SALE OF U.S. OPERATING PARTNERSHIPS BY NON-U.S. PERSONS MAY NOT GENERATE ECI—U.S. TAX COURT DECLINES TO FOLLOW REVENUE RULING 91-32

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U.S. Tax Alert

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In a recently published decision,[1] the U.S. Tax Court declined to follow the longstanding position of the U.S. Internal Revenue Service ("IRS"), articulated in Revenue Ruling 91-32,[2] that a non-U.S. partner's gain or loss from the disposition of an interest in a partnership that is engaged in a U.S. trade or business will be subject to U.S. net income taxation as "effectively connected income" to the extent attributable to unrealized appreciation in underlying partnership assets employed in that U.S. trade or business. Provided that the decision is not overturned on appeal or through legislative or regulatory action, the decision significantly alters the U.S. tax consequences of the disposition of partnership interests by non-U.S. persons and may impact the structuring of investments by non-U.S. persons in partnerships that are engaged in a U.S. trade or business.

BACKGROUND: EFFECTIVELY CONNECTED INCOME AND REVENUE RULING 91-32

Non-U.S. persons generally are subject to U.S. net income taxation on U.S.-source income (and certain foreign-source income) that is effectively connected with the conduct of a U.S. trade or business ("ECI"). Under Section 875(1) of the Internal Revenue Code (the "Code"), [3] a non-U.S. person that invests in a partnership generally is treated as engaged in a U.S. trade or business to the extent the partnership is so engaged. Thus, a non-U.S. partner, even though not directly engaged in a U.S. trade or business, may be subject to tax on allocations of U.S.-source operating income to the extent effectively connected with the partnership's U.S. trade or business.

By contrast, the appropriate tax treatment of a non-U.S. partner upon the disposition of a partnership interest has been less clear. As noted above, generally income must be U.S.-source to be treated as ECI. Under the Code's sourcing rules, income from the sale of personal property by a non-U.S. person generally is treated as foreign-source, unless the non-U.S. person maintains an office or other fixed place of business in the United States and the income is attributable to that office. Further, subject to certain exceptions, the Code's partnership tax rules appear generally to treat the disposition of a partnership interest as the disposition of a unitary capital asset (i.e., the gain or loss realized upon the disposition of a partnership interest is generally determined solely by reference to the partnership interest rather than the underlying assets). Thus, the Code's sourcing rules may be interpreted as treating a non-U.S. partner's income from the disposition of the partnership interest as foreign source and hence not as ECI subject to U.S. federal net income taxation.

The IRS, however, announced its position in Revenue Ruling 91-32 that, for purposes of determining the "source and ECI character" of gain or loss resulting from the disposition of an interest in a partnership that is engaged in a U.S. trade or business through a fixed office in the United States is determined by reference to the non-U.S. partner's beneficial interest in the partnership's underlying property. In other words, the ruling sources a portion of the resulting gain or loss based on the distributive share of partnership net ECI gain or loss that the non-U.S. partner would have borne if the partnership had itself disposed of all of its assets. Although not entirely clear from the ruling, it appears that the ruling's conclusion is premised on the notion that a non-U.S. partner, in disposing of a partnership interest, should be treated as realizing income from a deemed disposition of the partnership's underlying property that is attributable to the partnership's (and hence the partner's) fixed U.S. office.

GRECIAN MAGNESITE MINING

The U.S. Tax Court declined to follow Revenue Ruling 91-32, finding that the ruling was not entitled to deference due to its lack of "power to persuade" and criticizing the ruling's analysis as cursory and incomplete. Specifically, the court held that the ruling's aggregate approach (i.e., treating the partner as selling partnership assets as opposed to a partnership interest for source purposes) was inappropriate in light of the plain language of Sections 731 and 741, which view the gain or loss arising from the disposition of a partnership interest generally as arising from the disposition of a unitary capital asset (i.e., an entity approach) as opposed to the underlying partnership property (i.e., an aggregate approach). The court noted that to hold otherwise would render certain other Code provisions superfluous, such as Section 751 (treating amounts received in exchange for a partnership interest potentially as ordinary income to the extent attributable to unrealized receivables or inventory items of the partnership) and Section 897(g) (treating amounts received by a non-U.S. person in exchange for a partnership interest as subject to the Foreign Investment in Real Property Tax Act ("FIRPTA") (and hence ECI) to the extent attributable to U.S. real-property interests held by the partnership). The court next applied the Code's sourcing rules to conclude that the taxpayer's gain from the disposition of its partnership interest was not U.S.-source (and hence not ECI[4]) on the grounds that the gain was not properly attributable to the partnership's U.S. office.[5] The court reached this conclusion by looking to the Code and applicable U.S. Department of Treasury regulations, which provide that income is attributable to a U.S. office only if the U.S. office is a material factor in the production of the income and the income is realized in the ordinary course of the activities of the U.S. office. The court found neither condition was satisfied because the U.S. office was not a material factor in consummating the disposition (as opposed to the carrying on of the partnership's regular business activities) and, even if the U.S. office were material to the disposition, the disposition was a one-time extraordinary event not undertaken in the ordinary course of the partnership's business.

Notably, the Tax Court's decision does not affect the application of FIRPTA under the rules of Section 897(g) of the Code.[6] The decision also leaves unclear whether an application of Section 751 of the Code to the disposition of a partnership interest might result in all or a portion of a non-U.S. partner's gain from the disposition of a partnership interest being characterized as U.S.-source ECI.

PLANNING IMPLICATIONS

Non-U.S. persons often use blocker corporations to hold investments in partnerships that may be engaged in a U.S. trade or business. Although some uses of blocker corporations may have been occasioned by concerns that

Revenue Ruling 91-32 would be upheld in court, other rationales for using blocker corporation will persist, even if Grecian Magnesite is not overturned on appeal (or through legislation or administrative regulations). For example, Grecian Magnesite does not change the rule of Section 875(1), meaning that a non-U.S. partner directly investing in a partnership that generates ECI through its regular business operations will remain subject to tax on such ECI (including potentially a branch profits tax) and will be required to file a U.S. tax return; however, Grecian Magnesite may cause a non-U.S. partner to rethink the preferred jurisdiction under which a blocker should be organized. Under Grecian Magnesite, however, a non-U.S. blocker corporation would not recognize ECI (and thus should not be taxable in the United States) with respect to a disposition of the partnership interest, subject to Section 897(g) and potentially Section 751. In addition, if the Tax Court's holding in Grecian Magnesite is sustained, then it may be more structurally efficient (without sacrificing tax efficiency) to omit a blocker corporation where the non-U.S. investor anticipates that the investment returns largely will be realized as gains from the disposition of the partnership interest rather than through taxable operating profits treated as ECI (assuming such gains are not expected to be attributable to U.S. real-property investments to a significant extent). [7]

Non-U.S. investors holding interests in partnerships with U.S. investments, and non-U.S. investors that are contemplating making such investments, should evaluate their holding structures and disposition strategies in light of the Tax Court's recent decision.

Notes:

[1] *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner*, 149 T.C. 3 (2017).

[2] Rev. Rul. 91-32, 1991-1 C.B. 107.

[3] Unless otherwise indicated, all section references are to the Code.

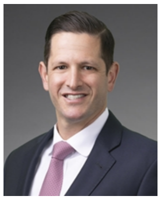
[4] The IRS conceded that the taxpayer's foreign-source gain from disposition of its partnership interest would not be treated as ECI in this case.

[5] The court assumed that the partnership's U.S. office should be deemed to be the taxpayer's office.

[6] The taxpayer in *Grecian Magnesite* conceded that the gain resulting from its disposition of the partnership interest that was attributable to U.S. real-property interests was taxable under Section 897(g).

[7] The potential impact of Section 751 also will need to be considered in these cases.

KEY CONTACTS



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