

TAX ALERT

TAX COURT REJECTS IRS GUIDANCE ON FOREIGN PARTNER REDEMPTION GAIN; CREATES REFUND POSSIBILITIES

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The Tax Court's recently released opinion, *Grecian Magnesite Mining, Industrial & Shipping Co., SA*, may have a significant impact on U.S. taxation of foreign partners. The case rejected the IRS position, promulgated in Revenue Ruling 91-32, which taxes foreign partners on certain gains derived from the disposition of a U.S. partnership interest.

As a general matter: foreign persons are only taxed on U.S.-source income that is effectively connected with the conduct of a U.S. trade or business ("ECI"). Moreover, gains from the sale of property are generally sourced to the residence of the seller. Thus, under general tax law principles, a foreign person selling an interest in a domestic entity would not be subject to U.S. taxation because the foreign person is not engaged in a U.S. trade or business and gains are sourced to the seller's residence.

However, Rev. Rul. 91-32 upended these general rules for foreign partners in domestic partnerships. The Ruling addressed the tax consequences of a foreign partner's sale or disposition of an interest in a domestic partnership that is engaged in a U.S. trade or business. Rev. Rul. 91-32 held that the foreign partner's gain or loss from such disposition is treated as ECI to the extent of that partner's distributive share of unrealized gain or loss attributable to property used in the partnership's U.S. trade or business. This ruling effectively required the foreign partner to look through the partnership, to partner level assets, to determine the proper taxation of the foreign partner's disposition of its partnership interest. The practical effect of Rev. Rul. 91-32 was to require foreign partners to report certain amounts of gain or loss from the disposition of domestic partnerships as ECI, subjecting that foreign partner to U.S. tax where there may not otherwise be any U.S. tax liability. This approach has long been controversial amongst many taxpayers and practitioners who have argued that it was a misreading of the tax law.

The theory advanced by the petitioner in *Grecian Magnesite*, and adopted by the Tax Court, rejects this look-through approach for characterizing gain or loss from a foreign partner's disposition of a partnership interest. The Tax Court explicitly declined to follow the Rev. Rul. 91-32 analysis of the issue. Rather, the Tax Court held that a foreign partner's gain from the disposition of its interest in a domestic partnership engaged in a U.S. trade or business is *not* ECI (except for certain gains that are taxable as related to U.S. real property interests). Thus, the *Grecian Magnesite* Court determined that a foreign partner's gain on the disposition of a U.S. partnership interest is generally not subject to U.S. tax (other than any portion of gain attributable to the partner's interests in U.S. real property).

This case could have significant ramifications for foreign persons with investments in U.S. partnerships. Foreign persons should review their tax returns for any open years in which they

disposed of a U.S. partnership as they may be able to submit refund claims on the basis of the *Grecian Magnesite* holding. However, it should be noted that the Service may still appeal the decision. It may also issue a *non-acquiescence* and continue to assert tax based upon Rev. Rul. 91-32's theory of foreign partner taxation.

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