TAX | UNITED STATES OF AMERICA | 18 JANUARY 2019

U.S. TAX APPLIES AGAIN TO A FOREIGN PARTNER'S SALE OF A PARTNERSHIP INTEREST: CONGRESS & IRS USE U.S. TAX REFORM TO OVERTURN TAX COURT

On December 20, 2018, the Department of Treasury and the Internal Revenue Service ("**IRS**") provided more details on Congress' swift reversal, under the Tax Cuts and Jobs Act of 2017 ("**TCJA**"), of the U.S. Tax Court's July 13, 2017 decision in the *Grecian Mining* case. The IRS confirmed that, contrary to the case decision, a foreign partner selling an interest in a partnership may be subject to U.S. federal income taxation ("**USFIT**"). Below, we look at the turbulent history and take you through the mechanics of the newly codified rule, as well as highlight some traps for the unwary associated with the new rules.

A. BACKGROUND

Before the TCJA, the U.S. Internal Revenue Code (the "**Code**") did not explicitly address the tax treatment of a foreign partner's gain or loss from the sale of a partnership that conducts a U.S. trade or business and/or holds U.S. assets (an "**ECI Partnership**"). In 1991, the IRS issued Revenue Ruling 91-32 (the "**Ruling**"), adopting what is generally known as the "aggregate theory" of partnership. The Ruling provided that gain derived by a foreign person from the sale or other disposition of an interest in an ECI Partnership should be treated as income effectively connected with a U.S. trade or business (such income known as "**ECI**") to the extent of the partnership's underlying U.S. business and/or assets. Accordingly, a foreign person's sale or other disposition of an interest in an ECI Partnership has generally been treated as a sale of the partnership assets, with the gain treated as U.S. source income to the extent attributable to assets producing ECI.

In 2001, Grecian Magnesite Mining, Industrial & Shipping SA, a Greek corporation ("**GMM**"), acquired an interest in a Delaware limited liability company treated as a partnership for USFIT purposes (the "LLC"). The LLC, through its U.S. office and operations, was engaged in the mining and selling of minerals in the United States. In 2008, the LLC redeemed GMM's partnership interest for cash. GMM treated its gain on this redemption as exempt from USFIT. Relying on the Ruling, the IRS challenged GMM's tax position on the redemption by arguing that the redemption gain was U.S. source income because it was ECI with respect to the LLC's U.S. business and assets. GMM took the matter to the Tax Court where Judge David Gustafson sided with GMM, rejecting the Ruling. The Tax Court held that GMM's gain (with the exception of a portion that was attributable to a U.S. real property interest held by the LLC), was not subject to USFIT because it was not ECI, and thus was not U.S. source income. The Tax Court looked to the general rule that gain from the sale of a capital asset, including a partnership interest, is sourced based on the tax residence of the seller. Accordingly, the Tax Court found that a foreign partner's sale or other disposition of an interest in an ECI Partnership generates foreign source gain and should not be subject to USFIT. The outcome provoked the IRS, and ultimately prompted a swift reversal from the U.S. Congress under the TCJA.

B. THE TCJA AND ENSUING REGULATIONS - THE CODIFICATION OF THE RULING

The U.S. Congress swiftly reversed the court's opinion in the *Grecian Mining* case by codifying the IRS' long standing position under the Ruling that a foreign partner selling a partnership interest should be subject to USFIT to the extent of any gain attributable to the partnership's U.S. business/assets. In December, the U.S. Treasury proposed regulations solidifying this result.

The proposed regulations do specify that assets that are exempted from taxation under U.S. tax treaty permanent establishment provisions, such as ships or aircraft, also should not be taken into account as U.S. assets for this purpose. By contrast, however, the proposed regulations also specify that existing tax treaty permanent establishment standards may not otherwise prevent application of the new rule, meaning this provision may function to apply USFIT where a treaty permanent establishment standard normally would have prevented taxation.

Mechanically, the proposed regulations provide a three step process for determining any USFIT liability. First, a determination must be made regarding the amount of gain or loss the partnership would recognize upon sale of all its assets; second, a determination must be made of the amount of gain or loss that would be treated as ECI (e.g., generally deriving from its U.S. assets); and, finally, a determination must be made of the foreign partner's share of the gain or loss that is considered ECI, and therefore subject to USFIT.

In addition to codifying the Ruling, the TCJA and proposed regulations institute a withholding requirement in order to enforce collection of the USFIT liability from foreign partners. Going forward, purchasers of an ECI Partnership interest, and in some instances the ECI Partnership itself, generally will be required to withhold 10% of the gross proceeds from the sale and remit to the IRS in order to satisfy, at least in part, any USFIT liability that may be due. This mechanic is contemplated to operate similarly to the existing withholding regime applied under the Foreign Investment in Real Property Tax Act, including certifications that can be provided by the seller to the purchaser where no withholding should be necessary.

C. TRAPS FOR THE UNWARY

First, under the mechanics outlined by the IRS, a foreign partner may be subject to USFIT even though the overall sale of an ECI Partnership interest may have resulted in a loss. For example, this may occur for an ECI Partnership holding appreciated U.S. assets but foreign loss assets. Notwithstanding the overall loss upon sale of the interest, because the gain attributed to the U.S. assets must be accounted for separately, the foreign partner may nonetheless be liable for USFIT. This possibility means that foreign partners in ECI Partnerships must remain vigilant regarding the U.S. trade or business/U.S. asset valuation throughout their ownership in order to anticipate potential USFIT liability upon exiting an otherwise loss making partnership investment.

Second, foreign partners must be aware of the new withholding obligation placed on the purchaser of an ECI Partnership interest. Notably, the purchaser is required to withhold 10% of the gross purchase price (not the net gain). Consequently, the withheld amount may or may not comport with the ultimate USFIT liability of the seller, including sometimes being more than the ultimate USFIT liability. In the case of an excess withholding, the foreign seller will need to apply directly to the IRS for a refund, or otherwise may have opportunity to apply for a reduced withholding before the sale. The IRS will publish more guidance regarding the withholding mechanics and obligations as much remains uncertain, including, for the moment, suspending the withholding obligation with respect to the sale of interests in publicly traded partnerships.

Finally, in the event a purchaser fails to withhold on the gross purchase price upon purchasing an interest in an ECI Partnership, the IRS will place the withholding obligation on the partnership, prior to distribution of the proceeds to a foreign partner. Here again, the complexity for ECI Partnerships to deal with their foreign partners has increased, and ECI Partnerships will need to take care to understand and follow their obligations under this new regime.

Conclusion

As with most international aspects of the TCJA, process and logistics of a foreign partner selling an interest in an ECI Partnership has become more complex, for the foreign partner, for the purchaser, and for the ECI Partnership.

This Alert provides only a high level snapshot of the issues a foreign partner must be aware of upon investing in or selling a partnership interest with any U.S. nexus. Please do not hesitate to contact Vanessa Tollis or Zach Pouga if you would like to discuss in more detail.

CONTACTS

VANESSA TOLLIS
Partner
tollis@gide.com

ZACH POUGA
Senior Associate
zach.pouga@gide.com

This memorandum relates to general information only and does not constitute legal advice. Facts and circumstances vary. We make no undertaking to advise recipients of any legal changes or developments.

You can also find this legal update on our website in the News & Insights section: **gide.com**

This newsletter is a free, periodical electronic publication edited by the law firm Gide Loyrette Nouel (the "Law Firm"), and published for Gide's clients and business associates. The newsletter is strictly limited to personal use by its addressees and is intended to provide non-exhaustive, general legal information. The newsletter is not intended to be and should not be construed as providing legal advice. The addressee is solely liable for any use of the information contained herein and the Law Firm shall not be held responsible for any damages, direct, indirect or otherwise, arising from the use of the information by the addressee. In accordance with the French Data Protection Act, you may request access to, rectification of, or deletion of your personal data processed by our Communications department (privacy@gide.com).