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New Tax Court Decision Opens the Door for Tax Planning for Non-US Investors into US LLCs

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On July 13, 2017, the US Tax Court issued a decision[1] which may provide non-US investors more flexibility and potentially better tax outcomes with respect to structuring their investments into US LLCs and partnerships.

Background

The Internal Revenue Service ("IRS") has long held the view that when a non-US person sells its interest in an entity taxed as a partnership (e.g., an LLC or a limited partnership) that is conducting an active business within the United States (i.e., the LLC operates an active business rather than serving as a holding company for businesses operated in corporate form), the non-US person is subject to US federal income tax on the portion of its gain that is attributable to the trade or business conducted by the LLC within the United States.[2] Non-US persons who incur such "effectively connected income" (as well as effectively connected income arising from operations of the LLC or partnership) are also required to file US federal income tax returns,[3] something that non-US persons generally would prefer not to do.

The Tax Court Decision

In **Grecian Magnesite Mining**, the investor, a Greek corporation, redeemed its interest in a Delaware LLC which was engaged in the business of extracting, producing and distributing magnesite. Under the theory of Revenue Ruling 91-32, when the investor received cash in redemption of its interest, it would be subject to tax on all or a portion of the gain it realized upon its redemption. The Tax Court, however, ruled completely in favor of the investor, flatly rejecting the holding of Revenue Ruling 91-32 and rejecting all of the IRS's other arguments that the investor should be subject to US tax upon the redemption. The decision was a clear victory for the investor.

Implications and Warnings

This is the first court decision which has concluded definitively that a non-US person is not subject to US tax when it sells an interest in a partnership or LLC engaged in a US business.[4] The decision, however, does not change the general rule that a non-US person is subject to US federal income tax with respect to its distributive share of US trade or business income (i.e., non-US investors investing directly in operating LLCs and partnerships are still subject to US tax on their share of the current income of the LLC or partnership). In addition, it is possible that the government will appeal the ruling[5] and that Congress may amend certain sections of the Internal Revenue Code of 1986 (the "Code") to codify the result of Revenue Ruling 91-32, effectively nullifying this decision.[6]

The foregoing warnings notwithstanding, the decision may have significant implications for how non-US investors approach

structuring their investments into LLCs and partnerships that operate a business in the United States. Many non-US investors in operating LLCs and partnerships have traditionally used so-called "blocker corporations" to shield them from direct US tax filing and payment obligations arising both from operating income from such LLCs and partnerships and also, due to Revenue Ruling 91-32, from gain on the sale of interests in such LLCs and partnerships. After this decision, some non-US investors may reconsider whether and to what extent to use blocker corporations in their investments and if so, where those blocker corporations should be organized.[7] These decisions will necessarily depend on the unique facts and circumstances of a specific investment. In addition, there may be an opportunity for non-US investors who have previously paid US federal income taxes with respect to gain realized upon a sale of an interest in an operating LLC or partnership to file claims for refunds of those taxes (assuming the statute of limitations has not yet expired with respect to any such tax years). In general, such refund claims are subject to a three year statute of limitations beginning on the date the applicable return was filed. Since the decision contradicts the IRS's longstanding position, they government may seek to litigate the issue again in a different court or in a proceeding appealable to a different circuit. Taxpayers may wish to consider filing protective claims to preserve refunds as we wait to see whether the decision is appealed and whether further litigation ensues.

Please contact any member of your Cooley tax team if you would like to discuss this decision and how it may affect how you consider structuring your investments into LLCs, partnership and private funds that may invest in LLCs and partnerships or if you would like to discuss filing a refund claim based on the decision.

Notes

1. Grecian Magnesite Mining, Industrial & Shipping Co. SA v. Commissioner, 149 T.C. No. 3 (2017).
2. Rev. Rul 91-32, 1991-2 CB 107.
3. Treasury Regulations Sections 1.6012-1(b)(1); 1.6012-2(g).
4. In the case, the LLC at issue also owned US real estate. The taxpayer was subject to tax upon disposition of its LLC interest to the extent the gain related to the real estate owned by the LLC, consistent with the US tax law's general treatment of dispositions of interests in LLCs that own US real property. Code Section 897(g).
5. The timing of an appeal will depend on when the parties complete post-decision computations. It is likely that a notice of appeal would not be due until early 2018.
6. The Obama administration introduced several budget proposals which would have had this effect.
7. For example, under Rev. Rul. 91-32, a Cayman "blocker" corporation would be subject to a 35% federal income tax and a 30% "branch profits" tax on any gain on sale of an interest in an operating LLC. Under the logic of this decision that gain may be completely tax free.

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