



Foreign partners: Tax Court rejects the IRS's position in Rev. Rul. 91-32

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This article describes a recent Tax Court case in which the court rejected the IRS's position in Rev. Rul. 91-32 that a foreign partner's capital gain from the sale of an interest in a partnership that is engaged in a U.S. trade or business is treated as gain that is effectively connected to a U.S. trade or business and therefore subject to U.S. federal income tax.

In *Grecian Magnesite Mining, Co. v. Comm'r*,¹ the U.S. Tax Court held that a foreign corporation, Grecian Magnesite Mining ("GMM"), was not subject to U.S. federal income tax on the gain that it realized upon the redemption of its interest in Premier Chemicals, LLC ("Premier"), a domestic entity treated as a partnership that was engaged in the conduct of a U.S. mining business (except to the extent that gain was attributable to the U.S. real property interests held by Premier). The case marks the first time that a court has addressed directly the IRS's controversial position in Rev. Rul. 91-32² that gain realized by a foreign person with respect to a disposition of a partnership interest should 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.

The holding of Rev. Rul. 91-32 has been controversial since its issuance. Many commenters agree that the holding is correct from a policy perspective, but most question whether it is supported by existing law.³ For its part, the IRS has consistently maintained that the holding is correct under existing law and has in recent years added an item to its Priority Guidance Plan under section 864 "implementing Revenue Ruling 91-32 relating to sales of certain partnership interests."⁴ In addition, the Obama Administration had proposed codifying the holding of the ruling as a revenue raiser in various budget proposals.⁵ In this case of first impression, the court soundly rejected both the analysis as well as the holding of the revenue ruling. While the court's opinion remains subject to appeal, it represents the Tax Court's views and supports the position that under most

¹ 149 T.C. 3 (July 13, 2017).

² 1991-1 C.B. 107.

³ See, e.g., Philip F. Postlewaite, *The Omnipresence of Subchapter K in the International Arena?*, 93 TAXES 173 (March 2015); Christopher Trump & Mark Graham, *In Search of a Normative Theory of Partnership Taxation for International Tax (or How We Learned to Stop Worrying and Love Subchapter K)*, 93 TAXES 143 (March 2015); Kimberly S. Blanchard, *Rev. Rul. 91-32: Extrastatutory Attribution of Partnership Activities to Partners*, 97 TAX NOTES 173 (Sept. 8, 1997); Alan Roy Hollander, *Is a Sale of a Partnership Interest 'Attributable' to the Partnership's Place of Business? The Missing Analysis in Rev. Rul. 91-32*, 52 Tax Notes 1321 (September 9, 1991); William W. Bell and David B. Shoemaker, *Revenue Ruling 91-32: Right Result for the Wrong Reasons*, 9 Journal of Partnership Taxation 80 (Spring 1992); Edwin J. Reavey & Richard M. Elliot, *Sales of U.S. Partnership Interests by Foreign Partners: New Rules After Rev. Rul. 91-32*, 91 TNT 50-27 (1991)

⁴ See, e.g., 2016-2017 Priority Guidance Plan, (August 15, 2016).

⁵ See, e.g., General Explanation of the Administration's Fiscal Year 2017 Revenue Proposals, p. 18-19 (Feb. 2016), available at <https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf>.

facts and circumstances such gain is not subject to U.S. federal income tax solely as a result of the partnership being engaged in a U.S. trade or business.

Summary of *Grecian Magnesite Mining* case

On July 21, 2008, GMM entered into an agreement pursuant to which Premier would redeem GMM's entire interest for \$10.6 million in two equal installments on July 31, 2008, and January 2, 2009. At the time of the July 31, 2008 \$5.3 million payment, GMM had a \$4.3 million adjusted tax basis in its partnership interest and realized about \$1 million of gain. At the time of the second payment on January 2, 2009, GMM realized over \$5.2 million of additional gain.⁶ GMM timely filed its 2008 Form 1120-F, "U.S. Income Tax Return of a Foreign Corporation," reflecting GMM's allocable share of taxable items from Premier, but it did not report the \$1 million of gain from the July 31, 2008 payment.⁷ GMM did not file any U.S. federal income tax returns for 2009.

The IRS audited GMM's 2008 and 2009 tax years and asserted that GMM should have reported and paid tax on the \$1 million of gain realized in 2008 and the \$5.2 million of gain realized in 2009. At some point between the conclusion of the audit and the date of the opinion, GMM and the IRS agreed that GMM was subject to tax on the \$1 million of gain realized in 2008 and \$1.2 million of the gain realized in 2009 by reason of section 897(g).⁸ The court's opinion is devoted to whether GMM was subject to tax on the approximately \$4 million remaining balance (the "disputed gain").

The crux of both the court's opinion and the IRS's position in Rev. Rul. 91-32 is whether the "aggregate" or "entity" approaches to partnerships should apply to determine the character of the gain realized by a selling foreign partner. Under the aggregate approach, favored by the IRS in this instance, the partnership is mostly disregarded as a separate entity and the partner is generally viewed as owning its proportional interest of the partnership's assets.⁹ Under the entity approach, favored by GMM in this instance, the partnership is treated as an entity completely separate from the partners. Subchapter K, which contains the partnership-specific provisions of the Code, does not clearly adopt

⁶ GMM had an adjusted tax basis of approximately \$55,000 at the time of the second payment as a result of its allocable share of partnership items for 2008.

⁷ GMM's U.S. federal income tax returns were prepared and filed by a certified public accountant that had been recommended by GMM's U.S. legal counsel. A secondary issue in the case was whether GMM should be subject to accuracy-related, failure-to-file and failure-to-pay penalties. With respect to the gain that GMM agreed was taxable, the court rejected the IRS's assertion of penalties on the grounds that GMM had reasonable cause to rely on its tax return preparer.

⁸ Unless otherwise stated, all section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"). Section 897(g) is described in more detail below, but essentially subjects a foreign person to tax on the portion of any gain from the sale of a partnership interest that is attributable to any U.S. real property interests that are held by the partnership.

⁹ As specifically noted by the court, the IRS did not argue that the partnership anti-abuse regulations under Treas. Reg. § 1.701-2(e) should apply to this case. That regulation provides the IRS can "treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations." It is not clear from the record or the court's decision why the IRS did not raise this argument or whether the outcome would have been different if it had.

one approach or the other, but rather alternately adopts each approach depending on the context.¹⁰

In rejecting the IRS's position that the aggregate approach should apply to a foreign person's disposition of an interest in a partnership that owns assets that are used or held for use in a U.S. trade or business, the court focused on the intersection of Subchapter K and Subchapter N, which contains the foreign-person specific provisions of the Code. In doing so, the court first noted that the gain realized by GMM upon receipt of its liquidating distributions was treated under Subchapter K as gain from the sale or exchange of a capital asset, specifically the partnership interest.¹¹ The court interpreted this as adopting an entity approach to the characterization of the gain realized by GMM and systematically rejected each of the IRS's arguments as to why an aggregate approach was more appropriate in this case.

Having concluded that GMM's gain was properly characterized as gain from the sale or exchange of an indivisible capital asset, the court turned to the question of whether that gain was effectively connected with a U.S. trade or business.¹² Both GMM and the IRS agreed that GMM was deemed to be engaged in a U.S. trade or business by reason of its partnership interest in Premier.¹³ Accordingly, the question turned on whether the gain realized from GMM's sale of its partnership interest was effectively connected to that U.S. trade or business. In general, all U.S.-source income (other than FDAP income) is treated as effectively connected with the conduct of a trade or business within the United States, but only a limited category of foreign-source income is so treated.¹⁴ The IRS argued that GMM's gain was attributable to Premier's U.S. office and thus U.S.-source income and effectively connected to GMM's U.S. trade or business; GMM argued that the gain was not attributable to Premier's U.S. office and thus foreign-source and not effectively connected to a trade or business pursuant to section 864(c)(3).¹⁵

¹⁰ See 1 William S. McKee, et al., *Federal Taxation of Partnerships and Partners*, para. 1.02, at 1-8 (4th ed. 2007).

¹¹ In this case, the tax treatment of the liquidating payments was governed by section 736(b)(1), which states that the payments are treated as distributions under section 731(a). Under section 731(a), any gain realized upon a distribution is treated as gain from the sale or exchange of the partnership interest. Under section 741, gain from the sale of a partnership interest is considered gain from the sale or exchange as a capital asset, except as otherwise provided in section 751. Section 751, which is not applicable in this instance, adopts an aggregate approach to potentially recharacterize a portion of any such gain as ordinary income to the extent attributable to certain ordinary-income producing assets held by the partnership.

¹² Under sections 881 and 882, a foreign corporation is generally only subject to U.S. federal income tax on income that is either (A) received from sources within the United States ("U.S.-source income") and fits within one of several categories of income, including "fixed or determinable annual or periodic" income ("FDAP income") or (B) the foreign corporation is engaged in a trade or business within the United States and the income is effectively connected with the conduct of that trade or business.

¹³ Section 875(1) provides that "[a] nonresident alien individual or foreign corporation shall be considered engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged."

¹⁴ See section 864(c).

¹⁵ In making this argument, the IRS asked the court to defer to Rev. Rul. 91-32 and the high-level aggregate theory articulated therein. In refusing to defer to Rev. Rul. 91-32, the court found that it did not owe deference to the ruling because it was an agency's interpretation of statutory provisions that was not

On the question of whether GMM's gain was U.S.-source income, the court noted that section 865(a) provides that the default rule for whether gain from the sale of personal property is based on the residence of the seller. As such, unless an exception applied, GMM's gain would be foreign-source income and not within the ambit of section 864(c)(3). The IRS argued that the disputed gain fell under just such an exception, specifically the "U.S. office rule" of section 865(e)(2)(A). Under that exception, if a nonresident maintains an office or other fixed place of business in the United States (a "U.S. office"), then income from the sale of personal property that is "attributable to" that U.S. office is U.S.-source income. Accordingly, GMM's gain would be U.S.-source if it was attributable to Premier's offices in the United States. For these purposes, the principles of section 864(c)(5) apply.¹⁶ Under those rules, income, gain or loss is attributable to a U.S. office only if: (A) the U.S. office is a "material factor" in the production of the income *and* (B) the U.S. office "regularly carries on" the type of activity from which the income, gain or loss is derived.¹⁷

The IRS's argument that the disputed gain was attributable to Premier's U.S. office had two prongs: (1) that GMM's redemption of its partnership interest was equivalent to Premier selling its underlying assets and distributing the partner's share of the proceeds; and (2) that the work done in the U.S. office is what made the operating business, and thus GMM's interest in that operating business, valuable. The court dismissed the first argument as essentially a repackaging of the aggregate-vs-entity question that the court had already answered. The court rejected the second argument on the grounds that whatever actions Premier had taken in regard to the underlying business, such actions were not a material factor in the actual transaction that gave rise to GMM's gain, i.e., the redemption of GMM's partnership interest. As support, the court pointed to regulations under section 864 that effectively provide that any work done that adds value to intangible property is not considered to be a material factor in determining whether the gain from an exchange of that intangible property is attributable to the U.S. office that conducted the value-adding work.¹⁸ Furthermore, the court held that even if Premier's U.S. office was a "material factor" in the production of the disputed gain, the gain would not be U.S.-source because the redemption of the GMM's partnership interest was not an ordinary-course activity that Premier's U.S. office "regularly carries on" as required by the second prong of the section 865 statutory test.¹⁹ Accordingly, GMM's disputed gain was not

supported by adequate reasoning. The court noted that it generally defers to an agency's interpretation of its own ambiguous regulations, but that issue was not presented by Rev. Rul. 91-32. Rather, the court undertook its own careful, generally mechanical reading of sections 864 and 865 and the regulations thereunder.

¹⁶ See Section 865(e)(3).

¹⁷ See Section 864(c)(5)(B). Treasury regulations explain that the effective standard for determining whether the regularly-carries-on prong is met is whether the income, gain or loss is "realized in the ordinary course." Treas. Reg. § 1.864-6.

¹⁸ Treas. Reg. § 1.864-6(b)(2)(i) (providing that "an office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain or loss for purposes of this subdivision merely because the office or other fixed place of business conducts one or more of the following activities: (a) develops, creates, produces, or acquires and adds substantial value to the property which is leased, license, or sold, or exchanged...").

¹⁹ The redemption of GMM occurred on the same terms as a prior transaction between Premier and IMin, another partner in Premier whose interest Premier had agreed to repurchase. Under its bylaws, when Premier accepted IMin's offer, it became obligated to offer to repurchase each other member's

“attributable to” Premier’s U.S. office and, thus, was foreign-source income not subject to U.S. federal income tax.

KPMG observation

There is much to consider in the aftermath of this decision and how it might apply to a wide variety of situations. Bearing that in mind, some initial observations:

- The facts of *Grecian Magnesite*, involved the *redemption* of an interest from a foreign partner by a U.S. partnership, as opposed to the *sale* of an interest by the foreign partner. As such, arguably the facts provided an additional avenue to the IRS under which to assert that the gain on the sale of the partnership interest was U.S.-sourced gain and therefore subject to U.S. tax. That is, since the redemption necessarily involved the purchase of the interest by the partnership, the partnership’s U.S. office participated in the sale. Under this view, the IRS had asserted that the sale was “attributable to” the U.S. office of the selling taxpayer and, therefore, there was at least some factual relationship between the disposition of the partnership interest and the U.S. office.²⁰ The court determined that the business of the partnership was not buying and selling partnership interests and, in having redeemed only two interests in seven years, its participation was not regular enough to be in the “ordinary course” of a business. Arguably, then, in the case of a *sale* of an interest by a foreign partner in a circumstance when the partnership has no involvement, this argument would not be available to the IRS.
- Query whether the court would have reached a different conclusion had the foreign partner held its investment through an upper-tier partnership engaged in buying and selling lower-tier partnership interests as part of its investment strategy. That is a common fact pattern for any U.S.-based private equity fund that invests in operating partnerships. In such case, the court’s material-factor analysis would presumably remain relevant, but it would be easier for the IRS to assert that the sale of the interest is an ordinary course transaction under section 865(e)(2)(A), which could then cause the capital gain allocable to a foreign partner to be U.S.-sourced and subject to U.S. federal income tax as attributable to a U.S. office of (presumably) the upper-tier partnership.²¹
- The case is not yet final so remains subject to appeal. As the issue presented is solely a legal question, any appellate court would review the issue *de novo*. As such, the

interest on the same terms. GMM chose to accept the offer to sell its interest. The court describes the redemption as an extraordinary event distinguishable from the ongoing business activities of Premier (primarily producing and selling magnesite) that therefore was not undertaken in the ordinary course of Premier’s business. Further, the court notes that Premier was not “engaged in the business of buying and selling interests in itself,” having engaged in only two such transactions in seven years.

²⁰ The same factual nexus normally would not exist when a partner sells its interest in the partnership, unless the partnership agreement required participation by the partnership itself.

²¹ The sale of a partnership interest may be distinct from the sale of stock in that a partnership interest is not a security for purposes of the exception from effectively connected income (ECI) provided in Treas. Reg. section 1.864(b)-2(c). Treas. Reg. 1.864-4(c)(5)(iii).

opinion is not yet binding on other courts. Taxpayers may nonetheless cite to the case and the court's reasoning therein in support of their position, noting in the citation the necessary caveats until the decision is final.²²

- The court specifically noted that the IRS did not raise an argument that the partnership anti-abuse regulations allowed the IRS to treat the partnership as an aggregate for purposes of determining the source of the selling partner's gain. As the IRS did not raise the argument at trial, the IRS may be barred from raising it in any appeal of this case. Even if so, the IRS would not be barred from raising that argument in any future case involving a different taxpayer even if the result in this case is ultimately upheld on appeal.

If the IRS were to raise that argument, it is not clear if doing so would change the outcome. In general, *Chevron* requires courts to give significant deference to an agency regulation that interprets an ambiguous statute. The partnership anti-abuse regulations address whether a taxpayer is relying on an aggregate or entity approach to achieve a result that is not clearly contemplated by the Code. This court did not seem to see much ambiguity in the statute as to whether the entity approach applies to gain from the sale of a partnership interests unless a specific statutory provision states otherwise. Rather, the ambiguity that this court focused on related to whether the partner's gain was "attributable to" a U.S. office. As such, it is not clear that this court (or any future court) would agree with the IRS that the partnership anti-abuse regulations are applicable in this instance.

- If this case goes final without appeal or is appealed and upheld, the IRS could potentially overturn the result by issuing additional regulatory guidance under section 864 to clarify what it means to be "attributable to" a U.S. office in the case of gain realized on the sale or exchange of a partnership interest. The IRS has not previously demonstrated much interest in doing so, instead seeking to clarify the matter through statutory amendments, but negative judicial precedent may cause the IRS to reconsider its position and pursue a regulatory solution.²³
- Similarly, the outcome of this case may provide impetus for Treasury and the IRS to more aggressively push for a statutory codification of the holding in Rev. Rul. 91-32. Such a codification had been included in several of the Obama Administration's budget proposals as a revenue raiser. While there is no specific mention of anything similar in the publicly available tax proposals under consideration by the current Congress or the Trump Administration, those proposals remain high level.

²² Even if the case is appealed and reversed, taxpayers can continue to cite the Tax Court's decision as indicative of the Tax Court's views on the issue, except in cases appealable to the reversing circuit, see *Golsen v. Comm'r*, 54 T.C. 742 (1970).

²³ Note there is an item on the IRS's current Priority Guidance Plan, as noted above.

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