Grecian Magnesite Mining, Indus. & Shipping Co. v. Commissioner, 149 T. C. No. 3 (2017)

In Grecian Magnesite Mining, Indus. & Shipping Co. v. Commissioner, the U. S. Tax Court ruled that capital gains from a foreign corporation's liquidation of its U. S. partnership interest were not U. S. -source income nor effectively connected to a U. S. trade or business, thus not taxable in the U. S. This decision rejected IRS Revenue Ruling 91-32, impacting how gains from partnership interest sales by foreign investors are treated for U. S. tax purposes.

Parties

Grecian Magnesite Mining, Industrial & Shipping Co. , SA (Petitioner) v. Commissioner of Internal Revenue (Respondent)

Facts

In 2001, Grecian Magnesite Mining, Industrial & Shipping Co. , SA (GMM), a Greek corporation, purchased a 15% interest in Premier Chemicals, LLC (Premier), a U. S. limited liability company treated as a partnership for U. S. tax purposes. From 2001 to 2008, GMM received allocations of income from Premier and paid U. S. income tax on these allocations. In 2008, after another partner's interest was redeemed by Premier, GMM's interest was similarly redeemed in two payments: $5. 3 million in July 2008 and another $5. 3 million in January 2009, deemed effective December 31, 2008. GMM realized a total gain of over $6. 2 million from these redemptions, with $2. 2 million conceded as taxable due to its connection to U. S. real property interests. The remaining $4 million in gain, termed "disputed gain," was not reported by GMM as taxable income on its U. S. tax returns for 2008 and 2009. GMM relied on advice from a certified public accountant (CPA) recommended by its U. S. attorney. The IRS issued a notice of deficiency, asserting that the entire gain from the redemption was U. S. -source income effectively connected with a U. S. trade or business, based on Revenue Ruling 91-32.

Procedural History

The IRS audited GMM's 2008 and 2009 tax years and issued a notice of deficiency on May 3, 2012, determining deficiencies in GMM's U. S. income tax and proposing penalties for 2008 under I. R. C. § 6662(a) and additions to tax for 2009 under I. R. C. § 6651(a)(1) and (2) for failure to file and pay. GMM timely petitioned the U. S. Tax Court for redetermination of these liabilities. The court reviewed the case de novo, with GMM bearing the burden of proof to show the IRS's determinations were incorrect.

Issue(s)

Whether the disputed gain of approximately $4 million from GMM's redemption of its partnership interest in Premier was U. S. -source income and effectively

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connected with a U. S. trade or business, making it subject to U. S. income tax?

Whether GMM is liable for the accuracy-related penalty under I. R. C. § 6662(a) for 2008 and additions to tax under I. R. C. § 6651(a)(1) and (2) for 2009?

Rule(s) of Law

I. R. C. § 882(a)(1) taxes the income of a foreign corporation engaged in a U. S. trade or business if that income is effectively connected with the conduct of that trade or business.

I. R. C. § 731(a) and § 736(b)(1) treat payments in liquidation of a partnership interest as distributions, with any recognized gain or loss considered as from the sale or exchange of the partnership interest.

I. R. C. § 741 generally treats gain from the sale or exchange of a partnership interest as capital gain from the sale of a capital asset, with exceptions noted in § 751 and § 897(g).

I. R. C. § 865(a) establishes the default source rule for income from the sale of personal property, sourcing it outside the U. S. for nonresidents unless an exception applies.

I. R. C. § 865(e)(2)(A) provides an exception to the default source rule, sourcing income from the sale of personal property in the U. S. if attributable to a U. S. office.

I. R. C. § 6662(a) imposes an accuracy-related penalty for underpayment due to negligence or substantial understatement of income tax.

I. R. C. § 6651(a)(1) and (2) impose additions to tax for failure to file a timely return and failure to pay tax shown on any return.

Holding

The U. S. Tax Court held that the disputed gain of approximately $4 million realized by GMM from the redemption of its partnership interest in Premier was not U. S. -source income and was not effectively connected with a U. S. trade or business. Therefore, GMM was not liable for U. S. income tax on this gain. The court also held that GMM was not liable for the accuracy-related penalty for 2008 under I. R. C. § 6662(a) nor the additions to tax for 2009 under I. R. C. § 6651(a)(1) and (2), as GMM reasonably relied on the advice of a competent CPA.

Reasoning

The court reasoned that under I. R. C. § 731(a) and § 736(b)(1), the payments received by GMM were distributions, and any gain realized was from the sale or exchange of its partnership interest, treated as a single capital asset under I. R. C. §

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741. The court rejected the IRS's position that the gain should be treated as arising from the sale of GMM's share of Premier's underlying assets, as posited in Revenue Ruling 91-32, finding no statutory basis for such treatment outside of the exceptions in § 751 and § 897(g).

The court further determined that the disputed gain did not meet the criteria for being sourced in the U. S. under I. R. C. § 865(e)(2)(A), as it was not attributable to a U. S. office. The "material factor" test under § 864(c)(5)(B) and the regulations required that Premier's U. S. office be a material factor in the production of the gain and that the gain be realized in the ordinary course of Premier's business. The court found that Premier's efforts to increase its value were not an essential economic element in the realization of the disputed gain, and the redemption was not an ordinary course activity of Premier's business.

Regarding the penalties and additions to tax, the court found that GMM had reasonable cause for its positions on its tax returns, as it relied in good faith on the erroneous advice of a competent professional, the CPA, who advised that the gain was not taxable.

Disposition

The court's decision was entered under Rule 155, reflecting the holdings that GMM was not liable for U. S. income tax on the disputed gain and was not subject to the proposed penalties and additions to tax.

Significance/Impact

This case significantly impacts the taxation of gains realized by foreign partners upon the liquidation of their interests in U. S. partnerships. By rejecting Revenue Ruling 91-32, the court clarified that such gains are not automatically treated as effectively connected income based on the partnership's U. S. business activities. This ruling may encourage foreign investment in U. S. partnerships by reducing the tax burden on the liquidation of partnership interests. It also underscores the importance of professional advice in tax matters, as reliance on such advice can provide a defense against penalties and additions to tax.

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