Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: , Team Manager
Group #

from:
LB&I Associate Area Counsel ( )

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subject: Rebuttal to Taxpayer's Protest –
UIL: 871.02-07; 453A.03-00

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: Rebuttal to Taxpayer's Protest - U.S. Source Income and Effectively Connected Income

Taxpayer	=
Partnership	=
Product	=
State	=
Date 1	=
Percentage Amount 1	=
Percentage Amount 2	=
Date 2	=
Year 1	=
Year 2	=
Amount 1	=
Amount 2	=
Amount 3	=

PRELIMINARY STATEMENT

The Notice of Proposed Adjustment proposes to assess interest annually to the taxpayer on deferred tax liability attributable to U.S. source income and effectively connected income arising from Taxpayer's disposition of her interest in a U.S. partnership that conducts a trade or business through a fixed place of business in the U.S.

	Year 1 12
Deferred Income	$Amount 2
Deferred Tax Liability	$Amount 3
Interest to be assessed annually to the taxpayer on the tax liability attributable to the deferred capital gain as fa the 15% capital gains tax rate.	

Exam issued a Notice of Proposed Adjustment on May 16, 2012 ("the Notice").

Taxpayer filed a protest on May 31, 2012 ("the Protest").

EXECUTIVE SUMMARY

Taxpayer ("Taxpayer"), a nonresident alien was a partner in Partnership ("Partnership"). Partnership develops and markets consumer products including the popular Product. Partnership is headquartered in State, where strategic direction, inventory, distribution and marketing decisions are handled. In Date 1, Taxpayer sold her Percentage Amount 1 interest in Partnership for a promissory note in the amount of $Amount 1 to another partner who already owned a Percentage Amount 2 interest in Partnership. Prior to Year 1, Taxpayer filed US nonresident individual income tax returns (Form 1040 NR), taking into account partnership income/loss from Partnership. Taxpayer did not file a return in Year 1 when she disposed of her interest in Partnership, and has not filed returns in the years thereafter.

In the Notice, Exam determined the taxpayer's gain from the sale of her partnership interest constituted effectively connected income (ECI), pursuant to Rev. Rul. 91-32. In the revenue ruling, the Service determined that: Gain or loss of a foreign partner that disposes of its interest in a partnership that is engaged in a trade or business through a fixed place of business in the United States will be United States source ECI gain or will be ECI loss that is allocable to United States source ECI gain, to the extent that the partner's distributive share of unrealized gain or loss of the partnership would be attributable to ECI (United States source) property of the partnership.

The sales agreement and promissory note provide that no principal payment is required prior to the maturity date of Date 2. Thus, under the installment sales

rules, the tax is deferred until that date. While the tax on the sale of the partnership interest is deferred until Year 2, the taxpayer must pay the interest each year on the deferred tax in accordance with §453A(a)(1).

Taxpayer disagrees with the proposed adjustment on the following grounds:

(1) Taxpayer "strongly disagrees" with the approach taken in Rev. Rul. 91-32 and argues that under §741, the sale of a partnership interest is treated as the sale of a capital asset. Capital gains are not taxable under § 871(a)(2), unless an alien is present in the United States 183 days or more. Taxpayer, a nonresident alien, was never present in the United States for 183 days or more, therefore, any capital gain derived from the sale of her partnership interest is not taxable to her. Taxpayer further argues even if the Revenue Ruling is correct, the 183 day rule still applies, and since Taxpayer was never present in the United States for more than 183 days, she is not subject to any tax on the sale of her partnership interest.

(2) Subchapter N provides no authority to apply Section 453A to a nonresident alien.

Taxpayer's arguments were previously addressed in the Notice. Taxpayer raises no new arguments in her protest of May 31, 2012. In the instant rebuttal, Exam reiterates its previous responses to taxpayer's arguments, and again rejects Taxpayer's positions.

DISCUSSION

Taxpayer argues that under §741, the sale of her partnership interest constitutes a capital sale and is not taxable in the US as she was never present in the United States for 183 days of more as required by §871(a)(2). Exam rejects Taxpayer's argument that Taxpayer's capital gain is not considered ECI and therefore is not subject to US Tax. Taxpayer is correct that § 741 provides that a gain or loss shall be recognized by the transferor partner and be considered as gain or loss from the sale or exchange of a capital asset. However, taxpayer fails to take into account that, as articulated in Rev. Rul. 91-32, §864(c)(2) provides that certain gains or losses from sources within the U.S. from the sale or exchange of capital assets are gains effectively connected with the conduct of a U.S. trade or business or losses that are allocable to ECI gain.

The starting point for determining whether gain from the sale of property is

effectively connected income (ECI) is whether the taxpayer is engaged in a US trade or business. Section 875(1) clearly states that "a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged." In this case, there is no dispute that Partnership, a U.S. partnership, was actively engaged in a trade or business in the U.S. By virtue of her interest in the partnership, the Taxpayer is considered to be engaged in a trade or business through the partnership's fixed place of business in the U.S. Moreover, the U.S. trade or business activity of the U.S. partnership flows through to Taxpayer.

Rev. Rul. 91-32 holds that because the value of the U.S. trade or business activity of the partnership affects the value of the foreign partner's interest in the partnership, an interest in the partnership that is engaged in a trade or business through a fixed place of business in the United States is an ECI asset of the foreign partner under Treas. Reg. § 1.864-4(c)(2) (the asset-use test). Further, taking into account the blend of aggregate and entity concepts under Subchapter K of the Code, the rules governing the sale of partnership interests should be interpreted in light of the purposes and policies of I.R.C. §§ 864(c) and 865(e). As such, Rev. Rul. 91-32 concludes that gain from the sale of partnership interest is treated as gain from the sale of the partner's proportionate share of the underlying assets of the partnership. Thus, Taxpayer's sale of an interest in a partnership that engaged in a U.S. trade or business, results in U.S. source gain effectively connected with that trade or business.

Taxpayer offers nothing further than the simple statement that she "strongly disagrees" with the "aggregate approach" taken by the Rev. Rul. 91-32. The reasoning of the revenue ruling is consistent with current law and is applicable to the facts of the instant case, as discussed in the Notice and in this rebuttal to the protest. Taxpayer's position (which is because §741 generally treats the gain or loss from sale of a partnership interest as that of a capital asset, the gain recognized by a nonresident alien must be foreign source) is not supported by the Internal Revenue Code, the revenue ruling, or court cases. Accordingly, the adjustments in the Notice should be sustained.

<u>The 183 day or more rule of §871(a)(2) is not applicable to ECI.</u>

Exam rejects Taxpayer's argument that she needs to be present in the US for 183 days or more to be taxed on her ECI. Section 871(b)(1) provides for the general imposition of tax on a nonresident alien's income effectively connected with a U.S. trade or business as follows: "[a] nonresident alien individual engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 1 or 55 on his taxable income which is effectively connected with the conduct of a trade or business within the United States." The imposition of tax by §871(b) on a nonresident alien's effectively connected

income with a U.S. trade or business is not dependant upon the nonresident alien's presence in the US in excess of 183 days. When a nonresident alien has ECI from a US trade or business, that nonresident alien's ECI is taxed similarly to the income of any of US citizen.

Taxpayer's argument, that a "nonresident alien's ownership of a partnership interest that conducts business in the US is similar to the ownership of stock in a US corporation", is without merit. A partnership interest cannot be viewed in the same light as corporate stock because a corporation has different characteristics from a partnership. For example, a corporation is taxed at the corporate level and then at the shareholders' level when the shareholders receive a dividend. On the contrary, a partnership is only taxed once at the partner level. In Unger v. Commissioner, 936 F.2d 1316 (D.C. Cir. 1991), aff'g T.C. Memo 1990-15, an appellate court upheld the attribution of a U.S. partnership's office to a foreign limited partner. The court held that the limited partner, a resident of Canada, had a permanent establishment in the United States by virtue of his interest in the partnership offices. Here again, as we have done in the Notice, we emphasize that the imputation rule of §875 applies and Taxpayer must take into account her distributive share of the items of income, gain, loss, deduction or credit of Partnership.

Section 453A is applicable to Taxpayer.

As discussed in the rebuttal portion of the Notice, §61(a)(3) provides that gross income means any income from whatever source derived, including gains derived from dealings in property. The government has established that the sale of Taxpayer's partnership interest constitutes effectively connected income. Section 1001 provides for the computation of gain or loss from the sale or disposition of property. Section 1001(d) further provides that "[n]othing in this section shall be construed to prevent…the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received."

The installment method of §453 is a statutorily prescribed method of accounting used for determining taxable income **from an installment sale** throughout Subtitle A[1]. Thus, the installment method of accounting for taxable income, within the limitations set forth in §453, is applicable to the determination of taxable income as referenced in §871(b). Section 453A is a subset of special rules applicable to §453. If §453 permits installment reporting in particular situations, §453A applies in certain instances to limit the benefits of installment method reporting within certain parameters. The application of the rules in §453A is not limited by Subchapter N in the determination of a nonresident

[1] Both Subchapter E which governs accounting periods and methods of accounting, including installment sales and Subchapter N relating to taxes on nonresident alien individuals are contained in Subtitle A: "Income Taxes."

alien's taxable income.

Furthermore, §864(c)(6) ensures that in the case of any income or gain of a nonresident alien individual which is taken into account for any taxable year, but is attributable to a sale or exchange of property or any other transaction in any other taxable year, the determination of whether such income or gain is taxable under §871(b) shall be made as if such income or gain were taken into account in such other taxable year and without regard to the requirement that the taxpayer be engaged in a U.S. trade or business during the taxable year in which the income is actually taken into account. Paragraph III of the Protocol to the U.S.-India income tax treaty incorporates this principle and states that any income attributable to a U.S. permanent establishment (PE) during its existence is taxable in the United States even if the payments are deferred until after the PE has ceased to exist. Thus, if payments that would be ECI and attributable to a U.S. PE in one year are deferred until a later year when the nonresident alien was not engaged in a U.S. trade or business, or had no U.S. PE, the payments would nevertheless be taxed as if they were ECI and attributable to a U.S. PE.

Government's Position:

In summary, Exam disagrees with the arguments made by Taxpayer in the Protest. The gain on Taxpayer's complete sale of her interest in Partnership, $Amount 2, is subject to US individual income taxation pursuant to the installment sales reporting rules of §453 which would defer taxation until the tax year in which principal payment is received by Taxpayer in satisfaction of the installment sale note. In this case, the principal payment is due on or before Date 2. However, the application of the rules of §453A serve to charge interest on the deferred tax liability associated with Taxpayer's deferred installment sale gain of $Amount 2 in an amount equal to the "applicable percentage" of the deferred tax liability of the installment sale obligation multiplied by the underpayment rate of §6621(a)(2) in effect for the month in which the taxable year ends.