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TaxNewsFlash

United States

No. 2024-282
July 23, 2024

D.C. Circuit: Gain recognized on sale of partnership interest attributable to inventory not U.S.-source income subject to U.S. tax; Tax Court reversed

The U.S. Court of Appeals for the District of Columbia Circuit today reversed a previous decision of the Tax Court and held that gain recognized by a nonresident alien individual partner on a sale of her interest in a U.S. partnership, which was attributable to inventory items, could not be treated as U.S.-source income subject to U.S. tax.

The case is: *Indu Rawat v. Commissioner,* No. 23-1142 (D.C. Cir. July 23, 2024). Read the D.C. Circuit's decision

Summary

The taxpayer, a nonresident alien individual, acquired a 29.2% interest in a U.S. partnership that sold the popular energy drink 5-Hour Energy. In 2008 the taxpayer sold her partnership interest in exchange for a promissory note worth approximately $438 million. At the time of the transaction, the partnership held inventory valued at $6.4 million that it later sold for a profit of $22.4 million. All agreed that of the $438 million the taxpayer received for her partnership interest, $6.5 million was attributable to a gain on the partnership's sale of inventory.

The IRS took the position that the inventory gain should be taxed as though the taxpayer had sold actual inventory and was therefore subject to U.S.-source taxable income. The taxpayer challenged the IRS assessment in the Tax Court.

The Tax Court agreed with the IRS, holding that under section 751(a), the taxpayer must be taxed as though she sold the inventory that gave rise to the section 751(a) gain. Thus, under the section 865 sourcing rules governing the sale of inventory, income from the sale could be considered U.S.-source (and taxable) depending on the particulars. Read *TaxNewsFlash*

The taxpayer appealed to the D.C. Circuit, which examined the statutory language of section 751(a) alongside its "companion provision" section 741 and concluded that a proper reading of section 751(a) and its legislative history does not treat inventory gain as gain from the actual sale of inventory. Section 751(a) converts the taxpayer's gain on her partnership interest from capital gain to ordinary income but goes no further. As a result, the inventory gain realized by the taxpayer when she sold her partnership interest must be treated as foreign-source income not subject to U.S. tax.

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