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# Tax Court Overrides Revenue Ruling to Hold That Gain on Sale or Redemption of Partnership Interest is Not Effectively Connected Income

## Tax Court Holds That the Character of Gain From the Sale or Redemption of a Partnership Interest as Effectively Connected or Not is Determined (Based on Statutory Analysis) by Reference to the Outside Partnership Interest, Not the Business Conducted by the Partnership


### SUMMARY

In *Grecian Magnesite Mining, Industrial & Shipping Co., SA* v. *Commissioner of Internal Revenue*, 149 T.C. No. 3 (July 13, 2017), the Tax Court held that a non-U.S. taxpayer's gain from redemption of a partnership interest in a United States partnership that was engaged in a U.S. trade or business was the disposition of an indivisible capital asset, and therefore no part of the gain was effectively connected income.[1] This decision rejects the reasoning of Revenue Ruling 91-32,[2] which ruled that gain from the disposition of such a partnership interest is effectively connected income to the extent a sale of the assets by the partnership itself would have given rise to effectively connected income. According to the Court, "where a revenue ruling improperly interprets the text of relevant statutes and has inadequate reasoning, we afford it no deference at all." Although the IRS may be expected to appeal the decision of the Tax Court, taxpayers who have sold interests in such partnerships in taxable years for which the statute of limitations has not yet closed should consider filing amended returns and claiming a refund.

## BACKGROUND

Gain on the sale of personal property by non-U.S. persons is generally taxable only if that gain is effectively connected with the conduct of a trade or business within the United States. Non-U.S. partners in a partnership engaged in a U.S. trade or business are themselves deemed to be engaged in the partnership's trade or business. However, for gain on a non-U.S. person's sale of personal property to be effectively connected income it must generally be U.S.-source. To be U.S.-source, such gain must be attributable to a U.S. office or fixed place of business. Gain is attributable to an office where the office is a material factor in the production of income and the U.S. office regularly carries on the activities of the type from which such gain is derived.

In Revenue Ruling 91-32, the IRS held that where a partnership conducts its U.S. trade or business through a U.S. office, non-U.S. partners are also deemed to conduct the same U.S. trade or business through that office. The ruling further concludes that gain on disposition of a partnership interest is attributable to such office and is therefore effectively connected income. More specifically, the ruling concludes that the portion of a non-U.S. partner's effectively connected income is determined as though the partner sold its proportionate interest in each of the partnership's underlying assets.

In *Grecian Magnesite Mining*, the taxpayer was a partner of a U.S. partnership[3] in the business of extracting, producing, and distributing magnesite mined in the United States. The partnership redeemed the taxpayer's partnership interest, and the taxpayer took the position that no part of the income from this redemption was effectively connected with the conduct of a U.S. trade or business.

## THE TAX COURT'S DECISION

The Tax Court held that under the statutory framework governing the sale and redemption of partnership interests, the disposition of a partnership interest is the disposition of a single, indivisible capital asset and is not a sale of an undivided interest in the underlying partnership property.[4] In analyzing whether the taxpayer's gain was effectively connected income, the Tax Court explicitly declined to defer to Revenue Ruling 91-32 because the ruling failed to follow the relevant statutory framework or offer any persuasive basis for departing from it. According to the Court, while deference is appropriate where a ruling construes the agency's own ambiguous regulation, no deference is owed where "a revenue ruling improperly interprets the text of relevant statutes and has inadequate reasoning." Between these two poles, deference is afforded to the extent a revenue ruling has the "power to persuade." The Court found that Revenue Ruling 91-32 lacked such power.

Having declined to follow Revenue Ruling 91-32, the Tax Court examined whether the taxpayer's gain from the disposition of the partnership interest was attributable to a U.S. office of the taxpayer.[5] First, the IRS argued that because the activities at this office increased the value of the taxpayer's interest, gain on the disposition of the interest was therefore attributable to the office. The Tax Court rejected this argument, explaining that the increase in value of the partnership as a going concern did not result in a realization of income to the taxpayer; rather, it was the disposition of the interest that produced the gain. Accordingly, the activities attributable to the partnership's office were not a material factor in the taxpayer's gain.

Second, the IRS argued that admitting and redeeming partnership interests was an activity regularly carried on by the partnership's office because redemption of the taxpayer's interest was not an isolated event. The Tax Court rejected this argument as well, ruling that two other such events during a seven-year period did not constitute regular conduct of such activities. Thus, the gain on the taxpayer's redemption of the partnership interest was not attributable to a U.S. office and was therefore not subject to tax as effectively connected income.

Finally, the IRS argued that its own revenue ruling on the subject should be afforded deference. As noted above, the Tax Court disagreed.

## IMPLICATIONS

The Tax Court's decision has two significant implications. First, non-U.S. partners are much less likely to be subject to U.S. tax on the disposition of an interest in a U.S. partnership even where the partnership is itself engaged in a U.S. trade or business. Additionally, taxpayers who have filed tax returns and paid income tax consistent with the holding of Revenue Ruling 91-32 should consider filing amended returns and claiming a refund. Second, the case underlines the fact that revenue rulings may not be followed (by the Tax Court, at least) where they deviate from the statutory text based on unpersuasive technical reasoning in order to implement perceived policy objectives.

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### ENDNOTES

1 The parties agreed that a portion of the gain was subject to tax because it was attributable to U.S. real property interests; the subject of the case was the remainder of the gain.

2 1991-1 C.B. 107.

3 The entity was a Delaware LLC treated as a partnership for U.S. federal income tax purposes.

4 The Tax Court acknowledged that there are exceptions to this general rule, including Section 751 (dealing with unrealized receivables and inventory items) and Section 897 (dealing with gain attributable to U.S. real property interests).

5 The Tax Court analyzed the taxpayer's income assuming (but not holding) that the partnership's U.S. office was also the taxpayer's office, a point which the parties disputed. Because the gain was not attributable to any such office, the Tax Court did not reach this question.

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