INTERNATIONAL TAX PLANNING: A CLOSER LOOK AT THE TAX COURT’S GROUNDBREAKING DECISION IN GRECIAN MAGNESITE

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RSVP: www.nyls.edu/taxlawrsvp
CLE: 1.5 credits in Professional Practice, transitional and non-transitional
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In its recent decision in Grecian Magnesite, the U.S. Tax Court rejected Revenue Ruling 91-32, holding that a foreign partner is not subject to U.S. tax on a sale or redemption partnership engaged in a U.S. trade or business. The panelists successfully tried this case and will present their views on its significance.
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Bio

Ellen Seiler Brody, for more than 15 years, has represented U.S. and international clients on complex transactions. Working with multinational corporations, high net worth individuals, and foreign governments, she has created tax-efficient structures to hold their investments and operating business activities. She also works with private equity and hedge funds in structuring their operations and investments. She has advised on the taxation of financial instruments, including the application of straddle and swap rules and management of interest rate risk. She has been involved in numerous tax controversy matters at both the federal and state and local levels, representing large multinational corporations in a wide variety of industries, ranging from manufacturing to financial services. Her experience with New York State and City tax litigation has included Personal Income, Corporate Franchise, General Corporation, UBT, and Real Property Transfer taxes.

She received a B.S. magna cum laude from the Wharton School of the University of Pennsylvania, and her J.D. cum laude and LL.M (Taxation) from New York University, where she was Note and Comment Editor of the Law Review. She is also a Certified Public Accountant.

PRACTICES

Corporate Taxation  
International Taxation  
Tax Controversy and Litigation
Michael J. Miller has provided U.S. tax advice to domestic and international clients for more than 20 years. Working with foreign clients, he has structured inbound U.S. investments and operations to avoid the creation of a U.S. permanent establishment and developed structures designed to take advantage of U.S. income tax treaties, the withholding tax exemption for portfolio interest, and other special rules for minimizing U.S. tax. This includes consideration of various anti-abuse rules, such as earnings-stripping limitations and restrictions on the ability to engage in treaty shopping or earn income through hybrid entities. He has worked with U.S. multinationals to structure their foreign investments and operations so as to minimize the impact of certain restrictions on outbound transfers and anti-deferral rules applicable to shareholders of controlled foreign corporations and passive foreign investment companies, as well as maximize the utilization of foreign tax credits.

Michael is an editor of the International column for the Journal of Taxation, and a member of the Advisory Boards of the International Tax Journal and the BNA Tax Management International Journal. He has co-authored two BNA Portfolios: Income Tax Treaties - The Limitation on Benefits Article and U.S. Taxation of International Shipping and Air Transport Activities.

Michael is currently Chair of the U.S. Activities of Foreign Taxpayers Committee of the American Bar Association Tax Section and a former Chair of the Business Entities Committee of the New York City Bar. Michael is designated as a leading tax professional in Chambers USA, Super Lawyers, and Legal Media Group’s Expert Guides: Tax Advisors.

He received a B.A. cum laude from Columbia College and his J.D. from New York University. He clerked on the U.S. Tax Court for the Honorable James S. Halpern from 1991-1993. Direct Tel. (212) 903-8757.
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A Closer Look at the Tax Court’s Decision in Grecian Magnesite:

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A Few Key Code Rules

- §864(c) -- source is key to ECI test
  - U.S.-source FDAP and capital gains ECI if certain additional requirements satisfied
  - Foreign-source income rarely ECI
- §865(a) – default rule
  - Source generally based on residence
- §865(e)(2) – U.S. office rule
  - Sale/redemption gain U.S. source if “attributable” to U.S. office
- §864(e)(3) – to determine if such sale attributable, apply “principles” of §864(c)(5)
- §865(c)(5) – provides guidance on attributable requirement for a similar U.S. office rule for FSI under §864(c)(5)
Revenue Ruling 91-32

- Foreign partner in ETBUS partnership sells partnership interest
- Sales gain taxed to extent attributable to “ECI assets”
- Ruling purports to rely on U.S. office rule
- Cites appropriate authority for attribution of partnership’s U.S. office to foreign partner
- Little or no explanation of how gain attributable to such office
  - Vague reliance on aggregate approach
Grecian Magnesite Mining ("GMM")

- GMM, a Greek corporation, which operated in Greece, acquired a 15% interest in Premier Chemicals LLC, a tax partnership.
- Premier’s assets included U.S. RPI and other assets used in a U.S. trade or business of extracting, producing and distributing magnesite which it mines or extracts in the U.S.
- Premier redeemed GMM’s interest at a gain, made payments in 2008 and 2009.
- GMM did not include any redemption gain as income in its 2008 U.S. tax return and did not file for 2009; IRS audited and asserted gain was U.S. source ECI and is taxable.
- Parties agreed that gain attributable to the U.S. real estate was taxable.
Key Issues

- Aggregate vs. entity
- Source of capital gain
  - U.S. office rule of §865(e)(2)
- Additional ECI Requirements (for FDAP, capital gain)
  - Asset use test
  - Business activities test
- Penalties; reasonable cause defense
GMM Argument for Entity Treatment Under §741

- Partnership interest a distinct, indivisible asset
  - §741 and pre-1954 cases forbid look-through, *e.g.*, 
    - Pollack v. Commissioner, 69 T.C. 142 (1977), rejecting taxpayer’s attempt to claim ordinary loss; partnership interest a capital asset without regard to underlying assets
    - Lehman v. Commissioner, 7 T.C. 1088 (1946), rejecting IRS’s attempt to measure HP for partnership interest by reference to partnership’s HP in underlying assets
  - Subject to exceptions, *e.g.*, 
    - §897(g) for U.S.RPIs
    - §751, perhaps
IRS Argument For Aggregate Treatment Under §741

- Subchapter K mixes aggregate and entity approaches
- Where another provision, such as §865, applies in partnership context, must consider intention and purpose of such provision in determining aggregate vs. entity
  - Cites numerous aggregate vs. entity cases where court considered intent and purpose of other Code provisions
- §741 only governs character
- Inconsistent to say §741 treats as indivisible capital asset, in light of exceptions under §§751 and 897(g)
Tax Court View on §741

- No conflict between aggregate approach under §897(g) and entity approach under §741
  - It’s very simple: general rule with exceptions
- §741 refers to “a” capital “asset” – singular
- §897(g) would be superfluous if §741 did not prescribe entity treatment
- §731 refers to gain or loss from sale of “the partnership interest”
- Not persuaded to reconsider Pollack
Focus on §736(b)(1)

- IRS: must look to purpose of applicable Code rules
  - Even if §741 generally adopts entity approach, must defer to §736(b)(1)
- IRS inferred aggregate approach from §736(b)(1) application to payments “determined … to be made in exchange for the interest of such partner in partnership property”
- GMM argued that §736(b)(1) treats payments to which such provision applies as distributions by the partnership; per §731(a) distribution in excess of basis treated as gain “from the sale or exchange of the partnership interest”; so after brief “pit stop” back to §741
- Tax Court agreed with GMM: §736(b)(1) the beginning not the end of the analysis; it directs us to §§731(a) and 741, which prescribe entity treatment
  - “We see no reason to abandon that conclusion, return to section 736(b)(1), and halt at the phrase that most nearly coincides with the Commissioner’s position.”
IRS Argument on Policy/Intention of §865

- §865(i)(5), generally providing that §865 applies at partner level
- §875(1), attributing partnership’s ETBUS status to partner
- Purpose of §865
  - Pre-1986 abuse of title-passage rule
- §897(g): §865 should be interpreted consistently with FIRPTA, which has a look through rule and was enacted just six years earlier

- Tax Court not persuaded: no look-through
Tax Court Rebuke of Rev. Rul. 91-32

- Criticizes the ruling
  - “lacks power to persuade”
  - Treatment of applicable partnership provisions “cursory in the extreme”
  - Sub K analysis essentially begins and ends with observation that Sub K is a blend of aggregate and entity treatment
  - Does not address or analyze when U.S. office a material factor in production of income
  - Makes no mention of ordinary course requirement
- No deference whatsoever
GMM Position on §865

- §865(a) default rule applies, unless §865(e)(2)
- §865(e)(2) requires sale to be attributable to U.S. office
- §865(e)(3) requires application of the principles of §864(c)(5)
  - Per §864(c)(5)(B), attributable requirement met if U.S. office
    - A material factor in realization of the income
      - Per Treas. Reg. sec. 1.864-6(b)(2)(i), in particular, focus is on activities in connection with realization; creation of value in U.S. not sufficient. (See next page.)
      - Test not met, as GMM’s activities in sale transaction all in Greece
    - regularly carries on activities of the type from which such income, gain, or loss is derived – interpreted by the regulations as requiring the income to be realized in the ordinary course of the trade or business carried on through U.S. office
      - Not met, as redemption was an extraordinary transaction; business conducted through U.S. office did not include trading partnership interests in Premier
      - IRS bound by ordinary course formulation in the regulations
More on Treas. Reg. Sec. 1.864-6(b)(2)(i)

- An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because the office or other fixed place of business … develops, creates, produces, or acquires and adds substantial value to, the property which is licensed, or sold, or exchanged …. (Emphasis added).”

- “Example (1). F, a foreign corporation, is engaged in the active conduct of the business of licensing patents which it has either purchased or developed in the United States. F has a business office in the United States. Licenses for the use of such patents outside the United States are negotiated by offices of F located outside the United States, subject to approval by an officer of such corporation located in the U.S. office. All services which are rendered to F's foreign licenses are performed by employees of F's offices located outside the United States. None of the income, gain, or loss resulting from the foreign licenses so negotiated by F is attributable to its business office in the United States.”
IRS Position on §865

- Cannot focus solely on redemption transaction
- Material factor
  - Activities of U.S. office created value realized by GMM; thus an “essential economic element” in realization, under Treas. Reg. sec. 1.864-6(b)(1)
  - Should disregard Treas. Reg. sec. 1.864-6(b)(2)(i)
    - Not directly on point
    - Apply to certain other intangible income, but not gains from dispositions of a partnership interest
- Ordinary course
  - U.S. office regularly engaged in activities that gave rise to the gain realized on the redemption
  - Redemption not an isolated transaction, had other transactions, e.g., admission of a new member, redemption of other partner prior to redemption of GMM
Tax Court Conclusion on §865

- Cannot dismiss Treas. Reg. sec. 1.864-6(b)(2)(i)
  - §864(c)(3) directs us to apply principles of §864(c)(5)(B) and regs thereunder
  - Cannot dismiss provisions that are not directly on point, as set of provisions directly on point is an empty set
- Agreed with GMM that the principle derived from regs is that creation of underlying value a distinct function from being material factor in realization in specific transaction
- Material factor requirement not met, as all GMM activities in connection with redemption carried out in Greece
- Ordinary course requirement not met, as extraordinary transaction and Premier not in business of buying and selling interests in itself
Tax Court Conclusion on ECI Issue

- U.S. office rule does not apply
- Redemption gain foreign-source
  - Not a situation where foreign-source income can be ECI, under §864(c)(4)
- Redemption gain not ECI
- Tax Court did not need to address whether additional requirements for ECI classification under §864(c)(2) met
Penalty Issue

- **GMM argued**
  - Reasonable cause; reliance on tax advisor
    - Specifically advised GMM no need to file for 2009
    - Had all information; missed FIRPTA issue
    - Preparer had prepared returns for 40 years, and prepared pre-redemption returns without incident; held himself out as qualified; GMM had no reason to think otherwise

- **IRS argued**
  - Reliance on return preparer not in good faith
  - GMM should have investigated return preparer’s background and qualifications
  - GMM should have hired expert in international tax or preparer with LLM degree.

- **Tax Court disagreed**
  - Questions whether GMM would even have known how to investigate preparer’s background and qualifications
  - Additional qualifications sought by IRS not the standard; preparer’s credentials sufficient to justify GMM’s reliance
Will Grecian Hold Up?

- **Appeal**
  - Will IRS appeal?
  - If so, to which Court of Appeals?

- **Codification**
  - Makes a great pay-for!
  - *See* Senate bills!

- **Regulations**
  - If so, what kind?
    - Adopting aggregate approach?
    - Looser requirements for attribution under §865(e)(2)?
  - Validity Issues
Caveats

- No help on FIRPTA
- “Hot asset” issues under §751
  - Is §751 a look-through rule?
- Partnership anti-abuse rule
  - Applies “if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K....”
Other Implications

- Time for refund claims?
  - Careful of wait and see: consider statutes of limitations!
  - Loss of FTCs at home if fail to seek refund?

- Eliminate U.S. blockers from inbound “playbook” for non-FIRPTA?
  - Foreign individuals must consider U.S. estate tax exposure and personal filing obligations
  - Foreign corporations (particularly with no treaty protection) will need to consider BPT
  - Can income interest be separated from interest in proceeds?

- Expect challenges to other international regulations?

- Cross-border estate and gift tax implications?