should not differ materially as to the character of the gain. The Tax Court rejected the I.R.S. argument and ruled that in the context of a sale of a partnership interest the entity theory should prevail. Under this view, a partnership interest is viewed as a sale of an indivisible capital asset in the form of the membership interest.

In reaching its conclusion, the Tax Court dismissed the validity of Rev. Rul. 91-32 because it improperly interpreted the text of the statute and was not supported by adequate reasoning. In declining to defer to the ruling, the court also criticized the ruling's treatment of the international issues. The Tax Court then addressed the nature of the redemption under the partnership rules of Subchapter K and determined that a redemption payment is treated as distribution by a partnership, and to the extent the distribution exceeds the basis in the partner's interest in the partnership, gain recognized in the transaction is considered gain from the sale or exchange of the partnership interest. For purposes of that transaction, the partnership is properly treated as an entity, so that the asset exchanged is the interest held by the partner and not an undivided interest in all assets owned by the partnership.

The Tax Court then addressed the source of the gain. To be taxable for Grecian Magnesite, the gain must be from a U.S. source. As the source of gain from the sale of personal property is generally allocated to the country of residence of the seller, the gain recognized by Grecian Magnesite would be considered to be foreign-source

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[4] 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).

[5] Code §864(c)(4)(A).

income unless an exception were to apply. Here the relevant exception is that gain derived by a foreign corporation could be viewed to be U.S.-source gain where attributable to the partner's U.S. office.

While Grecian Magnesite had no office in the U.S., the L.L.C.'s office was, arguably, attributed to it in connection with income generated by day-to-day operations. However, that does not mean that gain from the redemption of an interest in an L.L.C. is attributable to the office of the L.L.C.

For the gain to be U.S.-source income the L.L.C. office must (i) be a material factor in the production of the redemption gain of Grecian Magnesite and (ii) regularly carry on activities of the type from which the gain is derived – namely the redemption of membership interests. Because the actual transaction was a redemption of a membership interest and not a hypothetical sale of underlying L.L.C. assets, the L.L.C.'s office was not be a material factor in the redemption transaction.

The I.R.S. did not offer an explanation of why it believed the U.S. office was a material in the redemption transaction. Instead, it argued that the office was material in the realization of the gain because the office increased the overall value of the interest through its operation of the business. This argument was dismissed by the Tax Court.

In the Tax Court's view, the I.R.S. confused the ongoing value of a business operation and gain arising from the redemption of a membership interest. The L.L.C. office did not represent the foreign member in negotiating or performing an activity that was necessary in the realization of the redemption gain by Grecian Magnesite.

Additionally, the Tax Court ruled that even if the U.S. office of the L.L.C. were a material factor in the redemption transaction, the gain was not realized in the ordinary course of the L.L.C.'s business conducted through its office. Redeeming membership interests was not part of the day-to-day business operation of the L.L.C. Consequently, the redemption gain of a foreign member was not part of the ordinary trade or business activity carried on by the U.S. office of the L.L.C. In sum, the gain was not attributable to a U.S. office.

COURT OF APPEALS DECISION

On appeal, the I.R.S. argued that issue related to the character of the gain and the gain arose from the activity of the U.S. office. It was therefore proper to treat the gain as U.S.-source gain attributable to a U.S. office. In its view, the Tax Court erred by focusing exclusively on the selling activity. It should have looked at value creation. Because the partnership interest appreciated in value as a result of the success of the business in which the U.S. office undoubtedly participated in a material way, the gain must be attributed to that office. This argument was dismissed by the Court of Appeals.

The I.R.S. also argued the validity of the I.R.S. position enunciated in Rev. Rul. 91-32 and claimed that a long-held position of the I.R.S. is entitled to deference. The Court of Appeals disagreed. Initially the appeals court determined that Rev. Rul. 91-32. was not entitled to deference no matter the length of time it was held by the I.R.S.:

> While the Revenue Ruling has the benefit of longevity—it has been the IRS's unchanged position for some thirty years—little else militates in favor of deferring to it. The pertinent portion comprises a single unreasoned sentence in a Ruling that spans four pages of the Cumulative Bulletin. . . . That sentence cites the relevant statute, § 865(e)(3), but without any elaboration. And it also cites a Tax Court decision, *Unger v. Comm'r*, 58 T.C.M. (CCH) 1157, 1159 (1990), which neither involved nor purported to opine on the attribution of income from the sale of personal property by a foreign partner.

Having addressed the first two arguments of the I.R.S., the Court of Appeals focused on the regulations and legislative history behind the adoption of the E.C.I. concept in the Code. Both clearly indicate that the U.S. office rule is directed to the transaction rather than the appreciation of the asset. The Court of Appeals explained:

> The provisions at issue apply not only to the disposition of partnership interests but also to the sale of myriad other personal property. It is doubtful that Congress would have intended to source income according to the innumerable forces that change the market value of most personal property. In that light, Congress's choice to emphasize the sale struck an understandable balance between its dual aims of administrability and avoiding manipulation.

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Having ruled that the gain can be effectively connected only when the activity of the U.S. office is a material factor in arranging the transaction, the Court of Appeals examined whether the U.S. office materially participated in the redemption transaction. The I.R.S. argued that partnerships are inherently engaged in the business of managing transactions with members, and therefore, the U.S. office of the L.L.C. should be viewed as regularly being engaged in activities like redemptions. Again, this argument was dismissed.

In the view of the Appeals Court, the U.S. office of the L.L.C. regularly carried on activities related to the magnesite-mining business. It was not in the business of carrying on the redemption activities of its members. Production and sale of magnesite comprised the principal activity of the L.L.C., and that activity was carried on regularly by L.L.C. employees. In comparison, the redemption of membership interests was a rare occurrence. Therefore, redemptions were not part of the regular trade or business of the L.L.C.

CONCLUSION

As a final point, the Court of Appeals noted that its decision has little significance as a matter of prospective transactions. The Tax Cuts and Jobs Act of 2017 revised the tax law after the Tax Court issued its decision by adopting the aggregate theory of partnerships when determining the character of gain arising from a disposition or redemption of a partnership interest. That legislation enshrines one of the positions the I.R.S. unsuccessfully advanced before the Tax Court. The amended provision will control the outcome of disputes arising under the revised law. A dispute arising from prior law is controlled by the principles of prior law discussed here.

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