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Tax Court Declines to Follow IRS Ruling on Foreign Partner's Redemption Gain

In a significant setback for the IRS, the U.S. Tax Court held in a July 13 opinion that a foreign corporation did not have to pay U.S. tax on gain realized from the redemption of a partnership interest. While the decision specifically concerns the redemption of a partnership interest, its holding should apply to the sale of a partnership interest as well. The decision overturns controversial formal IRS guidance that has been widely cited—and criticized—for over a quarter century.

In *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Comm'r*, 149 T.C. No. 3, the U.S. Tax Court considered whether certain gain realized by a foreign corporation on the redemption of an interest in a limited liability company (LLC) taxed as a partnership should be treated as gain that was "effectively connected" with a U.S. trade or business and thus subject to U.S. taxation.

In 2001, the foreign corporation acquired a minority interest in a Delaware LLC in exchange for a capital contribution. Other than this interest in the LLC, the foreign corporation had no office, employees, or business operations in the United States. The LLC was actively involved in the mining business in locations throughout the United States and was headquartered in Pennsylvania. The LLC was treated as a partnership for U.S. tax purposes. In 2008, the LLC redeemed the foreign corporation's interest in the LLC for cash. At issue was whether a \$4 million gain the foreign corporation realized on the redemption was subject to U.S. tax.

The case involves fundamental principles of both international taxation and partnership taxation. In general, a foreign business entity is subject to U.S. tax only on U.S.-source income that is either (i) income "effectively connected" with a U.S. trade or business or (ii) "fixed or determinable annual or periodic" income. Gain from the sale of a capital asset is generally not taxable in the United States, unless the gain (i) arises from the sale of U.S. real property or from an interest in certain entities holding U.S. real property or (ii) is from the sale of property used in a U.S. trade or business.

On the partnership tax side, the general rule is that a partner is considered engaged in the business conducted by the partnership. Under this rule, a foreign business entity holding an interest in a partnership is taxable on its share of "effectively connected" income earned by the partnership. In the present case, the income earned by the LLC from activities in the U.S. was "effectively connected" income.

In arguing that the foreign corporation's \$4 million gain on redemption of its interest in the LLC was subject to U.S. tax, the IRS cited Revenue Ruling 91-32, issued in 1991. That ruling holds that gain recognized by a foreign partner on the sale or exchange of a partnership interest is subject to U.S. tax to the extent the underlying assets of the partnership generate income which is "effectively connected" with a business conducted in the United States. This is a significant exception to the general rule, i.e., that a foreign business entity is not taxable in the United States on the sale of most capital assets.

A Revenue Ruling is a public pronouncement by the IRS of its position on a legal issue. Although Revenue Rulings are not legally binding on taxpayers, courts ordinarily grant significant deference to such rulings, particularly when they have been in effect for a long time. This ruling, however, has been controversial. Practitioners have long questioned it, though it has been largely respected because it was never successfully challenged in court or otherwise withdrawn by the IRS.

The Tax Court, in ruling against the IRS, rejected the conclusion in Revenue Ruling 91-32, finding its reasoning unpersuasive. Accordingly, the court held that the disputed gain was not "effectively connected" income and thus was not subject to U.S. taxation.

This decision likely marks the beginning rather than the end of the story. The IRS likely will appeal the decision or seek to have Congress make statutory changes that codify the conclusions in Revenue Ruling 91?32. Nevertheless, the decision may provide a basis for non-U.S. taxpayers to take the position that they should not owe U.S. tax on the disposition of interests in partnerships conducting business in the United States, at least under certain circumstances. Moreover, the decision, if it stands, may ultimately have implications for the way investments in the United States are structured, which up to now have often been done through "blocker" corporations.

If you would like to discuss how this Tax Court decision may affect recent transactions you have undertaken or your plans for the future transactions, we encourage you to contact your attorney at Day Pitney LLP.

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