KPMG

TaxNewsFlash

United States

No. 2023-046
February 7, 2023

U.S. Tax Court: Gain recognized on sale of partnership interest attributable to inventory may be U.S.-source income

The U.S. Tax Court today released a memorandum opinion holding that gain recognized by a nonresident alien individual partner on a sale of her interest in a U.S. partnership, that was attributable to inventory items, may be treated as U.S.-source income and thus subject to tax in the United States.

The case is: *Indu Rawat v. Commissioner,* T.C. Memo 2023-14 (February 7, 2023). Read the Tax Court's **opinion** [PDF 180 KB]

Summary

The taxpayer was a nonresident alien individual for federal income tax purposes during 2008 and 2009. She filed U.S. federal income tax returns as a nonresident alien for the 2000 through 2007 tax years. She did not file returns for the 2008 and 2009 tax years.

Between 2000 and 2007, the taxpayer acquired a 30% interest in a U.S. partnership that manufactures and sells popular consumer products, including 5-hour Energy drinks. In 2008 the taxpayer sold her interest in the partnership for $438 million. At the time of the sale, the partnership held inventory items for future sale in the United States. The partnership later sold those inventory items for a profit of $22.4 million, and the taxpayer admits that her share of income "attributable to the inventory" was $6.5 million. Thus, of the $438 million sale price paid to the taxpayer for her partnership interest, $6.5 million was allocable to inventory held in the United States for sale therein.

The IRS conducted an examination of the partnership for the 2007 and 2008 tax years and proposed to include in the taxpayer's income for 2008 such $6.5 million of income allocable to the inventory. The taxpayer challenged the IRS assessment in the Tax Court and subsequently moved for summary judgment on the grounds that under the decisions of the Tax Court and the Court of Appeals for the D.C. Circuit in *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner*, 149 T.C. 63 (2017), aff'd, 926 F.3d 819 (D.C. Cir. 2019), a nonresident alien individual is not subject to U.S. income tax on the sale of the individual's interest in a U.S. partnership because those gains would be sourced

outside the United States under the general rule of section 865(a)(2), irrespective of whether any portion of the gains would be attributable to inventory items under section 751(a)(2).

The Tax Court first noted that Congress effectively overruled *Grecian Magnesite* in Pub. L. No. 115-97 (the "Tax Cuts and Jobs Act" of 2017), by adding section 864(c)(8) to the Code effective for transactions after November 27, 2017. Under section 864(c)(8), if a nonresident alien individual or foreign corporation owns an interest in a partnership which is engaged in any trade or business within the United States, gain or loss on the sale or exchange of all (or any portion of) such interest may be treated as effectively connected with the conduct of such trade or business. However, the taxpayer sold her partnership interest in 2008, before the effective date of section 864(c)(8).

The court ultimately rejected the taxpayer's argument and held that because $6.5 million of the taxpayer's gain on the sale of her partnership interest was allocable to inventory for purposes of section 751(a)(2), it is excepted from the general rule treating such gain as gain from a capital asset under section 741. This inventory exception applies equally when the selling partner is a nonresident alien individual. In other words, section 751 first governs the nature of the property considered to have been sold, and then the sourcing rules of section 865 dictate the source of the gain from the sale of such property and whether such gain may be effectively connected to a U.S. business. Because the taxpayer's gain was treated as attributable to inventory under section 751(a)(2), for purposes of the sourcing rules it is also considered "income derived from the sale of inventory property" under the exception of section 865(b) and therefore may therefore be U.S.-source income.

The court thus denied the taxpayer's motion for summary judgment.