



# TaxNewsFlash

## United States

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### **Tax Court: Foreign company's capital gain not effectively connected income; Rev. Rul. 91-32 is rejected**

The U.S. Tax Court today issued an opinion holding that capital gain realized by a foreign company on the redemption of its interest in a U.S. limited liability company was not U.S.-sourced income and that it was not effectively connected with a U.S. trade or business.

The Tax Court specifically rejected the position in an IRS revenue ruling—Rev. Rul. 91-32—as to what is effectively connected income. The court stated that it “will not follow Rev. Rul. 91-32.”

The case is: *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner*, 149 T.C. No. 3 (July 13, 2017). Read the Tax Court's [opinion](#) [PDF 200 KB]

*The following is intended to provide a summary overview of today's opinion. A more complete analysis will be provided in a future report from KPMG.*

#### **Background**

A company—established and organized under the laws of Greece and having its principal place of business in Athens—in 2001 purchased what ultimately was a 12.6% interest in a Delaware limited liability company (LLC). The LLC was engaged in mining and extracting magnesite in the United States.

The Greek company otherwise had no office, employees or business operations in the United States.

In 2007, the Greek company agreed to allow the LLC to redeem its 12.6% interest for \$10.6 million, with the redemption to be made in two liquidating payments. The

payments were made in July 2008 and in January 2009, but were deemed to have been made on December 31, 2008.

The company realized over \$6.2 million of gain, of which \$2.2 million was deemed attributable to U.S. real property interests (and which the company ultimately conceded was taxable income). However, the company contended that the remainder—that is, the “disputed gain” of \$4 million—was not taxable for U.S. purposes.

For 2008, the Greek company filed a Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*, and relying on the advice of a certified public accountant, reported its distributive share of the LLC’s income, gain, loss, deductions, and credits. However, the Greek company did not report any of the gain realized on the redemption of its interest in the LLC (neither the gain attributable to the U.S. real property nor the rest of the gain).

Relying on the advice from its CPA tax return preparer, the Greek company did not file a return for 2009 because the company’s entire interest was redeemed as December 31, 2008.

## **IRS actions**

The IRS audited the company’s 2008 and 2009 tax years and determined deficiencies in U.S. income tax for both years. The IRS prepared a substitute for return for 2009, determining that the Greek company had U.S.-sourced capital gain net income of \$1 million for 2008, and \$5.2 million for 2009 from the redemption of the interest in the LLC.

The IRS determined that the Greek company had to recognize its gain on the redemption of its partnership interest for U.S. tax purposes as U.S.-sourced income that was effectively connected with a U.S. trade or business—consistent with the IRS position in Rev. Rul. 91-32.

The IRS also assessed an accuracy-related penalty for 2008 and additions to tax for 2009 for failing to file a return and timely pay the tax.

## **Tax Court opinion**

The Tax Court today held:

- The “disputed gain” of \$4 million was capital gain that was not U.S.-sourced income and that was not effectively connected with a U.S. trade or business. Specifically, the court rejected Rev. Rul. 91-32. Thus, the company was not liable for U.S. income tax on the disputed gain.
- Concerning the conceded tax liability for gain on the real estate, the Tax Court held that the company was not liable for the accuracy-related penalty for 2008 or for the

additions to tax for 2009 because the company had reasonably relied on the “erroneous advice” from the CPA.

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