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Memorandum

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Major Tax Court Decision – Grecian Magnesite

Tax Court holds non-U.S. partners not subject to tax on gain from sale of interest in ECI Partnership

Summary

Yesterday, the Tax Court released a decision, *Grecian Magnesite Mining, Industrial & Shipping Co., SA*, which may have significant implications for non-U.S. investors investing in U.S. businesses that operate in pass-through form. The case addressed the IRS's position, articulated in a long-standing Revenue Ruling (Rev. Rul. 91-32), that a non-U.S. person's capital gain on the sale of an interest in a partnership that is engaged in a U.S. trade or business (an "ECI Partnership") is treated as effectively connected income ("ECI") and, thus, is subject to U.S. federal income tax, to the extent attributable to the partnership's U.S. trade or business. The Tax Court declined to follow Rev. Rul. 91-32, determining that the ruling could not be sustained on technical grounds. It held that a non-U.S. person's capital gain on the sale of an interest in an ECI Partnership is not generally subject to U.S. federal income tax, except with respect to the portion of the gain, if any, attributable to the non-U.S. person's share of the partnership's U.S. real property interests. Although the implications of the decision will require further consideration (and will depend in part on whether the decision is appealed, and, if so, with what result), the decision would appear to present significant opportunities for future structuring and planning.

Discussion

As background, the Internal Revenue Code does not explicitly address the tax treatment of gain derived from the sale by a non-U.S. person of interests in an ECI Partnership. In 1991, the IRS issued Rev. Rul. 91-32, holding that capital gain from the sale of an interest in an ECI Partnership by a non-U.S. person is generally treated as ECI (and thus subject to U.S. federal income tax) to the extent attributable to the partnership's U.S. trade or business, in effect relying on the so-called "aggregate" theory of partnerships. This is a similar result to that mandated by Sections 751 and 897(g) of the Code. Section 751 provides ordinary, rather than capital, treatment on a sale of a partnership interest to the extent attributable to the partnership's ordinary income assets, such as unrealized receivables, certain inventory, recapture and other similar items. Section 897(g) provides that the sale of an interest in a partnership holding U.S. real property interests by a non-U.S. person is treated as ECI to the extent the gain is derived from U.S. real property interests.

Rev. Rul. 91-32 has generated significant controversy, and commentators have argued that it conflicts with relevant statutory authorities that apply an "entity" rather than an "aggregate" approach to the sale of partnership interests (except in the limited situations described above). The Obama administration proposed codifying Rev. Rul. 91-32 on a number of occasions, but these proposals were never enacted.

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It should be noted that a non-U.S. partner's allocable share of income earned by an ECI Partnership remains taxable (to the extent it is ECI). Moreover, Section 897(g) continues to apply to non-U.S. investors in partnerships which hold U.S. real property interests. The decision does not expressly address gain attributable to recapture income and other Section 751 items.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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