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Gain Realized by Non-Resident Foreign Partner Upon the Sale of Its Interest in a U.S. Partnership is Not U.S.-Source Income Unless an Exception Applies

In *Grecian Magnesite Mining, Industrial & Shipping Co., SA, v. Commissioner of Internal Revenue* (filed on July 13, 2017), the United States Tax Court overturned Revenue Ruling 91-32 (which had been relied on since 1991) and held that gain recognized by a non-resident foreign partner of a U.S. limited liability company upon the sale of its interest was not U.S.-source income, except for the portion attributable to its interest in the company's real property.

The taxpayer, Grecian Magnesite, Mining, Industrial & Shipping Company (GMM), is a privately owned foreign corporation with a principal place of business in Athens, Greece. GMM held a membership interest in Premier Chemicals, LLC (Premier), a Delaware limited liability company (taxed as a partnership) with headquarters in Pennsylvania. Premier engaged in mining in the U.S. and held U.S. real property interests. In 2008, Premier purchased GMM's membership interest and GMM recognized a gain of $6.2 million from that sale ($2.2 million was attributable to Premier's interest in real property and $4 million was for the balance). GMM did not report any of the gain on its 2008 U.S. income tax return (Form 1120-F, U.S. Income Tax Return for a Foreign Corporation). On audit, the IRS asserted that all of the gain was taxable as U.S.-source income and issued a statutory notice of deficiency. GMM then filed a petition in the Tax Court challenging the IRS's deficiencies and, after a detailed analysis, the Tax Court found that of the $6.2 million received by GMM, $2.2 million qualified as U.S.-source income attributable to the sale of U.S. real property interests and the remaining $4 million was non-U.S.-source income.

The decision of the Tax Court is significant because it clarifies that a foreign non-resident foreign partner may sell their interest in a U.S. partnership (or entity taxed as a partnership) without incurring any U.S. tax liability on the sale except to the extent the partnership holds certain assets (such as real estate) which specific provisions of the Code treat the partner as selling and that sale itself generates U.S.-source income. For example, although Code Section 741 treats a partnership interest as a single capital asset, Code Section 897(g) overrides that general rule by treating a non-resident foreign partner's sale of their interest in a U.S. partnership that holds U.S. real property as if the partner sold its portion of the U.S. real property interests held by the partnership. All references to the "Code" are to the Internal Revenue Code of 1986, as amended.

<u>The Old Rule</u>: The old rule embodied in Revenue Ruling 91-32 was that gain recognized on a sale of an interest in a U.S. partnership by a non-resident foreign partner was considered U.S.-source income to the extent a sale of the underlying partnership assets would have been U.S.-source income.

Under Revenue Ruling 91-32, the Internal Revenue Service (IRS) determined that gain realized by a non-resident foreign partner with respect to a disposition of a partnership interest is to be treated as effectively connected income to the extent that partnership assets are used or held for use in a U.S. trade or business, i.e., by looking at the use of each asset of the partnership and determining whether the sale of the underlying asset would have generated U.S.-source income. Therefore, the gain realized by the non-resident foreign partner upon sale of its partnership interest would be attributed to U.S.-source income on U.S. tax returns to the extent it related to assets used in the U.S. whose sale would have generated U.S.-source income.

<u>The New Rule</u>: The gain recognized on the sale of a U.S. partnership interest by a non-resident foreign partner is the sale of a single capital asset, except to the extent the gain relates to the sale of a U.S. real property interest or other assets which under a specific Code Section the partner is treated as selling which generate U.S.-source income.

When a partnership redeems a partner's entire interest in the partnership, the payment for the interest is generally considered a distribution from the partnership under Code Section 736(b)(1) and the tax treatment is governed by Code Section 731, which governs the taxation of partnership distributions. Code Section 731 provides that to the extent the amount distributed by a partnership to the partner (including any amounts deemed distributed under Code Section 752 as a result of a reduction in the partner's share of partnership liabilities) exceeds the partner's basis in their partnership interest, the gain is recognized by the partner as a gain or loss from the sale of a capital asset under Code Section 741. Under Code Section 865, income from the sale of a capital asset by a non-resident foreign partner is sourced outside the United States, unless an exception applies (e.g., the income is attributable to a U.S. office of the taxpayer).

The taxpayer and IRS agreed that $2.2 million of gain attributable to the taxpayer's interest in partnership U.S. real property was U.S.-source income. Therefore, the question for the Tax Court was whether the $4 million remainder of the gain ("disputed gain") on the sale of the partnership interest was from a U.S.-source. The Tax Court addressed this question in a two-step process. First, the Court addressed the issue of whether the disputed gain was effectively connected with the business in the United States by looking at whether the disputed gain related to a sale of the taxpayer's interest in each of the properties held by Premier (which was the rule in Revenue Ruling 91-32) or whether the disputed gain related to a single capital asset - the membership interest. The Court analyzed the interrelationship between Code Sections 736, 731 and 741 and noted that those Sections treat the disputed gain as being from a single capital asset measured by the difference between the amount received by the partner and the partner's basis in the partnership (citing *Pollack v. Comm'r*, 69 T.C. 142 (1977) in support of that conclusion). Therefore, it found the membership interest to be a single asset and not an aggregate of each individual asset of Premier.

Second, the Court addressed the question of whether the sale of the indivisible capital asset was within the exception to Code Section 865(a), i.e., income from the sale of a capital asset by a non-resident foreign partner is sourced outside the United States, unless the income is attributable to a U.S. office of the taxpayer. Income is attributable to a U.S. office of the taxpayer under Code Section 864(c)(5)(B) if the U.S. office is a material factor in its production or the U.S. office regularly carries on activities of the type from which such income is derived. The Court found that the disputed gain relating to the sale of the membership interest was not effectively connected with the conduct of business of Premier because (1) the gain was not realized from Premier's mining of minerals but rather at the partner level from the sale of interest; and (2) the gain was not realized from the ordinary course of Premier's business because the redemption was a one-time, extraordinary event. The Tax Court therefore held that the exception to Code Section 865(a) did not apply and sourced the income outside the U.S.

<u>Exception to the New Rule</u>: The sale of an interest in a U.S. partnership by a non-resident foreign partner that is attributed to U.S. real property interest of the partnership is considered U.S.-source income.

Under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), Congress sought to impose income tax on foreign corporations that sell interests in partnerships that own U.S. real property. Specifically, FIRPTA (as set forth in Code Section 897(g)) provides that the amount of money received by a non-resident foreign partner in exchange for its interest in a partnership that holds U.S. real property would be considered U.S.-source income for the amount of the payment attributable to the partnership's interest in U.S. real property. Basically, FIRPTA allows the IRS to "look through" the partnership and consider the non-resident foreign partner as the seller of its portion of U.S. real property interests making the interest effectively connected with the non-resident foreign partner's U.S. business, which is subject to U.S. income tax under Section 882.

Therefore, the amount of partnership interest attributable to a partnership's real property interest is treated as U.S.-source income subject to income tax when sold by a non-resident foreign partner.

<u>Other Possible Exceptions to the New Rule</u>. In reaching its decision, the Tax Court noted that Code Section 751 is another specific exemption in the Code to Section 741 that causes the partner's interest in unrealized receivables and inventory items to be addressed separately from the partner's interest when it is sold (similarly to the treatment of real estate under Code Section 897(g)). The Tax Court noted that the IRS had not asserted a deficiency applicable to the taxpayer's interest in unrealized receivables or inventory items, so it did not need address it in that case. If there had been such a deficiency, the Tax Court may have held that the gain attributable to those assets was U.S.-source income. For instance, similar to the manner in which distributions in redemption of a partner's interest in real property are treated under Code Section 897(g), Code Section 751(b) provides that if a partner receives a distribution of cash in exchange for the partner's interest in unrealized receivables or inventory items which have appreciated substantially in value, such transaction shall be considered as a sale or exchange of such property between the distributee and the partnership.

In summary, a non-resident foreign may hold an interest in a U.S. partnership or entity taxable as a partnership, such as a limited liability company or limited partnership. If the non-resident foreign partner sells the interest held in the partnership, the gain realized upon that sale is not U.S.-source income, except to the portion of that gain attributable to the partnership's interest in U.S. real property or, perhaps, unrealized receivables or inventory items as defined in Code Section 751(c) that would be U.S.-source income if sold individually. That means that under the Tax Court's holding a non-resident foreign partner may have little or no U.S.-source income on the sale of their partnership interest to the extent the assets held by the partnership are not of a type that require separate treatment which would generate U.S.-source income on their sale.

For assistance in determining the tax consequences of a sale of a U.S. partnership or limited liability company interest by a non-resident foreign person, please contact one of the listed Roetzel & Andress attorneys from our Corporate, Tax, and Transaction group.

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