On July 13, 2017, in *Grecian Magnesite Mining, Industrial and Shipping Co. SA v. Commissioner* (149 T.C. No. 3 (2017), the U.S. Tax Court concluded that gain recognized by a foreign corporation upon redemption of its interest in a partnership that was engaged in a U.S. trade or business (an ECI Partnership) was not subject to U.S. federal income tax. In reaching its decision, the Tax Court refused to follow the long-standing Internal Revenue Service (IRS) position articulated in Revenue Ruling 91-32 that an “aggregation” approach rather than “entity” approach applies to a non-U.S. partner’s gain.

After determining an “entity” approach was more appropriate in this context, the court analyzed whether the gain at issue was effectively connected income (ECI). Certain categories of foreign source income can be ECI but the IRS acknowledged that the income at issue did not fall within any of those categories. Therefore, in order to be ECI, the income needed to be from U.S. sources. The court determined that the disposition of the partnership interest should be treated as a sale of personal property and that its source should be determined under section 865 of the Internal Revenue Code of 1986, as amended (the Code). Applying section 865 to the particular facts and circumstances before it, the court held that the gain at issue was not U.S. source income and therefore was not ECI.

**TAKEAWAYS**

- *Grecian* opinion upends long-standing IRS position that favored “aggregation” approach rather than “entity” approach to taxability of non-U.S. partner’s gain.
- Uncertainty remains, as an appeal to the Tenth Circuit appears likely.
- Affected taxpayers should consider seeking refunds, filing protective returns going forward and structuring future partnership sales with this opinion in mind.

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It is important to note that the decision does not represent a blanket exemption from U.S. federal income tax for non-U.S. partners disposing interests in ECI Partnerships. First, the decision does not affect the general result (subject to exceptions such as the one that may be available for certain foreign pension funds) that gain from the sale of a partnership interest to the extent attributable to U.S. real estate is subject to U.S. federal income tax under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). Second, non-U.S. partners that follow the analysis of the decision still will need to analyze whether their gain may be treated as ECI under their particular facts and circumstances.

Having said that, the Tax Court opinion is likely a welcome result for taxpayers but uncertainty remains as the IRS may move for reconsideration of the Tax Court opinion or appeal the decision to the Tenth Circuit Court of Appeals. A motion for reconsideration is not likely to be granted given that the case turned on a legal issue, while an appeal to the Tenth Circuit would likely be given serious consideration given the general deference that courts afford to IRS rulings. Until there is final resolution to the issue, uncertainty will continue for non-U.S. partners in ECI Partnerships and for such partnerships. Here is what those partners and partnerships need to know.

1. Claim for Refund—Any non-U.S. partners that have recently redeemed or sold an interest in an ECI Partnership and paid U.S. federal income tax on the gain under the principles of Revenue Ruling 91-32 should, taking into account their particular facts and circumstances, consider filing a claim for refund of the tax. Non-U.S. partners should also investigate the possibility of claiming state income tax refunds. Even though there is not yet a final resolution to the issue, affected taxpayers should, taking into account their particular facts and circumstances, consider filing a claim for refund to ensure that they are not barred by the statute of limitations once a resolution is reached. (Generally, a taxpayer is only permitted to file a claim for refund within three years of the filing of the return reporting the tax at issue.)

2. Payment of Tax—A non-U.S. partner that has recently disposed of an interest in an ECI Partnership should, taking into account their particular facts and circumstances, consider filing a protective federal income tax return reporting any gain. Although such return would report the gain from the disposition, the non-U.S. partner would not pay the associated tax, citing this decision as authority for the position. The filing of the protective return ensures that the statute of limitations begins to run and would preserve the ability to claim deductions and credits.

3. Sale of the Partnership Business—Following the decision, a non-U.S. partner in an ECI Partnership generally should prefer that the sale of a partnership business be structured as a sale of partnership interests and not partnership assets. Under Grecian, the sale of partnership interests may, depending upon the particular facts and circumstances, result in no tax payable on the gain (generally other than that attributable to U.S. real property) by the non-U.S. partners whereas a sale of partnership assets generally would result in the non-U.S. partners paying tax on their allocable share of the gain on the sale of the assets.
4. Investment via Partnerships—It is difficult to say whether investment by foreign persons in ECI Partnerships will increase meaningfully as a result of this decision. Anecdotal evidence suggests that many non-U.S. partners did not pay tax on the redemption or sale of their partnership interests even prior to this ruling, relying on the advice of practitioners who argued that the reasoning of Revenue Ruling 91-32 was flawed. Nonetheless, non-U.S. partners who were previously hesitant to invest in partnerships because of the uncertainty as to the taxation on disposition may be encouraged by this case depending upon the particular facts and circumstances.

5. Non-U.S. Partners Still Subject to Tax—Irrespective of the final resolution of *Grecian*, a non-U.S. individual or corporation should exercise caution in becoming a partner in an ECI Partnership. The decision does not affect a non-U.S. partner’s obligation to file a U.S. federal income tax return and pay U.S. federal income tax on its share of the partnership’s ECI. The decision also has no effect under FIRPTA. Further, the ECI Partnership will continue to be required to withhold U.S. federal tax from the non-U.S. partner’s distributive share of income pursuant to Code section 1446 regardless of whether the partnership makes any distributions to the foreign partner. Moreover, in order for a foreign partner to claim a refund, a valid Taxpayer Identification Number (TIN) would be required and the foreign partner would be required to file a U.S. income tax return (e.g., Form 1040NR for an individual, Form 1120-F for a corporation).