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Foreign Corporation Not Taxable on Redemption of Partnership Interest: Tax Court Rejects Rev. Rul. 91-32

By Michael J. Miller and Ellen S. Brody[*]

INTRODUCTION

In *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner*,[1] the Tax Court held that the capital gain recognized by the taxpayer, a Greek corporation, upon the redemption of its interest in a U.S. limited liability company classified as a partnership, is not taxable, because such gain is not effectively connected with the conduct of a trade or business in the United States (''effectively connected income'' or ''ECI''). In so holding, the Tax Court rejected Rev. Rul. 91-32, 1991-1 C.B. 107 (''Rev. Rul. 91-32'' or the ''Ruling''), which holds otherwise on similar facts.

As a matter of full disclosure, readers should be aware that the authors represented the taxpayer in this litigation.

BACKGROUND

Taxation of Foreign Corporations

Overview

Foreign corporations are subject to U.S. federal income tax on two types of income: (1) income that is effectively connected with the conduct of a trade or business in the United States, and (2) U.S.-source income (other than effectively connected income) that is considered to be fixed or determinable annual or periodical (''U.S. FDAP income'').[2] Effectively connected income is generally taxed on a net basis,[3] while U.S. FDAP income is generally taxed on a gross basis, at a 30% rate, unless an exemption or reduced treaty rate applies. Pursuant to §897(a), enacted as part of the Foreign Investment in Real Property Tax Act of 1980 (''FIRPTA''), gain from the disposition of a United States real property interest is treated as ECI. Pursuant to a ''look-through rule'' set forth in §897(g), an amount received in exchange for an interest in a partnership is treated as received in exchange for United States real property interests to the extent attributable to United States real property interests owned by the partnership.

There are limited exceptions, but typically foreign-source income will not be ECI, so in determining if a foreign corporation's income is ECI, the best place to start the analysis is to determine the source of the income. The Code includes quite a few (though not nearly enough) sourcing rules, but in the context of this discussion, two are particularly important. These rules are described below.

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1 149 T.C. No. 3 (July 13, 2017).

2 Section 882(b) and §881 of the Internal Revenue Code of 1986, as amended (the ''Code''). The rules for nonresident alien individuals are largely the same, pursuant to §872(a) and §871, provided, however, that certain capital gains may also be taxed in the case of an individual who is present in the United States for 183 days during the year but nevertheless a nonresident alien. Except as may otherwise be indicated, all ''Section'' and ''§'' references are to the Code or the Treasury regulations promulgated thereunder.

3 However, pursuant to §882(c)(2) and the regulations thereunder, a corporation that fails to file will be unable to claim its otherwise allowable deductions, and will therefore be taxed on a gross basis, in certain circumstances.

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Pertinent Source Rules

Default Rule for Dispositions of Personal Property

Code §865(a) sets forth a default rule pursuant to which income from any disposition of personal property by a nonresident is foreign-source income unless an exception applies.[4]

Exception for Sales Attributable to U.S. Office

Section 865(e)(2) provides a special rule, sometimes referred to as the ''U.S. office rule,'' pursuant to which income from a nonresident's disposition of personal property will be treated as U.S.-source income if (1) the nonresident maintains an office or other fixed place of business in the United States (''U.S. office''), and (2) such disposition of personal property is ''attributable'' to the nonresident's U.S. office.

Section 865(e)(3) provides that, in order to determine if a nonresident has a U.S. office, or if a sale is attributable to a U.S. office, the principles of §864(c)(5) apply. The rules of §864(c)(5) apply for purposes of §864(c)(4)(B), so in order to understand §864(c)(5), a brief description of §864(c)(4)(B) is necessary.

Section 864(c)(4)(A) provides, as a general rule, that foreign-source income cannot be ECI. However, pursuant to §864(c)(4)(B), certain specified items of foreign-source income, gain, or loss will constitute effectively connected income if (1) the foreign corporation has a U.S. office (the ''U.S. office requirement''), and (2) such item of foreign-source income, gain, or loss is attributable to such U.S. office (the ''attributable requirement'').[5]

Section 864(c)(5) provides guidance for determining if the requirements of §864(c)(4)(B) are satisfied. In particular, §864(c)(5)(A) provides rules for determining if the U.S. office requirement is satisfied, and §864(c)(5)(B) provides rules for determining if the attributable requirement is satisfied.[6] Section 864(c)(4)(B) does not apply to gains from dispositions of partnership interests,[7] and §864(c)(5) is by its terms applicable solely for purposes of §864(c)(4)(B). Nevertheless, as noted above, §865(e)(3) provides that the principles of this provision apply for purposes of the U.S. office rule of §865(e)(2).

With respect to the U.S. office requirement, §864(c)(5)(A) provides as follows:

> (A) in determining whether a nonresident alien individual or a foreign corporation has an office or other fixed place of business, an office or other fixed place of business of an agent shall be disregarded unless such agent (i) has the authority to negotiate and conclude contracts in the name of the nonresident alien individual or foreign corporation and regularly exercises that authority or has a stock of merchandise from which he regularly fills orders on behalf of such individual or foreign corporation, and (ii) is not a general commission agent, broker, or other agent of independent status acting in the ordinary course of his business[.]

With respect to the attributable requirement, §864(c)(5)(B) provides as follows:

> (B) income, gain, or loss shall not be considered as attributable to an office or other fixed place of business within the United States unless such office or fixed place of business is *a material factor in the production of such income, gain, or loss* and such office or fixed place of business *regularly carries on activities* of the type from which such income, gain, or loss is derived[.][8]

Reg. §1.864-6(b)(1) provides further guidance as to whether the requirements of §864(c)(5)(B) are met with respect to an item of income, gain, or loss. Such requirements are met only if (1) the U.S. office is a ''material factor'' in the realization of such income, gain, or loss (the ''material factor requirement''), and (2) such income, gain, or loss is realized in the ''ordinary course'' of the trade or business carried on through such U.S. office (the ''ordinary course requirement'').

Reg. §1.864-6(b)(1) provides a general rule whereby, in order for the material factor requirement to be satisfied, the U.S. office must provide ''a significant contribution to, by being an essential economic element in, the realization of the income, gain, or loss.'' It is noteworthy that the focus is upon the ''realization'' of the income.

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[4] Section 865(a) uses the term ''sale,'' but §865(i)(2) provides that, for purposes of §865, the term ''sale'' ''includes an exchange or any other disposition.''

[5] There are also limited circumstances, not relevant here, in which foreign-source income may be ECI pursuant to §864(c)(4)(C).

[6] Section 864(c)(5)(C) provides a limitation (not relevant here) on the amount of gain that may be considered attributable to a U.S. office in certain circumstances.

[7] Section 864(c)(4)(B) applies solely to (1) certain active rents and royalties for the use of intangible property, (2) certain active dividends, interest, and guarantee fees, (3) income from sales or exchanges of certain inventory-type property described in §1221(a)(1), and (4) income or gain that is ''equivalent'' to any of the foregoing.

[8] Emphasis added.

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Further guidance is set forth in Reg. §1.864-6(b)(2)(i), which provides in part as follows:

> An office or other fixed place of business in the United States *shall not be considered* to be *a material factor* in the realization of income, gain, or loss for purposes of this subdivision *merely because the office* or other fixed place of business . . . *develops, creates, produces, or acquires and adds substantial value* to, the property which is licensed, or sold, or exchanged . . . . (emphasis added).[9]

The regulations also include a helpful illustration:

> Example (1). F, a foreign corporation, is engaged in the *active conduct of the business of licensing patents which it has either purchased or developed in the United States*. F has a business office in the United States. Licenses for the use of such patents outside the United States are negotiated by offices of F located outside the United States, subject to approval by an officer of such corporation located in the U.S. office. All services which are rendered to F's foreign licensees are performed by employees of F's offices located outside the United States. *None of the income, gain, or loss resulting from the foreign licenses so negotiated by F is attributable to its business office in the United States.*[10]

ECI Rules

In order for a foreign corporation's U.S.-source income to be ECI, certain additional requirements must be satisfied. First, the foreign corporation must be engaged in the conduct of a trade or business within the United States (''ETBUS''). In this regard, §875(1) provides that, if a partnership is ETBUS, then each foreign partner in the partnership is deemed to be ETBUS as well.

Second, if the income is U.S. FDAP or U.S.-source capital gain, the income will be ECI, pursuant to §864(c)(2), only if it (1) ''is derived from assets used or held for use'' in the conduct of a trade or business within the United States, or (2) the activities of such trade or business were a ''material factor'' in the realization of such income. Any other type of U.S.-source income is automatically ECI, pursuant to §864(c)(3), provided that the foreign corporation is ETBUS.

[9] Reg. §1.864-6(b)(2)(i) also provides that the material factor requirement is satisfied ''if the office or other fixed place of business either actively participates in soliciting, negotiating, or performing other activities required to arrange, the lease, license, sale, or exchange from which such income, gain, or loss is derived or performs significant services incident to such lease, license, sale, or exchange.''

[10] Reg. §1.864-6(b)(2)(ii) *Ex.* 1 (emphasis added).

Key Facts in *Grecian*

Grecian Magnesite Mining, Industrial & Shipping Co., SA (''Grecian''), a Greek corporation, acquired a minority interest of approximately 15% in Premier Chemicals, LLC (''Premier'') in 2001. In 2007, Premier took in a new partner, so Grecian's interest was reduced to approximately 12.6%.

Premier is engaged in the business of extracting, producing, and commercializing magnesia and magnesite in the United States, which it sells to customers worldwide, and all of Premier's income is presumably ECI. Premier is classified as a partnership for U.S. federal tax purposes and, as a partner in Premier, Grecian filed IRS Form 1120-F and paid tax on its share of Premier's income each year from 2001 through 2008.

In 2008, one of Premier's other members, IMin Partners, offered to sell its entire membership interest back to Premier for $10 million, and Premier accepted. Due to a provision in its operating agreement, Premier was then required to offer to redeem each other member's interest at the same valuation, and Grecian accepted the offer. There were no negotiations between Premier and Grecian, and all of Grecian's activities with respect to such redemption transaction took place in Greece. Grecian received redemption payments on July 21, 2008 and January 2, 2009, though the parties considered Grecian to have been redeemed (and the second payment to have been made) as of December 31, 2008. Premier did not issue a Form K-1 to Grecian for 2009.

Grecian's tax return preparer prepared a final return for Grecian's 2008 taxable year, on IRS Form 1120-F. The 2008 return included Grecian's share of Premier's income, but did not include any gain arising from the redemption. Grecian's return preparer advised Grecian that no return was required for 2009. Following this advice, Grecian did not file a return for 2009.

Eventually, the Internal Revenue Service (IRS) conducted an audit and sent Grecian a statutory Notice of Deficiency on the ground that Grecian's 2008 and 2009 capital gain from the redemption was taxable as effectively connected income pursuant to the Ruling. Grecian filed a Petition with the Tax Court in due course.

During the pre-trial discovery phase, the IRS pointed out that based on Premier's ownership of substantial United States real property interests, a portion of Grecian's capital gain should be taxable as ECI pursuant to §897(a). Prior to trial, the parties stipulated to an amount of capital gain (representing all of the 2008 gain and a portion of the 2009 gain) that constitutes taxable gain from the disposition of United States real property interests. The remainder of the 2009 gain (the ''Disputed Gain'') remained in dispute.

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Moreover, the IRS sought penalties, i.e., an accuracy penalty, under §6662, for both 2008 and 2009, as well as failure-to-file and failure-to-pay penalties, under §6651(a)(1) and §6651(a)(2), for 2009.

Rev. Rul. 91-32

In 1991, the IRS issued Rev. Rul. 91-32, which held, on facts very similar to those in *Grecian*, that a nonresident's capital gain from the sale of the nonresident's partnership interest is ECI to the extent attributable to underlying assets of the partnership that generate ECI. The Ruling involved a sale of the partnership interest, whereas *Grecian* involved a redemption, but the facts are otherwise comparable.

The Ruling characterizes the foreign partner's gain as U.S.-source income on the ground that the U.S. office rule of §865(e)(2) applies.[11] The Ruling properly points out that the foreign partner is deemed to be ETBUS under §875(1), and that (at least for some purposes) the partnership's U.S. office is attributed to the foreign partner. However, the analysis thereafter is inadequate.

In order for gain to be U.S.-source under §865(e)(2), it is not enough that the foreign taxpayer have a U.S. office: the gain must also be *attributable* to such U.S. office. The Ruling states that the attributable requirement is satisfied to the extent the nonresident's capital gain is attributable to assets of the partnership that produce ECI, but provides little if any reasoning. For example, the Ruling contains no discussion whatsoever of §864(c)(5)(B) or Reg. §1.864-6(b), so unfortunately it provides little explanation of why the IRS considers the attributable requirement to be satisfied other than that the IRS finds that conclusion to be highly desirable.

TAX COURT DECISION

Section 736 Treatment of Partnership Redemption Payments

After describing some basic principles of international and partnership taxation, the Tax Court addressed the treatment of the redemption payments under §736, which provides rules for payments to a retiring partner or a deceased partner's successor in interest. Noting the parties' agreement that none of the redemption payments were subject to §736(a), the Tax Court observed that, under §736(b)(1), payments in liquidation of the interest of a retiring partner are ''considered as a distribution by the partnership.''[12] This brought the Tax Court to §731(a), which provides that any gain or loss arising from a partnership distribution ''shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.'' And this brought the Tax Court to §741, the same provision that would have applied (more directly) if Grecian had sold its interest in Premier to a third party.

General Approach of §741

Having dealt with these preliminaries, the Tax Court turned to the key issue of whether an interest in a partnership is considered a single, indivisible asset, pursuant to §741 (to the extent §751 does not apply).

Section 741 provides as follows:

> §741 Recognition and character of gain or loss on sale or exchange.
>
> In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss 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). [Emphasis added.]

Noting in particular the highlighted language above, the Tax Court stated that ''This statute thus suggests that, in this context, the partnership is conceived of as an entity separate and distinct from the individual partners, and a partner pays tax on the sale of its partnership interest, in a manner broadly similar to the manner in which it might pay tax on the sale of an interest in a corporation.''[13] The Tax Court acknowledged that ''Subchapter K adopts the entity or the aggregate approach depending on the context''[14] but, citing McKee's treatise on partnership taxation, observed that ''[t]he entity approach . . . predominates in the treatment of transfers of partnership interests as transfers of interests in a separate entity rather than in the assets of the partnership.''[15]

The Tax Court next considered the interaction of the foregoing entity approach with §897(g). Pursuant to §897(g), amounts received by a nonresident alien or foreign corporation in exchange for a partnership interest ''shall, to the extent attributable to United

[11] While not addressed in this article, the Ruling also holds the additional requirements for ECI treatment under §864(c)(2) to be satisfied.

[12] The Tax Court did not address §736(b)(2), which excludes certain redemption payments from the scope of §736(b)(1), but the parties were in agreement that §736(b)(2) did not apply.

[13] *Grecian*, at 15.

[14] *Grecian*, at 16.

[15] *Grecian*, at 16 (citation omitted).

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States real property interests, be considered an amount received from the sale or exchange in the United States of such property.'' Accordingly, the Tax Court noted that ''the 'entity' generality of sections 731, 736, and 741 admits exceptions. We must decide whether there exists an equivalent exception relevant to the disputed gain.''[16]

The IRS argued that §897(g), which undeniably prescribes an aggregate approach, is somehow inconsistent with §741's otherwise mandating an entity approach.

> The sale of a partnership interest cannot simultaneously be both (a) a sale of an indivisible asset, as petitioner argues is required by section 741, and (b) a sale of U.S. real property interests and a sale of a partnership interest, as required by section 897(g).[17]

Thus, the IRS argued that §741 applies only to determine the *character* of the gain recognized, i.e., as capital and not ordinary. As explained by the Tax Court, ''the Commissioner maintains that while section 741 expressly requires that the gain 'shall be considered as gain or loss from the sale or exchange of a capital asset', the statute does not preclude treating the (capital) gain as arising not from the sale of the partnership interest per se (which the entity theory would yield) but from the partnership's underlying assets that give value to the partnership interest (which the aggregation theory would yield).''[18]

The Tax Court not only rejected this argument, it did so on four separate grounds. First, the Tax Court observed that the IRS ''exaggerates the conflict between an 'entity theory' construction of section 741 and the existence of an exception in section 897(g). In its own terms section 741 acknowledges one exception . . . so section 741 is only a general rule, not a rule of absolute and universal application. Congress is always free, having enacted a general rule, to enact exceptions.''[19]

Second, the Tax Court emphasized the reference in §741 to ''capital *asset*'' and noted that Congress's use of the singular ''asset,'' rather than the plural ''assets'' is ''more consistent with the treatment of the sale of a partnership interest according to the entity theory, under which the selling partner is deemed to have sold only one asset (its partnership interest) rather than being deemed to have sold its interest in the multiple underlying assets of the partnership.''[20]

Third, the Tax Court noted that Congress explicitly carved out a few exceptions to §741 that, when applicable, require look-through treatment. ''If Congress had intended section 741 to be interpreted as a look-through provision, these exceptions in sections 751 and 897(g) would be superfluous.''[21]

Fourth, the Tax Court noted the language of §731(a) (applicable in the redemption scenario by reason of §736(b)(1)) which treats any gain recognized from a distribution as ''gain or loss from the *sale or exchange of the partnership interest* of the distributee partner'' explicitly takes an entity approach. As explained by the Tax Court,

> This wording could hardly be clearer. The partnership provisions in subchapter K of the Code provide a general rule that the 'entity theory' applies to sales and liquidating distributions of partnership interests—i.e., that such sales are not treated as sales of underlying assets but as sales of the partnership interest. Of course, Congress may enact exceptions or different rules, such as for foreign partners, and we consider that possibility below; but we begin our analysis with this generality from subchapter K.[22]

Proceeding from this general rule, the Tax Court then proceeded to consider the IRS's various arguments for nevertheless applying a look-through rule to the redemption of Grecian's interest in Premier.

The IRS's §736(b)(1) Argument

Section 736(b)(1) generally provides that payments made in liquidation of the interest of a retiring or deceased partner are treated as distributions by the partnership (and not as distributive share payments or guaranteed payments under §736(a)) to the extent such payments ''are determined . . . to be made in exchange for the interest of such partner in partnership property.'' This general rule is subject to certain limitations under §736(b)(2), but the parties agreed that §736(b)(2) did not apply and, moreover, that none of the payments in dispute were distributive share payments or guaranteed payments under §736(a).

The IRS attempted to seize upon the language in §736(b)(1) that refers to a liquidation payment as ''made in exchange for the interest of such partner in partnership property'' as evidence that, regardless of

[16] *Grecian*, at 19.
[17] IRS Response to Seriatim Reply Brief at pp. 7–8.
[18] *Grecian*, at 24–25.
[19] *Grecian*, at 25–26.
[20] *Grecian*, at 26.
[21] *Grecian*, at 27.
[22] *Grecian*, at 28.

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what §741 may otherwise provide, §736(b)(1) calls for an aggregate approach. However, the Tax Court was not persuaded.

The Tax Court properly pointed out that §736(b)(1) treats payments described therein as distributions by the partnership; that §731(a) deems the resulting gain to arise "from the sale or exchange of the partnership interest"; and that this brings us right back to §741, which (absent some exception) treats the partnership interest as a singular capital asset. "We see no reason to abandon that conclusion, return to section 736(b)(1), and halt at the phrase that most nearly coincides with the Commissioner's position."[23]

Congress's Intent in Enacting §865

The IRS also argued that, when another Code provision, such as §865, is involved, an aggregate approach may be appropriate based on the purposes of that provision.

> [I]n cases where a Code section outside of subchapter K of the Code (dealing with the taxation of partnerships and partners), such as section 865, must be applied in a partnership context, courts have considered the nature of the partnership interest involved, together with the intent and purpose of the non-subchapter K section being applied. A partnership, as a non-taxable entity, may be viewed in two ways, as an entity separate and distinct from its partners (the entity approach) or as an amalgam of individual partners jointly owning partnership property (the aggregate approach). *Rhone-Poulenc Surfactants & Specialties, L.P. v. Commissioner*, 114 T.C. 533, 539 (2000). Which approach governs depends on which approach is more consistent with the intent and purposes of the non-subchapter K Code section being applied in the partnership setting. H.R. Rep. No. 83-2543, at 59 (1954) (Conf. Rep.), *reprinted in* 1954 U.S.C.C.A.N. 5280, 5319–20.[24]

The IRS was unable to persuade the Tax Court that §865 actually embodies an intention to apply aggregate principles to dispositions of partnership interests, but it certainly wasn't for lack of effort. In support of its argument, the IRS emphasized, among other things that: (1) §865(i)(5) requires §865 to be applied at the partner level (except as otherwise provided in regulations); (2) §875(1) deems a foreign corporation to be engaged in a U.S. trade or business if it is a partner in a partnership that is so engaged; and (3) one of Congress's reasons for enacting §865 was its concern that foreign corporations with U.S. branches could improperly avoid U.S. tax on sales revenues by taking advantage of the title-passage rule, which made it relatively easy to arrange for income from inventory sales to qualify as foreign-source income, by choosing to pass title outside the United States.[25] With respect to the last point, the IRS quoted the legislative history (not reproduced herein) and argued as follows:

> To address its concerns, Congress supplanted the title passage rule with section 865. Section 865 provides rules designed to capture as U.S. source income derived from activities or assets in the United States regardless of the form or mechanics of any underlying sale. Congress sought to cast a wide net for U.S.-source income, targeting any income generated by U.S. activities.[26]

Nothing in the Government's briefs provided any support for such a sweeping statement as to Congress's intentions in enacting §865.

The IRS also tried to rely on §897(g), which was enacted in 1980, six years prior to §865, and which clearly does provide a look-through rule. The IRS argued, for example that "interpreting section 865 using an aggregate approach to partnerships is congruous with the approach taken in section 897, of which congress was aware when it enacted section 865."[27]

Of course, the fact that Congress specifically included a look-through rule in §897, and declined to include such a rule when it added §865 just six years later, is hardly helpful to the Government's case. As observed by the Tax Court: "the enactment of section 897(g) actually reinforces our conclusion that the entity theory is the general rule for the sale or exchange of an interest in a partnership. Without such a general rule, there would be no need to carve out an exception to prevent U.S. real property interests from being swept into the indivisible capital asset treatment that section 741 otherwise prescribes."[28]

ECI Analysis; Application of §865(e)(2)

Importance of Source

As a threshold matter, the Tax Court noted that, pursuant to §864(c)(4), only certain limited categories

[23] *Grecian*, at 29. Footnote omitted.

[24] IRS Seriatim Answering Brief at pp. 48–49.

[25] IRS Seriatim Answering Brief at pp. 56–70.

[26] IRS Seriatim Answering Brief at p. 59.

[27] IRS Seriatim Answering Brief at p. 67.

[28] *Grecian*, at 27.

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of foreign-source income may be ECI, and the Disputed Gain does not fall within any such category. Accordingly, the Tax Court held that the Disputed Gain can be ECI only if it is U.S.-source.

Rev. Rul. 91-32

The Tax Court opened its ECI analysis by considering whether the Ruling is entitled to any deference. To say that the Tax Court found the Ruling unpersuasive would be an understatement. The Tax Court stated, for example, that the Ruling's treatment of the applicable partnership provisions of the Code ''is cursory in the extreme . . . . 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.' ''[29] With respect to the analysis of the requirement that the gain be attributable to the taxpayer's U.S. office, the Tax Court faulted the Ruling for failing to address or analyze the question of whether the foreign taxpayer's U.S. office is a material factor in the realization of the gain and for failing even to mention the ordinary course requirement.

Accordingly, the Tax Court found that the Ruling ''lacks the power to persuade'' and is entitled to no deference. ''We decline to defer to the ruling. We will instead follow the Code and the regulations to determine whether the disputed gain is effectively connected income.''[30]

Section 865 Analysis of Source

Overview

The Tax Court noted that, under the default rule of §865(a), the Disputed Gain would be foreign-source, and thus the key question is whether the exception of the U.S. office rule of §865(e)(2) applies. Assuming (without holding) that Premier's U.S. office is attributed to Grecian for this purpose, the Tax Court addressed whether the redemption transaction giving rise to the Disputed Gain was attributable to such U.S. office.

As noted above, §865(e)(3) provides that, in order to determine if a sale is attributable to a U.S. office, the principles of §864(c)(5) apply. Pursuant to §864(c)(4)(B) and Reg. §1.864-6(b), an item of income (of the kind described in §864(c)(4)(B)) will be attributable to a U.S. office only if the ''material factor requirement'' and the ''ordinary course requirement'' are satisfied.

Material Factor Requirement

The IRS first argued that the material factor requirement is satisfied because the redemption of Grecian's partnership interest was equivalent to a sale by Premier of all of its assets, and Premier's U.S. office (assumed to be attributable to Grecian) would have been a material factor in such sale. The Tax Court properly rejected this argument as nothing more than a rehash of the IRS's argument for an aggregate approach.

The IRS also argued that the material factor requirement was met, under Reg. §1.864-6(b)(1), because the activities of Premier's office increased the value of the underlying business and thus were an essential economic element in Grecian's realization of the Disputed Gain. The Tax Court rejected this argument as well, stating that ''the Commissioner conflates the ongoing value of a business operation with gain from the sale of an interest in that business.''[31]

The Tax Court then turned to Grecian's argument, which relied on Reg. §1.864-6(b)(2)(i). As noted above, this regulation provides in part that a U.S. office ''shall not be considered a material factor in the realization of income . . . merely because the office or other fixed place of business . . . develops, creates, produces, or acquires and adds substantial value to, the property which is licensed, or sold, or exchanged[.]'' Based largely on this regulation, and the example cited above, Grecian argued that the focus of the material factor test is on the involvement (or not) of the U.S. office in the specific transaction giving rise to the realization of the income and that the mere creation of value by the U.S. office is insufficient.

The IRS argued that the regulation should be disregarded, as it was only intended to apply to certain specific categories of income and gain described in §864(c)(4)(B), and the Disputed Gain from the redemption of Grecian's partnership interest in Premier does not fall within any such category. However, the Tax Court rejected this argument on the ground that §865(e)(3) merely requires application of the *principles* of §864(c)(5).

The Tax Court acknowledged that a provision applying the material factor test to one type of income might not be suited for another type of income, but nevertheless saw no reason to disregard the regulation ''insofar as it provides an instance in which a U.S. office that '[d]evelops' and 'adds substantial value to' an income-generating asset is nonetheless *not* a 'material factor' in the realization of income from that asset. GMM reasonably derives from this regulation the principle that the creation of underlying asset value is simply a distinct function from being a material factor in the realization of income in a specific transac-

[29] *Grecian*, at 34.

[30] *Grecian*, at 34–35.

[31] *Grecian*, at 41.

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tion.''[32] Accordingly, Tax Court held that the material factor requirement was not satisfied.

Ordinary Course Requirement

Grecian argued that the ordinary course requirement was also not satisfied because the redemption of Grecian's interest in Premier was an extraordinary event and was therefore not undertaken in the ordinary course of Premier's business. Moreover, Grecian argued that Premier is in the business of producing and selling magnesite, not buying and selling partnership interests. The Tax Court noted these arguments with apparent approval, holding that ''[b]ecause the disputed gain was realized in the redemption of GMM's partnership interest in Premier, not from Premier's ordinary business—magnesite production and sale—it does not satisfy the ordinary course requirement and is not U.S.-source.''[33]

Since the Disputed Gain was not U.S.-source, and was not a type of income that can be foreign-source but nevertheless ECI under §864(c)(4), the Tax Court held the Disputed Gain not to be ECI.[34]

Penalty Issue

As noted above, the IRS sought an accuracy penalty, under §6662, for both 2008 and 2009 as well as failure-to-file and failure-to-pay penalties, under §6651(a)(1) and §6651(a)(2), for 2009. Grecian denied liability for the penalties on the ground that it had reasonable cause for failing to file in 2009 and for failing to report its FIRPTA gain in 2008, because it had relied on the advice of its tax return preparer. The return preparer failed to include any FIRPTA gain on Grecian's 2008 return and had specifically advised Grecian that there was no need to file a return for 2009.

Grecian's investment in Premier was its only investment in the United States, and it was generally ignorant of U.S. tax laws. Indeed, Grecian's chief financial officer did not even understand the concept of a partnership for U.S. tax purposes. Grecian relied completely on its return preparer to ensure compliance with the U.S. tax laws.

Among other qualifications, Grecian's return preparer was a certified public accountant and a licensed attorney. He had been recommended to Grecian by a trusted advisor and had been preparing U.S. income tax returns for nearly 40 years at the time he was engaged by Grecian. The return preparer had believed himself to be qualified to prepare Grecian's U.S. federal income returns and, moreover, had prepared such returns without incident prior to the redemption.

The IRS argued that Grecian was remiss in failing to conduct an investigation into the return preparer's qualifications and in failing to engage an expert who specialized in international tax law or who possessed an LL.M. degree. The Tax Court was not impressed. With respect to the first point, the Tax Court stated that Grecian acted reasonably in relying on its trusted advisor. Moreover, even if Grecian were to attempt to conduct an investigation into the return preparer's qualifications, the Tax Court questioned its ability to do so. With respect to the latter point, the Tax Court found that the return preparer's qualifications were sufficient to justify reliance. Accordingly, the Tax Court held that Grecian had reasonable cause and had acted in good faith, and thus was not liable for any penalties.

IMPLICATIONS

As of the date of this writing, the IRS has not yet appealed. If the IRS ultimately appeals the Tax Court's decision, the results of the appeal may not be known for some time. Notwithstanding the possibility of reversal, it may be prudent for foreign investors who have paid tax on their gains from sales or other dispositions of partnership interests pursuant to the Ruling to consider filing their refund claims now. Rather than taking a wait-and-see approach, care must be taken to ensure that any refund claims are filed before the statute of limitations period expires. *Grecian* may also have important implications for tax planners.

For example, cross-border tax planners often urge foreign clients investing in U.S. businesses to invest through a domestic ''blocker'' corporation, based in part on the assumption that the U.S. tax laws will in any event impose an income tax on exit, pursuant to Rev. Rul. 91-32. Depending on the circumstances, this assumption may no longer be warranted, and tax planners must readjust their expectations accordingly.

However, caution is warranted, as the scope of the Tax Court decision is limited to capital gains (other than FIRPTA gains) to which §741 applies. While the IRS did not assert the existence of any ''hot assets'' to which §751 applies in *Grecian*, it seems likely the IRS will look high and low for such assets in the future.

In addition, the IRS may invoke the partnership anti-abuse on appropriate facts. Pursuant to Reg. §1.701-2(b), the IRS may recast a transaction in certain circumstances if a partnership is formed or availed of in connection with a transaction a principal

[32] *See also* Reg. §1.864-6(b)(2)(ii) *Ex.* 1, set forth above.

[33] *Grecian*, at 45.

[34] *Grecian*, at 47. The Tax Court's original opinion, issued on July 13, 2017, suggested that, if the Disputed Gain had been U.S.-source it would have automatically been treated as ECI under §864(c)(3), but an order dated July 19, 2017, corrected the opinion to clarify that the requirements of §864(c)(2) would also need to be satisfied.

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purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K. The IRS did not raise the partnership anti-abuse rule in the *Grecian* case, and given Grecian's evident lack of U.S. tax planning, it's inconceivable that the IRS would have gotten anywhere with that argument if it had. However, a foreign investor who purposefully tries planning into the *Grecian* result will be in a different posture. Nevertheless, a "bad" principal purpose is fatal only to the extent that the intended treatment is determined to be inconsistent with the intent of subchapter K. A strong argument can be made that taking advantage of entity treatment under §741 is entirely consistent with the intent of subchapter K, but undoubtedly the IRS will argue otherwise.

Another key risk is that *Grecian* may be legislatively overruled. There have been prior proposals in the Obama Administration's "Green Book" to codify the Ruling, and this may be one of the few things that all of the politicians in Washington, D.C. can agree on. Alternatively, the Treasury Department may issue regulations implementing the Ruling. In that event, the issue arises as to how much deference a court would accord to those regulations and whether it would be sufficient to uphold them in light of the Tax Court's emphatic endorsement of the entity approach under §741.

Grecian may also have implications in the context of cross-border estate tax planning. Inasmuch as nonresident[35] aliens are subject to federal estate tax only with respect to U.S.-situs assets, one of the world's great unanswered questions is whether U.S. estate tax is imposed on a nonresident alien who dies while owning an interest in a partnership that owns U.S. real estate (or other assets with a U.S. situs).

One of the reasons for the uncertainty is that the IRS may well attempt to "look through" the partnership, thereby deeming the nonresident alien to own the underlying U.S. real estate (or other U.S.-situs assets). It may potentially be more difficult for the IRS to make this argument post-*Grecian*, but practitioners should keep in mind that the result in *Grecian* was highly dependent on the court's reading of §741 and the other applicable provisions of Subchapter K. Moreover, even if the IRS cannot look through a partnership for estate tax purposes, that does not answer the question of how one determines the situs of a partnership interest. Even in the case of a foreign partnership, a court may reasonably conclude that the partnership interest has a U.S. situs to the extent of the underlying U.S.-situs assets.

[35] In this context, a nonresident alien is one who is not domiciled in the United States.

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