D.C. Circuit: Foreign partners and effectively connected income ("Grecian Magnesite" case cited in 2017 tax law)

The U.S. Court of Appeals for the District of Columbia today affirmed a decision of the U.S. Tax Court—an opinion that rejected the IRS’s position in Rev. Rul. 91-32 that a foreign partner’s capital gain from the sale of an interest in a partnership that is engaged in a U.S. trade or business is treated as gain that is effectively connected to a U.S. trade or business and therefore subject to U.S. federal income tax.

The Tax Court case was specifically referenced in the legislative history to the 2017 U.S. tax law.


2017 tax law references Tax Court’s opinion in legislative history

The 2017 U.S. tax law (Pub. L. No. 115-97 or the law that is often referred to as the “Tax Cuts and Jobs Act”) amended section 864(c) to treat gain or loss on a sale of a partnership interest as effectively connected with a U.S. trade or business to the extent that a foreign corporation or foreign individual that owns the partnership interest (whether directly or indirectly through other partnerships) would have had effectively connected gain or loss had the partnership sold its underlying assets.

The 2017 tax law adopted a look-through rule somewhat similar to that provided in section 897(g) to the sale of all partnership interests—not just those that hold U.S. real property interests. Specifically, the 2017 tax law provided that gain or loss from the sale, exchange, or other disposition of a partnership interest is effectively connected with a U.S. trade or business to the extent that a partner that is a foreign individual or foreign corporation would have had effectively connected gain or loss if the partnership had sold all of its assets at fair market value on the date of the exchange.

For this purpose, the gain or loss from the hypothetical asset sale by the partnership is allocated to interests in the partnership in the same manner as nonseparately stated items of income or loss.
amount of the gain or loss treated as effectively connected income under the provision is reduced by the amount so treated with respect to U.S. real property interests under section 897.

While the provision applies to gain or loss from the sale, exchange, or other disposition of the partnership interest, it gives broad regulatory authority to determine the appropriate application of the provision, including to various corporate nonrecognition transactions—such as contributions, liquidations, and reorganizations.

**Tax Court’s opinion affirmed by D.C. Circuit**

The IRS in 1991 issued Rev. Rul. 91-32 that ruled that a foreign partner’s capital gain or loss on the sale of a partnership interest is properly treated as effectively connected with a U.S. trade or business if and to the extent that a sale of the underlying assets by the partnership would have resulted in effectively connected income for the foreign partner.

The U.S Tax Court in a July 2017 opinion refused to follow the revenue ruling in determining that a foreign partner was not subject to U.S. tax on a sale of a partnership interest (to the extent the gain was not attributable to U.S. real property interests). Rather, the Tax Court held that a foreign corporation was not subject to U.S. federal income tax on the gain that it realized upon the redemption of its interest in a U.S. domestic entity (LLC) treated as a partnership that was engaged in the conduct of a U.S. mining business (except to the extent that gain was attributable to the U.S. real property interests held by the LLC). Read a July 2017 report about the Tax Court’s opinion: [TaxNewsFlash](#)

The D.C. Circuit today affirmed the decision of the Tax Court.

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