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# Profit-Shifting Structures and Unexpected Partnership Status

Jeffrey M. Kadet
*University of Washington School of Law*

David Koontz

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By Jeffery M. Kadet and David L. Koontz

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# Profit-Shifting Structures and Unexpected Partnership Status

By Jeffery M. Kadet and David L. Koontz

Jeffery M. Kadet was in private practice for more than 32 years, working in international taxation for several major international accounting firms. He now teaches international tax courses in the LLM program at the University of Washington School of Law in Seattle. David L. Koontz is a retired CPA who, as a tax partner in a major accounting firm, spent 25 years working in offices in the United States and Asia. He was involved with international transactions, including raising capital from multiple sources and using that capital in public and private companies worldwide.

Multinational corporations operating worldwide businesses managed from their U.S. offices may have inadvertently created a partnership for U.S. tax purposes in connection with their profit-shifting strategies. When this happens, foreign group members treated by the IRS as partners will be engaged in a trade or business in the United States, which is the threshold test for application of the effectively connected income rules. Kadet and Koontz argue that affected multinationals and their auditors should reexamine existing tax structures to determine if they can withstand an assertion by the IRS that the arrangement constitutes a partnership and therefore results in taxable ECI.

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Many U.S.-managed businesses, whether as part of a U.S.-based or foreign-based[1] multinational corporation (MNC), use low-taxed foreign group members to record sales, service, and royalty income. This, of course, is nothing new. However, when the following three factors are present, statutory and regulatory authority exists for the IRS to assert that a foreign group member is conducting a trade or business in the United States and is directly taxable on the effectively connected income attributable to that business. These factors are:

- critical value drivers performed predominantly by U.S. group members;
- extensive U.S.-located control and decision-making that far exceeds what would be found in typical unrelated-party situations; and
- a lack of capable offshore foreign group member management personnel.[2]

The article referenced in footnote 2 provides technical background and examples of how the code's ECI rules may apply to various foreign companies that exhibit those three factors. It also explains how ECI is taxed by the United States at rates of up to 54.5 percent and higher. The purpose of this report is to illustrate that in many situations when the three factors exist, there will also be joint activities and other conditions that create a separate entity treated as a partnership for U.S. tax purposes, with the partners being the foreign and U.S. group members involved in the applicable business. Once a partnership is found to exist, the activities conducted and the assets used in that business are considered to be within the partnership and are no longer the activities and assets of the respective partners (that is, the foreign and U.S. group members). With the partnership carrying on a business through U.S. offices, the foreign group member is similarly conducting a trade or business in the United States, which is the threshold test for the ECI rules to apply. Thus, in these situations, the IRS should have a much easier time applying the ECI rules to assess tax on the foreign group members.[3]

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[1]Foreign-based MNCs include former U.S. MNCs that have inverted into foreign ownership, as well as foreign MNCs that own U.S.-managed businesses.

[2]*See* Jeffery M. Kadet, "Attacking Profit Shifting: The Approach Everyone Forgets," *Tax Notes*, July 13, 2015, p. 193.

[3]Finding the existence of a partnership with offices in the United States through which revenue is earned is significant.

**(Footnote continued on next page.)**

### U.S.-Managed Businesses: Background

Many MNC groups with U.S.-managed businesses interact with their worldwide markets seamlessly. Typically, the foreign group members have significant numbers of employees outside the United States performing various functions and activities, but they must depend on U.S. group members to perform critically important functions and activities to support their sales, services, and licensing revenues.[4] Functions and activities performed within the United States include:

- business management and direction;
- research and development;
- sourcing of inventory, including purchasing functions as well as activities that constitute manufacturing under reg. section 1.954-3(a)(4) (importantly, including paragraph (a)(4)(iv)[5]);
- negotiation, solicitation, and other activities involved in consummating sales, distribution agreements, and licensing arrangements; and
- corporate administration, legal and financial functions, etc.

Despite the seamless business model seen by customers worldwide, the typical strategies used by many MNCs to reduce their tax liabilities include two or more players: (1) a U.S. group member (US-Co, which may include other U.S. affiliated group members) and (2) one or more foreign group members (F-Co), established and tax resident in jurisdictions that subject them to low or no taxation. For purposes of this report, F-Co includes any disregarded entity (DRE) subsidiaries[6] that it might own.

US-Co and F-Co are separate legal entities and principals, each with full corporate authority to conduct business, provide services, license intangibles, and source and sell products to unrelated parties in its respective territory. The territory of US-Co is the United States, and for simplicity, it is assumed that there is just one F-Co, whose territory covers the rest of the world. In practice, an MNC group might have several F-Cos, each with a defined territory.

US-Co and F-Co fund their respective shares of R&D costs through a cost-sharing agreement (CSA) for the development of intangibles. Typically, the bulk of that R&D activity is conducted within the United States. Under the CSA, US-Co and F-Co each own a portion of the economic rights to all intangibles created, and they have the rights in their respective territories to provide services, license intangibles, and sell hardware or software products based on those intangibles. Further, those rights allow them to manufacture, or have manufactured, the products sold in their respective territories.[7]

Even with the increasing reliance of MNC groups on Asian contract manufacturers over the past several decades, US-Co has remained responsible for almost all significant product sourcing and manufacturing decisions and the support functions, the bulk of which take place within the United States. Some of these U.S.-led functions and activities might take place at the Asian contract manufacturers and other suppliers or in support offices located strategically nearby. (These functions include many of the activities described in reg. section 1.954-3(a)(4)(iv)(*b*).[8]) These product-sourcing and manufacturing support functions (including negotiation of all contract manufacturing and other product-sourcing contracts) are performed by US-Co not only for its own inventory requirements

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With this result, there is no need to establish (as is the case when there is no partnership) that any U.S. person is a de facto agent of the foreign group member, that an office of a U.S. person is an office of the foreign group member, or that any of the foreign group member's sales are attributable to that U.S. office.

[4]This MNC example will be used throughout this report and will refer, as appropriate, to these three categories of income. This example recognizes that the three factors for determining the presence of ECI will be common to many MNCs with operations in a variety of industries, making the issues raised in this report applicable to a broad range of MNCs.

[5]Paragraph (a)(4)(iv) concerns whether specific activities conducted by the employees of a controlled foreign corporation that direct a related- or unrelated-party contract manufacturer will cause that CFC to be treated as having manufactured, produced, or constructed the applicable products for purposes of determining the CFC's foreign base company sales income.

[6]F-Co DRE subsidiaries are foreign legal entities wholly owned by F-Co for which an active or deemed election under reg. section 301.7701-3(b) is in effect that treats each such foreign legal entity as a branch or division of F-Co for U.S. tax purposes.

[7]Note that the same effect is reached when US-Co licenses the foreign rights to exploit intangibles to F-Co, in which case there will be a royalty stream flowing from F-Co to US-Co.

[8]The activities listed in reg. section 1.954-3(a)(4)(iv)(*b*) include:

- oversight and direction of the activities or process pursuant to which the property is manufactured, produced, or constructed;
- material selection, vendor selection, or control of the raw materials, work-in-process, or finished goods;
- management of manufacturing costs or capacities (for example, managing the risk of loss, cost reduction or efficiency initiatives associated with the manufacturing process, demand planning, production scheduling, or hedging raw material costs);
- control of manufacturing related logistics;
- quality control (for example, sample testing or establishment of quality control standards); and
- developing, or directing the use or development of, product design and design specifications, as well as trade secrets, technology, or other intellectual property for the purpose of manufacturing, producing, or constructing the personal property.



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for sales in the United States but also to fulfill F-Co's inventory requirements for its sales throughout the rest of the world.

Acting independently in form (as opposed to substance), US-Co and F-Co separately contract with and pay the Asian contract manufacturers and other suppliers for the inventory to be sold in their respective territories.[9]

Even though F-Co personnel provide significant support for its sales and other revenues, US-Co personnel must still manage, oversee, and set the terms for those sales, services, licenses, etc. US-Co personnel are also often directly involved in solicitation, negotiation, and other significant activities leading to distribution agreements and to sales to major customers and major participants within indirect distribution channels.

The above-mentioned functions and activities are provided by US-Co in support of F-Co's business under service agreements that require F-Co to pay service fees to US-Co. Although those service fees must, of course, reflect arm's-length pricing, evidence suggests that this is not always the case.[10]

Profit-shifting tax strategies, if ultimately successful for tax purposes, depend on intercompany service or other agreements being respected, thereby preserving the fiction that US-Co is acting as an independent contractor performing services for F-Co. Often, profit-shifting strategies have been implemented with little or no change in the actual conduct of an MNC's business (for example, the same functions continue to be performed by the same persons in the same locations). Especially in those cases, although F-Co's employees may perform important functions such as marketing, dealer support, and warehousing, F-Co may have no CEO or other personnel capable of actually directing either its own business or an independent contractor (that is, US-Co) engaged to perform functions critical to F-Co's business.

Several publicly available sources have reported that MNC profit-shifting structures sometimes involve nothing more than shell companies that have no employees and are not managed and controlled or otherwise tax resident in any country.[11] Even if F-Co has a CEO, he may be a CEO in name only. A nominal CEO and other personnel, including officers and directors of DRE subsidiaries, are unlikely to have either global authority over F-Co's business or the knowledge, experience, or authority to actually direct and oversee US-Co purportedly acting in its independent contractor role.[12]

Accepting that F-Co lacks qualified management to oversee and direct the services that US-Co performs for it, US-Co personnel must make all significant business decisions and conduct activities for F-Co that far exceed the scope of authority that would be given to any unrelated independent contractor in similar circumstances. As such, the real effect of the putative intercompany service agreements is not to place US-Co in the role of an independent contractor, but rather in the role of actually conducting some of the most critical parts of F-Co's business. With the centrally managed and directed worldwide business models favored by many MNCs, US-Co personnel in fact make the managerial decisions and conduct the business of *both* companies in the areas of licensing, sales and marketing, and product sourcing and manufacturing. This will be equally true in situations in which US-Co and F-Co provide services in their respective territories through Internet platforms that rely on US-Co personnel who are almost solely responsible for those platforms' development, enhancement, maintenance, protection, and exploitation.

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[9]Note that contractual arrangements whereby F-Co (including its DRE subsidiaries) acquires inventory from *unrelated* contract manufacturers and sells to *unrelated* customers have been specifically structured so that those sales fall outside the foreign base company sales income definition in section 954(d)(1).

[10]Publicly available sources have indicated that those service fees (including those for sourcing and manufacturing functions) are sometimes based on cost-plus pricing with rates that appear to be significantly below the value of the services that a US-Co provides. *See, e.g.*, the "Fifth Restated and Amended Service Agreement" between Caterpillar Inc. and Caterpillar SARL, a Swiss entity. This agreement, which provides for a cost plus 5 percent service fee, may be found at page 165*ff* of Exhibits Part 2 of 2 (exhibits 22-50) issued in connection with the April 1, 2014, hearings of the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations (PSI). *See* Joint Committee on Taxation, "Present Law and Background Related to Possible Income Shifting and Transfer Pricing," JCX-37-10 (July 20, 2010). The JCT report includes disguised examples of profit-shifting structures used by U.S.-based MNCs. *See* Bravo example at 70.

[11]*See, e.g.*, the details of Apple Operations International (AOI) as provided in PSI hearing documents dated May 21, 2013. Regarding AOI, see pages 21-22 of the memorandum dated May 21, 2013, prepared by Sen. John McCain, R-Ariz., and former Sen. Carl Levin.

[12]The majority staff report released in connection with the 2014 Caterpillar PSI hearings (*supra* note 10) illustrates this point well. See in particular note 440 on page 78 of the report. Despite Caterpillar SARL's conduct of a worldwide parts business, the few personnel located in Switzerland appear to have had at best specific regional roles. The report indicates that there was no CEO with worldwide responsibility for the company's operations, and definitely no one with the knowledge, authority, skills, or experience capable of directing Caterpillar Inc. in its role as an independent contractor performing services for Caterpillar SARL in connection with Caterpillar SARL's replacement parts business.



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The result of the foregoing is that US-Co and F-Co have each contributed capital and services to exploit the intangibles created under the CSA. This is evidenced by:

- joint sourcing and production of inventory;
- joint conduct of services using jointly produced intangibles (the Internet platforms);[13]
- joint licensing of intangibles;
- joint sales activities, especially on sales to major customers and sales through distributors, wholesalers, and other indirect sales channel participants; and
- a single management directing the worldwide business.

**Existence of P/S for Federal Tax Purposes**

Characterization of the US-Co/F-Co relationship as a partnership is a two-step process. First is the threshold issue of whether the relationship is a "separate entity for federal tax purposes" as defined by reg. section 301.7701-1. Second is whether that entity is to be treated as a partnership or an association taxable as a corporation. This second step is governed by the check-the-box rules of reg. section 301.7701-2 and -3.

While the application of the second step is mechanical, examining the threshold issue of the first step must be done taking into account the implementation of the check-the-box rules effective from 1997.[14] Before 1997, which is the period during which almost all relevant judicial and IRS guidance for entity characterization was issued, most analyses focused on whether the particular multiparty arrangement was a partnership or some other type of arrangement (for example, joint ownership of property versus partnership, employment versus partnership). The prior focus was normally not on whether there was a separate entity for federal tax purposes, which is what is required from 1997 onward. Fortunately, since the principles have not changed (that is, any multiparty arrangement found to be a partnership or corporation would also have been found to be a separate entity for federal tax purposes), these pre-1997 cases and rulings are still relevant.

In considering the threshold issue of whether a separate entity exists between US-Co and F-Co, there is no express agreement, written or oral, between them that purports to create a separate entity in which each holds an ownership interest and through which they conduct a joint business. Despite the lack of any kind of agreement, when the arrangements and activities of two parties support such a finding, a separate entity for federal tax purposes shall be found to exist. In this regard, reg. section 301.7701-1(a)(2) provides:

> A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom.

In many MNC groups, the R&D, production, and revenue-generating operations are fully integrated and centrally managed. Profits, however, are not accumulated in one worldwide pool. Rather, significant R&D, production, and revenue-generating expenses are shared through the mechanisms of CSAs and intercompany service agreements. For example, hardware products sold, whether by US-Co or by F-Co, are designed, developed, and engineered through one combined process that uses the same component sources and contract manufacturers, all of which are orchestrated by centralized management and technical personnel located mostly in the United States. The same is often true for services income arising from U.S.-managed and -maintained Internet platforms.

The acquisition of inventory for worldwide sales illustrates how US-Co and F-Co use one combined process for the benefit of both companies. Since inventory is often not unique for any particular location, contract manufacturers may not be required to identify whether any specific product is destined for US-Co or F-Co. To the extent required, identification likely occurs only shortly before or right when a product is prepared for shipment. Thus, if a product requires localized software, localized alphabets for the product's controls and labeling, or local distributor names or logos, this work can usually be completed near the end of production, or earlier if necessary.

Profits of US-Co and F-Co are not divided using a percentage basis applied to one worldwide pool, as is typically found in partnerships. Rather, the split of group-wide profits is achieved in the normal course of business because US-Co and F-Co record in their separate books and records the profit or loss that each derives from earning revenues within its respective territory. The split also reflects the economic results of the CSA and intercompany service agreements between the group companies.

Assume that under the first step it is determined that the US-Co/F-Co relationship is a separate entity for federal tax purposes (USF-PS). The second step, which is to characterize the relationship between the two entities, is then easily resolved. Reg. section 301.7701-2(a) provides:

[13]Note that F-Co is treated under the reg. section 1.482-7(j)(3) characterization rule to have directly developed its ownership interest on account of activities conducted in the United States.

[14]T.D. 8697.



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> For purposes of this section and section 301.7701-3, a *business entity* is any entity recognized for federal tax purposes . . . that is not properly classified as a trust under section 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.

Reg. section 301.7701-3(b) provides two check-the-box default rules. If no active election has been made,[15] these default rules treat USF-PS as a partnership (and not as a corporation) under both the domestic and foreign eligible entity rules. It will not matter which of the two default rules applies, meaning that there is no need to determine whether USF-PS is a domestic or foreign eligible entity.

### Effect of P/S on ECI Calculations

Before citing the technical support by which USF-PS is determined to be a separate entity for federal tax purposes and then characterized as a partnership, it may be helpful to first set out the consequences of that determination. For tax purposes, all activities undertaken by US-Co and F-Co employees and all assets used in their respective operations that further the joint business will be considered the activities and assets of the partnership, USF-PS, and not activities or assets of the separate "partners" (that is, US-Co and F-Co).[16] In the case of US-Co and F-Co, and in the typical fact pattern found in profit-shifting structures, many of the activities and assets treated as being within USF-PS will physically be in US-Co's offices and other facilities located within the United States.

Under the assumed fact pattern, it is clear that the partnership USF-PS is conducting a trade or business in the United States through any offices or other fixed places of business there. The activities conducted within the United States include both (1) activities that direct, manage, and control all group members' production requirements (for example, quantities ordered, product characteristics, production processes, quality control, and pricing) and relationships with all component suppliers and Asian contract manufacturers; and (2) sales and licensing activities that involve management, solicitation, negotiation, and execution of sales contracts, distribution agreements, and licenses. If USF-PS earns services income attributable to its Internet platforms, U.S. activities would also include (3) the development, enhancement, maintenance, protection, and exploitation of those platforms.

Section 875(1) provides:

> A foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such . . . corporation is a member is so engaged.

Sections 861 through 865 and the regulations thereunder define and identify both the source of income and the ECI on which F-Co is taxable as a partner in the USF-PS partnership. Given the production activities conducted by the partnership within the United States, a significant portion of income attributable to production activities under section 863 and reg. section 1.863-3 will be U.S.-source, and, as a consequence, ECI under section 864(c)(3). Similarly, even for income from sales that are made outside the United States but attributable to an office or fixed place of business in the United States, section 865(e)(2) will cause that income to be U.S.-source ECI. This will be the case for sales when no partnership foreign offices or other fixed places of business materially participate in the sale. There will also be ECI arising from services performed in the United States through the Internet platforms. And the same will generally be true for income attributable to licenses under the section 864 regulations.[17]

All of F-Co's ECI will be taxed at 54.5 percent or higher. This rate is the sum of both the normal 35 percent corporate tax rate and the 30 percent branch profits tax applied generally to profits after payment of the 35 percent corporate tax.[18] (When a tax treaty applies that reduces the branch profits tax to a lesser rate, such as 5 percent, the effective combined rate will be 38.25 percent or higher.) For any prior year for which F-Co failed to file a U.S. tax return on Form 1120-F, "U.S. Income Tax Return of a Foreign Corporation," deductions and credits applicable to taxable gross income generally will not be allowed,[19] thus causing the actual effective tax rate to be higher than the combined statutory

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[15]Because any profit-shifting structure will rely on US-Co and F-Co operating independently of each other and not in any partnership or other joint format, it is very unlikely that any active election under reg. section 301.7701-3(c) will have been made regarding USF-PS.

[16]*See, e.g.*, the treatment described in LTR 201305006.

[17]In examining whether the US-Co/F-Co relationship is a partnership, a principal focus of this report is how partnership status may affect taxable ECI. However, the code and regulations include many provisions with special rules applicable to partnerships. For example, section 703(b) requires some elections to be made at the partnership level. Accordingly, any MNC that determines it is at risk of having created a partnership should review the potential effects that could arise under other provisions of the code and regulations.

[18]Section 884.

[19]Section 882(c)(2).

rate of 54.5 percent. Finally, for any prior year for which F-Co failed to file a U.S. tax return, the year will still be open to IRS adjustment.[20] This will be true even if that tax year for US-Co is closed. It seems likely that few companies like F-Co will have filed Form 1120-F for any year, even on a protective basis. As such, the IRS has authority to impose tax on ECI from the year the profit-shifting structure was put in place. Given the heightened profit-shifting efforts immediately following the 2004 American Jobs Creation Act repatriation holiday, this open period will often be a decade or longer.

### Why USF-PS Is a Separate Entity

The code and regulations, case law, and IRS administrative authorities taken together provide more than sufficient authority to demonstrate that the interrelated and joint manner in which US-Co and F-Co[21] conduct business creates a separate entity for federal tax purposes. Once that determination is made, USF-PS will be treated under the check-the-box rules as a partnership whose global activities include (1) the creation, production, and sale of inventory; (2) the licensing of intangibles; and (3) services rendered through Internet platforms.[22]

Because the code and regulations provide such black-and-white rules that cause relationships similar to that of US-Co/F-Co to constitute a partnership for U.S. tax purposes, this report includes only a discussion of the applicable provisions of the code and regulations. However, as additional guidance, a limited discussion of some landmark case law and IRS administrative authorities is included in the accompanying Appendix.

### Code and Regulations Authority

The code and regulations clearly contemplate that activities conducted by two or more persons that amount solely to joint production will be a partnership. In most cases, US-Co and F-Co are not only conducting some joint production activities, they also earn revenues from joint sales, licensing, and service activities attributable to one central management.

Sections 761(a) and 7701(a)(2) provide, with only minor language differences:

> For purposes of this subtitle, the term ''partnership'' 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, within the meaning of this title, a corporation or a trust or estate.

Focusing solely on this statutory language, the joint production alone carried out by US-Co and F-Co reasonably falls within ''any business, financial operation, or venture.'' When the joint sales, licensing, and service activities plus the central management are included, these joint activities absolutely fall within this statutory expression.

The statutory definition of partnership is very broad and includes organizations established under applicable local law and those established through contracts and the joint actions of the parties. The US-Co/F-Co relationship is established through the joint activities of the parties and by other relevant factors, including verbal understandings, internal group policies, management lines of authority, and contracts — including the CSA and any intercompany service agreements under which US-Co provides services to F-Co.

Interestingly, the definition of partnership found in sections 761(a) and 7701(a)(2) makes no mention of profits and losses, and therefore is silent about the allocation of them among partners. However, the existence of profits and their division among the partners is alluded to in the first sentence of reg. section 301.7701-1(a)(2), which states:

> A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and *divide the profits* therefrom. (Emphasis added.)

This, of course, implies that for a joint venture or other contractual arrangement to be a separate entity for federal tax purposes, there must be profits (and presumably the potential for losses) and a division of the profits therefrom.

The partnership concept is very flexible, with wide latitude regarding how income and loss may be allocated among the partners. Thus, income can be allocated on a fixed percentage basis, as is typical, or on most any other basis that satisfies the

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[20]Section 6501(c)(3).

[21]F-Co for this purpose includes any F-Co DRE subsidiaries that are treated as branches or divisions of F-Co under the check-the-box rules included in reg. section 301.7701-3.

[22]For completeness, note that reg. sections 1.482-7(j)(2)(iii) and 301.7701-1(c) provide that a CSA will not be treated as a partnership. This is appropriate when the participants to a CSA have not already created through other joint activities a relationship that constitutes a separate entity for federal tax purposes under reg. section 301.7701-1(a). When such a separate entity has been created (and is treated as a partnership under reg. section 301.7701-3(b)) and all activities otherwise performed under the CSA are performed within that separate entity, the CSA will generally be irrelevant, and there will be no CSA for tax purposes. The contractual terms of the CSA may, of course, be relevant in determining each partner's interest in the partnership for purposes of section 704.



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partnership regulations under section 704(b). William S. McKee et al. comment:

> The partnership rules provide for the computation and allocation of income and loss derived from jointly-owned capital and pooled services. There is no requirement that income or loss be shared in proportion to capital interests or in proportion to the value of services; instead, partners are free to allocate the risks and rewards of partnership operation flexibly. . . . *Congress enacted a broad and inclusive definition of "partnership" to assure that all multi-party arrangements in which income is produced from capital and services are subject to the partnership rules (unless they are classified as corporations, trusts, or estates), and do not fall into an unregulated twilight zone*.[23] (Emphasis added.)

Considering the above, the "divide the profits" language in reg. section 301.7701-1(a)(2) does not prevent the US-Co/F-Co relationship from being a separate entity for federal tax purposes and thus a partnership after the check-the-box default rule is applied.[24]

For the US-Co/F-Co relationship, there clearly will be profits (or an expectation of profits) when all jointly managed and conducted activities are accounted for on a combined basis. However, the US-Co/F-Co profit split is based on the geographically based revenues and related expenses that each company records in its financial books and records (also reflecting the CSA and intercompany service agreements) rather than on the more commonly used fixed percentage basis applied to a worldwide pool of combined income or loss. There is nothing in this method for the division of profits and losses that is inconsistent with the partnership concept. Various authorities all support the finding of a partnership when profits are not divided on the typical fixed percentage basis, but on many different bases, including those that rely on each participant's sale of its respective share of the property produced by the joint business. In many of these cases, such as those concerning utilities that sell electricity within their respective territories, the splits are made geographically.[25]

Reg. section 301.7701-1(a)(2) includes this guidance:

> A separate entity exists for federal tax purposes if co-owners of an apartment building lease space *and in addition provide services* to the occupants either directly or through an agent. Nevertheless, *a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes*. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes. [Emphasis added.]

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[23]McKee et al., *Federal Taxation of Partnerships and Partners*, at para. 3.02[4] (2016).

[24]Interestingly, the pre-1997 regulation (reg. section 301.7701-3(a)) from which this language was taken read, in part:

> (a) *In general.* The term "partnership" is broader in scope than the common law meaning of partnership and may include groups not commonly called partnerships. Thus, the term "partnership" 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 or a trust or estate. . . . Mere co-ownership of property which is maintained, kept in repair, and rented or leased does not constitute a partnership. . . . Tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and *divide the profits* thereof. For example, a partnership exists if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. (Emphasis added.)

This phrase to "divide the profits" was previously only a means of distinguishing a situation involving co-ownership of property and did not modify the basic definition of a partnership as including "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."

By moving this "divide the profit" phrase to become a principal part of the definition of a separate entity for federal tax purposes, the check-the-box regulations have potentially changed the meaning, or at least the emphasis, of the regulatory definition of separate entity for federal tax purposes. Despite this, it seems doubtful that this would have been an intentional narrowing of the definition and likely was seen as merely cleaning up the language of the reconfigured regulations. Clearly, because the check-the-box regulations were an intended simplification mechanism produced not by Congress but by Treasury and the IRS exercising their regulatory authority, there was certainly no congressional intent or any authority to narrow this broad and decades-old definition of partnership or "separate entity for federal tax purposes."

[25]This report assumes that US-Co and F-Co's distributable shares of partnership profit and loss are based on the geographical split of their revenues and their intercompany agreements (the CSA and intercompany service agreements). When the IRS sustains the existence of a partnership, a determination would have to be made whether this approach or some other approach meets the requirements of section 704(b) and the regulations thereunder.



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This additional language is particularly relevant to US-Co/F-Co's relationship because their joint activities are quite extensive, including licensing, sales, and service activities that in part use intangibles commonly owned under the terms of the CSA. This relationship — especially the joint production and the development, enhancement, maintenance, protection, and exploitation of Internet platforms — simply cannot be characterized as "a joint undertaking merely to share expenses."

The undivided co-ownership of physical property, such as real estate with rental income accruing to each owner, is clearly covered by this regulatory language. The same regulation applies for the US-Co/F-Co Internet platforms because they are assets, albeit intangible assets, in which US-Co and F-Co have direct undivided ownership interests (F-Co would have an economic ownership interest under the CSA rather than a title interest). US-Co and F-Co jointly exploit the co-owned intangible assets to earn services income from customers within each company's respective territory.

Section 761(a) and reg. section 1.761-2 provide that some "unincorporated organizations" otherwise covered by subchapter K (and therefore within the broad partnership definition) may elect to be excluded from the application of all or a part of the provisions of subchapter K. An unincorporated organization that conducts joint production may qualify for this exclusion only if specific requirements are met, including:

- the participants "reserve the right separately to take in kind or dispose of their shares of any property produced" (see reg. section 1.761-2(a)(3)(ii)); and
- the participants "do not jointly sell services or the property produced" (see reg. section 1.761-2(a)(3)(iii)).

The second requirement (no joint selling of services or property) reinforces that an unincorporated organization will still be classified as a partnership even if it does not conduct joint sales or services and does not calculate a pool of earnings from which each party takes its respective percentage interest.

The US-Co/F-Co relationship, even if there were no joint revenue-generating activities, includes joint production and joint conduct of services. This means that as long as the actual joint activities are more than "a joint undertaking merely to share expenses" (clearly true for any significant profit-shifting arrangement), that relationship creates USF-PS as a separate entity for federal tax purposes and thus a partnership under the reg. section 301.7701-3(b) default rules.

Reg. section 1.863-3(g) provides special sourcing of income rules in the case of partnerships. Example 2 in paragraph (g)(3) involves a U.S. corporation and a foreign corporation that are partners in a partnership that conducts manufacturing of widgets through the partnership's manufacturing facilities in the United States. The facts further provide that the partnership does not sell its production. Rather, it distributes the production in kind to the partners for their further processing and sale.

This is further regulatory acknowledgement that joint production will constitute a partnership, even if no production is sold by the partnership, but is distributed to the partners. This applies to the joint production carried out by US-Co and F-Co through USF-PS.

## Conclusion

This report makes a compelling case for characterizing many US-Co/F-Co relationships within MNCs as partnerships (USF-PS) for U.S. tax purposes. This is significant to all affected MNCs because of section 875(1), which stipulates that a foreign corporate partner of a partnership engaged in a trade or business in the United States will also be engaged in a U.S. trade or business. Absent this clear rule, an F-Co, as part of its attempt to counter any assertion that it has ECI, could more easily dispute that it is engaged in a U.S. trade or business, which is the threshold test for application of the ECI rules. However, once F-Co is found to be engaged in a U.S. trade or business by reason of being a partner in USF-PS, F-Co will be subject to U.S. tax on all of its ECI.

Given the importance of partnership status, the authors recommend that the IRS issue a revenue ruling that provides guidance to identify factual situations where a partnership will be found to exist.

## Appendix: Case Law and IRS Authority

Several landmark decisions are regularly cited as important precedents in the many cases and rulings that focus on the existence of either a partnership or separate entity for federal tax purposes. One of these is *Commissioner v. Tower*,[26] which essentially asks whether all the facts, including the conduct of the parties, reflect an intention to join together in carrying on business and sharing in profits and losses. *Tower* also made clear that if an alleged partner does not contribute either capital or services, that person cannot be a partner.

Considering this in the context of the US-Co/F-Co relationship, both companies supply substantial resources to their jointly conducted activities. In US-Co's case, it provides financial resources, and its personnel perform significant services. In F-Co's

[26]327 U.S. 280 (1946).



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case, it supplies both financial resources and services, but with the services possibly being more limited quantitatively and qualitatively. While there may be many foreign-based employees within F-Co and its DRE subsidiaries around the world, it is unlikely that many will be directly involved in or hold significant authority over either product sourcing or the performance of services involving Internet platforms. Many would be involved in marketing for both licensing and product sales and in customer and distributor support activities, but, typically, few if any of these employees would conduct solicitation, negotiation, and other activities that would qualify as material participation under the ECI rules.[27] While it seems clear that neither US-Co nor F-Co intended to form a partnership or other separate entity that would be recognized for federal tax purposes, their actions, including their extensive joint management, production, R&D, sales, marketing, and financial activities, create a solid fact pattern to find that they are partners in USF-PS.

A second landmark decision often noted is *Commissioner v. Culbertson*.[28] Like *Tower*, it involved a family partnership. After the Supreme Court reiterated the basic message of *Tower*, Justice Felix Frankfurter in a concurring opinion commented:

> In plain English, if an arrangement among men is not an arrangement which puts them all in the same business boat, then they cannot get into the same boat merely to seek the benefits of sections 181 and 182. But if they are in the same business boat, although they may have varying rewards and varied responsibilities, they do not cease to be in it when the tax collector appears.

Clearly, US-Co and F-Co's extensive joint activities and single management place them squarely within the "same business boat."

There are other relevant cases and IRS administrative authorities that involve situations in which particular physical property is commonly owned by several parties. These include real estate held for rental, a facility such as a power plant, or an extraction site such as an oil or gas well. For US-Co and F-Co, which both use contract manufacturers, the physical property effectively used as their own production facilities is the group's offices and other facilities, which are primarily in the United States. The majority of the product sourcing, manufacturing support, and R&D activities occur within those U.S. facilities. The Internet platforms are also developed, managed, and operated from these same U.S. facilities. Moreover, under the reg. section 1.482-7(j)(3) characterization rule, F-Co is considered to have developed and economically own an undivided interest in these U.S.-based Internet platforms as a result of its participation in the CSA. This places the US-Co/F-Co relationship on an exact par with the cases and rulings concerning co-ownership of physical property, in which a partnership was found to exist.

Rev. Rul. 68-344[29] concerns an arrangement among four electrical power companies operating in several states consisting of several large coal-fired electrical generating units located near a coal source. The units are owned and operated by the four corporations as tenants in common. A cotenancy agreement and an operating agreement govern the manner in which the units are operated. These agreements expressly provide that the participants do not intend to form a joint venture, partnership, or association taxable as a corporation.

One of the participants (M) acts as the operating agent. Neither the venture as such nor M in its capacity as operating agent has any right to market the electric power that the venture produces. Rather, as electricity is produced, each participant takes and sells its share of electricity through its own distribution system.

Under various agreements, each participant contributes money to pay for its share of fixed and variable costs. While fixed costs are based on fixed percentages, the variable costs vary daily depending on how much power each participant orders for that day.

After determining (before the check-the-box rules) that the arrangement was not an association taxable as a corporation, the ruling examined whether the arrangement would fall within the section 7701(a)(2) definition of partnership. Based on then reg. section 301.7701-3(a), which is now found in substantially the same language in reg. section 301.7701-1(a)(2), the ruling concluded that "the venture is an unincorporated organization through or by means of which an activity is carried on."

This arrangement as described in Rev. Rul. 68-344 was found to be an unincorporated organization despite the lack of any joint selling or service activities. The US-Co/F-Co relationship includes not only joint production facilities and operations such as those described in Rev. Rul. 68-344, but also highly integrated and centrally managed licensing, selling, and service activities. Rev. Rul. 68-344 clearly supports that USF-PS is an unincorporated

[27]*See* section 865(e)(2) and reg. section 1.864-6.

[28]337 U.S. 733 (1949).

[29]1968-1 C.B. 569.

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organization and a separate entity for federal tax purposes within the meaning of reg. section 301.7701-1(a).

A case that cites Rev. Rul. 68-344 and involved a similar situation is *Madison Gas & Electric Co*.[30] Aside from the type of power generation (nuclear versus coal fired), the facts in *Madison* generally mirror those in Rev. Rul. 68-344. One difference was the method used for the allocation of electricity to the participants. Rather than electricity being distributed based on daily needs with a variable cost factor as was the case in Rev. Rul. 68-344, in *Madison*, all power produced was distributed to the three participants based on their respective ownership percentages, and there was no variable cost factor. Instead, all costs were borne by the participants in accordance with their respective ownership shares.

Although the utilities intended to create only a co-tenancy and not a partnership and to be taxed as co-tenants and not as partners, the managing participant filed Form 1065, ''U.S. Return of Partnership Income,'' that included an election out of the provisions of subchapter K. The Tax Court ignored this as a factor in determining whether the arrangement of the three participants was a partnership under section 7701(a)(2).

In reviewing the Tax Court's decision that the utilities' arrangement was a partnership, the Seventh Circuit first commented that the arrangement of the three participants:

> clearly establishes an unincorporated organization carrying on a ''business, financial operation, or venture'' and therefore falls within the literal statutory definition of a partnership.

The Seventh Circuit noted in particular one of *Madison*'s arguments, which is directly on point with the US-Co/F-Co relationship. In *Madison*, the participants did not share ''a single joint cash profit from their joint activity.'' Similar to *Madison*, US-Co and F-Co each takes its respective products and services from the joint production activity and sells those products and services within its separate territory. Also, in the US-Co/F-Co relationship, there is no calculation of any joint profit to be shared.

On this issue, the Seventh Circuit stated:

> Because its common venture with [Wisconsin Public Service Corp.] and [Wisconsin Power and Light Co.] does not result in the division of cash profits from joint marketing, [Madison Gas and Electric Co. (MGE)] contends that the venture constitutes only a co-tenancy coupled with an expense-sharing arrangement and not a tax partnership. The Tax Court held that the Code definition of partnership does not require joint venturers to share in a single joint cash profit and that to the extent that a profit motive is required by the Code it is met here by the distribution of profits in kind. We agree.

In support of this, the Seventh Circuit looked to the legislative history of section 7701(a)(2) dating back to the 1930s. The court noted that ''Congress intended to broaden the definition of partnership for federal tax purposes to include a number of arrangements, such as joint ventures, which were not partnerships under state law.''

The court went on to cite the section 761(a) elective provision allowing exclusion from subchapter K for some unincorporated organizations conducting joint production, extraction, or use of property. In particular, the court noted the condition in section 761(a)(2) that the organization can ''not [be used] for the purpose of selling services or property produced or extracted.'' The Seventh Circuit then quoted with approval the following from the Tax Court's decision:

> If distribution in kind of jointly produced property is enough to avoid partnership status, we do not see how such distribution could be used as a test for allowing an election to be excluded from the partnership provisions of subchapter K.

The Seventh Circuit court of appeals ended its discussion by focusing on the fact that any joint production venture within which the participants take their production in kind will still have profits and a profit motive. In support of this, the court commented:

> Neither the above-quoted Treasury Regulation Sections nor the case law distinguish between the division of cash profits and the division of in-kind profits, and none of the cited cases involved in-kind profits. Moreover, while distribution of profits in-kind may be an uncommon business arrangement, recognition of such arrangements as tax partnerships is not novel. . . .
>
> The practical reality of the venture in issue here is that jointly produced electricity is distributed to MGE and the other two utilities in direct proportion to their ownership interest for resale to consumers in their service areas or to other utilities. The difference between the market value of MGE's share of that electricity and MGE's share of the cost of production obviously represents a profit. Just as obviously, the three utilities joined together in the construction and operation of the Plant with

[30] 72 T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980).

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> the anticipation of realizing these profits. The fact that the profits are not realized in cash until after the electricity has been channeled through the individual facilities of each participant does not negate their joint profit motive nor make the venture a mere expense-sharing arrangement. We hold therefore that MGE's joint venture with WPS and WPL constitutes a partnership within the meaning of Sections 7701(a)(2) and 761(a) of the Code. [Footnotes omitted.]

The court added the following in note 5 concerning the example now in reg. section 301.7701-1(a)(2) about neighboring landowners who jointly constructed a ditch to drain surface water from their properties:

> We agree with the Tax Court that the venture here is "in no way comparable to the joint construction of a drainage ditch" (72 T.C. at 560).

The same is true for the extensive joint production activities conducted by US-Co and F-Co. Their joint activities are far more than some joint efforts to resolve a common problem. Rather, their joint activities cover all aspects of licensing, sales, and the sourcing and production of products for sale in their respective territories.

Many other cases and published and private rulings could be discussed.[31] However, the above are sufficient to demonstrate that joint activities, such as those conducted by US-Co and F-Co, will cause USF-PS to be treated as a separate entity and classified as a partnership for federal tax purposes.

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[31]These include *Bentex Oil Corp. v. Commissioner*, 20 T.C. 565 (1953); *Cokes v. Commissioner*, 91 T.C. 222 (1988); *Methvin v. Commissioner*, T.C. Memo. 2015-81; Rev. Rul. 82-61, 1982-1 C.B. 13; TAM 9504001; TAM 9414004; ILM 200844011; Rev. Rul. 78-268, 1978-2 C.B. 10; TAM 7951006; Rev. Rul. 80-219, 1980-2 C.B. 18; LTR 7846031; LTR 7926092; LTR 7919065; LTR 7922110; LTR 7924056; LTR 8011040; LTR 8341057; LTR (unnumbered), Dec. 4, 1992 (1992 WL 355145); TAM 8333006; and *Vanderschraaf v. Commissioner*, T.C. Memo. 1997-306.

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