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Tax Cuts and Jobs Act Reverses Short Lived *Grecian Magnesite Mining* Holding: Will the U.S. Depart from Global Norms in Tax Treaty Interpretation?

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I. Introduction

Investors need certainty about the taxation of an investment to effectively decide among alternative investments.[1] For more than 25 years, foreign investors have faced uncertainty over how the United States would tax them on the gain realized on a disposition of an interest in a U.S. partnership. In June of 1991, the IRS issued Revenue Ruling 91-32,[2] which departed from the commonly understood interpretation of U.S tax law, and ruled that such gain would be treated as U.S. source effectively connected income and taxable by the United States. Moreover, the revenue ruling departed from the commonly understood interpretation of bilateral income tax treaties and held that such gain was attributable to a U.S. permanent establishment (PE) of the foreign investor by virtue of the part-

* JD Candidate, Loyola University Chicago School of Law.

[1] *See, e.g.*, Jason Piper, *Certainty in Tax*, Association of Chartered Certified Accountants (Nov. 2014), http://www.accaglobal.com/content/dam/acca/global/PDF-technical/tax-publications/tech-tp-cit.pdf; *cf.* Paul Ryan (@SpeakerRyan), Twitter, (June 22, 2017, 12:00 PM), https://twitter.com/SpeakerRyan/status/877964416842518528 ("Businesses need certainty from permanent tax cuts to invest in their businesses and plan for the future.").

[2] Rev. Rul. 91-32, 1991-1 C.B. 20.

nership having a PE.[3] A PE is a fixed place of business or other substantial base of operations that a U.S. based partnership would ordinarily have in the United States.[4] The more common interpretation of U.S. income tax treaties is that only the country of the investor's residency can tax the gain on the sale of an interest in a business unless that interest forms part of the business assets of the investor's own PE, in the absence of an explicit treaty provision to the contrary.[5] Thus, Revenue Ruling 91-32 held that foreign investors qualifying for the benefits of a U.S. bilateral income tax treaty would be subject to U.S. taxation on such a gain.

In July of 2017, the U.S. Tax Court in *Grecian Magnesite Mining* declined to follow the revenue ruling and held that gain (or loss) on disposition of a U.S. partnership by a foreign partner was not effectively connected income (or loss) and, therefore, not subject to U.S. taxation.[6] As the gain or loss was not subject to U.S. taxation, the court did not have to rule with respect to whether a U.S. income tax treaty protected an investor who qualified for the benefits of the treaty from U.S. taxation on the gain.[7] Less than six months later, Congress reversed *Grecian Magnesite Mining* in the recent tax overhaul popularly known as the Tax Cuts and Jobs Act of 2017[8] (TCJA). The change taxes foreign partners gain on sales, exchanges, and dispositions of U.S. partnerships occurring on or after November 27, 2017. Still unsettled is whether the IRS will continue to maintain that such gain or loss is attributable to a PE, overriding historic treaty interpretations of U.S. income tax treaties.[9] Here we will examine the Tax Court's decision in *Grecian Magnesite Mining* as well as the implications of its reversal by the TCJA.

Foreign direct investment (FDI) into the United States was 468.33 trillion dollars in 2017.[10] The United States has consistently ranked as the world's top investment destination.[11] Limited liability companies (LLCs) are popular for

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3 *Id.*

4 *See generally* Rufus Rhoades & Marshall Langer, U.S. International Taxation & Treaties: § 44.01 Introduction to the Permanent Establishment Concept, Lexis (database updated Mar. 2018).

5 *See, e.g.,* Dep't of the Treasury, U. S. Model Income Tax Convention of September 20, 1996 Tech. Explanation, https://www.irs.gov/pub/irs-trty/usmtech.pdf; Dep't of the Treasury, U. S. Model Income Tax Convention of November 16, 2006 Tech. Explanation, https://www.treasury.gov/press-center/press-releases/Documents/hp16802.pdf (only mentioning the taxation of a partner's distributive share of gains from the partnership's alienation of property in its discussion of gains from the alienation of moveable property).

6 *Grecian Magnesite Mining, Indus. & Shipping Co., SA, v. Comm'r,* 149 T.C. No. 3, US-TAXCOURT 11322 (July 13,2017), *appeal docketed,* No. 12-1268 (DC Cir. Dec. 18, 2017).

7 *Id.* at *5 n. 2.

8 Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, §13501, 131 Stat. 2054 [hereinafter TCJA].

9 *See* Dep't of the Treasury 1996, *supra* note 5; *See* Dep't of the Treasury 2006, *supra* note 5.

10 *Foreign Direct Investment Statistics: Data, Analysis and Forecasts,* Organization for Economic Cooperation and Development (July 31, 2017), http://www.oecd.org/investment/statistics.htm.

11 Paul A. Laudicina, The 2017 A.T. Kearney Foreign Direct Investment Confidence Index: Glass Half Full, ATKearney (2017), https://www.atkearney.com/documents/10192/12116059/2017+FDI+Confidence+Index+-+Glass+Half+Full.pdf/5dced533-c150-4984-acc9-da561b4d96b4; *See also* World Investment Report 2017, *Country Fact Sheet: United States,* United Nations Conference on Trade and Development, http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/Country-Fact-Sheets.aspx.

foreign investors in strategic U.S. joint ventures and entrepreneurial enterprises,[12] and the United States treats most LLCs as partnerships for U.S. federal income tax purposes.[13] Subjecting new partnership transactions to U.S. tax can potentially affect the shape and structure of the U.S. and global economy, especially considering neo-classical theory of investment, which predicts increased investment when host country taxes fall, and decreased investment as foreign investment taxes rise.[14] Taxes on investors in partnerships can especially discourage small and medium-sized enterprises (SMEs) from investing in the U.S. as SMEs frequently use partnership or hybrid structures for cross-border business.[15] SMEs are responsible for most of the net job creation in OECD countries and make significant contributions to innovation, productivity and economic growth.[16] SMEs have a high compliance tax burden relative to their size, measured by turnover or profit, and one can argue that this disproportionate burden results in a misallocation of resources.[17] Disproportionate tax compliance costs may result in under-investment in SMEs.[18]

Taxing foreign partners' gains on partnership sales may also upset settled norms on the taxation of capital gains as historically set by bilateral tax treaties. The United States, its major trading partners, and many developing countries have entered into bilateral income tax treaties. The purpose of these treaties is to limit double taxation of income.[19] In keeping with this purpose bilateral income tax treaties generally limit the taxation of business profits of foreign persons to profits attributable to a permanent establishment of the foreign person in the country of non-residence.[20] Historically, it was understood that an ownership in-

[12] *See, e.g.*, Lowell Yoder, *The Limited Liability Company (LLC) is the Entity of Choice for a Joint Venture*, Forbes (Apr. 17, 2012), https://www.forbes.com/sites/lowellyoder/2012/04/17/the-limited-liability-company-llc-is-the-entity-of-choice-for-a-joint-venture/#765e756532d8; *LLCs: Is the Future Here? A History and Prognosis*, GP Solo Law Trends & News Business Law (Oct. 2004), https://www.americanbar.org/newsletter/publications/law_trends_news_practice_area_e_newsletter_home/llc.html.

[13] Domestic LLCs with two or more members are taxed as partnerships by default under U.S. federal tax law, while foreign LLCs frequently elect to be taxed as partnerships if they are not taxed as partnerships by default. *See* Treas. Reg. § 301.7701-2 (2016); Treas. Reg. § 301.7701-3 (2006) (stating that if it has only one owner, it can elect to be treated as a disregarded entity).

[14] Organization for Economic Cooperation and Development, *Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis*, Tax Policy Studies No. 17 (Dec. 20, 2007), http://www.oecd-ilibrary.org/taxation/tax-effects-on-foreign-direct-investment_9789264038387-en. The effect of U.S. taxing disposition of the U.S. investment may be offset to the extent that a foreign corporate investor pays a reduced corporate income tax due to the TCJA's lower corporate tax rates. *See* TCJA, *supra* note 8, at §13001.

[15] Organization for Economic Cooperation and Development, *Taxation of SMEs: Key Issues and Policy Considerations*, Tax Policy Studies No. 18, at 92, 92-94 (Oct. 12, 2009).

[16] *Id.* at 22.

[17] *Id.* at 93-94.

[18] *Id.* at 94.

[19] *See, e.g.*, Dep't of the Treasury, U.S. Model Income Tax Convention, 2016, https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf [hereinafter U.S. Model Income Tax Convention]; Organization for Economic Cooperation and Development, Model Double Taxation Convention on Income and Capital 2014, http://dx.doi.org/10.1787/978926423908l-en.

[20] *See* U.S. Model Income Tax Convention, *supra* note 19, at art. 5; Organization for Economic Cooperation and Development 2014, *supra* note 19, at art. 5.

terest in a business was an investment of the owner, not itself the conducting of business, and therefore gain on its disposition was not business profits.[21] One of the exceptions is the United States-Netherlands income tax treaty, which specifically allows for the taxation of the disposition of an interest in a partnership that has a permanent establishment in a contracting nation.[22]

Revenue Ruling 91-32[23] upset that general understanding by holding that passive foreign investors were subject to U.S. taxation on the gain from the disposition of their interest in a U.S. partnership and attributable to a permanent establishment (PE) when the partnership has a PE in the United States. By declining to follow the IRS's long controversial ruling in Revenue Ruling 91-32,[24] the U.S. Tax Court in *Grecian Magnesite Mining*[25] would have implicitly cemented the general understanding of the protection afforded foreign investors in U.S. bilateral income tax treaties. TCJA's codification of Revenue Ruling 91-32[26] raises the specter that the IRS may assert, based on the same reasoning as in the revenue ruling, that a treaty protected foreign investor's gain on disposition of a U.S. partnership interest is taxable in the United States to the extent of the investor's pro rata gain on a hypothetical disposition of the partnership's U.S. assets.

II. Background

A. U.S. Taxation of Foreign Persons

The United States subjects its citizens, residents, and domestic corporations to income tax on their worldwide income.[27] Because other countries frequently also use a residency-based system of taxation, double taxation is generally avoided by means of either a unilateral grant of a tax credit for foreign taxes paid on income from foreign sources or by exclusions of certain foreign source income.[28]

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[21] *See, e.g.*, Tax Convention, U.K.-U.S. art. 13, July 24, 2001, S. Treaty Doc. No. 107-19; Tax Convention, Spain-U.S. art. 13, Feb. 22, 1990, S. Treaty Doc. 101-16; Tax Convention, China-U.S. art. 12, Apr. 30, 1984, S. Treaty Doc. 98-30.

[22] Tax Convention, Neth.-U.S. art. 14(3), Dec. 18. 1992, S. Treaty Doc. No. 103-6; Dep't of the Treasury, Technical Explanation of the Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income art. 14(3) (1992), https://www.irs.gov/businesses/international-businesses/netherlands-technical-explanation.

[23] Rev. Rul. 91-32, *supra* note 2.

[24] *Id.*

[25] *Grecian Magnesite Mining, Indus. & Shipping Co., SA, v. Comm'r*, 149 T.C. No. 3, US-TAXCOURT 11322 (July 13,2017), *appeal docketed*, No. 12-1268 (DC Cir. Dec. 18, 2017).

[26] Rev. Rul. 91-32, *supra* note 2.

[27] *See* I.R.C. §§ 61, 872(a), 882(b) (2017). It is alone, with the exception of Eritrea, in taxing its citizens on their worldwide income. *See* U.S. State Dep't, Eritrea Investment Climate Statement 2015 (June 2015), https://www.state.gov/e/eb/rls/othr/ics/2015/241552.htm (Eritrea imposes a 2 percent tax on the income of its nonresident citizens).

[28] *See, e.g.*, I.R.C. §§ 901, 911 (2017).

Taxation of foreign persons is thought to require some sort of substantial or "genuine" connection to the taxing nation to justify taxation.[29] The U. S. Internal Revenue Code (I.R.C.) provides detailed rules for determining whether income will be treated as derived from U.S. or foreign sources.[30] For example, interest is generally sourced to the country of residence of the obligor,[31] while dividends are generally sourced to the country of incorporation of the corporation distributing the dividend.[32] Capital gain from the sale of personal property is generally sourced to the country of residence of the seller.[33] U.S. income taxation of foreign persons (non-resident aliens and non-domestic entities) is limited to two categories of income: (i) U.S. source fixed or determinable annual or periodical income (FDAP) and (ii) income (U.S. or foreign source) that is effectively connected to a trade or business conducted within the United States (ECI).[34]

FDAP includes certain investment income, like interest, dividends, rents, royalties and annuities, and certain compensation, like wages and salaries.[35] FDAP is taxed at a flat 30% rate that is withheld at the source of the payment of the FDAP.[36] There are numerous exceptions from taxation for certain FDAP items, such as for interest on portfolio investments.[37] Bilateral income tax treaties frequently reduce the rate of tax imposed by the country of source on certain FDAP or eliminate it entirely.[38]

To be subject to U.S. income tax, business income of foreign persons must be ECI, which means that both the foreign person must be engaged in a trade or business within the United States and the foreign person's income must be effectively connected to that trade or business. The I.R.C. does not define a trade or business within the United States other than to provide two primary exceptions from a U.S. trade or business,[39] although case law provides some guidance.[40]

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29 *See* Jérôme Monsenego, Taxation of Foreign Business Income within the European Internal Market: An Analysis of the Conflict between the Objective of Achievement of the European Internal Market and the Principles of Territoriality and Worldwide Taxation, 31 (2011), https://online.ibfd.org/collections/tfbi/html/tfbi_c02.html?WT.z_nav=crosslinks.

30 I.R.C. §§ 861-65 (2017).

31 I.R.C. §§ 861(a)(1), 862(a)(1) (2017).

32 I.R.C. §§ 861(a)(2), 862(a)(2) (2017).

33 I.R.C. § 865(a) (2017) (although there are special rules for the sale of inventory, depreciable property, and certain intangible property and sales through offices or fixed places of business); I.R.C. § 865(b)-(e) (2017).

34 I.R.C. §§ 872(a), 882(b) (2017).

35 I.R.C. § 1441 (2017).

36 I.R.C. §§ 1441, 1442 (2017).

37 *See, e.g.*, I.R.C. §§ 871(h), 881(c) (2017).

38 *See, e.g.*, U.S. Model Income Tax Convention, *supra* note 19; Organization for Economic Cooperation and Development, Model Double Taxation Convention on Income and Capital, 2014, http://dx.doi.org/10.1787/9789264239081-en.

39 I.R.C. §864(b) (2017) (The performance of services within the United States for a foreign employer is excepted from being treated as a trade or business within the United States if both the compensation is less than $3,000 and the individual is present within with United States for not more than 90 days in the taxable year. Also, trading in stocks, securities, or commodities is generally excepted if done through a resident broker, commission agent, custodian, or other independent agent or is done for one's own account).

The I.R.C. provides different rules for when income is treated as ECI depending on the source of income. Whether U.S. source FDAP type income and capital gains are ECI depends on the extent to which the income, gain, or loss is derived from assets used in or held for use in the conduct of the U.S. trade or business (the "asset use test") or whether the activities of the trade or business are a material factor in the realization of the income, gain, or loss (the "business activities test").[41] All other U.S. source income is ECI.[42] Foreign source income is ECI if the foreign person has an office in the United States to which the income is attributable and the income is (i) certain investment income derived in the active conduct of a banking, financing, or similar business in the United States, (ii) from the sale of personal property unless it is for use, consumption, or disposition outside the United States and a foreign office materially participated in the sale, or (iii) rents or royalties from patents, copyrights and the like derived in the active conduct of the trade or business.[43] Treaties modify these rules by requiring that the business income of the foreign person be attributable to a PE in the country of non-residence. A PE is usually defined as a branch, office, factory, or workshop, and often includes a place of management, place of natural resource extraction, a building site or construction or installation project if it lasts a certain extended period of time. It will also include the office of an agent, other than an agent of independent status, if the person has, and habitually exercises in that country, an authority to conclude contracts in the name of the foreign person.[44]

B. U.S. Taxation of a Foreign Person's Capital Gain and Loss

As noted, gain from the sale of personal property is sourced to the seller's place of residence.[45] There are special rules for the taxation of U.S. real property interests (USRPIs), which are broadly subject to U.S. tax with a special withholding tax to enforce administration of the tax.[46] A USRPI includes stock of a corporation if more than 50% of the value of the corporation's assets are USRPIs,[47] while I.R.C. Section 897(g) applies a look-through rule for partnership interests, but a temporary regulation applies this rule only if at least 50% of the value of the partnership's assets are comprised of USRPIs.[48] Since the enactment of the

40 *See, e.g., Pinchot v. Comm'r,* 113 F.2d 718 (2d Cir. 1940); *M. L. Neill v. Comm'r,* 46 B.T.A. 197 (1942); *Herbert v. Comm'r,* 30 T.C. 26 (1958).

41 I.R.C. § 864(c)(2) (2017).

42 I.R.C. § 864(c)(3) (2017).

43 I.R.C. § 864(c)(4) (2017).

44 U.S. Model Income Tax Convention, *supra* note 19; I.R.C. §864(b) (2017).

45 I.R.C. § 865(a)(2) (2017).

46 *See* I.R.C. §§ 897, 1445 (2017); *see generally* The Foreign Investment Real Property Tax Act of 1980 (FIRPTA), which was enacted as Subtitle C of Title XI of the Omnibus Reconciliation Act of 1980, Pub. L. No. 96-499, 94 Stat. 2599, 2682 [hereinafter FIRPTA].

47 I.R.C. § 897(c)(2) (2017).

48 Treas. Reg. § 1.897-7T (1988).

special rules for the taxation of foreign investment in real estate in 1980,[49] the exception for real property interests has been reflected in most treaties.[50]

C. Partnership Taxation

A partnership is a flow-through entity for U.S. tax purposes that is generally not itself taxed, but is treated a conduit for taxing the partners.[51] A partner realizes capital gain on the sale or exchange of a partnership interest except to the extent of the partnership's unrealized receivables and inventory assets that are taxed as ordinary income.[52] As previously mentioned, gain from the alienation of personal property is generally sourced to the alienor's place of residence, which in the case of a nonresident alien or foreign entity would generally be outside the United States. For purposes of U.S. taxation, domestic LLCs are ordinarily treated as partnerships if they have more than one owner.[53] In contrast, foreign LLCs are ordinarily treated as corporations, although foreign LLCs with more than one owner may elect to be treated as partnerships.[54]

A partnership, including an LLC treated as a partnership, must pay a quarterly withholding tax on a foreign partner's share of estimated ECI.[55] This withholding tax did not extend to gain on disposition of an interest in the partnership. Now, TJCA imposes a requirement. effective January 1, 2018, on the transferee of a partnership interest to withhold 10% of the amount realized on the transfer of a partnership interest by a foreign person to the extent that the new act treats the gain as ECI.[56]

The United States taxes foreign investment in a U.S. corporation differently than foreign investment in a U.S. partnership. A U.S. corporation is subject to tax on its income (previously generally at a 34% or 35% rate),[57] and then a 30% (or lower treaty rate) tax is withheld on the payment of a dividend.[58] TJCA reduces the corporate tax rate to 21%.[59] Disposition of shares in a corporation will typically give rise to capital gain or loss, which generally is not subject to U.S. tax. If a foreign corporation is engaged in business directly through a branch, the branch is subject to U.S. tax at the same corporate rate as a U.S. corporation,[60] and then

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49 FIRPTA, *supra* note 46.

50 *See, e.g.*, Tax Convention, Japan-U.S., art. 13(1), Nov. 6, 2003, S. Treaty Doc. No. 108-14; Tax Convention, Belg.-U.S., art. 13(1)-(2), Nov. 27, 2006, S. Treaty Doc. No. 110-3.

51 I.R.C. § 865(a)(2) (2017).

52 I.R.C. §§ 741, 751 (2017); Treas. Reg. §1.741-1 (2000), Treas. Reg. § 1.751-1 (2004).

53 Treas. Reg. § 301.7701-2 (2016) (stating that an entity is disregarded if it has only one owner); Treas. Reg. § 301.7701-3 (2006) (stating that an entity can elect to be treated as a corporation).

54 Treas. Reg. § 301.7701-2 (2016); Treas. Reg. § 301.7701-3 (2006) (stating that if it has only one owner, it can elect to be treated as a disregarded entity).

55 I.R.C. § 1446 (2017).

56 TCJA, *supra* note 8.

57 *See* I.R.C. § 11 (2017).

58 I.R.C. §§ 871(a), 881 (2017).

59 TCJA, *supra* note 8.

60 I.R.C. § 882 (2017).

a branch profits tax is imposed on its dividend equivalent amount.[61] In contrast, a U.S. partnership does not pay an income tax, but its foreign investors are subject to tax currently on their share of the U.S. partnership's share of ECI at their applicable rate of tax.[62] Until the issuance of Revenue Ruling 91-32[63] it was generally thought that a disposition of a U.S. partnership interest, as with the disposition of shares of a corporation, would not generally be subject to U.S. tax. In mid-2017, the U.S. Tax Court in *Grecian Magnesite Mining*[64] ruled that there generally would not be a U.S. tax (which the IRS is appealing), but the TCJA imposes a tax for dispositions on or after November 27, 2017.

To understand the reasoning of the IRS in the revenue ruling and the Tax Court in *Grecian Magnesite Mining* case, it is necessary to know that the U.S. income tax rules relating to the taxation of partnerships and their partners reflect two broad approaches to taxation: the partnership as an entity (the "entity approach") and the partnership as an aggregation of the partners (the "aggregate approach"). Under the aggregate approach, the partners, not the partnership itself, are subjected to taxation with certain of the partnership's tax items attributed to the partners.[65] Under the entity approach, the disposition of a partnership interest is treated as the sale of a capital asset, rather than as a sale of the partnership's underlying individual assets,[66] with an exception for certain assets, such as inventory and accounts receivables.[67]

III. Discussion

A. Review of Revenue Ruling 91-32

Revenue Ruling 91-32[68] addressed the U.S. tax treatment of gains from the sale of a U.S. partnership interest by a nonresident individual. It described three situations. In the first situation, a nonresident alien individual sold his interest in a partnership that engaged in a U.S. trade or business and the partnership had real and personal property located both within and without the United States. The second situation posited the same facts, but provided the additional facts and value numbers regarding the partnership's real and personal property located outside the United States as well as personal property located within the United States. In the third situation, the foreign partner was a tax resident of a treaty country and the partnership had assets that were attributable to a PE in the United States and assets that were not attributable to that PE. The provisions of the tax

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61 I.R.C. § 884 (2017).

62 *See* I.R.C. §§ 871(b), 882 (2017); TCJA, *supra* note 5, at § 11011 allows pass-through entities a 20% deduction for qualified business income. Foreign partners, like U.S. partners, are not generally subject to U.S. tax on distributions from the partnership. Thus, there is only one level of taxation.

63 Rev. Rul. 91-32, *supra* note 2.

64 *Grecian Magnesite Mining, Indus. & Shipping Co., SA, v. Comm'r*, 149 T.C. No. 3, US-TAXCOURT 11322 (July 13,2017), *appeal docketed,* No. 12-1268 (DC Cir. Dec. 18, 2017).

65 *See* I.R.C. § 701 (2017).

66 *See* I.R.C. § 741 (2017).

67 *See* I.R.C. § 751 (2017).

68 Rev. Rul. 91-32, *supra* note 2.

treaty were identical to those of the Draft U.S. Model Income Tax Treaty (1981).[69]

In the first two situations, the foreign partner's gain is subject to U.S. taxation as U.S. source ECI to the extent that the partner would have had U.S. source ECI if the partnership had disposed of all of its assets at fair market value on the date of the sale of the partnership interest.

In the third situation, the foreign partner's gain is subject to U.S. taxation as income attributable to a U.S. PE to the extent that the partner would have had income attributable to the partnership's PE if the partnership had disposed of all of its assets at fair market value on the date of the sale of the partnership interest.

Revenue Ruling 91-32 recognized that the gain on the sale of the partnership interest was the gain on the sale of a separate asset under I.R.C. section 741 and not from the sale of the partner's share of the partnership's assets. Nevertheless, it made reference to the FIRPTA[70] rules to conclude that it is "appropriate" to treat a foreign partner's disposition of his interest in a partnership as a disposition of an aggregate interest in the partnership's underlying property for purposes of determining the source of the gain and whether it was ECI. In support of this conclusion, the revenue ruling cited *Unger v. Commissioner,*[71] in which the business profits of a partnership with a U.S. PE were attributed to a foreign partner. Unlike *Unger*, however, the gain in the revenue ruling was not business profits of the partnership, but of the partner. Just the same, the revenue ruling concluded in the first situation that: (1) gain from the sale of the partnership interest was sourced to the U.S. because it was "attributable" to the foreign partner's fixed place of business in the United States, and (2) such gain was effectively connected income under the "asset use test" of I.R.C. section 864(c)(2) because the value of the partnership's business activity affected the value of the partnership interest.

The revenue ruling noted that characterizing the entire amount of gain or loss would effectively subject to U.S. tax items that may not be described in I.R.C. section 864(c), which defines income that is ECI. Accordingly, the revenue ruling determined that the amount of the foreign partner's gain on disposition of his partnership interest that should be treated as ECI is the partner's share of the partnership's gain that would be ECI in a hypothetical sale of the partnership's assets on the date that the foreign partner disposed of his interest. The revenue ruling did not cite authority for this proposition. Citing the "general principle" that the burden of proof is on the taxpayer, the revenue ruling also stated that the gain on disposition will be presumed to be U.S. source ECI in its entirety unless the partner is able to produce information showing what his distributive share of net ECI and net non-ECI gain or loss would be if the partnership had sold all of its assets.[72]

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[69] Dep't of Treasury, U.S. Model Income Tax Convention, 1981, *reprinted in* 1 TAX TREATIES 158 (1982).

[70] FIRPTA, *supra* note 46.

[71] *Unger v. Comm'r*, 58 T.C.M. (CCH) 1157 (1986).

[72] Rev. Rul. 91-32, *supra* note 2.

Without separately analyzing whether a foreign partner's gain or loss on the disposition of an interest in the partnership would be treated as attributable to a PE under the applicable U.S. income tax treaty (here, the U.S. Model Treaty), the revenue ruling simply declared that the principles of attributing to a PE are analogous to those governing whether an item is ECI. The revenue ruling comes to this conclusion although it admits that "the 'attributable to' concept of the Treaty is more limited in scope than the 'effectively connected' concept of the Code,"[73] by generally citing Revenue Ruling 81-78.[74] Without support, the revenue ruling stated that it is appropriate under the applicable treaty to look beyond a foreign partner's interest in a partnership to the partner's interest in the underlying assets of the partnership.[75] To determine the amount of the foreign partner's gain on the disposition of his partnership interest attributable to a U.S. PE, the revenue cites to OECD's Model Income Tax Treaty.[76] The commentary associated with the OECD's treaty simply remarks that some countries tax a partnership while others do not.[77] If a partnership is not subject to tax, the partnership itself is not a beneficiary of a treaty in the absence of a specific provision in that article addressing partnerships.[78] Concluding that under the Treaty the foreign partner's gain on disposition of its interest in a partnership is subject to U.S. taxation, the revenue ruling held only to the extent that the partner's potential distributive share of unrealized gain of the partnership is attributable to the partnership's U.S. PE.[79]

B. Commentary on Revenue Ruling 91-32

The revenue ruling, prior to its codification in the TCJA, had been heavily criticized as a tortured reading of both the partnership and the international tax rules.[80] There are two possible approaches to the taxation of gain or loss on a partnership transaction. The first approach starts with I.R.C. section 741 provides

73 *Id.*

74 Rev. Rul. 81-78, 1981-1 C.B. 604.

75 *Id.*

76 *Id.*

77 *See* Organization for Economic Cooperation and Development, *Comments. on the Articles of the Model Tax Convention*, http://www.oecd.org/berlin/publikationen/43324465.pdf.

78 *Id.*

79 Rev. Rul. 91-32, *supra* note 2.

80 *See, e.g.*, Kimberly S. Blanchard, *Rev. Rul. 91-32: Extrastatutory Attribution of Partnership Activities to Partners*, 76 TAX NOTES 1331 (1997) ("an outlandish hodgepodge of half baked theories"); Kenneth Harris & Francis Wirtz, *The Interplay Between Partnership and International Tax Rules in the* Internal *Revenue Code: Revenue Ruling*, 91-32, 20 TAX MGMT. INT'L J. 345, 350 (1991); William W. Bell & David B. Shoemaker, *Revenue Ruling 91-32: Right Result for the Wrong Reasons*, 9 J. PARTNERSHIP TAX'N 80 (1992) (IRS is "relying principally upon 'the nature of things' and then adding its own gloss and substance"); Alan R. Hollander, *Is a Sale of a Partnership Interest 'Attributable' to the Partnership's Place of Business? The Missing Analysis in Rev. Rul. 91-32*, 52 TAX NOTES 1321 (1991) ("surprising"); Philip F. Postlewaite, *The Omnipresence of Subchapter K in the International Arena?*, 93 TAXES 143 (2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2548749 ("articulated rationale . . . is clearly suspect"); Edwin J. Reavey & Richard M. Elliott, *Sales of U.S. Partnership Interests by Foreign Partners: New Rules After Rev. Rul. 91-32*, 91 TAX NOTES TODAY 50-27 (1991) ("no basis for [conclusion]").

gain or loss on the exchange of a partnership interest is generally treated as an intangible capital asset.[81] Under the general sourcing rule for sales and exchanges of personal property, capital gains are sourced to the residence of the seller.[82] This approach applies entity theory to the sale of a partnership interest.[83] Some commentators contend that this approach would also lead to an exemption from taxation under I.R.C. section 864(c)(4) because capital gains of a foreign person are normally foreign source income under I.R.C. section 865(a).[84]

The revenue ruling's analysis, or lack thereof, has been soundly criticized by commentators.[85] The revenue ruling relies on the I.R.C. section 865(e)(2) exception from the general rule of I.R.C. section 865(a) to treat the gain as U.S. source. That exception requires that the income be "attributable" to the U.S. office of the partnership. Blanchard claims the revenue ruling's statement that supports the attribution is tautological, bolstered with a citation to the wholly irrelevant *Unger*[86] case, neither of which addresses how a gain becomes attributable to an office or other fixed place of business.[87] Hollander provides a similar criticism of the revenue ruling's mere assertion that the sale of the partnership interest is attributable to the partner's fixed place of business in the United States and, thus, U.S. source income, but does not provide an analysis for this conclusion.[88] Instead, the revenue ruling moves to analyze whether the gain is ECI.[89]

For this analysis, the revenue ruling uses the "asset-use" test found under I.R.C. section 864(c)(2)(A) and Treasury Regulations section 1.864-4(c)(2). However, applying the asset-use test would lead to the conclusion that the assets were not effectively connected unless the proceeds are reinvested in the business.[90] Obviously if a partnership interest is disposed of in a sale, its proceeds are not reinvested in the business. In addition, the asset use test does not cover income that is not either capital gains or FDAP and some of the proceeds would be neither.[91]

A number of the commentators believe that the revenue ruling's holding to allocate the gain would technically make sound policy if the policy maker's goal was to tax capital gains on the sale of a partnership. However, some question

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81 *See* I.R.C. § 751 (2017) (providing exceptions from this treatment).

82 I.R.C. § 865 (2017).

83 Postlewaite, *supra* note 80. The revenue ruling ignores the implications of I.R.C. section 741 and instead, under an aggregate theory, treats the partnership interest as an aggregate of the partner's interest in each of the partnerships' assets and treat's the partner as if the individual assets were disposed of in a deemed sale.

84 *See, e.g.*, Blanchard, *supra* note 80.

85 *See, e.g.*, *id.*; Bell & Shoemaker, *supra* note 80; Hollander, *supra* note 80; Postlewaite, *supra* note 80.

86 Unger v. Comm'r, 58 T.C.M. 1157 (1986).

87 Blanchard, *supra* note 80.

88 Hollander, *supra* note 80.

89 *Id.*

90 Bell & Shoemaker, *supra* note 80, at 84.

91 *Id.*

whether taxing these gains is sound policy.[92] Blanchard specifically questions why, since a foreign shareholder may avoid the individual level of corporate tax on a similar share of a corporate interest, which the foreign investor not be allowed to avoid the partner level tax on a sale of a partnership interest.[93] What most commentators agree is that there was insufficient statutory support for the United States to tax a foreign partner on the disposition of an interest in a U.S. partnership.[94]

C. Review of *Grecian Magnesite Mining* Case

Grecian Magnesite Mining (GMM) was a Greek corporation that mined, produced and commercialized magnesite in Greece. GMM had all its offices and facilities in Greece and no office, employees, or business operations in the United States. In 2001, it purchased a 15% interest in Premier, a U.S. LLC (taxed as a partnership) headquartered in Pennsylvania, with offices in several other states, which was engaged in the magnesite mining business in the United States. GMM hired a lawyer and a CPA to handle its U.S. tax obligations.[95]

In 2008, one of GMM's partners requested Premier to redeem its interest, which obligated Premier to make the same offer to the other partners. GMM opted to sell its interest in the partnership. On advice of the CPA, it filed a Form 1120-F "U.S. Income Tax Return of a Foreign Corporation" to report its distributive share of the partnership items of income and loss, but it did not report any income from the redemption of its partnership interest. GMM did not receive the final payment for the redemption until January 2, 2009, although the parties treated it as having been made on December 31, 2008.[96] In 2009, GMM received a Schedule K-1 "Partner's Share of Income, Deductions, Credits, etc." from Premier showing a capital account balance of zero and no items of income or loss.[97]

The IRS audited and adjusted both 2008 and 2009. GMM later conceded that the portion of the proceeds attributable to USRPIs were subject to U.S. tax and taxable by the United States under the United States – Greece Income Tax Treaty, but not the remainder of the proceeds.[98]

GMM's gain on the disposition of its interest in the partnership was a capital gain that was not U.S. source income and therefore could not be ECI. As a result, the gain was not subject to U.S. tax.

The court reviewed certain basic principles of partnership taxation to determine the character and the nature of the gain from GMM's sale of its partnership interest. I.R.C. section 701 exempts the partnership itself from tax and limits

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92 Reavey & Elliott, *supra* note 80; Blanchard, *supra* note 80.

93 Blanchard, *supra* note 80.

94 *Id.*; Bell & Shoemaker, *supra* note 80; Hollander, *supra* note 80.

95 *Grecian Magnesite Mining, Indus. & Shipping Co., SA, v. Comm'r,* 149 T.C. No. 3, US-TAXCOURT 11322 at *6-*7 (July 13,2017), *appeal docketed,* No. 12-1268 (DC Cir. Dec. 18, 2017).

96 *Id.*

97 *Id.* at *7-*10.

98 *Id.* at *11-*12.

taxation to the partners in their individual capacities. When a partnership redeems a partner's interest through a payment, I.R.C. section 736(b)(1) provides that the liquidating payment is a distribution by the partnership. I.R.C. section 731(a) provides that in the case of a distribution, gain is recognized only if any money distributed exceeds the partner's basis in the partnership and any gain recognized by that provision is treated as a capital gain.[99] In addition, I.R.C. section 741 (with narrow exceptions) generally treats the sale of a partnership interest as the sale of a capital asset.[100]

Reasoning that the entity approach predominates in the I.R.C.'s treatment of a transfer of partnership interests as a transfer of interest in a separate entity, the court rejected the Commissioner's aggregation approach such that the gain would be deemed to arise from the sale of GMM's interest in the assets that make up the partnership's business.[101] The court also looked to the language of I.R.C. section 741 that provides that income realized on the sale of a partnership interest is to be considered as gain from the sale of a capital asset, noting that "Congress used the singular 'asset', rather than the plural 'assets,'" which it found to be more consistent with the treatment of the sale of a partnership interest according to the entity approach than the aggregate approach.[102] Instead, the Tax Court concluded that the express wording of I.R.C. section 731(a) could not be clearer that an entity approach applied as it provides that any gain or loss under that subsection "shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner."

The court also reviewed the relevant international tax law. The Commissioner admitted that if the gain was foreign source, it could not fall within the limited categories of foreign source income that could be ECI under I.R.C. section 864. Rather, it had to be U.S. source if it were to be treated as ECI.[103] The Commissioner asked the court to give deference to Revenue Ruling 91-32,[104] but the court found the revenue ruling's analysis to be cursory and lacking "the power to persuade."[105] The court therefore performed its own analysis.[106] The court identi-

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99 *Id.* at *4-*5.

100 *Id.* at *5.

101 *Id.* at *15-*16.

102 *Id.* at *21-*26. The court also rejected the Commissioner's argument that enactment of I.R.C. section 897(g), under which amounts received by a foreign person in exchange for all or part or its interest in a partnership are taxable gain or loss to the extent attributable to USRPIs, indicated Congress' intent to treat a foreign partner's disposition of his partnership interest as a disposition of an aggregate interest in the partnership's underlying property. Instead, the Court found that the enactment of I.R.C. section 897(g) reinforces its conclusion that the entity theory is the general rule for the sale or exchange of an interest in a partnership because "[w]ithout such a general rule, there would be no need to carve out an exception to prevent U.S. real property interests from being swept into the indivisible capital asset treatment that section 741 prescribes." *Id.* at *27.

103 *Id.* at *13-*14.

104 Rev. Rul. 91-32, *supra* note 2.

105 *Grecian Magnesite Mining, Indus. & Shipping Co., SA, v. Comm'r*, 149 T.C. No. 3, US-TAXCOURT 11322 at *34 (July 13,2017), *appeal docketed*, No. 12-1268 (DC Cir. Dec. 18, 2017).

106 *Id.* at *35-*37. The court noted that there is no I.R.C. section that specifically provides the source of a foreign partner's income from the sale or liquidation of its interest in a partnership, it looked to

fied the redemption of the partnership interest to be the relevant sale for tax purposes rather than a hypothetical sale of the partnership's assets. The court found that the revenue ruling "missed the mark" by analyzing whether Premier's U.S. office would have been a material factor in a hypothetical sale of the underlying partnership assets.[107] In addition, the court found that the Commissioner had conflated the office being material to the ongoing value of a business with the office being material in the distinct situation of a sale of an interest in that business.[108]

For all these reasons, the court found the source of income to be foreign and therefore not ECI. As a consequence, the gain was not subject to U.S. income tax. Because the court found that gain was not subject to U.S. income tax under the U.S. tax law, it did not have to consider whether the United States — Greece income tax treaty prohibited the United States from taxing the gain.[109]

D. Commentary on the *Grecian Magnesite Mining* Case

The early commentators on the case agree that *Grecian Magnesite Mining*[110] was generally a win for foreign investors.[111] There will always be exceptions to the rule. One commentator pointed out that the case's reasoning would make it easier for the IRS to assert U.S. taxation in the common fact pattern for United States-based private equity funds that invest in operating partnerships. This structure involves an upper-tier partnership engaged in buying and selling lower-tier partnership interests, and the court's material-factor analysis would be relevant in finding U.S. source income. Therefore ECI on the sale of interests in the lower-tier partnerships.[112]

Other commentators looked at the structuring implications of the case for private equity and other funds from a different standpoint.[113] These commentators are concerned with whether to use a U.S. or foreign blocker corporation to pre-

§865(a)'s default source rule for gain realized on the sale of personal property, which treats the gain realized by a foreign person as foreign source income.

107 *Id.* at *41.

108 *Id. at* *41-*44 (The question is whether the office was a material factor in the realization of income in the specific transaction. The court held that the material factor test is not satisfied because Premier's actions to increase its overall value were not an essential element to GMM's realization of income on the sale of its interest; in addition, the ECI regulations required that the income be realized in the ordinary course of the business carried on by the office, and the court found that the gain on the sale of the partnership interest missed this test as well).

109 *Id.* at *5.

110 *Id.* at *1.

111 *See, e.g.*, Courtney Snelling, *The Grecian Battle and the Attributes of the Prevailing Entity* (Jul. 31, 2017) https://www.bna.com/grecian-battle-attributes-b73014462447; Kristen E. Hazel, Sandra P. McGill & Susan E. O'Banion, *United States: Grecian Magnesite Mining v. Commissioner: Foreign Investor Not Subject To US Tax On Sale Of Partnership Interest*, (Nov. 7, 2017), http://www.mondaq.com/404.asp?404;http://www.mondaq.com:80/unitedstates/x/643688/tax+authorities/State+And+Local+Tax+Aspects+Of+Republican+Tax+Reform+Framework&login=true.

112 KPMG, Foreign partners: Tax Court rejects IRS's position in Rev. Rul. 91-32 (2017), https://home.kpmg.com/content/dam/kpmg/us/pdf/2017/07/tnf-taxcourt-july17-2017.pdf [hereinafter KPMG].

113 Hazel, McGill and O'Banion, *supra* note 111; David A. Sausen, Laurie Abramowitz & Sarah C. Solveichik, *Grecian Magnesite Decision Could Have Significant Tax Implications for Non-US Investors*

vent foreign investors from having to recognize ECI.[114] They noted that after the case the use of a foreign blocker, as opposed to a U.S. blocker, would have a tax advantage on disposition in that its gain on the sale of a partnership interest with a U.S. trade or business would not be subject to U.S. tax.[115]

From a tax law standpoint, commentators noted that the case was a victory for the entity approach over the aggregate approach for characterization of foreign partner's dispositions of a partnership interest.[116] However, they differed in their view of the implications of the case. One commentator explicitly questioned whether many taxpayers actually followed the holdings in Rev. Rul. 91-32.[117] Others implicitly suggested that some do not. They advised taxpayers who did follow the revenue ruling to file protective amended returns claiming the benefits of Tax Court holding.[118] Most commentators noted that the taxpayer victory may be short-lived, questioning whether the IRS would appeal the case, issue regulations incorporating the holding of the revenue ruling,[119] or seek a legislative "fix."[120]

E. Changes Made by the 2017 Tax Cut and Jobs Act

The Obama Administration had previously proposed codifying Revenue Ruling 91-32[121] in its budget proposals for Fiscal Years 2013 and 2015.[122] The Administration's reason for the change was that if a partnership made the election allowed under I.R.C. section 754 to increase the partnership's basis in its assets upon a transfer of an interest in the partnership to reflect the transferee's basis in its partnership interest. The foreign transferor partner was not taxed by the United States on the foreign partner's gain from the sale of the foreign partner's interest, that gain would forever escape U.S. taxation.[123] The Administration was concerned that foreign partners' may take a position that was contrary to the holding of Revenue Ruling 91-32[124] because there was no I.R.C. provision that

in a US Fund (2017), https://www.apks.com/en/perspectives/publications/2017/09/grecian-magnesite-decision-could-have.

114 *Id.* In addition, a blocker corporation would protect U.S. tax-exempt entities from having to recognize unrelated business taxable income.

115 *Id.*

116 KPMG, *supra* note 112. https://home.kpmg.com/content/dam/kpmg/us/pdf/2017/07/tnf-taxcourt-july17-2017.pdf.

117 Snelling, *supra* note 111.

118 *See, e.g.*, Hazel, McGill & O'Banion, *supra* note 111.

119 The IRS included providing guidance under I.R.C. section 864 to implement Rev. Rul. 91-32 in its 2016–2017 Priority Guidance Plan, available at https://www.irs.gov/pub/irs-utl/2016-2017_pgp_initial.pdf.

120 *Id.;* KPMG, *supra* note 112.

121 Rev. Rul. 91-32, *supra* note 2.

122 Dep't of the Treasury, Gen. Explanation of the Admin. Fiscal Year 2013 Revenue Proposals 96 (2012) [hereinafter Dep't of the Treasury 2012]; Dep't of the Treasury, Gen. Explanation of the Admin. Fiscal Year 2015 Revenue Proposals 51-52 (2014) [hereinafter Dep't of the Treasury 2014].

123 *Id.*

124 Rev. Rul. 91-32, *supra* note 2.

explicitly provided that gain from the sale or exchange of a partnership interest would be treated as ECI.[125] The proposal would have treated the gain or loss from the sale or exchange of a partnership interest as ECI to the extent that it was attributable to the transferor's distributive share of the partner's distributive share of the partnership's unrealized gain or loss that is attributable to ECI property.[126] It would have also adopted a withholding tax regime similar to that of FIRPTA[127] to ensure collection of the tax.[128]

The TCJA overrides *Grecian Magnesite Mining*[129] for sales or exchanges on or after November 27, 2017. It treats a foreign partner as having effectively connected gain or loss to the extent that the foreign partner would have received effectively connected gain or loss if the partnership had liquidated its assets at fair market value on the date of the disposition of the partnership interest.

To prevent avoidance of its provisions, the Act gives the I.R.S. the authority to provide appropriate regulations for application of the provision, including with respect to corporate transactions in which no gain or loss is recognized, which includes corporate liquidations described in I.R.C. section 332 and corporation reorganizations described in I.R.C. sections 332, 351, 354, 355, 356, or 361. In addition, the TCJA adopts a withholding tax regime that requires the purchaser of the interest, to withhold 10 percent of the amount realized unless the selling partner certifies that the partner is not a foreign person.[130] The withholding provisions apply to sales and exchanges after December 31, 2017.

Unlike FIRPTA,[131] the TCJA does not include a treaty override, and treaty provisions that may limit U.S. taxation of foreign partners remain in force for foreign partners entitled to the benefits of U.S. income tax treaties.[132] The current U.S. Model Income Tax Treaty[133] does not contain a provision specially allowing for the taxation of gains on disposition of partnership interests. The Treasury Departments' technical explanation of the 2006 U.S. Model Income Tax Treaty, like the technical explanation of the 1996 U.S. Model Treaty,[134] cites Revenue

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125 Dep't of the Treasury 2012, *supra* note 122; Dep't of the Treasury 2014, *supra* note 122.

126 Dep't of the Treasury 2012, *supra* note 122; Dep't of the Treasury 2014, *supra* note 122. This TCJA codified the first two holdings of Revenue Ruling 91-32. TCJA *supra* note 8.

127 FIRPTA, *supra* note 46.

128 Dep't of the Treasury 2012, *supra* note 122; Dep't of the Treasury 2014, *supra* note 122.

129 *Grecian Magnesite Mining, Indus. & Shipping Co., SA, v. Comm'r,* 149 T.C. No. 3, US-TAXCOURT 11322 (July 13,2017), *appeal docketed,* No. 12-1268 (DC Cir. Dec. 18, 2017).

130 This withholding regime is similar to FIRPTA's withholding of a purchaser of a U.S. real property interest. *See* FIRPTA, *supra* note 46.

131 FIRPTA, *supra* note 46.

132 *See* Allyson Versprille, *Senate Tax Proposal Would Override Grecian Magnesite Decision,* Daily Tax RealTime (Nov. 10, 2017), https://www.bna.com/senate-tax-proposal-n73014472032/.

133 Dep't of Treasury, U.S. Model Income Tax Convention of November 15, 2006, https://www.irs.gov/pub/irs-trty/model006.pdf.

134 Dep't of the Treasury, U. S. Model Income Tax Convention of September 20, 1996 Tech. Explanation, https://www.irs.gov/pub/irs-trty/usmtech.pdf.

Ruling 91-32 in connection with the article on gains but only to state a non-controversial proposition.[135]

The analysis that follows will concentrate on the uncertainties that have been created by the passing of this new law, particularly in regards to whether the IRS will interpret the law to allow the IRS to tax foreign persons covered under treaty provisions.

IV. Analysis

A. Will the IRS attempt to tax treaty protected partners disposing of partnership interests?

There are only two articles of U.S. bilateral income tax treaties under which a foreign enterprise or foreign individual entitled to the benefits of a U.S. income tax treaty disposing of a partnership may be subject to U.S. tax: the article on gains or the article on business profits.

U.S. income tax treaties generally limit the taxation of gains of foreign persons to gains on disposition of U.S. real property interest, certain ships, aircraft, and containers, and business property of a PE, including gains from the sale of such a PE.[136] This provision has changed little over the years.[137]

The United States — Netherlands Income Tax Treaty signed in 1992 contains the exact verbiage of the 2006 and 2016 U.S. model income tax treaties. The Treasury Department's explanation of the Dutch Treaty's provision on capital gains adds that the provision permits gains from the alienation of an interest in a partnership that has a PE to be taxed as gains attributable to such a PE, "regardless of whether the assets of such partnership consist of personal property as defined in Article 14."[138] This explanation does not appear in other treaty commentary or in the Treasury Department's commentary of the 1996 and 2006 U.S. model treaties. Instead, the explanations of the 1996 and 2006 U.S. model treaties provide merely that a resident of the other Contracting State that is a partner in a partnership with a PE in the United States generally will have a U.S. PE as a

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135 Dep't of the Treasury, U. S. Model Technical Explanation Accompanying the U. S. Model Income Tax Convention of November 15, 2006, 45-46, https://www.treasury.gov/press-center/press-releases/Documents/hp16802.pdf; *see* Blanchard, *supra* note 80. Revenue Ruling 91-32 is cited in the Technical Explanation for the proposition that a partner in a partnership having a U.S. PE will generally be treated as having a U.S. PE, a non-controversial proposition that has long been acknowledged in cases such as *Unger* and *Donroy*. This proposition underpins the Model Treaty's approach of allowing the United States to tax a foreign partner's distributive share of income *realized by the partnership* with a U.S. PE from the disposition of movable property forming *part* of the partnership's U.S. business property.

136 Dep't of the Treasury, U.S. Model Income Tax Convention, art. 13, 2016, https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf.

137 *See* Dep't of the Treasury, U.S. Model Income Tax Convention, art. 13, 1996, https://www.irs.gov/pub/irs-trty/usmodel.pdf (adding to personal property gains attributable to the enterprise such gains "attributable to a fixed base that is available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services").

138 Dep't of the Treasury, Technical Explanation of the Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income art. 14(3) (1992), https://www.irs.gov/businesses/international-businesses/netherlands-technical-explanation.

result of the partnership, citing Revenue Ruling 91-32. The United States generally may tax a partner's distributive share of income realized by a partnership on the disposition of business property of the partnership in the United States.[139]

It is curious that the IRS points the reader to Revenue Ruling 91-32, but cites it for the noncontroversial principal that a partner is treated as having a PE if the partnership has a PE and not for the revenue ruling's controversial holding that a foreign partner would be taxed on the gain realized on disposition of the partner's interest in the partnership.[140] Instead, the explanation merely states that a partner may be taxed on their distributive share of the partnership's gain on the disposition of personal property of the partnership's U.S. PE. This suggests that Treasury had concerns over the validity of the revenue ruling's holding and its acceptability to the U.S.' treaty partners.[141] The 2006 Protocol to the United States – Germany Income Tax Treaty also included a provision that nothing in the gains article will prevent gains realized by a resident of a contracting state from the sale of an interest in a partnership that has a PE in the other contracting state from being treated as a taxable gain from moveable property of a PE.[142]

A central feature in U.S. income tax treaties has long been to limit income taxation of business profits to those attributable to a PE in the taxing jurisdiction.[143] The U.S. Treasury's explanations of the business profits article of the U.S. model treaties do not mention the disposition of an interest in a partnership.[144]

It is unclear whether Revenue Ruling 91-32 was referring to the business profits article or the gains article because it mentions both "gain from the alienation of moveable property," which is covered by the gains article, and "attributable to" a PE, which is generally covered by the business profits article. Indeed, the revenue ruling mentions that the attributable to concept is analogous to the ECI concept, but fails to mention that it is "somewhat different" from the ECI concept, as pointed out by the Treasury explanation of the business profits article.[145] The Treasury understands, as pointed out by some commentators, that a partnership is not engaged in the business of selling its interests. The Treasury also understands that the partners typically are not engaged in the business of trading in partnership interests, with the exception of traders who hold partnership interests in inventory.[146]

139 Dep't of the Treasury, *supra* note 134, at 42-43; Dep't of the Treasury, *supra* note 136, at 45-46.

140 *Id.*

141 *Id.*

142 Protocol Amending Tax Convention, Ger.-U.S., art. XVI (13), June 1, 2006, S. Treaty Doc. No. 109-20 (2006), https://www.irs.gov/pub/irs-trty/germanprot06.pdf.

143 *See* Rhoades & Langer, *supra* note 4.

144 *See e.g.*, Dep't of the Treasury, *supra* note 135, at 21. The explanation does include a discussion of the on-going profits of a partnership with a PE, just not the case of a disposition of interest in a partnership.

145 *Compare* Rev. Rul. 91-32, *supra* note 2, with Dep't of the Treasury, *supra* note 135, at 22.

146 *See, e.g.*, Hollander, *supra* note 80.

The passage of the TCJA raises the question: will the IRS seek to apply the TCJA's codification of Revenue Ruling 91-32 in the treaty context, upsetting the general understanding of these agreements? The treaty context is especially important since most U.S. trade is conducted with countries that have signed tax treaties with the United States. Businesses within these countries have established expectations of what can be taxed.

The TCJA codified the revenue ruling's analysis by modifying I.R.C. Section 864(c) to treat gain and loss on the sale or exchange of a U.S. partnership interest as in whole or in part ECI.[147] The legislative history is silent as to its application to treaties.[148] The IRS could conceivably try to apply the reasoning of Revenue Ruling 91-32 in a future case against a treaty-protected partner.

B. What are the potential consequences?

1. *The logic of* Grecian Magnesite Mining *in the treaty context*

At first blush, it does not appear Revenue Ruling 91-32's treaty holding would be accepted by the U.S. Tax Court in the absence of a mention of the legislative history of applying the revenue ruling's holding to treaties.[149] The court's rejection in *Grecian Magnesite Mining* of the reasoning of Revenue 91-32 in the absence of a specific statutory provision suggests that the court might similarly reject this reasoning in the treaty context, especially where a few U.S. treaties adopted a specific provision in their gains article to allow for such taxation.[150] The notion of "attributable to" in the PE context is typically more limited than in a non-treaty context. The court may have rejected the attribution of the sale to a PE on similar grounds. However, the holding in *Grecian Magnesite Mining* was reversed by Congress in the TCJA, and a higher court could conceivably view Congress as approving of the logic of the revenue ruling, even applicable in the treaty context.

2. *Response from Trèaty Partners*

Surprise "tax traps" discourage businesses from investing in the United States. Treaty countries expect to be generally the jurisdiction taxing the capital gains of its tax residents, except in those limited contexts explicitly enumerated in treaties.[151] Affected investors can seek consideration by competent authority to avoid double taxation, when provided for in bilateral treaty arbitration provisions,[152]

147 TCJA, *supra* note 8.

148 H.R. Rep. No. 115-466, at 509-512 (2017) (Conf. Rep.).

149 See *id.*

150 *See, e.g.*, Tax Convention, Neth.-U.S. art. 14(3), Dec. 18. 1992, S. Treaty Doc. No. 103-6 (1992); Protocol Amending Tax Convention, Germany-U.S., art. XVI (13), June 1, 2006, S. Treaty Doc. No. 109-20 (2006), https://www.irs.gov/pub/irs-trty/germanprot06.pdf.

151 Jeswald W. Salacuse & William P. Streng, International Business Planning: Law and Taxation § 16.04 (2018) ("Many bilateral income tax treaties reserve to the state of residence the exclusive right to tax capital gains, even as to those capital gains realized in the source country.").

152 *See* Rhoades & Langer, *supra* note 4, at § 62.04.

but that can be a costly and time-consuming process. Treaty partners may be unaware of the U.S.'s treaty interpretation.

V. Proposal

The IRS should respect the traditional understanding of treaty protection afforded by U.S. treaties. These norms are a mutually beneficial arrangement that both ease investment between the treaty countries and set a standard for future treaties. However, in the current environment foreign investors in the United States cannot be sure that their country's treaty will protect them from United States taxing gain on their sale of a U.S. partnership interest. This uncertainty may affect the structure of foreign investment and even discourage investment in U.S. business ventures.

The international business community would welcome clarification by the IRS that it will respect its own historic boundaries. An argument can be made that, generally, when the United States fails to uphold its prior treaty commitments, its global leadership is diminished.[153] Moreover, despite the United States commonly following international norms, its relatively rare departures are magnified in the eyes of the world.[154] In the tax treaty context, where the relationship with important trade partners are implicated, a spirit of mutuality is more important.

The IRS may be unwilling to follow this proposal. Just as it is appealing the *Grecian Magnesite Mining* decision as to pre-TCJA transactions,[155] the IRS may want to apply its expansive interpretation to treaties without an explicit understanding with treaty partners.

VI. Conclusion

The TCJA's codification of Revenue Ruling 91-32 undermines the significance of the *Grecian Magnesite Mining*[156] case in encouraging international investment and keeping U.S. tax rules consistent with expectations of taxation in the context of international business. The taxation of gain on the disposition of a U.S. partnership interest can be a tax trap that undermines the intent of TCJA to make the United States more competitive. It also discourages foreign investment in the United States, particularly if the IRS extends the taxation to dispositions covered by U.S. income tax treaties without an explicit change to the applicable treaty.

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153 *See Why The Sheriff Should Follow The Law*, THE ECONOMIST (May 23, 2014), https://www.economist.com/blogs/democracyinamerica/2014/05/america-and-international-law.

154 *Id.*

155 *Grecian Magnesite Mining, Indus. & Shipping Co., SA, v. Comm'r*, 149 T.C. No. 3, US-TAXCOURT 11322 (July 13,2017), *appeal docketed*, No. 12-1268 (DC Cir. Dec. 18, 2017).

156 *Id.*