



To Our Clients and Friends:

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Tax Court Rejects Revenue Ruling 91-32—Holds Greek Corporation's Gain from the Redemption of Its Partnership Interest Not To Be Taxable as Effectively Connected Income

On July 13, 2017, the Tax Court issued its much anticipated decision in *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner*, 149 T.C. No. 3, a case that Roberts & Holland LLP has been litigating for nearly five years.

Background

In 2001, Grecian Magnesite Mining, Industrial & Shipping Co. ("Grecian"), a Greek corporation, purchased a minority interest of less than 15% in Premier Chemicals, LLC ("Premier"), a domestic limited liability company classified as a partnership. In 2008, Premier agreed to redeem Grecian's partnership interest and made a first redemption payment on July 21, 2008. Premier made a second redemption payment on January 2, 2009, but the parties considered the redemption to be complete as of December 31, 2008. Grecian realized capital gain on the redemption in both 2008 and 2009. Grecian's tax return for 2008 did not include any portion of the redemption gain and, on the advice of its tax return preparer, Grecian did not file a tax return for 2009.

The Internal Revenue Service ("IRS") issued a Notice of Deficiency claiming that all of Grecian's capital gain on the redemption was taxable as income effectively connected with the conduct of a trade or business within the United States ("effectively connected income"). The IRS and Grecian agreed on an amount of Grecian's capital gain that was attributable to U.S. real property interests and was therefore taxable, pursuant to a statutory "look-through rule" that applies to U.S. real property interests. The remaining capital gain (the "disputed gain") was the primary subject of the Tax Court litigation. In addition, the IRS sought to impose penalties on Grecian for failing to report the redemption gain and for failing to file a 2009 return.

The IRS Position and Ruling 91-32

In order for the disputed gain to be taxable as effective connected income it must first be U.S.-source. The IRS argued that the disputed gain was U.S.-source on the basis of Revenue Ruling 91-32, 1991-1 C.B. 107 (the "Ruling").

On facts very similar to those presented in *Grecian*, the Ruling holds a foreign partner's gain on the sale of a partnership interest to be U.S.-source income to the extent attributable to assets of the partnership that

produce effectively connected income, on the ground that (1) the partnership's U.S. office is deemed to be a U.S. office of the foreign partner, and (2) the sale is attributable to such (deemed) U.S. office of the foreign partner.

The Ruling fairly concludes, on the basis of existing case law, that the partnership's U.S. office is attributed to the foreign partner (for at least some purposes), but fails to explain why the IRS considers the sale to be attributable to such U.S. office. Indeed the Ruling fails even to discuss certain statutory and regulatory provisions that are directly on point. Accordingly, the Ruling has been highly controversial, and much criticized, since it was issued over 25 years ago.

Grecian's Position and the Tax Court Litigation

Grecian argued that the statutory and regulatory requirements for treating the disputed gain as attributable to a U.S. office were not satisfied and that the disputed gain was therefore foreign-source non-effectively connected income. Among other things, Grecian maintained that, subject to the look-through rule for U.S. real property interests, its partnership interest in Premier was considered a single, indivisible capital asset under Code section 741. The IRS disagreed, taking the position that an "aggregate" approach to partnerships should apply for purposes of determining the source of the disputed gain.

The Tax Court agreed with Grecian that Code section 741 mandates an entity approach and held the disputed gain to be foreign-source non-effectively connected income. In reaching this conclusion, the Tax Court rejected the Ruling and, moreover, held it was entitled to no deference whatsoever, as it "lacks the power to persuade." The Tax Court also rejected the IRS's attempt to impose penalties on Grecian's underpayment of tax, because Grecian reasonably relied on the advice of its tax return preparer.

We expect to circulate an article discussing the case in greater detail, within the next several weeks.

If you have any questions concerning this release, please contact Michael J. Miller at (212) 903-8757, Ellen S. Brody at (212) 903-8712, or Mark David Rozen at (212) 903-8743.

Roberts & Holland LLP