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Critical Analysis and Strategies for U.S. Overseas Business Participating as a Foreign Joint Venture Partner

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Critical Analysis and Strategies for U.S. Overseas Businesses Participating as a Foreign Joint Venture Partner

Michael B. Nelson*

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I. INTRODUCTION

The global economy is producing growth areas outside the United States, especially in Europe and Asia. United States business is seeking to establish links within these countries to share in this growth. Several foreign countries have legislation limiting U.S. participation and setting strict international business structures in which U.S. businesses must restructure their legal entities, manner of operations and limited foreign participation.¹

Many of the growth countries of Eastern Europe and Asia are legislating favorable business structures in which their country and/or their companies are actual participants in enterprises and industries. Although U.S. businesses prefer to operate overseas as wholly owned U.S. entities, subsidiaries or branches, the economic, financial, governmental and legal barriers become quite complex and

1. See generally Tina M. Rinehart, *Forming a High Technology Joint Venture In Hungary*, 11 SANTA CLARA COMPUTER & HIGH TECH. L.J. 287-318 (1995); Nina Schuyler, *The Mexican Connection: U.S. Business South of the Border Creates Legal Problems as Two Different Cultures Blend Together*, (California Law Business), L.A. DAILY J., May 15, 1995, at 516; Henry T. King Jr., *Joint Ventures and Technology Transfers in Mexico*, 11 CORP. COUNS. Q. 36-49 (1995); Michael Hrasky & Alexangra Hrasaka, *International Joint Ventures in the Czech Republic*, 23 INT'L BUS. LAW. 63 (1995); Tim Tien-Chun Chang, *Doing Business with Vietnam*, 40 PRAC. LAW. 33 (1994); Paul Drager, *The Legal Framework for Doing Business In Russia*, 32 ALBERTA L. REV. 310-327 (1994); Marita Barbier, *Joint Ventures in Poland*, 22 INT'L BUS. LAW. 206 (1994).

inoperable within the foreign country. Generally, the foreign country prefers a joint venture with the foreign government and/or industry being one of the partners in the joint venture.

Each country has its own individual and specific legislation and procedures for purposes of creating, formulating, operating, terminating, distributing and liquidating a joint venture. This article's purpose is to provide a successful guide to the international practitioner in assisting in the initial set-up, proposal and establishment of a foreign joint venture agreement. Too often, joint venture agreements are entered into without proper thought as to the form of entity desired by U.S. participants. Unfortunately, once the joint venture agreement is executed, it is extremely difficult and frustrating (especially to the foreign partner) to "un-ring the bell" and change business entity form within the joint venture's host country. U.S. tax laws have been significantly changed in recent reformations. These reformations have now called into question the conventional wisdom of operating a foreign joint venture in corporate form.

Real alternatives now exist for U.S. joint venture partners to operate outside the corporate form. Tax legislation now exists that dictates entity classification for U.S. taxation based solely on the legal and contractual language expressed in the joint venture agreement, independent from what was actually intended as the entity classification. Dangerous waters lurk ahead for those who perform with due diligence to structure a business entity to achieve specific tax benefits, but thereafter find the joint venture agreement deems the operation to be different than that planned for and expected. Be aware that even after the practitioner reads and implements the suggestions made by this article in drafting a joint venture agreement, the foreign partner may not recognize the choice of form legally and decline to sign the joint venture agreement.

United States tax law in this area is unsettled and continues to require additional legislation for added clarity and certainty. Even though this legislation acts to clarify some areas of concern, it also adds uncertainty and confusion in other areas. This uncertainty in taxation may yield unfavorable surprises as well as provide valuable planning techniques for beneficial tax mitigation. The fundamental issue is in the basic structure of the U.S. entity holding itself out for participation in the joint venture. There are two general forms of business operation outside the United States and each form has its own peculiar and specific benefits and burdens within the perspective of international taxation, legal operation and local preference. The first form, the partnership, has a combination of entity characteristics: the "entity" and the "aggregate."² The other form, the corporation,

2. The tension between entity and aggregate models for international partnerships is noted in Rev. Rul. 91-32, 1991-20 I.R.B. 20, which adopts an aggregate approach to characterize the gain or loss recognized by a foreign partner on the sale of an interest in a partnership that conducts a U.S. trade or business.

Accordingly, in applying I.R.C. §§ 864(c) and 865(e), 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

also has entity combinations. In its international structures it possesses characteristics of both partnerships and corporations. The relevant treatment of double taxation will also be affected by form of entity choice.³

Utilization of either the entity or the aggregate model in formation of foreign joint ventures creates planning opportunities for the attainment of beneficial tax consequences. Tax planning differs markedly at the inception of the venture in its classification as either a partnership or a corporation. Although international tax planning is paramount to overall joint venture formation, tax burdens and benefits are two of several significant factors considered simultaneously in planning and structuring the total joint venture approach. Traditionally, U.S. joint partners were corporations. As such, foreign joint venture partners have come to expect a U.S. partner to be a corporation. However, recent changes in U.S. tax law have caused international tax planners to completely re-think strategies and formations for foreign joint ventures.

This article will provide the international tax planner with: (1) a fundamental understanding of entity classification that will be "imposed" upon them by the U.S. Internal Revenue Service (IRS); (2) problems associated with the transfer of property into a foreign joint venture to insure equity participation; and (3) a model joint venture structure.

Upon exhaustion of efforts for classification as either a corporation or a partnership by participation in the joint venture agreement, the next step is to implement funding of the joint venture. Funding should occur through the

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. I.R.C. §§ 856(c), 865(e) (West 1995). The determination of the source and the ECI character of gain or loss of a foreign partner from the disposition of a partnership interest will therefore be determined in the manner described below and Rev. Rul. 90-112, 1990-2 C.B. 186, which adopts an aggregate approach to treat a partner that is a controlled foreign corporation (CFC) as owning a share of the partnership's U.S. property for purposes of I.R.C. § 956.

Section 956 of the Code and the regulations thereunder, do not specifically address the treatment of a CFC's investment in U.S. property through a partnership. I.R.C. § 956 (West 1995). Whether a CFC partner is treated as holding, on the last day of its taxable year, a portion of the United States property owned by the partnership depends upon whether the partnership is viewed as an "entity" separate from its partners or as an "aggregate" of its partners for purposes of I.R.C. § 956. There is no exclusive rule as to when a partnership will be treated as an entity or as an aggregate for purposes outside of subchapter K. The resolution depends upon which approach is more appropriate to the specific Code section involved. *See, e.g.*, Rev. Rul. 89-72, 1989-1 C.B. 257 (a CFC's distributive share of income from a non-controlled partnership is treated as foreign base company sales income, if it would have been treated as such had it been realized directly by the CFC). *See also* Rev. Rul. 89-85, 1989-2 C.B. 218, and the authorities cited therein.

In contrast, for example, I.R.C. § 954(c)(1)(B)(ii) adopts an entity approach to treat gain on the sale of a partnership interest as foreign personal holding company income, and therefore as passive income under § 904(d)(2)(A)(I), even if a sale by the partnership of its assets would generate active income. I.R.C. §§ 954(c)(1)(B)(ii) (West 1995).

3. To determine the applicable limitation on the foreign tax credit, a shareholder can sometimes "look through" to a corporation's assets or income. *See* I.R.C. § 904(d)(3) (West 1995); 26 C.F.R. §§ 1.861-12T(c)(3), 1.904-5 (1996).

outward transfer of assets, tangible and intangible, from the United States to the foreign joint venture. This apparently innocent act under Internal Revenue Code (hereinafter I.R.C. or the Code) Sections 351 or 361 should produce a non-recognition of gain or loss. The anticipation of non-recognition does not always occur and the venture may find the transaction subject to taxation without the normal proceeds from a sale transaction to allow for the payment of the tax. This payment of tax without the corresponding receipt of sales proceeds will subject the joint venture's U.S. partner to severe financial hardship at the very beginning of the joint venture, when liquid assets are most needed and contractually required under the terms of the joint venture agreement.

II. ENTITY CLASSIFICATION AND RELATED ISSUES

The U.S. taxation of a foreign joint venture depends on whether it is treated as a partnership or as an association that is taxable as a corporation. Thus, extreme care must be taken when drafting a joint venture agreement. For example, the members of the joint venture may intend a joint venture partner to be a U.S. corporation, but drafting certain attributes to the entity can cause the corporation to be deemed a partnership. This error in legal drafting will cause the unravelling of all anticipated tax benefits and may ultimately be responsible for the failure of the joint venture as a whole. This article will assist the practitioner in proper drafting in order to minimize risk of reclassification of the U.S. partner by the IRS. In this way, a tax plan will remain valid and the reliance upon that plan will remain intact. As the initial drafting and subsequent negotiation of the joint venture agreement with new joint venture foreign partner or partners begins, an understanding is needed of what the IRS views to be a corporation.

At one time, the I.R.S. considered a foreign entity to be a corporation for U.S. tax purposes if it was treated as such under foreign law, and the courts occasionally seemed to agree.⁴ As indicated by the more recent authorities discussed below, however, both the IRS and U.S. courts now recognize that a foreign entity is classified according to U.S. law, applying the rules of Section 7701(a)(5); "[t]he term 'foreign' when applied to a corporation or partnership means a corporation or partnership which is not domestic." Sections 301.7701-1(c) and 301.7701-2 of the regulations provide an important working definition of the specific corporate characteristics.⁵

4. See N.Y. State Bar Association Tax Section, Comm. On Foreign Activities of U.S. Taxpayers, *Report on Foreign Characterization for Federal Income Tax Purposes*, 35 TAX L. REV. 167, 192-93 (1980) and the rulings and other authorities discussed therein.

5. 26 C.F.R. §§ 301.7701-1(c); 301.7701-2 (1996):

(a) Characteristics of corporations.

(1) The term "association" refers to an organization whose characteristics require it to be classified for purposes of taxation as a corporation rather than as another type of organization such as a partnership or a trust. There are a number of major characteristics ordinarily found in a pure

A. Distinguishing Corporations From Partnerships

U.S. tax law distinguishes a corporation from other forms of organizations on the basis of six principal characteristics: (1) association; (2) an objective to carry on business and divide the gains therefrom (often referred to as a joint profit motive); (3) continuity of life; (4) centralized management; (5) limited liability; and (6) free transferability of interests.⁶

corporation which, taken together, distinguish it from other organizations. These are: (i) Associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests. Whether a particular organization is to be classified as an association must be determined by taking into account the presence or absence of each of these corporate characteristics. The presence or absence of these characteristics will depend upon the facts in each individual case. In addition to the major characteristics set forth in this subparagraph other factors may be found in some cases which may be significant in classifying an organization as an association, a partnership, or a trust. An organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust. *See Morrissey et al. v. Commissioner* 296 U.S. 344 (1935).

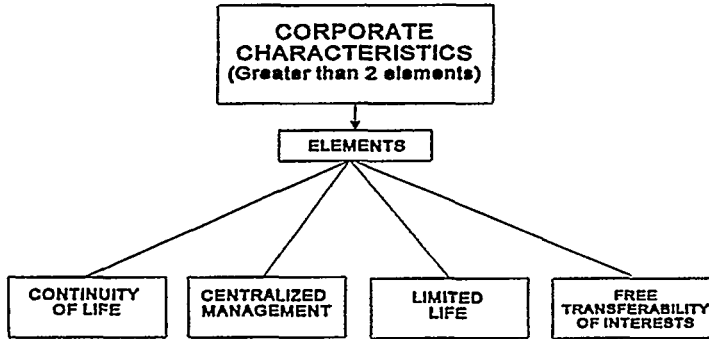
(2) Since associates and an objective to carry on business for joint profit are essential characteristics of all organizations engaged in business for profit (other than the so-called one-man corporation and the sole proprietorship), the absence of either of these essential characteristics will cause an arrangement among co-owners of property for the development of such property for the separate profit of each not to be classified as an association. Some of the major characteristics of a corporation are common to trusts and corporations, and others are common to partnerships and corporations. Characteristics common to trusts and corporations are not material in attempting to distinguish between a trust and an association, and characteristics common to partnerships and corporations are not material in attempting to distinguish between an association and a partnership. For example, since centralization of management, continuity of life, free transferability of interests, and limited liability are generally common to trusts and corporations, the determination of whether a trust which has such characteristics is to be treated for tax purposes as a trust or as an association depends on whether there are associates and an objective to carry on business and divide the gains therefrom. On the other hand, since associates and an objective to carry on business and divide the gains therefrom are generally common to both corporations and partnerships, the determination of whether an organization which has such characteristics is to be treated for tax purposes as a partnership or as an association depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability.

(3) An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics. In determining whether an organization has more corporate characteristics than noncorporate characteristics, all characteristics common to both types of organizations shall not be considered. For example, if a limited partnership has centralized management and free transferability of interests but lacks continuity of life and limited liability, and if the limited partnership has no other characteristics which are significant in determining its classification, such limited partnership is not classified as an association. Although the limited partnership also has associates and an objective to carry on business and divide the gains therefrom, these characteristics are not considered because they are common to both corporations and partnerships.

6. 26 C.F.R. § 301.7701-2(a)(1) (1996). These six corporate characteristics are the so-called "Morrissey factors," set forth by the Supreme Court. *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

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The first two of these corporate characteristics (associates and a joint profit motive) are also common to partnerships, and therefore are not material to a determination of whether a particular entity is more properly classified as a corporation or as a partnership.⁷ The latter four characteristics (continuity of life,⁸ centralized management,⁹ limited liability,¹⁰ and free transferability of interests¹¹)



are more typical of corporations than of partnerships, and therefore are taken into account in classifying an entity.¹² In general, an unincorporated organization is classified as an association taxable as a corporation, rather than as a partnership,

7. 26 C.F.R. § 301.7701-2(a)(2) (1996).

8. An entity has continuity of life if the death, insanity, bankruptcy, retirement, resignation or expulsion of any owner does not cause the entity's dissolution. This is true, even if the agreement establishing the entity provides that it will continue only for a stated period or until the completion of a stated transaction, if the effect of the agreement is that no owner has the power to cause a dissolution. 26 C.F.R. § 301.7701-2(b) (1996).

9. "An organization has centralized management if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed." 26 C.F.R. § 301.7701-2(c) (1996). It is not necessary that the managers be owners of the entity or that they hold their office as a result of a selection (vote) by the owners. However, there is no centralized management unless the managers have sole authority to make independent business decisions on behalf of the entity without ratification by the owners. *Id.*

10. An entity has "limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization." 26 C.F.R. § 301.7701-2(d) (1996). In the case of an entity formed as a limited partnership, personal liability does not exist with respect to a general partner that: (1) has no substantial assets (other than the interest in the entity) that could be reached by a creditor of the entity; and (2) is merely a "dummy" acting as the agent of the limited partners. *Id.*

11. Free transferability exists if each of the entity's owners, or those owners that hold substantially all the interests in the entity, have the power (without the consent of the other owners) to substitute for themselves a person who is not presently an owner. The right of substitution must include all the attributes of the owner's interest in the entity. Thus, the ability to assign only the right to share in profits, but not the right to participate in management, does not result in free transferability. If free transferability exists, but is subject to a requirement that the interest first be offered to the other owners at its fair market value (a right of first refusal), this modified free transferability is accorded less weight in classifying the entity than if free transferability were present in unmodified form, 26 C.F.R. § 301.7701-2(e) (1996). In view of the general counting-of-factors approach, it is not clear whether according a factor "less weight" is really material.

12. 26 C.F.R. § 301.7701-2(a)(2) (1996).

only if it has more than two of these latter four corporate characteristics.¹³

All foreign entities are considered to be "unincorporated organizations" for purposes of applying I.R.C. Section 7701.¹⁴ Although a foreign joint venture's classification as a corporation or partnership is made under Section 7701 regulations, this classification is based on the rights and obligations established under local law. The application of this regulation is significantly influenced by the foreign jurisdiction's local law for determination of, (1) the legal relationship of the venturers among themselves; (2) the legal relationship between the venturers and the public at large; and (3) the venturers' interests in the venture's assets.¹⁵ This influence of local law may provide venturers with considerable flexibility as to whether a foreign joint venture is treated as a corporation or as a partnership for U.S. tax purposes; particularly in those jurisdictions where local law permits the election of corporate characteristics such as limited liability or freely transferable interests.

Example One: Registration of a United Kingdom (U.K.) company's memorandum of association and articles of association creates a cor-

13. 26 C.F.R. § 301.7701-2(a)(3) (1996). The regulations suggest that other factors may be found significant in classifying an organization, but the potential significance of these other factors has been virtually ignored by the Internal Revenue Service (other than to the extent that they may relate to the existence of the six major corporate characteristics described above). See Rev. Rul. 79-106, 1979-1 C.B. 448.

14. Rev. Rul. 88-8, 1988-1 C.B. 403, 404 was in reference to the year 1986, when 25 U.S. citizens organized an entity in the United Kingdom as an unlimited company by registering the entity under the Companies Act of 1985; the Act is, for all intents and purposes, U.K.'s corporation statute. The entity's organizational memorandum sets forth its company name, location, business objective, and share capital. According to the memorandum, there will be no limit on the liability of its members and no member may substitute another individual for his membership without permission from the other members.

At issue was whether the entity is classified for Federal tax purposes on the basis of characteristics set forth in regulation 26 C.F.R. § 301.7701-2 (1996).

The Internal Revenue Service held that an entity organized under foreign law was classified for federal tax purposes on the basis of characteristics set forth in regulation C.F.R. § 301.7701-2. The entity at issue in this ruling was held to be a partnership for Federal tax purposes. The Internal Revenue Service cited Rev. Rul. 73-254, 1973-1 C.B. 613, in noting that the classification of a foreign unincorporated business organization for federal tax purposes will be determined under I.R.C. § 7701. "It is the local law of the foreign jurisdiction" the Internal Revenue Service added, "that must be applied in determining the legal relationships of the members of the organization among themselves and with the public at large." Furthermore, I.R.C. § 7701 regulations provide a general rule that all foreign entities will be considered to be "unincorporated entities," unless corporate characteristics outnumber non-corporate characteristics. Noting that the entity's members did not enjoy limited liability (a corporate characteristic) and did not have the right to freely transfer their interests (another corporate characteristic), the Internal Revenue Service concluded that the entity must be classified as a partnership for Federal tax purposes.

15. 26 C.F.R. § 301.7701-1(c) (1996); Rev. Rul. 73-254, 1973-1 C.B. 613 states:

The tests and standards which will be applied in classifying the unincorporated business organization as a partnership, as a trust, as an association taxable as a corporation, or as some other taxable entity will be determined under I.R.C. § 7701 and the regulations thereunder. However, it is the local law of the foreign jurisdiction that must be applied in determining the legal relationships of the members of the organization among themselves and with the public at large, as well as the interests of the members of the organization in its assets. *Id.*

porate body under the U.K. Companies Act of 1985.¹⁶ The company's owners may have limited or unlimited liability, depending on the terms of the memorandum of association. The interests in the company may be freely transferable or their transfer may be subject to restriction, depending on the terms of the articles of association. Thus, by varying the terms of the memorandum and articles of association, the U.K. company's owners may choose whether the company will be classified for U.S. purposes as a partnership or as a corporation. If the owners have unlimited liability and their interests cannot be transferred freely, the company generally is a partnership for U.S. tax purposes even though formed under the U.K. incorporation statute.¹⁷

Until August of 1991, the IRS *Internal Revenue Manual* (the Manual) attempted to classify many types of foreign entities. It called some of them corporations,¹⁸ some partnerships,¹⁹ while on others it bestowed the mysterious label "quasi-corporation."²⁰ The status of the last label was unclear since there is no such entity in the Code or the Treasury regulations. Most likely, the intent was merely to indicate that the entity could have both corporate and partnership characteristics, and that its classification was therefore uncertain. Unfortunately, the Manual also expressed certainty when it should not have. For example, the Manual classified the German *Gesellschaft mit beschränkter Haftung* (GmbH) as a corporation, even though the Internal Revenue Service had ruled that a GmbH could be a corporation or a partnership depending on the facts of the particular case.²¹ The Manual warned that its classification of various foreign entities was

16. Companies Act, 1985, Ch. 1.

17. Rev. Rul. 88-8, 1988-1 C.B. 403, 404. Like most powerful tools, the ability to affect the classification of the venture can result in unforeseen negative tax consequences if used without an understanding of the implications. For example, a foreign partnership or corporate joint venture may amend its charter or other governing instruments in a manner that changes its classification for U.S. tax purposes. This change is considered to result in a deemed liquidation of the former venture, followed by a deemed re-contribution of assets to the new venture. The deemed liquidation and re-contribution may trigger gain recognition or other tax consequences under both domestic and international tax provisions. See 26 C.F.R. §§ 1.367(a)-1T(c)(6) (1996); and Rev. Rul. 63-107, 1963-1 C.B. 71, 72.

18. For example, a French Societe Anonyme (SA), a German Aktiengesellschaft (AG), a Japanese Yugen Kaisha, or a Dutch Besloten Vennootschap (BV) was treated as a corporation. 1 Internal Revenue Manual (Audit) (CCH) exhibit 500-4, at 7283-55 through 7283-59, prior to its amendment on August 20, 1991.

19. For example, a French Societe en nom collectif (SNC), a Japanese Gomei Kaisha, or a Mexican Sociedad colectiva (SC) was treated as a partnership. *Id.*

20. For example, a Mexican Sociedad en comandita por acciones (SCpA) or a Swiss Kommanditgesellschaft auf Aktien (KGaA) was treated as a quasi-corporation. *Id.*

21. In Rev. Rul. 77-214, 1977-1 C.B. 408, the GmbH was formed by two wholly owned U.S. domestic subsidiaries of a U.S. corporation. One subsidiary owned 90% of the quotas (shares) of the GmbH, while the other subsidiary owned the remaining 10% of the quotas. The two subsidiaries were expressly formed by the parent to provide marketing and support services for the parent's operation in foreign countries. The GmbH in turn was formed by the subsidiaries to facilitate the provision of those services in Germany.

to be viewed as a source of information not evidence on which to base an IRS position.²² This warning, meant for IRS examiners, needed equally to be taken to heart by private sector tax planners who may have been tempted to rely (favorably or unfavorably) on the Manual's classifications. In view of these problems, the IRS withdrew the manual's classifications and substituted general principles for entity classification that are consistent with more recent statements.²³

One difficulty faced by drafters of the prior manual provisions was that this classification of foreign entities was done during a period when the IRS was actively considering the adoption of a per se rule denying partnership status to any limited liability company.²⁴ The per se rule first received widespread notice when the IRS included it in proposed amendments to the Section 7701 regu-

The GmbH's memorandum of association provided that it would be dissolved by the death, insanity, or bankruptcy of any of the quota holders. The memorandum of association also provided that the GmbH's quotas were not freely transferable, and the sale, pledging, or disposal of the quotas required the prior written approval of all quota holders.

Rev. Rul. 77-214 pointed out that under German law, the GmbH possessed the characteristics of associates and an objective to carry on business and divide the gain therefrom, which characteristics are common to both corporations and partnerships. The GmbH also had, under German law, the corporate characteristics of limited liability and centralization of management. Therefore, the GmbH would be classified as an association if it possessed either of the two remaining corporate characteristics: continuity of life or free transferability of interests. The 1977 ruling concluded that because all members of the GmbH were commonly controlled, consent to transfer was not meaningful and the GmbH possessed the characteristic of free transferability of interests. In determining that the GmbH possessed the characteristic of continuity of life, Rev. Rul. 77-214 provided that a dissolution event has significance in establishing that characteristic only if there exist separate interests that could compel a dissolution.

Rev. Rul. 93-8 reaffirms Rev. Rul. 77-214's conclusion on free transferability of interests. However, the new ruling states that the presence or absence of separate interests is not relevant to the determination of whether an entity possesses continuity of life. Because the memorandum of association in this case required dissolution on the bankruptcy of either quota holder, without further action, the GmbH lacked continuity of life, the Internal Revenue Service said.

Rev. Rul. 93-8 concludes that the GmbH has three of the four corporate characteristics that distinguish an association taxable as a corporation from a partnership, and it is still classified as an association for federal tax purposes.

Rev. Rul. 93-8 modifies and supersedes Rev. Rul. 77-214 effective as of February 18, 1993. Organizations existing before that date that reasonably relied on Rev. Rul. 77-214 can maintain their current classification by reporting consistently with that classification on the first relevant federal income tax return of the organization or member filed after February 18, 1993.

22. Internal Revenue Manual, *supra* note 18, ch. 5(10) 2, at 7283-31.

23. *Id.* ch. 5(10) (1)-(4), at 7283-31 to 7283-32.

24. During the 1970's the Internal Revenue Service adopted the view in an internal memoranda that a foreign entity would be classified automatically as a corporation if it was formed under a law that was conceptually similar to a domestic incorporation statute. *See* G.C.M. 34376 (Nov. 13, 1970), revoked by G.C.M. 39693 (Jan. 22, 1988) (which considered and approved the proposed revenue ruling that was published as Revenue Ruling 88-8, 1988-1 C.B. 403). In effect, the Internal Revenue Service simply was extending to the foreign context the well-established rule that a domestic entity formed under an incorporation statute would be classified as a corporation without regard to whether it had a preponderance of the corporate characteristics set forth in the § 7701 regulations. *See, e.g.*, Rev. Rul. 70-101, 1970-1 C.B. 278, modified by Rev. Rul. 73-596, 1973-2 C.B. 424, and amplified by Rev. Rul. 70-455, 1970-2 C.B. 297, Rev. Rul. 72-468, 1972-2 C.B. 647, Rev. Rul. 74-439, 1974-2 C.B. 405, and Rev. Rul. 82-212, 1982-2 C.B. 401.

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lations.²⁵ Under severe pressure from the private bar, the IRS withdrew the proposed regulations in 1983 and announced that it would undertake a study of what role limited liability should play in classifying an entity.²⁶ During the years immediately following this announcement, including the time of issuance of the *Internal Revenue Manual's* list of foreign entity classifications, the IRS gave several indications that the per se rule was still alive.²⁷

The IRS completed its study of the role of limited liability in 1988. It announced its rejection of the per se rule and its intention to revise its revenue procedures to permit partnership classification even as to limited liability companies.²⁸ At about the same time, the IRS held that a Wyoming limited liability company (LLC) could qualify as a partnership even though no member is personally liable for the debts of the company.²⁹ Subsequently, the Internal Revenue Service extensively modified its revenue procedures to clarify, among other things, that the existence of limited liability would not necessarily preclude the issuance of a private ruling that a company is a partnership.³⁰

25. 45 Fed. Reg. 75709, 75710 (1980). Concurrently, the Internal Revenue Service began refusing to issue private rulings classifying a foreign limited liability joint venture as a partnership if (1) the venturer is a corporation and less than 20% of the interests in the venture are held by independent parties, or (2) the venturer is not a corporation and independent parties hold only a nominal interest in the venture. First implemented by Rev. Proc. 80-22, 1980-1 C.B. 654, this no-ruling position was most recently restated in Rev. Proc. 91-3, 1991-1 I.R.B. 52, 57. It seems strange that the no-ruling policy also did not apply to U.S. limited liability companies, since they would have been equally affected by the adoption of a per se rule. Only months after the issuance of the proposed regulations and the adoption of the no-ruling position for foreign limited liability companies, the Internal Revenue Service found a Florida limited liability company to be a partnership, though it noted in the ruling that the proposed regulations would have the effect of reversing that conclusion. Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980).

26. Announcement 83-4, 1983-2 I.R.B. 31 (Jan. 10).

27. See Priv. Ltr. Rul. 84-26-031 (Mar. 26, 1984) in which three domestic corporations created a new corporation in a foreign country. The three domestic parents will transfer their stock in another subsidiary organized under the laws of a second foreign country to the new corporation in exchange for its stock. The old subsidiary will then be merged into the new subsidiary.

The Internal Revenue Service has ruled, provided that the temporary regulations are complied with, the subsidiary corporations will be considered corporations for purposes of section 367(b)(1) and that the transaction constitutes a D reorganization. The Internal Revenue Service also held that the new foreign corporation will be a "per se" corporation under section 7701.

28. Announcement 88-118, 1988-38 I.R.B. 25 (Sept. 19). The Internal Revenue Service has completed a study of the rules for classifying entities for Federal tax purposes under regulation §§ 301.7701-2, 301.7701-3. As a result of its study, the Internal Revenue Service has decided that it will not withdraw its acquiescence in *Larson v. Commissioner*, 66 T.C. 159 (1976). In *Larson*, the Tax Court ruled that a partnership may lack the corporate characteristic of limited liability, even though the general partner may not have met a minimum net worth requirement. The Internal Revenue Service has been using a minimum net worth requirement for partnerships with corporate general partners that seek to be classified as a partnership for Federal tax purposes.

29. Rev. Rul. 88-76, 1988-2 C.B. 360, 361.

30. Rev. Proc. 89-12, 1989-1 C.B. 798; and Rev. Proc. 88-44, 1988-2 C.B. 634. With the rejection of a per se rule, one might ask why the Internal Revenue Service continues to refuse to rule on the classification of foreign liability companies in which an independent party does not hold a large enough interest. See Rev. Proc. 91-3, 1991-1 I.R.B. 52. The answer seems to be related to the ongoing reconsideration of Revenue Ruling 77-214.

Adoption of a per se rule would have impaired the flexibility of foreign joint ventures by forbidding a limited liability entity to be classified as a partnership for U.S. tax purposes. With the rejection of the per se rule, it is even more important that venturers consider how differences in the U.S. tax regime for partnerships as opposed to corporate joint ventures will affect particular venture. In some cases, these differences may be significant enough to justify structuring the venture to qualify for a more favorable U.S. tax classification.

B. Inconsistency Between Tax Jurisdictions

Although an entity is classified under Section 7701 for U.S. tax purposes, its classification for foreign tax purposes is governed by the laws of the foreign country. Often, the U.S. and foreign classifications do not coincide. An entity may be a partnership under U.S. law and a corporation under foreign law or vice versa. Inconsistent classifications can provide an opportunity for worldwide tax minimization, potential double taxation, or pose other traps for the unwary.³¹

Revenue Ruling 72-197³² addressed the foreign tax credit consequence when a *domestic* joint venture with foreign operations is classified as a corporation for U.S. purposes, but as a partnership for foreign purposes. The foreign country, consistent with its view of the venture as a partnership, imposed tax on the U.S. venturers with respect to their shares of the venture's net profits. The IRS held that a Section 901 foreign tax credit could not be claimed by the venture, but could be claimed by the venturers who were liable for the tax under foreign law.

It is interesting to consider the implications of Revenue Ruling 72-197 in the *foreign* joint venture context. Suppose the foreign joint venture is classified as a corporation for U.S. tax purposes, but as a partnership for foreign tax purposes. Because the United States considers the joint venture to be a foreign corporation, its earnings generally will qualify for U.S. tax deferral.³³ Concurrently, the foreign government will impose tax on those earnings at the "partner" level. Under Revenue Ruling 72-197, it appears that the U.S. venturer can claim a Section 901 foreign tax credit³⁴ even while continuing to enjoy deferral on the

31. For an example of the latter, an entity that is a partnership under U.S. law, but is a corporation under foreign law, and which may therefore be treated as a "separate unit" whose losses may not offset income of other members of a consolidated return group for U.S. tax purposes. I.R.C. § 1503(d) (West 1995).

32. In 1972-1 C.B. 215, the taxpayer, a domestic unincorporated association, taxable as a corporation for Federal income tax purposes, owned and operated several large properties in a foreign country. The foreign country did not recognize the taxpayer as a separate entity but as a partnership. Thus, the shareholders who were United States citizens were held liable by the foreign country for the payment of income tax upon their respective shares of the net profits of the taxpayer. Rev. Rule 72-197, 1 C.B. 215.

33. Deferral and the various exceptions to deferral are considered subsequently in the text.

34. 26 C.F.R. § 1.901-2(b)(2)(iv) (1996). Ex. 4, suggests that the tax on the owners of the venture would be considered to meet the "realization" requirement for creditability even though the tax is imposed on income that has not yet been realized by the owners under U.S. tax principles, as cited:

Country X imposes a tax on the realized net income of corporations that do business in country X

venture's earnings.³⁵ Although the ruling involves a domestic joint venture, it did not involve a situation where the earnings of the venture enjoyed the benefit of U.S. deferral. This distinction would appear to be immaterial to the credit result since the basis of the ruling was that, subject to the Section 904 limitation, the credit is allowable to the taxpayer legally liable for the foreign tax.

The consequences of inconsistent classification of a foreign venture are addressed in *Abbott Laboratories International Co. v. United States*,³⁶ which denied a foreign tax credit to the domestic owner of a ninety-five percent interest in Argentine and Colombian limitadas treated as partnerships under foreign law, but as corporations under U.S. law. This case may be distinguishable from Revenue Ruling 72-197 on the basis of the court's finding that the foreign taxes at issue were actually "paid" by the limitadas rather than by their domestic owner. However, the district court opinion reveals that the parties stipulated to the domestic owner's legal liability for the taxes at issue under foreign law. In this respect, the precedential vitality of the case is doubtful. It is inconsistent with subsequent regulations which state that the person who is considered to have paid the tax for purposes of Sections 901 and 903, is the person upon whom legal liability for such tax is imposed by foreign law. Such is the case even if another person (e.g., a withholding agent) remits such tax.³⁷

The IRS has indicated that it will not issue a private ruling: (1) classifying a foreign "corporation" as a partnership; or (2) classifying a foreign "partnership" as an association taxable as a corporation. They will issue such a ruling if it is

(the "country X corporate tax"). Country X also imposes a separate tax on shareholders of such corporations (the "country X shareholder tax"). The country X shareholder tax is imposed on the sum of the actual distributions received during the taxable year by such a shareholder from the corporation's realized net income for that year (i.e., income from past years is not taxed in a later year when it is actually distributed) plus the distributions deemed to be received by such a shareholder. Deemed distributions are defined as (A) a shareholder's pro rata share of the corporation's realized net income for the taxable year, less (B) such shareholder's pro-rata share of the corporation's country X corporate tax for that year, less actual distributions made by such corporation to such shareholder from such net income. A shareholder's receipt of actual distributions is a realization event within the meaning of paragraph (b)(2)(I)(A) of this section. The deemed distributions are not realization events, but they are described in paragraph (b)(2)(ii) of this section. Accordingly, the country X shareholder tax satisfies the realization requirement. *Id.*

35. The practical ability to claim the credit depends in part on whether the U.S. venturer has other foreign source income that has been subject to foreign tax at a rate lower than the U.S. rate and which is in the same § 904 limitation basket as the venture's earnings (in other words, whether the U.S. venturer has excess foreign tax credit limitation).

36. 160 F. Supp. 321 (N.D.Ill. 1958), *aff'd*, 267 F.2d 940 (7th Cir. 1959).

37. 26 C.F.R. § 1.901-2(f)(1) (1996). *Cf. Nissho Iwai Am. Corp. v. Commissioner*, 89 T.C. 765, 774 (1987); *Continental Ill. Corp. v. Commissioner*, 55 T.C.M. (CCH) 1325 (1988) (stating that an American lender was entitled to foreign tax credit on Brazilian withholding tax even though Brazilian borrower paid the tax, because under Brazilian law the tax was on the receipt of the interest and, thus, the tax was imposed on the foreign lender).

justified by unique and compelling reasons.³⁸ In the past this no-ruling position was observed only in case of a breach and did not act as an impediment to obtaining IRS guidance on the classification of a foreign entity.³⁹ More recently,

38. Rev. Proc. 91-6, 1991-2 I.R.B. 29, 31 (Jan. 14), and Rev. Proc. 91-6 was superseded by Rev. Proc. 92-9; and Rev. Proc. 92-9 was superseded by Rev. Proc. 93-7

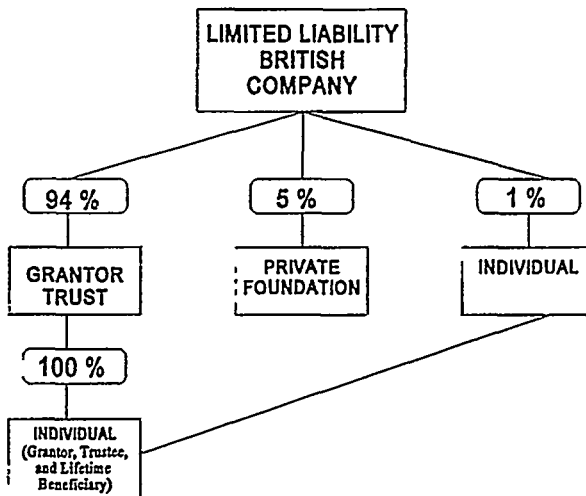
These revenue procedure updates Rev. Proc. 91-6, 1991-1 C.B. 413, provide a list of subject matters under the jurisdiction of the Associate Chief Counsel (International) in which the Internal Revenue Service will not issue advance rulings or determination letters. Rev. Proc. 92-3, this Bulletin, lists the subject matters under the jurisdiction of the Associate Chief Counsel Domestic in which the Internal Revenue Service will not issue advance rulings or determination letters.

Rev. Proc. 94-7 was superseded by Rev. Proc. 95-7 dates Rev. Proc. 93-7, 1993-1 C.B. 465, as modified by Rev. Proc. 93-44, 1993-34 I.R.B. 14 by providing a list of subject matters under the jurisdiction of the Associate Chief Counsel (International) in which the Internal Revenue Service will not issue advance letter rulings or determination letters. Rev. Proc. 94-3, this Bulletin, lists the subject matters under the jurisdiction of the Associate Chief Counsel (Domestic) in which the Internal Revenue Service will not issue advance letter rulings or determination letters.

The Internal Revenue Service in Rev. Proc. 95-7 has provided a revised list of subject matters under the jurisdiction of the Associate Chief Counsel (International) in which it will not issue advance letter rulings or determination letters. Rev. Proc. 95-7 supersedes Rev. Proc. 94-7, 1994-1 C.B. 542.

In the only substantive change, a new section, dealing with situations in which a taxpayer or related party is domiciled or organized in certain foreign jurisdictions, has been added to reflect the fact that the Internal Revenue Service is ordinarily unwilling to rule when the foreign jurisdiction lacks an effective mechanism through which the Internal Revenue Service can obtain the information needed for civil tax examinations and criminal tax examinations with regard to one or more of the issues involved in the ruling request. In such a situation, the Internal Revenue Service may rule when the taxpayer or related party enters into appropriate consents and waivers.

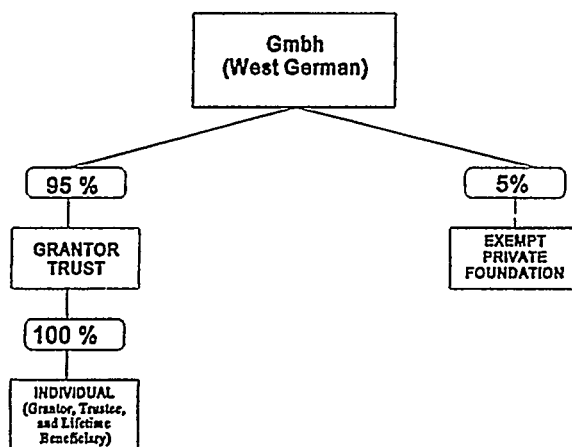
39. See Priv. Ltr. Rul. 90-02-056 (Oct. 18, 1989) in which a U.K. limited liability company was treated as a partnership. An individual was the grantor, trustee, and lifetime beneficiary of a grantor trust. The individual also was the sole shareholder of a corporation. The individual, the trust, and a private foundation formed a British company, limited by shares, to license software designed by the corporation to British customers. The trust owned 94% of the shares in the company, while the private foundation owned 5%, and the individual owned 1%.



Under the company's articles of association, no share transfer may be made without the unanimous written consent of all the company's shareholders. Further, the articles provide that the company will be wound up on December 31, 2099, or by the earlier occurrence of dissolution, bankruptcy, insolvency of a shareholder, or by a shareholder assignment to or for the benefit of creditors. The occurrence of any of these events will cause a shareholder meeting—at which time all shareholders are required to vote for winding up the company.

The Internal Revenue Service has determined that the company will be treated as a partnership for Federal tax purposes since it lacks the corporate characteristics of free transferability and continuity of life.

In Priv. Ltr. Rul. 90-01-018 (Oct. 6, 1989) a GmbH was treated as a partnership; Priv. Ltr. Rul. 89-08-035 (Nov. 28, 1988), an individual was the grantor, trustee, and lifetime beneficiary of a grantor trust. The in-



dividual also was the sole shareholder of a corporation which designs and produces software. The trust and an exempt private foundation have formed a Gesellschaft mit beschränkter Haftung (GmbH), in accordance with the relevant portions of the law of West Germany (GmbH-Gesetz). The GmbH will license the corporation's software to customers in West Germany. The quotas (shares) of the GmbH are owned 95% by the trust and 5% by the foundation.

Under the GmbH's articles of association, no transfer of a quota may be made without the prior written consent of all the quotaholders in the GmbH. The articles of association further provide for the automatic liquidation of the GmbH if a quota holder becomes subject to proceedings for bankruptcy or if a natural quotaholder deceases or is declared incapacitated.

The Internal Revenue Service has ruled that the GmbH will be classified as a partnership for Federal income tax purposes, provided that the organization and operation of the GmbH is in accordance with the GmbH-Gesetz of West Germany.

In Priv. Ltr. Rul. 88-28-022 (Apr. 13, 1988) foreign unlimited liability companies were treated as corporations, respectively. In Priv. Ltr. Rul. 89-08-035 (Mar. 13, 1989) a foreign limited liability company was engaged in manufacturing. Virtually all of its stock was owned by a domestic, publicly traded manufacturer. To avoid financial reporting rules applicable to limited liability companies in the foreign subsidiary's home country, the domestic parent intends to convert the foreign subsidiary to a private unlimited liability company under the foreign country's laws. The foreign subsidiary will amend its articles, apply with the foreign country's registrar, and complete all other steps necessary for the reorganization.

The Internal Revenue Service has ruled that the foreign subsidiary will be classified as a corporation for U.S. tax purposes. The Internal Revenue Service concluded that the entity will have more corporate characteristics than noncorporate characteristics, as stated in the regulations under 26 C.F.R. § 301.7701 (1996). The Internal Revenue Service found that the subsidiary will have continuity of life, centralized management, and free transferability. The Internal Revenue Service also ruled that the conversion will constitute a tax-free reorganization under I.R.C. § 368(a)(1)(F) (West 1995).

however, the IRS has required a taxpayer to explain (preferably in writing) the unique and compelling reasons that justify the requested ruling.⁴⁰

C. "Deemed" Corporations and Partnerships

The participation in activities for joint profit may result in the existence of a partnership or an association that is taxable as a corporation, even if no separate entity has been formed under the laws of a state or foreign country.⁴¹

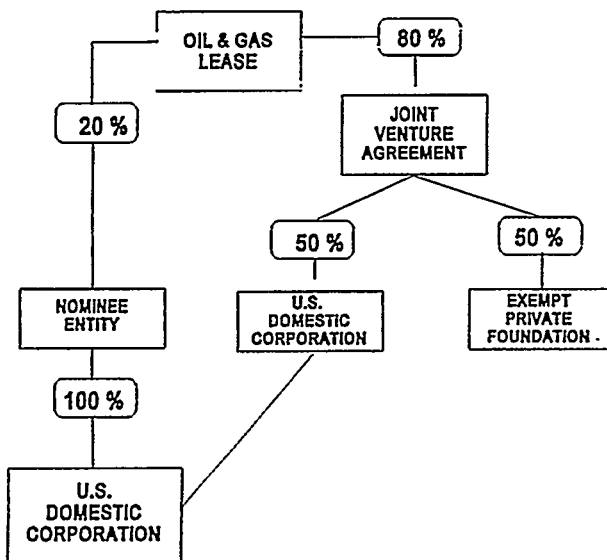
Example Two: Domestic corporation *DC* owns a twenty percent beneficial interest (through a nominee) in a U.K. oil and gas license (which for U.S. tax purposes is considered equivalent to an oil and gas lease). As is customary in the industry, *DC* and the owners of the remaining eighty percent of the license enter into a joint operating agreement which names one of the parties as the "operator" and provides the terms for making decisions relating to drilling and production. Even though no separate entity is created under U.K. law, under U.S. tax law the relationship between *DC* and the other parties is considered to be either a partnership or a corporation.⁴²

In Priv. Ltr. Rul. 88-28-022 (Apr. 13, 1988), a U.S. parent corporation owned more than 99% of a foreign subsidiary which was a private limited liability company incorporated under the laws of a foreign country. The subsidiary intends to convert from a private limited liability company to a private unlimited liability company under the laws of the foreign country. The parent intends to amend the memorandum of association and the articles of association, converting the subsidiary to a private unlimited liability company, and to file the amendments with the foreign country's registrar of companies. Under the proposed articles, the subsidiary will be limited by shares. The Internal Revenue Service has classified the subsidiary as a corporation for Federal tax purposes.

40. Rev. Proc. 91-6, 1991-2 I.R.B. 29.

41. I.R.C. § 7701(a)(2) (West 1995); *Madison Gas & Elec. Co. v. Commissioner*, 633 F.2d 512, 514-17 (7th Cir. 1980). The term "partnership" is not limited to its common law meaning, but is broader in scope and includes groups not commonly called partnerships. The term includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation or venture is carried on, and which is not a corporation, trust or estate. 26 C.F.R. § 301.7701-3(a) (1996); *see also* I.R.C. §§ 761(a), 7701(a)(2) (West 1995); 26 C.F.R. § 301.7701-1(c) (1996).

42. This arrangement is usually treated as a partnership, although its classification depends on whether the particular facts indicate the presence of the corporate characteristics. *See Cokes v. Commissioner*, 91 T.C. 222 (1988); *Bentex Oil Corp. v. Commissioner*, 20 T.C. 565 (1953); Priv. Ltr. Rul. 89-11-021 (Dec. 15, 1988).



Much case law and other authority relating to “deemed” partnerships has developed in the context of oil and gas arrangements such as illustrated in Example Two. Over the years, the mineral industry has learned to anticipate the potential creation of a deemed partnership, and generally to cope with it in the domestic context.⁴³ More recently, especially in international transactions, the deemed partnership issue has arisen outside the mineral industry and has caught some taxpayers by surprise.⁴⁴

43. For example, oil and gas operating agreements often include an election out of partnership status under I.R.C. § 761(a). The election out is only effective with respect to the provisions of subchapter K (I.R.C. §§ 701-761). As discussed below, most of the relevant international tax provisions are not in subchapter K and are therefore unaffected by the election out.

44. See Rev. Rul. 90-80, 1990-2 C.B. 170 (referencing an international bartering arrangement held to be a partnership for U.S. tax purposes). A U.S. citizen and resident entered into a written contract with a citizen and resident of a foreign country on January 1, 1989. The two persons will contribute US\$10,000 each to fund barter transactions in the United States. The agreement provides that the two persons are jointly and severally liable for obligations arising under the U.S. person’s barter transactions; disputes between the two will be governed by the law of the foreign person’s country. The foreign country has an income tax convention [hereinafter the Convention] with the United States identical to the draft U.S. Model Income Tax Convention of 1981.

The agreement allocates two-thirds of all profits and losses to the U.S. person and one-third to the foreign person. The U.S. person will maintain an office in the United States to conduct the barter transactions and to store goods obtained. The U.S. person will not trade in stocks, securities, or commodities under I.R.C. § 864(b)(2) (West 1995). In January 1989, the U.S. person bought goods and services from U.S. sellers with the US\$20,000 cash. By the end of the year, the U.S. person had reaped US\$90,000 in profits.

In a second situation, a citizen and resident of the foreign country, wishing to invest US\$20,000 in the United States, contracted with a U.S. citizen and resident. The agreement gives the U.S. person the authority to negotiate and conclude barter transactions in the foreign person’s name. The U.S. person will act only on behalf of the foreign person in these transactions, will be under the foreign person’s control and management,

Whenever two or more participants (otherwise affiliated or not) act in concert with a joint profit motive, the possible existence of a deemed partnership for U.S. tax purposes must be considered.

One potential application of the deemed partnership problem in an international context is in the area of global trading. As a relatively new phenomenon, there does not yet exist a "typical global trading operation." Nevertheless, the following description is realistic enough to serve for purposes of discussion, although not universally representative of the industry.⁴⁵

Example Three: A domestic corporation, *DC*, and its worldwide affiliates trade in financial products for their own account. Trading in a particular financial product is usually conducted on that product's primary exchange by the affiliate based in the country where the exchange is located. For example, *DC*'s U.K. affiliate trades in British bonds in London and *DC* trades in U.S. bonds in New York. When a product's primary market is closed, trading may take place in a secondary market. For example, U.S. bond trading may be conducted in London by the U.K. affiliate if a trade is to be executed before the New York exchange has opened. *DC* and its affiliates determine each company's share of net profit according to a formula, the factors of which include total world-

and will have no other employment during 1989.

The U.S. person maintained an office and performed barter transactions similar to those performed in the first situation. After paying the U.S. person for his services, the foreign person made a profit of US\$70,000 on the 1989 barter transactions.

At issue is whether the foreign persons in the two situations are subject to U.S. tax on their gain from U.S. barter transactions. The Internal Revenue Service (IRS) has held that the foreign persons in both situations are subject to U.S. tax on their gain from the barter transactions.

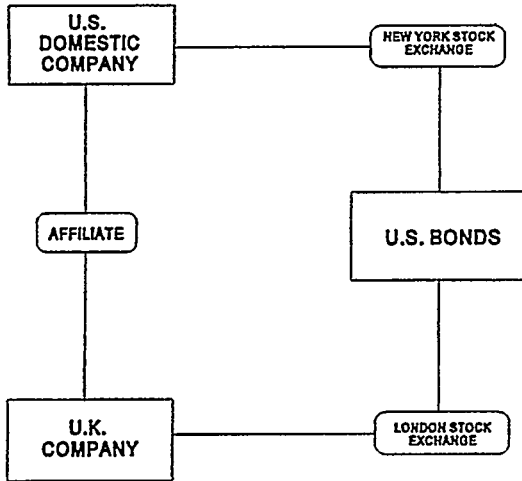
The IRS concluded that the arrangement between the U.S. person and the foreign person in the first situation was a partnership. I.R.C. § 7701(a)(2) (West 1995); 26 C.F.R. §§ 301.7701-2(a)(1),(2)(3) (1996). Furthermore, the IRS said the partnership has a permanent establishment in the United States under Article 5 of the Convention by virtue of the U.S. person's barter activities and the partnership's U.S. office. *Citing Donroy, Ltd. v. United States*, 3011 F.2d 200 (9th Cir. 1962), *Unger v. Commissioner*, T.C. Memo. 1990-15. The IRS also concluded that, because the partnership has a permanent establishment in the United States, the foreign person is treated as having a permanent establishment in the United States. Finally, the IRS determined that under I.R.C. § 702, the foreign person's distributive share of the partnership's 1989 income is US\$30,000, and that amount is taxable in the United States under article 7(l) of the Convention and I.R.C. § 871(b).

With respect to the second situation, the IRS concluded that under Article 5 of the Convention, the foreign person has a permanent establishment in the United States by virtue of the U.S. person's habitual exercise of authority to enter transactions in the foreign person's name. As in the first situation, the IRS concluded that since the foreign person is treated as having a permanent establishment in the United States under article 7(l) of the Convention the 1989 profits are taxable in the United States under I.R.C. § 871(b) (West 1995).

45. Announcement 90-106, 1990-38 I.R.B. 29 (Sept. 17):

The Internal Revenue Service intends to clarify and update the regulations under sections 482, 864, and other sections in order to address the taxation issues raised by global trading of financial instruments. Commentators are requested to suggest unilateral and multilateral measures that might be adopted to improve the existing rules.

wide trading profit, the percentage of total trading volume conducted by a particular company, the amount of salary and bonus paid by the company to its traders, and the profit attributable to financial products whose primary exchange is located in the country in which the particular company is based.



Rarely is a partnership considered to exist in the absence of a joint profit motive, and a sharing of gross receipts is not equivalent to a sharing of profits.⁴⁶ On the facts of Example Three, however, the global trading arrangement between DC and its worldwide affiliates seems to involve something more than a mere sharing of gross receipts, since one company's costs may affect the income of the other affiliates. The existence of a partnership is a highly factual determination, however, and there is not enough information to indicate whether a partnership would be deemed to exist between DC and its affiliates. Nevertheless, the

46. The Internal Revenue Service sometimes takes the litigation position that a partnership can exist even without a joint profit motive. *See, e.g., Madison Gas & Elec. Co. v. Commissioner*, 633 F.2d 512, 516 n.3 (7th Cir. 1980). This litigation position has not enjoyed general success, as it is inconsistent with many cases that have considered a joint profit motive to be an essential partnership characteristic. *See Commissioner v. Tower*, 327 U.S. 280, 286-87 (1946); *but see Brannen v. Commissioner*, 78 T.C. 471, 512 n.16 (1982), *aff'd*, 722 F.2d 695 (11th Cir. 1984) (the Internal Revenue Service did not contend that lack of a joint profit motive resulted in lack of a partnership, but disallowed the partner's loss deductions due to the lack of profit motive). When the shoe is on the other foot, and partnership status would confer a tax benefit on the participants, the Internal Revenue Service has argued successfully that a mere revenue sharing arrangement without a joint profit motive does not result in the existence of a partnership. *See Form Builders Inc. v. Commissioner*, 58 T.C.M. (CCH) 1415, 1417 (1990).

arrangement is close enough to the line that the participants need to be aware of the risk. They should perhaps even consider structuring their income allocation formula in a manner intended to give the arrangement more of a mere revenue sharing character.⁴⁷

In a relatively small class of cases, some of the difficulties that would result from having joint activities treated as a partnership can be avoided by making a Section 761 election out of the application of subchapter K.⁴⁸ The election out is limited to joint activities that are (i) for investment purposes only, and not for the conduct of a business; (ii) for the joint production, extraction or use of property, but not for the purpose of selling services or property produced or extracted; or (iii) by dealers in securities for a short period for the purpose of underwriting, selling or distributing a particular issue of securities. In addition, the election out is available only if the income of the participants can be adequately determined without the computation of partnership taxable income.⁴⁹ For example, while the typical oil and gas joint operating venture illustrated in *Example Two* probably could elect out of subchapter K, the global trading operation in *Example Three*, if it would otherwise constitute a partnership, probably could not.⁵⁰

For the limited class of partnerships that fit the Section 761 profile, the election out of subchapter K can be made by attaching a statement to the partnership return.⁵¹ Alternatively, for a partnership that has U.S. source income, the election out is deemed made if the facts indicate that the owners intended not to be subject to subchapter K.⁵² A partnership that has no U.S. source income, and which would not otherwise be required to file a U.S. return,⁵³ nevertheless must

47. The allocation formula could be modified to disregard each company's overhead, salaries and other costs associated with trading, thus moving away from a profit allocation and closer to a mere sharing of revenues.

48. I.R.C. § 761(a) (West 1995); 26 C.F.R. § 1.761-2 (1996).

49. *Id.*

50. The global trading activity is the conduct of a business, is not for the joint production, extraction or use of property, and is not limited to the short-term marketing of a particular issue of securities. In addition, a global trading activity would be ineligible for the election out if its allocation formula requires an overall net income computation in order to determine each participant's share of profits.

51. 26 C.F.R. § 1.761-2(b)(2)(i) (1996).

52. *Id.* § 1.761-2(b)(2)(ii) (1996).

53. 26 C.F.R. §§ 1.6031-1(c), (d) (1996). Existing regulations state that a partnership which derives no U.S. source income and is not engaged in a trade or business within the United States generally is not required to file a return. *Id.* Under proposed regulations, however, this exemption would be limited to foreign partnerships, and therefore would not be available to a domestic partnership whether or not it has only foreign income and activities. 51 Fed. Reg. 3075, 3076 (1986). Even a foreign partnership with solely foreign income and activities would be required to file a return for any year in which at least 25% of any partnership item of income, gain, loss, deduction or credit is allocable (directly or indirectly) to a U.S. person or persons. 51 Fed. Reg. 3075, 3076 (1986). These proposed regulations respond to an off-Code provision (I.R.C. § 404) of the Tax Equity and Fiscal Responsibility Act of 1982, which states: "Except as hereafter provided in regulations prescribed by the Secretary of the Treasury or his delegate, nothing in I.R.C. § 6031 of the Internal Revenue Code of 1954 shall be treated as excluding any partnership from the filing requirements of such section for any taxable year if the income tax liability under subtitle A of such Code of any United States person is determined

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file (or have a U.S. partner file on its behalf) a partnership return in order to elect out under Section 761.⁵⁴ Several commentators have construed this rule to mean that the deemed Section 761 election is apparently not available to a partnership with only foreign operations and income.⁵⁵

Assuming that a valid Section 761 election out has been made or is deemed made, the election out is *not* effective for purposes outside of subchapter K.⁵⁶ Because most international tax provisions applicable to partnerships are not in subchapter K,⁵⁷ the Section 761 election has only limited effect on international aspects of U.S. taxation of the partnership, and its partners, when it is used to conduct a foreign business.⁵⁸

in whole or in part by taking into account (directly or indirectly) partnership items of such partnership for such taxable year." Pub. L. No. 97-248, § 404, 96 Stat. 324, 669. This statutory reference to regulations "hereafter" provided has created a considerable degree of confusion as to the continued viability of the rule of the existing regulations that partnerships with no U.S. income or activities need not file a U.S. return. The consequences of a failure to comply with the requirements of I.R.C. § 6031 can be severe. *See* I.R.C. § 6231(f) (West 1995), which disallows a partner's share of losses and credits in some circumstances.

54. 26 C.F.R. § 1.6031-1(d)(2) (1996). Existing 26 C.F.R. § 1.6031-1 provides exceptions from the requirements that a partnership return be filed for two classes of partnerships: partnerships electing exclusion from the partnership provisions of the Code under I.R.C. § 761(a) and partnerships that neither carry on any business in the United States nor derive any income from sources within the United States. Section 404 of TEFRA in effect nullified these exceptions in any case in which the tax liability of any United States person is affected by items flowing from a partnership. That section authorizes new regulations to provide exceptions from the filing requirement.

If a foreign partnership would not be required to file a partnership return but for the 25% rule discussed above, the draft regulations provide that the reporting requirements of paragraphs (a)(2) and (b) of proposed 26 C.F.R. § 1.6031-1, which relate to a specific partner or partners, apply only with respect to partners who are United States persons or pass-thru partners through which United States persons hold interests in the foreign partnership as indirect partners. Although the foreign partnership must report, for example, all items of gross income and all allowable deductions, it need not report the distributive shares of its partners other than for its partners who are United States persons or pass-thru partners through which United States persons are indirect partners.

55. *See, e.g.,* C. RUSSELL, *INCOME TAXATION OF NATURAL RESOURCES* § 10.06 (1990); *cf.* *Atlantic Veneer Corp. v. Commissioner*, 812 F.2d 158, 160 (4th Cir. 1987), (holding that a foreign partnership, which was not otherwise required to file a U.S. partnership return, nevertheless should have filed one (or a partner should have filed one for it) expressly to make an effective I.R.C. § 754 election to step up its basis with respect to the share of partnership assets of a U.S. purchaser of an interest in the partnership).

56. *See* *Cokes v. Commissioner*, 91 T.C. 222, 231 (1988); *Bryant v. Commissioner*, 46 T.C. 848, 864 (1966), *aff'd*, 399 F.2d 800 (5th Cir. 1968); *Rev. Rul. 65-118*, 1965-1 C.B. 30, 31; *but see* I.R.C. § 1031(a)(2) (West 1995) (stating that an interest in a partnership that has an I.R.C. § 761 election is treated, in effect, as an interest in the partnership's assets for purposes of I.R.C. § 1031).

57. The tax provisions for foreign business operations conducted through partnerships are discussed in Section IV.

58. Exclusion of eligible unincorporated organizations—

In general, an unincorporated organization may be excluded from the application of all or a part of the provisions of Subchapter K of Chapter 1 of the Code. Such organization must be availed of (i) for investment purposes only and not for the active conduct of a business, or (ii) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted. The members of such organization must be able to compute their income without the necessity of computing partnership taxable income. Any syndicate, group, pool, or joint venture which is classifiable as an association, or any group operating under an agreement which

D. Tax Avoidance Partnerships: Sham and Other Attacks

The preceding section analyzed the rules under which a partnership may be found to exist even though the parties never intended to form a partnership entity. Conversely, this section discusses a partnership established to exploit certain U.S. tax provisions which the IRS may attack as a sham or otherwise attempt to disregard or recharacterize so that the anticipated tax benefits are denied.⁵⁹

A partnership exists only if it is determined, considering all the facts, that "the parties in good faith . . . intended to join together in the present conduct of an enterprise."⁶⁰ This subjective test presents a significant problem.⁶¹ Although the question is an old one, recent developments in the corporate tax arena highlighted the fundamental issue of determining when a partnership exists. After the 1986 repeal of the *General Utilities* doctrine,⁶² extraordinary effort has been devoted to the creation of techniques designed to postpone (perhaps forever) corporate level tax on the gain from the disposition of appreciated assets. Some techniques involve the use of partnerships. The IRS indicates that it intends to attack a certain number of alleged partnership deals. Potentially the attack will take the form of an assertion that a partnership has not been formed, that one or more of the investors should not be treated as a partner for tax purposes, or that the partnership allocations do not meet the requirements of Section 704(b).⁶³ One variation of the post-1986 corporate tax minimization techniques involves the

creates an organization classifiable as an association, does not fall within these provisions. I.R.C. § 761 (West 1995).

59. For example, in *Badger Co. v. Commissioner*, 26 T.C.M. (CCH) 869 (1967), Japanese licensees withheld Japanese tax on royalty payments paid to another company which remitted one-half of the payments to the taxpayer. The taxpayer claimed a foreign tax credit for one-half of the withheld taxes, on the basis that there was a partnership between it and the company that received the payments from the Japanese licensees. The court disagreed, concluding that the taxpayer was merely an independent contractor receiving service income from the other company with no economic interest in the license payments or in the foreign tax withheld thereon.

60. *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949).

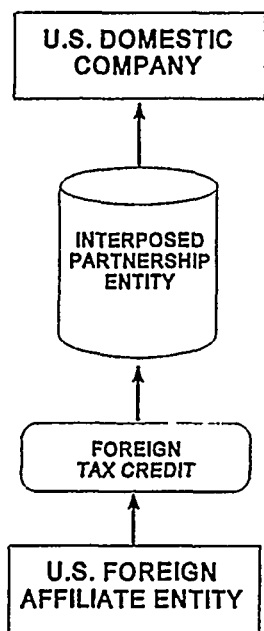
61. The boundary between partnerships and arrangements lacking sufficient jointness to be classified as partnerships is a shifting no-man's-land. The intensely factual character of this aspect of the partnership definition makes generalizations difficult.

62. Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, 2269.

63. Notice 90-56, 1990-2 C.B. 344. The Internal Revenue Service also indicated that, in the partnership context, it may determine that: (1) a true partnership has not been formed; (2) that one or more of the purported partners should not be treated as a partner for tax purposes; or (3) that the partnership allocations do not satisfy § 704(b). See also Rev. Rul. 89-85, 1989-2 C.B. 218 (stating that Subchapter K of the Code is a blend of the "aggregate" and "entity" treatment for partners and partnerships). Cf. § 751 of the Code with § 741 (stating that for purposes of interpreting provisions of the Code not contained in Subchapter K, a partnership also may be treated either as an aggregate of its partners or as an entity distinct from its partners). Cf. *Casel v. Commissioner*, 79 T.C. 424 (1982); *Madison Gas and Electric Co. v. Commissioner*, 72 T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980) (holding the treatment of partnerships in each context must be determined on the basis of countervailing factors applicable to such context). See H.R. Conf. Rep. No. 2453, 83rd Cong., 2d Sess. 59 (1954).

formation of a partnership between affiliated corporations.⁶⁴ The renewed interest in this technique implies that structures once in vogue among international tax planners for the attainment of foreign tax credit benefits⁶⁵ are still used to achieve worldwide tax minimization.

All members included in a U.S. affiliated group are bound by the group's election to file a consolidated tax return.⁶⁶ The filing of a consolidated return has significance for several international tax computations. For example, the election to deduct or credit foreign taxes must be made on a consistent basis for all members of the consolidated return group.⁶⁷ In addition, the group's Section 904 limitation is generally computed on a consolidated basis.⁶⁸ This consolidated computation creates an incentive to isolate foreign source losses in a corporation that was not a member of the consolidated return group. Thus, foreign losses would not reduce the group's Section 904 limitation, either directly or indirectly through resourcing of foreign income under Section 904(f).



Prior to 1989, some taxpayers interposed a partnership (or other entity not a domestic corporation) between the crediting group and the corporation that had foreign source losses. The loss corporation would not join in the U.S. affiliated group's consolidated tax return because Section 1504(a) requires that an affiliated group consist of a *direct* ownership chain between includable corporations, and a partnership is not considered an includable corporation.

Example Four: Domestic corporation DC has US\$100 of U.S. source income and US\$100 of foreign source loss. DC has paid no foreign taxes. DC's U.S. affiliates, which file a consolidated return with DC, have elected to credit foreign taxes, and have US\$100 of foreign (general basket) income on which they have paid US\$34 of foreign tax. If DC is a member of the consolidated return group, the

64. See Freeman, *Response to Loss Disallowance Rule: Partial Deconsolidation*, 47 TAX NOTES 1349, 1368-70 (June 11, 1990). See also Freeman, *Some Early Strategies for the Methodical Disincorporation of America After the Tax Reform Act of 1986: Grafting Partnerships Onto C Corporations, Running Amok with the Master Limited Partnership Concept, and Generally Endeavoring to Defeat the Intention of the Draftsmen of the Repeal of General Utilities*, 64 TAXES 962 (1986). For a summary of relevant pre-1987 law, see Stara, *Tax Problems in Forming a Partnership of Controlled Corporations*, 18 TAX ADVISER 12 (1987).

65. See, e.g., Michael Nelson, *An Analysis of Foreign Investment in the People's Republic of China in the Aftermath of the Sino-U.S. Tax Agreement*, 2 TRANSNAT'L LAW. 572 (1988).

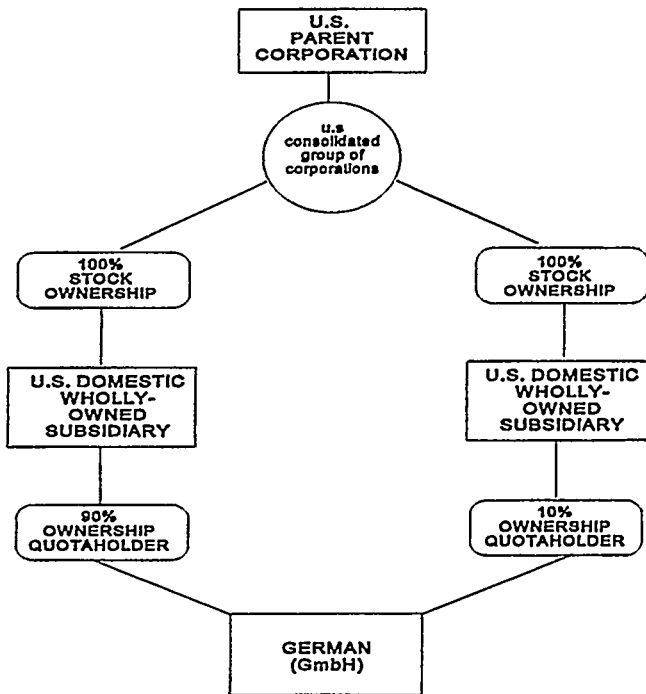
66. I.R.C. § 1501 (West 1995).

67. 26 C.F.R. § 1.1502-4(a) (1996).

68. *Id.* § 1.1502-4(d).

group has a Section 904 limitation of zero and, therefore, cannot claim a foreign tax credit. If the group interposes a partnership between it and DC, and if the interposed partnership is respected, the group can claim a US\$34 foreign tax credit.

For taxable years beginning after July 10, 1989, Section 904(i) provides regulatory authority to limit the use of deconsolidations as a foreign tax credit planning technique. The IRS can be expected to issue regulations preventing the taxpayer from obtaining a better Section 904 limitation through deconsolidation than it would have if the domestic corporations were members of the same consolidated return group.⁶⁹ In addition, IRS officials have indicated recently that they are scrutinizing the use of interposed partnerships as a deconsolidation technique, at least in the domestic context.⁷⁰



69. The interest expense allocation and apportionment rules of the regulations intend to perform an antideconsolidation function similar to that of I.R.C. § 904(I). 26 C.F.R. §§ 1.861-11T(d)(6), (g) (1996). Now that Congress has given the IRS regulatory authority to address the problem directly through I.R.C. § 904(I), consideration should be given to whether the I.R.C. § 861 antideconsolidation rules are redundant and could be cut back or even eliminated. Cf. 56 Fed. Reg. 27,907 (1991) (assessing the treatment of disaffiliated corporations under the "earnings stripping" provisions of I.R.C. § 163(j)).

70. *Consolidated Returns*, 37 Daily Tax Rep. (BNA), Feb. 25, 1991, at G-7, G-8 (comments of Edward Cohen, a branch chief in the Internal Revenue Service Office of Assistant Chief Counsel (Corporate)).

Even after the enactment of Section 904(I), the ability to form a partnership between affiliates remains of interest as a tax planning technique.⁷¹ In an important ruling addressed to this issue,⁷² two domestic, wholly-owned subsidiaries of a U.S. parent corporation (a U.S. consolidated group of corporations) formed a German GmbH, with one of the domestic subsidiaries owning ninety percent and the other owning ten percent of its quotas (shares). The GmbH's memorandum of association provided that it would be dissolved by the death, insanity, or bankruptcy of any quotaholder, and that a quotaholder's interest in the GmbH could not be transferred without the prior written approval of all quotaholders.

Under the Section 7701 regulations, the GmbH cannot have more corporate than noncorporate characteristics (since it would lack continuity of life and free transferability of interests). So, the GmbH would be classified as a partnership. An IRS ruling took the analysis one step further, however, by noting that the two quotaholders in this case were owned by the same parent.⁷³ Thus, reasoned the ruling, the controlling parent could make all the transfer decisions for its wholly-owned subsidiaries despite any provisions in the memorandum of association that might indicate otherwise.⁷⁴ Similarly, if an event of dissolution such as the bankruptcy of a quotaholder should occur, the ruling reasoned that there were no separate interests to compel dissolution pursuant to the provisions of the memorandum of association.⁷⁵ Applying this "separate interests analysis" to look behind the legal rights and obligations of the quotaholders (as set forth in the memorandum of association) and consider the nature of their relationship (based on their common ownership) instead, the ruling concluded that the GmbH did, in fact, possess the corporate characteristics of free transferability and continuity of life.⁷⁶ Since the GmbH also had limited liability and centralized management, it was classified as an association taxable as a corporation.

Within months after the publication of Revenue Ruling 77-214, the IRS issued a series of private rulings under which foreign entities within the control of a single economic interest were classified not as partnerships or corporations, but surprisingly, as branches. Apparently, the theory was that ownership by a single economic interest meant there were no associates. Thus an essential characteristic of both a partnership and a corporation was lacking.⁷⁷ Within a few

71. Consider, for example, the use of intragroup partnerships as a *General Utilities* avoidance technique and the use of partnerships as a means of making source-based special allocations of income between the worldwide members of an affiliated group.

72. Rev. Rul. 77-214, 1977-1 C.B. 408.

73. *Id.* at 409.

74. *Id.*

75. *Id.*

76. *Id.*

77. Priv. Ltr. Rul. 78-02-012 (Oct. 11, 1977); Priv. Ltr. Rul. 77-48-038 (Aug. 31, 1977); Priv. Ltr. Rul. 77-47-083 (Aug. 26, 1977); Priv. Ltr. Rul. 77-43-077 (July 29, 1977); Priv. Ltr. Rul. 77-43-060 (July 28, 1977).

more months, the rulings were all revoked and the IRS instead decided that the foreign entities were classified as corporations for U.S. tax purposes based on the separate interests analysis of Revenue Ruling 77-214.⁷⁸ Still later, the IRS further modified the rulings because taxpayers, thinking that their foreign entities were branches (in reliance on the original rulings), failed to obtain rulings that outbound transfers of property to foreign entities lacked a tax avoidance purpose (as then required under Section 367(a) for tax-free outbound transfers of property to foreign corporations). Thus, the IRS issued one more batch of rulings, granting a grace period before the corporate classification of foreign entities would become effective.⁷⁹ Practitioners and commentators reacted with a predictable combination of amusement and confusion.⁸⁰ Meanwhile, the IRS reconsidered the wisdom of its application of separate interests analysis.⁸¹ Its reconsideration continues today.

The separate interests analysis of Revenue Ruling 77-214 should be contrasted with a revenue ruling involving domestic entities published less than three years earlier and another published a few years later. In the earlier Revenue Ruling 75-19,⁸² four domestic wholly owned subsidiaries of a U.S. parent corporation entered into a joint business arrangement under a statute that corresponded to the Uniform Partnership Act. Citing the Section 7701 regulations, and without looking behind the legal relationship of the parties as established by that statute, the ruling concluded that the arrangement was a partnership.⁸³ Although Revenue Ruling 75-19 was still outstanding at the time that Revenue Ruling 77-214 was published, the latter made no attempt to explain why the former failed to apply a separate interests analysis to classify the arrangement as a corporation. In the later Revenue Ruling 83-156,⁸⁴ a domestic corporation

78. Priv. Ltr. Rul. 78-06-062 (Nov. 11, 1977); Priv. Ltr. Rul. 78-06-058 (Nov. 11, 1977); Priv. Ltr. Rul. 78-06-057 (Nov. 11, 1977); Priv. Ltr. Rul. 78-06-056 (Nov. 11, 1977); Priv. Ltr. Rul. 78-06-055 (Nov. 11, 1977).

79. Priv. Ltr. Rul. 78-21149 (Feb. 28, 1978); Priv. Ltr. Rul. 78-21-147 (Feb. 28, 1978); Priv. Ltr. Rul. 78-21-143 (Feb. 28, 1978); Priv. Ltr. Rul. 78-21-142 (Feb. 28, 1978); Priv. Ltr. Rul. 78-21-134 (Feb. 28, 1978); Priv. Ltr. Rul. 78-21-125 (Feb. 28, 1978).

80. See Nelson, *supra* note 65, at 572.

81. See G.C.M. 37859 (Feb. 16, 1979).

82. Rev. Rul. 75-19, 1975-1 C.B. 382. Partnership arrangement among corporations; tax classification. A partnership formed under a statute corresponding to the Uniform Partnership Act by a domestic corporation's four domestic subsidiaries, each with business reasons for independent existence outside the partnership, for the purpose of purchasing a crude oil storage barge and chartering it to an unrelated corporation, and not to avoid tax, is classified as a partnership.

83. *Id.* at 383.

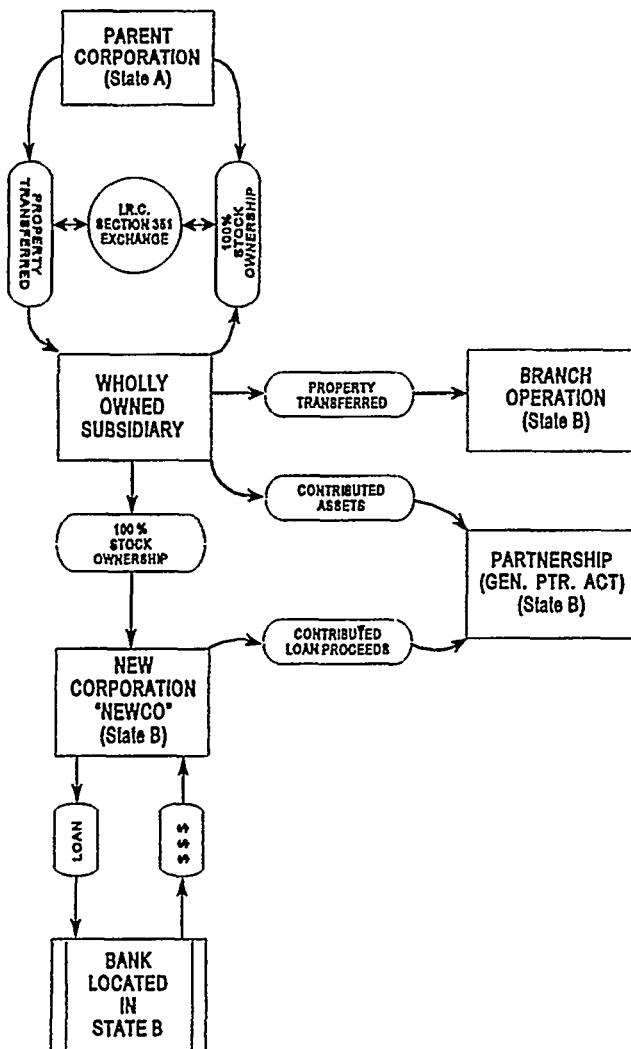
84. Rev. Rul. 83-156, 1983-2 C.B. 66.

P corporation and its wholly owned subsidiary, S-1, are incorporated in state A. State A has advantageous corporate laws. P transferred to S-1 certain property with which S-1 set up a branch operation in state B. No liabilities of P were assumed by S-1 and the assets transferred were not subject to liabilities. In order for the branch operation to avail itself of financing at favorable interest rates under the laws of state B, S-1 formed a new corporation (Newco) in state B. Newco borrowed the necessary operating funds from a bank in state B. Then, as part of the same plan,

Newco and S-1 established a partnership (PRS) formed under a statute of state B corresponding to the Uniform Partnership Act, to which Newco contributed the borrowed funds and S-1 contributed the assets it received from P. PRS conducted the business of the state B branch operation under the sole management of S-1.

Section 351(a) of the Code provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control (as defined in I.R.C. § 368(c)) of the corporation. Section 368(c) defines the term "control" to mean the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. I.R.C. § 351(a) (West 1995).

In Rev. Rul. 77-449, 1977-2 C.B. 110, a corporation transferred assets to a wholly owned subsidiary, which in turn transferred, as part of the same plan, the same assets to its own wholly-owned subsidiary.



formed a wholly-owned domestic subsidiary. As part of the same plan, the two corporations formed a partnership under a statute corresponding to the Uniform Partnership Act and contributed assets to the partnership. The partnership conducted its business under the sole management of the first corporate partner. The revenue ruling held, in part, that the contribution of assets to the partnership satisfied the requirements of Section 721.⁸⁵ To reach this holding, the ruling must have concluded that the partnership was to be respected (since Section 351 would have applied if the partnership were classified as a corporation under a separate interests analysis). Revenue Ruling 83-156 made no mention of Revenue Ruling 77-214.⁸⁶

transfers were viewed as separate transactions, each of which satisfied the requirements of I.R.C. § 351. I.R.C. § 351 (West 1995). Under the circumstances described above, the transfers are also viewed separately.

Because the transfer from P to S-1 satisfies the requirements of I.R.C. § 351, and the contributions by S-1 and Newco to PRS satisfy the requirements of I.R.C. § 721, no gain or loss is recognized by the transferors. I.R.C. §§ 351, 721 (West 1995).

85. See *supra* note 84 and accompanying text.

86. Rev. Rul. 75-19 and 83-156, dealing with partnerships formed under a statute corresponding to the Uniform Partnership Act, the IRS may have felt constrained by its regulations, which state that such a partnership lacks the corporate characteristics of continuity of life and centralized management. See 26 C.F.R. § 301.7701-2(b)(3) (1996). An agreement establishing an organization may provide that the organization is to continue for a stated period or until the completion of a stated undertaking or such agreement may provide for the termination of the organization at will or otherwise. In determining whether any member has the power of dissolution, it will be necessary to examine the agreement and to ascertain the effect of such agreement under local law. For example, if the agreement expressly provides that the organization can be terminated by the will of any member, it is clear that the organization lacks continuity of life. However, if the agreement provides that the organization is to continue for a stated period or until the completion of a stated transaction, the organization has continuity of life if the effect of the agreement is that no member has the power to dissolve the organization in contravention of the agreement. Nevertheless, if, notwithstanding such agreement, any member has the power under local law to dissolve the organization, the organization lacks continuity of life. Accordingly, a general partnership subject to a statute corresponding to the Uniform Partnership Act and a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act both lack continuity of life.

26 C.F.R. § 301.7701-2(c)(4) under which there is no centralization of continuing exclusive authority to make management decisions, unless the managers have sole authority to make such decisions. 26 C.F.R. § 301.7701-2(c)(4) (1996). For example, in the case of a corporation or a trust, the concentration of management powers in a board of directors or trustees effectively prevents a stockholder or a trust beneficiary, simply because he is a stockholder or beneficiary, from binding the corporation or the trust by his acts. However, because of the mutual agency relationship between members of a general partnership subject to a statute corresponding to the Uniform Partnership Act, such a general partnership cannot achieve effective concentration of management powers and, therefore, centralized management. Usually, the act of any partner within the scope of the partnership business binds all the partners; and even if the partners agree among themselves that the powers of management shall be exclusively in a selected few, this agreement will be ineffective as against an outsider who had no notice of it. In addition, limited partnerships subject to a statute corresponding to the Uniform Limited Partnership Act, generally do not have centralized management, but centralized management ordinarily does exist in such a limited partnership if substantially all the interests in the partnership are owned by the limited partners. Furthermore, if all or a specified group of the limited partners may remove a general partner, all the facts and circumstances must be taken into account in determining whether the partnership possesses centralized management. A substantially restricted right of the limited partners to remove the general partner (e.g., in the event of the general partner's gross negligence, self-dealing, or embezzlement) will not itself cause the partnership to possess centralized management.

The U.S. government asserted a separate interests analysis in one litigated case. In *MCA Inc. and Universal City Studios, Inc. v. United States*,⁸⁷ twenty-nine distributorships were each owned ninety-five percent by a Netherlands corporation (CIC) and five percent by an employee trust (Stichting).⁸⁸ Stichting, in turn, had been created by the two corporate owners of CIC for the benefit of CIC's top directors. In part, the issue was whether the twenty-nine distributorships were properly classified as partnerships (as asserted by the taxpayer) or as corporations (as asserted by the government). The government argued that CIC and Stichting were under common control, their interests in the distributorships were therefore identical, and under the principles of Revenue Ruling 77-214, the corporate characteristics of continuity of life and free transferability were therefore present notwithstanding the partnership agreement to the contrary.⁸⁹ These characteristics, in combination with other characteristics of the distributorships, resulted in their classification as corporations. The district court agreed with the government's separate interests analysis,⁹⁰ but the Ninth Circuit reversed.⁹¹ The Ninth Circuit observed that the fiduciary duties of the of Stichting's trustees would prevent them from necessarily being under common control with CIC; and that in the absence of common control, the facts did not present the prerequisite identity of interests for the government's separate interests analysis.⁹² It is important to note, however, that by finding a lack of common control, the Ninth Circuit never addressed the classification of an entity whose owners did have the identity of interests asserted by the government in Revenue Ruling 77-214.

87. 685 F.2d 1099 (9th Cir. 1982), *rev'g* 502 F. Supp. 838 (C.D. Cal. 1980).

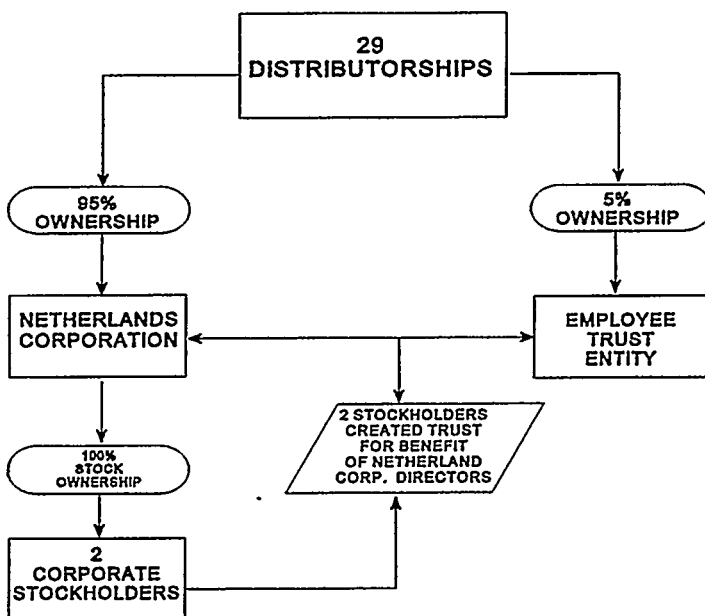
88. 685 F.2d at 1101. Stichting itself owned its interests in the ventures through a 100% owned foreign corporation (Proteus). *Id.* at 1101 n.1. The references to Stichting include Proteus where appropriate.

89. *Id.* at 1102.

90. 502 F.Supp. 838 (C.D. Cal. 1980).

91. 685 F.2d 1099 (9th Cir. 1982).

92. *Id.* at 1104.



The U.S. government also asserted that entity classification regulations under Section 7701 were written with domestic entities rather than foreign entities in mind, and therefore, should be applied differently to the latter. The Ninth Circuit summarily rejected this interesting argument, noting that the regulations prescribe a mechanical and formalistic test which permits taxpayers to select a form of business organization with certainty about the attendant tax consequences. As the court stated, “[i]f the test has proven unsatisfactory, or if the Commissioner determines that the test should not apply to foreign entities, the Commissioner is free to promulgate a new regulation that taxpayers can rely on in planning their foreign business ventures.”⁹³

In the aftermath of judicial consideration of Revenue Ruling 77-214 in *MCA*, the IRS issued another series of private rulings that implicitly ignore separate interests analysis on facts to which it potentially could have applied.⁹⁴ Recent

93. The IRS has apparently (and correctly) adopted a straightforward application to the I.R.C. § 7701 entity classification regulations without regard to whether the entity in question is foreign or domestic.

94. See Priv. Ltr. Rul. 93-49-006 (June 11, 1993), Priv. Ltr. Rul. 91-31-057 (May 8, 1991), Priv. Ltr. Rul. 91-03-033 (Oct. 23, 1990), and Priv. Ltr. Rul. 91-22-074 (Mar. 6, 1991) (societe en nom collectif classified as a partnership when its interests were owned by two members of a U.S. affiliated group); Priv. Ltr. Rul. 91-32-054 (May 14, 1991); Priv. Ltr. Rul. 90-01-018 (Oct. 6, 1989).

Priv. Ltr. Rul. 93-49-006: Before 1991, a domestic corporation and common parent of a consolidated group that included four subsidiaries owned all the stock of the subsidiaries (S1, S2, S3, and S4). In 1991, the parent corporation transferred the stock of S3 to S1 and the stock of S4 to S2. S1 then transferred stock it owned in a French corporation (FS1) to S3, and S2 transferred the stock of another French corporation (FS2)

to S4. No transferor received stock in exchange for stock. Lastly, S3 transferred the stock of FS1, and S4 transferred the stock of FS2, to a French partnership (FP), in which S3 and S4 each owned 50% shares.

Under I.R.C. § 1492(2)(B), the parent elected, in lieu of paying the § 1491 excise tax, to apply principles similar to those in I.R.C. § 367 to the transfers of FS1 and FS2 to FP; S3 and S4 each entered a 10-year gain recognition agreement for the 1991 tax year, as provided in Priv. Ltr. Rul. 91-22-074. *Id.*

Currently, FP owns all the stock of FS1, FS2, and FS3 directly. In order to consolidate business operations, the domestic parent corporation wants to merge FS2 and FS3 into FS1. The parent has proposed to have FP transfer the stock of FS2 and FS3 to FS1, followed by the liquidation of FS2 and FS3 into FS1. *Id.*

The IRS has ruled that if the transfers qualify as a "D" reorganization, 26 C.F.R. §§ 7.367(b)-7(a), (b) and 26 C.F.R. § 7.367(b)-9 will apply to FP's exchange of FS2 and FS3 stock for FS1 stock and the transfers will be nontaxable under I.R.C. § 1492; 26 C.F.R. §§ 7.367(b)-7(a), (b), 7.367(b)-9 (1996). The IRS further ruled that if S3 and S4 each submit with their return a gain recognition agreement substantially in the form set forth in the ruling, S3 and S4 will not recognize gain under the 1991 gain recognition agreement.

Priv. Ltr. Rul. 91-31-057: A domestic corporation is the parent of a wholly owned domestic subsidiary and a foreign subsidiary, which was formed under the foreign nation's laws as a "Societe Anonyme" (S.A.). To comply with the laws of the country, six individuals each own a share in the foreign subsidiary. The remaining shares, representing a 99.76% interest, are owned by the domestic corporation.

The domestic subsidiary owns 95% and the foreign subsidiary owns 5% of a company organized in the foreign country as a "Societe en Nom Collectif." The two subsidiaries formed the company to own real property, to construct a warehouse and distribution facility, and to collect rent from the facility in the foreign country. This will result in minimizing any future real estate transfer taxes in the nation should the real property ever be sold.

The IRS has ruled that the Societe en Nom Collectif will qualify as a partnership for U.S. federal income tax purposes. Citing Rev. Rul. 73-254, 1973-1 C.B. 613, the IRS said that in classifying the foreign business the local law of the foreign jurisdiction must be applied in determining the legal relationship of the members or the organization. Further, citing the articles behind the Societes en Nom Collectif, the IRS ruled that the foreign business would lack the corporate characteristics of limited liability and continuity of life.

Priv. Ltr. Rul. 91-22-074: A domestic parent corporation's consolidated group includes four wholly owned domestic subsidiary corporations. Two of the domestic subsidiaries each wholly owns a foreign subsidiary in the same country. The other two domestic subsidiaries own 50% of a foreign organization in that country. The foreign organization owns a third foreign subsidiary. To consolidate its ownership of the three foreign subsidiaries, the domestic parent proposes a transaction by which the foreign organization will acquire the stock of the two foreign subsidiaries that it currently does not own.

The parent will transfer stock of the two domestic subsidiaries with an interest in the foreign organization each to one of the other domestic subsidiaries. Those other two subsidiaries will then transfer their stock in their wholly owned foreign subsidiaries each to one of the domestic subsidiaries with an interest in the foreign organization; this stock will then be transferred to the foreign organization.

The IRS has ruled that, based only on the information provided it by the consolidated group, the foreign organization is a partnership for federal income tax purposes. In addition, the IRS ruled that provided the two domestic subsidiaries, which continue as partners of the foreign partnership, each elect on Form 926 to apply principles similar to the principles of I.R.C. § 367, those two domestic subsidiaries will not be subject to tax under I.R.C. § 1491 on the transfer of property by a domestic corporation to a foreign partnership. In addition, the ruling contains a gain recognition agreement that must be substantially followed and submitted by the two domestic-partner corporations.

Interestingly, in connection with a 1979 private letter ruling, Priv. Ltr. Rul. 79-34-096 (May 24, 1979), the IRS considered the potential applicability of Revenue Ruling 77-214 to the classification of a societe en nom collectif, but closed out the consideration for undisclosed reasons (although the reconsideration of Revenue Ruling 77-214 continued). *See also* Priv. Ltr. Rul. 90-47-020 (withdrawn) (classifying a domestic entity as a partnership based in part on a lack of free transferability of interests, even though the foreign corporate owner of approximately a 99% direct interest in the entity also owned the remained interest in the entity indirectly through a corporate subsidiary; ominously, the IRS has withdrawn this ruling without comment); *but see* Priv. Ltr. Rul. 89-08-035 (Nov. 28, 1988) (whose classification of a foreign unlimited liability company as an association taxable as a corporation seems to have taken into account the common

comments by IRS officials indicate that Revenue Ruling 77-214 remains under reconsideration.⁹⁵ The difficulty faced by the IRS is that, at its most fundamental level, Revenue Ruling 77-214 threatens to expose the shaky foundation upon which the U.S. entity classification regime is built. In applying a separate interests analysis, the ruling attempts to look behind the legal relationship of the venturers and examine their true economic relationship. This emphasis on economic substance is misplaced in the context of entity classification, however, because the rules for taxation of partnerships as compared to corporations are themselves arbitrary and have little dependence on the economics of the relationship.⁹⁶ In such an environment, a determination of "substance" when classifying an entity is illusory.

Where substance is necessarily lacking, the goal should be certainty as to which regime applies (as suggested the *MCA* court's response to the government's argument that the Section 7701 regulations ought to be interpreted differently for foreign entities than for domestic ones).⁹⁷ The use of a separate interests analysis does not serve the goal of certainty since it disregards the legal relationships established by the parties and local law in favor of a judgmental examination of factual relationships akin to Section 482. In contrast, a mechanical application of the regulatory test for entity classification respects these legal relationships. A mechanical application does not attempt to speculate whether the parties' interests are sufficiently adverse so that legal rights and obligations will actually be enforced. As discussed in the remainder of this article, substantive tax rules applicable to a foreign joint venture depend to a great extent on how the venture is classified for U.S. tax purposes. In order to promote certainty regarding the tax consequences of conducting international business through foreign joint ventures, the separate interests analysis should be abandoned and Revenue Ruling 77-214 should be revoked.

A more lasting and satisfying solution to the entity classification problem would be to move the U.S. tax system further in the direction of reducing the disparities between the taxation of joint ventures classified as corporations and those classified as partnerships. Full consistency between the two regimes will have to await monumental developments, such as the integration of corporate and shareholder level taxes. In the meantime, however, even if the U.S. domestic tax regimes for corporations and for partnerships remain largely inconsistent, special considerations in the international context justify aggressively moving toward

control of the members, although the ruling did not cite Revenue Ruling 77-214).

95. See Evans & Sheppard, *Internal Revenue Service to Close Passive Loss Loophole, Review State Partnership Laws*, 46 TAX NOTES 1113, 1114 (Mar. 5, 1990) (comments of William O'Shea, a branch chief in the Internal Revenue Service Office of Assistant Chief Counsel (Passthroughs and Special Industries)).

96. See I.R.C. §§ 1361-1379 (West 1995). The best illustration of this arbitrariness is the subchapter S election, which permits a qualified corporation to choose whether to be taxed as a corporation or under a regime similar to that for partnerships, with no change in the nontax economic relationship of the parties. *Id.*

97. *MCA Inc. & Universal Studio, Inc. v. U.S.*, 685 F.2d 1105 (9th Cir. 1982).

consistency for foreign joint ventures.⁹⁸ This article⁹⁹ offers specific suggestions to conform the treatment of partnership and corporate foreign joint ventures and to tax each in a more rational matter. The adoption of these suggestions will allow tax considerations to play a less dominant role in the process of determining how the venture is structured and operated, thereby enhancing the efficiency of joint ventures through which U.S. investors compete in the worldwide business arena.

III. FOREIGN JOINT VENTURES THROUGH CORPORATIONS

Entity classification is a crucial, and initial step in analyzing the tax treatment of a foreign joint venture. This section discusses some of the difficult issues that arise if the venture is considered a corporation for U.S. tax purposes. Partnership joint ventures are considered in the next section.

A. Formation of Venture

The formation of a foreign corporate joint venture often involves outbound Section 351 property transfers subject to Section 367(a).¹⁰⁰ In addition, an outbound Section 351 transfer of intangible property is subject to the harsh rules of Section 367(d).¹⁰¹ The need to avoid Section 367(d) often compels the U.S.

98. For example, in *United States v. Goodyear Tire & Rubber Co. and Affiliates*, 493 U.S. 132 (1989), the Supreme Court reaffirmed the U.S. tax policy that the foreign tax credit provisions of the Code should be construed in a manner that minimizes the significance of whether the taxpayer chooses to conduct foreign operations through a branch or a foreign corporate subsidiary. For this purpose, a partnership would be analogous to a branch, so the policy should apply with equal force to the need to reduce disparities between the treatment of foreign partnerships and foreign corporate joint ventures.

99. See *infra* Section V.

100. For example, in *United States v. Goodyear Tire & Rubber Co. and Affiliates*, 493 U.S. 132 (1989), the Supreme Court reaffirmed the U.S. tax policy that the foreign tax credit provisions of the Code should be construed in a manner that minimizes the significance of whether the taxpayer chooses to conduct foreign operations through a branch or a foreign corporate subsidiary. For this purpose, a partnership would be analogous to a branch, so the policy should apply with equal force to the need to reduce disparities between the treatment of foreign partnerships and foreign corporate joint ventures.

101. This section provides rules under I.R.C. § 367(d) concerning transfers of intangible property by U.S. persons to foreign corporations pursuant to I.R.C. §§ 351 or 361. Paragraph (b) of this section specifies the transfers that are subject to I.R.C. § 367(d) and the rules of this section, while paragraph (c) provides rules concerning the consequences of such a transfer. In general, the U.S. transferor will be treated as receiving annual payments contingent on productivity or use of the transferred property, over the useful life of the property (regardless of whether such payments are in fact made by the transferee). Paragraphs (d), (e), and (f) of this section provide rules for cases in which there is a later direct or indirect disposition of the intangible property transferred. In general, deemed annual license payments will continue if a transfer is made to a related person, while gain must be recognized immediately if the transfer is to an unrelated person. Paragraph (g) of this section provides several special rules, including a rule allowing appropriate adjustments where deemed payments under I.R.C. § 367(d) are not in fact received by the U.S. transferor of the intangible property, and a rule providing for a limited election to treat certain transfers of intangible property as sales at fair market value (in lieu of applying the general useful life-contingent payment rule). In addition, paragraph (g) of this section provides rules coordinating the application of I.R.C. § 367(d) with other relevant Code sections.

transferor to restructure the manner in which the venture obtains the use of intangibles. For example, the transferor may separately license the intangibles, rather than contribute them to the venture. Issues raised by each of these and related categories of transactions are discussed below.

1. Section 367(a) Transfers

An asset generally may be transferred tax free to a newly formed foreign corporate joint venture in a Section 351 exchange if the asset will be used by the venture in the active conduct of a trade or business outside the United States.¹⁰² The test is applied on an asset-by-asset basis. Thus, even if the taxpayer establishes the existence of an active trade or business, it also must show that the particular asset in question will be used in that trade or business.¹⁰³

Certain categories of assets (inventory, accounts receivable, foreign currency denominated instruments, and certain leased property) are not eligible for the active trade or business rule.¹⁰⁴ The nonrecognition rule may also be overridden in cases where: (1) the transferred assets are part of a foreign branch that has incurred losses;¹⁰⁵ (2) the taxpayer has an overall foreign loss¹⁰⁶ or separate limitation loss;¹⁰⁷ (3) the assets are transferred pursuant to an outbound corporate reorganization to which Section 361 applies.¹⁰⁸

Paragraph (h) of this section defines the term "related person" for purposes of this section. Finally, paragraph (i) of this section provides the effective date of this section for rules concerning transfers of intangible property pursuant to I.R.C. § 332.

102. I.R.C. § 367(a)(3)(A) (West 1995).

103. 26 C.F.R. § 1.367(a)-2T(b)(5) (1996).

104. See I.R.C. § 367(a)(3)(B) (West 1995); 26 C.F.R. § 1.367(a)-5T (1996).

105. I.R.C. § 367(a)(3)(C) (West 1995).

106. *Id.* § 904(f)(3).

107. *Id.* § 904(f)(5).

108. *Id.* § 367(a)(5). In the case of a transferor corporation that is at least 80% controlled by five or fewer domestic corporations, the gain recognition rule of I.R.C. § 367(a)(5) does not apply, but the IRS will impose special adjustments to the basis that the exchanging shareholders take in the stock of the transferee foreign corporation. See also Priv. Ltr. Rul. 91-11-033 (Dec. 17, 1990), in which a domestic corporation is the common parent of a consolidated group. The corporation's second-tier domestic subsidiary has been managed and controlled in a foreign country since its incorporation and is a "dual resident corporation" subject to I.R.C. § 1503(d). The dual-resident corporation owns all of the stock of the parent of the group's controlled foreign corporations (CFCs). *Id.*

A first-tier domestic subsidiary of the group's parent will incorporate a new foreign subsidiary to which it will contribute all of the stock of the dual-resident corporation. The dual-resident corporation will then transfer all of its assets, including the stock of the corporation that holds all of the CFC stock, to the new foreign subsidiary.

The IRS has ruled, citing Rev. Rul. 87-27, 1987-1 C.B. 134, that the transaction will be treated as a transfer of the assets of the dual-resident corporation to the new foreign corporation in exchange for all of the new corporation's stock, followed by a liquidating distribution by the dual-resident corporation of the stock in the new corporation. The transaction, the IRS ruled, will, thus, constitute a mere change in form of the dual-resident corporation and will qualify as a reorganization under I.R.C. § 368(a)(1)(F).

Outbound transfers of stock are subject to Section 367(a) rules that are entirely distinct from the asset transfer regime. Although a complete description of the Section 367 stock transfer rules is beyond the scope of this article, certain aspects of the regime are of special interest in the joint venture context. If the U.S. transferor owns at least five percent of the vote or value of the venture after the transfer, the stock transfer is tax free only if the transferor enters into a gain recognition agreement.¹⁰⁹ These rules, which permit tax-free treatment for the outbound transfer of stock subject to the necessity of entering into a gain recognition agreement, in some instances are overridden by gain recognition rules. For example, if stock of a domestic corporation is transferred and the U.S. transferor owns more than fifty percent of the vote or value of the venture per Section 958 after the transfer, the transfer is taxable, notwithstanding any other exception.¹¹⁰

2. Transfers of Intangibles

A foreign joint venture often is formed for the purpose of exploiting intangible property owned by one of the venturers. There are many ways to make the intangibles available to the venture. These include: contribution of the intangibles to the venture, sale, license or other contractual arrangement. A discussion of these vehicles must begin, however, with the problem of categorization.

Before the 1980s, a U.S. venturer could generally transfer intangible property to a foreign corporation in exchange for stock of the transferee in a Section 351 transaction without the recognition of gain or loss.¹¹¹ The IRS would sometimes attack these transactions by asserting that the interests transferred were not "property," and therefore did not qualify for Section 351 nonrecognition. When contested by taxpayers, these attacks were often not sustained by the courts. But,

109. The term of the gain recognition agreement is five or ten years, depending on whether U.S. transferors in the aggregate own at least 50% (by vote or value) of the venture after the transfer. 26 C.F.R. § 1.367(a)-3T (1996); see Rev. Rul. 92-86 1992-2 C.B. 199.

Moreover, for purposes of I.R.C. § 351(a), DX is considered to own the stock owned by other members of the consolidated group of which DX is a member. 26 C.F.R. § 1.1502-34 (1996). Thus, DX is considered to "control" FX for purposes of I.R.C. § 351, and the contribution of the FY stock to FX qualifies as a transfer to a controlled corporation under I.R.C. § 351(a). Because DX is a United States person and FX is a foreign corporation, the transfer under I.R.C. § 351 is also subject to I.R.C. § 367(a). See I.R.C. § 367(a) (West 1995); Rev. Rule 87-85, 1987-2 C.B. 395 (outlining requirements applicable to such transfers); see also 56 Fed. Reg. 41993 (1991) (discussing proposed Treas. Reg. 1.367(a)-3).

110. Notice 87-85, 1987-2 C.B. 395. This gain recognition rule is intended to make it more difficult to achieve the disaffiliation benefits described in Section II.D, *supra* through the interposition of a foreign corporation between members of a U.S. affiliated group. Subsequent changes in the law, such as the enactment of I.R.C. § 904(f), have made this disaffiliation unattractive, and have, therefore, reduced the need for or relevance of the gain recognition rule. As a result, when final § 367(a) regulations are adopted, the rule should be eliminated. *But see* 56 Fed. Reg. 41,993 (1991) (which maintains a gain recognition rule in such instances).

111. See Rev. Proc. 68-23, 1968-1 C.B. 821, 823-25 (which sets forth the IRS guidelines to be used to determine which outbound I.R.C. § 351 property transfers nevertheless would be subject to gain recognition or the payment of a "toll charge" as a condition for nonrecognition treatment).

the IRS has not acquiesced in many of these judicial pronouncements.¹¹² As a result, there is an internal body of inconsistent guidance from the courts and the IRS as to what factors distinguish a license from a sale or other transfer of intangibles.¹¹³ Further complicating the analysis in the international context, statutory changes adopted in the 1980s, such as the enactment of Sections 367(d) and 865 have produced a regime where a license often achieves tax-favored treatment, as compared to a contribution or sale of intangibles.¹¹⁴ In a sense, the parties have switched sides. The taxpayer may argue for license characterization while the IRS attempts to treat the transaction as a transfer of property. The potential for conflict and uncertainty will persist as long as economically similar transactions are taxed differently and commentators have argued that the applicable tax rules for the various categories of intangibles transactions should, therefore, be conformed.¹¹⁵ Until such a suggestion is adopted, much continues to depend on whether the taxpayer's characterization of the transaction is respected by the IRS (or by the courts if litigated.) The following description of the applicable tax rules should be read with an eye toward potential tax implications if the taxpayer's characterization is not upheld.¹¹⁶

a. Section 367(d) Transfers

A U.S. venturer owning intangible property may be inclined, as a business matter, to contribute the intangibles in exchange for stock of the venture. Such a transaction, described in Sections 351 or 361, would be subject to Section 367(d) rather than Section 367(a).¹¹⁷ The U.S. transferor in a Section 367(d) transfer is

112. See *E.I. Du Pont de Nemours & Co. v. United States*, 471 F.2d 1211 (Ct. Cl. 1973) (in which the U.S. transferor granted to the foreign transferee a *nonexclusive* right to exploit certain French patents, and the transferor received stock in the transferee in lieu of royalties). The IRS asserted that the transfer did not qualify for nonrecognition because the stock was not received in exchange for property. *Id.* at 1213. The court rejected this argument, stating that the term "property" generally is to be construed broadly in the tax law unless the particular context requires a narrow construction, and that, in the context of I.R.C. § 351, it would include the nonexclusive rights granted to the foreign transferee. *Id.* at 1218.

113. See Gosain, *How to Structure Outbound Transfers Under I.R.C. § 367*, in *U.S. TAX'N OF INT'L OPERATIONS 7551-7580* (1995).

114. For a comprehensive discussion of pre-1980's law, see Gosain, *supra* note 113, at 7551.

115. *Id.*

116. Note that the manner in which a transaction is characterized for domestic tax purposes may not control its characterization for source or other international tax purposes. *AMP, Inc. v. United States*, 492 F. Supp. 27, 33-35 (M.D. Pa. 1979).

117. I.R.C. § 367(a)(3)(B)(iv),(d)(1) (West 1995). "Intangible property" for purposes of I.R.C. § 367(d) is defined by cross reference to § 936(h)(3)(B), which definition was itself based on the definition contained in the I.R.C. § 482 regulations. See 26 C.F.R. § 1482-2A(d)(3) (1993). This broad definition includes not only patents and copyrights, but also contracts, customer lists, know-how, technical data and many other items that one would not normally consider "intellectual" property. *Id.* The scope of the term is limited under I.R.C. § 936(h)(3)(B), however, if such property has a substantial value apart from an individual's services. *Id.* In addition, the I.R.C. § 367(d) regulations exclude intangibles that consist of foreign goodwill or going concern value (although it should be noted that categorizing goodwill or going concern value as "foreign" or "domestic"

generally treated as having sold the intangibles to the venture in exchange for annual payments that are contingent on the productivity, use or disposition of the intangibles by the venture.¹¹⁸ These deemed payments are to be “commensurate with the income attributable to the intangibles.”¹¹⁹

Amounts included in gross income by reason of Section 367(d) are treated as ordinary U.S. source income.¹²⁰ The U.S. source treatment virtually compels most taxpayers to structure their intangibles transfers so that they are not subject to Section 367(d). In some cases, the commensurate-with-income standard may also be inapplicable if Section 367(d) is avoided.¹²¹ The need to avoid this U.S. source treatment is one of the most problematic tax concerns raised by foreign joint ventures. Several alternatives described below have the intended effect of restructuring the transaction so that it no longer falls within the statutory scope of Section 367(d). Before proceeding to an analysis of the alternative restructured transactions, however, one should consider certain options provided in the regulations under Section 367(d) itself.

The regulations allow a limited election to treat a Section 351 or Section 361 transfer of intangible property as a sale.¹²² The deemed sale results in U.S. source income equal to the gain in the intangible property on the transfer date.¹²³ This U.S. source treatment of the gain, though no bargain, may be preferable to the normal Section 367(d) regime. The Section 367(d) regime imposes U.S. source treatment, but also provides that the amount taken into account annually over the useful life of the intangibles shall be commensurate with the income attributable to the intangibles. Therefore, it is not limited to the amount of gain realized by the initial transfer. Even this marginal benefit of a deemed sale in relation to the normal operation of Section 367(d) may be denied if the U.S. transferor and the foreign joint venture are considered to be under common control. In which case, the deemed sale may be subject to the commensurate-with-income standard of Section 482.¹²⁴

Availability of the deemed sale election under the Section 367(d) regulations is limited to three cases. The first is when the intangible property constitutes an “operating intangible,” defined as intangible property of a type not ordinarily

may be difficult in some cases), or certain copyrights, literary, musical or artistic compositions, letters or memoranda, and similar property. *See* 26 C.F.R. §§ 1.367(a)-1T(d)(5), 1.367(d)-1T(b) (1996).

118. I.R.C. § 367(d)(2)(A) (West 1995).

119. *Id.* *Cf.* I.R.C. § 482 (West 1995). The precise measure of what is commensurate with income remains uncertain and is likely to remain so even after regulations are eventually issued. *See* U.S. Treasury Department and Internal Revenue Service, A Study of Intercompany Pricing Under I.R.C. § 482 *reprinted in* Notice 88-123, 1988-2 C.B. 458 [hereinafter White Paper].

120. I.R.C. § 367(d)(2)(A) (West 1995).

121. *See supra* Section III.

122. 26 C.F.R. § 1.367(d)-1T(g)(2) (1996).

123. *Id.*

124. The potential reach of I.R.C. § 482 in the context of transfers to joint ventures is discussed in Section III. *See supra* Section III.

licensed or otherwise transferred in a transaction between unrelated parties for consideration contingent on the licensee's or the transferee's use of the property.¹²⁵ Examples of operating intangibles include: long-term purchase or supply contracts, surveys, studies and customer lists.¹²⁶

A second category of intangibles eligible for the deemed sale election includes those intangibles whose transfer is either: (1) legally required as a condition of doing business by the government of the foreign country in which the transferee is organized and will conduct that business; or (2) compelled by a genuine threat of immediate expropriation by the foreign government.¹²⁷

The final category of intangibles eligible for the deemed sale election includes those whose transfer meets all the following requirements: (1) the intangibles are transferred within three months of the transferee's organization and are transferred pursuant to the transferee's original plan of capitalization; (2) the U.S. transferor owns forty to sixty percent of the vote and value of the transferee immediately after the transfer; (3) foreign co-venturers unrelated to the U.S. transferor own forty to sixty percent of the vote and value of the transferee immediately after the transfer; (4) at least half of the value of what the U.S. transferor contributes to the transferee consists of intangible property; and (5) the transferred intangibles will be used in the active conduct of a trade or business outside the United States and will not be used in connection with the manufacture or sale of products in or for use or consumption in the United States.¹²⁸ This narrow category, specifically directed to the joint venture context, is apparently based in part on the fact that the presence of a third party allows government to rely on valuation of intangible property as agreed by those dealing at arm's length.¹²⁹ Given this premise, it would seem appropriate to expand the availability of the election to a broader range of ventures for which the transferor of the intangibles is unlikely, as a business matter, to understand the value of what is contributed to the venture.

One cannot help feeling a bit underwhelmed by the "relief" offered by the Section 367(d) regulations. Even in the limited cases for which deemed sale treatment is available, its tax consequences are generally inferior to virtually every restructuring alternative described below with the exception of an actual sale of the intangibles for a fixed price (the consequences of which are similar to those for the Section 367(d) deemed sale). Thus, although the results of the deemed sale are slightly better than the normal rules of Section 367(d),¹³⁰ it should be used

125. 26 C.F.R. § 1.367(a)-1T(d)(5)(ii) (1996).

126. *Id.* § 1.367(d)-1T(g)(2)(i).

127. *Id.* § 1.367(d)-1T(g)(2)(ii).

128. *Id.* § 1.367(d)-1T(g)(2)(iii).

129. White Paper, *supra* note 119, at 474.

130. As noted above, I.R.C. § 367(d) without a deemed sale would not only impose a U.S. source rule, but also a commensurate-with-income rule that results in potential U.S. source gain in excess of the gain realized on the initial transfer. Note, however, the potential application of the commensurate-with-income rule

only when all other options are foreclosed by the business constraints of the moment (not the least of which may be an uncooperative foreign co-venturer that attempts to extract additional business concessions as a price for consenting to restructure the intangibles aspect of the venture).

b. Sale of Intangibles to Foreign Venture

i. Sale for Fixed Price

If the U.S. venturer sells intangible property¹³¹ to the foreign joint venture for a fixed price, the resulting gain is generally U.S. source income.¹³² Even so, the sale may be preferable to a Section 367(d) transfer (at least where Section 482 is inapplicable). Such a sale limits the U.S. source income to the amount of gain existing on the transfer date, whereas Section 367(d) contains the commensurate-with-income rule, which permits the U.S. source income imputed back to the U.S. transferor over time to exceed the gain existing on the transfer date.¹³³

Even though a fixed price sale provides slightly better results than a Section 367(d) transfer, the U.S. source treatment of the gain makes the sale a relatively undesirable means of restructuring around Section 367(d). Assuming it can be accomplished from a business viewpoint, a sale may be preferable to a license in a limited set of cases, despite the U.S. source taint. For example, if the U.S. transferor is in danger of attaining U.S. personal holding company status,¹³⁴ the sale (unlike most licenses) does not produce personal holding company income¹³⁵

of I.R.C. § 482 if the transferor and the foreign joint venture are under common control. *See* 26 C.F.R. § 1.367(d)-1T (1996); I.R.C. § 482(i) (West 1995).

In general, I.R.C. § 367(d) and the rules of this section shall not apply in the case of an actual sale or license of intangible property by a U.S. person to a foreign corporation. If an adjustment under I.R.C. § 482 is required with respect to an actual sale or license of intangible property, then I.R.C. § 367(d) and the rules of this section shall not apply with respect to the required adjustment. If a U.S. person transfers intangible property to a related foreign corporation without consideration, or in exchange for stock or securities of the transferee in a transaction described in I.R.C. §§ 351 or 361, no sale or license subject to adjustment under I.R.C. § 482 will be deemed to have occurred. Instead, the U.S. person shall be treated as having made a transfer of the intangible property that is subject to I.R.C. § 367(d); 26 C.F.R. § 1.367(d)-1T(g)(4) (1996).

131. Congress, worried that life was becoming too simple in the international tax area, chose a definition of intangible property for this purpose that is slightly different from the definition used in I.R.C. §§ 367(d), 482, and 936(h)(3)(B). *See* I.R.C. § 865(d)(2) (West 1995). "For purposes of paragraph (1), the term "intangible" means any patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise, or other like property." *Id.*

132. *Id.* § 865(a)(1), (d)(1)(A); *but see id.* § 865(d)(3) (under which payments in consideration of goodwill, to which I.R.C. § 865 applies, are sourced by reference to the country in which the goodwill was generated). In addition, under I.R.C. § 865(d)(4), if the transferor has claimed a deduction or otherwise recovered capital costs with respect to the intangibles, the gain is sourced by reference to the source of the income against which those deductions or other cost recovery were allocated.

133. I.R.C. § 367(d)(2)(A) (West 1995).

134. *See id.* § 542.

135. *See id.* § 543.

that could result in personal holding company tax.¹³⁶ The key point here is that, while foreign source treatment of the income is nearly always better than U.S. source treatment because of the Section 904 limitation on the foreign tax credit, sometimes character (passive or active, ordinary or capital, and so forth) can be even more critical. There is no single best structure for a U.S. venturer's intangibles transfer. The particular facts and tax situation of the transferor must be carefully considered.

Gain on the sale (whether fixed or contingent price) of intangible property is treated as ordinary income if the sale is from a U.S. seller to a foreign corporation that the seller controls.¹³⁷ Control for this purpose is defined as more than fifty percent of the combined vote in the foreign corporation. The attribution rules of Section 958 are applied to determine ownership.¹³⁸ It seems to have been an oversight that this definition was not changed to vote *or value* reflecting the change to the definition of controlled foreign corporation under Section 957(a)(2) made by the 1986 Act. Thus, it is possible for U.S. and foreign venturers to enter into a foreign joint venture that qualifies as a CFC, but to which the U.S. venturer can sell intangible property without invoking Section 1249.¹³⁹

136. *Tomerlin Trust v. Commissioner*, 87 T.C. 876, 892 (1986).

137. I.R.C. § 1249(a) (West 1995). Congress has provided yet another definition of intangible property, which is close to, but not quite the same as, the I.R.C. § 865 definition. *See supra* note 131 (giving a definition of intangible).

138. I.R.C. §§ 1249(b), 958(b) (West 1995).

For purposes of I.R.C. §§ 951(b), 954(d)(3), 956(b)(2), and 957, § 318(a) (relating to constructive ownership of stock) shall apply to the extent that the effect is to treat any United States person as a United States shareholder within the meaning of I.R.C. § 951(b), to treat a person as a related person within the meaning of I.R.C. § 954(d)(3), to treat the stock of a domestic corporation as owned by a United States shareholder of the controlled foreign corporation for purposes of I.R.C. § 956(b)(2), or to treat a foreign corporation as a controlled foreign corporation under I.R.C. § 957, except that—

(1) In applying paragraph (1)(A) of § 318(a), stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered as owned by a citizen or by a resident alien individual.

(2) In applying subparagraphs (A), (B), and (C) of § 18(a)(2), if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50% of the total combined voting power of all classes of stock entitled to vote of a corporation, it shall be considered as owning all the stock entitled to vote.

(3) In applying subparagraph (C) of § 318(a)(2), the phrase "10 percent" shall be substituted for the phrase "50 percent" used in subparagraph (C).

(4) Subparagraph (A), (B), and (C) of § 318(a)(3) shall not be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person.

Paragraphs (1) and (4) shall not apply for purposes of § 956(b)(2) to treat stock of a domestic corporation as not owned by a United States shareholder.

Id. § 958(b).

139. Section III discusses several techniques for achieving CFC status (in order to obtain look-through treatment under I.R.C. § 904(d)(3)) that involve ownership by the U.S. venturer of more than 50% of the value, but not vote, of the foreign joint venture.

Section 1249 is of relatively minor significance in a tax regime providing only a limited capital gains preference.¹⁴⁰ Nevertheless, as an academic matter, and in the event a broader capital gains preference is ultimately reinstated, it is worth exploring whether Section 1249 serves any remaining tax policy. It was enacted as part of the same legislative package that included subpart F.¹⁴¹ As originally proposed by the U.S. House of Representatives, certain types of income were to be simply a component of subpart F income.¹⁴² The House bill would have required that a controlled foreign corporation's U.S. shareholders include as income their shares of the CFC's income that arise from certain intangible property that has been substantially developed, created, or produced in the United States or acquired from related U.S. persons.¹⁴³ The House would have taxed, not only income derived by the CFC in the form of royalties, but also income generated from the sale of manufactured goods to the extent that the sales income was attributable to the use of the intangibles in the manufacturing process.¹⁴⁴ However, while the legislation was pending Congress became convinced that the approach of the House bill would not be able to be administered. For example, Congress felt it would be impractical to determine the amount of sales income attributable to the use of intangibles in the manufacturing process. Furthermore, even in the case of income from licensing the intangibles, Congress noted the difficulty in determining how much income was attributable to the intangibles as distinguished from income attributable to services rendered in connection with the use of the intangibles. Thus, Congress opted instead simply to treat the gain on the outbound sale of the intangibles in the circumstances described in Section 1249 as ordinary income.¹⁴⁵

Despite misgivings expressed in 1962, Congress, in subsequent legislation (especially the 1986 Act), has apparently decided that it may be more practical to determine the income attributable to intangibles transferred by a U.S. person to a foreign corporation that it controls and then impute the income back to the U.S. transferor.¹⁴⁶ Thus, in the case of a sale of intangibles by a U.S. person to a foreign corporation that it controls, there is potential overlap between Sections 482 and 1249. In 1962 Congress envisioned that the ordinary income treatment of Section 1249 was to be instead of, rather than in addition to, the application of an attribution regime. Now that the judgment of the 1962 Congress has been

140. On the other hand, if the transferor has capital losses that are subject to the limitation of I.R.C. § 1211, capital gain treatment on the intangibles sale can be an important consideration.

141. Revenue Act of 1962, Pub. L. No. 87-834, § 16a, 76 Stat. 960, 1045.

142. H.R. Rep. No. 1447, 87th Cong., 2d Sess. (1961), reprinted in 1962-3 C.B. 405, 465.

143. 1962-3 C.B. at 462-63, 465.

144. *Id.* at 465.

145. S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), reprinted in 1962-3 C.B. 707, 816.

146. See I.R.C. § 482 (West 1995); see also *id.* § 367(d)(2)(A). Note that one of the intercompany pricing methods adopted by Congress in 1986 for U.S. corporations operating in the possessions even requires, in part, a division of sales income between that produced by marketing intangibles. *Id.* § 936(h)(5)(C)(II).

reversed and an attribution regime serving a function similar to the one considered in the 1962 House bill has more generally been adopted, Section 1249 should be repealed. This would leave Section 482 as the means to retain U.S. tax jurisdiction over income attributable to the transferred intangibles.

ii. Sale for Contingent Consideration

Midway between a fixed price sale and a license (to be discussed below), there is an intermediate transaction. The U.S. venturer can sell intangible property to the foreign joint venture and receive consideration that is, in whole or part, contingent on future events such as use or productivity of the intangible. The contingent payments are generally sourced as if they were royalties.¹⁴⁷

In a contingent consideration sale of intangible property, the amount of consideration is normally based on the use or productivity of the intangibles. This case is specifically addressed by the deemed royalty rule for purposes of determining the source of the contingent payments. If the contingent consideration is based on something other than the use, productivity, or disposition of the intangibles, the deemed royalty source rule is inapplicable by its own terms.¹⁴⁸ Gain on the contingent consideration sale is sourced in the same manner as the fixed priced sale,¹⁴⁹ so the gain is generally U.S. source income to the U.S. seller.¹⁵⁰ On the other hand, the sale for contingent payments generally constitutes an installment sale,¹⁵¹ the income from which is to be taken into account under the install

147. *Id.* § 865(d)(1)(B). Consider whether the deemed royalty treatment will apply only for purposes of source (as the literal terms of I.R.C. § 865 suggest), or also for purposes of determining the I.R.C. § 904 basket and other tax consequences of the contingent consideration sale (which would be a more sensible construction if the goal is to equalize the tax treatment of a contingent payment sale and a royalty). In addition, I.R.C. § 865 itself contains specific exceptions to those deemed royalty sourcing rule. Payments in consideration of goodwill are sourced by reference to the place in which the goodwill was generated (I.R.C. § 865(d)(3)), and, if the transferor has claimed a deduction or otherwise recovered capital costs with respect to the intangibles, the source of the gain is to that extent sourced by reference to the source of the income against which those deductions or other cost recovery were allocated (I.R.C. § 865(d)(4)). *Id.* § 865.

148. *Id.* § 865(d)(1)(B). If the payments to be received by the seller are only partly contingent on the productivity, use or disposition of the intangibles, the seller is required to bifurcate the sale into two transactions, one subject to the deemed royalty rule and the other giving rise to gain from the sale of personal property. Staff of Joint Comm. on Tax'n, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986 at 923 (Comm. Print 1987) [hereinafter 1986 Bluebook]. This bifurcation rule differs from the de maximis rule of former I.R.C. § 871(e), under which gain from the sale of certain intangible property was treated as being entirely contingent on the productivity, use or disposition of the intangibles if more than 50% of the payments from the sale were contingent on such events.

149. *See supra* notes 129-30 and accompanying text.

150. I.R.C. §§ 865(a)(1), 865(d)(1)(A) (West 1995).

151. An installment sale generally is defined as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. I.R.C. § 453(b)(1) (West 1995); 26 C.F.R. § 15A.453-1(b)(1) (1996). Again, uncertainty is introduced by the fact that the I.R.C. § 865 deemed royalty rule seems to apply, by its terms, only for purposes of source. Thus, for other purposes, it is possible that the installment sale characterization applies whether or not the payments to be received are contingent on the use, productivity or disposition of the intangibles, and as an installment sale for all purposes

ment method.¹⁵² The nuances and hazards of the installment method¹⁵³ are beyond the scope of this article. However, one important generalization to consider in the present context is that, under the installment method, a portion of the contingent payments received by the U.S. seller is treated as interest income rather than as gain.¹⁵⁴ Although interest income to the U.S. venturer is generally income in the passive basket for purposes of the Section 904 limitation,¹⁵⁵ the appropriate basket is determined on a look-through basis if the foreign joint venture is a CFC in which the U.S. venturer is a "United States shareholder."¹⁵⁶

The IRS considers contingent payment transactions to be an especially tempting target for inappropriate characterization by taxpayers. Several provisions warn that contingent payment "sales" will be taxed according to their substance and not their form. For example, suppose a U.S. transferor sells intangibles to a

if the future payments are not so contingent.

152. I.R.C. § 453(a) (West 1995); 26 C.F.R. § 15a.453-1(a) (1996). The regulations specifically provide that contingent payment sales are to be reported on the installment method unless the taxpayer otherwise elects. See 26 C.F.R. § 15a.453-1(1996):

(c) Contingent payment sales—

(1) In general.

Unless the taxpayer otherwise elects in the manner prescribed in paragraph (d)(3) of this section, contingent payment sales are to be reported on the installment method. As used in this section, the term "contingent payment sale" means a sale or other disposition of property in which the aggregate selling price cannot be determined by the close of the taxable year in which such sale or other disposition occurs.

The term "contingent payment sale" does not include transactions with respect to which the installment obligation represents, under applicable principles of tax law, a retained interest in the property which is the subject of the transaction, an interest in a joint venture or a partnership, an equity interest in a corporation or similar transactions, regardless of the existence of a stated maximum selling price or a fixed payment term. See paragraph (c)(8) of this section, describing the extent to which the regulations under section 385 apply to the determination of whether an installment obligation represents an equity interest in a corporation.

For purposes of the following discussion, it is assumed that the seller of the intangible property does not elect out of the installment method.

I.R.C. § 453(a) (West 1995); 26 C.F.R. § 15a.453-1(a) (1996).

153. One especially noteworthy hazard is found in I.R.C. § 453A(c) which imposes an interest charge on the deferred tax liability with respect to certain installment sales.

154. See 26 C.F.R. § 15A.453-1(c) (1996).

155. I.R.C. §§ 904(d)(2)(A)(I), 954(c)(1)(A) (West 1995), but see *id.* §§ 904(d)(1)B), (d)(2)(A)(iii)(I), (d)(2)(B) (establishing a separate limitation basket for interest subject to foreign withholding tax at a rate of at least 5%). The latter basket could apply to the imputed interest if the foreign country imposes such a tax on the contingent payment.

156. *Id.* § 904(d)(3)(C). For this purpose, the term "United States shareholder" has the same meaning as set forth in I.R.C. § 951(b) (taking into account I.R.C. § 953(c), where applicable). *Id.* § 904(d)(4)(B):

(b) United States shareholder defined:

For purposes of this subpart, the term "United States shareholder" means, with respect to any foreign corporation, a United States person (as defined in section 957(c)) who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

I.R.C. § 951(b) (West 1995).

foreign joint venture for contingent consideration equal to a share of the total net profits of the venture over the next twenty years. This profit-based consideration has an equity flavor.¹⁵⁷ The IRS suggests that a contingent payment transaction will not be respected according to its form as a sale if the contingent consideration represents, under applicable principles of tax law, an interest in a joint venture or a partnership.¹⁵⁸ If the "sale" is in substance an exchange for additional equity in the venture, the Section 367(d) regulations may come into play. The IRS further provides that a purported sale of intangible property may be disregarded and treated as a transfer subject to Section 367(d). This treatment includes the twin hammers of U.S. source and a commensurate-with-income rule, if the terms of the purported sale differ so greatly from the economic substance of the transaction, or from terms that would obtain between unrelated persons, that the purported sale is a sham.¹⁵⁹ Thus, it will be prudent to heed not only the form, but the substance, of the intangibles transfer to the foreign venture.

c. License of Intangibles to Foreign Venture

Royalties received for the use of intangible property outside the United States generally are treated as foreign source income.¹⁶⁰ Although royalty income is usually income in the passive basket¹⁶¹ for purposes of the Section 904 limitation,¹⁶² some important exceptions to this passive basket rule often apply. If the foreign joint venture is a CFC in which the U.S. venturer is a U.S. shareholder, the basket of the royalty income is determined on a look-through basis. Furthermore, the royalty is income in a particular basket to the extent the royalty expense is allocable to the CFC's income in that basket.¹⁶³ A second exception to the placement of royalty income in the passive basket applies if the

157. Whether the equity flavor is strong enough to support an IRS attack is a highly factual question for which no definite answer is possible in the abstract. Additional adverse factors for the taxpayer might include: if the partners reasonably expect that at the end of the 20 years the intangibles will no longer have substantial value; if the venture will be liquidated at the end of 20 years; if the paper trail of negotiations suggests that the profit-based consideration was crafted by the parties for tax rather than business reasons; and so forth. However, even these factors are not clearly necessary or sufficient to sustain an IRS attack on the form of the transaction.

158. 26 C.F.R. § 15a.453-1(c)(1) (1996).

159. *Id.* § 1.367(d)-1T(g)(4)(ii). This substance over form rule applies also to transactions that purport to be licenses.

160. I.R.C. § 862(a)(4) (West 1995).

161. The policy underpinnings of the separate basket limitations added by the Tax Reform Act of 1986 are explained in the General Explanation of the Tax Reform Act of 1986. STAFF OF JOINT COMM. ON TAXATION, 100th Cong., 1st Sess. 863-65 (Comm. Print 1987).

162. I.R.C. §§ 904(d)(2)(A)(i), 954(c)(1)(A) (West 1995).

163. *Id.* § 904(d)(3)(C); 26 C.F.R. § 1.904-5(c)(3) (1996). For this purpose, the term "United States shareholder" has the same meaning as set forth in I.R.C. § 957 (taking into account section 953(c)). I.R.C. § 904(d)(4)(B) (West 1995).

royalty is considered derived in the active conduct of a trade or business.¹⁶⁴ In such a case, the royalty will usually be income in the general basket, rather than the passive basket. This is so if the venture that pays the royalty is not a related person.¹⁶⁵ Finally, if neither of these two exceptions apply, but the royalty is subject to foreign tax at a rate exceeding the maximum U.S. rate, it will be reclassified as income in the general basket under the so-called "high tax knockout."¹⁶⁶

Under these rules, the U.S. venturer licensing intangibles to a foreign joint venture usually achieves a more favorable Section 904 foreign tax credit limitation than could have been obtained through a contribution or sale of the intangibles to the venture. Note however that the license obviously remains subject to Section 482 and its commensurate-with-income standard if the U.S. venturer controls the venture. If the royalty is determined by reference to the venture's net profits or has an otherwise equity flavor, then the U.S. venturer should be aware of the risk that the transaction may be recharacterized by the IRS. As noted earlier in connection with a similar risk of recharacterization of contingent payment "sales,"¹⁶⁷ the regulations indicate that a purported license of intangible property may be disregarded and treated as a transfer subject to Section 367(d). This recharacterization will occur if the license is made to a foreign corporation in which the licensor holds (or is acquiring) an interest, and if the terms of the license differ so greatly from the economic substance or the terms that would obtain between unrelated persons that the purported license is a sham.¹⁶⁸ For this purpose, the terms of the purported license are considered to

164. 26 C.F.R. § 1.904-4(b)(2)(i) (1996). A royalty generally will be considered to be derived in the active conduct of a trade or business if it is derived from licensing either: (1) property that the licensor has developed, created or produced, or has acquired and to which the licensor has added substantial value (other than through the performance of marketing functions), but only so long as the licensor is regularly engaged in such activity with respect to property of such kind; or (2) property that is licensed as a result of the performance of marketing functions by the licensor which, through its own staff of employees located in a foreign country, is regularly engaged in the business of marketing (or of marketing and servicing) the licensed property and which activity is substantial in relation to the amount of royalties derived from licensing the intangibles. *Id.* In addition, for purposes of § 904, but apparently not for purposes of § 954, those requirements can be met by a member of the licensor's worldwide affiliated group rather than by the licensor itself. *Id.* § 1.904-4(b)(2)(ii).

165. I.R.C. § 954(c)(2)(A) (West 1995). For this purpose, I.R.C. § 954(c)(2)(A) refers to the definition of "related person" as prescribed by I.R.C. § 954(d)(3). The I.R.C. § 904 regulations clarify that the I.R.C. § 954(d)(3) test is applied without regard to whether the relationship is between a CFC and another person, or, instead, is between two persons neither of which is a CFC. 26 C.F.R. § 1.904-4(b)(2)(iii) (1996).

166. I.R.C. § 904(d)(2)(A)(iii)(III), (F) (West 1995).

167. See *supra* note 154 and accompanying text.

168. I.R.C. § 367(d) (West 1995). The IRS has raised the possibility of adopting a broader test under which a license payment that is less than some specific percentage of the appropriate arm's length amount could be considered so devoid of economic substance that the arm's length charge would be subject to the U.S. source rule of I.R.C. § 367(d). Thus, those related party transfers which deviate substantially from the proper commensurate-with-income payment would be subject to I.R.C. § 367(d) even if they take the form of a sale or license.

include not only the normal terms of the agreement, but also the actual practice of the parties under that agreement.¹⁶⁹ Thus, calling the intangibles transfer a license and reporting the income stream as royalties on the tax return does not necessarily guarantee tax-favored treatment.

d. Cost Sharing or Other Contractual Arrangements

In unique circumstances, venturers may wish to consider cost sharing or other contractual arrangements as an alternative to the outright transfer of intangibles to the foreign joint venture by contribution, sale or license. Cost sharing generally involves an agreement between the parties to share the costs and risk of developing intangible property, in return for which each party obtains the specific right to use any resulting intangibles in their business. Currently, there is limited guidance on the definition of a bona fide cost sharing arrangement.¹⁷⁰ Section 482 in the White Paper suggests the potential adoption of more detailed and very restrictive conditions that must be met in order for a cost sharing arrangement between related parties to be respected for tax purposes.¹⁷¹

Obviously, the ultimate resolution of these issues in future regulations will determine the usefulness of these types of arrangements in a related party setting. Where the intangibles are already developed, the IRS traditionally required that the party providing the intangibles receive a value-based "buy in" payment,¹⁷² rather than simply receiving a share of historical costs. This limited the initial attractiveness of the cost sharing regime. Where, however, the joint venture is created to incur development costs with the view toward the exploitation of resulting intangibles, cost sharing may be a useful method of avoiding many of the issues discussed above. This may be particularly true where the U.S. venturer and the foreign joint venture are not under common control within the meaning of Section 482.¹⁷³

Another arrangement that may be useful in some instances is contract manufacturing. Under this regime, a venture is provided with the ability to use existing intangibles for the purpose of manufacturing a product on behalf of the intangibles' owner. Generally, the agreement provides that the venture will produce the product in accordance with the specifications of and using the process dictated by the owner. The owner bears the risk of loss in connection with the

169. 26 C.F.R. § 1.367(d)-1T(g)(4)(ii) (1996).

170. *Id.* § 1.482-2A refers to the existence of a "good faith" effort by the parties to bear their share of costs and risk on an arm's length basis.

171. White Paper, *supra* note 119, at 495-500.

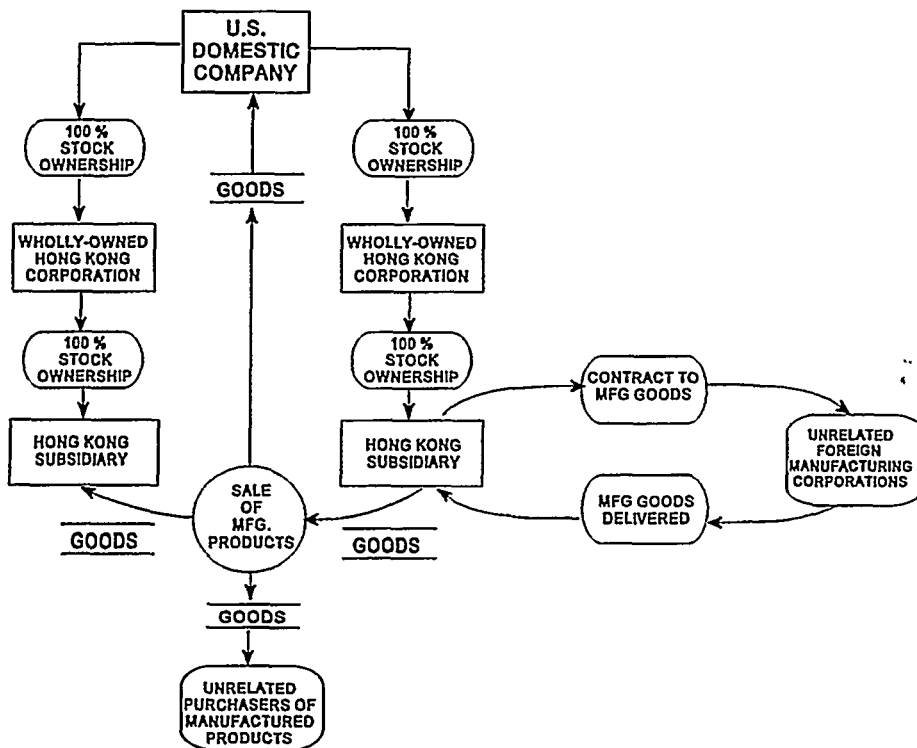
172. *Id.* at 497.

173. See *infra* notes 190-94 and accompanying text.

manufacture and sale.¹⁷⁴ For tax purposes, the owner of the intangibles is treated

174. See Rev. Rul. 75-7, 1975-1 CB. 244, in which a controlled foreign corporation does not realize foreign base company income within the meaning of I.R.C. § 954(a) of the Code from the sale of a ferroalloy derived from ore concentrate purchased from related persons in the United States and Canada, converted for a fee by a controlled process in the plant of a foreign corporation in a country with a lower tax rate, and sold to unrelated foreign persons.

Priv. Ltr. Rul. 87-49-060 (Sept. 8, 1987), a domestic parent company owned 100% of the stock of two Hong Kong corporations. The domestic parent contracted with an unrelated production company to develop its line of products. The parent has contracted with several foreign corporations to manufacture its products, though the parent maintained substantial control over the quality and quantity of the products manufactured. The parent has marketed its products internationally through F1, one of the Hong Kong subsidiaries.



The domestic parent intends to assign to F2, its second Hong Kong subsidiary, the contractual right to manufacture the parent's products. F2 will contract with unrelated foreign corporations to actually manufacture the products. F2, according to its contract with the parent, will own the products manufactured, will bear the risk of loss with respect to the products, and will sell the products to the parent, F1, and unrelated parties.

The Hong Kong effective rate of tax imposed on sales income of F2 on sales from products manufactured in Hong Kong is 18.5%. Manufacturing will also be performed in other countries with the following effective tax rates: the Shenzhen zone in the People's Republic of China, 15% Korea, 23.5% or more; and Taiwan, 23.5% or more.

The Internal Revenue Service, has ruled that the income derived by F2 from the sale to unrelated persons of the products produced by independent contractors in Hong Kong will not constitute foreign base company sales income for purposes of I.R.C. § 954(d)(1). In so holding, the IRS noted F2's complete control over the processes employed by the independent contractors, its quality control, and its risk of loss. The fact that

as the manufacturer of the products.¹⁷⁵

From a business perspective, it is unlikely that many prospective co-venturers are prepared to enter into an arrangement whereby the joint venture is entitled only to a contract manufacturer's return (usually determined on a cost plus or set amount per unit basis). However, the contract manufacturing structure may be worth exploring in some instances.

e. Use of Tiered Structures to Avoid Section 367(d)

In some cases, the co-venturer, as a business matter, may require that the U.S. venturer's intangibles be contributed to the venture. This requirement would preclude a sale, license, or other arrangement as described above. But for U.S. tax reasons, it is still essential that the U.S. venturer not contribute the intangibles directly to the foreign venture since that contribution would result in the punitive application of Section 367(d). The following are two alternative techniques for reaching a result economically similar to an equity contribution of the intangibles,

technical title to certain parts or components used in making the product is held by the contract manufacturers does not alter the holding because the "economic risk of loss remains at all times with F2." Rev. Rul. 75-7, 1975-1 C.B. 244.

The IRS also held that the income derived by F2 from the sale to unrelated persons of products produced by its independent contractors outside of Hong Kong will not constitute foreign base company sales income "if it is determined that Hong Kong would not tax the income allocated to F2 under 26 C.F.R. § 1.954-3(b) in the year when earned at an effective rate that is less than 90% of, and at least five percentage points less than, the effective rate of tax which would apply to such income under the laws of the countries in which the manufacturing occurs." Such income will constitute foreign base company sales income if it is determined that Hong Kong would tax the allocated income at less than 90% of, and at least five percentage points less than, the effective tax rate in the countries in which manufacturing occurs. 26 C.F.R. § 1.954-3(b) (1996).

A domestic corporation will establish a controlled foreign corporation (CFC). The CFC will purchase three components for use in manufacturing a product. It will purchase one component from its parent, a second component from its parent and from independent local suppliers, and the third component from independent sources. Manufacture of the product involves several complex steps. The CFC will use independent contractors to manufacture the product but will control every phase of the manufacture. The CFC will sell the product to its parent, to other subsidiaries of the parent, and to unrelated buyers. It will sell at wholesale those components that it does not need for manufacturing the product. Priv. Ltr. Rul. 84-13-062 (Dec. 29, 1983).

The IRS has ruled that sales of the product will be sales of a manufactured product rather than sales of the components. The IRS also held that the CFC will be treated as manufacturing the product itself. Accordingly, the CFC's sales of the product will not produce "foreign base company sales income" under I.R.C. § 954(d) (West 1995).

175. Historically, the question of who is considered the manufacturer had primary importance in the excise tax area in determining the party liable for the manufacturer's excise tax. *See, e.g., Polaroid Corp. v. United States*, 235 F.2d 276 (1st Cir. 1956), *cert. denied*, 352 U.S. 953 (1956); Priv. Ltr. Rul. 90-34-005 (May 22, 1990); Priv. Ltr. Rul. 90-34-006 (May 22, 1990); Priv. Ltr. Rul. 90-34-008 (May 22, 1990), and the rulings and cases cited therein. In recent years, the treatment of the owner as manufacturer has been important in planning under the exception to foreign base company sales income for purposes of subpart F. *See* I.R.C. § 954(d)(2) (West 1995). Recent Tax Court cases have called into question the continuing attribution of the activities of a contract manufacturer to the party contracting for its services for purposes of subpart F, and, therefore, the continuing validity of Rev. Ruling 75-7 and *Ashland Oil Co. v. Commissioner*, 95 T.C. 348 (1990). *See* *Vetco Inc. v. Commissioner*, 95 T.C. 579 (1990).

while avoiding Section 367(d) through the use of tiered structures.

i. License to Foreign Subsidiary

Under this approach, the U.S. venturer licenses its intangibles to a wholly-owned foreign subsidiary (CFC). The CFC then contributes all of the rights, but not obligations, it holds as licensee to the foreign corporate joint venture. In exchange for this contribution the CFC receives stock of the venture.¹⁷⁶ This

176. See *MacDonald v. Commissioner*, 55 T.C. 840 (1971), *acq.*; Rev. Rul. 78-328, 1978-2 C.B. 215. Rev. Rul. 78-328, advice has been requested whether the sale of all rights to a patent by a corporation that is not a dealer in patents is the sale of property used in its trade or business within the meaning of I.R.C. § 1231 of the Internal Revenue Code of 1954 when the rights transferred are all the then existing rights to the patent except for a nonexclusive, royalty-free license acquired by an unrelated party from the corporation's predecessor transferor. *Id.*

In 1974 X corporation developed a device and secured a patent on it. In 1975 X assigned to Y corporation a royalty-free, nonexclusive license for the sale or use of the device and sold its remaining rights in the patent to Z corporation. Z used the patent in its manufacturing business. Z depreciated the cost of the patent over its remaining useful life. 26 C.F.R. § 1.167(a)-6 (1996).

In 1976, more than six months after acquiring the patent rights, Z sold all the rights it ever held in the patent (although not all the existing rights) and realized a gain on the sale. Z realized no losses from the sale of other property during 1976. The consideration for this transfer was a lump-sum of 100,000x dollars and certain additional amounts to be paid in the future based on a percentage of gross sales from marketing the device.

The question presented is whether the gain from the transaction is income to Z attributable to the sale of property used in the trade or business within the meaning of I.R.C. § 1231 of the Code. I.R.C. § 1231 (West 1995).

Although I.R.C. § 1235 is inapplicable to this case because that section only applies to transfers of patents by individuals, Rev. Rul. 69-482, 1969-2 C.B. 164, states that when holders make transfers of patents that do not meet the requirements for capital gains treatment under section 1235, the tax consequences of such transfers will be determined under other sections of the Code. Rev. Rul. 69-482, 1969-2 C.B. 164.

Section 1231(a) of the Code provides, in part, that if, during the taxable year, the recognized gains on sales of property used in the trade or business held for more than six months (nine months for taxable years beginning in 1977; one year for taxable years beginning after 1977). If one exceeds the recognized losses from such sales, such gains and losses shall be considered gains and losses from sales of capital assets held for more than six months (nine months for taxable years beginning in 1977; one year for taxable years beginning after 1977). I.R.C. § 1231(a) (West 1995).

Section 1231(b) of the Code provides, in part, that the term "property used in the trade or business" means property used in the trade or business of a character that is subject to the allowance for depreciation provided in I.R.C. § 167, and that is held for more than six months (nine months for taxable years beginning in 1977; one year for taxable years beginning after 1977). I.R.C. § 1231(b) (West 1995).

Section 167(a)(1) of the Code provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear, and tear of property used in the trade or business. I.R.C. § 167(a)(1) (West 1995).

Section 1.167(a)-6 of the regulations provides that the cost or other basis of a patent shall be depreciated over its remaining useful life. 26 C.F.R. § 1.167(a)-6 (1996).

In *MacDonald v. Commissioner*, a case in which I.R.C. § 1235 did not apply, the United States Tax Court concluded that the sale of all the rights a taxpayer ever held in a patent, but which rights did not include all existing rights in the patent because the patent was already subject to a nonexclusive license, may qualify for capital gains treatment under I.R.C. § 1231. 55 T.C. 840 (1971), *acq.*, 1973-1 C.B. 2.

In *MacDonald*, the court questioned the validity of 26 C.F.R. § 1.1235-2(b). The issue in *MacDonald* was whether the sale of less than all the then existing, substantial rights to a patent was nevertheless the sale

structure results in the U.S. venturer owning some¹⁷⁷ or all¹⁷⁸ of its interest in the venture indirectly through the CFC.

If this alternative form is respected, it avoids Section 367(d) because the first step is a license, not a Section 351 or 361 transfer to which Section 367(d) might apply. The second step is a transfer by a foreign corporation and Section 367(d) applies only to a US. transferor. Where this alternative is adopted, the license to the CFC by the U.S. venturer must be made under terms that withstand the potential application of a Section 482 adjustment and commensurate-with-income standard, since the U.S. venturer and the CFC are clearly under common control. The arrangement must also give the CFC sufficient potential economic gain and risk of loss that it will not be regarded as a mere conduit. A further risk is that the IRS will attempt to reverse the order of the steps. For example, the IRS might assert that the transaction should be treated for tax purposes as a transfer by the U.S. venturer of less than its entire interest in its intangibles to the foreign corporate venture in exchange for stock in the venture.¹⁷⁹ This would be followed by a transfer of that stock to the CFC in exchange for a stream of contingent pay-

of a capital asset within the meaning of I.R.C. §§ 1221 or 1231 (as the case may be) when the taxpayer transferred all the rights the taxpayer had. The IRS's acquiescence in MacDonald merely indicates that the IRS agrees with the court that the sale of the patent in question qualifies for capital gain treatment. No inference should be drawn from the IRS's acquiescence in MacDonald that the regulations under I.R.C. § 1235 are not controlling for purposes of I.R.C. § 1235. See *Kueneman v. Commissioner*, 68 T.C. 609 (1977) (stating on appeal in the 9th circuit that the court will no longer follow the cases of *Rodgers v. Commissioner*, 51 T.C. 619 (1977), and *Fawick v. Commissioner*, 52 T.C. 104 (1969), *rev'd* 436 F.2d 655 (6th Cir. 1971) which were cited in MacDonald as the authority for the invalidity of the I.R.C. § 1235 regulations).

In the present case, Z acquired the patent already subject to a license and transferred no interest in the patent prior to its sale. Therefore, Z transferred all the rights it had ever held in the patent.

Consequently, because Z transferred all the rights it had ever held in the patent and because these rights are depreciable property used in Z's business, the sale of the patent rights is considered the sale of property used in the trade or business within the meaning of I.R.C. § 1231(a) (West 1995).

Accordingly, except to the extent provided in I.R.C. § 1245, the income from the sale of all the rights the taxpayer had in the patent will be treated as long term capital gain. *Id.*

177. This is the case if other (non-intangible) property is contributed by the U.S. venturer directly to the venture in exchange for an additional interest in the venture.

178. This is the case if all property to be transferred by U.S. venturer (both intangible and non-intangible property) is contributed through CFC, and the U.S. transferor, therefore, does not obtain a direct interest in the venture, but obtains only an indirect interest held through CFC.

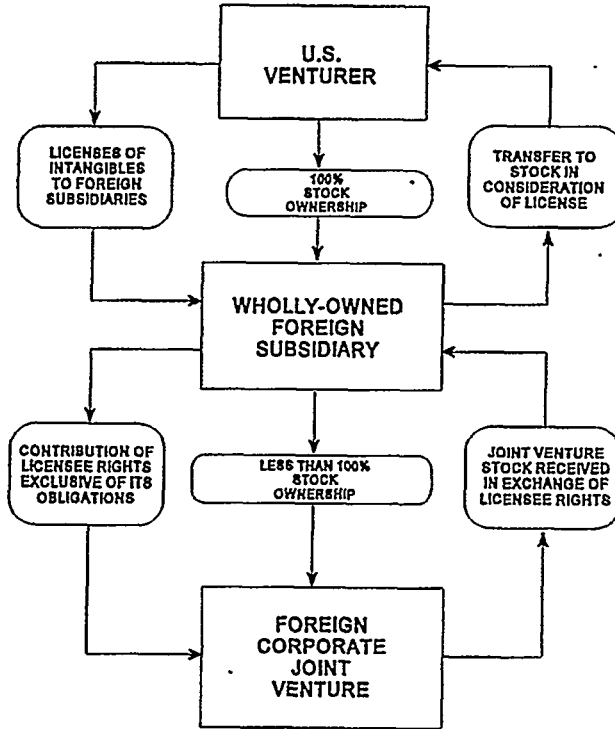
179. It is unclear whether the transfer of less than the U.S. venturer's entire interest in its intangibles is considered a transfer of "property" to which I.R.C. §§ 351 and 367(d) could apply. See *supra* notes 109-11 and accompanying text. Much would depend on the exact nature of the transferred rights. Cf. I.R.C. § 1253 (West 1995). Further, where the order of the steps is reversed, it is possible that the deemed first step would not qualify as a I.R.C. § 351 exchange because the deemed second step would cause the transferor not to be treated as controlling the transferee immediately after the transaction.

See Rev. Rul. 70-140, 1970-1 C.B. 73. Pursuant to a prearranged plan, assets were transferred to an existing controlled corporation in exchange for additional stock of the transferee corporation in a transaction intended to qualify under I.R.C. § 351. All of the transferee corporation stock was then exchanged for stock of an unrelated corporation in a transaction intended to qualify as a I.R.C. § 368(a)(1)(B) reorganization. The ownership of the additional transferee stock was disregarded and the transaction was treated as a taxable sale of the transferred assets to the second corporation.

ments (designated by the parties as “royalties,” but not treated as such for tax purposes because they are in consideration for stock rather than the intangibles).¹⁸⁰ The probability of this step transaction analysis being upheld by a court is uncertain.

ii. Contribution to U.S. Partnership

If the co-venturer insists on holding an interest in a venture that has actual ownership of the intangibles themselves rather than mere rights as a licensee, the



parties may want to consider forming a U.S. partnership. In a U.S. partnership, the U.S. venturer can contribute the intangibles without being subject to Section 367(d) or Section 1491, each of which only applies to a transfer of intangibles to a foreign transferee. The U.S. partnership then licenses the intangibles to a lower tier foreign corporation which conducts the actual operations of the foreign business. There are, however, tax risks associated with the use of this two-step transaction. For example, the IRS might assert that the transaction should be treated as if the U.S. venturer had transferred rights with respect to the intangibles

180. The transfer of stock in exchange for contingent payments would probably be treated for tax purposes as an installment sale of the stock, unless the right to receive the contingent payments is characterized as an equity interest in the venture (in which case the transfer might be subject to I.R.C. § 367(a)). See *supra* notes 100-08 and accompanying text.

directly to the foreign corporation in exchange for stock,¹⁸¹ followed by the U.S. venturer's transfer of that stock (plus any remaining rights in the intangibles) to the U.S. partnership. As a practical matter, in addition to the tax risks to the U.S. venturer, the foreign co-venturer may veto the use of a U.S. entity as a holding vehicle for the venture because of a desire to minimize all contacts with the United States.¹⁸² Despite these obstacles, the U.S. holding partnership alternative may be an appropriate method to avoid Section 367(d).¹⁸³

f. Why Congress Should Revisit Section 367(d)

It is far from clear why U.S. venturers have to subject themselves and their co-venturers to formalistic distractions such as those described in the preceding sections in order to avoid the U.S. source rule of Section 367(d). What is the overriding U.S. tax policy that motivated such an awkward regime? The Joint Committee staff describes the abuse at which Section 367(d) was targeted in the following manner:

[A] number of U.S. companies adopted a practice of developing patents or similar intangibles at their facilities in the United States, with a view toward using the intangibles in foreign operations. When these intangibles were ready for profitable exploitation, they were transferred to a manufacturing subsidiary incorporated in a low-tax foreign jurisdiction (or a high-tax jurisdiction that offered a tax holiday for specified local manufacturing operations). By engaging in such practices, the transferor U.S. companies hoped to reduce their U.S. taxable income by deducting substantial research and experimentation expenses associated with the development of the transferred intangible and, by transferring the intangible to a foreign corporation at the point of profitability, to ensure deferral of U.S. tax on the profits generated by the intangible. By incorporating the transferee in a low-tax jurisdiction, the U.S. companies also avoided any significant foreign tax on such profits.¹⁸⁴

Congress chose to shut down this perceived abuse by treating the transfer as a sale of the intangible property for contingent payments. It is less clear, however, why the contingent payments were treated as U.S. source income. It is possible that U.S. source rule was considered appropriate because income not subject to

181. See *supra* note 175 and accompanying text.

182. For example, under limited circumstances, a foreign source royalty may be treated as income effectively connected with a U.S. trade or business. See I.R.C. § 864(c)(4)(B)(I) (West 1995).

183. For example, if the U.S. venturer does not have a majority interest in the joint venture, a collateral benefit is that having the venturers own their interests in the venture through a U.S. partnership enables the venture nevertheless to qualify as a controlled foreign corporation.

184. 1986 Bluebook, *supra* note 148 at 427.

foreign tax should be U.S. source so that the untaxed income does not result in the availability of additional foreign tax credits through an increased Section 904 limitation. Also, foreign country should not recognize or impose tax on the deemed payments by the foreign transferee to the U.S. transferor of the intangibles. This argument, however, would have to ignore the fact that the foreign country generally taxes the transferee's foreign source income attributable to the use of the intangibles; the deemed payments under Section 367(d) reduce the foreign transferee's foreign source income attributable to the use of the intangibles; and the deemed payments under Section 367(d) reduce the foreign transferee's earnings and profits for purposes of the foreign tax credit.¹⁸⁵ In order to reach the appropriate Section 904 foreign tax credit limitation, the reduction in the transferee's (foreign source) earnings and profits by reason of the deemed payments under Section 367(d) should be offset by corresponding treatment of the deemed payments as foreign source income in the hands of the U.S. transferor.¹⁸⁶

A possible alternative reason for the U.S. source treatment of contingent payments under Section 367(d) is that Congress was concerned whether the IRS could value newly developed intangible property at the time of the transfer to determine the proper amount of the contingent payments. As a result, the perceived abusive transfers would have continued.¹⁸⁷ Section 367(d), however, was amended by the 1986 Act to provide that contingent payments are to be commensurate with the income attributable to the intangibles.¹⁸⁸ This rule, as implemented by the IRS via regulations that can be expected to include some form of "periodic adjustment" mechanism,¹⁸⁹ takes pressure off of the initial valuation of the intangible property. Therefore, the need for a U.S. source rule that forces the taxpayer into restructuring the intended contribution of the intangible property to the venture is reduced.

In addition, the commensurate-with-income standard should have made moot Congress' concern that intangibles would be transferred to a tax haven and therefore result in an inappropriate degree of worldwide tax deferral. Under post-1986

185. I.R.C. § 367(d)(2)(B) (West 1995); 26 C.F.R. § 1.367(d)-1T(c)(2)(i) (1996); see 1986 Bluebook, *supra* note 148, at 433.

186. It is instructive that the 1986 amendments to I.R.C. § 482 contained a commensurate-with-income standard for transferred intangibles that increase the likelihood of deemed payments to the U.S. transferor, and yet the statutory regime did not include a special U.S. source rule under I.R.C. § 482 corresponding to the U.S. source rule of I.R.C. § 367(d)(2)(C). Furthermore, the disparity between the source rules for I.R.C. § 367(d), as compared to I.R.C. § 482, was specifically recognized in 1984: "[T]he source of any adjustment to the income of a U.S. taxpayer under section 482 would be determined without regard to the sourcing rule in the Act." 1986 Bluebook, *supra* note 148, at 433.

187. Of course, this valuation problem does not go away even if the transaction is restructured as a sale or license. Thus it remains unclear what tax policy is achieved by the adoption of a U.S. source rule that forces the U.S. transferor into a different form of intangibles transfer.

188. I.R.C. § 367(d)(2)(A) (West 1995).

189. See White Paper, *supra* note 119, at 474.

Section 367(d), an amount of profits attributable to the transferred intangibles is deemed repatriated to the U.S. transferor in the form of contingent payments commensurate with income, just as if the intangibles had been licensed or sold to a foreign subsidiary that the U.S. transferor controlled for purposes of Section 482.¹⁹⁰ The U.S. foreign subsidiary deserves no more than this. Layering a U.S. source rule on top of the commensurate-with-income standard in Section 367(d) is simply overkill.

Beyond these technical arguments, the U.S. source rule of Section 367(d) was probably a reaction in part to the anti-government whipsaw of allowing a deduction against U.S. taxable income for the cost of developing intangibles destined to be used overseas.¹⁹¹ Ironically, in the same act adopting Section 367(d), Congress extended the moratorium on the application of research and experimental expenses apportionment regulations contained in Section 1.861-8¹⁹² of the regulations issued in 1977.¹⁹³ Under the regulations, a portion of the expense of developing intangibles would have been apportioned to foreign source income, but the moratorium effectively permitted the expenses to be allocated against U.S. source income. With the resolution of the U.S. expense/foreign income whipsaw that existed in 1984, there will be no reason to subject the taxpayer to a similarly unfair apportioned expense/U.S. income whipsaw. Thus, the final resolution of the expense apportionment issue should spur Congress to repeal the U.S. source rule of Section 367(d)(2)(C).¹⁹⁴ While the deemed contingent payment rule itself would remain a constraint on the use of joint ventures in some cases, removal of the U.S. source barrier would be an important step worth taking.

190. I.R.C. § 367(d)(2)(A) (West 1995).

191. Thus, Congress was far less concerned about the transfer of intangibles whose development did not generate deductions against U.S. income. For example, in describing pre-1984 law, Congress concluded that the outbound transfer of goodwill, going concern value or certain marketing intangibles did not result in U.S. tax avoidance because these intangibles "are generated by earning income, not by incurring deductions." 1984 Bluebook, *supra* note 148, at 428.

192. *Id.* at 382.

193. 42 Fed. Reg. 1195 (1977).

194. I.R.C. § 367(d)(2)(C) (West 1995).

Amounts received treated as United States source ordinary income. For purposes of this chapter, any amount included in gross income by reason of this subsection shall be treated as ordinary income from sources within the United States.

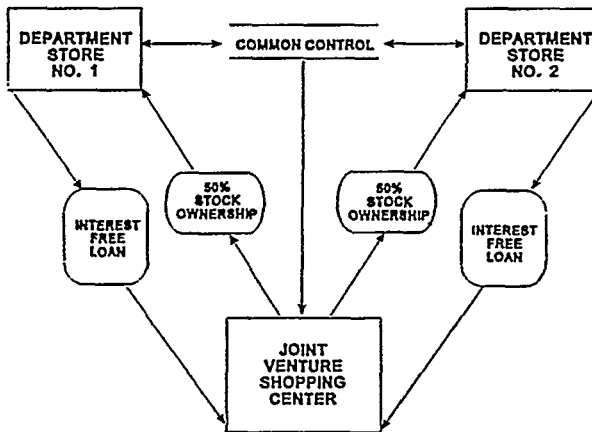
Id.

3. Section 482 Issues

a. Existence of Common Control

The U.S. participant in the foreign joint venture may license or sell (or be deemed to sell under the Section 367(d) regulations)¹⁹⁵ intangibles or other property to the venture. The cautious tax advisor should consider whether the facts indicate common control between the U.S. venturer and the foreign venture. If common, the IRS might attempt to invoke Section 482. If the U.S. venturer receives a majority interest in the venture, it seems fairly clear that common control for purposes of Section 482, will be considered to exist. Even if the U.S. venturer does not own a majority interest, however, transactions between the U.S. venturer and the venture may not be insulated from the reach of Section 482. While the Section 482 regulations provide that control in fact is sufficient for purposes of involving Section 482 (regardless of the percentage of stock controlled), such cases have rarely been the subject of judicial scrutiny. One situation of particular interest in the joint venture context is raised by the following example.

Example Five: Two competing department stores form a fifty-fifty joint venture to own a shopping center. Each venturer subsidizes the venture



through non-arm's length transactions (e.g., interest free loans).

In *B. Forman Co., Inc. v. Commissioner*,¹⁹⁶ the Second Circuit, reversing the Tax Court, held that the venture was under the common control of the ven-

195. 26 C.F.R. § 1.367(d)-1T(g)(2) (1996) (discussing one deemed to sell section); see *supra* notes 120-28 and accompanying text.

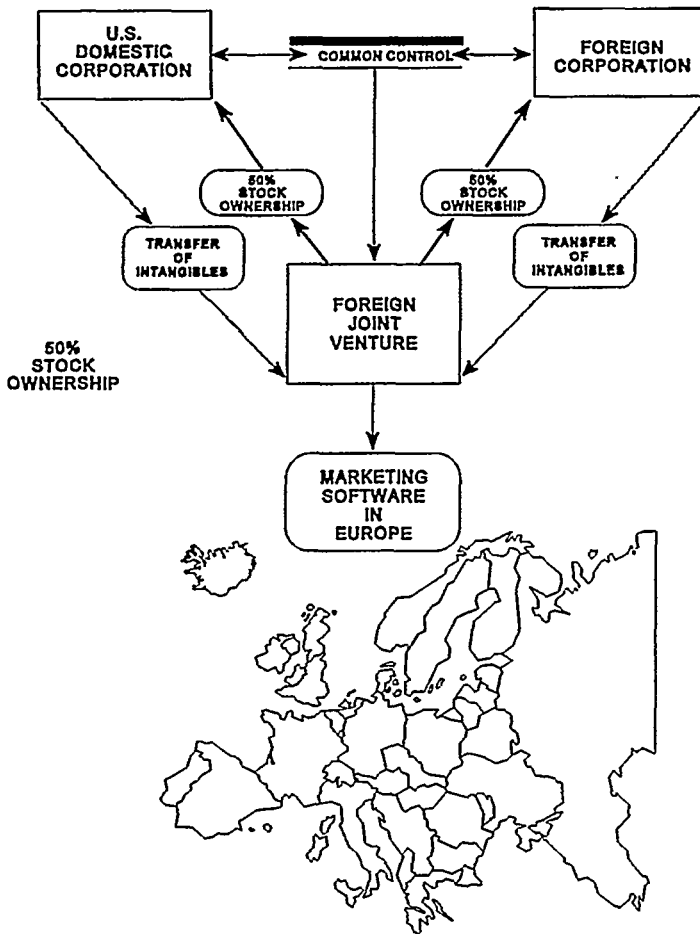
196. 453 F.2d 1144 (2d Cir. 1972), *cert. denied*, 407 U.S. 934 (1972).

turers.¹⁹⁷ The court sustained an increase to the income of each of the venturers under Section 482. Although *Forman* involved a purely domestic setting and did not involve the transfer of intangibles, its common control holding can be imported into the foreign joint venture context.

Example Six: Domestic corporation DC and foreign corporation FC form a fifty-fifty foreign corporate joint venture (FJV) to market software in Europe. DC and FC each transfers to FJV its software licenses, patents, and copyrights that are enforceable in Europe. To defer taxable income in their respective home countries, DC and FC each transfers its intangibles for \$10 million less than fair market value. Under *Forman*, DC and FJV may be considered to control the venture, and the IRS may attempt to invoke Section 482 to adjust the price charged by DC and thereby increase DC's income.¹⁹⁸

197. *Id.* at 1155.

198. *See supra* notes 195-205 and accompanying text (concerning the relationship between I.R.C. §§ 482, 351, 367(d)).



Forman suggests that even a venturer not owning a majority interest may be considered to control a joint venture if the co-venturers act in concert. This holding is clearly of limited scope. Where the IRS is unable to show that both co-venturers are engaging in non-arm's length dealings with the venture, it should not be able to argue that the co-venturers have acted in concert for purposes of Section 482. Thus its ability to show common control will be impaired. Furthermore, as a practical matter, in the absence of a corresponding non-arm's length transaction by the co-venturer, a court would certainly ask why a rational business person would intentionally shift profits to an entity in which a material unrelated party owned a substantial interest. This would dilute one's share of profits,

therefore requiring a much more convincing showing of control in fact.¹⁹⁹ Thus, while the presence of a material unrelated co-venturer does not automatically preclude the IRS from making a Section 482 adjustment on a transfer of property to the venture, the presence of the co-venturer certainly raises the burden to a level that the government rarely will be able to meet.

b. Section 482's Relationship to Other Sections

Over the years, the courts and the IRS have found it necessary to clarify the relationship between Section 482 and other provisions of the Code. A full discussion of the relationship is beyond the scope of this article,²⁰⁰ but a few points are worth noting. Although many I.R.C. provisions have been the subject of clarification (Sections 61, 446 and 1502 for example), the most relevant for purposes of analyzing outbound transfers are Sections 351 and 367(d).

The regulations state that Section 482 can be invoked when necessary to prevent the avoidance of tax or to clearly reflect income. This is so even if the transaction is also described in a Code provision such as Section 351 that would otherwise provide nonrecognition treatment.²⁰¹ This view has been adopted in cases decided both before²⁰² and after²⁰³ the issuance of the applicable regulations. Nevertheless, a significant degree of uncertainty remains as to the relationship between Section 482 and Section 351. Although there are indications that the reach of Section 482 may be limited in the context of a nonrecognition exchange,²⁰⁴ The IRS has indicates that it will continue with the position that Section 482 may override Section 351 in a broader category of cases.²⁰⁵ However,

199. *Brittingham v. Commissioner*, 66 T.C. 373, 398 (1976), *aff'd*, 598 F.2d 1375 (5th Cir. 1979); *R.T. French Co. v. Commissioner*, 60 T.C. 836, 851 (1973).

200. For a comprehensive discussion of pre-1980's law, see Gosain, *supra* note 113, at 7551-580.

201. 26 C.F.R. § 1.482-2A(d)(2) (1996).

202. *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214, 215-17 (2d Cir. 1952), *cert. denied* 344 U.S. 874 (1952); *National Sec. Corp. v. Commissioner*, 137 F.2d 600, 601-03 (3rd Cir. 1943), *cert. denied* 320 U.S. 794 (1943).

203. *Searle & Co. v. Commissioner*, 88 T.C. 252, 359-63 (1987).

204. *Eli Lilly & Co. v. Commissioner*, 856 F.2d 855, 861-66 (7th Cir. 1988), *rev'g* in part 84 T.C. 996 (1985).

205. A.O.D. 1989-011 (July 31, 1989) (disagreeing with the *Eli Lilly* decision). Refer to Tech. Adv. Mem. 89-25-003, in which a U.S. corporation has a wholly owned U.S. subsidiary with which it files a consolidated return. In year one, an unrelated pharmaceutical company was under court order to divest itself of properties, including certain drugs. In the same year, the subsidiary purchased the patents to drug one and drug two from the pharmaceutical company. The pharmaceutical company retained ownership of the foreign patents and continued to manufacture and sell the drugs in foreign markets. Tech. Adv. Mem. 89-25-003 (Feb. 27, 1989).

In year three, subsidiary incorporated a wholly owned Puerto Rican subsidiary, which began the production of drug one purchased from the pharmaceutical company's Puerto Rico operations. The Puerto Rican subsidiary qualified as a I.R.C. § 931 corporation in year two through five and as a I.R.C. § 936 corporation in year six. The Puerto Rican subsidiary sold most of its production to its immediate parent, with a small portion sold to the U.S. government for use in VA hospitals. The price the U.S. subsidiary paid to the

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for the reasons described below, the issue is of minimal importance in the context addressed here for taxable years after Section 367(d)'s 1984 enactment.

As discussed above, Section 367(d) does not apply to an actual sale or license of intangible property to a foreign corporation, even if the sale or license results in a Section 482 adjustment.²⁰⁶ The White Paper suggests that Section 367(d) may apply even to licenses that are not shams if the license payments are less than an arm's length price by some specific percentage.²⁰⁷

If a U.S. person transfers intangible property to a related foreign person without consideration, or via a section 351 or section 361 transaction, no sale or license subject to adjustment under Section 482 is deemed to have occurred. Instead, the U.S. transferor is treated as having made a transfer of intangible property subject to Section 367(d).²⁰⁸ In effect, the IRS can rely on Section 367(d) rather than Section 482 to protect the U.S. tax jurisdiction in the case of outbound

Puerto Rican subsidiary was determined by reducing the subsidiary's third-party selling price by its direct and period expenses and by an amount used to compensate the U.S. subsidiary for its distribution and other activities. *Id.*

During the period of the Puerto Rican subsidiary's operation in year three, it manufactured drug one under two trade-names under a license from the U.S. subsidiary granting the Puerto Rican subsidiary the right to use the patent for drug one in return for payment to subsidiary of a royalty in an amount equal to a percentage of subsidiary's net sales of the two drugs. *Id.*

In year four, subsidiary transferred the drug one patent, the know-how, and the trademarks to the Puerto Rican subsidiary in a I.R.C. § 351 exchange. Under the transfer, the subsidiary and the Puerto Rican subsidiary entered into a management IRS and technical assistance agreement for which subsidiary was required to pay the Puerto Rican subsidiary an annual fee of subsidiary's net sales of drug one under both trademarks. A distribution agreement between the Puerto Rican subsidiary and its parent provided that the parent became the exclusive distributor in the United States and Puerto Rico of both trade-names. *Id.*

The IRS proposed not to recognize the transfer of the pharmaceutical intangibles and the marketing agreement from the subsidiary to the Puerto Rican subsidiary and to redetermine the Puerto Rican firm's sale price to subsidiary. The IRS proposed to disregard the transfer under the authority of I.R.C. § 482. The redetermined sale price was based on the Puerto Rican subsidiary's costs plus 25%. For year three, this would substantially decrease the intercompany sales prices with a corresponding decrease in the subsidiary's cost of goods sold and an increase in the subsidiary's income. *Id.*

In technical advice, the IRS held that the I.R.C. § 351 transfer of the drug patents to Puerto Rican subsidiary must be recognized as to years four through six. The IRS concluded that the facts involved neither income distortion attributable to the transfer of unrealized appreciation or depreciation, nor distortion resulting from the artificial separation of income from the expenses incurred in producing income. Instead, the IRS found the transaction was essentially equivalent to the subsidiary's transfer of cash to the Puerto Rican subsidiary and the Puerto Rican firm's outright purchase of the intangibles. *Id.*

According to the IRS, any I.R.C. § 482 income allocation for year four through year six must be based on the factual determination that the Puerto Rican subsidiary's sales prices to subsidiary were not arm's length, having concluded that the Puerto Rican subsidiary owned the intangibles at issue. *Id.*

While it is clear that a I.R.C. § 482 override of I.R.C. § 351 remains possible in situations resembling the *National Securities* and *Central Cuba* lines of cases, it is less clear in modern day pricing cases whether this theoretical debate is of lasting importance. As in *Eli Lilly* and *Searle*, courts seem fully prepared to make the dollar amount of transfer pricing adjustments they wish to make, regardless of their views on the sanctity of I.R.C. § 351.

206. 26 C.F.R. § 1.367(d)-1T(g)(4) (1996).

207. White Paper, *supra* note 119, at 474.

208. 26 C.F.R. § 1.367(d)-1T(g)(4)(I) (1996).

transfers of intangibles in a Section 351 or Section 361 transaction. As noted above, it is not mere coincidence that the Section 367(d) regime, with its U.S. source rule not found in Section 482,²⁰⁹ virtually always produces a harsher result than from a Section 482 adjustment. It was argued earlier that the Section 367(d) U.S. source rule should be repealed as no longer serving a valid U.S. tax policy. If this suggestion were adopted, it would not usually matter whether any adjustment is made under Section 482 or under Section 367(d). Each now includes a requirement that the amount taken into account by the U.S. transferor be commensurate with the income attributable to the transferred intangibles.²¹⁰

IV. FOREIGN JOINT VENTURES THROUGH PARTNERSHIPS

Most features of the U.S. tax regime for domestic partnerships²¹¹ and their partners carry over to the foreign context.²¹² For example, the United States imposes a single tax on partnership income. The tax is imposed at the partner rather than the partnership level. Also, a partner must include its distributive share of the income earned by the partnership for its taxable year ending within the taxable year of the partner.²¹³ The following discussion focuses on the means by which the partnership regime has been modified and adapted to address the special problems arising in an international context. Similarly, attention is devoted to how the international tax regime includes, or fails to include, special rules directed to the partnership context. The analysis includes techniques by which the U.S. venturer may cope with sometimes surprising, and often irrational, interaction between the partnership and international tax rules. This section also offers suggestions as to how the rules may be clarified or revised to reach more sensible results consistent with congressional and judicial statements of U.S. tax policy. As was the case with corporate joint ventures, the discussion is organized according to the life cycle of the partnership: formation, operation, and finally disposition.

209. See I.R.C. § 367(d)(2)(C) (West 1995).

210. See *id.* §§ 367(d)(2)(A), 482.

211. This section assumes that the joint venture is instead classified as a partnership for U.S. (though not necessarily for foreign) tax purposes.

212. This section assumes that the partnership will conduct its business primarily or exclusively abroad. For particular cases, the tax planner also should consider whether the U.S. tax rules described below may be varied through the application of a tax treaty.

213. I.R.C. §§ 701, 706(a) (West 1995). This latter feature in the international context does not necessarily equate to a loss of deferral even if the venture is classified as a partnership rather than as a corporation, since a U.S. venturer in a partnership sometimes may achieve deferral by owning its partnership interest through a foreign subsidiary.

A. Formation of Venture

Establishment of a partnership structure to conduct business abroad often involves outbound property transfers. Three categories of outbound transfers are considered here: (1) transfers to a partnership; (2) transfers by a partnership; and (3) transfers of a partnership interest. As the following discussion demonstrates, the United States subjects outbound property transfers to tax treatment much more onerous than that applicable to similar transfers to domestic partnerships. The U.S. venturer sometimes obtains a clear tax advantage by using a domestic partnership as the vehicle to conduct the venture's business, which avoids rules governing transfers of property to foreign partnerships. As a practical matter, however, venturers often find that the foreign business environment requires the use of an entity established under foreign law. In addition, a foreign co-venturer may want to minimize contacts with the U.S. tax and legal jurisdiction. Therefore, the use of a domestic partnership as the operating entity may be vetoed by the foreign partner.

1. Outbound Transfer to Partnership

a. Imposition of Thirty-Five Percent Excise Tax

The most common means of establishing a foreign joint venture as a partnership is for each of the venturers to contribute property to the partnership in exchange for an interest in the partnership. In a purely domestic context, such a transaction is usually protected from adverse tax consequences under Section 721(a). Section 721(a) provides that the partnership and its partners do not recognize gain or loss on contributions of property.²¹⁴ If the transferee partnership is a foreign partnership,²¹⁵ however, the U.S. venturer's gain in the contributed assets is potentially subject to a thirty-five percent excise tax under Section 1491, unless one or more elections are made *before the transfer*.

The character of the tax as an excise tax rather than an income tax adds multiple insult to the injury. An excise tax cannot be offset by a Section 901 foreign tax credit. So, even a transferor with excess foreign tax credit carryovers will be affected by Section 1491.²¹⁶ Furthermore, despite having been taxed at a

214. Even in the domestic context, there are some exceptions to this nonrecognition rule. *See, e.g.*, I.R.C. §§ 721(b), 707(a)(2) (West 1995). Additional tax concerns are raised if a venturer performs services in consideration for a partnership interest. *See, e.g.*, *Diamond v. Commissioner*, 492 F.2d 287 (7th Cir. 1974); *but see Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991), *rev'g* 59 T.C.M. (CCH) 236 (1990).

215. A foreign partnership is one that is not created or organized in the United States or under the laws of the United States or any state. I.R.C. §§ 7701(a)(4), (5) (West 1995).

216. In contrast, if the transferor makes the I.R.C. § 1057 election, excess credits may be available to offset some of the potential tax liability on the transfer. In lieu of payment of the tax imposed by I.R.C. § 1491, the taxpayer may elect (for purposes of this subtitle), at such time and in such manner as the Secretary may

thirty-five percent rate, the transferor is not considered to have recognized its gain in the asset for income tax purposes.²¹⁷ Thus, the transferee partnership takes a carryover basis, rather than a fair market value basis, in the transferred asset.²¹⁸ Finally, the amount of gain subject to the excise tax is determined on an asset-by-asset basis. This is so that the built-in gain in one transferred asset cannot be offset by the built-in loss in another transferred asset.²¹⁹

prescribe, to treat a transfer described in I.R.C. § 1491 as a sale or exchange of property for an amount equal in value to the fair market value of the property transferred and to recognize as gain the excess of: (1) the fair market value of the property so transferred, over; (2) the adjusted basis (for determining gain) of such property in the hands of the transferor.

217. I.R.C. § 721(a) (West 1995).

218. *Id.* § 723. This lack of a basis step up may be partially mitigated if the excise tax is considered to be incurred immediately before the transfer, and if the transferor partner can successfully argue that the excise tax is a cost that should be capitalized to the transferred property. Subject to each of these conditions, the property in the hands of the partnership potentially receives a basis step up to the extent of the excise tax. This partial step up merely would limit the double taxation to 65% of the built-in gain, which is of little consolation when a I.R.C. § 1057 election would have triggered a 100% step up (perhaps even with a foreign tax credit to offset U.S. tax on the recognized gain) and a I.R.C. § 1492 election might have provided deferral.

219. In Rev. Rul. 71-433, 1971-2 C.B. 325, advice was requested regarding the application of I.R.C. § 1491 to the transaction described below.

A U.S. citizen, transferred the following stock to a trust which is a foreign trust within the meaning of I.R.C. § 7701(a)(31). Section 1491 of the Code imposes, on the transfer of stock or securities by a U.S. citizen or resident to a foreign trust, an excise tax equal to 27.5% of the excess of the value of the stock or securities so transferred over its adjusted basis (for determining gain) in the hands of the transferor.

Section 1492(2) of the Code and the Income Tax Regulations thereunder provide that the tax imposed by I.R.C. § 1491 will not apply if before the transfer it is established to the satisfaction of the Commissioner of Internal Revenue that such transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.

The citizen did not request a ruling from the Commissioner under I.R.C. § 1492(2) prior to the transfer of the stock and, consequently, the citizen is liable for the excise tax imposed by I.R.C. § 1491.

Stock	Adjusted Value	Appreciation Basis	(Depreciation)
75 shares of X (block 1)	\$ 450	\$ 600	(\$150)
150 shares of X (block 2)	900	450	450
200 shares of Y	1,200	1,800	(600)
100 shares of Z	900	500	400

The question presented is whether in computing the amount of excise tax imposed by § 1491 of the Code, A may offset the unrealized appreciation in the X (block 2) and Z stocks (totaling \$850) by the unrealized depreciation in the X (block 1) and Y stocks (totaling \$750).

In its enactment of the predecessor of I.R.C. § 1491 (§ 901 of the Revenue Act of 1932) Congress made clear its intent that the excise tax was imposed to prevent transfers of appreciated stock or securities to a foreign entity in order to avoid a tax on capital gains. See H.R. Rep. No. 708, 72d Cong., 1st Sess. 20 (1932) reprinted in 1939-1 C.B. (Part 2) 457, 494; S. Rep. No. 665, 72d Cong., 1st Sess. 26-7 (1932), reprinted in 1939-1 C.B. (vol. 2) 496, 536.

Thus, Congress was concerned with the transfer of appreciated stock or securities and there is no indication that it intended that the transfer of depreciated stock or securities in any way affect the amount of excise tax imposed on the transfer of appreciated stock or securities. Furthermore, the literal language of I.R.C.

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The harshness of the excise tax makes it essential that the U.S. venturer avoid Section 1491 if transferring appreciated assets to a foreign partnership. The statutory regime itself provides several escape elections which almost always provide more favorable treatment. The Section 1491 excise tax thus takes on the status of a trap for the unwary,²²⁰ and the statutory rules place a premium on timely elections.

b. Election of Section 367 Principles

Under Section 1492, the U.S. transferor can avoid the Section 1491 excise tax if it elects to be subject to principles "similar" to those of Section 367.²²¹ The election must be made before the transfer. Thus, if the Section 1491 trap is not discovered until after the transfer, or if an IRS examiner discovers an improperly reported Section 1491 transfer on audit, the U.S. transferor may not avoid the excise tax with the Section 1492 election. The corresponding, but much less certain, post-transfer remedy is a request for abatement under Section 1494.²²²

If the Section 1492 election is made, it is necessary to define what is meant by "principles similar to the principles of Section 367." In recent private rulings²²³

§ 1491 of the Code speaks only in terms of appreciated stock or securities since it states that the excise tax is imposed on the excess of the value of stock or securities transferred over its adjusted basis (for determining gain) in the hands of the transferor.

Accordingly, A may not, in computing the excise tax imposed by I.R.C. § 1491, offset the appreciation in the X (block 2) and Z stocks by the depreciation in the X (block 1) and Y stocks. The amount of excise tax imposed by section 1491 of the Code is, therefore, \$233.75 (27.5% x \$850—the excess of the total value of the X (block 2) and Z stocks over their total adjusted bases).

Pursuant to I.R.C. § 1494(b), the tax imposed by I.R.C. § 1491 may be abated, remitted, or refunded if after the transfer it is established to the satisfaction of the Secretary or his delegate that such transfer was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

220. The trap is especially insidious in the case of deemed transfers, such as the transfers that may result from a I.R.C. § 708 termination of a foreign partnership or a reclassification of a foreign 80% (or greater) subsidiary corporation as a partnership.

221. I.R.C. § 1492(2)(B) (West 1995). Nontaxable transfers. Wherein the tax imposed by I.R.C. § 1491 shall not apply: (1) If the transferee is an organization exempt from income tax under part I of subchapter F of chapter 1 (other than an organization described in I.R.C. § 401(a)); or (2) to a transfer—(A) described in § 367, or (B) not described in I.R.C. § 367 but with respect to which the taxpayer elects (before the transfer) the application of principles similar to the principles of I.R.C. § 367, or (3) to a transfer for which an election has been made under I.R.C. § 1057.

222. See Section IV.

223. In Priv. Ltr. Rul. 91-03-033 (Oct. 23, 1990), a U.S. parent corporation wishes to consolidate its ownership of three foreign subsidiaries into a same-country foreign entity that will be taxed as a partnership for federal income tax purposes. The subsidiaries are two first-tier subsidiaries and one second-tier subsidiary. The new foreign entity will be organized as a *societe en nom collectif* under the laws of the foreign country. The parent believes this new structure will result in more efficient management and reduce the tax liability in the foreign country of its two first-tier subsidiaries.

The laws of the foreign country require two or more persons to organize a *societe en nom collectif*. Accordingly, the parent corporation will transfer 12% of its shares of the two first-tier subsidiaries to a domestic subsidiary as a contribution to capital. Then the parent and the domestic subsidiary will each contribute their shares in the two foreign corporations to the new foreign entity.

the IRS indicated that it would apply a relatively straightforward mechanical test to determine how Section 367 principles are imported into the partnership context. Each ruling involved the transfer of CFC stock by U.S. corporations to a foreign partnership²²⁴ in exchange for interests in that partnership. A similar transfer to a foreign corporation would have qualified for nonrecognition treatment under Section 367(a) if the transferors entered into a gain recognition agreement.²²⁵ Such an agreement generally requires the transferors to file an amended return for the year of the original transfer if the transferee disposed of the stock

The bankruptcy or incapacity of a partner will cause the dissolution of the *societe en nom collectif*. Personal liability will exist for each of the partners in the *societe en nom collectif*.

The IRS has ruled that the transfer of stock by the parent and its domestic subsidiary to the *societe en nom collectif* will be exempt from the excise tax imposed by I.R.C. § 1491 if the parent and its subsidiary enter into a 10-year gain recognition agreement. The IRS further ruled that the *societe en nom collectif* will be classified as a partnership for federal income tax purposes.

Under the gain recognition agreement, a contributing partner will not be required to amend its return for the year of the initial transfer in the event of a subsequent disposition of the transferred stock, provided that any gain realized from such a disposition is allocated under I.R.C. § 704(c) to the contributing partner to the extent of that partner's pre-contribution gain in the stock. The contributing partner shall be required, however, to pay interest relating to the deferral of tax that resulted from the gain recognition agreement.

The transfer of stock to a foreign partnership, and election under I.R.C. § 1492(2)(B) to apply principles similar to the principles of I.R.C. § 367, the IRS explained, would generally require the application of rules similar to the rules of regulation 26 C.F.R. § 1.367(a)-3T and Rev. Rul. 87-85, 1987-2 C.B. 395. The parent and its domestic subsidiary must each elect on Form 926 prior to the transfer to apply principles similar to principles of I.R.C. § 367 to the transfer.

In Priv. Ltr. Rul. 91-22-074 (Mar. 6, 1991), a domestic parent corporation's consolidated group includes four wholly owned domestic subsidiary corporations. Two of the domestic subsidiaries each wholly owns a foreign subsidiary in the same country. The other two domestic subsidiaries own 50% of a foreign organization in that country. The foreign organization owns a third foreign subsidiary. To consolidate its ownership of the three foreign subsidiaries, the domestic parent proposes a transaction by which the foreign organization will acquire the stock of the two foreign subsidiaries that it currently does not own.

The parent will transfer stock of the two domestic subsidiaries with an interest in the foreign organization each to one of the other domestic subsidiaries. Those other two subsidiaries will then transfer their stock in their wholly owned foreign subsidiaries each to one of the domestic subsidiaries with an interest in the foreign organization; this stock will then be transferred to the foreign organization.

The IRS has ruled that, based only on the information provided it by the consolidated group, the foreign organization is a partnership for federal income tax purposes. In addition, the IRS ruled that, provided the two domestic subsidiaries, which continue as partners of the foreign partnership, each elect on Form 926 to apply principles similar to the principles of I.R.C. § 367, those two domestic subsidiaries will not be subject to tax under I.R.C. § 1491 on the transfer of property by a domestic corporation to a foreign partnership. In addition, the ruling contains a gain recognition agreement that must be substantially followed and submitted by the two domestic-partner corporations.

224. The foreign entity was actually a French *société en nom collectif*, and the rulings held in part that the entity was properly classified as a partnership for U.S. tax purposes. One of the interesting aspects of the rulings is that the foreign entity was owned entirely by members of a single U.S. consolidated return group, yet the rulings did not apply (or even refer to) the separate interests analysis of Revenue Ruling 77-214, 1977-1 C.B. 408. As discussed in Section I, application of separate interests analysis potentially could have cast doubt on the entity's partnership classification.

225. See 26 C.F.R. § 1.367(a)-3T (1996), as modified by Rev. Rul. 87-85, 1987-2 C.B. 395; 26 C.F.R. § 1.367(a)-3(b)(1)(ii)(B) (1996), 56 Fed. Reg. 41,999 (1991). The stock transfer rules of I.R.C. § 367(a) are discussed further in Section III. See *supra* Section III.

within the ten years following the initial transfer.²²⁶ The amended return will reflect recognition of the gain on the original transfer, and interest would be imposed on any resulting tax liability. The rulings held that the transfer to the foreign partnership would qualify for nonrecognition if the transferors entered into a gain recognition agreement substantially similar to the one prescribed by the Section 367(a) regulations.²²⁷ In an interesting variation from strict application of the Section 367(a) regulations, however, each ruling provides that an amended return need not be filed if, in the subsequent transfer, pre-contribution gain was allocated back to a contributing partner under Section 704(c). Although, the partner would nevertheless have to pay an interest charge with respect to such gain.²²⁸ The rulings also require a U.S. transferor to file an amended return recognizing gain in the year of initial transfer if it disposed of its partnership interest during the ten-year period. This aspect of the rulings provides an even harsher result than would occur under Section 367(a) and may simply have been the result agreed to as part of the ruling process. It is not at all clear that the statutory language will result in the application of Section 367 principles. This is because the gain recognition agreement imposed by Section 367(a) is not triggered by the original transferor disposing of its stock in the transferee corporation.

By not requiring the U.S. transferors to file an amended return in the event of a subsequent disposition causing pre-contribution gain allocation to the partners under Section 704(c), these rulings implicitly acknowledge the failure of Sections 1491 and 1492 to keep up with changes in related areas of the tax law. The object of the latter two sections, as well as the gain recognition election under Section 1057,²²⁹ is to assure that the U.S. partner's gain in the transferred asset remains within U.S. tax jurisdiction.²³⁰ Before Section 704(c) became mandatory, there was arguably some risk that a U.S. partner's pre-contribution gain could be shifted to a foreign partner thus escaping U.S. tax. After the 1984 amendments to Section 704(c) made allocation of pre-contribution gain to the contributing partner mandatory,²³¹ and later changes further tightened the provision's application,²³² the potential for loss of U.S. tax jurisdiction over U.S. partners' pre-

226. See *supra* note 107 and accompanying text.

227. Cf. Priv. Ltr. Rul. 79-48-081 (Aug. 30, 1979), in which a U.S. partner was required to enter into a similar closing agreement with respect to know-how that it transferred to a foreign partnership.

228. Generally, if the transferee foreign corporation disposes of the transferred property, then the transferor will file an amended return for the year of the transfer and recognize any gain realized but not recognized on the initial transfer. Exceptions are provided for an I.R.C. § 332 liquidation of the transferred corporation, a compulsory transfer described in 26 C.F.R. § 1.367(a)-4T(f) that was not reasonably foreseeable when the initial transfer occurred and a nonrecognition transaction. 26 C.F.R. § 1.367(a)-4T(f) (1996).

229. See *infra* Section IV.A.1.c.

230. H.R. Rep. No. 708, 72d Cong., 1st Sess. 20 (1932), reprinted in 1939-1 C.B. (Part 2) 494; S. Rep. No. 665, 72d Cong., 1st Sess. 26-7 (1932), reprinted in 1939-1 C.B. (vol. 2) 536.

231. Pub. L. No. 98-0369, § 71(a), 98 Stat. 494, 589 (1984).

232. See, e.g., the changes to § 704(c) made in 1989 by Pub. L. No. 101-239, § 7642(a), 103 Stat. 2106, 2379-2380.

contribution gain in the transferred asset is remote indeed. Furthermore, to the extent there remain some technical "loopholes" to Section 704(c) after these changes,²³³ they do not depend on the characterization of the transferee partnership as foreign rather than domestic. In the context of property transfers to partnerships, it is apparent that Sections 1491 and 1492 have lost whatever policy function they may once have fulfilled. Their repeal would be a welcome step toward a rational international tax regime for partnerships.²³⁴

c. Election of Gain Recognition

If a U.S. transferor of appreciated assets to a foreign partnership does not elect under Section 1492 to apply the Section 367 principles, Section 1057 nevertheless allows it to avoid the Section 1491 excise tax. The transferor may elect to recognize its gain in the transferred asset.²³⁵ Section 7.0 of the temporary regulations permits a Section 1057 election any time up to the due date of the tax return for the year including extensions. However, instructions to Form 926 require that the form be filed by the date of the transfer. The form asks whether an election is being made under Section 1057.²³⁶

Unlike the Section 1491 excise tax, the Section 1057 election to recognize gain results in a full basis step up (defined as the amount in value in excess of the fair market value of the property transferred in the sale or exchange) in the transferred assets. Of even greater potential importance for a U.S. transferor with excess foreign tax credits transferring assets whose sale gives rise to general basket foreign source income (as is often the case when the transferred assets are those of a foreign branch),²³⁷ is that the recognized gain may increase the transferor's Section 904 limitation and thus, not give rise to any additional U.S. tax liability. The potential for utilizing excess foreign tax credits sometimes makes the Section 1057 election preferable, even to deferral obtained under a Section 367 principles application election. For example, the Section 1057 election might be a useful means to "soak up" excess foreign tax credits that would otherwise expire un-

233. See John P. Steines, *Partnership Allocations of Built-In Gain or Loss*, 45 TAX L. REV. 615 (1990).

234. A report being prepared for the Section of Taxation of the American Bar Association correctly points out that repeal of I.R.C. § 1491 should be accompanied by an expansion of I.R.C. § 367(c)(2) to cover all capital contributions to foreign corporations.

235. Section 1492(3) provides that the excise tax imposed by I.R.C. § 1491 shall not apply to a transfer for which an election has been made under I.R.C. § 1057. I.R.C. § 1492(3) (West 1995).

236. Since the time for making the I.R.C. § 1057 election is not fixed by statute, unlike the election to apply § 367 principles, requests for relief under 26 C.F.R. § 1.9100-1 of the regulations may have been available. However, 26 C.F.R. § 1.9100-1 extension of time for making certain elections was removed pursuant to 56 Fed. Reg. 64,982 (1991).

237. As noted earlier, however, there may be a lack of clarity as to how the source rules apply in the case of property that is "deemed" to have been sold, if the source depends on the place at which such deemed sale is considered to have occurred.

used.²³⁸ In which case, the danger is that the Section 1057 election may be invalid. The legislative history accompanying the enactment of Section 1057 indicates that the gain recognition election is not available if a principal purpose is the avoidance of federal income tax.²³⁹ However, this election availability limitation was based on the pre-1984 version of Sections 1491, 1492 and 367, which contained a tax avoidance purpose concept.²⁴⁰ With the removal of the subjective tax avoidance test from these sections in 1984,²⁴¹ the better policy is to construe the Section 1057 election as being available without regard to the taxpayer's principal purpose. The potential downside of an invalid Section 1057 election is the punitive application of the Section 1491 excise tax. This risk is so great, that the IRS should issue regulations under Section 1057 at least clarifying the tax avoidance limitation was extinguished by the 1984 legislation.

The availability of gain recognition under Section 1057 highlights the irrationality of the Section 1491 excise tax regime. Even assuming that the transfer of appreciated property to a foreign partnership has sufficient avoidance potential that a departure from the usual domestic nonrecognition treatment is appropriate, the imposition of an excise tax, rather than gain recognition, seems designed to create double or multiple taxation.²⁴² Although the statute provides escape elections, unwary taxpayers sometimes fail to spot the dangers until too late and become subject to Section 1491. Thus, if it is not possible to exempt transfers to foreign partnerships from the regime of Sections 1491 and 1492 altogether, an alternative solution is for the the statutory regime to be amended to provide for gain recognition unless the taxpayer elects the application of Section 367 principles to the transfer. In essence, the statutory default should be no worse than the treatment currently provided if the taxpayer elects under Section 1057 to recognize gain instead of paying the excise tax. By eliminating the possibility of the excise tax, the most unreasonable element of the regime would be neutralized. In the author's view, however, the regime should be eliminated, not merely amended.

238. The same principle may make the I.R.C. § 1057 election desirable in the case of a U.S. transferor with loss carry overs that can be used to offset the recognized gain.

239. See, e.g., STAFF OF THE JOINT COMM. ON TAX'N, TAX REFORM ACT OF 1976, 94th Cong., 2d Sess. 226 (Comm. Print 1976), which states:

Since the objective of section 1491 is to prevent a transfer which is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes without payment of tax, the making of an election which has as one of its principal purposes the avoidance Federal income taxes is not permitted.

Id.

240. *Id.*

241. Pub. L. No. 98-369, § 131(f)(1), 98 Stat. 494, 665 (1984).

242. In addition to the adverse consequences discussed above, the U.S. tax treaty network will not relieve the double taxation, since the "relief from double taxation" article generally is subject to U.S. domestic limitations on the foreign tax credit, and in any event the article obligates the United States to grant a credit against the U.S. tax on income, but not against a U.S. excise tax. See MODEL INCOME TAX TREATY arts. 2(1)(a), 23(1) (U.S. Treasury Dep't draft of June 16, 1981).

d. *Transfer of Intangibles*

Suppose the U.S. venturer wants to transfer an entire foreign branch to a foreign partnership in exchange for an interest in the partnership. If the Section 1492 election is made, it is likely that most branch's assets will qualify for nonrecognition under the principles of Section 367(a)(3)(A).²⁴³ In addition to active business assets qualifying for nonrecognition, however, the transfer of the foreign branch also often involves the transfer of intangible property.²⁴⁴ The Section 1492 election throws the treatment of the intangible property into the principles of Section 367(d).²⁴⁵ As noted earlier,²⁴⁶ the harsh Section 367(d) regime generally imputes a stream of contingent payments to the U.S. transferor commensurate with the income attributable to the transferred intangible and deemed to be U.S. source income. Since the U.S. source income does not improve the transferor's Section 904 foreign tax credit limitation, and since a foreign country is likely to impose tax on the income generated by the intangibles, the application of Section 367(d) principles often results in worldwide double taxation.²⁴⁷

243. To qualify, the assets generally must be used by the partnership in an active trade or business outside the United States and must not be described in I.R.C. § 367(a)(3)(B). In addition, the nonrecognition of gain for active business assets may be overridden under I.R.C. § 367(a)(3)(C) to the extent the branch has generated net losses, or under I.R.C. §§ 904(f)(3) and (f)(5) to the extent the U.S. venturer has an overall foreign loss or a loss in a particular foreign tax credit basket. I.R.C. §§ 367, 904 (West 1995).

244. For purposes of this discussion, it is assumed that the intangibles transfer qualifies as a transfer of "property" rather than a mere "right to use property." Much turns on this semantical hair-splitting, as I.R.C. §§ 1491 and 1492 apply only to a transfer of "property." The distinction between property and the mere right to use property in the context of intangibles transfers is noted in the lead-in discussion of Section III.A.2 dealing with outbound transfers to corporations. *Cf.* *United States v. Stafford*, 727 F.2d 1043 (11th Cir. 1984), in which the court applied authorities in the I.R.C. § 351 area of determining whether certain interests were property for purposes of I.R.C. § 721. Is it possible that intentionally failing to have the transferred interest in intangibles qualify as property may be an untrodden path to the avoidance of the I.R.C. § 1491 excise tax? The venturer that might wish to explore this uncharted terrain should beware of the collateral consequences that accompany the characterization of the transferred interest as other than property, including the inapplicability of I.R.C. § 721 (which grants nonrecognition to the partners *and the partnership* only in the case of a contribution of property to the partnership in exchange for an interest therein).

245. In connection with the amendment of I.R.C. § 1492, the Bluebook indicates that the election to apply principles similar to those of I.R.C. § 367(d) with respect to intangibles. *See* 1986 Bluebook, note 148, at 435. Under the principles of I.R.C. § 367(d), the term "intangible property" is itself a trap for the unwary, as it has a surprisingly broad definition. *See supra* Section III.A.2.a.

246. *See supra* Section III.

247. I.R.C. § 367(d)(2)(B) (West 1995). Contingent payments that are deemed received by a U.S. transferor reduce a foreign corporate transferee's earnings and profits. *Id.* In a partnership context, if the transferor partner elects to apply the principles of I.R.C. § 367, the reduction of earnings and profits in the corporate context would seem to correspond to the allowance of a deduction to the transferee partnership to the extent of its deemed payments to the transferor partner. *Id.* This deduction, though helpful, generally does not eliminate the potential for worldwide double taxation. *Id.* The deduction is not recognized by a foreign country, and, therefore, does not reduce foreign tax liability. The foreign tax may not be fully creditable against U.S. tax liability, because the partner's income is U.S. source whereas the partnership deduction is at least partly allocable to foreign source income for purposes of determining the relevant I.R.C. § 904 limitation. 26

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Thus, the Section 1492 election, carrying the benefit of nonrecognition for the foreign branch's active business assets, may be prohibitively expensive if the branch has intangibles subject to the principles of Section 367(d).²⁴⁸ In this case, two general avenues should be explored. One is to carve out the tainted intangibles from the assets transferred to the foreign partnership and use alternative means to provide the venture with the use of those intangibles. Several options to avoid Section 367(d) were discussed in the context of corporate joint ventures:²⁴⁹ (1) licensing or selling the intangibles to the venture; (2) licensing the intangibles to a foreign affiliate which then contributes the intangibles to the foreign venture or contributing the intangibles to a domestic partnership which then licenses them to the foreign joint venture. These techniques are equally applicable in the context of a partnership joint venture. They serve to escape the punitive effect of U.S. source treatment under the principles of Section 367(d) for future earnings attributable to the intangible property.

It is also wise to explore alternatives found under the principles of Section 367(d) itself. The regulations under Section 367(d) contain certain escape provisions such as an election to recognize gain on certain intangibles immediately, instead of being subject to the contingent payments/commensurate with income rule.²⁵⁰ Depending on the types of intangibles transferred and the structure of the foreign partnership, electing the principles of Section 367 and electing deemed sale treatment under Section 367(d) may combine the best elements of the Section 1492 election (nonrecognition for tangible assets) and the Section 1057 election (avoidance of the commensurate with income rule of Section 367(d)). The recognized gain on the intangibles is still U.S. source income, however, so even this alternative is no bargain. The restructuring alternatives discussed in the corporate area²⁵¹ are therefore preferable, provided they can be accomplished in a manner consistent with the venture's business and the objectives of the venturers.

C.F.R. § 1.861-8(b), 1.861-8T(c)(1) (1996). The source rules applicable to a partner's share of partnership items, and the foreign tax credit rules are discussed in Section IV. *See supra* Section IV.

248. The amorphous "commensurate-with-income" standard also introduces an undesirable degree of uncertainty as to the amount of the deemed payments, and this uncertainty is itself a powerful incentive to pursue other options.

249. *See supra* Section III.

250. 26 C.F.R. § 1.367(d)-1T(g)(2) (1996). In the case of a U.S. transferor and a foreign partnership considered to be "owned or controlled directly or indirectly by the same interests," however, electing to treat an intangibles transfer as a deemed sale may throw the transfer back into a commensurate with income rule via § 482. For more detailed discussion of the deemed sale election under the I.R.C. § 367(d) regulations, and analysis of when a transferor venturer and a transferee venture can be considered under common control for purposes of I.R.C. § 482. *See supra* Sections III.A.2.a and III.A.3.a.

251. *See supra* Section III.

e. Abatement

Unfortunately, the above discussion assumes that the U.S. venturer has dealt with the Section 1491 issues before consummating the transaction. If such issues are not addressed until after the deal is completed, the best chance for damage control may be to seek abatement.

Under Section 1491(b), the IRS can abate, remit, or refund the Section 1491 excise tax if the taxpayer elects to be subject to the principles of Section 367 after the transfer.²⁵² Abatement is the administrative equivalent of throwing oneself on the mercy of the court. The IRS has virtually no experience in applying Section 1492 abatement. Presumably, a case needs to be built as to inadvertence. This is because in deciding whether to grant abatement, the IRS will ask why the taxpayer failed to make a timely Section 1492 election. Considering the lack of policy support for the Section 1491 excise tax, the IRS should adopt a liberal policy of abatement. For the cautious tax planner, however, the discretionary nature of the remedy dictates that Section 1494 abatement be viewed as a last resort. It should never be relied upon if there is still time to make a Section 1057 or Section 1492 election or otherwise to avoid the Section 1491 excise tax.

Here, too, the policy supporting the Section 1491 excise tax is called into question. In the context of abatement, why must the election to avoid the excise tax by applying Section 367 principles be made *before* the transfer? This article previously argued that transfers to foreign partnerships should be removed from the Sections 1491 and 1492 regime entirely. As an alternative, this article argues that the general rule should be Section 367 principles or gain recognition rather than an excise tax. If legislative inertia prevents even this modest proposal, taxpayers should be permitted to make the elections to avoid the excise tax after the transfer. To do otherwise is simply to punish the U.S. venturer, whose attention was focused on the economics of the venture, and therefore, failed to consult a tax advisor until the deal was done and the time for tax elections had expired.

2. Outbound Transfer by Partnership

a. Outbound Transfer to Foreign Corporation

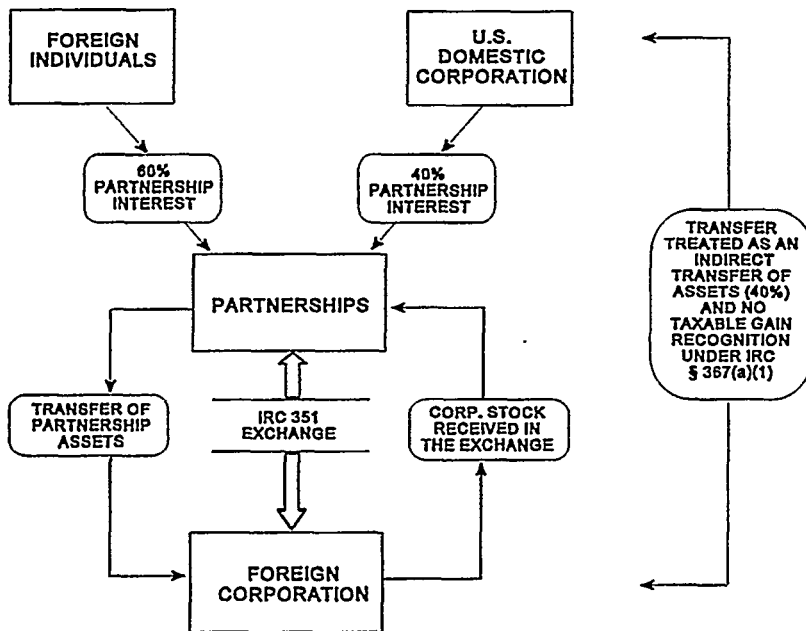
The Section 367(a) regime applies to certain outbound transfers of property by a United States person.²⁵³ The definition of the term "United States person"

252. I.R.C. § 1492 (West 1995). Nontaxable transfers, the tax imposed by I.R.C. § 1491 shall not apply: (1) if the transferee is an organization exempt from income tax under part I of subchapter F of chapter 1 (other than an organization described in I.R.C. § 401(a)); or (2) to a transfer—(A) described in I.R.C. § 367, or (B) not described in I.R.C. § 367 but with respect to which the taxpayer elects (before the transfer) the application of principles similar to the principles of I.R.C. § 367; or (3) to a transfer for which an election has been made under I.R.C. § 1057. *Id.* § 1491.

253. *Id.* § 367(a)(1).

includes a domestic partnership, but not a foreign partnership.²⁵⁴ Thus, on the face of the statute, it may appear that the scope of section 367(a) omits transfers by a foreign partnership even if the partnership is owned by U.S. persons. Instead, the regulations adopt an aggregate (look-through) approach to treat a partnership's transfer of property to a foreign corporation as an indirect transfer by the partners for purposes of Section 367(a). This is without regard to whether the transferor partnership is domestic or foreign.²⁵⁵

Example Twelve: Domestic corporate DC has a forty percent interest in partnership P. The other sixty percent of P is owned by foreign persons. P transfers assets to a foreign corporate in an exchange described in Section 351. The transfer is treated as an indirect transfer by DC to the extent of forty percent of the transferred assets, and forty percent of the gain in the transferred assets, and forty percent of the gain in the transferred assets is recognized under Section 367(a)(1) unless an



254. I.R.C. § 7701(a)(30) (West 1995). A United States person is:
 (A) a citizen or resident of the United States,
 (B) a domestic partnership,
 (C) a domestic corporation, and
 (D) any estate or trust (other than a foreign estate or foreign trust, within the meaning of section 7701(a)(31)).

Id.

255. 26 C.F.R. § 1.367(a)-1T(c)(3)(i) (1996).

exception applies.²⁵⁶

The aggregate approach adopted by the regulations is good policy.²⁵⁷ Neither a domestic nor a foreign partnership is itself subject to tax in the United States, so the U.S. tax regime should not distinguish between the two for purposes of Section 367(a).²⁵⁸ Furthermore, as discussed below, the same principle of neutrality between domestic and foreign partnerships regarding transfers to foreign corporations should be applied to transfers to foreign partnerships as well.

b. Outbound Transfer to Foreign Partnership

The scope of Section 1491 includes a property transfer by a domestic corporate or partnership to a foreign partnership. Putting aside the question of whether the limiting word “domestic” modifies only the word “corporation” or also “partnership,” it is clear that the transfer by a domestic partnership to a foreign partnership is subject to the Section 1491 excise tax unless a Section 1057 or Section 1492 election is made. What happens if the domestic transferor partnership has both U.S. and foreign partners? Consider the example in which a domestic partnership transfers property to a foreign partnership: the transferor partnership is owned forty percent by a domestic corporation (*DC*) and sixty percent by foreign persons.

In the absence of a Section 1057 or 1492 election,²⁵⁹ it is not clear whether the Section 1491 excise tax applies to all of the built-in gain of the transferred

256. See *supra* Section III (discussing the exceptions to the gain recognition rule of I.R.C. § 367(a)(1) in the case of a U.S. person’s transfer of assets to a foreign corporation).

257. In defending the regulations, the IRS could note that the lead-in language of I.R.C. § 7701(a) suggests that its definition of U.S. person should not apply if manifestly incompatible with the intent of § 367(a). See SENATE COMMITTEE ON FINANCE, DEFICIT REDUCTION ACT OF 1984, EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, S. Rep. No. 98-169, 98th Cong., 2d Sess. 362 (1984).

258. For the same reason, I noted earlier the lack of policy supporting I.R.C. § 1491, which distinguishes between transfers to foreign partnerships as compared to domestic partnerships.

259. If the I.R.C. § 1492 election is made with respect to a domestic transferor partnership, the look-through principles of 26 C.F.R. § 1.367(a)-1T(c)(3)(i) cause the transfer to be treated as if the transferor partnership’s partners had transferred their shares of partnership assets. 26 C.F.R. § 1.367(a)-1T(c)(3)(i) (1996) United States partners would apply the principles of I.R.C. §§ 367(a) or (d) to their shares of transferred assets, and foreign partners would not be subject to tax with respect to their shares of the transferred assets. In the case of an election under I.R.C. § 1057 to recognize gain rather than to apply the principles of I.R.C. § 367, the amount of gain to be recognized presumably is whatever gain would have been subject to the I.R.C. § 1491 excise tax.

A separate but related issue is whether the I.R.C. §§ 1492 or 1057 election is made by the partnership or is made separately by the partners. Section 703(b) provides (with exceptions not here relevant) that any election affecting the computation of taxable income derived from a partnership is made by the partnership. The I.R.C. § 367 regulations are far from clear on this subject, but appear to contemplate that the gain recognized under I.R.C. § 367(a) would be taken into account by the deemed transferor partners, and not by the partnership. (The partnership would be eligible for a basis adjustment under I.R.C. §§ 743 and 754). 26 C.F.R. § 1.367(a)-1T(c)(3) (1996). The safest course, if the partnership will cooperate, would be to make the I.R.C. §§ 1492 or 1057 election at both the partnership and partner levels, and to let the IRS sort out which election is to be respected. See generally *supra* Section IV.A.1.c.

assets or only to DC's forty percent share of the gain. In other words, it is unclear whether Section 1491 looks through to the partners of the transferor partnership. Once again, the issue is whether the transferor partnership is properly viewed as an entity so the entire transfer is subject to the Section 1491 excise tax, or as an aggregate so that the transfer is subject to Section 1491 only to the extent of the transferor partnership's U.S. partners.

On the facts of the above example, the IRS may be tempted to adopt an entity view so that Section 1491 has maximum applicability. But before it does so, it would do well to consider a *foreign* partnership's transfer of assets to a second-tier foreign partnership: Is the transaction subject to Section 1491? The statute states that Section 1491 applies to a transfer by a domestic corporation or partnership. Restricting the application of the word "domestic" in Section 1491 as applying only to transferors in corporate form is contradictory to the Congressional intent. For example, transfers by a foreign partnership (without any U.S. partners) are not subject to the excise tax, since there is not U.S. tax on the transaction. However, transfers by a foreign partnership with U.S. partners is subject to U.S. tax, since there is a potential for tax avoidance by the U.S. partners. On the other hand, what if a foreign transferor partnership has U.S. partners? Consider the same facts as in the previous example, except that the transferor partnership is foreign rather than domestic.

The potential for U.S. tax avoidance, if it exists at all, is just as great in the second case as in the case of a domestic transferor partnership. Also, it defies reason that the two should have dramatically different tax treatment. With this case in mind, the IRS should adopt an aggregate approach to Section 1491 in the context of partnership transferors, thus giving up some tax jurisdiction in the case of a domestic transferor partnership that has a foreign partner, but retaining jurisdiction over the foreign transferor partnership that has a U.S. partner. From the government's perspective this is a no-loss proposition since, even in the case of the domestic transferor partnership, the taxpayer always has the ability to elect into an aggregate regime under Section 1492.²⁶⁰

3. Outbound Transfer of Partnership Interest

The preceding section addressed the case in which a partnership that owns property (the "first partnership") contributes the property to a foreign corporation or partnership in exchange for an interest in the transferee. This transfer results in a tiered structure, in which the first partnership ends up owning an interest in

260. 26 C.F.R. § 1.1367(a)-1T(c)(3)(i) (1996). As indicated above, an I.R.C. § 1492 election allows a domestic transferor partnership to qualify for look-through treatment via the principles of 26 C.F.R. § 1.1367(a)-1T(c)(3)(i). *Id.*

the first partnership rather than being owned by the first partnership.²⁶¹ To achieve this structure, the owner of an interest in the first partnership can contribute his interest to the foreign transferee. The tax consequences of the transfer again differ depending on whether the foreign transferee is a corporation or a partnership.

a. Transfer of Partnership Interest to Foreign Corporation

A U.S. partner's transfer of a partnership interest to a foreign corporation is generally treated as a transfer of a share of the partnership's assets for purposes of Section 367(a).²⁶²

Example Thirteen: Domestic corporation *DC* owns forty percent of partnership *P*. *DC* transfers its partnership interest to foreign corporation *FC* in a Section 351 exchange. The transfer is treated as a transfer by *DC* of forty percent of *P*'s assets to *FC* and is taxable unless the assets qualify for an exception to Section 367(a)(1).

In providing for a general look-through rule in the case of a transfer of a partnership interest, however, Congress noted that limited partnership interests frequently represent passive investments comparable to stock or securities and should therefore be treated in a similar manner.²⁶³ The regulations have partially fulfilled these expectations by providing that, for purposes of Section 367(a), a transfer of a limited partnership interest regularly traded on an established securities market is treated in the same manner as a transfer of stock.²⁶⁴ One of the historically significant aspects of this rule is that before the enactment of Section 7704, it was antecedent for other regulations which treated publicly traded partnership interests treated in a manner similar to stock.²⁶⁵

b. Transfer of Partnership Interest to Foreign Partnership

A U.S. person's transfer of a domestic or foreign partnership interest to a foreign partnership is subject to the Section 1491 excise tax. This is unless the U.S. transferor makes the Section 1057 or Section 1492 election. Sections 1057

261. The transferee obviously cannot end up owning all of the interests in the partnership, since a partnership cannot exist with only one partner. See 26 C.F.R. § 1.708-1(b)(1)(I) (1996); Rev. Rul. 84-111, 1984-2 C.B. 88; Rev. Rul. 86-139, 1986-2 C.B. 95.

262. I.R.C. § 367(a)(4) (West 1995); 26 C.F.R. § 1.367(a)-1T(c)(3)(ii)(A) (1996).

263. See, e.g., 1986 Bluebook, note 148, at 431-32.

264. 26 C.F.R. § 1.367(a)-1T(c)(3)(ii)(C) (1996).

265. See, e.g., 26 C.F.R. §§ 1.367(e)-2T(b)(1)(iii)(C), 1.897-1(c)(2)(iv) (1996). These regulations each employ a slightly different set of rules for determining whether the partnership interests are publicly traded to a sufficient extent that they resemble, and should be treated in a manner similar to, stock. Wherever possible, the IRS should attempt to conform these definitional rules.

and 1492 provide elections for the built-in gain to be treated as either: a gain in the transferor's partnership interest; or a gain in the partnership's assets. These elections provide yet another variation that results from choosing the entity or aggregate approach. Again, an aggregate (i.e., look-through) approach seems to work better. For example, looking solely to the transferor's gain in its partnership interest would effectively allow the offsetting of built-in loss against built-in gain through the pre-transfer stuffing of built-in loss assets in the partnership. The IRS would assert that the pre-transfer contribution should be disregarded, thus sending the parties into a swamp of step transaction and substance over form with all its concomitant uncertainty. The look-through approach not only avoids this gamesmanship, but is also more consistent with the Section 367 regime. The Section 367 regime generally treats the transferor partner as transferring an interest in each of the partnership's assets.²⁶⁶ This consistency point is especially important since the taxpayer always has the Section 1492 option to treat the transfer as subject to the principles of Section 367. It would be incongruous to have a regime in which the amount of built-in gain at issue depends on how the taxpayer elects to have the gain treated.

V. AN AGGREGATE MODEL FOR TAXING FOREIGN JOINT VENTURES

This article noted at the outset that the entity/aggregate tension exists for foreign joint ventures whether classified as corporations or partnerships. Section II, dealing with foreign entity classification, concluded with the suggestion that tax administration and international business planning would benefit if the tax treatment of a foreign joint venture were made less dependent on how it is classified for U.S. tax purposes. Sections III and IV explored areas in which the existing rules frustrate established congressional policies and in which formalistic devices may be used to exploit gaps or areas in the law that need further legislative revision and achieve more favorable tax treatment.

Conformity between the partnership and corporate tax regimes for international joint ventures, and rationalization of the specific rules in each regime, would be advanced by moving further in the direction of an aggregate (look-through) approach to income characterization of the venture at the time it is subject to U.S. taxation. Thus, throughout this article the author has noted how various issues should be resolved and existing rules amended in order to implement an aggregate approach. The discussion below provides a side-by-side review of some of the ways identified earlier in which the partnership tax regime and/or the corporate tax regime in the context of international joint ventures currently fails to adopt the aggregate approach. It further discusses how that failure prevents the regimes from achieving the proper international tax result.

266. See I.R.C. § 367(a)(4) (West 1995).

A. Formation of Venture

In the formation phase of foreign joint ventures, the most significant difficulties are presented by the Section 1491 regime, in the case of partnerships. In the case of corporate joint ventures difficulties are presented by 367(d). The Section 1491 regime relies on an entity model. It therefore treats the outbound transfer of appreciated assets potentially resulting in U.S. tax avoidance through the shifting of pre-contribution gain away from the U.S. transferor. Such an entity approach leads to two principal fallacies. First, attaching significance to the status of the transferee as an entity results in treating the transfer as outbound if, and only if, the transferee partnership is foreign. This distinction between foreign and domestic transferee-partnerships makes little sense since a transferee-partnership is not itself subject to U.S. tax in either case and its status as foreign or domestic should therefore be immaterial. Second, and more important, even if the transferee-partnership (whether domestic or foreign) has foreign partners, the applicable domestic tax law has been revised to prevent the transferor-partner's pre-contribution gain from being redefined as tax-free to prevent the transferor-partner's pre-contribution gain from being shifted from taxable to non-taxable as a result of the transfer. The basic point is that if the domestic rules for transfers to partnerships adopt an aggregate model, there is no justification for the imposition of an excise tax or other impediments to the tax-free transfer of assets by a U.S. venturer to a foreign partnership.

This same basic point, that the U.S. tax rule should not impede an outbound transfer of appreciated assets as long as the pre-contribution gain remains with the transferor, is equally useful in the context of outbound transfers of intangible property to a foreign corporation. Since 1984, Section 367(d) has imputed deemed annual payments treated as U.S. source income to the U.S. transferor. This U.S. source treatment causes no increase in the transferor's Section 904 foreign tax credit limitation and is, therefore, likely to result in worldwide double taxation. As a result of the 1986 Act, the deemed payments under Section 367(d) are to be an amount commensurate with the income attributable to the transferred intangibles. This deemed income stream should assure that the income attributable to the intangibles (including to a realization of pre-contribution gain) remains with the U.S. transferor even after the transfer, and that the transferor cannot achieve deferral by having the income realized after the intangibles are in the hands of a foreign corporation. These effects are a departure from the domestic treatment of a corporate transferee as a separate entity whose future income is not normally imputed to a transferor. With a view to preservation of U.S. tax jurisdiction over future income attributable to intangibles, there is no reason to penalize the outbound Section 367(d) transfer through treatment of the deemed payments as U.S. source income.

Thus, in both the partnership and corporate contexts, changes in the applicable law have moved toward an aggregate approach ensuring that U.S. tax

jurisdiction, with respect to transferred property, is preserved even after the transfer of the property to a foreign joint venture. In light of this development, the excise tax regime of Section 1491 and the U.S. source treatment of the Section 367(d) deemed payments are no longer appropriate (if they ever were) and should be repealed.

VI. CONCLUSION

This article has provided the international tax planner with the proper list of questions, concerns and alternatives demanding resolution prior to the commencement of preparations for establishing and participating in a foreign joint venture. The laws of the United States in these areas are continuing to be redefined and reformed. Prior to entering into a joint venture agreement, the relevant laws and cases cited herein should be reviewed for current applicability as well as relevant foreign joint venture countries' laws and regulations.

Within the initial stages of structuring the joint venture agreement, innocent agreements to transfer monies, assets or liabilities into the venture may cause financially devastating effects. Sections 367 and 482 must be revisited to determine current effect of these Internal Revenue Code Sections on promised transfers within the agreement that will provide for a more successful beginning of the venture and the tax relief available to the U.S. joint venture party.

As new legislation reshapes and redefines the laws and cases presented in this article, the lines between aggregate and entity will continue to be blurred. The international tax planners must continue to evolve new strategies and formations as Congressional and foreign legislation changes the transactional and tax effects of U.S. partners participating in foreign joint ventures.

