NO TAX ON SALE OF US LP UNITS

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In a July 13, 2017 decision (Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner), the US Tax court rejected the IRS's longstanding position in rev. rul. 91-32 and held that the gain on the disposition of a US partnership interest by a foreign partner was US-tax-exempt. (The exempted gain was not attributable to US real estate.) The decision represents a significant loss for the IRS and is a welcome new planning tool for international tax practitioners who structure inbound US investment.

Assume that a Canadian or other foreign business expands into the United States through a new US entity. Should the entity be a corporation, or a flowthrough entity such as an LLC, LP, or LLP? Flowthrough structures often provide tax advantages over corporate structures for ongoing operations, but corporate structures have provided more certainty when it comes to avoiding US tax
on a sale. A gain from the sale of a USco's shares was clearly exempt from US tax (if the Foreign Investment in real property Tax Act of 1980 [FIRPTA] did not apply), but the US tax treatment of a gain from the sale of an LP or LLC interest was not clear. For a long time, the IRS treated the latter gain as taxable if the LP or LLC was engaged in a US trade or business (rev. rul. 91-32).
(See, for example, "US Tax on Sale of LP and LLC Interests," Canadian Tax Highlights, June 2013.) practitioners questioned the reasoning in that ruling on the grounds that the gain should be taxed like a gain from the sale of a USco's shares. Now, with the Grecian decision, a more definitive authority has emerged.

The fundamental tax principle at issue in Grecian was whether the sale of an LP interest should be taxed under an entity approach (the sale of a single asset, an interest in an LP) or under an aggregate approach (a sale of the LP's underlying assets). The Tax court endorsed the entity approach, saying that the wording of section 731(a) "could hardly be clearer. The partnership provisions in subchapter K of the code provide a general rule that the 'entity theory' applies to sales and liquidating distributions of partnership interests—i.e., that such sales are treated not as sales of underlying assets but as sales of the partnership interest."

The court analyzed whether the gain should be taxed as effectively connected income (ECI), which is subject to US tax, or as non-ECI, which is exempt from tax, and concluded that it was not ECI. This finding rejected the IRS's contrary position —namely, that on the basis of section 865(e)(2)(A), the gain should be considered attributable to the LP's US office or other fixed place of business. The court concluded that the gain would be considered ECI only if it was a US-source gain and that it should be considered foreign-source income under the general rule of section 865(a)(2), which considers the source of the gain to be the seller's residence. According to the court, the commissioner of revenue's position "conflates the ongoing value of a business operation with gain from the sale of an interest in that business," and the taxpayer "was not engaged in the business of buying or selling interests in itself."

As a result of this decision, partnership structures may now offer to a foreign owner potential advantages over corporate structures on a sale. For a foreign owner to be exempt from US tax on a sale of a corporate structure, the sale must be a sale of the USco's shares and not its assets. However, a share sale does not allow the purchaser to obtain stepped-up basis in the target's assets, absent special tax elections that are practical only in unusual circumstances. In contrast, the purchaser of an LP interest is generally entitled to a basis step-up in the LP's assets that is equal to the price paid for the LP interest: that basis can be amortized over 15 years if it is attributable to goodwill and more quickly if it is attributable to other asset classes. In the latter case, the purchaser may be willing to pay a higher purchase price for the target.

The IRS is expected to appeal the decision, but it is unlikely to be overturned. It is more likely that congress will attempt to revisit a possible codifying of the rev. rul. 91-32 principles into the code. That possibility was floated under the Obama administration but never gained traction. Although *Grecian* provides welcome certainty for sale transactions, it is still unclear whether partnership structures are to be taxed under the entity or the aggregate approach in other contexts, such as the US gift tax and the US estate tax. As a result, special planning continues to be needed in those areas in certain circumstances, including, for example, circumstances that involve the use of tiered partnership structures or the use of trust structures or blocker entities to hold the LP interest, as well as foreign tax credit planning and planning to avoid timing mismatches between the United States and Canada, especially if hybrid entities are used. Special planning also remains important for entities, including LPs and LLCs, that hold US real estate interests, when FIRPTA applies to override the general no-tax treatment on sales.

In addition to influencing the "choice of entity" decision for Canadian businesses that are expanding into the United States, the Tax court decision in *Grecian* is likely to enhance the volume of foreign investment in US venture capital funds, private equity funds, joint ventures, and other partnership structures.