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US Tax Court Exempts Gain on Sale of a Partnership Interest

Decision could open planning opportunities for non-US partners regarding sale of a partnership interest.

The *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner*[1] case — which the US Tax Court decided July 13, 2017 — may significantly change how non-US investors invest in US businesses that are in partnership or other pass-through form. The Tax Court held that a non-US person's capital gain from the sale of its interest in a partnership engaged in a US trade or business generally is not subject to US federal income tax, except to the extent attributable to the non-US person's share of the partnership's US real property interests.

The Grecian Magnesite Case

Grecian Magnesite Mining, Industrial & Shipping Co., SA (GMM), a Greek corporation, invested in a Delaware LLC that was classified as a partnership for US income tax purposes[2] and engaged in a US trade or business. The LLC redeemed GMM's interest in 2008 in exchange for cash. A portion of GMM's gain on the redemption was attributable to US real property interests held by the LLC and taxable under Section 897(g).[3] The taxability of the remainder of GMM's gain was disputed, with the IRS asserting it was treated as effectively connected income and taxable.

The IRS' position was premised on a revenue ruling from 1991. Revenue Ruling 91-32 concludes that a non-US partner's gain on the sale or taxable exchange of its partnership interest is effectively connected income and subject to US federal income tax to the extent attributable to property of the partnership that is used or held for use in the partnership's US trade or business.

US taxation of partnerships adopts an "entity" approach (which treats a partnership interest as an interest in an entity) for some purposes and an "aggregate" approach (which treats a partnership interest as an aggregation of assets held by the partnership) for others. Commentators have criticized Revenue Ruling 91-32 for departing from the entity approach if there is no clear statutory support to do so (for example, as in the case of proceeds attributable to US real property).

The Tax Court declined to follow Revenue Ruling 91-32, instead holding that GMM's disputed gain was gain from the sale of an indivisible capital asset (the entity approach) and thus is not subject to US federal income tax.[4]

Conclusion

The implications of the Tax Court decision, which was three years in the making, will depend in part on whether the decision is appealed and, if appealed, sustained. If the decision is not appealed or is sustained on appeal, there could be significant planning opportunities for non-US investors. In the meantime, taxpayers and their advisers will need to assess the implications of the Tax Court's decision in structuring and reporting sales of interests in US partnerships.

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Endnotes

1 149 T.C. No. 3 (July 13, 2017).

2 In the United States, an LLC with multiple owners is generally classified as a partnership for income tax purposes unless it affirmatively elects to be classified as a corporation.

3 References to "Section" refer to sections of the Internal Revenue Code of 1986, as amended.

4 The decision does not address gain attributable to recapture income and other items under Section 751.