Deloitte.

Tax Court declines to follow Rev. Rul. 91-32

On July 13, the US Tax Court issued its opinion in Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner, T.C. No. 19215-12, 149 T.C. No. 3, 7/13/2017, in which the taxpayer, a foreign corporation, challenged the validity of the holding in Rev. Rul. 91-32, 1991-1 C.B. 107. After a three-year period following the trial and brief submissions from the taxpayer and the IRS, during which period the Obama administration each year sought legislation ratifying the IRS's position in Rev. Rul. 91-32, the Tax Court has finally issued its opinion and declined to follow Rev. Rul. 91-32, holding that:

1. The aggregate approach used in Rev. Rul. 91-32 is inconsistent with the Tax Court's general view that, without a specific exception, a disposition of a partnership interest should be governed by entity principles.

2. The foreign corporation's gain on the redemption of its interest in a US partnership was capital gain that was not US-source income and was not effectively connected with a US trade or business (ECI). The Tax Court made the following holdings necessary to the non-ECI treatment, discussed in further detail below:

    a. The foreign corporation's gain from the disposition of its partnership interest was not attributable to the US office or fixed place of business of the partnership's US trade or business under Section 865(e)(2);

    b. The partnership's US office or other fixed place of business was not a material factor in the realization of the foreign partner's income pursuant to Treas. Reg. §1.864-6(b) (which was relevant by reference to section 864(c)(5) from section 865(e)(3));

    c. The partnership did not redeem the foreign corporation's partnership interest in the ordinary course of the partnership's regular US trade or business; and

    d. Because the gain was not attributable to a US office or other fixed place of business, the disposition of the partnership interest was subject to residence-based sourcing under section 865(a) and was therefore treated as foreign source non-ECI. No discussion of potential resourcing of all or a part of the gain under section 865(c) was argued to the Court or discussed in the opinion.

3. In a second holding addressing the taxpayer's concession during the litigation that a portion of its gain was taxable ECI under section 897(g) attributable to appreciated US real property interests held by the partnership, the Tax Court held that the foreign corporate taxpayer reasonably relied in good faith on the advice of its US tax return preparer and adviser in not declaring Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) ECI gain on its annual Form 1120-F corporate tax return for the 2008 year and for its failure to file a 2009 return and pay the 2009 tax. Therefore, GMM was not subject to accuracy-related penalties under section 6662 for 2008 or to non-filer penalties under section 6651 for 2009.

In addition to a detailed discussion of the Tax Court's sourcing and ECI analysis, some observations about the scope of the Tax Court's opinion and additional issues raised by the holdings are provided below.

Facts

The taxpayer, Grecian Magnesite Mining, Industrial & Shipping Co., SA ("GMM"), is a Greek corporation that is in the business of extracting, producing, and commercializing magnesia and magnesite, which it sold to customers worldwide. Since 2001, GMM owned a membership interest of Premier Chemicals, LLC

("Premier")[1], a Delaware LLC treated as a partnership for US federal tax purposes. Premier is in the business of extracting, producing, and distributing magnesite in the United States. During the years at issue, Premier's headquarters were located in Pennsylvania and it owned several mines or industrial property in the United States. Its activities caused GMM to be treated as engaged in a US trade or business under section 875(1). Each year that it owned an interest in Premier, GMM was allocated a distributive share of ECI and filed annual corporate income tax returns on Forms 1120-F through a US-based certified public accountant that had specialized in partnership reporting over a 30-year career but was not a specialist in international tax matters. Other than through its ownership interest in Premier, GMM had no office, employees, or other business operations in the United States.

In 2008, GMM redeemed its 12.6% interest in Premier for a total of $10.6 million; the redemption was effected by two equal transactions for which GMM realized a gain of $1 million and $5.2 million in 2008 and 2009, respectively. GMM's US tax return preparer advised that a portion of the redemption value attributable to appreciated US real estate in the Premier partnership was not subject to US tax to GMM. No tax attributable to the US real estate appreciation was withheld by Premier and none was paid by GMM with its final tax return filings in 2008 and 2009. During the litigation, GMM conceded that the redemption distribution portion attributable to the US real estate appreciation was taxable, and conceded the issue. The IRS sought 20% accuracy-related penalties under section 6662 attributable to taxpayer negligence or disregard of the US tax rules in addition to penalties under section 6651(a)(1) for failure to file a corporate tax return for the remainder of the gain received in 2009 attributable to US real estate appreciation in the Premier partnership.

Issue

The IRS and GMM agreed that $2.2 million of the $6.2 million gain was attributable to the sale of US real property interests pursuant to section 897(g) and was US-source income treated as effectively connected with the conduct of GMM's US trade or business. However, the Commissioner and GMM disputed whether the remaining gain of $4 million was US-source income that is ECI. Specifically, the Court addressed whether GMM's gain from the disposition of its partnership interest in Premier should be treated as (1) a disposition of GMM's share of each asset Premier owned, and if so, (a) whether that disposition was attributable to GMM's deemed US office or fixed place of business under section 865(e)(2) where Premier conducted its US trade or business, and (b) whether such deemed office was a material factor in the production of GMM's gain under Treas. Reg. §1.864-6(b) as argued by the IRS, or (2) whether such disposition gain should be analyzed as only a partnership-entity-instrument disposition that was not attributable to a US office and therefore was foreign source and non-ECI to GMM's Premier-operated trade or business in the United States.

Revenue Ruling 91-32

Rev. Rul. 91-32, 1991-1 C.B. 107, holds that the gain realized by a foreign partner upon disposing of its interest in a US partnership should be analyzed asset by asset, and that, to the extent the assets of the partnership would give rise to ECI if sold by the entity, the departing partner's pro rata share of such gain should be treated as ECI. The Commissioner asked the Tax Court to defer to Rev. Rul. 91-32, the facts of which essentially mirror those of this case, and to also take into account certain judicial practices for providing general deference to IRS administrative rulings in interpreting statutes and regulations.

Tax Court's Subchapter K Analysis

To begin its analysis of whether the disputed gain was "effectively connected with the conduct of a trade or business within the US" under section 882(a)(1), the Tax Court looked at the provisions of subchapter K to determine the nature of the gain from the liquidation of a partnership interest.

---

[1] Premier was organized as Premier Chemicals, LLC in January 2001, and it is now known as Premier Magnesia, LLC.

The Tax Court concluded that the payments from Premier to GMM were made in exchange for the interest of GMM in partnership property under section 736(b)(1), and therefore should be considered as a distribution by the partnership. To determine the effect of such "distribution," the Tax Court noted that section 731(a) provides that "[i]n the case of a distribution by a partnership to a partner… [a]ny gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner." (Emphasis added.) Then, relying on section 741, which provides that "gain or loss [recognized by the transferor partner] shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items)," the Tax Court concluded "that the entity theory is the general rule for the sale or exchange of an interest in a partnership."

Lack of Deference to Revenue Ruling

In deciding whether to give Rev. Rul. 91-32 "appropriate deference," the Tax Court noted that where a ruling interprets "an agency's own ambiguous regulation, that interpretation is accorded deference [but] where a revenue ruling improperly interprets the text of relevant statutes and has inadequate reasoning, we afford it no deference at all." If a ruling is between "these poles," the Tax Court will defer to a revenue ruling to the extent that it has "the 'power to persuade.'" The Tax Court, however, was unpersuaded. It noted that the ruling's discussion of the relevant subchapter K provisions is "cursory in the extreme" and "did not even cite section 731." Instead, "the ruling's subchapter K analysis essentially begins and ends with the observation that '[s]ubchapter K of the Code is a blend of aggregate and entity treatment for partners and partnerships.'" Ultimately, the Tax Court wrote that "in order to view the redemption transaction as a hypothetical sale of GMM's portions of partnership property, one would have to abandon, for no reason evident in the statute or the regulations, the conclusions called for by subchapter K."

Sourcing and ECI Analysis

The Tax Court stated that section 864(c)(3) provides that US-source income, other than fixed, determinable, annual or periodic (FDAP) income, is treated as effectively connected with the conduct of a trade or business within the United States. While some types of foreign source income are also treated as effectively connected income under section 864(c)(4)(B), the parties acknowledged that the income at issue does not fall within that provision. Consequently, the court focused on whether or not the disputed gain ought to be treated as US-source income and thus ECI. Given its lack of deference to Rev. Rul. 91-32, the Tax Court followed the Code and the regulations to determine whether the disputed gain was ECI.

Under the default sourcing rules for gain realized on the sale of personal property under section 865(a), a nonresident's income from the sale of personal property is sourced outside of the United States unless an exception applies. The IRS argued that GMM's gain was US source under the "US office rule" exception of section 865(e)(2)(A), which provides that "[I]f a nonresident maintains an office or other fixed place of business in the United States, income from any sale of personal property (including inventory property) attributable to such office or other fixed place of business shall be sourced in the United States." The Tax Court assumed, but did not conclude, that GMM did have an office or other fixed place of business within the United States, attributing Premier's office to GMM under Section 875(1). Thus the analysis centers on whether or not the disputed gain is attributable to such office.

To determine whether GMM's gain from the sale of its interest in Premier was attributable to Premier's US office, the Tax Court applied section 865(e)(3), which provides that the principles of section 864(c)(5) should be applied to determine whether income is attributable to a US office or fixed place of business. Pursuant to section 864(c)(5), income, gain, or loss is attributable to a US office only if (1) the US office is "a material factor in the production of such income" and (2) the US office "regularly carries on activities of the type from which such income, gain, or loss is derived."

Material Factor

The regulations provide that to be a material factor, the activities of the office or other fixed place of business must be "significant" and "essential" but do not necessarily have to be a "major" factor.[2] Dismissing the Commissioner's argument that this redemption was equivalent to a sale of the partnership's underlying assets, the Tax Court concluded that for Premier's US office to have been a "material factor" in the relevant sense, Premier's office must have been material to the redemption transaction itself. The Tax Court also dismissed the Commissioner's alternative argument that because Premier increased the value of its underlying assets and thereby increased its overall value, "Premier's US offices were an essential economic element in GMM's realization of gain in the redemption." Instead, the Tax Court reasoned that, because section 865(e)(3) refers to the principles of section 864(c)(5), "we must take guidance as appropriate from section 864(c)(5) and the regulations thereunder." Taking into consideration these underlying principles, the Tax Court determined that it was reasonable to conclude based, in part, on Treas. Reg. §1.864-6(b)(2)(i) that Premier's actions to increase its overall value were not "an essential economic element in the realization of income" by GMM on the redemption transaction. Therefore, the Tax Court held that Premier's efforts to develop, create, or add substantial value to the property sold (i.e., GMM's interest in Premier) were not a material factor in the realization of GMM's gain.

Ordinary Course

The second part of the "attributable to" inquiry is whether "the income, gain, or loss is realized in the ordinary course of the trade or business carried on through that office or other fixed place of business." The Tax Court explained that even if it had determined that Premier's office was a "material factor" in the production of GMM's gain, it would have had to find that GMM's gain had been realized in the ordinary course of Premier's business conducted through its US office in order for the gain to be attributable to that office. The Tax Court held that GMM's gain realized on the redemption of its partnership interest in Premier was not realized in the ordinary course of the trade or business carried on through Premier's US offices because Premier was in the business of producing and selling magnesite products and not redeeming and selling partnership interests, noting that only two such redemptions other than GMM's occurred over a seven-year period.

Observations

The Tax Court's opinion raises the following significant ECI issues –

1. **Whether gain in excess of depreciation adjustments under section 865(c) are subject to the place of sale rule for capital gains** - The Tax Court's reference to all US source income other than FDAP income as being treated as ECI under section 864(c)(3) is overbroad. Section 864(c)(3) does not apply to US-source capital gains, which remain subject to separate ECI analysis under the asset-use and business-activities tests of section 864(c)(2). The Tax Court did not make this analysis because it held that the capital gain from the disposition treatment of the partnership interest was foreign source under section 865(a). However, the Tax Court did not address whether any depreciation adjustments under section 865(c) were present and if so, whether any such adjustments were applicable to the non-FIRPTA portion of the gain on disposition of the partnership interest. Accordingly, there is no discussion of whether the "place of sale rule" for gain in excess of depreciation adjustments could have resulted in a US-source capital gain that would have required asset-use and business-activity test analyses. US-source capital gains do not require attribution to a US office or other fixed place of business to be ECI, but the Tax Court's opinion implies that capital gains do need to be attributable to a US office or other fixed place of business in order to obtain US-source treatment. This potential circularity and its coordination with the "place of sale" rule for gains in excess of depreciation adjustments under

---

[2] Treas. Reg. §1.864-6(b)(1).

section 865(c) remain unresolved by the Tax Court's holding. Accordingly, the holding is not necessarily precedent for a case that expressly addresses the treatment of depreciation adjustments that are in the factual record.

2. **Whether a partnership interest may be ECI in its entirety with another US trade or business of the foreign partner and cause non-ECI income of the partnership to be converted to ECI** - The Tax Court's holding appears to prohibit bifurcation of the potential sourcing treatment of the partnership interest under its "entity theory" approach to determining the source and ECI treatment of the foreign partner's gain on disposition of the partnership interest. The Tax Court's emphasis of the singular use of the word "asset" in section 741, instead of the plural "assets," arguably implies that the partnership interest may be tested as a separate ECI asset in other circumstances, with no room for an aggregate analysis of the partnership's property. For instance, if a partnership has both ECI and non-ECI property, the Tax Court's holding creates an issue of whether the partnership interest may be ECI in its entirety with another US trade or business of the foreign partner. The IRS previously addressed this issue in its Technical Advisory Memorandum LTR 200811019, Nov. 29, 2007, and applied the aggregate theory advocated in Rev. Rul. 91-32. The 2008 IRS pronouncement confirmed that an aggregate approach was necessary to meet the purposes and intents of section 864(c)(2) with respect to certain classes of income, particularly non-ECI treatment of investment dividends from the holding of non-dealer and non-trader stock that was not eligible for the trading safe harbor of section 864(b)(2)(A). The ECI treatment of proprietary trading securities was covered in the companion TAM LTR 200811018, Nov. 29, 2007. The Tax Court's opinion now raises the question whether non-ECI property such as dividends on portfolio or subsidiary stock held for investment by the partnership, including a partnership that is not otherwise engaged in a trade or business, might be converted to ECI merely by holding the partnership interest in connection with a foreign partner's other US trade or business, if looking through to the composition of the partnership income is now rendered irrelevant.

3. **Whether the good faith treatment provided the foreign taxpayer for penalty relief may inform good faith treatment for restoration of deductions to foreign non-filers of US tax returns** - The standard for good faith in abating the late payment of the ECI gains from the FIRPTA portion of the disposition in 2008 and 2009 is not the same as the standard for obtaining relief from the denial of deductions for not filing tax returns under Treas. Reg. §1.882-4(a)(3)(ii). Even though the Tax Court found that GMM acted in good faith in relying on advice not to report a gain, it had a history of filing tax returns since the 2001 tax year. Those are factual conditions that may weigh against a good faith treatment of non-filing in a later year under Treas. Reg. §1.882-4(a)(3)(ii).

Conclusion

The Tax Court held that since GMM's gain on its redemption was not attributable to a US office or other fixed place of business, it was therefore not US-source income under section 865(e)(2)(A). Consequently, the disputed gain is not ECI.[3] The ancillary questions raised by the holding require additional scrutiny, and the Court's holding should not be understood tacitly to extend to other factual conditions of the type observed above, because of the limited factual record the Court had before it. Caution is still warranted for non-filing positions in light of the issues and observations raised above which were not expressly addressed in the factual record of this case or in the Court's decision.

---

[3] The Commissioner had conceded that GMM's gain was not one of the types of foreign source income treated as effectively connected by section 864(c)(4)(B).

For additional information or questions, please contact:

Ted Dougherty
National Managing Partner –
Investment Management Tax
Deloitte Tax LLP
+1 212 436 2165

Jim Calzaretta
Partner
Washington National Tax
Deloitte Tax LLP
+1 312 486 9138

Tom Butera
Principal
International Tax
Deloitte Tax LLP
+1 212 436 3231

Lisa Sergi
Principal
Investment Management
Deloitte Tax LLP
+1 213 688 3206

Dave Earley
Partner
Investment Management
Deloitte Tax LLP
+1 203 708 4696

Aubrey Buono
Senior Manager
Deloitte Tax LLP
+1 203 708 4696

This alert contains general information only and Deloitte is not, by means of this alert, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This alert is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional adviser. Deloitte shall not be responsible for any loss sustained by any person who relies on this alert.

About Deloitte
As used in this document, “Deloitte” means Deloitte Tax LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of our legal structure. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2017 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited