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Tax Court Refuses to Follow Rev. Rul. 91-32 in Grecian Magnesite Mining Decision

In a recent decision, the U.S. Tax Court refused to accord deference to an Internal Revenue Service (IRS) administrative ruling treating the sale of partnership interests as a sale of assets the partnership uses in a U.S. trade or business, thereby subjecting the resulting gain to taxation as income effectively connected to a U.S. trade or business.

Introduction

As a general rule, under U.S. federal income tax law, the taxation of gain from the sale of personal property (e.g., stocks in a corporation or interests in a partnership) depends on the tax residence of the seller. If the seller is a U.S. tax resident, the gain is subject to U.S. federal income taxation. If the seller is not a U.S. tax resident, the gain is not subject to U.S. taxation.

There are two exceptions to the above rule that are pertinent to investments in U.S. partnership interests. The first exception relates to gain derived by a partnership from the sale of assets which it has been using in a U.S. trade or business and which is eventually distributed to its partners. The second exception relates to the sale by a partner of his/her interest in a U.S. partnership whose assets consist predominantly of U.S. real property interests (e.g., U.S. real estate or interests in entities majority of whose assets consist of U.S. real estate). If any of these exceptions applies, gain derived by a partner is subject to U.S. federal income taxation as income effectively connected to a U.S. trade or business (ECI). If the partner is a non-U.S. person, this ECI gain would be subject to withholding tax (with the partnership acting as the withholding agent) at the highest marginal rates applicable to the partner. The partner also would have to file a U.S. federal income return for the year in which he received the gain, compute the final tax due on the gain on his return and claim a credit for the tax withheld by the partnership. If the partner is a U.S. taxpayer, the gain is not subject to withholding, but the taxpayer must pay tax on it, at the rates applicable to him/her, when computing his/her overall tax liability on the tax return for the year in which he/she derived the gain.

Rev. Rul. 91-32

In 1991, the IRS published an administrative ruling, Rev. Rul. 91-32, which, among others, treats the sale of an interest in a partnership as the sale of a proportionate share of the assets the partnership uses in a U.S. trade or business. In this administrative ruling, the IRS conflated the two well-known theories regarding partnership taxation: the entity theory, under which a partnership is treated as an entity in its own right that issues equity interests to and which are transferable by its partners (as distinguished from assets it uses in its trade or business) and the aggregate theory, which treats a partnership as an aggregation of its partners with respect to the imposition of tax liability and not as a taxable entity.

Rev. Ru. 91-32 has been criticized by tax practitioners for decades for not having applied the principles regarding the taxation of partnership interests correctly. As if to admit implicitly that the reasoning in Rev. Rul. 91-32 stood on shaky grounds, the IRS attempted, albeit unsuccessfully, to have the ruling's positions codified into law during the Obama administration. However, it was only until recently that this administrative ruling was challenged in court, in a case before the U.S. Tax Court.

Grecian Magnesite Mining Decision

In *Grecian Magnesite Mining, Industrial & Shipping Co., SA, v. Commissioner of Internal Revenue, 149 T.C. No.3*[1] ("Grecian"), a Greek mining company (Grecian) contributed $1.8 million in 2001 to a U.S. limited liability company, Premier Magnesia, LLC ("Premier"), a U.S. partnership engaged in the business of extracting, producing and distributing magnesite, in exchange for a 15% interest in 2001. Other than this investment, Grecian had no U.S. office or other fixed place of business, nor did it have any other investments in the United States.

In 2008, Premier redeemed Grecian's interest (which at that time had been diluted from 15% to 12.6%) for $10.6 million, which was paid to Grecian in two instalments (on July 31, 2008 and January 2, 2009. It was the parties' understanding that Grecian was fully redeemed out by December 31, 2008). Overall, Grecian realized gain of $6.2 million on the redemption. Of this amount, $2.2 million was attributable to Premier's U.S. real estate ("FIRPTA gain") and the remaining $4 million was attributable to non-U.S. real estate assets ("non-FIRPTA gain").

Relying on the advice of a U.S. CPA, Grecian did not file U.S. federal corporate income tax returns for 2008 and 2009 and never paid U.S. federal corporate income tax on any portion of the $6.2 million gain it made on the redemption of its interests in Premier. The IRS assessed Grecian for unpaid taxes, interest and penalties on those taxes, and failure to file penalties.

Before the Tax Court, Grecian conceded that, contrary to the erroneous advice it had received from its U.S. CPA, it owed U.S. federal income tax on the $2.2 million FIRPTA gain it made on the redemption. Apart from this concession, however, the IRS argued that even the $4 million non-FIRPTA gain Grecian made on the redemption was subject to U.S. federal income taxation, and sought to rely on Rev. Rul. 91-32 as an authority for its position.

In declining to accord deference to Rev. Rul. 91-32, the Tax Court noted that this administrative ruling's treatment of partnership taxation provisions is "cursory in the extreme". The Court decided to follow instead provisions of the Internal Revenue Code ("Code") and Code regulations in determining whether the $4 million portion of the gain was subject to U.S. federal income taxation. Ultimately, the Court ruled that the $4 million gain from the redemption was not income effectively connected to a U.S. trade or business and that, since Grecian was not a U.S. person, that gain was not subject to U.S. federal income taxation.

Impact of the Decision

The IRS is yet to announce its formal response to the Grecian decision. It is not yet clear whether it will appeal the decision or let it stand. If the IRS decides against appealing the decision, it is still not yet clear whether it will acquiesce in it (in which case taxpayers who apply the decision properly to their own circumstances do not risk being challenged by the IRS with respect to that application) or not (in which case taxpayers who apply the decision properly to their own circumstances risk being challenged by the IRS with respect to that application).

Regardless of how the IRS decides to respond to the decision, *Grecian* has significantly undermined the technical validity of Rev. Rul. 91-32, which was already on shaky technical ground prior to the decision. The decision has provided judicial support for non-U.S. partners selling equity interests in U.S. partnerships that have for years been taking a position that gain resulting from such dispositions shouldn't be subject to U.S. federal income taxation provided it is not attributed to U.S. real estate or the sale of the partnership's trade or business or assets used in that trade or business.

[1] Decided on July 13, 2017.

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