DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL
LARGE AND MID-SIZE BUSINESSES AREA 3

FROM: Associate Chief Counsel
Passthroughs and Special Industries CC:PSI:1

SUBJECT: Federal Tax Classification of an Agreement

This Chief Counsel Advice responds to your memorandum dated March 28, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

A =

B =

X =

Agreement =

Year 1 =

Year 2 =

Date 1 =

Date 2 =

Date 3 =

Product =

Territory =

$n1 =

$n2 =

$n3 =

n4 =

$n5 =

$n6 =

n7 =

$n8 =

ISSUE

1. Whether the Agreement between A and B created a partnership for federal tax purposes, and, if so, whether the partnership created under the Agreement was required to withhold under section 1446 .

CONCLUSION

1. Although an argument could be made that the Agreement between A and B created a partnership for federal tax purposes, we believe that further factual development of the case is necessary, however, before conclusive advice can be provided or the relative merits of the government's case can be evaluated. Because we are unable to determine whether the Agreement between A and B created a partnership for federal tax purposes, we do not reach the issue of whether any such partnership created under the Agreement was required to withhold under section 1446.

FACTS

In Year 1, A and B entered into Agreement, whereby A was to be the exclusive distributor of Product for B in Territory. In Year 2, A and B modified the terms of the Agreement.

The Agreement provided that with respect to , the parties would determine and mutually agree upon the "Marketing Expense" which was comprised of the total expenditures for promotion, publicity and market research of an in connection with the sale and distribution of Product in Territory. B was required to remit its share of the Marketing Expense to A after its receipt of monthly invoices from A detailing the Marketing Expenses during the preceding monthly period. Subject to the prior general acceptance of B, A had the sole authority to decide upon the nature and content of all materiels and programs for Product the Territory. It was the understanding of the parties that they would meet every at specified times to determine the budget and the allocation of the general expenses among the various types of Marketing Expenses such as promotion, publicity and/or market research in connection with Product.

The Agreement provided that with respect to sales and purchases, the parties could not change either B's production cost ("Production Cost") which was used to calculate B's selling price ("Selling Price") of the Product to A or A's selling cost ("Selling Cost") of distributing Product without three months prior written notice by the party initiating the change to the other. The parties were required to provide documents to substantiate the change. A had the right to order Product from B for shipment to customers designated by A. Additionally A was required to submit to B quarterly reports setting forth its sales state by state, any reports it may obtain from its wholesalers, the breakdown of marketing expenses during such quarterly period and any other pertinent information with respect to the sale and distribution of the Product.

The parties agreed that A would remit one-half of its gross profit ("Gross Profit") to B after the close of each month during the term of the Agreement. The Agreement defined Gross Profit as the extent to which A's revenues from the resale of the Product to its customers exceed the sum of A's net cost ("Net Cost") of purchasing the Product from B, plus B's Selling Cost. By way of example, the Agreement provided that, if during a particular month the Net Cost was $n2, the selling cost was $n1, the selling price was $n3, and n4 were sold, then the total amount to be shared would be $n5 and A was required to remit $n6 to B after the close of such month.

The parties agreed that in the event the actual Selling Cost of the Product on the date of B's invoice to A differed from the calculated Selling Cost agreed upon by the parties, the difference would be shared equally between the parties on a monthly basis.

The parties did not file a partnership return, nor does it appear that they held themselves out formally as joint venturers. However, A's owner publically used the word partnership to describe the relationship between A and B. The parties did not formally set up a separate entity to account for the income of losses of the business arrangement. However, A maintained separate accounts to track the profits from the sale of Product that it remitted to B and to track the gain or loss from the exchange rate differential. Additionally, A and B agreed that upon a minimum of ten days written notice, either party would make available to the other party for inspection during normal business hours, such books and records as pertain to the terms and conditions of the Agreement.

The parties agreed upon the following: (1) B agreed not to sell Product to any other purchaser inside the Territory, (2) A would undertake the distribution of any new product B introduced into the Territory, (3) A agreed to exercise its best efforts to effect, promote, maintain and expand distribution and sale of Product in all parts of the territory, (4) A agreed to furnish to B a monthly report showing unit and dollar sales of Product to each wholesaler. A also agreed to furnish a monthly statement of A's inventory of Product, a breakdown of marketing expenses, and any other pertinent information requested by B with respect to the sale and distribution of Product, (5) A agreed to consult with B before making its price resale determination and to give consideration B views and suggestions as to the resale prices, (6) A would not begin or stop selling Product to any wholesaler without first obtaining the written consent of B, which will be granted unless B, reasonably believed that promotion or sale of Product will thereby be adversely affected, (7) the parties agreed to meet at least once every six months to determine and agree upon , promotional and sales objectives, strategy, programs and budgets, (8) A a greed that the appointment of to be used to promote Product in the would be subject to the prior written approval of B, (9) B would have the right to terminate the Agreement if P or any company directly or indirectly owned by P, gained access to any of the confidential information covered by the provisions of the Agreement, (10) A agreed to keep strictly confidential and not to disclose any B trade secret information concerning Product.

On Date 2 A and B entered into a agreement, which all of the rights and obligations of the parties under the Agreement. Also on Date 2, A and X entered into an agreement in connection with the of the existing Agreement. X was to pay A of $n8 or an adjusted amount if the number of units of Product by A for a specified period of Date 1 to Date 3 exceeded n7 units.

LAW AND ANALYSIS

In your request for advice you have asked that we consider whether the Agreement between A and B created a partnership for federal tax purposes. Because the case requires further factual development we are unable to evaluate the relative merits of the government's case. Therefore, we have provided a general discussion of the issues raised by your request for your reference as you develop the facts surrounding the Agreement and to advise you of the Service's litigating position.

Prior to January 1, 1997, the classification of any particular organization was determined under the tests and standards set out in old section 301.7701-2, section 301.7701-3, and section 301.7701-4 of the Procedure and Administration Regulations. Old section 301.7701-2(a)(1) set forth six major characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These are (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property, and (6) free transferability of interests. Old section 301.7701-2(a) provided that whether an organization is to be classified, for federal income tax purposes, as a partnership or as an association, depends upon the extent to which the organization possesses the following characteristics ordinarily found in a corporation: (1) centralization of management, (2) continuity of life; (3) free transferability of interests; and (4) limited liability.

An organization which possesses three or more of these corporate characteristics will be treated as an association taxable as a corporation. An organization which possesses two or less of the above characteristics will generally be classified as a partnership for federal income tax purposes. Old section 301.7701-2(a)(2) provided that characteristics common to partnerships and corporations are not material in attempting to distinguish between an association and a partnership. Old section 301.7701-2(a)(3) provided that because associates and an objective to carry on a business and divide the gains therefrom are generally common to corporations and partnerships, an organization that has such characteristics will be classified as a partnership if it lacks at least two of the remaining four characteristics.

Sections 761 and 7701(a)(2) of the Internal Revenue Code provide, in part, that 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 trust, estate, or corporation.

A partnership is created for income tax purposes when persons join together their money, goods, labor, or skill for the purposes of carrying on a trade, profession, or business and when there is a community of interest in the profits and losses. Commissioner v. Tower, 327 U.S. 280 (1946). Whether a partnership exists depends on whether the taxpayer and others intended to join together in order to carry on a business for joint economic gain. Commissioner v. Culbertson, 337 U.S. 733 (1949). The following factors, none of which are conclusive, are evidence of this intent: (1) the agreement of the parties and their conduct in executing its terms; (2) the contributions, if any, which each party has made the venture; (3) the parties' control over income and capital and the right of each to make withdrawals; (4) whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; (5) whether business was conducted in the joint names of the parties; whether the parties filed federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; (6) whether separate books of account were maintained for the venture; and (7) whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise. See Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964).

Case Development, Hazards, and Other Considerations

[redacted]

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

Associate Chief Counsel
Passthroughs and Special Industries
By: DIANNA K. MIOSI
Chief, Branch 1
Associate Chief Counsel
(Passthroughs and Special Industries)