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INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR SPECIAL TRIAL ATTORNEY, CC:LM:NR:SLDAL

FROM: Elizabeth G. Beck
Branch Chief, CC:INTL:6

SUBJECT:

This Chief Counsel Advice responds in part to your memorandum dated June 29, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Country A =

Country B =

Country C =

FCorpA-1 =

FCorpA-2 =

FPtnrshipA =

FPtnrshipA/B =

Project A =

USCorpA =

=
USCorpB
=
Year 1
=
Year 2
=
Year 3
=
Year 6
=
a
=
b
=
c
=
d
=
e

ISSUES

1. Whether the partnership anti-abuse regulation, Treas. Reg. § 1.701-2(e), is applicable to treat transactions between USCorpA and FPtnrshipA/B as transactions between USCorpA and FPtnrshipA/B's foreign partners.

2. Whether and how section 482 of the Internal Revenue Code applies to allocate income to USCorpA from FPtnrshipA/B in connection with USCorpA's Project A development activities.

CONCLUSIONS

1. The partnership anti-abuse regulation does not apply to FPtnrshipA/B because the partnership form has not been interposed to create the alleged abuse.

2. We are continuing to review the section 482 issue and will respond shortly by supplementing this advice.

FACTS

The issues in this case relate to USCorpA's activities in developing Project A in Country A, with unrelated USCorpB as a co-developer. USCorpA and USCorpB, both U.S. corporations, used their resources and skills to identify the opportunity for Project A, to design Project A, and to develop, negotiate and obtain a complete package of authorizations and contracts for Project A, including project financing.

USCorpA and USCorpB placed all of the Project A contractual rights and obligations in FPtnrshipA/B, a Country B limited partnership in which USCorpA and USCorpB each held, through other foreign entities, a 50% interest in profits and losses. The specifics of the transaction are as follows:

In Year 1, USCorpB, a corporation unrelated to USCorpA, began to compete for the rights to develop Project A in Country A. In Year 2, after USCorpB had developed valuable relationships with Country A authorities and had submitted a formal Project A proposal to Country A authorities, USCorpB approached USCorpA to discuss a possible joint venture. According to a USCorpA employee involved in the negotiations, USCorpB needed USCorpA's manpower and expertise in order to complete Project A. After negotiations, USCorpA and USCorpB agreed to pursue Project A through a 50/50 joint venture.

In Year 3, FPtnrshipA/B was formed as a joint venture to hold the ownership rights with respect to Project A. USCorpA and USCorpB each owned, through foreign affiliates, a 50% interest in FPtnrshipA/B. In the initial ownership structure, the foreign affiliates of USCorpA that held direct interests in FPtnrshipA/B were FPtnrshipA, a Country C limited partnership that held a 49% limited partnership interest in FPtnrshipA/B, and FCorpA-1, a Country C corporation that held a 1% general partnership interest in FPtnrshipA/B. The foreign affiliates of USCorpA that held direct interests in FPtnrshipA were FCorpA-2, a Country C corporation that held a 99% limited partnership interest in FPtnrshipA, and FCorpA-1, which held a 1% general partnership interest in FPtnrshipA. FCorpA-1 was owned 100% by FCorpA-2 and FCorpA-2 was owned 100% by USCorpA. The identity of the foreign affiliates of USCorpA that held direct interests in FPtnrshipA/B changed over time, but the ratio of ownership between USCorpA and USCorpB remained the same.

In their joint venture agreement, USCorpA and USCorpB agreed that they would share equally the costs of developing Project A and that, if they were successful in obtaining nonrecourse financing for Project A, they would each be reimbursed for their costs out of the proceeds of such financing. They also agreed that each would receive a development fee, which was also contingent on the availability of sufficient financing proceeds. USCorpA agreed that USCorpB would be entitled to receive a development fee substantially greater than that which USCorpA would receive, to compensate USCorpB for the value of the development activities that it performed before agreeing to pursue Project A as a joint venture with USCorpA.

In Year 6, as a result of the combined project development activities of USCorpA and USCorpB, financial closing on Project A was reached and USCorpA was reimbursed by FPtnrshipA/B out of the financing proceeds for its project development costs, plus interest. The amount of the reimbursement was $a. USCorpB also received reimbursement for its project development costs, plus interest. USCorpA and USCorpB also received subordinated promissory notes from

FPtnrshipA/B as payment of their respective development fees. USCorpA received a note for $b and USCorpB received a note for $c. At the date of the financial closing, the projected net present value of USCorpA's interest in Project A was $d. Based on this projected net present value, USCorpA's employees and managers involved in the development of Project A earned bonuses of approximately $e, with one-half of that amount payable at the financial closing date and the other one-half payable when Project A begins commercial operation. The cost of these bonuses was not reimbursed by FPtnrshipA/B.

LAW AND ANALYSIS

Examination proposes an allocation of income to USCorpA from FPtnrshipA/B under section 482 of the Internal Revenue Code, in order to prevent evasion of taxes or clearly to reflect the income of USCorpA with respect to its Project A development activities. Examination believes that the lack of adequate compensation to USCorpA with respect to its project development activities and the fact that the benefits of those activities is largely realized by USCorpA's foreign affiliates would result in a distortion of taxable income to USCorpA that section 482 was intended to prevent. Accordingly, Area Counsel requests field service advice on whether income may be allocated to USCorpA under section 482. This request will be addressed in supplemental advice.

Area Counsel also asks whether the partnership anti-abuse rule, Treas. Reg. § 1.701-2(e), may apply. Specifically, Area Counsel states with respect to Treas. Reg. § 1.701-2(e) that, assuming section 482 does apply, the ultimate tax results of the transactions are not clearly contemplated by section 482. Area Counsel asks whether Treas. Reg. § 1.701-2(e) may be applied to consider the transaction to involve the performance of development services by USCorpA for FPtnrshipA/B's foreign partners, rather than for FPtnrshipA/B.

Subchapter K, sections 701 through 777 of the Internal Revenue Code, provides rules regarding taxation of partners and partnerships. Treas. Reg. § 1.701-2(e) provides that the Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out any provision of the Internal Revenue Code. This regulation does not apply to the extent that a provision of the Code prescribes the treatment of a partnership as an entity and that treatment and the ultimate tax results, considering all facts and circumstances, are clearly contemplated by that provision.

From the incoming documents, it appears that USCorpA and USCorpB had a valid reason to join together in a partnership form: USCorpB had valuable rights in its pre-negotiations with Country A officials and USCorpA had the manpower and expertise to develop a Project A. Accordingly, we believe that FPtnrshipA/B had substance.[1]

While the alleged distortion of income may have been taken place through a partnership form, it was not strictly dependent on that form. It is conceivable that if USCorpA had been developing the project alone, it could have under-billed its own related entities. Accordingly, it is not appropriate to apply the anti-abuse rule in this context because we do not believe that the partnership form was interposed in order to effectuate the claimed abuse.

Please call our branch at (202) 874-1490 if you have any further questions.

ELIZABETH G. BECK
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Branch Chief, CC:INTL:6

[1] Examination has not inquired about the potential application of Treas. Reg. § 1.701-2(e) to FPtnrshipA, nor has it given any facts to guide such an analysis. Accordingly, we offer no opinion on Treas. Reg. § 1.701-2(e)'s potential application to FPtnrshipA.