Court Holds Non-U.S. Investor Is Not Taxable on Sale of U.S. Operating Partnership Interest

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In a **decision** released July 13, the U.S. Tax Court held that gain realized by a non-U.S. investor on the disposition of an interest in a partnership that operated a U.S. business was generally not subject to U.S. tax.[1] In holding for the taxpayer, the Tax Court refused to follow a published ruling issued by the IRS in 1991 ("**RR 91-32**"),[2] stating that the ruling lacked the "power to persuade." The Tax Court holding does not apply to the portion of the gain that was attributable to U.S. real property interests held by the partnership, which the parties conceded was subject to U.S. tax.

Background

If a non-U.S. individual or corporation (a "**Non-U.S. Investor**") owns an interest in an entity, including an LLC, that is treated as a partnership for U.S. federal income tax purposes (a "**Partnership**") and the Partnership is engaged in a business in the United States, the Non-U.S. Investor will be treated for U.S. federal income tax purposes as engaged in that business. As a result, the Non-U.S. Investor will be required to file a U.S. federal income tax return for each year in which it holds an interest in the Partnership and to pay U.S. federal income tax on a net basis, at the rates applicable to U.S. persons, in respect of the Non-U.S. Investor's share of any income that is "effectively connected" with the underlying business (any such income, "**ECI**"). In addition, except to the extent provided in an applicable tax treaty, if the Non-U.S. Investor is a corporation, it will be subject to U.S. branch profits tax, at a rate of 30%, on its "dividend equivalent amount" attributable to certain ECI (generally, the after-tax amount of certain ECI to the extent that it is not treated as reinvested in the trade or business).

In general, a Non-U.S. Investor's share of gain derived by a Partnership from a sale of assets used in the business will be treated as ECI if it is attributable to the Partnership's office or other fixed place of business in the United States (a "**U.S. Office**"). Under the rules applicable to dispositions of U.S. real property interests ("**USRPIs**"), commonly referred to as "FIRPTA," a Non-U.S. Investor's share of gain from the Partnership's sale of any USRPI will be treated as ECI regardless of whether it is attributable to the Partnership's U.S. Office. Moreover, Section 897(g) of the Internal Revenue Code of 1986, as amended (the "**Code**"),[3] provides that if a Non-U.S. Investor sells or otherwise disposes of an interest in a Partnership that holds any USRPIs, the portion of the sales proceeds attributable to the USRPIs will be treated as proceeds from the disposition of the USRPIs, and any gain from this deemed disposition of USRPIs will therefore constitute ECI.

In RR 91-32, the IRS concluded that gain derived by a Non-U.S. Investor from the sale or other disposition of an interest in a Partnership constitutes ECI to the extent that the gain is attributable to Partnership assets, other than USRPIs, the sale of which by the Partnership would have given rise to gain

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[1] *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner,* 149 T.C. No. 3 (2017) ("***Grecian***").

[2] IRS Revenue Ruling 91-32, 1991-1 C.B. 107.

[3] All "Section" references in this memorandum are to the Code.

treated as ECI.[4] Under RR 91-32, the U.S. federal income tax consequences to a Non-U.S. Investor of a sale of its Partnership interest are essentially the same as the consequences to the Non-U.S. Investor of the Partnership's sale of all of its assets. RR 91-32 thus adopts what some consider to be an "aggregate" approach to Partnerships, under which a Partnership is treated as an aggregate of its underlying assets, rather than an "entity" approach, under which a partner is treated as having an interest in the Partnership as an entity that is separate from its indirect interest in the underlying assets.

The validity of RR 91-32 under the Code and the current Treasury regulations thereunder has been questioned since the ruling was issued. The Obama Administration suggested codifying the principle set forth in RR 91-32, and Treasury has announced that it plans to issue additional regulations addressing the application of the ECI rules to sales of Partnership interests, but neither any legislation nor any Treasury regulations have yet adopted the "aggregate" approach of RR 91-32 for gain attributable to Partnership assets other than USRPIs.

The *Grecian* Case

The taxpayer in *Grecian*, a non-U.S. corporation and thus a Non-U.S. Investor, was a member of a Partnership that was engaged in the business of extracting, producing and distributing the mineral magnesite in the United States. When the Partnership redeemed the taxpayer's membership interest for cash, the taxpayer did not report on its U.S. tax return any of the gain it realized on the redemption. The taxpayer later conceded that the portion of the gain that was attributable to the Partnership's USRPIs was taxable as ECI under Section 897(g), but challenged the assertion of the IRS that the remainder of the gain constituted ECI under the principle announced in RR 91-32.

The Tax Court concluded that the "aggregate" approach adopted by RR 91-32 was not appropriate in the case of a disposition of a Partnership interest, absent an explicit exception.[5] It pointed out that Section 741, which treats gain or loss from the disposition of a partnership interest as derived from the disposition of a capital asset, adopts an "entity" approach, and that explicit provisions of the Code (specifically, Sections 751 and 897(g)) were required to override that approach in the case of specific types of underlying assets. The Tax Court therefore rejected the government's position that the gain realized by the taxpayer was properly treated as gain from the sale of the taxpayer's interest in the underlying assets held by the Partnership. Applying the relevant Treasury regulations, the Tax Court further concluded that the gain realized by the taxpayer from the redemption of its Partnership interest did not constitute ECI because it was not attributable to the Partnership's U.S. Office in the United States.[6]

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[4] Specifically, RR 91-32 states that the portion of the gain from the disposition of the Partnership interest that will be treated as ECI is the amount that bears the same ratio to that gain as the Non-U.S. Investor's share of gain treated as ECI would have borne to the Non-U.S. Investor's share of the Partnership's entire net gain if the Partnership had sold all of its assets for fair market value at the time of the Non-U.S. Investor's disposition of its Partnership interest.

[5] The Tax Court noted that (i) pursuant to Section 736, the payments made by the Partnership to the taxpayer in redemption its Partnership interest were treated as distributions by the Partnership and (ii) pursuant to Section 731, these distributions caused the taxpayer to realize gain that was treated as gain from the sale or exchange of its Partnership interest.

[6] The IRS and the taxpayer agreed that the gain would be treated as ECI only if it were U.S.-source gain, and under Section 865, the gain would be U.S.-source gain only if it were attributable to a U.S. Office maintained by the taxpayer in the United States. The only U.S. Office that the taxpayer had was the Partnership's U.S. Office, which was attributed to the taxpayer because of the taxpayer's membership interest in the Partnership. For this purpose, the gain would be attributable to the Partnership's U.S. Office only if (i) the U.S. Office had been "a material factor" in the production of the gain and (ii) the U.S. Office regularly carried on activities of the type from which the gain was derived. Applying the relevant Treasury regulations, the Tax Court determined that (i) the activities of a business are not a material factor in the realization of gain from the sale of an equity interest in the business and (ii) the Partnership's U.S. Office was not regularly engaged in redeeming interests in the Partnership.

Blocker Corporations

A Non-U.S. Investor investing in a Partnership that conducts business activities in the United States (an "**Operating Partnership**") typically holds its interest in the Operating Partnership indirectly through an entity that is treated as a corporation for U.S. federal income tax purposes. In the private equity context, the corporation is typically referred to as a "**Blocker Corporation**" and is shared with other investors (collectively, the "**Blocker Investors**"). The Blocker Corporation, rather than any Blocker Investor, files U.S. federal, state and local income tax returns and pays U.S. federal, state and local income taxes in respect of its interest in the Operating Partnership. Blocker Corporations are often capitalized with a combination of equity and loans made, directly or indirectly, by the Blocker Investors. In order to prevent the imposition of U.S. branch profits tax on the Blocker Corporation, Blocker Corporations for Operating Partnerships are typically organized in the United States. A U.S. Blocker Corporation is subject to U.S. federal income tax on its worldwide income, including any gain it recognizes on the sale or other disposition of its interest in the Operating Partnership.

What's Next?

The IRS will presumably appeal the *Grecian* decision and announce that it does not intend to follow it. The decision may also serve as an incentive for Treasury and the IRS to issue regulations adopting the "aggregate" approach of RR 91-32. In addition, it is possible that legislation adopting this approach would be part of any upcoming tax legislation.

It seems unlikely that the *Grecian* case will affect the desire of Non-U.S. Investors to invest in an Operating Partnership through a Blocker Corporation. If a Non-U.S. Investor held an interest in an Operating Partnership directly or through entities treated as Partnerships, the Non-U.S. Investor would be required (i) to file a U.S. federal income tax return (and possibly also various state and local income tax returns) for each taxable year in which it held the Operating Partnership interest and (ii) to pay U.S. taxes on its share of the Operating Partnership's ECI (and possibility state and local taxes).

Assuming, however, that the *Grecian* case is not overturned on appeal, and that the "aggregate" approach of RR 91-32 is not adopted in new legislation or Treasury regulations, the *Grecian* holding may cause some Non-U.S. Investors (and investment funds) to consider using non-U.S. Blocker Corporations, rather than U.S. Blocker Corporations, for investments in certain Operating Partnerships because, under *Grecian*, a non-U.S. Blocker Corporation would not be subject to U.S. federal income tax on the disposition of its interest in the Operating Partnership, while a U.S. Blocker Corporation would. Nevertheless, given the possibility of U.S. branch profits tax for a non-U.S. Blocker Corporation, the efficiencies produced by leveraging a U.S. Blocker Corporation with debt, the possibility of exit through a sale of interests in a Blocker Corporation and the real potential for *Grecian* to be overturned (on appeal or by future legislation or regulation), it seems unlikely that there will be a significant movement (at least in the near term) toward the use of non-U.S. Blocker Corporations for investments by Non-U.S. Investors in Operating Partnerships.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Mary Conway	**212 450 4959**	**mary.conway@davispolk.com**
Lucy Farr	**212 450 4026**	**lucy.farr@davispolk.com**
Ethan Goldman	**212 450 4523**	**ethan.goldman@davispolk.com**
Omer Harel	**011 44 20 7418 1040**	**omer.harel@davispolk.com**
David Schnabel	**212 450 4910**	**david.schnabel@davispolk.com**