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Implications of the Tax Court's Opinion in *Grecian Magnesite Mining Co. v. Commissioner* for Private Equity Funds

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The Tax Court in *Grecian Magnesite Mining Co. v. Commissioner* rejected the IRS position set forth in Revenue Ruling 91-32 that a foreign partner is generally subject to U.S. tax on gain from the sale of an interest in a partnership to the extent the gain is attributable U.S. trade or business assets of the partnership. Private equity fund sponsors accustomed to using U.S. blocker corporations to hold investments in U.S. operating companies classified as partnerships for federal tax purposes should consider whether foreign blocker corporations have become relatively more attractive for this purpose in light of the court's opinion. Private equity fund sponsors should also consider whether there are opportunities for their foreign blocker corporations, or fund partners, to file refund claims with respect to tax paid or withheld in connection with prior sales of interests in portfolio companies that were treated as partnerships for U.S. tax purposes and that were engaged in U.S. trades or businesses.

In *Grecian Magnesite Mining Co. v. Commissioner*,[1] the Tax Court rejected the IRS's position that a foreign partner's gain from a sale of an interest in a partnership that is engaged in a U.S. trade or business is necessarily subject to U.S. tax to the extent the gain is attributable to partnership assets

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

that are used or held for use in that U.S. trade or business. Private equity funds using "blocker" structures to invest in U.S. portfolio companies classified as partnerships for federal tax purposes should be aware that the Tax Court's holding may change the calculus as to whether to use a U.S. or a foreign corporation as the blocker entity. Private equity fund sponsors should also determine whether there are opportunities for their foreign blocker corporations or for fund partners to file refund claims with respect to taxes previously paid or withheld as a result of prior sales of interests in U.S. trade or business partnerships.

The *Grecian Magnesite* Case

Grecian Magnesite involved the redemption of a foreign corporation's interest in a U.S. limited liability company ("LLC") that was classified as a partnership for federal tax purposes. The LLC was engaged in the business of mining and extracting magnesite in the United States. The foreign corporation did not otherwise have an office, employees, or business in the United States. The foreign corporation conceded that the portion of its gain from the redemption that was attributable to the LLC's real estate assets was taxable as if it were effectively connected income ("ECI") pursuant to section 897(g) of the Code,[2] but argued that the remaining portion of the gain should not be subject to U.S. tax.

The IRS position in the case was based on Revenue Ruling 91-32, which applied an "aggregate" theory of partnerships to determine that the portion of any gain realized by a foreign partner on a sale of a partnership interest that is attributable to the partnership's U.S. trade or business assets is taxable as ECI. In reaching this conclusion, Revenue Ruling 91-32 starts with the proposition that a foreign partner in a partnership that is engaged in a U.S. trade or business is itself treated as engaged in a U.S. trade or business pursuant to Code section 875(1). It reasons that the fixed place of business of the partnership in the United States should be treated as the fixed place of business of the partner, with the sale of the partnership interest being attributable to that fixed place of business, thereby resulting in the gain being U.S. source. The ruling then treats the U.S. source gain as ECI under section 864(c)(2) on the theory that because the U.S. trade or business activity of the partnership affected the value of the partnership interest, the partnership interest could itself be treated as an asset used or held for use in the U.S. trade or business.

The Tax Court found the Revenue Ruling 91-32 analysis unpersuasive. The court initially determined that a redemption of a partnership interest should be treated the same as a sale, and that section 741 of the Code calls for an entity rather than an aggregate approach to sales of partnership interests, except as otherwise specifically provided in section 751 with respect to unrealized receivables and inventory items (so-called "hot assets") and section 897(g) with respect to real estate assets. The court then applied the general rule that gain on a sale of personal property is sourced based on the residence of the seller under section 865(a). Because the taxpayer was a foreign corporation—a nonresident of the United States—the gain was accordingly foreign source rather than U.S. source income, and hence

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[2] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code"), or the applicable regulations promulgated pursuant to the Code (the "regulations").

not ECI (the IRS had conceded that the gain was not within the limited categories of foreign source income that may be treated as ECI). The court rejected the IRS's argument that the gain should be U.S. source under section 865(e)(2)(A) because it was attributable to a U.S. office of the taxpayer. The court held that, even assuming the U.S. office of the LLC was properly treated as a U.S. office of the taxpayer, the gain from the redemption was not attributable to that office because (1) the LLC's office was not a material factor in the taxpayer's realization of income from the redemption transaction, and (2) the LLC was not regularly engaged in the business of transacting in its own LLC interests.

KPMG Observations

Grecian Magnesite represents a potentially important change in the landscape for private equity funds making investments in U.S. passthrough entities. For several reasons, however, the full implications of the case will depend on future events. First, it is not yet known whether the IRS will appeal the Tax Court's decision, and if it does so, what the outcome of that appeal would be. Second, it is possible that the IRS could respond to the case by attempting to publish regulations to reinstate its position. The 2016-2017 IRS Priority Guidance Plan already includes an item for "[g]uidance under § 864 implementing Revenue Ruling 91-32 relating to sales of certain partnership interests." Third, Treasury and the IRS may seek legislation codifying the Revenue Ruling 91-32 result. The Obama Administration had proposed legislation to codify Revenue Ruling 91-32 as part of its annual budget proposals. It is unclear, however, whether the current administration will take a similar view of the issue, and in any event the prospects for corrective legislation in the current environment are uncertain.

Moreover, the precise scope of the court's holding is not entirely clear. For example, would the court's holding extend to shield a foreign partner from U.S. tax in a "sale of the company" case in which there is extensive involvement of the partnership's U.S. office in negotiating and effecting the sale of interests in the partnership? Under the court's reasoning, it appears that a foreign partner in such a partnership would still not be subject to U.S. tax unless the partnership could be shown to be regularly engaged in arranging transactions in its own equity, but there may be some uncertainty on the point. The IRS also might argue in certain fact patterns that gain from a sale of an interest in a partnership portfolio company that is engaged in a U.S. trade or business could be sourced in the United States by virtue of being attributable to a U.S. office of the fund that owns the partnership interest, although it would still be necessary for the IRS to establish that the U.S. source gain is ECI under section 864(c)(2) for capital gain from the sale to be taxable.

In addition, the case does not address whether an aggregate approach might still be applied to tax as ECI any portion of a foreign partner's sale gain that is attributable to U.S. trade or business assets of the partnership that are described in section 751 of the Code (*i.e.,* unrealized receivables and inventory).

Another question is whether the IRS might seek in subsequent cases to invoke the partnership anti-abuse rule as an alternative basis for reaching the Revenue Ruling 91-32 result. As the court noted, the IRS did not make this argument in *Grecian Magnesite*.

Nevertheless, while recognizing that significant uncertainties remain, the increased likelihood that gain on sales of interests by foreign partners in U.S. trade or business partnerships would be exempt from U.S. tax should be taken into account in private equity structuring decisions. In particular, private equity funds should consider whether foreign blocker corporations may have become relatively more attractive than U.S. blocker corporations in light of the court's holding.

Blocker corporations have become a familiar part of the private equity structuring toolkit. When investing in U.S. operating partnerships, they are typically used to protect foreign investors from recognizing ECI and tax-exempt investors from recognizing unrelated business taxable income ("UBTI"). In determining whether to use a U.S. or a foreign blocker corporation to hold interests in a particular partnership investment (whether a "downstream" blocker owned by the fund or a blocker owned by an alternative investment vehicle established for ECI/UBTI sensitive investors), relevant considerations include the tax impact on the blocker during the fund's "hold" period with respect to the partnership investment and the potential impact on after-tax returns in connection with an exit event.

With respect to taxation during the hold period, a U.S. blocker and a foreign blocker are both subject to U.S. tax on their distributive share of a partnership's ECI. In the case of a foreign blocker, this substantive tax liability is backstopped by Code section 1446, which requires the partnership to pay a withholding tax at the highest marginal corporate rate on any ECI that is allocable to the blocker. The U.S. blocker would in addition be taxable on its distributive share of non-ECI income, if any, while certain non-ECI income of the partnership that qualifies as U.S. source fixed or determinable annual or periodical income (so-called "FDAP") would generally attract gross basis withholding taxes to the extent allocable to a foreign blocker.

A foreign blocker generally would also be subject to the branch profits tax ("BPT") on any "dividend equivalent amounts" that are imputed under the relatively complex BPT rules, which could for example arise if the underlying partnership were to make significant distributions. In the case of a foreign blocker that is organized in a non-treaty jurisdiction such as the Cayman Islands, there would be no treaty-based reduction in the 30 percent BPT rate. By contrast, partnership distributions to a U.S. blocker would generally be non-taxable to the extent of the blocker's basis in its partnership interest, and dividends paid by the blocker may be eligible for reduced dividend withholding rates under an applicable tax treaty depending on the identity of the blocker's shareholders (treaty benefits may also be available to reduce withholding tax on interest on debt used to leverage the U.S. blocker). Avoidance of the substantive liability and administrative complexity associated with the BPT, as well as the potential to access treaty benefits to reduce or eliminate a second layer of tax on amounts distributed to the blocker and then returned to investors, are reasons funds may choose to use a U.S. blocker.

In the wake of *Grecian Magnesite,* however, these potential advantages of a U.S. blocker should be weighed against the greater tax-efficiency that a foreign blocker could potentially provide with respect to an exit transaction. To the extent Revenue Ruling 91-32 applies, gain on a sale of a partnership interest by a blocker would in each case result in entity-level tax—in the case of a U.S. blocker, because the blocker is taxable on its worldwide income; in the case of a foreign blocker, because Revenue Ruling 91-32 would render the blocker taxable on the portion of the gain that is attributable to the partnership's

U.S. trade or business assets (although not on the portion of the gain, if any, that is allocable to other assets). As a result, in each case, there is an incentive for funds to structure exits as a sale of interests in the blocker entity, which generally would not result in U.S. tax being imposed with respect to foreign and tax-exempt investors. However, acquiring shares in the blocker is likely to be less attractive to a buyer, including because the buyer would not get a step-up in the basis of the partnership assets as would be the case if the buyer were instead to purchase the blocker's partnership interest or the partnership's assets. At a minimum, this can become a deal point and affect pricing.

By contrast, if the *Grecian Magnesite* holding is ultimately sustained, a foreign blocker could sell its partnership interest without being subject to U.S. tax on its capital gain, while still providing the buyer a basis step up. This would enhance flexibility with respect to, and potentially the return on, exit transactions. Accordingly, funds that have customarily used U.S. blockers for U.S. passthrough investments should evaluate whether to change that approach in light of the court's ruling. While the optimal blocker structure will depend the facts of each individual investment, unless there are particular reasons that a domestic blocker is preferable in a particular case, it may make sense to use a foreign blocker to preserve the potential ability to sell partnership interests without the imposition of U.S. tax, depending on future developments with respect to the *Grecian Magnesite* case.

As a final point, some funds and foreign investors had, even before *Grecian Magnesite,* taken the position that Revenue Ruling 91-32 was incorrect and that gain from the sale of a partnership interest in a U.S. trade or business partnership by a foreign partner, or a foreign partner's distributive share of any such gain, should not be subject to U.S. tax. Other funds, however, may have been reluctant to challenge the stated position of the IRS and caused their foreign blockers to report and pay tax on gain arising from such sales or withheld tax on gain allocable to foreign investors under section 1446. Funds should identify any such cases for which the relevant tax years remain open, and particularly cases in which the statute of limitations for filing a refund claim may be close to expiring. Although it remains to be seen whether the IRS will file an appeal in *Grecian Magnesite* and hence what the final outcome of the litigation will be*,* funds should cause the applicable blockers to file protective refund claims to preserve eligibility to recoup any previously paid tax amounts while the refund statute is still open, and they should notify affected investors of the potential ability to file such claims for previously withheld amounts. Generally, Code section 6511(a) requires that a claim for refund be made within three years from the time the relevant return was filed or two years from the time the tax was paid, whichever period expires later.

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