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Guidance Is Definitive, Reality Is Frequently Inaccurate: The Lingering Saga of Rev. Rul. 91-32

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GUIDANCE IS DEFINITIVE, REALITY IS FREQUENTLY INACCURATE: THE LINGERING SAGA OF REV. RUL. 91-32

Robert L. Daily[*]

Partnership and international taxation are two of the most mind-numbing and inconsistent areas of the law. Even more confusion occurs when the two intersect, such as when a nonresident sells an interest in a U.S. partnership. Many have wasted precious time and abundant ink to come up with a solution. The IRS first tried in Rev. Rul. 91-32, concluding that a nonresident would be subject to tax if the partnership had assets producing income generated from property in United States. Although the guidance was appropriately criticized for being statutorily inconsistent, this Note argues that it nonetheless got to the right policy outcome. In 2017, the Tax Court disagreed with the long-standing IRS guidance; it declined to defer to the IRS's interpretation and held that a nonresident selling a U.S. partnership interest would not be subject to tax. Fearing abuse, Congress enacted a "look-through" approach in § 864(c)(8) that requires nonresidents to pay tax on the gain from the sale of a U.S. partnership under certain circumstances. Unfortunately, Congress created a burdensome system for nonresidents trying to sell their partnership interest.

This Note recounts the lingering saga of Rev. Rul. 91-32 and illustrates why the intersection of partnership taxation and international taxation remains convoluted, unfair, and unwieldy. This Note also provides recommendations to Congress that will lessen the

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administrative headache and provide for a more equitable way to tax nonresidents.

Daily: Guidance Is Definitive, Reality Is Frequently Inaccurate: The Lin

TABLE OF CONTENTS

I. INTRODUCTION 804

II. NONRESIDENTS & PARTNERSHIPS 807
- A. TAXING PARTNERS IN PARTNERSHIPS? 808
- B. WHEN IS A NONRESIDENT SUBJECT TO U.S. TAXATION? .. 810

III. ENTITY-AGGREGATE THEORY 815
- A. PRACTITIONER PRESUMPTION 816
- B. REV. RUL. 91-32: THE IRS APPLIES THE QUASI-AGGREGATE THEORY 820
- C. *GMM*: TAX COURT APPLIES THE ENTITY THEORY 824
- D. TCJA: CONGRESS APPLIES A LOOK-THROUGH APPROACH 829

IV. WHAT CONGRESS SHOULD DO 838
- A. REPEAL §§ 864(C)(8) & 897(G) 838
- B. PROVIDE SAFEGUARDS FOR ABUSE VIA § 743(A) 839
- C. SIMPLIFY THE SOURCING RULES 840
- D. PROVIDE A COMPOSITE RETURN FOR NONRESIDENTS 842

V. CONCLUSION 843

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Georgia Law Review, Vol. 53, No. 2 [2019], Art. 10

I. INTRODUCTION

> *"In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time."*[1]

The Internal Revenue Service (IRS) and the Department of Treasury want taxpayers to believe that their guidance is definitive, but that may not reflect reality.[2] With regulations, the IRS and Treasury's interpretation often carries the day. Most courts adopt and agree with the Treasury's and the IRS's definitive conclusion on the law if there is a regulation on point.[3] But courts do not give the same level of deference to sub-regulatory guidance. And taxpayers are more willing than ever to challenge the authority and conclusions of this type of administrative guidance.[4]

A recent example of that willingness to question guidance occurred in *Grecian Magnesite Mining, Industrial & Shipping Co. v. Commissioner of Internal Revenue* (*GMM*).[5] The taxpayer questioned a longstanding piece of guidance issued by the IRS, Revenue Ruling 91-32 (Rev. Rul. 91-32).[6] Published in 1991, Rev,

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[1] Learned Hand, *Thomas Walter Swan*, 57 YALE L. J. 167, 169 (1947).

[2] The inspiration for my title came from a notice in the Hitchhiker's Guide to the Galaxy. *See* DOUGLAS ADAMS, THE ULTIMATE HITCHHIKER'S GUIDE TO THE GALAXY 174 (2002) ("The *Guide* is definitive. Reality is frequently inaccurate.").

[3] *See* Kent Barnett & Christopher J. Walker, *Chevron in the Circuit Courts*, 116 MICH. L. REV. 1, 54 tbl.2 (2017) (noting that the government wins 81.5% of tax cases when circuit courts apply *Chevron* deference).

[4] *See* Lee A. Sheppard, *A New Model for Taxation of Nonresident Partners*, 150 TAX NOTES TODAY 657, 657–658 (Aug. 7, 2017) (noting that "Silicon Valley has also upended administration of income taxes" by "declar[ing] war on excessive exercises of administrative power," so that "business taxpayers everywhere have become emboldened to challenge guidance they may have accepted for years").

[5] 149 T.C. No. 3 (2017), *appeal docketed*, No. 19215-12 (D.C. Cir. Dec. 15, 2017), *partially superseded by statute*, I.R.C. § 864(c)(8) (2018). See *infra* Part III.C for a discussion of the case's holding.

[6] *Id.*

Rul. 91-32 classified the gain or loss from the sale of a partnership that has "fixed place of business" or "a permanent establishment in the U.S." as effectively connected income, which is subject to taxation by the United States.[7]

In *GMM*, the Greek corporation argued that "[w]hile the Ruling may provide a rational policy argument for imposing tax on sales of partnership interests by foreign partners, it does not provide a cogent explanation of how [the IRS] purports to reach that conclusion under current law."[8] The Tax Court agreed with the taxpayers, issuing a thorough opinion that all but eviscerated the long-standing piece of guidance.[9]

The facts were straightforward. The taxpayer was a Greek corporation that had invested in a U.S. partnership.[10] The U.S. partnership mined and extracted magnesite in various states in the United States.[11] The taxpayer redeemed its partnership interest at a significant gain.[12] The taxpayer had no office in the United States, nor did it have any U.S. "office, employees, or business operation" outside of its investment in the U.S. partnership.[13] The issue was simple: is a nonresident subject to U.S. federal income tax when it disposes or redeems its interest in a U.S. partnership for a gain?[14]

The *GMM* court said the answer to that question depended on partnership tax theory, framed as a debate over the eternal question of whether a partnership should be taxed as an agglomeration of its partners (aggregate theory), or as an entity separate and distinct from its owners (entity theory).[15] The IRS in Rev. Rul. 91-32

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[7] Rev. Rul. 91-32, 1991-1 C.B. 107, 1991 WL 734875.

[8] Petitioner's Reply Brief at 88–89, *GMM*, 149 T.C. No. 3 (2017) (No. 19215-12), 2014 WL 10123472 at *40.

[9] *GMM*, 149 T.C. No. 3 at 34 ("We decline to defer to [Rev. Rul. 91-32].").

[10] *Id.* at 6.

[11] *Id.* at 6–7.

[12] *Id.* at 8.

[13] *Id.* at 6.

[14] *Id.* at 12. The partnership also had gain attributable to U.S. real estate which is taxable under I.R.C. § 897(g) (2017) (more commonly known as "FIRPTA" gain). That gain was stipulated, however, and was not an issue at trial. *Id.* at 18.

[15] *See id.* at 16 ("[O]ne way of describing the dispute in this case is to say it raises the question whether, as to a foreign partner's liquidation of its interest in a U.S. partnership, the 'entity' approach applies (as GMM contends) so that the gain arises from the sale of a single asset (i.e., GMM's interest in the U.S. partnership), or instead the 'aggregation' approach applies (as the Commissioner contends), so that the gain arises from the sale of GMM's interest in the assets that make up the partnership's business, in which business

primarily used the aggregate theory and said that the selling partner's gain would be taxable in the U.S. because it would be effectively connected income to the taxpayer.[16] Although many tax lawyers criticized Rev. Rul. 91-32 prior to *GMM*,[17] most nonetheless accepted it as the law of the land.[18]

The IRS unsuccessfully put forward the Rev. Rul. 91-32 argument in *GMM*.[19] The *GMM* court sharply criticized the IRS for its revenue ruling, noting that the IRS's position contradicted general theories of partnership taxation.[20] The Tax Court instead used the entity theory and held that the gain would not be taxable in the United States.[21] Yet, this framing only helps so much.[22] The *GMM* court interpreted international tax statutes and regulations based on general theories of partnership tax; in trying to fit these concepts together, the court attempted to answer the unanswerable.

Congress superseded *GMM*'s core holding in the Tax Cuts and Jobs Act (TCJA), codified as I.R.C. § 864(c)(8).[23] The statute uses a

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GMM is conceived of as having been engaged."); *see also* William S. McKee et al., FED. TAX'N PARTNERSHIPS & PARTNERS at ¶ 1.02 (2018) (discussing the differences between the aggregate and entity theories of partnership taxation).

[16] Rev. Rul. 91-32, 1991-1 C.B. 107, 1991 WL 734875.

[17] *See* William W. Bell & David B. Shoemaker, *Revenue Ruling 91-32: Right Result for the Wrong Reasons*, 9 J. PARTNERSHIP TAX'N 80, 88 (1992) ("Revenue Ruling 91-32 reads like *Marbury v. Madison*, relying principally upon 'the nature of things' and then adding its own gloss and substance to a variety of issues that are not addressed by statute, regulation, or treaty."); Kimberly S. Blanchard, *Rev. Rul. 91-32: Extrastatutory Attribution of Partnership Activities to Partners,* 76 TAX NOTES 1331 (Sep. 8, 1997) ("Rev. Rul. 91-32 represents a truly unprecedented application of attributional principles not sanctioned or even suggested by any provision of the code. It appears doubtful that the ruling would withstand scrutiny by a court.").

[18] *See* Rufus Rhoades & Cynthia Brittain, *2017 Emerging Issues 7584, An Analysis of* Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Comm'r, Sept. 22, 2017 (LEXIS) (noting that the *GMM* "decision surprised virtually everyone").

[19] Respondent's Answering Brief at 101, *GMM*, 149 T.C. No. 3 (2017) (No. 19215-12), 2014 WL 10123471.

[20] *See infra* Part III.C.

[21] *Id.*

[22] *See* Robert J. Staffaroni, *Partnerships: Aggregate vs. Entity and U.S. International Taxation*, 49 TAX LAW. 55, 58 (1995) (noting that "the aggregate or entity label is a convenient shorthand for what often are more subtle and more difficult issues").

[23] *See* I.R.C. § 864(c)(8) (2018); *see also infra* Part IV (discussing the TCJA's entity-aggregate approach to foreign partner transactions). A word of caution: the Government has appealed the *GMM* decision, but the appeal does not affect this Note's main point: that Congress needs to adopt wholesale change regarding the interaction between partnership and international taxation. The appeal also does not affect this Note's analysis of the government's aggregate theory argument because the government did not raise this

look-through approach that requires nonresidents to pay tax on any gain they earn from selling an interest in a partnership doing business in the United States.[24] But the saga of Rev. Rul. 91-32 remains. The statutes and regulations that apply to the intersection of partnership and international taxation remain convoluted, unfair, and unwieldy. After the TCJA, nonresidents will be unable to comply with their tax obligations without the help of sophisticated tax advisers. Congress should adopt wholesale changes to ensure that foreign individuals and entities are equitably taxed and can comply with their U.S. tax obligations in a non-onerous way.

This Note proceeds as follows: Part II explains core concepts needed to understand the debate over this intersection of partnership and international taxation. Part III then articulates the distinctions between the entity and aggregate theories of partnership. Part III also examines how the entity and aggregate theories have been applied to foreign partner transactions via the practitioner presumption, Rev. Rul. 91-32, the *GMM* case, and the newly enacted § 864(c)(8). Part IV discusses how Congress can provide a better solution to fix the intersection of partnership and international taxation. Part V concludes.

II. NONRESIDENTS & PARTNERSHIPS

Before getting into the central debate over entity theory versus aggregate theory, this Note will provide context for the debate about Rev. Rul. 91-32. This part will lay out the statutory and regulatory principles of both partnership and international taxation.[25]

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argument on appeal. *See* Opening Brief for the Appellant at 19–20, *GMM*, No. 17-1268 (D.C. Cir. June 8, 2018), 2018 WL 2761967.

[24] *See* I.R.C. § 864(c)(8).

[25] A few partnership concepts are outside the scope of this Note: the implications of the *GMM* decision on publicly traded partnerships, foreign personal holding corporations, partnerships that have withholding obligations, and nonresidents seeking benefits from U.S. tax treaties with foreign governments.

A. TAXING PARTNERS IN PARTNERSHIPS?

Start with a basic proposition: partnerships do not pay federal income tax.[26] Instead, the partnership calculates its taxable income as if the partnership were an individual and gives its partners a schedule K-1 which shows each partner's share of that income.[27] Partners must pay tax on their "distributive share" of income from the partnership.[28]

But all good things must end. Eventually, a partner sells her interest in the partnership, or the partnership stops operating.[29] In either case, a partner will recognize gain on the sale of her partnership interest if her proceeds from the sale exceed her basis in the partnership.[30] The partnership interest is considered a capital asset,[31] but selling that interest is considered a sale of personal property.[32] Generally, that gain will be capital, which allows the partner to pay tax at a preferential capital gains rate.[33] A part of the gain, however, will be considered ordinary if the partnership holds assets that produce ordinary income.[34]

The government's ability to tax a partner disposing of her partnership interest is critical. Partners contributing to a partnership for a partnership interest do not recognize gain or loss on that transaction.[35] And partnerships do not recognize gain or loss

[26] I.R.C. § 701 (2012). *But see* I.R.C. § 6225 (2016) (noting that under the new partnership audit regime, some partnerships will pay an "imputed underpayment," which may be considered a "tax" for § 701 purposes).

[27] I.R.C. § 702 (2012).

[28] I.R.C. § 721 (2012). The timing and character of the income will not change on the partner. *See* Staffaroni, *supra* note 22, at 60 n.13 (discussing Treas. Reg. 1.702-1(b) and noting that "the character of a partnership item ordinarily is determined at the partnership level and taken into account by the partner separately").

[29] A third possibility would be if the partner died and the partner's heirs inherited the partnership interest. In this case, heirs would receive a stepped-up basis in their partnership interest under I.R.C. § 1014 (2012), but their inside basis in the partnership's assets would not change.

[30] A little more technical: I.R.C. § 736 (2012) will govern in cases of redemption, whereas I.R.C. §731 (2012) will control sales.

[31] I.R.C. § 741 (2012).

[32] This distinction is important for the international tax rules, as the sourcing of personal property will depend on I.R.C. § 865 (2012).

[33] I.R.C. § 751(a) (2012).

[34] *Id.*

[35] I.R.C. § 721 (2012).

on the appreciation of assets while the partnership is operating.[36] A partner is only taxed on the appreciation of the partnership's assets when that partner leaves the partnership.[37]

But there is a discrepancy: when the partner sells her interest in the partnership (and is taxed on the appreciation of partnership assets), the partnership does not usually sell those appreciated assets. Put differently, the buying partner's basis in her partnership interest (outside basis) likely will differ from the partnership's basis in the partner's share of assets (inside basis). To counteract this discrepancy, the Code typically allows a partnership to "step-up" its basis in appreciated assets if a new partner joins the partnership.[38] This step-up basis allows a buying partner's outside basis to equal her share of the partnership's inside basis.[39]

To illustrate, take a simple example: in year 1, assume A and B decide to each contribute $50 to a partnership called AB. After 5 years, B sells her interest in the partnership to C. At the time of sale, AB was worth $200. While B's inside and outside basis at the time of sale was $50,[40] C's outside basis is $100 after the time of sale. Because C steps into B's inside basis at the time of sale, C's inside basis is only $50. To counter this discrepancy, AB makes an election to revalue C's basis. C would then have an inside basis of $100 and would get the benefit of the extra $50 of basis.

If B does not pay tax when it sells the partnership interest, the United States has effectively lost its ability to tax the full appreciation of the partnership's assets. Because C's basis is stepped up to $100, she gets credit for the $50 asset appreciation without paying U.S. tax. Although that gain is only $50 in our example, the United States could lose millions of dollars in revenue if it is unable to tax these appreciated assets. This situation gets more complicated when the selling partner is a nonresident.

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[36] *Id.*

[37] I.R.C. § 741 (2012).

[38] I.R.C. §§ 743(b), 754 (2012). *See* LAURA E. CUNNINGHAM & NOEL B. CUNNINGHAM, THE LOGIC OF SUBCHAPTER K: A CONCEPTUAL GUIDE TO THE TAXATION OF PARTNERSHIPS 200 (5th ed. 2017) (noting that the effect of a § 754 election and corresponding § 743(b) adjustment "is to treat the purchasing partners as if she had purchased an undivided interest in each asset").

[39] *See* I.R.C. §§ 743(b), 754 (2012) (discussing the effects of the stepped-up basis).

[40] Assuming, for simplicity, that the partnership does not have other inside and outside basis differences, or any income or loss in the intervening years.

B. WHEN IS A NONRESIDENT SUBJECT TO U.S. TAXATION?

Nonresident citizens are not subject to taxation in the United States unless an explicit statutory exception imposes a tax on the individual.[41] Nonresidents[42] are not subject to U.S. taxation on their foreign source income.[43] And under the default rule, a seller sources the gain from a sale of personal property to her country of residence.[44] One exception[45] to the default rule is that a nonresident is subject to U.S. tax if (1) the nonresident has income derived from a U.S. trade or business; (2) that income is U.S. sourced; and (3) the income is "effectively connected income" (ECI).[46] This discussion will explain these three separate and nuanced concepts.[47]

1. Does the Nonresident Have a U.S. Trade or Business?

First, the nonresident taxpayer must have a U.S. trade or business.[48] The test for whether a nonresident is engaged in a "U.S. trade or business" is comparable to the test for personal jurisdiction, effectively asking whether the "taxpayer availed himself of the privileges of business activity within the borders of the United States under the protection of its laws to such a degree that the taxpayer should help pay for those privileges and that protection."[49] The analysis for this Note is straight-forward: being a partner in a U.S. partnership is enough to say that the partner has a U.S. Trade

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[41] *See* David L. Forst, *The U.S. International Tax Treatment of Partnerships: A Policy-Based Approach*, 14 BERKELEY J. INT'L L. 239, 241 (1996) ("Through whatever prism international tax policy is viewed, there is a general international consensus that income earned in a source country by a resident of a different country should not be subject to double taxation, or more precisely, should not be taxed fully by both countries."). This is different from the general presumption for U.S. citizens that the individual has gross income "from whatever source derived" unless there is a statute that states otherwise. I.R.C. § 61(a) (2012).

[42] I.R.C. § 7701(b)(1)(B) (2012).

[43] I.R.C. § 871(i) (2012).

[44] I.R.C. § 865(a) (2012).

[45] Another exception is when a nonresident who spends over 183 days in the U.S. sells personal property. In that case, the nonresident will be subject to U.S. taxation. I.R.C. § 871(a)(2) (2012).

[46] I.R.C. § 872(b)(2) (2012).

[47] *See* Alfred H. Bae, *My Big Fat Grecian Divorce: A Labyrinthine Tale of ECI*, 47 TAX MGMT. INT. J. 390 (June 8, 2018) (using a similar structure to discuss whether a taxpayer has ECI).

[48] I.R.C. § 872(b)(2) (2012).

[49] *See* 2 Rhoades & Langer, U.S. INT'L TAX'N & TAX TREATIES § 28.03 (2017) (citing International Shoe Co. v. Washington, 326 U.S. 310, 319 (1945))).

or Business.[50] Nonresidents that invest in a foreign partnership engaged in a U.S. trade or business would, by being a partner in that partnership, be engaged in a U.S. trade or business and would be subject to U.S. tax on ECI from the partnership.[51] Put another way, "the partnership's U.S. trade or business will be attributed to the foreign partners."[52]

2. Does the U.S. Trade or Business Have U.S. Sourced Income?

Second, the U.S. trade or business must have U.S. source income.[53] Generally, when a nonresident sells personal property (e.g., a partnership interest), that sale is sourced outside the United States.[54] There is an exception to this general rule—where the partnership interest would be U.S. sourced income—under the so-called "U.S. Office Rule." [55] The U.S. Office Rule applies if (a) the taxpayer has a U.S. office or fixed place of business, (b) that office is "a material factor in the production of such income, gain, or loss" (material factor test), and (c) that "office or fixed place of business regularly carries on activities of the type from which such income, gain, or loss is derived" (regular activities test).[56] Note that this is a "conjunctive 'and' test" so that all three conditions must be met.[57]

3. Is the U.S. Sourced Income ECI?

Finally, the U.S. source income must also be ECI under § 864(c). Although there may be other forms of ECI, this Note will focus on only one: when a nonresident has gain attributable to a U.S. office or fixed place of business.[58] Relevant to this discussion is § 864(c)(2), which provides that U.S. sourced gain will be ECI if the gain is attributable to a U.S. office or fixed place of business according to

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[50] I.R.C. § 875(1) (2012).

[51] *See* Unger v. Comm'r, 936 F.2d 1316, 1320 (D.C. Cir. 1991) (holding that a taxpayer's "limited partnership interest" created "a permanent establishment in the United States").

[52] Bae, *supra* note 47.

[53] I.R.C. § 872(b)(2).

[54] I.R.C. § 865(a) (2012).

[55] I.R.C. § 865(e)(2) (2012). *See* I.R.C. § 865(e)(3) (2012) (noting that the "[t]he principles of section 864(c)(5)" apply for purposes of determining gain attributable to a U.S. office).

[56] I.R.C. § 864(c)(5)(B) (2012).

[57] Bae, *supra* note 47.

[58] This Note will not focus on "FDAP" income under I.R.C. §871(a) (2012), as that statute was not at issue in the *GMM* case. *GMM*, 149 T.C. No. 3 at 13. Instead, this Note will focus on ECI under I.R.C. § 871(b) (2012).

either the "asset-use test" or the "business activities test."[59] The asset-use test is satisfied when the income derives from an asset used in a U.S. trade or business.[60] The business activities test is satisfied when the activity of the U.S. trade or business is "a material factor in the realization of the income."[61]

Although this test looks similar to the U.S. Office Rule, it imposes different obligations on the inbound investor. This part of the analysis is tricky and was the subject of confusion even with the *GMM* court.[62] Even if the gain is classified as U.S. source under the U.S. Office Rule, the partner may not have ECI income or the ECI income amount may differ from the amount of U.S. source gain. It is at least theoretically possible that the analysis under either the U.S. Office Rule or the ECI test may diverge. While the U.S. Office Rule focuses on the activities of the *office* in question (i.e., whether the Office is a material factor in a type of income that the business regularly earns),[63] the ECI test focuses on *assets* and *activities* from which the business earns its income. Such a subtle distinction may be normatively unnecessary, but taxpayers still need to go through both tests to comply with the law.

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[59] I.R.C. § 864(c)(2) (2012).

[60] *Id. See* Treas. Reg. §§ 1.864-4(c)(2) - (iv)(b) ("[There is a rebuttable presumption] that an asset will be treated as held in direct relationship to the U.S. trade or business if 1) the asset was acquired with funds generated by that trade or business, 2) The income from the asset is retained or reinvested in that trade or business, and 3) personnel who are present in the United States and actively involved in the conduct of that trade or business exercise significant management and control over the investment of such asset.").

[61] I.R.C. § 864(c)(2) (2012). *See* Treas. Reg. §1.864-4(c)(3) ("[T]he business-activities test shall ordinarily apply in making a determination with respect to income, gain, or loss which, even though generally of the passive type, arises directly from the active conduct of the taxpayer's trade or business in the United States. The business-activities test is of primary significance, for example, where . . . (b) gain or loss is derived from the sale or exchange of capital assets in the active conduct of a trade or business by an investment company.").

[62] *See* Bae, *supra* note 47 (noting that "the Tax Court itself misunderstood" a particularly confusing sourcing provision—whether the income was FDAP income, under § 871(a)(1), or whether it was ECI income that would potentially be "FDAP if it were not effectively connected with a U.S. trade or business").

[63] *See* Kimberly Blanchard, *What Is the Government's Appeal in 'Grecian' About?,* 47 TAX MGMT. INT'L J. 546, 547 (Aug. 10, 2018) ("This [U.S. Office Rule test] is a high bar, and was intended as such. . . . A foreign person could have a U.S. office engaged in nothing but accounting, with all sales being made through an office outside the United States, and that would not be enough to cause the sales income to be sourced to the United States. Moreover, even if the U.S. office did everything necessary to cause the sale to occur, it won't be enough to find U.S.-source income unless the office does that regularly.).

4. Invest via Blocker Corporations?

Most nonresidents are able to avoid this convoluted analysis by investing in U.S. partnerships through a "blocker corporation."[64] In this scenario, the foreign resident makes a contribution in a newly formed U.S. or foreign corporation, which will invest directly into the U.S. partnership.[65] The main advantage of this structure is that the nonresident can avoid filing a U.S. tax return.[66] Most foreign investors structure their investments so they can avoid filing a U.S. tax return.[67]

But nonresidents face significant drawbacks to using this blocker structure. During the operating life of the partnership, the nonresident "will bear the full economic burden" of "two levels of tax, first at the corporate-level on their allocable share of the operating income . . . [from the] partnership and second at the shareholder level on any dividends received from the Blocker."[68] If the nonresident sells his partnership interest directly to a buying partner, the nonresident will likewise face two levels of tax.[69] The nonresident can avoid the double layer of taxation associated with selling the partnership interest by selling the "[b]locker shares" to the buying partner. The buying partner, however, would likely pay less for these shares as "the sale will not convey a basis step-up in the portfolio company assets to the buyer."[70]

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[64] *See id.* ("To avoid having to file a U.S. tax return and, where the foreign person is a corporation, to avoid becoming subject to the branch tax, most foreign persons invest in operating partnerships through U.S. corporations (often referred to as "blockers")); Gregg D. Polsky & Adam H. Rosenzweig, *The Up-C Revolution*, 71 TAX L. REV. 415, 440 (2018) ("Typically, when private investment funds (for example, VC/PE funds) own interests in an LLC, a 'blocker' corporation will be inserted into the ownership structure to protect the fund's tax-exempt and foreign investors from realizing unrelated business taxable income (UBTI) or effectively connected income (ECI), respectively.").

[65] *See, e.g.,* Polsky & Rosenzweig, *supra* note 64, at 440.; Omri Marian, *The Other Eighty Percent: Private Investment Funds, International Tax Avoidance, and Tax-Exempt Investors*, 2016 B.Y.U. L. REV. 1715, 1731 (2016) (noting that foreign investors prefer investing through a blocker structure to prevent risk of having ECI).

[66] Polsky & Rosenzweig, *supra* note 64, at 440.

[67] *See* Barbara C. Spudis et al., *Using Partnerships in International Tax Planning*, 73 TAXES 834, 854 (1995) (noting "the seemingly minor concern" of U.S. filing obligations on nonresidents "may be a deciding factor in the structuring decision").

[68] Andrew W. Needham, *Private Equity Funds*, 735 Tax Mgmt. (BNA) U.S. Income, at VIII.D (last visited Jan. 20, 2019).

[69] *Id.*

[70] *Id.*

5. The Intersection of Partnership and International Taxation

A simple example illustrates why partnership theory is relevant to our international taxation question and why the government cares about the intersection of the two. Assume that a nonresident disposes of her partnership interest in a U.S. partnership that only holds assets and conducts business within the United States.

Applying the aggregate theory, the partnership, as an aggregation of its partners, would compute the gain or loss based on the unrealized gain or loss in the underlying partnership assets. The selling partner would need to recognize gain in the same way as if the partnership had sold assets to another party. This result follows because (a) the partner has a trade or business; (b) that sale is likely U.S. source income under the U.S. Office Rule because the partnership is a material factor in that gain (assuming, for example, the Office negotiated the terms of the sale) and is a regular activity of the partnership (assuming that the partnership regularly buys and sells assets in its normal course of business); and (c) that the gain is ECI because the asset is used in the U.S. partnership.

If the partner sold a 25% share in the partnership, the partnership would act as if it liquidated 25% of each asset. The selling partner would recognize gain or loss equal to the combined gain or loss from each asset. The nonresident would then need to pay U.S. tax because the gain is ECI. But if the nonresident did not want to go through the convoluted ECI analysis, the nonresident could have invested through a blocker corporation and sold the corporate stock directly to the buying partner.

Applying the entity theory would lead to the opposite result. The partnership would be treated as an entity separate and distinct from its partners, like a corporation. As the next part shows, it is textually difficult under an entity theory to argue that the gain is U.S. sourced income or ECI. The default sourcing rule would apply, and the gain would be sourced based on the residence of the partner.[71] That partner would then escape U.S. taxation if she was a nonresident.

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[71] *See supra* note 54 and accompanying text.

III. ENTITY-AGGREGATE THEORY

Notably missing in Part II was any statutory authority that governs our quandary of whether a nonresident who sells or redeems his interest in a U.S. partnership for a gain should pay U.S. tax on that gain. While the broad principles underlying international and partnership taxation provide some guidance, those statutes stop short of providing a definite answer to this problem.[72] From a policy perspective, it seems like the government should prevent the nonresident's "asset appreciation from escaping taxation."[73] But tax lawyers prefer to interpret statutes textually and give little weight to arguments of fairness or policy.[74]

Congress enacted § 864(b)(8) to solve the foreign partner, entity-aggregate problem in a new way. Others, including practitioners, the Treasury, and the *GMM* court, also offered solutions to this problem. A close look at the different approaches yields insights into the benefits and drawbacks of each solution. At bottom, each of the pre-TCJA approaches was flawed, and § 864(b)(8) has not mended those flaws. Drawing on these insights, Part IV will offer a better solution.

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[72] *See GMM*, 149 T.C. at 35 ("There is no Code section that specifically provides the source of a foreign partner's income from the sale or liquidation of its interest in a partnership."); Christopher Trump & Mark Graham, *In Search of a Normative Theory of Partnership Taxation for International Tax (Or How We Learned to Stop Worrying and Love Subchapter K)*, *in* The Partnership Tax Practice Series: Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances (Practicing Law Inst. 2d ed. 2017), at 278-25, *reprinted in* 93 TAXES 143 (March 2015) ("Thus, there is very little if any direct guidance on the treatment of the gain or loss recognized at the partner level on the sale or exchange of the partnership interest.").

[73] *See infra* part IV.D.1; *see also* Tyler A. LeFevre, *Justice in Taxation*, 41 VT. L. REV. 763, 786–87 (2017) ("Practitioners reach different conclusions on this issue: the language of relevant tax law and foreign tax law of partnership interests lead to one conclusion, while the United States' general tax policy preventing asset appreciation from escaping taxation leads to another conclusion.").

[74] *But see* LeFevre, *supra* note 73, at 787 (advocating for tax lawyers to use more policy arguments when interpreting statutes with the understanding that right now, it is "taboo for a technical memorandum, judicial opinion, or tax authority ruling to deal with issues of justice").

A. PRACTITIONER PRESUMPTION

There is no "unifying entity or aggregate theme" of partnership taxation.[75] While this lack of a theme may seem innocuous, it creates a tremendous amount of "uncertainty."[76] Scholars have yearned to fix this uncertainty,[77] yet no clear answers are in sight. In absence of any unifying theme, practitioners have stepped in to fill the theoretical inconsistency built into the Code by presuming the entity theory applies. But, as this section explores, this practitioner presumption may contravene current law.

1. Practitioner Presumption of Entity Theory

Most practitioners argue that, absent any explicit statutory override, the entity theory should apply when a partner sells or redeems his partnership interest.[78] This presumption is not found in the Code,[79] but is derived from a type of Congressional intent. Put differently, although Congress has not explicitly said there is an entity presumption, some argue it has legislatively enacted such a presumption through the statutes it creates.

Practitioners base their entity presumption argument on two premises. First, § 741 provides the general rule of partnership disposition. That section states that a sale of a partnership interest is considered a sale of a capital *asset* (not assets), which seems to suggest that an entity approach is more appropriate.[80] Second,

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[75] *See* McKee, *supra* note 15, at ¶1.02[3] ("The absence of a unifying entity or aggregate theme in the statute means that these situations must be resolved on an ad hoc basis by reference to the way in which the statute applies the entity and aggregate concepts to related or analogous situations—a process that is difficult, tedious, and uncertain.").

[76] *Id.* at ¶1.02[3] (noting that the "blending of aggregate and entity concepts is one of the primary sources of uncertainty in the interpretation and application of Subchapter K").

[77] *See, e.g.*, Bradley T. Borden, *Aggregate-Plus Theory of Partnership Taxation*, 43 GA. L. REV. 717, 773 (2009) (arguing that the tax community should adopt an "aggregate-plus" approach—which presumes the aggregate approach unless there is an explicit statutory provision that overrides the presumption—because it would "promote[] economic efficiency and allocate[] partnership tax items accurately," unlike our current "entity-minus" approach).

[78] *See* McKee, *supra* note 15, at ¶1.02[3]. The Tax Court favorably cited to McKee's treatise in its opinion. Grecian Magnesite Mining, Indus. & Shipping Co. v. Comm'r, 146 T.C. No. 3, at 16 (2017), *appeal docketed*, No. 19215-12 (D.C. Cir. Dec. 15, 2017), *partially superseded by statute*, I.R.C. § 864(c)(8) (2018).

[79] Some commentators have argued that such a statement would be very beneficial. *See* McKee, *supra* note 15, at ¶1.02[3] (noting that "a simple statement . . . would go a long way toward resolving many of the difficult problems discussed" in partnership taxation).

[80] *See supra* note 31 and accompanying text.

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practitioners stress that Congress has *sub silenco* adopted the practitioner presumption. Congress knows about this presumption, and, when it disagrees with the results that the entity theory provides in a particular situation, Congress chooses to legislatively fix the abuses via an aggregate-type statute. If Congress chooses not to adopt an aggregate-type statute, the practitioner view is that entity theory controls.

Two aggregate-type statutes seem to confirm that Congress knows how to fix entity-type statutes when it sees there is a potential abusive situation. First, § 751(b) requires that a partnership look through to its assets to determine a disposing partner's share of cash or cash-like assets.[81] The partner then must pay tax at an ordinary rate for its §751(b) gain, and at a capital gains rate for the rest of the gain. This section has been described as a "super-aggregate" Code section because the section recalculates types of income and loss normally calculated using the entity theory as if the type of income and loss were calculated using the aggregate theory.[82] Second, Congress requires partnerships to use the aggregate approach to calculate its gain under § 897(g), which requires non-residents to pay tax on the portion of gain attributable to U.S. real property.[83] Yet, there is a reasonable argument that some commentators have misconstrued the aggregate and entity debate.[84]

2. Practitioner Presumption is not Supported by Current Law.

A passage from a 1954 House Report shows that the Congress did not intend for the entity presumption to exist.[85] In the report, Congress added an explanation in the House Report to § 707, which uses an entity approach to decide when a partnership has entered a transaction with its partner. The report stated:

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[81] *See* Blanchard, *supra* note 17.

[82] *Id.*

[83] I.R.C. § 897(g) (2012).

[84] In the process, it is likely that practitioners have engaged in "planning drift"—a process whereby practitioners shape law by using their interpretation in transactions, leaving the IRS hamstrung to challenge the interpretation after the fact. *See* Sloan G. Speck, *Tax Planning and Policy Drift*, 69 TAX L. REV. 549, 551 (2016) ("The Wall Street Rule provides one vehicle through which private actors and their expert advisors influence public policy by 'creat[ing] law through their own practices.'" (alteration in original)).

[85] H.R. REP. NO. 2543, at 59 (1954) (Conf. Rep.).

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Georgia Law Review, Vol. 53, No. 2 [2019], Art. 10

> Both the House provisions and the Senate amendment provide for the use of the "entity" approach in the treatment of the transactions between a partner and a partnership which are described above. No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals *is more appropriate for such provisions*.[86]

But that section is not helpful because it does not say *who* gets to decide what is "more appropriate": should the taxpayer, the IRS, or the courts decide?[87] And when can a statute be interpreted in a "more appropriate" way? Even if Congress did not intend for an entity presumption to exist, the passage creates more questions than it answers.

Congress also touched on the issue when it added § 897(g) to the Code. That section took an aggregate approach to ensure that nonresidents pay tax on the portion of the gain attributable to the partnership's U.S. real estate. The House Report associated with the statute stated:

> [T]o impose tax on gains from the sale of U.S. real estate, it is also necessary to impose a similar tax on gain from the disposition of interests in entities which hold substantial U.S. real property. Otherwise, a foreign investor could, as under present law, *avoid tax on the gain by holding* the real estate through a corporation*, partnership,* or trust *and disposing of his*

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[86] *Id.* (emphasis added); *see also* Monte A. Jackel, *Aggregate and Entity in the Partnership World*, 136 TAX NOTES TODAY 559, 559 (Jul. 30, 2012) (discussing the relevance of the report on the aggregate and entity debate).

[87] *See id.*at 569 ("I do not believe that any consistent theory of what is 'appropriate' can be derived from [the legislative history of other statutes]. If I am correct, then predicting the results of any situation is a matter of making the best guess at the most appropriate tax policy result. After almost 60 years of the existence of subchapter K, that should not be the case.").

Daily: Guidance Is Definitive, Reality Is Frequently Inaccurate: The Lin

> *interest in that entity rather than having the entity itself sell the real estate.*[88]

With that report, Congress did two things. First, it suggested that the entity approach presumption was appropriate not just for partnership tax issues, but also for international tax issues.[89] Without applying the entity approach to international sourcing provisions, § 897(g) would be "superfluous."[90] Second, because the legislative language was from 1980, far later than the 1954 report described above, Congress may have changed its stance on the entity and aggregate debate. If Congress believed that a presumption did not exist, it would have concluded that the IRS could collect tax on the dispositions of U.S. real estate held in a partnership and would not have enacted § 897(g). And if Congress did not believe that such a presumption was appropriate, it could have clarified through legislation that no presumption existed.

But practitioners may be attributing too much to this language; Congress may not have presumed as much. Maybe Congress tried to enact statutes to address discrete issues, hoping only to affect a small sliver of the Code. Section 751 changes the *character* of the gain, but does not discuss when a gain must be included in the ambit of U.S. taxation. It has a much broader reach than § 741. And § 897(g) may have targeted a particular type of foreign investor driving up real estate prices in the 1980s; perhaps it was enacted for "xenophobic" non-tax reasons.[91] Congress may not have wanted to answer the entity-aggregate question in more general terms.

Perhaps Congress even thought it was "superfluous," but wanted to enact the legislation anyway to ensure that foreigners, who may

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[88] H.R. REP. NO. 1167, at 511 (1980) (Conf. Rep.), *as reprinted in* 1980 U.S.C.C.A.N. 5526, 5874 (emphasis added).

[89] *See* Staffaroni, *supra* note 22, at 91 n.168 (noting that the "language in the legislative history of section 897(g) suggests that the general entity rule of section 741 applies outside Subchapter K to a foreign partner's sale of a-partnership interest").

[90] Grecian Magnesite Mining, Indus. & Shipping Co. v. Comm'r, 146 T.C. No. 3, at 27 (2017), *appeal docketed*, No. 19215-12 (D.C. Cir. Dec. 15, 2017), *partially superseded by statute*, I.R.C. § 864(c)(8) (2018).

[91] Richard L. Kaplan, *Creeping Xenophobia and the Taxation of Foreign-Owned Real Estate*, 71 GEO. L.J. 1091, 1128 (1983) (noting that the stated goal of § 897 to reduce "horizontal inequity" between nonresidents and U.S. residents selling real estate was "spurious" and that the actual intention of the statute was "to discourage foreign investment in United States real estate").

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be harder to track down than U.S. citizens, pay tax on their share of income derived from U.S. real estate. Congressional intent is much less clear than it seems, especially when Congress enacted most of the international tax code sections after the 1954 Act. And without this congressional intent, the practitioner entity presumption argument falls on its head. While the presumption may help guide practitioners in areas of uncertainty, it is unjustified given current law.

B. REV. RUL. 91-32: THE IRS APPLIES THE QUASI-AGGREGATE THEORY

With Congress's mixed signals, the IRS tried to answer the entity-aggregate question in Rev. Rul. 91-32. The guidance contains three fact patterns, two of which relate to this Note.[92] In the first fact pattern, a nonresident individual owns an interest in a U.S. partnership.[93] That partnership "owns appreciated personal property . . . that is used [in the partnership's] trade or business within the United States."[94] In the second fact pattern, the partnership, besides owning appreciated personal property in the United States, also owns machinery and real property outside of the country.[95] In both scenarios, the foreign partner disposed of her partnership interest. [96]

As Part II explained, there are three requirements to tax a foreign partner disposing of his interest: (1) a nonresident needs a U.S. trade or business; (2) the income derived needs to be U.S. sourced from a U.S. office under both the material factor and regular activities test; and (3) the U.S. sourced income needs to be ECI under either the asset-use or business activities test. The IRS concluded that these three prongs were met in both scenarios.

First, although the IRS did not explicitly state that a U.S. partnership creates a U.S. trade or business for foreign partners

[92] The third fact pattern explains how Rev. Rul. 91-32 applies when a resident is a member of a country with a tax treaty with the United States. As noted above, this Note will not focus on the implications of Rev. Rul. 91-32 from a tax treaty perspective.

[93] Rev. Rul. 91-32, 1991-1 C.B. 107, 1991 WL 734875.

[94] *Id.*

[95] *Id.*

[96] *Id.*

who invest in that partnership, it relied on that assumption. The Code establishes this bright line.[97]

Second, the IRS explained that the partnership's activities would be classified as U.S. sourced income. The IRS began its analysis by acknowledging that a partnership interest is personal property, which will only be taxable in the United States under the U.S. Office Rule, § 865(e)(2).[98] The IRS then explained:

> Income from the disposition of a partnership interest by the foreign partner will be attributable to the foreign partner's fixed place of business in the United States. See section 865 (e)(3); cf. Unger v. Commissioner, T.C. Memo 1990-15 . . . . By virtue of its interest in the partnership, the foreign partner is considered to be engaged in a trade or business through the partnership's fixed place of business in the United States. Moreover, the value of the trade or business activity of the partnership affects the value of the foreign partner's interest in the partnership. Consequently, an interest in a partnership that is engaged in a trade or business through a fixed place of business in the United States is an ECI asset of a foreign partner.[99]

But there is a fatal flaw in the IRS's rationale: it never discussed the material factor or regular activities test of the U.S. Office Rule.[100] To many commentators, the IRS simply stated a tautology that "[i]ncome from the disposition . . . will be attributable to the foreign partner's fixed place of business."[101] Under § 865(e)(2), the partnership would be subject to U.S. tax if, under the "principles of § 864(c)(5)"[102]—that is, if the disposition is a material factor and the

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[97] *See supra* note 51.

[98] Rev. Rul. 91-32, 1991-1 C.B. 107, 1991 WL 734875.

[99] *Id.*

[100] *See* Bae, *supra* note 47, at 393 ("The lack of adequate treatment of the U.S. Office Rule is Rev. Rul. 91-32's greatest shortcoming.").

[101] Blanchard, *supra* note 17 (citing Unger v. Comm'r, 936 F.2d 1316 (D.C. Cir. 1991)) (emphasis removed); *see also id.* ("Rev. Rul. 91-32 never discussed or applied the principles of Section 864(c)(5). Instead, the ruling found the partner's gain to be U.S.-sourced gain based solely on the tautological statement quoted above." (emphasis removed)).

[102] I.R.C. § 865(e)(3) (2012).

activities from which the income derives regularly occurs—that partnership has U.S. sourced gain. And the IRS's cite to *Unger* was similarly unpersuasive, as that case concerned whether a partnership's distributive share was ECI, not whether a partnership's gain on disposition was U.S. sourced.[103]

The IRS did not apply either the aggregate or entity theory in this part of the analysis; it did something much more novel. Kim Blanchard, in her seminal 1997 paper on the Revenue Ruling, said that the IRS took an "attributional" approach to the problem.[104] She said that the Code "expressly attribute[s] certain activities of a partnership to its partners for purposes of characterizing a partner's distributive share income," that is, the partner "step[s] into the shoes of the partnership."[105] Blanchard defined the "aggregate" approach as "an undivided interest in the partnership's assets and liabilities."[106] This distinction is critical: if Rev. Rul. 91-32 was a pure aggregate approach, the taxpayer would still need to source and characterize the nature of every asset according to §§ 864 & 865. Rev. Rul. 91-32 instead *attributed* the activities of the partnership to the partner.[107]

Third, the IRS explained that the U.S. sourced income may partially be ECI. The agency said that "certain gain or loss from sources within the [United States] from the sale or exchange of a capital asset is gain that is" ECI if the gain qualifies under the either-or asset-use or business activities test in § 864(c)(2).[108] The IRS then summarily asserted that because "the value of the trade or business activity of the partnership affects the value of the foreign partner's interest in the partnership," this gain was ECI.[109]

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[103] *See* Blanchard, *supra* note 17 ("The citation to *Unger* was pointless, since that case did not involve the sale of personal property by the foreign partner . . . .").

[104] Blanchard, *supra* note 17 ("[Rev. Rul. 91-32] represents a truly unprecedented application of attributional principles not sanctioned or event suggested by any provision of the code.").

[105] *Id.* (alterations added).

[106] *Id.*

[107] Blanchard further reasoned that a 1991 Private Letter Ruling, which involved the same issue except in the S Corporation context, added credence to her analysis. *See id.* ("If Rev. Rul. 91-32 can logically be extended to S corporations, the authority for the ruling must be derived from some rule independent of [partnership] aggregate theory." (citing I.R.S. Priv. Ltr. Rul. 91-42-032 (Oct. 18, 1991), 1991 WL 778337)).

[108] Rev. Rul. 91-32, 1991-1 C.B. 107, 1991 WL 734875.

[109] *Id.*

But to make matters even more confusing, although the IRS used an attributable approach for the U.S. sourced test, it applied the aggregate method for calculating the ECI.[110] The IRS explained:

> [I]n applying sections 864(c) and 865(e) of the Code, *it is appropriate to treat* a foreign partner's disposition of its interest in a partnership that is engaged in a trade or business through a fixed place of business in the United States as a disposition of an aggregate interest in the partnership's underlying property for purposes of determining the source and ECI character of the gain or loss realized by the foreign partner.[111]

Instead of engaging in the language in §§ 864 and 865, the IRS simply concluded that it had the power to use the aggregate theory in any situation according to the legislative history of § 707.[112] But the legislative history only said that Congress expressed no view on whether the entity or the aggregate theory was more appropriate in a situation, not that the IRS had the authority to determine what was more appropriate. Even if it had the power, the IRS gave no reasons to support why the holding was the "more appropriate" result. It did not explain why the aggregate theory was more appropriate to interpret the principles of § 864, nor did it address the general entity presumption when considering dispositions of partnership interests. Some commentators note this "application of the asset use test lacked precision" and was not persuasive.[113]

The IRS concluded that the nonresident individual would have ECI "to the extent that the partner's distributive share of unrealized gain or loss of the partnership would be attributable to ECI . . . property of the partnership."[114] The guidance went one step further, creating a presumption that gain would be ECI and loss would not

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[110] Blanchard, *supra* note 17 ("[T]he IRS in Rev. Rul. 91-32 became so uncomfortable with its . . . strained analysis . . . [that it] revered to what it conceived of as the policy underlying the AGGREGATE theory of partnership taxation" to determine the amount of gain." (emphasis in original)).

[111] Rev. Rul. 91-32, 1991-1 C.B. 107, 1991 WL 734875 (emphasis added).

[112] *See* Jackel, *supra* note 86, at 569 (describing the IRS's broad claim to interpretive authority).

[113] Bae, *supra* note 47.

[114] Rev. Rul. 91-32, 1991-1 C.B. 107, 1991 WL 734875.

Georgia Law Review, Vol. 53, No. 2 [2019], Art. 10

be ECI "unless the partner is able to produce . . . information . . . showing the distributive share of net ECI and net non-ECI gain or loss . . . would have been allocated if the partnership sold all of its assets."[115]

In 2012, the IRS doubled down on the approach articulated in Rev. Rul. 91-32 in a field advice memorandum.[116] A year after, however, the Obama administration asked for a codification of Rev. Rul. 91-32.[117] The Treasury and IRS also included the regulation in their priority guidance plan for the 2016-2017 tax year.[118] Without stating it, the Treasury likely realized that it needed explicit statutory or regulatory authority to implement Rev. Rul. 91-32.[119]

C. *GMM*: TAX COURT APPLIES THE ENTITY THEORY

The *GMM* Court did not agree with the IRS's view on the entity-aggregate debate and refused to give any deference to the IRS's interpretation.[120] The court all but eviscerated the power of the revenue ruling, stating that Rev. Rul. 91-32

> is not simply an interpretation of the IRS's own ambiguous regulations, and we find that it lacks the power to persuade. Its treatment of the partnership provisions discussed above . . . is cursory in the extreme, not even citing section 731 (which, as we set out, yields a conclusion of "gain or loss from the sale or exchange

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[115] *Id.*

[116] 2012 IRS NSAR 3903F, 2012 WL 12093537 (July 17, 2012) (rejecting a taxpayer's protest of Rev. Rul. 91-32 and application of the entity theory to sourcing by reasoning that "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)").

[117] DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2013 REVENUE PROPOSALS 96 (Feb. 2012).

[118] DEP'T OF THE TREASURY, 2016–2017 PRIORITY GUIDANCE PLAN, at 15 (Aug. 2016). The Treasury and the IRS, however, did not include the project on the priority guidance plan prior to the enactment of TCJA. *See generally* DEP'T OF THE TREASURY, 2017–2018 PRIORITY GUIDANCE PLAN (Oct. 2017).

[119] *See* Bae, *supra* note 47 (noting some commentators construed "attempts by the Obama Administration to codify Rev. Rul. 91-32" as "the government's tacit acknowledgement that the ruling itself rested on brittle reasoning that might not hold up to challenge in the absence of a new statute").

[120] Grecian Magnesite Mining, Indus. & Shipping Co. v. Comm'r, 149 T.C. No. 3, at 34 (2017), *appeal docketed*, No. 19215-12 (D.C. Cir. Dec. 15, 2017), *partially superseded by statute*, I.R.C. § 864(c)(8) (2018).

> *of the partnership interest*" (emphasis added)). The ruling's subchapter K analysis essentially begins and ends with the observation that "[s]ubchapter K of the Code is a blend of aggregate and entity treatment for partners and partnerships."[121]

By refusing to defer to the guidance, the court did not accept the strained textual rationale in Rev. Rul. 91-32. Instead, it made its own determination of "whether the disputed gain" was ECI.[122]

1. The GMM Holding

The *GMM* court analyzed how to characterize the sale of the foreign partner's interest in the partnership. It determined, based on the entity theory, that the sale of a U.S. partnership interest was a sale of an indivisible capital *asset* not a sale of capital *assets*, meaning that the tax court believed that § 741 controlled which, as discussed above, is an entity-theory type Code section.[123] The court based its reasoning on the general entity-level presumption as articulated by many commentators.[124]

Next, the court said that the disputed gain would only be subject to tax in the U.S. if the gain "fall[s] under an exception to the default rule—namely, the [U.S. Office Rule] of section 865(e)(2)(A)."[125] The partnership income would satisfy the U.S. Office Rule if the material factor and the regular activities test were both met.[126]

The IRS had two arguments for the material factor test; both of which were rejected by the court. First, as in Rev. Rul 91-32,[127] the IRS argued under the aggregate theory "that [the taxpayer's] redemption of its partnership interest . . . was equivalent to [the partnership] selling its underlying assets and distributing to each partner its pro rata share of the proceeds."[128] The *GMM* court rejected such an approach and said such a reading "would render

[121] *Id.*
[122] *Id.* at 35.
[123] *Id.* at 23.
[124] *See supra* Part III.A.
[125] *GMM*, 149 T.C. at 36.
[126] *See supra* Part II.B.
[127] Notably, this argument does not rely on the "attributional" part of the Rev. Rul. 91-32 analysis. *See* Blanchard, *supra* note 17.
[128] *GMM*, 149 T.C. at 39.

superfluous sections 751 and 897(g), both of which presume a contrary, 'entity theory' general rule to which sections 751 and 897(g) are 'aggregation theory' exceptions."[129] The *GMM* court also said that the IRS's argument contradicted § 731(a), which unequivocally used "a [singular] capital asset" to describe the sale of a partnership interest.[130]

Second, the IRS argued that because the value of the partnership interest went up as the value of the underlying assets increased, the partnership's "U.S. offices were an essential economic element in [the taxpayer's] realization of gain in the redemption."[131] The *GMM* court disagreed, pointing to Treas. Reg. § 1.864-6(b)(2)(i), which notes the material factor prong would not be realized "merely because the office . . . [d]evelops, creates, produces, or acquires and adds substantial value to, the property which is leased, licensed, or sold, or exchanged."[132] The IRS argued that the Treasury regulation addressed intangible property, not personal property. But the *GMM* court rejected this argument because, in its view, no regulation was directly on point in determining whether the gain was attributable to the office, and thus the court should look to the "principles of section 864(c)(5)" rather than dismissing the Treasury Regulation for not being directly applicable to the facts at issue.[133]

The *GMM* court also dismissed the government's argument that the redemption satisfied the regular activities test. Even though partners frequently buy and sell interests in partnerships, the taxpayer argued that this redemption was a "one-time, extraordinary event."[134] Although the IRS tried to convince the Tax Court that this redemption was not an "isolated event," the *GMM* court said that the underlying partnership was "in the business of producing and selling magnesite products, and therefore [the taxpayer's] gain realized on the redemption . . . was not realized in the ordinary course of the trade or business carried on" by the underlying partnership.[135]

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[129] *Id.*
[130] *Id.* at 40.
[131] *Id.* at 41.
[132] *Id.* at 42 (quoting Treas. Reg. 1.864-6(b)(2)(i)) (emphasis removed).
[133] *Id.* (emphasis omitted) (internal quotations omitted). Section 865(e)(3) directs the court to look to "the *principles* of section 864(c)(5)." *Id.*
[134] *Id.* at 45.
[135] *Id.* at 46–47.

The *GMM* court concluded its forty-seven-page discussion by holding that the disputed gain was not ECI because the U.S. Office Rule did not apply as the government failed to show that the sale satisfied the material factor and the regular activities test. As the default rule of § 865(a) applied, the sale of the partnership interest was foreign sourced and not subject to U.S. taxation.[136]

2. The Abuse-of-Entity Rule

The *GMM* Court noted in a footnote that the IRS did not invoke the abuse-of-entity rule.[137] That rule allows the IRS to "treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder."[138] The IRS created the rule due to "the belief that significant potential for abuse exists in the inappropriate treatment of a partnership as an entity in applying rules outside of subchapter K to transactions involving partnerships."[139]

The IRS would have had been more likely to prevail if it had raised the abuse-of-entity rule. The regulation is on point because the IRS's main argument was that it had the ability to say when the aggregate method applied.[140] And if a court aggreged that the IRS has the ability to treat § 864 under the aggregate method, that court would likely defer to the agency's interpretation.[141] The rule even uses the same "as appropriate" language that the IRS used in Rev. Rul. 91-32.[142] But practitioners do not like this rule.[143] The wording

[136] *Id.* at 47. The Court also held that that the taxpayer was not liable for certain penalties and additions to tax under I.R.C. § 6662(a) (2012) and I.R.C. §§ 6651(a)(1)–(2) (2012), *id.* at 2, but that discussion is not relevant to this Note.

[137] *Id.* at 24 n.15. This rule, although promulgated within the more despised "anti-abuse rule," is *not* only targeted at abusive transactions but equally applies to non-abusive transactions.

[138] Treas. Reg. § 1.701-2(e)(1) (emphasis added).

[139] T.D. 8588, 60 FR 9776, 1995-1 C.B. 109.

[140] *But see* Blanchard, *supra* note 17 (arguing that the abuse-of-entity rule would not work in such a situation, because of the entity presumption in § 741).

[141] *See supra* note 3.

[142] *See supra* note 138 and accompanying text.

[143] *See* Andrea Monroe, *What's in a Name: Can the Partnership Anti-Abuse Rule Really Stop Partnership Tax Abuse?*, 60 CASE W. RES. 401, 415–16 (2010) (noting that practitioners described the proposed anti-abuse rule as the "greatest derogation of executive authority since Watergate"; said "that the proposed regulation would cause 'nuclear winter [to] descend

of the rule is so broad it could apply to *every* transaction, even non-nefarious transactions.[144] Perhaps as a reaction to the practitioner's aversion, the IRS rarely uses the rule to challenge a transaction,[145] no court has favorably cited the rule in a holding,[146] and commentators have suggested these regulations exceed the Treasury's statutory authority.[147] Some argue that the abuse-of-entity rule is practically "irrelevant."[148] But even if the rule is irrelevant, why didn't the IRS use the abuse-of-entity rule here?

The IRS had a few reasons for not raising the argument. First, the IRS may have agreed with practitioners that the rule was too broad to apply. Second, the IRS may have believed it was inappropriate to raise the argument in *GMM* —where the foreign taxpayer with unsophisticated tax counsel did not "intend" to engage in any tax planning to circumvent the entity-aggregate debate.[149] Third, the IRS may have worried that the *GMM* court would invalidate the abuse-of-entity rule.[150] Even though the IRS

upon the joint venture profit-oriented partnership'"; and likened the rule "to a meat cleaver, an atomic bomb, and a generally blunderbuss approach to rulemaking" (citations omitted)).

[144] *See, e.g.,* Emily Cauble & Gregg D. Polsky, *The Problem of Abusive Related-Partner Allocations*, 16 FLA. TAX REV. 479, 501 (2014) ("[B]ecause it is a general standard, as opposed to a technical rule, there will be significant litigation risk if the IRS were to challenge related-partner allocations by relying on the Partnership Anti-Abuse Rule."); Jellum, *infra* note 147, at 154 (noting that the rule is "unusual" because "it imposes an overarching standard on top of subchapter K's rules, and in doing so, it fundamentally changed existing law").

[145] *See* Monroe, *supra* note 143, at 433 (noting that the IRS has only challenged a transaction in court under the rule twenty times).

[146] *Id.* at 434.

[147] *See, e.g.,* McKee, *supra* note 15, at ¶1.05[6] (arguing that the regulations are invalid); Linda D. Jellum, *Dodging the Taxman: Why the Treasury's Anti-Abuse Regulation is Unconstitutional*, 70 MIAMI L. REV. 152, 154 (2015) (same); James B. Sowell, *The Partnership Anti-Abuse Rules: Where Have We Been and Where are We Going*, 89 TAXES 69 (2011) (same).

[148] *See* Monroe, *supra* note 143, at 437.

[149] Respondent's Answering Brief at 136, *GMM*, 149 T.C. No. 3 (2017) (No. 19215-12), 2014 WL 10123471 (noting that the taxpayer's tax preparer did not know about Rev. Rul. 91-32 or § 897(g) before the taxpayer filed its return).

[150] *See* Sowell, *supra* note 147, at 93 ("It is interesting to note that one IRS official has stated that he expects a 'literalist judge' may someday invalidate Reg. §1.701-2." (citations omitted)). Practitioners similarly believe the rule is invalid. *See* McKee, *supra* note 15, at ¶1.05[6] ("The abuse-of-entity-treatment rule, by contrast, lays out a general rule that appears to stand rules of statutory interpretation on their head, but then applies the rule in its examples in ways that seem obvious and clear. Like the abuse-of-Subchapter-K rule, however, the abuse-of-entity-treatment rule represents a clear contradiction of the words and intent of Congress."); Sowell, *supra* note 147, at 91 ("Taxpayers have first argued that the regulation violates the constitutionally required separation of powers since it attempts to override both legislative and judicial powers.").

rarely uses the rule in court, the agency vigorously uses the rule in audits and IRS appeals.[151] Since this rule is fundamental to agency proceedings, the IRS likely wanted to minimize its litigation risk.[152]

D. TCJA: CONGRESS APPLIES A LOOK-THROUGH APPROACH

After *GMM*, some argued that the decision would usher in a new wave of inbound tax planning. Commentators argued that investing through a corporate blocker would be unnecessary.[153] That approach was misguided. Although tax payments play a significant role in any inbound structure, foreign investors likely care about U.S. filing obligations and establishing a U.S. trade or business more than paying tax on the gain.[154] If a party can load up a blocker corporation with debt or specially allocate tax and interest deductions to the corporation, the corporate tax may be relatively small.[155] And nonresidents are not taxed on gains from sales of a corporate blocker.[156] But given the publicity surrounding the *GMM* decision, some planners were already trying to change planning structures to take advantage of the § 754 step-up.[157] Without the statutory change, planners would have pushed the envelope by engaging in even more aggressive transactions.

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[151] *See id.* at 74 (noting that the IRS applied the rule at least 128 times in the appeals or audit process between 1995 and 2007).

[152] Raising the rule in only agency settings limits the IRS's litigation risk because it is unlikely that an IRS appeals judge will invalidate the rule.

[153] *Cf.* David Sausen et al., *United States: Grecian Magnesite Decision Could Have Significant Tax Implications for Non-Us Investors In A US Fund*, MONDAQ BUS. BRIEFING, (Sept. 28, 2017) ("[The *GMM*] decision could have significant implications in the investment fund context by opening up new structuring opportunities for [non-U.S.] investors.").

[154] *See* Elizabeth L. McGinley & Michele J. Alexander, *Can Foreign Partners Now Exit Partnerships Tax Free?*, BRACEWELL (Aug. 3, 2017) ("[T]o the extent [investors] are investing in partnerships engaging in U.S. trades or businesses, blocker corporations likely still will be necessary to 'block' ultimate investors from being treated as being engaged in a U.S. trade or business.").

[155] *See* DAVIS POLK & WARDWELL LLP, COURT HOLDS NON-U.S. INVESTOR IS NOT TAXABLE ON SALE OF U.S. OPERATING PARTNERSHIP INTEREST (July 17, 2017) (noting that the firm believed it "seems unlikely that [*GMM*] will affect the desire of Non-U.S. Investors to invest in an Operating Partnership through a Blocker Corporation").

[156] I.R.C. § 865(a) (2012).

[157] *See infra* Part IV.D.1; *see also* Lee Sheppard, *Making Partnership Tax Safe for Foreign Investors,* 92 TAX NOTES TODAY 410 (Oct. 23, 2017) (discussing extremely aggressive partnership planning opportunities that tax lawyers were publicly talking about at a bar panel).

In response to these potential abuses, Congress enacted § 864(c)(8) in the TCJA. As this section explains, the Congressional response does not uniformly codify Rev. Rul. 91-32, nor does it apply a pure aggregate or entity method to solving the problem. This new approach comes with added compliance costs that outweigh the benefits the statute provides.

1. Why Congress Needed to Act

Some commentators argue that *GMM* was not bad from a policy perspective.[158] That view is mistaken. The government should have worried about at least one potentially abusive transaction after *GMM*: nonresidents selling partnership interests and making § 754 elections. That potential result was the reason the Rev. Rul. 91-32, while wrong from a technical perspective, gets to the correct policy answer.[159]

If the United States does not tax a nonresident's gain, it effectively loses its ability to collect tax revenue from a nonresident's share of U.S. assets held in the partnership.[160] The lack of tax imposed on the selling partner and the § 743 basis adjustment for the buying partner means that the U.S. cannot collect tax from that U.S. partnership on the appreciation of its assets. There is a lack of parity between a nonresident's choice of entity—the nonresident who held assets attributable to a U.S. trade or business would be subject to U.S. taxation, but the nonresident

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[158] *See* Blanchard, *supra* note 17 ("To the extent Rev. Rul. 91-32 is justified on policy grounds, it should apply equally to a selling partner who happens to be a domestic tax-exempt organization. It is clear, however, that the ruling does not, and cannot, apply in that case."); Lucas M. Rachuba, Grecian Magnesite *and the Rev. Rul. 91-32 Roller Coaster*, 2017 TAX NOTES TODAY 528 (Dec. 26, 2017) ("[I]t is not necessarily obvious that the result of Grecian Magnesite offends any policy goals."); Trump & Graham, *supra* note 72, at 278–30 (arguing that although "all would acknowledge that" the U.S. "should be allowed to tax income that is effectively connected with a trade or business," Rev. Rul. 91-32 did not get to the right policy answer because Congress already made "very specific . . . policy calls" about ECI in §§ 864 and 865). *But see* Bell & Shoemaker, *supra* note 17, at 80 (arguing that Rev. Rul. 91-32 "struggles laboriously to reach conclusions that are sound from a policy perspective").

[159] The Joint Committee on Taxation also cited § 754 in discussing why President Obama was proposing a statute in 2012 that was substantially similar to § 864(c)(8). The report noted that taxing the selling partner would be the "only opportunity for the United States to impose tax on the unrealized appreciation of assets" if the partnership made an election under § 754. *See* THE STAFF OF THE JOINT COMM. ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2013 BUDGET PROPOSAL 89 (June 2012) [hereinafter JCT 2012 Report].

[160] *See supra* Part II.A.

who put those assets into a partnership would have avoided U.S. taxation.

Some commentators argue this transaction already exists in the domestic context with tax-exempt organizations.[161] The government also loses its ability to collect tax from gain attributable to a selling tax-exempt partner. While there are similarities between the two contexts, there are two essential differences. First, Congress intentionally made exceptions for organizations that conduct certain types of charitable activities.[162] What has happened with the taxation of the gain of nonresidents is the result of a haphazard scheme rather than an intentional plan.

Second, the step-up is potentially more-abusive in the nonresident context than for tax-exempt organizations because of related-party transactions.[163] To take advantage of the *GMM* result, nonresidents would be incentivized to sell their interests to other "related" U.S. entities or to create joint-ventures with U.S. companies. The related buying entity would receive more basis under § 743(a), minimizing the overall tax burden to the group.[164] There is no similar incentive for a partnership to allocate to tax-exempt entities because the partnership could not give away

[161] *See* Blanchard, *supra* note 17 (noting that "[i]f a tax-exempt organization could sell, free of tax, an interest in a partnership that had borrowed to acquire property, it could avoid the tax that would be payable if the partnership had instead sold the debt-financed property"); JCT 2012 Report, *supra* note 159 (discussing that Congress should "examine whether parity between foreign persons and tax-exempt organizations is appropriate in enacting a lookthrough approach to the taxation of the disposition of partnership interests").

[162] In fact, Blanchard acknowledged that Congress made a distinction "that normative principles of tax law permit built-in, unrecognized gain to escape tax whenever a tax-exempt entity sells appreciated property and the purchaser obtains a stepped-up basis." Blanchard, *supra* note 18. Although she referred to this to support her inapposite point, this reference confirms that the Congress *has* recognized the distinction between tax-exempt entities and nonresidents.

[163] *Cf.* Cauble & Polsky, *supra* note 144, at 482–83 (discussing the substantial economic effect partnership allocation, which "was designed only with arm's length partners in mind" and therefore is a "pointless exercise" as applied to related-party allocations).

[164] *See id.* at 494 ("But, in the context of related partners, the partners are effectively different pockets of the same taxpayer. Therefore, the risk of making one partner worse off will not result in any deterrent effect because the other related partner(s) would always receive an equal and offsetting windfall."). Additionally, if the buying entity was not related, the two parties could negotiate the purchase price based on the value of the step-up. The selling party could also insist on receiving a more income allocation, allowing the selling party to receive part of the benefit of the step-up without giving up an economic right.

taxable income without also giving up the economic right to that property.[165]

Tax practitioners were envisioning even more abusive scenarios. Planners were talking about using "splitter partnerships," which would siphon profits to avoid triggering a U.S. filing requirement for nonresidents.[166] In this aggressive scenario, a nonresident would invest directly into a U.S. partnership and the operating partnership's "agreement could be drafted to run operating profits from a portfolio business through the partnership to the blocker but allocate capital gains on the portfolio business assets directly to the foreign investors without running them through the blocker."[167] The nonresident would receive credit for the appreciation of the partnership assets when it sells its interest, which would not be ECI under *GMM*. This scenario would create the best of both worlds for planners and investors: no filing requirement (no filing requirement without ECI) and no U.S. tax (no ECI, no U.S. tax).[168] Congress was correct to shut down these potentially abusive transactions before it became a problem.

2. Congressional Response in the TCJA

Buried deep within the TCJA, Congress—in its infinite wisdom—enacted a provision to supersede the *GMM* decision. Section 864(c)(8) provides that a nonresident who owns "an interest in a partnership which is engaged in any trade or business within the United States" shall treat any "gain or loss on the sale or exchange" as ECI regarding the conduct of the partnership.[169] The statute provides that ECI will be computed given a hypothetical liquidation: first, imagine "the partnership had sold all of its assets at their fair market value as of the date of the sale or exchange of such interest," and second, calculate the portion of the selling partner's distributive

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[165] *See id.* at 493 ("When partners are transacting at arm's length, the economic effect and substantiality rules are, at least in theory if not in practice, sensible. If two arm's length partners want to use allocations to play tax games, then they must take the risk that one partner might suffer a loss and the other might receive a windfall.").

[166] *See* Sheppard, *supra* note 157.

[167] *Id.*

[168] *Cf. id.* (noting that the lawyer who argued the *GMM* case for the taxpayers joked that "If it works, it's a beautiful thing," suggesting that even he had strong doubts about the legality of the aggressive transaction). It is unclear if the § 704 substantiality requirement or other anti-abuse rules would have been able to stop this abusive planning opportunity.

[169] I.R.C. § 864(c)(8)(A) (2018).

share on that hypothetical liquidation.[170] The partnership reduces any gain treated as ECI if the partner has § 897(g) gain.[171] The statute also gives broad authority to the Treasury to promulgate regulations regarding certain non-recognition Code provisions like §§ 332 and 351.[172]

Congress added a withholding provision, § 1446(f), which requires a partnership to withhold "10 percent of the amount realized on the disposition."[173] This withholding provision was vital. Although the Treasury could have arguably promogulated a regulation superseding *GMM*, the agency would not have enacted a withholding obligation without Congressional intervention.[174] Without § 1446(f), the Treasury's policy would have been for naught: the right tax policy with no additional tax revenue.

Section 864(c)(8) is not an explicit codification of Rev. Rul. 91-32, nor does it overrule *GMM*.[175] The statute provides a look-through approach for ECI purposes without expressing an opinion on the source of the gain or the entity or aggregate debate. And while § 864(c)(8) offers an aggregate flavor for the calculation of ECI gain, it simultaneously provides an entity flavor for withholding under § 1446 and potentially an entity flavor regarding non-recognition provisions.

3. A Convoluted, Unfair, and Unwieldy Solution

Setting the sound policy intentions aside, § 864(c)(8) is a poor solution to the problem. First, the statute only exacerbates the § 864 convoluted "maze" that foreign taxpayers need to navigate in order

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[170] I.R.C. § 864(c)(8)(B) (2018).

[171] I.R.C. § 864(c)(8)(C) (2018).

[172] I.R.C. § 864(c)(8)(E) (2018).

[173] I.R.C. § 1446(f)(1) (2018).

[174] *See* Trump & Graham, *supra* note 72, at 27829 (noting that even if Rev. Rul. 91-32 was correct, the guidance failed "to consider how, if at all, the IRS and Treasury would collect the underlying tax due on the sale").

[175] *See* THE STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF PUBLIC LAW 115-97, 220 (Dec. 2018) (noting that the "overturns the result in" *GMM* but does not codify the previous approach taken in Rev. Rul. 91-32); Nils Cousin, *How Do the New Rules for Sales of Partnership Interests Interact With Income Tax Treaties?*, 47 TAX MGMT. INT'L J. 363, 366 (June 08, 2018) ("Section 864(c)(8) has been described as a codification of Rev. Rul. 91-32. However, a more accurate description may be that it codified the result in Rev. Rul. 91-32, but did not codify the approach used in the ruling to get to that result.").

to comply with their U.S. tax obligations.[176] Section 864(c)(8) "does not address broader ECI and sourcing issues touched upon in Rev. Rul. 91-32 and" *GMM*.[177] That is, the most confusing part in this sourcing analysis—all of the cross-references and the panoply of tests taxpayers need to use—remains after the TCJA.[178]

Because Congress did not change this sourcing analysis, some commentators have suggested that § 864(c)(8) does *not* supersede the *GMM* opinion. Put differently, some argue that a nonresident may still not need to pay tax when the partner sells her partnership interest for a gain.[179] The problem with the statute is that it does not address the source of the gain, which as this Note covered in Part II, is separate and distinct from the ECI analysis.[180] This fundamental flaw is the same fundamental flaw that the IRS failed to convincingly address in Rev. Rul. 91-32,[181] in its arguments in the *GMM* case,[182] and in the § 864(c)(8) proposed regulations.[183]

Without addressing the source rule, and the U.S. Office Rule in particular, the government has a significant degree of litigation risk

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[176] *See generally* Alan B. Stevenson, *Is the Connection Effective? Through the Maze of Section 864*, 5 NW. J. INT'L L. & BUS. 213 (1983).

[177] Bae, *supra* note 47.

[178] Nothing in § 864(c)(8) changes or supersedes the byzantine rules of sourcing and ECI. Section 864(c)(8)(A) merely provides that the sale "of such interest shall be treated as effectively connected with the conduct of such trade or business"—meaning that such interest must be categorized as U.S. source income under the U.S. Office Rule. *See supra* note 55. Section 864(c)(8)(B) then provides for a limitation to the amount of ECI that a partner will recognize under § 864(c)(2).

[179] *See* Lee A. Shepperd, *Implementing Taxation of Foreign Sales of Partnership Interests*, 162 TAX NOTES TODAY 723 (Feb. 18, 2019) (noting that "[u]nder the new statute, effective connection is not determined based on the source of the gain," which "is usually the first question" that needs to be addressed); *cf.* Blanchard, *supra* note 63, at 547 (noting that the government applied *GMM* after § 864(c)(8) was enacted because the "IRS dislikes the narrow constraints of the U.S. office rule when it applies to foreign persons").

[180] *See* Sheppard, *supra* note 179, at 723; *supra* Part II.B.5.

[181] *See supra* note 100 and accompanying text.

[182] *See supra* note 127 and accompanying text.

[183] *See* Gain or Loss of Foreign Persons from Sale or Exchange of Certain Partnership Interests, 83 Fed. Reg. 66647, 66649 (proposed Dec. 27, 2018) (noting that "[n]either section 864(c)(8) nor the proposed regulations address the source of gain or loss from the transfer of a partnership interest" and requesting comments as to "whether, and what, additional guidance is necessary regarding the source of gain or loss subject to section 864(c)(8)"). The proposed regulations take a rebuttable presumption approach to the U.S. Office Rule. Under the approach, "gain or loss" under § 864(c)(8) "is treated as attributable to an office or other fixed place of business maintained by the partnership in the United States" unless the asset did not produce any ECI income or gain in the ten years before sale or the asset was not used in a U.S. trade or business in the ten years before sale. *Id.* at 66652.

when litigating a similar case. Taxpayers may still be able to escape taxation by relying on *GMM* for the proposition that the gain is not U.S. sourced income because the U.S. Office Rule does not apply when a nonresident sells or redeems her partnership interest for a gain. This result contravenes the Congressional intent of taxing nonresidents and superseding the *GMM* result,[184] but is possible given a strict textual reading of the statute.

Additionally, Congress did not express any intentions on the broader entity-aggregate debate critical to the *GMM* opinion; Congress merely provided a look-through band-aid fix without addressing the hard, yet essential, fundamental questions. Congress has kicked the proverbial entity-aggregate and the ECI sourcing cans down the road. Perhaps Congressional members hope that they will be long retired before having to deal with these convoluted questions again.

Second, the Congressional solution is unfair to foreign investors. Although one of the goals of the TCJA was to "level the playing field for inbound investors" into the U.S., § 864(c)(8) sends a "signal[] that making the United States a more attractive investment opportunity was not as high of a priority for lawmakers."[185] One problem with the statute is that it does not provide a de minimis rule, which in some situations could burden foreign investors with added compliance costs that far exceed any tax revenue that the U.S. would obtain.[186] Nor does the statute give a minority partner a mechanism from which to calculate the nature and inside basis of

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[184] *See supra* note 175 and accompanying text.

[185] Michele Alexander and Ryan Davis, *Tax Reform Is Hurting Foreign Investors In The US*, LAW360 (Mar. 22, 2018, 12:37 PM), https://www.law360.com/articles/1024847/tax-reform-is-hurting-foreign-investors-in-the-us. *Cf.* Jonathan William Benowitz, Comment, *Tax Cuts and Jobs Act Reverses Short Lived Grecian Magnesite Mining Holding: Will the U.S. Depart from Global Norms in Tax Treaty Interpretation?*, 15 LOY. U. CHI. INT'L L. REV. 171, 190 (2018) (noting that § 864(c)(8) may "discourage investment in U.S. business ventures" because "foreign investors in the United States cannot be sure that their country's treaty will protect them from United States taxing gain on their sale of a U.S. partnership interest").

[186] *See* AM. BAR ASS'N SECTION ON TAXATION, Comments On Sections 864(C)(8) And 1446(F) As Added To The Internal Revenue Code Of 1986 By P.L. 115-97 On December 22, 2018, at 18 (Mar. 18, 2018) [hereinafter ABA Report] (recommending the IRS provide for a de minimis rule because "[m]any transactions involving sales of partnership interests involve small amounts, relative to the situations that apparently motivated the statutory provisions"). Even so, this Note believes that it is unlikely that the IRS will create a de minimis rule because such a rule may exceed the agency's statutory authority.

each partnership asset.[187] The IRS could audit and impose penalties on a nonresident who fails to calculate her § 864(c)(8) gain even if the amount of compliance costs *exceeds* the amount of gain or even if the partnership *refused* to give the partner information she needs to calculate the tax.

Although one of the sound intentions of §864(c)(8) was that it would create parity between a nonresident selling assets and a nonresident selling an interest in a partnership interest, § 864(c)(8) actually creates a parity problem because the nonresident investing in a partnership is treated worse than if she would have held the assets in her own name. Partnerships will likely withhold an amount under § 1446 which is higher than the amount of tax the nonresident will owe under § 864(c)(8).[188] And when the nonresident files her tax return, she will likely be unable to take the new "passthrough deduction" under § 199A.[189]

In response to this inequitable treatment, nonresidents will be encouraged to invest through a corporate blocker. But investing through a blocker adds significant costs. Nonresidents would either have to struggle with the inequitable outcome discussed above or face two levels of taxation.[190] And nonresidents would have significantly higher compliance costs than if they had just invested directly into a U.S. partnership.[191]

Third, § 864(c)(8) is an unwieldy statute. Even if nonresidents invest in U.S. partnerships without the use of a blocker, the nonresident would be unable to comply with her tax obligations

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[187] *See* Lee A. Sheppard, *Is Withholding on Sales of Partnership Interests Enforceable?*, 2018 TAX NOTES TODAY 1197 (Aug. 27, 2018) (noting that a minority owner "has no way of knowing or getting information about the nature and inside basis of a partnership's assets"); *cf.* Trump & Graham, *supra* note 72, at 278-30 (discussing the "issue of information sharing" when a minority partner is "required to determine the nature of the assets in a partnership . . . in order to apply and determine its tax liability" but does not have information needed to do the computations).

[188] *See* ABA Report, *supra* note 186, at 18.

[189] Ajay Gupta, *A Passthrough Deduction for Foreigners*, 2018 TAX NOTES TODAY 509, 512–13 (Apr. 23, 2018) (discussing the policy and legal arguments for and against nonresidents investing in U.S. partnerships taking the § 199A deduction).

[190] *See supra* note 69 and accompanying text.

[191] *Cf.* Polsky & Roszenweig, *supra* note 64, at 463 (discussing how "foreign investors necessitate blockers" which creates a "more unwieldy" ownership structure).

without the use of sophisticated tax advisers.[192] The statute itself leaves a lot of questions unanswered.[193] Answering these questions requires complicated solutions.[194] Taxpayers have highlighted potential abuse from the statute when nonresidents contribute their partnership share into another entity. Simply put, a taxpayer can escape his tax obligation and remove the partnership's withholding obligation by contributing his partnership interest into a newly formed partnership[195] or corporation.[196]

If the history of § 897(g) is a guide, the IRS cannot provide enough comfort to practitioners and taxpayers looking to comply with their obligations. That statute provides that a nonresident's gain from a sale of a partnership interest will be U.S. sourced if a portion of that gain relates to real property held in the United States.[197] Many of the same issues the IRS faced with § 897(g) appear in § 864(c)(8).[198] Yet thirty-eight years after the enactment of § 897(g), the IRS has yet to promulgate any regulations "as to how to calculate the tax due under §897(g)."[199]

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[192] *Cf.* Trump & Graham, *supra* note 72, at 278-30 ("[A] rule that requires a foreign transferor of a partnership interest to report and pay U.S. tax, even if laudable from a policy perspective, makes little if any sense if it is impossible to apply.").

[193] *See* Rachuba, *supra* note 158, at 528 (noting that the statute "is very general and resolves precious few of the concerns raised by commentators about the" earlier legislative proposals in 2016 and 2017).

[194] The American Bar Association and New York State Bar have already provided robust reports on the many pitfalls of § 864(c)(8). *See generally* ABA Report, *supra* note 186; N.Y. ST. BAR ASS'N, TAX SEC., Report on Guidance Implementing Revenue Ruling 91-32 (Jan. 21, 2014); N.Y. ST. BAR ASS'N, TAX SEC., Report on Sections 864(C)(8) and 1446(F) (Aug. 10, 2018).

[195] *See* Fanny Karaman & Stanley Ruchelman, *How to Minimize Withholding Tax on Sale Of LLC Interest*, LAW360 (Jul. 05, 2018), https://0-www.law360.com/articles/1059815/how-to-minimize-withholding-tax-on-sale-of-llc-interest (discussing a scenario in which a foreign partner first contributes his partnership interest into a U.S. partnership, which would in turn sell the partnership interest to a third party and not need to withhold any tax).

[196] The buying partner could keep the partnership interest in the corporation forever or could dissolve the corporation immediately after buying it. If the buying partner prefers not to hold the partnership interest in corporate solution, the buying partner can negotiate a gross-up, so that the buying partner could liquidate the corporation soon after buying it and pay the same after tax that it would have paid for the partnership interest directly. *See* ABA Report, *supra* note 186, at 10.

[197] *See supra* note 83.

[198] *See* Kim Blanchard, *Gain or Loss on Sales of Partnership Interests by Foreign Partners: Issues for Guidance Under §864(c)(8) and §1446(f)*, 47 TAX MGMT. INT'L J. (June 8, 2018) ("Many of the issues presented by these new provisions are similar to those presented by §897(g) and §1445.").

[199] *Id.* (emphasis added).

Georgia Law Review, Vol. 53, No. 2 [2019], Art. 10

Some commentators have even suggested that the problems raised by § 864(c)(8) are more difficult than the problems of § 897(g) due to the flexible nature of the partnership arrangements.[200] The Treasury proposed regulations in December 2018 that address many taxpayer concerns.[201] Although the regulations generally provide a useful "formulaic approach" to figure out the amount of gain, some commentators stress that the rules "appear to place a significant burden on partnerships with foreign partners."[202] No doubt most taxpayers who have access to big accounting firms can comply with this obligation. But it remains to be seen whether other taxpayers can comply with these onerous obligations.

IV. WHAT CONGRESS SHOULD DO

The saga of Rev. Rul. 91-32 is not yet complete. Sooner or later, Congress will realize it needs to write a better statute which will not over-burden nonresidents from investing in U.S. partnerships. This section provides a series of recommendations to fix the thorny intersection between partnership and international taxation. These four suggestions work together to address the problem without opening the door to abusive tactics that undermine the ability of the IRS to tax the gain on appreciated assets.

A. REPEAL §§ 864(C)(8) & 897(G)

Congress should repeal §§ 864(c)(8) and 897(g). These statutes are unwieldy and unworkable.[203] Nonresidents will likely continue to invest through blocker corporations, rather than try to comply with these onerous requirements. Investing through blocker corporations, however, adds another layer of unnecessary

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[200] *See id.* ("The calculations and procedural issues raised by new §864(c)(8) and §1446(f) are far more complex and difficult than those presented by [§ 897(g)].").

[201] Gain or Loss of Foreign Persons from Sale or Exchange of Certain Partnership Interests, 83 Fed. Reg. 66647 (proposed Dec. 27, 2018).

[202] ERNST & YOUNG LLP, US PROPOSED REGULATIONS ADDRESS CHARACTERIZATION OF FOREIGN PERSONS' TAXABLE GAIN OR LOSS FROM SALE OR EXCHANGE OF INTERESTS IN PARTNERSHIPS ENGAGED IN BUSINESS IN THE UNITED STATES (Jan. 7, 2019). *See also* Rachuba, *supra* note 158 (arguing that the problems created by § 864(c)(8) "*could* be addressed by some really complicated rules" but that it is not "worth the time, energy, and complexity of everyone" trying to comply with the rules).

[203] *See supra* Part III.D.3.

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complexity. We should not have a system where nonresidents who want to infuse their capital into U.S. partnerships need to engage with expensive tax advisers before investing. But Congress needs to enact safeguards to ensure we do not end up with a pre-*GMM* result.

B. PROVIDE SAFEGUARDS FOR ABUSE VIA § 743(A)

Congress should enact two safeguards in § 743(a). One, Congress should add another subsection to § 743: if a nonresident or a related-party-tax-exempt entity sells a partnership interest at a gain, the partnership must prove that the gain was subject to taxation in the U.S. before the partnership takes an adjustment under § 743. A 1997 tax bill proposed in the House of Representatives provided a similar solution. In that bill, Congress proposed that in a sale of property between a "tax-exempt entity and a related person," the buyer's basis would be limited to the adjusted basis of the seller.[204] The buying partner would not get the benefit of the inside basis adjustment under § 743 if the nonresident selling partner did not pay U.S. tax.[205] This subsection would ensure that the United States does not lose the ability to tax appreciation of partnership assets. It also provides a more administrable system for taxpayers and the IRS.[206]

Two, if the partnership makes a § 743(b) basis adjustment, Congress should require that the partnership compute the selling partner's tax based on a look-through approach.[207] This proposal would apply to all partnership dispositions, not just ones involving

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[204] H.R. REP. NO. 105–148, at 159 (1997) (Conf. Rep.) (proposing a new § 1061 in the Code that provides "[i]n the case of a sale or exchange of property directly or indirectly between a tax-exempt entity and a related person, the basis of the related person in the property acquired shall not exceed the adjusted basis of such property (immediately before the exchange) in the hands of the tax-exempt entity, increased by the amount of gain recognized to the tax-exempt entity on the transfer which is subject to tax under section 511.").

[205] *See supra* note 157. This solution has some practitioner support. *See* Trump & Graham, *supra* note 72, at 278 (discussing the 1997 legislative proposal to "deny the . . . Sec. 743 adjustment *in toto*" and arguing that the "result is entirely appropriate and would preserve the U.S. federal income tax on ECI assets" (citing Blanchard, *supra* note 17)). But none of the authors that proposed this idea believed such a comprehensive solution was necessary.

[206] Put differently, this type of approach would provide an "entity-type" treatment because the selling partner would not need to calculate gain; as articulated before, the main source of complexity results from the aggregate or look-through approach treatment.

[207] Professor Gregg Polsky suggested this idea in an email to the author. Email from Gregg Polsky, Francis Shackelford Distinguished Professor in Taxation Law, University of Georgia School of Law to Robert Daily (Sept. 12, 2018) (on file with author).

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Georgia Law Review, Vol. 53, No. 2 [2019], Art. 10

nonresidents. But this proposal is needed because the current system for taxing the selling partner is flawed, as it is both "unduly favorable to taxpayers and unduly unfavorable to taxpayers" relative to a look-through or aggregate-type approach.[208] This Note's proposal combines the entity and aggregate concepts discussed in Part III—adopting an aggregate-type approach if the partnership makes a § 743(b) adjustment and an entity-type approach absent such adjustment.

As the previous Part explained, a pure look-through approach is an inefficient solution.[209] Congress should not force each and every partnership to calculate the look-through gain as it currently does under § 864(c)(8). Instead, Congress should only require a look-through approach when partnerships make a § 743 adjustment. The information the selling partner needs to calculate a look-through gain is the same information the partnership needs to make a § 743 adjustment. This Note's proposal is more administrable than any other solution because it would provide an "opt-in" rule that only applies if the partnership wants to make a basis adjustment. If the partnership does not want to deal with the complexity, the partnership can use the traditional entity method to compute gain or loss and forgo the § 743(b) basis adjustment.[210]

C. SIMPLIFY THE SOURCING RULES

The *GMM* case highlights three things about sourcing. First, the rules are too confusing.[211] The *GMM* court itself got tangled up in the sourcing web and misstated which statute applied in the case.[212] Second, the rules, especially after the enactment of § 864(c)(8), are inequitable. Foreign investors are less likely to invest in U.S.

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[208] *See generally* Emily Cauble, *Taxing Selling Partners*, 94 WASH. L. REV., at *42 (forthcoming 2019).

[209] *See supra* part III.D.3. *But see id.* at *43–44 (arguing that her approach does not result in an unduly burdensome method of computing gain or loss relative to the current system).

[210] Nevertheless, partnerships that need to make the § 743(b) adjustment because of a substantial built-in-loss are out of luck. Still, the thrust of the argument remains because Congress forces partnerships with such a built-in-loss to make the basis adjustment, so the added administrative complexity in these situations is low.

[211] Bae, *supra* note 47 ("Furthermore, perhaps in illustrating the uncertainty in the application of the ECI rules, [*GMM*] may serve as a valid criticism of the current taxing regime.").

[212] *See supra* note 62.

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companies after TCJA due to the difficulties of complying with the statute.[213] Third, the fundamental flaw of the sourcing rules applied to nonresidents selling a partnership interest is that the U.S. Office Rule likely does not apply. These partners escape taxation because the U.S. office of the partnership conducting business in the United States is likely not a "material factor" in the production of that gain and the office does not "regularly carr[y] on activities of the type from which" the gain "is derived."[214] And as addressed in the previous section, the flaw in the U.S. Office Rule still exists post-TCJA.[215] To provide real international tax reform, Congress needs to write better sourcing rules.

This Note recommends that Congress discontinue the U.S. Office Rule requirement under § 865(e)(3). Congress may want to enact in its place a prophylactic rule that states any sale from or to a U.S. Office (including any sale of a partnership interest) will be presumed to be ECI and U.S. sourced income under § 865(e)(2) unless a taxpayer can prove that the sale was not derived from a U.S. Office. This rule will serve as a burden-shifting mechanism: foreign taxpayers, will need to prove that the gain *should not* be taxed rather than the government trying to prove that the gain *should* be taxed. This proposed statute would be similar to the approach taken in § 864(c)(8) proposed regulations.[216] With this change, partnerships with foreign partners will no longer need to engage with the convoluted regular activities and material factor tests. Such a rule would also eliminate the potential litigation risk that § 864(c)(8) does not actually supersede *GMM*.[217]

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[213] *See supra* Part III.D.3.

[214] *See supra* Part II.B.2.

[215] *See supra* Part IV.D.3.

[216] *See supra* note 183.

[217] *See supra* note 179 and accompanying text. Kim Blanchard has noted that the government may have regulatory authority to correct this flaw, but that it does not want the rule "when the shoe is on the other foot," (i.e., when the government is trying to tax outbound multinational investors who are arguing that their property should be foreign sourced instead of in the U.S.). Blanchard, *supra* note 63, at 547. In the process, she argues that the government "wants to have its cake and eat it too" by not promulgating a regulation in which the U.S. Office Rule does not apply to both U.S. residents and nonresidents. *Id.* Blanchard is correct in noting that we need to treat taxpayers equitably with respect to the ECI rules, but this Note argues that such an approach is not justified for the sourcing rules given the real threat of a nonresident escaping taxation.

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Georgia Law Review, Vol. 53, No. 2 [2019], Art. 10

With this proposal, it is likely that the *GMM* case would have been decided the other way: there would be a presumption that the taxpayer's sale would be ECI and U.S. sourced income, and the taxpayer would have been unable to show that the presumption was inappropriate.

An even better solution would be to substitute "old-fashioned" and cumbersome rules in §§ 864 and 865 with "broad general theories of value creation."[218] This is easier said than done.[219] One solution would be to provide a formula to a company's worldwide sales. The multinational entity would multiply its worldwide income by the company's percentage of U.S. property, sales, and payroll—similar to how multi-state entities "apportion" and source income to a particular state.[220] Although this proposal is more of a rough-justice solution, it would both prevent the gamesmanship and replace the outdated sourcing statutes.[221]

D. PROVIDE A COMPOSITE RETURN FOR NONRESIDENTS

Congress should also allow partnerships to pay tax on behalf of any nonresidents via a composite tax return. This composite return would fulfill the nonresident's U.S. tax filing obligation and provide an efficient way for the government to collect tax on U.S. sourced income, similar to the composite returns that some states require for partnerships who have nonresident partners.[222] A nonresident

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[218] Kim Blanchard used this phrase when explaining her thoughts on why the government appealed the *GMM* case, but it applies equally to the proposition it supports. *See* Blanchard, *supra* note 63, at 547.

[219] Blanchard notes that the government believes such an approach "is too fuzzy, and too easy for taxpayers and governments to game." *Id.* But considering that the rest of the developed world is taxing residents based on a value creation method, this author believes that such an approach is necessary, especially by using a less-gameable apportionment-type model described below.

[220] *See* Walter Hellerstein, *International Income Allocation in the Twenty-first Century: The Case for Formulary Apportionment*, INT'L TRANSFER PRICING J., May–June 2005, at 103 (arguing for a formulaic approach to sourcing income).

[221] *See id.* at 111 (arguing that the current method of sourcing income is "theoretically questionable and practically inadministrable").

[222] *See* Peter L. Faber, *State and Local Tax Planning for Partnerships*, 2017 STATE TAX NOTES 463, 471 (May 1, 2017) ("Recognizing the administrative burden on partners, many states allow a partnership to file a composite return for its nonresident partners, in which case the partners — though required by the partnership to pay their share of tax — do not have to file separate returns in those states. Typically, a partner can be in a composite return only if it has no other income from the state."); *cf.* Marc Yassinger, *An Updated Consideration*

investing in a partnership that does business in another state need not invest through a blocker corporation to avoid filing a tax return in that state; the partnership simply needs to make a composite return election.

The current use of blocker structures is cumbersome and unnecessary. A composite return is a better solution and may encourage more investment in the United States.[223] There may be a political rationale not to allow certain types of investments, but such justification cannot be found in tax policy.

V. CONCLUSION

The crossroads of partnership and international tax law remain difficult to navigate. This Note considered the collateral effects of Rev. Rul. 91-32, *GMM*, and the Congressional response to *GMM*. First, this Note considered the broader entity and aggregate debate as applied by practitioners, by the IRS in Rev. Rul. 91-32, by the Tax Court in *GMM*, and by Congress in the TCJA. Second, this Note provided a list of solutions to solve the puzzling interaction of the international and partnership tax provisions. If this Note has explained anything, it is that the saga of Rev. Rul. 91-32 is far from over.

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of a Taxing Problem: The Harmonization of State and Local Tax Laws Affecting Nonresident Professional Athletes, 19 HASTINGS COMM. & ENTM'T L.J. 751, 764 (1997) (arguing for a composite return model for professional athletes such that the team can file a return and satisfy their player's state tax obligations).

[223] That is, foreign investors invest in U.S. partnerships *despite* having to pay two levels of tax on any gain. Combine this U.S. tax with the nonresident's home county tax and it is likely that the foreign investor's after-tax gain is lower than a U.S. investor's after-tax gain would be. A composite return eliminates one level of the foreign investor's U.S. tax, which would necessarily increase their after-tax return and would likely increase foreign investor's propensity to invest in the United States.

Georgia Law Review, Vol. 53, No. 2 [2019], Art. 10

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