

# DAILY BUSINESS REVIEW

PRACTICE FOCUS / TAX LAW



## Welcome News for Non-US Persons Investing in US Businesses

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On July 13, the U.S. Tax Court, issued a decision that is of major importance to non-U.S. investors. In *Grecian Magnesite Mining, Industrial & Shipping v. Commissioner (Grecian)*, the court held that if a non-U.S. person sells an interest in a partnership that is engaged in business in the United States, the non-U.S. seller is not subject to U.S. federal income tax on the gain from the sale. By so holding, the Tax Court, in no uncertain terms, rejected a long-standing IRS ruling to the contrary.

### BACKGROUND

Under the Internal Revenue Code (the code), a non-U.S.

person is subject to U.S. tax on income that is “effectively connected” with the conduct of a “trade or business in the United States” (referred to as “effectively connected income”). Furthermore, under the code, if a non-U.S. person is a partner in a partnership that earns effectively connected income, the non-U.S. partner is taxed, on an annual basis, on its share of the partnership’s effectively connected income.

What if a non-U.S. person sells an interest in a partnership that earns effectively connected income? The code does not directly address this scenario. IRS Revenue Ruling 91-32 holds that the non-U.S. partner is taxable in a case such as this. Many practitioners and academics have long believed that this

26-year-old ruling is incorrect. Until the *Grecian* case, however, this issue was never directly addressed by the courts.

### ‘GRECIAN’

In *Grecian*, a Greek corporation owned an interest in a U.S. LLC (classified as a partnership for U.S. tax purposes) that was engaged in the business of extracting, producing and distributing magnesite in the United States. The LLC redeemed the Greek corporation’s interest for cash. For tax purposes, this was equivalent to the Greek corporation selling its interest in the LLC.

The Greek corporation had \$6.2 million of gain on the redemption. Of this \$6.2 million gain, \$2.2 million was attributable to the Greek corporation’s

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share of the U.S. real estate owned by the LLC, and the remaining \$4 million was attributable to the Greek corporation's share of the LLC's other assets that generated effectively connected income. The Greek corporation did not pay tax on any of its gain. The IRS audited the Greek corporation, claiming that it was subject to tax on the entire \$6.2 million of gain. Eventually, the Greek corporation agreed that its \$2.2 million of gain attributable to U.S. real estate owned by the LLC was taxable under FIRPTA (the Foreign Investment in Real Property Tax Act). What it did not agree on was the remaining \$4 million of gain.

The IRS followed its 1991 ruling and asserted the gain was taxable, while the Greek corporation argued that the ruling was wrong. The case went to Tax Court and the IRS lost. The court stated that it would not follow the IRS's approach in Revenue Ruling 91-32, which it criticized as "cursory in the extreme" and lacking in "the power to persuade." Therefore,

the court held that the Greek corporation was not taxable on its \$4 million of gain.

### **RAMIFICATIONS OF 'GRECIAN'**

The court's decision in *Grecian* has major implications for non-U.S. persons who invest in the United States through partnerships or LLCs that are treated as partnerships for U.S. tax purposes.

For example, take the case of X, a resident of Colombia who is not a U.S. citizen or resident. X has invested in a U.S. LLC (classified as a partnership for U.S. tax purposes) that operates a high-tech business in Miami. Assume, for the sake of simplicity, that the LLC owns no U.S. real estate. Although the LLC's annual operating income is taxable to X, X's major profit from his investment in the LLC will come from his future sale of his LLC interest.

If X sold his interest prior to the Tax Court's holding in *Grecian*, X may have complied with the IRS's position and paid tax on his gain. Now that the IRS's position has been rejected

by the court, X may be able to hold a direct interest in the LLC and sell the interest free of tax.

### **CONCLUSION**

*Grecian* is of great importance to non-U.S. investors. Non-U.S. investors may wish to reassess the structures of their investments and those who previously paid tax in accordance with the IRS position that was rejected by the Tax Court in *Grecian* should consider filing refund claims if the statute of limitations on such claims is open.

Of course, it is possible that the IRS may appeal this decision. It is also possible that there may in the future be legislative or regulatory developments that override or limit this decision. Nonetheless, non-U.S. persons investing in the United States should carefully consider the effects of *Grecian* on their U.S. tax planning.

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