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U.S. Tax Court Exempts Gain on Sale of Interests in ECI-Generating Partnerships

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The Tax Court in *Grecian Magnesite Mining, Industrial & Shipping Co., SA* (149 TC No. 3 (2017)) (*Grecian Magnesite*) has determined that gain from a non-U.S. corporation's sale of an interest in a U.S. partnership that was engaged in a U.S. trade or business did not give rise to income that was taxable by the United States. The Tax Court's holding was contrary to a 1991 published ruling of the IRS, to which the Tax Court gave no deference.

Background

Generally, under section 741 of the U.S. Internal Revenue Code of 1986, as amended (the Code), gain or loss recognized by a partner disposing of an interest in a partnership is considered gain or loss from the sale or exchange of a capital asset. If the selling partner is a non-U.S. individual or a non-U.S. corporation, generally, gain from the sale or exchange of a capital asset is only subject to U.S. tax if (i) the asset is a U.S. real property interest or (ii) the partnership conducts a trade or business through a fixed place of business, or has a permanent establishment, in the United States and the gain is effectively connected with that U.S. trade or business (effectively connected income, or ECI).

The Code does not provide guidance for determining whether, and to what extent, a non-U.S. partner's gain from the disposition of a partnership interest is treated as ECI and, therefore, subject to U.S. tax.

In 1991, the IRS issued a controversial ruling, Rev. Rul. 91-32, in which the IRS addressed a situation in which a non-U.S. partner disposed of an interest in a partnership that owned (among other assets) appreciated property in the United States that was used or held for use in connection with a U.S. trade or business engaged in by the partnership through a fixed place of business in the United States. For purposes of determining the source of such gain and whether the gain gave rise to ECI, the IRS applied an "aggregate approach" looking to the underlying assets and activities of the partnership and treated gain on the sale of the partnership interest as ECI on the basis of the ratio of that partner's share of the net gain or loss that would be ECI to the partner's share of the partnership's entire net gain or loss, as if the partnership had disposed of all of its assets at fair market value. While some practitioners have questioned the conclusion reached by the IRS in this ruling, it has never before been reviewed by the Tax Court.

The Tax Court Held for the Taxpayer

In *Grecian Magnesite*, a non-U.S. corporation (GMM) acquired an interest in a U.S. limited liability company (Premier) that was treated as a partnership for U.S. federal income tax purposes. Premier held U.S. real property interests and assets that were held in connection with a U.S. trade or business. From 2001 through 2008, GMM paid U.S. federal income tax on its allocable share of income from Premier. In 2008, GMM's interest in Premier was redeemed, resulting in gain of US\$4 million attributable, in an economic sense, to the U.S. trade or business assets (GMM conceded that gain attributable to the U.S. real property was subject to U.S. federal income tax under FIRPTA).

GMM did not report for U.S. federal income tax purposes the \$4 million of gain attributable to the U.S. trade or business assets of Premier, taking the position that gain from the redemptive exchange of GMM's interest in Premier should be respected as capital gain from the exchange of an indivisible item of intangible personal property, and should not be recharacterized as being derived from a sale of a proportionate interest in each of the assets held by Premier. The IRS disagreed and argued that the Tax Court should give deference to Rev. Rul. 91-32.

The Tax Court found the reasoning in Rev. Rul. 91-32 lacking and agreed with the taxpayer, relying on the legislative scheme of subchapter K of the Code, which includes the partnership provisions.

Conclusion

The Tax Court has provided some welcome relief to taxpayers and practitioners by resolving in taxpayers' favour an issue of long-standing uncertainty. We note, however, that the decision of the Tax Court could be challenged by the IRS or negated by a change of law from the Treasury Department or Congress, either of which may be seeking revenue-raising opportunities.

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