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

March 25, 2002

Number: **200230001**
Release Date: 7/26/2002
CC:INTL:Br6
TL-N-1655-01
UILC: 482.09-00
482.11-00

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 supplements our October 26, 2001, response 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

Activity A =

Banks =

Country A Concession Authority =

Country A =

Country B =

Country C =

FCorpA-1 =

FPtnrshipA =

FPtnrshipA/B	=
FPtnrshipB	=
Individual A	=
Individual B	=
Individual C	=
Individual D	=
Input	=
Output	=
Project A	=
Project(s)-Type A	=
USCorpA	=
USCorpA-1	=
USCorpA-2	=
USCorpB	=
USCorpB-1	=
USPtnrshipA	=
Year 1	=
Year 2	=
Date 1, Year 2	=
Year 3	=
Date 1, Year 3	=
Date 2, Year 3	=

Year 4 =

Date 1, Year 4 =

Date 2, Year 4 =

Date 3, Year 4 =

Year 5 =

Year 6 =

Date 1, Year 6 =

Date 2, Year 6 =

Date 3, Year 6 =

Date 4, Year 6 =

Year 7 =

Year 9 =

Month A, Year 9 =

a =

b =

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d =

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ii

ISSUES

1. Whether USCorpA, USCorpB and FPtnrshipA/B were, with respect to the Project A development activities USCorpA and USCorpB performed after formation of their joint venture, "owned or controlled directly or indirectly by the same interests," within the meaning of section 482 of the Internal Revenue Code.

2. Whether USCorpA's Project A development activities were, within the meaning of Treas. Reg. § 1.482-2(b)(1) & (2), performed for the benefit of, or on behalf of FPtnrshipA/B, or for the benefit of, or on behalf of the foreign affiliates of USCorpA through which USCorpA held its 50% ownership interest in FPtnrshipA/B ("USCorpA Foreign Affiliates").

3. Whether the facts to be taken into account in determining whether the various "situations in which services shall be considered an integral part of the business activity of a member of a group of controlled entities," described in Treas. Reg. § 1.482-2(b)(7), are limited to those that exist in a particular taxable year and, if so, which taxable years should be considered for purposes of this case.

4. Whether USCorpA's Project A development activities constitute a "construction activity" for purposes of Treas. Reg. § 1.482-2(b)(7)(ii).

5. Whether USCorpA's Project A development activities were an integral part of the business activity of USCorpA, within the meaning of Treas. Reg. § 1.482-2(b)(7)(iii).

6. Whether FPtnrshipA/B "received the benefit of a substantial amount of services from one or more related parties during its taxable year" as a result of USCorpA's Project A development activities, within the meaning of Treas. Reg. § 1.482-2(b)(7)(iv).

7. Whether some or all of USCorpA's Project A development activities were "stewardship" activities for purposes of section 482.

8. Whether USCorpA's Project A development activities and related transactions with FPtnrshipA/B may, in the alternative, be characterized as the development of intangible property and the transfer of that property to FPtnrshipA/B.

CONCLUSIONS

1. With respect to the Project A development activities of USCorpA and USCorpB performed after formation of their joint venture, USCorpA, USCorpB and FPtnrshipA/B were "owned or controlled directly or indirectly by the same interests," within the meaning of section 482.

2. USCorpA's Project A development activities were, within the meaning of Treas. Reg. § 1.482-2(b)(1) & (2), performed for the benefit of, or on behalf of, FPtnrshipA/B.

3. We believe that, except where specific language of Treas. Reg. § 1.482-2(b)(7) limits the facts that may be considered for certain purposes to those within a particular taxable year, the significance of facts with respect to issues arising under this regulation will depend on the relevance and materiality of such facts to the particular issue in question.

4. We believe USCorpA's Project A development activities, considered as a whole, constituted a "construction activity" for purposes of Treas. Reg. § 1.482-2(b)(7)(ii).

5. We believe there is a reasonable basis on which to maintain that USCorpA's Project A development activities were an integral part of the business activity of USCorpA, within the meaning of Treas. Reg. § 1.482-2(b)(7)(iii).

6. We have found it difficult to apply Treas. Reg. § 1.482-2(b)(7)(iv) to the facts of this case. In view of our belief that the Project A development activities of USCorpA are appropriately treated as integral to the business activities of USCorpA under both subsection (ii) and subsection (iii) of this regulation, we have not analyzed this issue any further.

7. We do not believe any of USCorpA's Project A development activities were "stewardship" activities for purposes of section 482.

8. USCorpA's Project A development activities and related transactions may be characterized, under Treas. Reg. § 1.482-4(f)(3)(ii)(B), as having created intangible property owned by USCorpA and as a transfer by USCorpA of

such intangible property to FPtnrshipA/B that is subject to the transfer pricing rules for intangibles of Treas. Reg. § 1.482-4.

FACTS

A. Background Information

This case involves USCorpA's activities in developing Project A in Country A. Through a joint venture, USCorpA and unrelated USCorpB 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 providing for the financing, construction and operation of Project A. USCorpA and USCorpB caused the ownership of Project A and all of the contractual rights and obligations with respect to Project A to be held by 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.

USCorpA was actively engaged in developing projects such as Project A ("Projects-Type A") in international markets from Year 2 through Year 6 (the "Relevant Period"). It did so through the use of non-recourse or limited-recourse financing, known generally as "project finance." Project finance has been described generally as "the financing of long-term infrastructure, industrial projects and public services based upon a non-recourse or limited recourse financial structure where project debt and equity used to finance the project are paid back from the cash flow generated by the project." The International Project Finance Association (IPFA), <http:// www.ipfa.org/ > ("IPFA Website").

A typical project finance arrangement involves numerous parties, including the developers of the project; a concession authority, which is typically a government or other public body that awards the right to construct, own and operate the facility; a contractor or contractors to construct the facility; an operator of the facility; the supplier or suppliers of the input for the facility; a purchaser or purchasers of what the facility produces; the lenders for the project; and a special purpose vehicle ("SPV"), which is an independent legal entity that is created to enter into the contracts with the other parties and to own the assets to which the lenders to the project are limited in their recourse with respect to their loans. *See, e.g.,* IPFA Website, *supra*. "Central to the project finance transaction are the contractual agreements put in place between all the parties. These contracts set out and define each party's role and make clear their liabilities and expected roles within the transaction." *Id*.

The activities required to develop and obtain the authorizations and contracts to create a Project-Type A are extensive, time-consuming and costly. USCorpA

states that “a large part of [USCorpA’s] activities, at least initially, consists of working to establish the [Project-Type A] and takes place before the formation of the subsidiary that will operate the project, or the foreign project entity (‘FPE’).” May 22, 2000 Memorandum of Individual B on Stewardship Expenses, p.2. The scope of the development activities has been outlined by USCorpA as follows:

> Typically, it is necessary for the developer to negotiate a[n output] purchase agreement with a governmental purchaser or other customer to ensure a revenue stream; this also is crucial to obtaining limited recourse financing. In addition, the developer usually must secure a[n input] supply agreement, arrange financing, and coordinate other contractual arrangements such as turnkey contracts for the construction, technical assistance, and operation and maintenance of the project. The FPE enters into the contracts, constructs the [physical facility], and manages its day-to-day operations.

Id.

USCorpA performed its development activities using teams of specialists from among its employees. Such Project-Type A Teams included staff and manager employees who directly performed development activities (the “rendering employees”) and manager and executive employees who were less involved in performing such activities on a daily basis, but who were in the line of authority above the rendering employees (the “managing employees”). The managing employees “participate in high-level negotiations with government officials, third party contractors, and partners in the project. They are briefed regularly by the development team working on the project and provide advice and insight with respect to overall strategy and financing.” May 22, 2000 Memorandum of Individual B on Stewardship Expenses, p.2. USCorpA, which had extensive experience in developing Projects-Type A, had a “superb” reputation based on its “project successes.” Individual A Interview, p. 78.

During the Relevant Period, USCorpA was engaged in developing Projects-Type A throughout the world. USCorpA stated that “this business is inherently capital intensive and extremely risky.” April 23, 2001 Memorandum of Individual B on Taxpayer’s Position, p.2. USCorpA did “not develop FPEs as vehicles through which [USCorpA] will operate, manage or maintain the physical assets of the project.” *Id.* Rather, USCorpA’s development activity was “primarily to obtain a return on its equity capital.” *Id.* USCorpA stated that “[h]istorically, its returns have come primarily from sell-downs of interests in foreign project entities (‘FPEs’) and, to a lesser extent, out of dividends from the FPE’s cash flow.” *Id.*

USCorpA incurred significant expenses and risks related to the development of Projects-Type A during the Relevant Period. About 80 percent of USCorpA's

potential Projects-Type A for which development activities took place during the Relevant Period failed to reach a Financial Close. According to a representative of USCorpA, in Year 5 and Year 6 alone, USCorpA "wrote off" approximately $a in development costs attributable to unsuccessful and abandoned projects. September 13, 2001 Letter of Individual C.

However, for those Projects-Type A that reached a Financial Close, the present net value to the owners of the equity interest in the FPE, which could be projected based on the performance by various parties of the various contracts held in the name of the FPE, far exceeded the costs incurred in developing those contracts.

B. Project A

1. Preliminary Activities

In Year 1, an opportunity to develop a Project-Type A in Country A ("Project A") became generally known. At that time, USCorpB, a U.S. corporation unrelated to USCorpA, was actively pursuing Project A through negotiations with Country A Concession Authority. USCorpA and numerous other interested parties also began competing for the rights to develop Project A. Early in Year 2, USCorpB submitted a formal proposal to Country A Concession Authority to develop Project A.

After having developed valuable relationships with Country A Concession Authority, USCorpB approached USCorpA-1, a U.S. subsidiary of USCorpA,[1] to participate in developing Project A because USCorpB needed USCorpA's manpower and expertise in order to complete Project A. Individual A Interview, pp. 10, 21-22. After negotiations, USCorpA-1 and USCorpB agreed, during the summer of Year 2, to pursue Project A through a 50/50 joint venture.

Early in Year 3, Country A Concession Authority selected USCorpA/USCorpB as the joint venture with which it would pursue further negotiations with respect to Project A.

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[1] USCorpA developed Projects-Type A through a variety of domestic subsidiaries, including USCorpA-1. For convenience, USCorpA and its domestic subsidiaries involved in Project-Type A development activities are referred to herein, collectively or individually, as USCorpA, unless the context makes identification of a particular subsidiary appropriate.

2. Formation of Foreign Partnership with USCorpB

On Date 1, Year 3, USCorpB and USCorpA formed FPtnrshipA/B, a Country B limited partnership, as a joint venture to develop Project A. FPtnrshipA/B's two general partners, each of which held a 1% general partnership interest, were FCorpA-1, a Country C corporation affiliated with USCorpA, and USCorpB-1, a U.S. corporation affiliated with USCorpB. FPtnrshipA/B's two limited partners, each of which held a 49% limited partnership interest, were FPtnrshipA, a Country C limited partnership affiliated with USCorpA, and FPtnrshipB, a Country B limited partnership affiliated with USCorpB. The identity of the USCorpA's foreign affiliate partners in FPtnrshipA/B changed over time, but the 50/50 ratio of ownership between USCorpA and USCorpB remained the same.

3. Joint Venture Agreement with USCorpB

On Date 2, Year 3, USCorpB and USCorpA entered into a letter agreement (the "JV Agreement") containing the terms and conditions to apply to the joint venture until a final joint venture agreement was entered into. The JV Agreement includes the following provisions:

a. Ownership of Project A Assets. The JV Agreement recites that "affiliates of the Parties have formed . . . [FPtnrshipA/B]" and that

> [FPtnrshipA/B] shall be considered the "Joint Venture" for purposes of this [JV Agreement], and all development rights and interests in the Project, the [contract currently being negotiated by the parties with Country A Concession Authority] and any other Project agreements or assets (the "Project Assets") are, and in the future shall be, deemed to be owned solely by the Joint Venture as Joint Venture property."

JV Agreement, ¶ 3.

b. Percentage Interests. The JV Agreement provides generally that "all Joint Venture profits, gains, credits and losses shall be allocated and borne, for both accounting and tax purposes, in accordance with the following proportions (the 'Percentage Interests')," which are:

USCorpB (and its affiliates) - 50%
USCorpA (and its affiliates) - 50%.

Contributions of capital or equity to the Joint Venture are generally to be made in accordance with these percentages. JV Agreement, ¶ 6.

c. Management Authority. The JV Agreement provides that "[i]n general, the management of the Joint Venture shall be shared by the Parties on an equal basis, with all policy decisions . . . requiring the consent of each Party." JV Agreement, ¶ 7.a.

d. Reimbursement of Costs and Payment of Fees. The JV Agreement provides for reimbursement by the Joint Venture of "Development Costs" and "Other Costs" incurred by USCorpA and USCorpB in connection with developing Project A and for payment by the Joint Venture of "Development Fees" to USCorpA and USCorpB. JVAgreement, ¶ 9. All such reimbursements and payments are contingent on Project A reaching a Financial Close and on the availability of funds from the construction financing, from the permanent financing, or from subsequent available cash of the Joint Venture. JV Agreement, ¶ 9.h.

(i) Development Costs. The Parties agree "to share, on the basis of their Percentage Interests," all Development Costs. JV Agreement, ¶ 9.a. "Development Costs" for purposes of the JV Agreement are "limited solely to third-party costs and fees incurred in the development of the Project." JV Agreement, ¶ 9.c. Such Development Costs include those actually incurred by each party prior to Date 2, Year 3 (the effective date of JV Agreement), and those incurred on or after that date, provided that they are in accord with Project A development budgets agreed to by the Parties or are otherwise approved by the other Party to the agreement. To accomplish the equal sharing of such Development Costs, payments are to be made between the parties in order to equalize the amount of such costs borne by each. JV Agreement, ¶¶ 9.a., 9.b. & 9.e.

In recognition of the fact that, prior to the effective date of the JV Agreement, USCorpB incurred Development Costs in excess of those incurred by USCorpA, the JV Agreement recites that USCorpA made a payment of $b to USCorpB, "[i]n order to reduce(but not eliminate) the difference between such amounts incurred by [USCorpB] and by [USCorpA]." JV Agreement, ¶ 9.b. As to Development Costs that are not reimbursed, the JV Agreement provides

> . . . if there are not sufficient proceeds from the construction financing or if the Joint Venture is not selected by [Country A Concession Authority] to enter into the [Output Agreement] or if the Parties otherwise mutually agree to abandon the Project, then, upon a full accounting of Development Costs incurred hereunder, the Parties shall equalize their individual accounts by means of a payment by one Party to the other so that each Party's total contribution to unreimbursed Development Costs incurred hereunder is in proportion to such Party's Percentage Interest.

JV Agreement, ¶ 9.f.

(ii) Other Costs. The JV Agreement provides for a payment to each Party of "an equal amount as reimbursement of internal costs incurred during the development of the Project (including personnel costs, travel expenses, other out-of-pocket disbursements, and a reasonable overhead allocation)," plus an amount of interest to be agreed upon. JV Agreement, ¶ 9.g. The "equal amount payable to each Party" was "deemed to be the actual amount of such internal costs . . . as incurred by the Party which incurs the greater amount of such costs during the development of the Project." *Id.* Unlike the Development Costs, the Parties were not obligated to equalize the amounts of their other costs. Such amounts were "recoverable solely from the proceeds of a Project financing." *Id.*

(iii) Development Fee. The JV Agreement provided that the Parties would develop and agree on a financing budget for Project A covering all Costs required for Project A, through construction and start-up, and "to include in the Financing Budget a Project development fee of not less than $c." JV Agreement, ¶ 9.d. The Development Fee, to be paid by the Joint Venture to the Parties after reimbursement of all Development Costs and after payment to the parties of the "Other Costs" as set forth in subparagraph 9.g., was to be shared as follows: (i) the first $d to be paid to USCorpB; (ii) the next $e to be shared equally; and (iii) another $f to be paid to USCorpB if certain financial targets were met. JV Agreement, ¶ 9.h.

e. Construction and Term Financing. The JV Agreement described the anticipated financing arrangements as follows:

> The Parties intend that the Project Financing, which shall be in place by the commencement of construction, shall consist of non-recourse debt financing for 100% of Project Costs (as defined below) through the construction period of the Project, with take-out financing at the commercial operation date (the "Conversion Date") in the form of a term loan, with a term of at least 15 years, for 80-90% of Project Costs. The remaining Project Costs will be funded at the Conversion Date by equity contributions of the Parties . . . , which equity contributions (if permitted by Project lenders) may be in the form of subordinated debt . . . . For purposes of the foregoing, Project Costs shall include all Development Costs, the Development Fee, costs and interest payments described in subparagraph 9.g. [Other Costs], all engineering, construction and procurement costs, land acquisition costs, interest during construction, working capital, Project management and administration costs during the construction period, start-up expenses, insurance and tax costs, financing fees and contingency.

JV Agreement, ¶ 10.k.

f. Confidentiality. The JV Agreement provides that the JV Agreement is subject to the provisions of a "Confidentiality, Non-Disclosure and Non-Circumvention Agreement dated [Date 1, Year 2], between the Parties." JV Agreement, ¶16.

g. Projections. The parties agreed that the "Effective Date Project Proforma" attached to the JV Agreement as an exhibit

> (a) is based on reasonable assumptions as to all legal and factual matters material to the estimates set forth therein, (b) contains reasonable estimates and forecasts of the costs and revenues associated with the Project, [and] (c) provides a reasonable estimate of the net present value of the cashflows expected to be derived from the Project . . . . The Parties agree to update and revise the Project Proforma (so as to ensure the continuing correctness of the statements set forth in clauses (a) through (c) of the foregoing) no less than quarterly following the Effective Date [of the JV Agreement]. . . .

JV Agreement, ¶ 22

4. Project A Agreements Entered into by FPtnrshipA/B

Following execution of the JV Agreement, USCorpA and USCorpB negotiated numerous contracts with respect to Project A, which were entered into in the name of FPtnrshipA/B. As we understand the facts, FPtnrshipA/B's obligations under these contracts did not become effective until the contracts were reviewed and approved by Country A Concession Authority and by Banks, and until the financing for Project A was obtained and the Financial Closing occurred. These contracts included the following significant agreements:

a. Output Agreement. On Date 1, Year 4, an Output Purchase and Operating Agreement (the "Output Agreement") was entered into by FPtnrshipA/B and Country A Concession Authority. According to a USCorpA employee, "before you could actually sign [such a contract], you had to do huge amounts of work to figure out that what you're about to sign up - - since the . . . contract virtually defines your economics in terms of the revenue side, at least in 20 years, you had to be pretty sure of what your cost side was going to be so you knew there would be a spread between the revenues and the costs." Individual A Interview, p.68.

b. Construction Agreement. On Date 2, Year 4, a construction contract (the "Construction Agreement") was entered into between FPtnrshipA/B and USPtnrshipA, an affiliate of USCorpA.

c. Input Agreement. Also on Date 2, Year 4, an Input supply contract (the "Input Agreement") was entered into between FPtnrshipA/B and USCorpA-2.

d. Financing Term Sheet. On Date 3, Year 4, Banks provided to FPtnrshipA/B, at the request of USCorpA and USCorpB, a "Term Sheet" for the senior debt financing of FPtnrshipA/B, which was accepted by USCorpA and USCorpB on the same date. To obtain this Term Sheet, the project finance team prepared an offering memorandum and sent it to about 40 banks. Ten banks responded with offers to finance Project A and term sheets were negotiated with five banks, from which Banks were selected to lead the financing of Project A. Individual D Interview, p. 24.

The "Credit Facilities" covered by the Term Sheet included a "Construction Credit Facility," and a "Term Credit Facility," among others. Term Sheet, ¶ 1, "Credit Facilities." The Term Sheet stated that the Partnership had entered into an Output Purchase and Operating agreement with Country A Concession Authority (Term Sheet, ¶ 1, "[Output] Purchase Agreement"); that it would enter into one or more agreements with USCorpA subsidiaries with respect to the turnkey design, construction and procurement of the Project A facilities, which would be guaranteed by USCorpA (Term Sheet, ¶ 1, "Construction Contract"); that it would enter into a long-term Operations and Maintenance Agreement with a subsidiary of USCorpA (Term Sheet, ¶ 1, "Operations and Maintenance Agreement"); that it would enter into a long-term Administrative Services Agreement with USCorpB or an affiliate (Term Sheet, ¶ 1, "Administrative Services Agreement"); that it would enter into a long-term [Activity A] Agreement with an affiliate of USCorpA (Term Sheet, ¶ 1, "[Activity A] Agreement"); and that it would enter into various other agreements related to Project A (Term Sheet, ¶ 1, "Other Agreements").

The Construction Credit Facility was in an amount equal to $g plus interest accruals. Term Sheet, ¶ 2, "Construction Credit Facility." The Term Credit Facility was for the same amount as the Construction Credit Facility, minus a specified "Required Equity Contribution." Term Sheet, ¶ 2, "Term Credit Facility." This Required Equity Contribution was to be made by USCorpA and USCorpB at the time the Construction Credit converted to Term Credit. It was to be in an amount equal to 10% of the Borrower's final capital structure, which was expected to be equal to the total Construction Credit amount, and not more than one-half of the Required Equity Contribution could be in the form of subordinated debt. The ability of the USCorpA Foreign Affiliates to make the Required Equity Contribution was to be supported by a USCorpA guarantee, and the ability of the USCorpB partners was to be supported by letters of credit or by corporate guarantees with an AA credit rating. Term Sheet, ¶ 3, "Required Equity Contribution."

Project costs were defined generally to include all Project A-related costs and expenses for the acquisition, construction and financing of Project A, including,

among other specific items, “Partners’ Cost Reimbursements” and other fees and amounts required to be paid to the partners or their affiliates in accordance with Project A contracts. Also, 50% of the amount of any unused construction contingency was to be “paid to the Sponsors as additional incentive payment in connection with the development and financing of the Project.” Term Sheet, ¶ 5, “Project Costs.”

The Term Sheet also provided that at the Initial Advance Date, the Sponsors or their affiliates would be paid a lump sum amount equal to 10% of the Construction Credit Facility, out of which such parties were to bear or to reimburse the following Project A Costs incurred through and including the Closing: reimbursement of allocated internal and third-party development expenses, payment of a development fee, partnership legal expenses, site acquisition costs, and local Country A consultants. Term Sheet, ¶ 5, “Partners’ Cost Reimbursement.”

The “security package” in which a security interest would be held by the lenders furnishing the credit facilities included, among other items, “(i) the Project and all inventory, machinery and equipment of the Partnership; (ii) contract rights and general intangibles of the Partnership; [and] (iii) all agreements entered into by the Partnership, ...” Term Sheet, ¶ 5, “Security,” p.26.

Except with respect to the Required Equity Contribution, the Lender was to have recourse under the Credit Facilities to the assets of the Partnership, but not the assets of any partners or any affiliated companies. Term Sheet, ¶ 5, “Non-Recourse Borrowings.”

Conditions precedent to Closing and the advance of funds included the negotiation and execution of definitive Credit Documents, the execution and delivery of material Project A agreements, and receipt of the approved construction budget and pro-forma projections. Approval of the pro-forma projections was required by the lender’s agent and by an independent engineer, and the pro-forma projections were required to show certain debt service coverage ratios over the life of the credit facilities. Additional conditions precedent included delivery by an independent engineer of a “reasonably acceptable technical assessment of the Project confirming that its design and development and construction plans are consistent with its ability to perform its obligations under the [Output Sales Contract].” Term Sheet, ¶ 6, “Conditions Precedent to Closing.”

FPtnrshipA/B was required to make certain covenants in the Credit Agreement, including that it “will not, unless approved by the Majority Banks, materially adversely amend or cancel or permit any materially adverse amendment or cancellation of any material project agreement.” Term Sheet, ¶ 8(xii).

5. Credit Agreement

Date 2, Year 6 is the stated effective date of the “Credit Agreement” for Project A. Apparently, after this date and before Date 4, Year 6, when the Credit Agreement was executed, the entire package of contracts that were conditions precedent to the final approval and execution of the Credit Agreement underwent the final reviews and revisions necessary for their approval by Banks and by Country A Concession Authority.

6. Services Agreement with FPtnrshipA/B

The stated effective date of a “Financing and Project Services Agreement” between USCorpA and FPtnrshipA/B (the “Services Agreement”) is Date 2, Year 3, which is the date on which USCorpA and USCorpB entered into their JV Agreement. However, this Services Agreement includes references to an agreement dated as of Date 3, Year 6 and appears, therefore, to have been prepared in preparation for and in satisfaction of the conditions precedent to Financial Close, as contained in the Credit Agreement, discussed below. This Services Agreement refers to an identically titled “Financing and Project Services Agreement” between USCorpB and FPtnrshipA/B, also with an effective date of Date 2, Year 3.

a. Services Covered. The services FPtnrshipA/B requests USCorpA to provide under the Services Agreement are:

> Services outside [Country A] to FPtnrshipA/B in connection with the development of the Project, including but not limited to: arranging the primary [input] for the Project, including supply, storage and transportation; providing technical support and assistance for the obtaining of Project permits, licenses, environmental impact reports and easements; having primary responsibility for providing a bondable turnkey construction contractor and for developing the technical design and construction specifications for construction of the Project; arranging and obtaining, along with [USCorpB], on behalf of [FPtnrshipA/B], construction and long-term financing of the Project; identifying, structuring and negotiating, along with [USCorpB], other contractual arrangements required for a successful project financing; and generally coordinating development efforts with [FPtnrshipA/B’s] agents and representatives (the “Services”).

Services Agreement, Recitals.

b. Payment Terms. The Services Agreement provides that USCorpA "shall loan money or otherwise make available additional resources to [FPtnrshipA/B] in order to advance 50% of all third party expenses, including legal expenses, incurred by or on behalf of [FPtnrshipA/B] after the Effective Date in connection with the development of the Project." Services Agreement, section 1.1(a)(i). It also provides that USCorpA's internal costs, including interest, "shall be treated as loans by [USCorpA] to [FPtnrshipA/B]." Services Agreement, section 1.1(a)(ii).

Payment by FPtnrshipA/B for the Services covered by the Agreement was to consist of reimbursement of USCorpA's "Development Expenses," defined by the Services Agreement to include USCorpA's third party expenses and its internal costs, and of payment of "a fee of $h for the performance of the Services." FPtnrshipA/B's obligation to make these payments was not unconditional. FPtnrshipA/B was obligated to "use its best efforts to reimburse [USCorpA] out of the proceeds of the nonrecourse financing obtained for the Project (the 'Project Financing') and at the time proceeds of such Project Financing first become available to FPtnrshipA/B (the 'Financial Closing Date'), for [the defined Development Expenses]." Services Agreement, ¶ 1.2. Similarly, FPtnrshipA/B was obligated to "use its best efforts to pay [USCorpA], out of the proceeds of the Project Financing and on the Financial Closing Date, a fee of $h for the performance of the Services." Services Agreement, ¶ 1.3. This fee was part of a "Total Fee" of $i, of which $d was first to be paid to USCorpB, with the next $j to be split equally between USCorpA and USCorpB, and the final $f to be paid to USCorpB.[2] *Id.*

In the event that USCorpA did not "receive payments on the Financial Closing Date equal to the [specified amounts of reimbursement and fee], the amount of any such shortfall shall be carried forward as a debt of [FPtnrshipA/B] to [USCorpA]." Services Agreement, ¶ 1.4. Such indebtedness of FPtnrshipA/B to USCorpA was to be evidenced by a subordinated promissory note in a specified form. *Id.*

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[2] This Services Agreement provides for USCorpA and USCorpB each to receive fees that are $d more than the development fee amounts that were provided for by the JV Agreement. Also, in this Services Agreement, the payment of the final $f to USCorpB is not conditioned on Project A attaining certain financial goals, as in the JV Agreement. We believe these revised terms reflect the fact that the present value of the net future income of Project A had been determined and agreed upon for purposes of the Financial Close at the time this Services Agreement was prepared, which we believe was shortly before the Financial Close took place.

The specified form of the note stated that

> It is the intent of [FPtnrshipA/B] and [USCorpA] that (a) this Subordinated Note shall constitute indebtedness of [FPtnrshipA/B] and amounts evidenced hereby shall not be construed as capital contributions to [FPtnrshipA/B] and (b) each payment made by [FPtnrshipA/B] to [USCorpA] under this Subordinated Note is a payment of principal of, or interest on, this Subordinated Note, as the case may be, and shall not be construed as a payment in respect of a dividend or other return on equity to [USCorpA].

Services Agreement, Exhibit A, ¶ 12.

FPtnrshipA/B's obligation under the Subordinated Note was "to pay (subject to the provisions of [the terms of subordination] and only to the extent of Available Funds, as defined [under the Credit Agreement as available for withdrawal or as permitted to be paid]) to the order of [USCorpA] . . . the principal sum . . . together with interest . . . ." Services Agreement, Exhibit A, ¶ 1.

USCorpA's performance of all of its obligations to provide Services under the Services Agreement was conclusively acknowledged by FPtnrshipA/B on the occurrence of the Financial Closing. Services Agreement, ¶ 1.5.

7. Financial Close

On Date 4, Year 6, the Joint Venture reached the Financial Close on Project A. According to an employee of USCorpA,

> Financing documents are probably . . . 20 or 30 documents. It's a gigantic negotiation process. The banks review everything you've done up till that point, they make little adjustments to it in their financing terms and conditions, you have to negotiate loan agreements, security documents - -
>
> The business we're in, basically, is to get vital [non]recourse project financing for each project and it's just huge stacks of paper. And it takes hours and hours and thousands of hours of lawyers to get it done.

Individual A Interview, p.100.

Thus, upon Financial Close, all of the contracts for the construction and operation of Project A, including long-term contracts for the purchase of Input and for sale of Output had been finalized and approved by Banks and Country A

Concession Authority and they were made effective, as was the Credit Agreement. FPtnrshipA/B at that point was able to begin to draw funds under that Agreement.

On the Financial Close Date, Project A had an estimated cost of approximately $k and the present value of its predicted net future income was $l. On that date, USCorpA and USCorpB invoiced FPtnrshipA/B for reimbursement of their development costs. On that date also, USCorpA and USCorpB received subordinated promissory notes from FPtnrshipA/B in payment of Development Fees. Members of the USCorpA Project Team assigned to Project A, along with other USCorpA participants in a USCorpA Project Participation Plan, earned cash bonuses upon the Financial Close Date ("Project A Bonus"), the total amount of which was based on the present value of the predicted net future income of Project A attributable to USCorpA's 50 percent interest in FPtnrshipA/B of $m.

8. Sale of USCorpB's Interest

In Year 7, after Financial Close and before the beginning of commercial operations, USCorpB sold its 50% interest in the Joint Venture to an unrelated third party for $n. According to USCorpA, USCorpB made the sale because it would not have been able to contribute its share of the equity to Project A that would be necessary when Project A began commercial operation. Individual A Interview, pp. 41-42.

C. Contributions to Capital

The FPtnrshipA/B Agreement provided for USCorpA and USCorpB to contribute initial fixed capital of $o, according to their ownership interests. The JV Agreement provided that Development Costs incurred by the Parties were to be considered to have been "funded by capital contributions of the Parties or their affiliates." JV Agreement, ¶ 9.e. The Services Agreement states that USCorpA "shall loan money or otherwise make available additional resources" to FPtnrshipA/B " for 50% of the Development Costs incurred by or on behalf of FPtnrshipA/B. We are not aware that any such costs were treated as capital contributions or as loans. USCorpA has advised that, as of the close of Year 6, USCorpA had not made any cash capital contributions to FPtnrshipA/B. And, as noted above, it appears that USCorpB sold its interest in FPtnrshipA/B before it was required to make any capital contribution to FPtnrshipA/B. Individual A Interview, pp. 41-42.

D. Payments Related to Development Activities

1. Development Costs

On or before the Date 2, Year 3 effective date of the JV Agreement, USCorpA paid USCorpB $b, in order to reduce the difference between the amounts of Development Costs incurred by USCorpB and by USCorpA prior that date. JV Agreement, ¶ 9.b. We understand that following formation of their joint venture, no further payments were made between USCorpA and USCorpB to equalize the amount of Development Costs among them, as provided for by the JV Agreement.

On Date 4, Year 6, USCorpA invoiced FPtnrshipA/B for reimbursement of its Development Costs and Internal Costs in the total amount of approximately $p and received payment of approximately this amount from FPtnrshipA/B on the same day. These costs consisted of approximately $r in Development Costs, approximately $q in Internal Costs, and approximately $s in interest on these above amounts.

The costs invoiced by USCorpA to FPtnrshipA/B had been accumulated over the Relevant Period in a USCorpA Project Ledger Journal under a Project A account as a capital item. When paid by FPtnrshipA/B, USCorpA recorded the cash receipt and offset the Project A account. These costs did not include the Project A Bonus paid by USCorpA to its employees with respect to Project A.

USCorpA has advised that USCorpB billed FPtnrshipA/B and received reimbursement for Development Costs and Internal Costs in the amount of approximately $t, which represented Development Costs of approximately $v, Internal Costs of approximately $u, and interest on these amounts of approximately $w.

2. Development Fees

In the negotiations to form the joint venture to pursue the development of Project A, USCorpB sought payment from USCorpA for the value of the work that USCorpB had done with respect to Project A before USCorpA's involvement. Individual A Interview, pp. 44-45. In response, USCorpA agreed that it would be responsible for one-half of the costs incurred by USCorpB in connection with its Project A development activities prior to formation of the joint venture and that the Joint Venture would pay a larger development fee to USCorpB than would be paid to USCorpA. A $d portion of that preferential payment was regarded by USCorpA as ". . . almost a token recognition of the fact that they [USCorpB] had been the ones who put in the initial proposal . . . and we had sort of joined their proposal . . . ." *Id.* USCorpA also agreed to a further preferential payment by FPtnrshipA/B to USCorpB of up to $f, if certain rates of return were met in the financial projections on which the financing for Project A would be based. USCorpA was willing to allow these additional preferential payments to be made by FPtnrshipA/B to USCorpB because, "if this [project] is really successful and beats these rate of return hurdles, then that means that we will deem that [USCorpB has] created more value by

bringing a more viable project here and, therefore, [USCorpB is] entitled to more of a development fee than if the project isn't as valuable." *Id.* Payment of development fees was contingent on the availability of funds from the lenders, following Financial Close.

On Date 1, Year 6, USCorpA and USCorpB received subordinated promissory notes from FPtnrshipA/B in payment of the Development Fees, USCorpA's portion being $h and USCorpB's aggregate portion being $x. On its books, USCorpA recorded the Development Fee as "Other Revenue - Construction."

3. Project A Bonuses Paid to USCorpA's Employees

The y member Team assigned to Project A, along with z other participants through an USCorpA Project Participation Plan, earned cash bonuses upon the Financial Close Date ("Project A Bonus"). The total amount of the Project A Bonus was calculated by using the estimated net Project A value as of the Financial Close Date of $m (USCorpA's 50% share), and multiplying it by the specified percentage (aa%). Fifty percent (50%) of that resulting amount ($bb), or $cc, was payable upon Financial Close Date, with the balance payable when Project A reached commercial operation. The amount of the payment due upon commercial operation was subject to adjustment, to the extent that the net present value of Project A between the Financial Close Date and the date of successful commercial operation changed[3].

The Team Leader and the rendering employees on the Project A Team were involved in development activities on a daily basis. Their regular salaries were included in the Internal Costs billed to FPtnrshipA/B. The Team Leader has stated that his or her bonus arrangement was made at the beginning of the process, in Year 2 or Year 3[4]. It is unclear when or how USCorpA may have committed to pay a Project A Bonus to the other rendering employees on the Project A Team. The z USCorpA Project Participation Plan members consist mainly of managers and executives of USCorpA. The scope and extent of their direct involvement in Project A is not known but several of the individuals are generally known from public sources to have been active participants for USCorpA in high-level negotiations on projects of this type.

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[3] Commercial operation was achieved in Month A, Year 9. Examination has not verified if and when the bonuses payable upon this event were paid, the amount of the commercial operation payment, nor whether USCorpB had a similar bonus program.

[4] Examination requested a copy of any written agreements related to Team Leader's bonus arrangement but has not received any such documents, if any exist.

The USCorpA Project Participation Plan ("Plan") is described as a general obligation of the Corporation, as opposed to an ownership interest in any particular project or venture. The committee that administers the Plan grants interests in bonus pools for each of the included projects. These interests are stated as percentages of the total bonus for the included project. The bonus pool for each included project is dd% of the Net Project Value ("NPV") limited to $ee. Half of the bonus pool is granted at Financial Close and the other half at successful commercial operation or sale/withdrawal/termination of the Company's interest in the project. At the later date, the dollar amount of grants is dd% of the revised NPV, limited again to $ee, minus previous payments. Vesting of the bonus grants occurs with continued employment over a five-year period, which period may be accelerated by the Plan at its discretion. The Plan has a mechanism for participants to contest the Project NPV calculation and to resolve the dispute by mediation.

Only the portion of the Project A Bonus paid to Team Leader was reviewed for its treatment by USCorpA. This bonus was capitalized by USCorpA when awarded and was expensed when it was paid. USCorpA has advised that in has not invoiced the Project A Bonus to FPtnrshipA/B and that it has not been reimbursed by FPtnrshipA/B for the Project A Bonus.

LAW AND ANALYSIS

1. Whether USCorpA, USCorpB and FPtnrshipA/B were, with respect to the Project A development activities USCorpA and USCorpB performed after formation of their joint venture, "owned or controlled directly or indirectly by the same interests," within the meaning of section 482 of the Internal Revenue Code.

   a. Section 482 in General. Section 482 provides as follows:

   In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the

> meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

I.R.C. § 482.

Section 482 was designed to prevent the artificial shifting, milking, or distorting of the true net incomes of commonly controlled enterprises. *See, e.g., Commissioner v. First Security Bank of Utah, N.A.*, 405 U.S. 394, 400 (1972). *Cf.* H.R. Rep. No. 2, 70th Cong., 1st Sess., 16-17. "The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer." Treas. Reg. § 1.482-1(a)(1).[5]

i. Two or More Organizations, Trades, or Businesses. For section 482 to apply, the taxes or income of two or more "organizations, trades, or businesses" must be involved. This phrase has been broadly construed. Thus, for example, section 482 can be applied to reallocate income from a partnership to a corporate partner of such partnership. *See, e.g.*, *Aladdin Industries, Inc. v. Commissioner*, T.C. Memo. 1981-245. *See also* Treas. Reg. § 1.482-1(i)(1) & (2) (definitions of "organization" and of "trade or business").

ii. Ownership or Control. Treas. Reg. § 1.482-1(i)(4) defines "controlled" for purposes of section 482 to include

> any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

Case law supports this broad definition of control, indicating, for example, that actual and practical control, rather than legally enforceable control, is what counts in the application of section 482. *See, e.g., Ach v. Commissioner,* 42 T.C.

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[5] We assume for purposes of this field service advice that the final section 482 regulations, effective for taxable years beginning after October 6, 1994, apply. To the extent that any aspects of this case may relate to earlier taxable years, earlier versions of the regulations may apply. We do not believe the results discussed herein are affected by the version of the section 482 regulations that may apply.

114, 125 (1964), *aff'd*, 358 F.2d 342 (6th Cir. 1966), *cert. denied*, 385 U.S. 899 (1966); *Grenada Indus., Inc. v. Commissioner*, 17 T.C. 231 (1951), *aff'd*, 202 F.2d 873 (5th Cir. 1953), *cert. denied*, 346 U.S. 819 (1953), *acq. in part and nonacq. in part*, 1952-2 C.B. 2, 5. *See also Appeal of Isse Koch & Company, Inc.*, 1 B.T.A. 624, 627 (1925), *acq.,* 1925-1 C.B. 2 ("[C]ontrol not arising or flowing from legally enforceable means may be just as effective in evading taxation as if found on the most formal and readily enforceable legal instrument.").

Case law also supports the presumption of control that arises when there has been an arbitrary shifting of income or deductions. *See, e.g., Dallas Ceramic Co. v. Commissioner*, 598 F.2d 1382, 1389 (5th Cir. 1979), *rev'g*, 35 A.F.T.R.2d (RIA) ¶ 75-394 (N.D. Tex. 1974) (stating that the government correctly argued that proof of a shifting of income between two corporations establishes a presumption of common control under Treas. Reg. § 1.482-1(a)(3) (1968) - predecessor to current section 482 regulations); *Hall v. Commissioner*, 294 F.2d 82, 85 (5th Cir. 1961), *aff'g,* 32 T.C. 390 (1959), *acq.*, 1959-2 C.B. 4 (finding presumption of control under section 29.45-1 of Regulation 111 - predecessor to current section 482 regulations).

iii. The Same Interests. The regulations do not provide guidance on the meaning of the term "the same interests," which is used in section 482 to identify the holders of the necessary ownership or control. However, case law indicates that, in using the term "the same interests," Congress intended to include more than "the same persons" or "the same individuals." *See, e.g., B. Forman Co., Inc. v. Commissioner*, 598 F.2d 1144 (2d Cir. 1972), *rev'g in part* 54 T.C. 912, *cert. denied*, 407 U.S. 934 (1972) (rejecting Tax Court's view that two independently owned corporations acting in concert to make interest-free loans to a jointly owned corporation did not constitute the same interests within the meaning of section 482). *See also Brittingham v. Commissioner*, 598 F.2d 1375, 1379 (5th Cir. 1979), *citing,* H. Rept. No.2, 70th Cong., 1st Sess. (1927), 1939-1 C.B. (Part 2) 384, 395; S. Rept. No. 960, 70th Cong., 1st Sess. (1928), 1939-1 C.B. (Part 2) 409, 426. *See also* H. Rept. No. 350 and S. Rept. No. 275, 67th Cong., 1st Sess. In other words, different persons with a common goal or purpose for artificially shifting income can constitute the "same interests" for purposes of the statute. *Brittingham*, *supra*, at 1379; *South Texas Rice Warehouse Co.* v. *Commissioner*, 366 F.2d 890, 894-5 (5th Cir. 1966), *aff'g*, 43 T.C. 540 (1965), *cert. denied*, 3861016 (1967). See also *Brittingham*, *supra*, at 1378, *citing*, *Ach*, 42 T.C. at 125-6 (The phrase, "same interests," should not be narrowly construed to frustrate the intent of section 482.) *Accord Grenada Indus.*, *supra*. Thus, where there is a common design for the shifting of income, different entities may constitute the "same interests."

iv. Preventing Evasion of Taxes or Providing for Clear Reflection of Income. Where the parties to a transaction are owned or controlled by the same interests, the Secretary may allocate income "between or among such organizations, trades or businesses, if he determines that such . . . allocation is

necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades or businesses." Section 482. For purposes of section 482, a "transaction" is defined to mean

> any sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property (whether tangible or intangible, real or personal) or money, however such transaction is effected, and whether or not the terms of such transaction are formally documented. A transaction also includes the performance of any services for the benefit of, or on behalf of, another taxpayer.

Treas. Reg. § 1.482-1(i)(7).

"True taxable income" for purposes of section 482 means, in the case of a controlled taxpayer,

> the taxable income that would have resulted had it dealt with the other member or members of the group at arm's length. It does not mean the taxable income resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement the controlled taxpayer chose to make (even though such contract, transaction, or arrangement is legally binding upon the parties thereto).

Treas. Reg. § 1.482-1(i)(9).

b. Discussion. We believe the facts in this case show that USCorpA and USCorpB acted in concert to shift income attributable to the Project A development activities they performed after formation of their joint venture. The income was shifted from the U.S. corporations that performed the activities, USCorpA and USCorpB, to their equally owned foreign joint venture, FPtnrshipA/B. Accordingly, USCorpA and USCorpB should be considered to constitute the "same interests" owning or controlling FPtnrshipA/B for purposes of section 482, under the "acting in concert" theory of *B. Forman Co., Inc. v. Commissioner*, *supra*.

Just as in the *B. Forman* case, the reality of the circumstances in this case is that two equal owners, USCorpA and USCorpB, acting together, have complete control over their foreign joint venture, FPtnrshipA/B. In the *B. Forman* case, the Second Circuit found "the conclusion . . . inescapable that [the two taxpayer corporations holding equal ownership interests in a joint venture corporation] acted in concert in making loans without interest to a corporation, all of whose stock they owned and all of whose directors and officers were their alter egos." *B. Forman Co., Inc. v. Commissioner*, *supra*, 453 F.2d 1144 at 1155. The court based this conclusion on several facts, including the following:

> The loans by taxpayers to Midtown [their joint venture corporation], without interest, affected the incomes of taxpayers and of Midtown. By not reporting interest on these loans, taxpayers reported lower earnings and, in turn, lower taxes. Midtown, in not paying interest, eliminated a business expense which would have further increased its yearly losses. Because of Midtown's unfavorable financial condition, it was encountering difficulty in the rental of stores, a matter of concern to McCurdy and Forman [the taxpayer corporations], the actual owners of Midtown.

Id. at 1154. Accordingly, the court determined that "[t]he instant loans without interest are obviously not at arm's length, since no unrelated parties would loan such large sums without interest. The allocation of the interest income to taxpayers was necessary in order to properly reflect their taxable incomes." *Id*. at 1156.

Thus, by shifting interest income from themselves to their equally owned joint venture, the taxpayers in the *B. Forman* case reduced the amount of their current taxable income without causing any corresponding increase in the current taxable income of their joint venture. They also sought, in exchange for foregoing the present receipt of interest income, to increase the future value of their ownership interests in their joint venture by enhancing its ability to generate future rental income.

We believe the Project A development activity transactions of USCorpA and USCorpB with their commonly owned FPtnrshipA/B closely follow the pattern of the loan transactions in the *B. Forman* case. Most importantly, USCorpA and USCorpB shifted large amounts of income from themselves to FPtnrshipA/B by allowing FPtnrshipA/B to receive the benefit of their joint Project A development activities at a charge that was not equal to an arm's length charge. Examination has determined that the appropriate arm's length charge for the value of USCorpA's Project A development activities is substantially in excess of the amount USCorpA received from FPtnrshipA/B. We note, as discussed further herein, that this determination is strongly supported by the facts in this case.

For example, upon Financial Close, before FPtnrshipA/B received any capital contributions or engaged in any activities, the present value of its predicted net future income was approximately $I. We believe this value was the direct result of the Project A development activities of USCorpA and USCorpB. In exchange for receiving the benefit of these activities, however, FPtnrshipA/B reimbursed USCorpA and USCorpB only for certain costs they incurred in connection with their

Project A development activities[6] and paid them development fees that totaled only $i.[7] We believe these are among the facts demonstrating that USCorpA and USCorpB provided the benefits of their Project A development activities to FPtnrshipA/B on terms that were obviously not at arm's length, since no unrelated parties would have provided such substantial benefits without a charge that more appropriately reflected their value. *Id.*

The incentives for USCorpA and USCorpB to act in concert to shift income to their commonly owned foreign joint venture, FPtnrshipA/B, were similar to those affecting the taxpayers in the *B. Forman* case. By shifting the income attributable to their Project A development activities to FPtnrshipA/B, USCorpA and USCorpB had less current taxable income. And, as in the *B. Forman* case, by charging less than an arm's length amount for the value of their Project A development activities, USCorpA and USCorpB sought to enhance the value of their interests in their commonly owned FPtnrshipA/B.

USCorpA stated, for example, that its development activity was "primarily to obtain a return on its equity capital." April 23, 2001 Memorandum of Individual B on Taxpayer's Position, p.2. USCorpB demonstrated that it shared this objective by selling its interest in FPtnrshipA/B to an unrelated party after Financial Close had occurred and before USCorpB was required to make any contribution to the capital of FPtnrshipA/B. USCorpB received $n, which was $ff more than the net present

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[6] In the case of USCorpA, the Project A development costs for which it received reimbursement did not include the cost of the bonuses it paid to its employees for the successful development of Project A. By prior agreement with its employees, the amount of these bonuses was a specified percentage (aa%) of USCorpA's 50 percent ownership interest in the present value of the predicted net future income of FPtnrshipA/B. One-half the amount of the bonuses was based on the present value, upon Financial Close, of USCorpA's interest in this predicted net future income ($m). The other one-half was to be based on the present value, upon commencement of commercial operations by Project A, of USCorpA's interest in this predicted net future income (which was not anticipated to differ significantly from the value upon Financial Close). In total, these bonuses paid by USCorpA to its employees for the successful development of Project A amounted to approximately $z.

[7] As discussed below, we believe USCorpA and USCorpB were each paid a development fee of only $h for the Project A development activities each of them performed following formation of the joint venture. The additional development fee of $gg paid to USCorpB represented an arm's length charge by USCorpB for the value of the preliminary Project A development activities USCorpB performed before the joint venture with USCorpA was formed.

value of USCorpB's interest in Project A, as projected at the time of Financial Close.[8]

We are aware that the incentive for equal owners of a joint venture to shift income to their joint venture may be diminished if the owners do not consider that the amount of income to be shifted by each owner will be approximately equal.[9] The taxpayer in this case has argued that certain facts should be viewed as showing that USCorpA and USCorpB did not regard their Project A development activities to be of equal value and that USCorpA and USCorpB cannot, therefore, be regarded as having acted in concert. As discussed below, we believe the facts of this case demonstrate that USCorpA and USCorpB treated the Project A development activities that they performed following the formation of their joint venture as having equivalent value.

At the outset, USCorpA and USCorpB agreed to maintain equality in the amount of costs each would incur in connection with their Project A development activities and to make payments between them, if necessary, to reach this result. JV Agreement, ¶ 9. The amount of financial risk to which each was exposed with respect to their Project A development activities was therefore kept equal. If Project A had failed to reach Financial Close, USCorpA and USCorpB would have suffered equal losses as a result of their unsuccessful Project A development efforts.

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[8] The value of FPtnrshipA/B at the time of this sale was due mainly, if not entirely, to the Project A development activities of USCorpA and USCorpB, since FPtnrshipA/B had received no contributions to capital and its assets were entirely the result of the contracts that had been negotiated and secured for it in the course of the Project A development activities of USCorpA and USCorpB. We believe this strongly supports Examination's determination that the arm's length value of USCorpA's Project A development activities is substantially greater than the amount USCorpA received from FPtnrshipA/B.

[9] In the *B. Forman* case, the amount of interest income shifted by the equal owners of the joint venture to their joint venture corporation was equal because they made interest-free loans of the same amount. *Cf. R. T. French Co. v. Commissioner*, 60 T.C. 836, 851 (1973). In that case, two unrelated companies owned all of the stock of one party to a transaction and 51 percent of the stock of the other party to the transaction. This made it unlikely that the two parent companies of the first party to the transaction would have caused it to shift income to the other party because "they would thus have been diverting funds from a corporation . . . in which they were the sole stockholders to another corporation . . . in which a stranger . . . owned 49 percent of the stock. *Id.* (footnote omitted).

When Financial Close was reached in this case, USCorpA and USCorpB had apparently incurred different amounts of costs in connection with their Project A development activities and USCorpA received reimbursement for a larger amount of Project A development costs than USCorpB. The taxpayer in this case has argued that where, as in this case, parties incur different amounts of cost in providing services to a 50-50 joint venture, one party will be the loser by charging only cost for its services. We do not believe this argument can be sustained under the facts of this case.

When Financial Close was reached, the risk that Project A might not be successfully developed was removed and there was no longer any need for USCorpA and USCorpB to make payments between themselves to equalize the amounts they would have at risk if Project A failed. At that point, the reimbursement of the Project A development costs by FPtnrshipA/B out of its financing proceeds meant that those costs were, as a practical matter, borne equally by USCorpA and USCorpB. Following such reimbursement, neither USCorpA nor USCorpB suffered any diminution in value as a result of having incurred such costs. However, the interests of USCorpA and USCorpB in FPtnrshipA/B were reduced equally in value as a result of the reimbursement payments by FPtnrshipA/B.

Also upon Financial Close, FPtnrshipA/B paid development fees to USCorpA and USCorpB. As agreed by USCorpA and USCorpB, the amount of the development fee FPtnrshipA/B paid to USCorpB was $gg more than that paid to USCorpA. The taxpayer in this case has argued that the structure of these development fee payments was evidence of the adverse economic interests of USCorpA and USCorpB because this was not the type of deal that would have been agreed to by parties acting in concert.

When the reason for the payment of different amounts of development fees is examined, however, it is evident that USCorpA and USCorpB regarded themselves as entitled to equal (and nominal) development fees with respect to the Project A development activities they each performed after their joint venture was formed. The additional amount of the development fee that USCorpB received reflects a separate, arm’s length bargain between USCorpA and USCorpB regarding USCorpB’s compensation for the preliminary Project A development activities it performed before the joint venture was formed.

Thus, in the negotiations to form the joint venture, USCorpB sought payment from USCorpA for the value of the work that USCorpB had done with respect to Project A before USCorpA became involved. Since USCorpA and USCorpB were negotiating an arrangement under which USCorpA would have a one-half interest in Project A, if it was successfully developed, USCorpB was presumably seeking compensation from USCorpA for one-half of the value of the Project A development

activities it performed before the joint venture was formed. USCorpB had no incentive to shift income with respect to these pre-joint venture activities to the joint venture, inasmuch as USCorpA had not, at that point, performed any similar activities that would benefit the joint venture.

USCorpA and USCorpB agreed that USCorpB would be compensated for its pre-joint venture development activities in two ways. First, USCorpA reimbursed USCorpB for approximately one-half of the costs USCorpB had incurred with respect to its pre-joint venture Project A development activities. The JV Agreement recites that USCorpA, prior to the effective date of the JV Agreement, made a payment of $b to USCorpB, "[i]n order to reduce (but not eliminate) the difference between" the amount of development costs incurred by USCorpB and by USCorpA. JV Agreement ¶ 9.b. Second, provided that USCorpB's pre-joint venture Project A development activities, together with the Project A development activities performed by USCorpA and USCorpB after formation of the joint venture, were successful and Project A reached a Financial Close, USCorpB would receive payment of development fees out of the Project A financing proceeds on a preferential basis.

The preferential $gg Project A development fee that FPtnrshipA/B paid to USCorpB was, therefore, the agreed-upon payment to USCorpB for the value of its pre-joint venture Project A development activities.[10] The USCorpA employee involved in the negotiations described the reasons for this preferential payment to USCorpB as "almost a token recognition that [USCorpB's employees] had been the ones who put in the initial proposal" and that, if certain rates of return were met when Project A reached Financial Close, USCorpA would "deem that [USCorpB had] created more value by bringing a more viable project [to the joint venture] and, therefore, [USCorpB would be] entitled to more of a development fee than if the project isn't as valuable." Individual A Interview, pp. 44-45. Thus, by acting in concert, USCorpA and USCorpB used their common control of FPtnrshipA/B to carry out their arm's length bargain to compensate USCorpB for its preliminary Project A development activities.

Inasmuch as FPtnrshipA/B paid the $gg preferential development fee to USCorpB out of its financing proceeds, the cost of this payment was, as a practical matter, borne equally by USCorpA and USCorpB. Because of this payment, the indirect interests of USCorpA and USCorpB in FPtnrshipA/B were reduced equally

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[10] Thus, USCorpA agreed that USCorpB would be compensated for its pre-joint venture Project A development activities in an amount that far exceeds the costs incurred by USCorpB in connection with those activities. We view this as a clear refutation of the taxpayer's argument that the parties in this case charged cost for their Project A development activities not because they were acting in concert, but, rather, because charging cost was an arm's length bargain.

in value, by $ff. However, the payment increased the direct value of USCorpB by $ff but had no effect on the direct value of USCorpA. Thus, the combined value of USCorpA and of its interest in FPtnrshipA/B was reduced by $ff in this transaction, while the combined value of USCorpB and of its interest in FPtnrshipA/B was increased by $ff. This $ff transfer of value, from USCorpA to USCorpB, represented payment by USCorpA to USCorpB for one-half the value of USCorpB's pre-joint venture Project A development activities. This payment was in addition to USCorpA's prior reimbursement of approximately one-half of the costs USCorpB incurred in performing those activities.[11]

Finally, the taxpayer in this case has argued that the Project A development activity transactions of USCorpA and USCorpB with FPtnrshipA/B must have been on arm's length terms for two additional reasons. First, the taxpayer maintains that lenders providing limited recourse "project financing" carefully scrutinize all contracts to ensure that they contain arm's length terms. Second, the taxpayer claims that because other contracts between FPtnrshipA/B and affiliates of either USCorpA or USCorpB were on arm's length terms, the Project A development activity transactions of USCorpA and USCorpB with FPtnrshipA/B must also have been on arm's length terms. In our view, neither of these arguments is persuasive.

We do not believe that lenders in project finance arrangements have any interest in protecting against the type of income shifting at issue in this case, which involve USCorpA and USCorpB shifting income attributable to the Project A development activities they performed to FPtnrshipA/B, the foreign project entity that was created to hold title to Project A. Indeed, since the project lenders have recourse only to the foreign project entity and its assets as security for their loans,

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[11] The terms on which USCorpB was compensated by USCorpA for one-half the value of its pre-joint venture Project A development activities were negotiated at arm's length in connection with the formation of the joint venture. They are strikingly different than the terms on which USCorpA and USCorpB arranged to compensate themselves for the Project A development activities they performed following formation of their joint venture. Thus, the amount USCorpA paid USCorpB for one-half the value of USCorpB's pre-joint venture activities, $ff, reflected a total value of those activities of $gg, which is more than 15 times the approximate amount of costs incurred by USCorpB in connection with performing those activities (approximately $hh). In contrast, the combined amount of Project A development fees received by USCorpA and USCorpB for the Project A development activities they performed after formation of their joint venture was $j, which is only about one-third of the costs that were incurred in connection with performing these activities (approximately $ii). We believe these facts also support Examination's determination that the payments USCorpA received with respect to its Project A development activities fall far short of an appropriate arm's length charge.

any increase in the amount of income attributed to the foreign project entity would be expected to enhance the security for their loans.

We do not doubt that project finance lenders seek to prevent the foreign project entity that is exclusively responsible for repayment of the project finance loans from making any payments that would impair its ability to make such repayment. On the other hand, project finance lenders would be expected to be equally concerned that the project they rely upon as the source of funds to repay their loans will generate a sufficient return to its owners to make the project financially sound. Such lenders should, however, be indifferent as to whether the income resulting from project operations is viewed as income attributable to the foreign project entity or as income attributable to the U.S. corporations that used their resources and took the risks to develop the project. Distribution by the project entity of income attributable to the project development activities of the U.S. corporations would not necessarily impair the ability of the project entity to repay its project finance loans. Such income could, for example, be distributed in the form of royalties for the creation and transfer of intangible property, or in the form of profit split payments representing payments for project development services that were contingent on project performance.

We are aware that FPtnrshipA/B entered into a variety of contracts with affiliates of both USCorpA and USCorpB. However, we are not aware that any of these other contracts involved parallel activities by USCorpA and USCorpB. Moreover, we understand that these other contracts included a reasonable profit for the parties involved. For example, Examination does not contend that the contract between USPtnrshipA and FPtnrshipA/B for construction of the Project A physical facilities, which included a profit for USPtnrshipA, was not on arm's length terms. The consideration received by USPtnrshipA under this contract was a significant portion of the overall cost of Project A. USCorpB did not have a similar contract to perform construction services for FPtnrshipA/B. Thus, there was no economic incentive, with respect to this contract, for USCorpA to shift construction activity income from its wholly owned construction affiliate to its 50% owned FPtnrshipA/B.[12]

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[12] This assumes that there were not any other transactions in which compensating amounts of income might have been shifted by USCorpB, either to FPtnrshipA/B or directly to USCorpA. The need to consider all transactions between and among the participants in a joint venture is illustrated by the decision in *GAC Produce Co. v. Commissioner*, T.C. Memo 1999-134, 62-63. In that case, a U.S. taxpayer and a foreign entity under common control had contracts with the same unrelated third party. The taxpayer argued that the income of the U.S. taxpayer was the result of "an arm's- length agreement between two unrelated parties," while the Service maintained that the "contract represent[ed] a complicated arrangement in which

Thus, we view the Project A development activities of USCorpA and USCorpB, and their transactions with FPtnrshipA/B regarding those activities, to have been, in substance, as follows:

(1) USCorpB used its resources and skills, incurred costs, and took risks in performing preliminary Project A development activities;

(2) Following formation of their joint venture, USCorpA and USCorpB both used their resources and skills, incurred substantial costs, and took all of the further risks in performing further Project A development activities;

(3) Unless and until Financial Close was reached, USCorpA and USCorpB were financially at risk for equal amounts;

(4) Upon Financial Close, all of the benefits of the Project A development activities of USCorpA and USCorpB were received by FPtnrshipA/B;

(5) Upon Financial Close, USCorpA and USCorpB were both reimbursed for their Project A development costs out of the financing proceeds received by FPtnrshipA/B, so that neither of them suffered any diminution in value because of their individually incurred costs, and they each paid, in effect, an equal amount of such costs through equal reductions in the value of their interests in FPtnrshipA/B;

(6) Upon Financial Close, USCorpA and USCorpB were paid development fees out of the financing proceeds received by FPtnrshipA/B. Of the $i total amount of such fees, $gg, plus the reimbursement of approximately $hh in costs, represented an arm's length charge for the value of USCorpB's pre-joint venture Project A development activities. The remaining amount, $j, plus the reimbursement of approximately $ii in costs, is the total amount received by USCorpA and USCorpB from FPtnrshipA/B for the value of their joint Project A development activities performed after they formed their joint venture agreement.

(7) Examination has determined that the appropriate arm's length charge for the value of USCorpA's Project A development activities is far greater than the

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petitioner functioned as a member of a combined group, not as an independent negotiating party." *Id.* The court agreed with the Service, stating that "[w]hile, on its face, the SCP contract [in question] was between [the unrelated party] and petitioner, we are persuaded that, in substance, it was not merely between those two parties. Rather, in our view, the SCP [overall] deal, to which the SCP contract [in question] related, constituted a joint venture between [the unrelated party] on the one hand and the [controlled group, including the U.S. taxpayer and its related foreign entity,] on the other." *Id.*

amount FPtnrshipA/B paid USCorpA in order to receive the benefit of those activities. We believe this determination is strongly supported by the facts in this case, including the fact that the present value of the predicted net future income of FPtnrshipA/B, upon Financial Close and before FPtnrshipA/B had received any capital contributions or performed any activities, was $I. We believe this represents a substantial shifting of income attributable to the Project A development activities, from USCorpA and USCorpB, which used their resources and skills to perform the activities, incurred all of the costs, and took all of the risks with respect to those activities, to FPtnrshipA/B.

We therefore believe that common control among USCorpA, USCorpB and FPtnrshipA/B exists for purposes of section 482 with respect to the Project A development activities they performed after formation of their joint venture, under the "acting in concert" theory of the *B. Forman* case and consistent with the principle that it is the reality of control that determines whether section 482 applies to a transaction.

2. Whether USCorpA's Project A development activities were, within the meaning of Treas. Reg. § 1.482-2(b)(1) & (2), performed for the benefit of, or on behalf of FPtnrshipA/B, or for the benefit of, or on behalf of the foreign affiliates of USCorpA through which USCorpA held its 50% ownership interest in FPtnrshipA/B ("USCorpA Foreign Affiliates").

Generally, an activity of one member of a controlled group involves the rendering of services to another member of the group where that activity, at the time it is performed, relates to the carrying on of an activity by another member of the group or is intended to benefit another member of the group, either in that member's overall operations or in its day-to-day activities. Treas. Reg. § 1.482-2(b)(2)(i).

Examination has suggested that the Project A development activities of USCorpA could be regarded as services rendered for the benefit of the USCorpA Foreign Affiliates, through which USCorpA held its 50% interest in FPtnrshipA/B. Examination believes that the USCorpA Foreign Affiliates had joint venture development obligations that may be viewed as having been satisfied by the development services rendered by USCorpA.

We are unable to find a basis on which to maintain that the benefits of USCorpA's Project A development activities were received by the USCorpA Foreign Affiliates, rather than by FPtnrshipA/B. USCorpA and USCorpB undertook to develop Project A jointly. JV Agreement, ¶ 2. In our view, no independent development obligation was imposed on the USCorpA Foreign Affiliates by the part of the JV Agreement that stated that its provisions "shall accrue to the benefit of

and bind the Parties' respective affiliates who are parties to the [FPtnrshipA/B] Partnership Agreement as if they were parties hereto." JV Agreement, ¶ 4.

We believe FPtnrshipA/B must be viewed as the member of the group of controlled entities that benefitted from the development activities of USCorpA in this case, due to the fact that the contracts developed by USCorpA and USCorpB became effective in the name of FPtnrshipA/B and operated to give FPtnrshipA/B ownership of the Project A physical facilities and the right to receive the income from its operations. Moreover, the USCorpA Foreign Affiliates were not, as far as we are aware, engaged in any active business activity. We do not believe that any indirect benefits they may have derived as owners of FPtnrshipA/B can be regarded as the receipt of a service that was "related to the carrying on of an activity by another member or was intended to benefit another member, either in the member's overall operations or in its day-to-day activities." Treas. Reg. § 1.482-2(b)(2)(i).

Accordingly, our view is that USCorpA's Project A development services were rendered for the benefit of FPtnrshipA/B, within the meaning of Treas. Reg. § 1.482-2(b)(1) & (2).

3. Whether the facts to be taken into account in determining whether the various "situations in which services shall be considered an integral part of the business activity of a member of a group of controlled entities," described in Treas. Reg. § 1.482-2(b)(7), are limited to those that exist in a particular taxable year and, if so, which taxable years should be considered for purposes of this case.

Treas. Reg. § 1.482-2(b)(7) describes four situations in which services are considered an integral part of the business activity of a member of a group of controlled entities. For services treated as "integral" under this rule, the required arm's length charge is "the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts." Treas. Reg. § 1.482-2(b)(3). For services not treated as "integral" under this rule, the arm's length charge is "deemed equal to the costs or deductions incurred with respect to such services by the member or members rendering such services." *Id.*

Services are considered "integral" in the following situations: (i) if either the renderer or the recipient of the services is engaged in the trade or business of rendering the same or similar services to third parties; (ii) if providing services to related parties is one of the principal activities of the renderer; (iii) if the renderer is "peculiarly capable of rendering the services and such services are a principal element in the operations of the recipient" and "the value of the services is substantially in excess of the costs or deductions of the renderer attributable to

such services;" or (iv) if the recipient has received the benefit of a substantial amount of services from one or more related parties during its taxable year. Treas. Reg. § 1.482-2(b)(7). You have asked whether the facts to be taken into account in determining whether these situations exist are limited to those that exist in a particular taxable year.

In our view, although subparagraphs (ii) and (iv) of Treas. Reg. § 1.482-2(b)(7) contain references to taxable years that may limit the facts that may be considered for certain purposes to those within a particular taxable year, the regulation does not contain any overall limitation in this regard. Thus, there is no reference to a taxable year in the introductory paragraph, in subparagraph (i), or in subparagraph (iii) of this regulation. Nor are there any references to taxable years in the examples illustrating these subparagraphs of the regulation. Treas. Reg. § 1.482-2(b)(7)(v), *Examples* 1, 10, 11, 12, 13, and 14.

We believe, therefore, that except where specific language of Treas. Reg. § 1.482-2(b)(7) limits the facts that may be considered for certain purposes to those within a particular taxable year, the significance of facts with respect to issues arising under this regulation will depend on the relevance and materiality of such facts to the particular issue in question. As explained below, in this case, we believe this issue does not need to be addressed as it applies to subsections (ii) and (iv).

4. Whether USCorpA's Project A development activities constitute a "construction activity" for purposes of Treas. Reg. § 1.482-2(b)(7)(ii).

As noted above, Treas. Reg. § 1.482-2(b)(7)(ii) includes a provision that limits the facts that may be considered for certain purposes to those within a particular taxable year. However, the general rule under this subsection (ii) does not refer to a taxable year. It simply provides that services are integral where "the renderer renders services to one or more related parties as one of its principal activities." *Id.* Whether rendering related-party services is a principal activity of the renderer for this purpose is determined either by a presumption or under a facts and circumstances test.

Under the presumption, which contains the taxable year reference of this subsection (ii), services (other than those which "constitute a manufacturing, production, extraction, or construction activity") are presumed to be non-integral if "the cost of services of the renderer attributable to the rendition of services for the taxable year to related parties do[es] not exceed 25 percent of the total costs or deductions of the renderer for the taxable year." (the "25-percent test") Treas. Reg. § 1.482-2(b)(7)(ii)(A).

The facts and circumstances test, which does not contain any reference to a taxable year, applies to services which "constitute a manufacturing, production, extraction, or construction activity." It also applies to other services if they are not presumed to be non-integral under the 25-percent test. Under the facts and circumstances test,

> the determination of whether the rendition of such [related-party] services is one of the principal activities of the renderer will be based on the facts and circumstances of each particular case. Such facts and circumstances may include the time devoted to the rendition of the services, the relative cost of the services, the regularity with which the services are rendered, the amount of capital investment, the risk of loss involved, and whether the services are in the nature of supporting services or independent of the other activities of the renderer.

Id.

Treas. Reg. § 1.482-2(b)(7)(v), *Example 9*, provides a set of facts in which services constitute a construction activity and which cannot, therefore, be presumed to be non-integral under the 25-percent test, as follows:

> *Example 9*. X is a domestic manufacturing corporation. Y, a foreign subsidiary of X, has decided to construct a plant in Country A. In connection with the construction of Y's plant, X draws up the architectural plans for the plant, arranges the financing of the construction, negotiates with various Government authorities in Country A, invites bids from unrelated parties for several phases of construction, and negotiates, on Y's behalf, the contracts with unrelated parties who are retained to carry out certain phases of the construction. Although the unrelated parties retained by X for Y perform the physical construction, the aggregate services performed by X for Y are such that they, in themselves, constitute a construction activity. Thus, the 25-percent test in paragraph (b)(7)(ii) of this section does not apply with respect to such services.

In this case, the activities performed by USCorpA and USCorpB in developing Project A include activities substantially identical to all of those described in Example 9. The contracts developed by USCorpA and USCorpB provided for everything necessary for the construction of the physical facilities of Project A. In the course of their Project A development activities, USCorpA and USCorpB either drew up the architectural plans for the physical facilities of Project A or had them drawn up at their expense; they arranged the financing of the construction of the physical facilities of Project A, as well as of all other Project A costs; they negotiated with Country A Concession Authority and with other Country

A authorities; they invited bids from both related and unrelated parties for all phases of construction; and they negotiated not only the contracts for carrying out certain phases of the construction, but all of the contracts for future construction and operation of all aspects of Project A.

Based on this Example, we believe there is a strong basis on which to maintain that USCorpA's Project A development activities constituted a construction activity, within the meaning of Treas. Reg. § 1.482-2(b)(7)(ii). We also note that the facts considered in Example 9 to determine whether the described services constituted a construction activity were not confined to a particular taxable year. Indeed, for any major construction project it would appear unlikely that all of the activities described in the Example would take place within a single taxable year. Thus, a determination regarding whether a series of activities taking place over a number of years should be considered to constitute a particular type of activity could not reasonably be based on a consideration of only the particular activities that might have occurred within a single taxable year.

Our view that USCorpA's Project A development activities constitute a construction activity is consistent with the apparent reason that services which constitute a construction activity are excluded from services that can be presumed to be non-integral under the 25-percent test. The Technical Memorandum prepared in connection with the issuance of this regulation includes the following statements regarding application of the 25-percent test:

> One of the reasons . . . for the use [in the 25-percent test] of the high 25-percent figure was the assumption that a major portion of the services affected by the safe-haven rule [non-integral services] are services of the type which would command a minimal profit. The services so contemplated are services such as bookkeeping, supervisory services, minor technical services, etc. However, manufacturing, production, extraction, and construction services are ordinarily not of such a nature. Normally, services of the latter type will command a high profit and be a key element in the operations of an entity. In the case of a large diversified corporation, the costs of such services may often represent less than 25 percent of its "total costs." For this reason, these services were specifically excluded from the 25-percent test.

1969 TM Lexis 65 (T.D. 6998) (January 14, 1969), at 23-24.

We believe the Project A development services rendered by USCorpA would command an even higher profit in uncontrolled transactions than ordinary construction services because the benefits FPtnrshipA/B received as a result of these Project A development services were not limited to the fact that FPtnrshipA/B

became the owner of the physical facilities that were constructed with respect to Project A. These benefits also included the receipt of income over the life of Project A as a result of operations under all the contracts that were developed as a part of the Project A development activities of USCorpA and USCorpB. Thus, the Project A development activities of USCorpA do not appear to be the type of services to which the presumption under the 25-percent cost test was intended to apply. These activities are therefore appropriately excluded from application of the 25-percent test in this case.

Since we believe that USCorpA's Project A development activities constituted a construction activity, whether rendering such services was one of the principal activities of USCorpA should be determined under the facts and circumstances test of Treas. Reg. § 1.482-2(b)(7)(ii)(A). As in determining whether these services constituted a construction service, we believe that the facts and circumstances that may be considered for purposes of applying this test are not constrained to those within a particular taxable year.

We believe it is relevant in this regard that the general rule stated in Treas. Reg. § 1.482-2(b)(7)(ii) focuses on whether rendering certain services by a renderer is "one of its principal activities," without reference to a taxable year. In contrast, the 25-percent test for determining whether certain services are presumed to be non-integral is, by its terms, based on certain facts with respect to certain taxable years. This is also shown by Treas. Reg. § 1.482-2(b)(7)(v), *Examples* 2, 3, 4, and 5. The facts and circumstances test, used where the 25-percent test does not apply or where its application does not result in a presumption that services are non-integral, does not, by its terms, require any facts to be determined on a taxable year basis.

In fact, several of the elements specifically mentioned in the regulation's description of the facts and circumstances test appear to relate to time periods that would normally precede, or would be contemporaneous with, the time period in which the renderer of services would incur costs with respect to the services, without regard to the time when the benefits of the services might be received or when the services would be considered to have been rendered. Thus, the "time devoted to the rendition of the services" may, as in this case, extend over a period of years that occurs well before any benefits are received by the recipient of the services. The same is true with respect to the "amount of capital investment," which may build up over a period of years before any benefits are received by the recipient, or even before any activities are performed by the renderer of the services. Similarly, "the risk of loss involved" may grow more significant with the passage of time, as in this case, where additional resources were employed in developing Project A and before the point at which the results of the activities in question were determined, the benefits of the activity were received by the recipient, and an obligation to pay for the services arose.

Treas. Reg. § 1.482-2(b)(7)(v), *Example 3*, supports the conclusion that there is no limit on the time within which facts relevant to application of the facts and circumstances test may occur. In this example, services are determined to be an integral part of the business activity of a renderer under the facts and circumstances test of Treas. Reg. § 1.482-2(b)(7)(ii)(A). The fact that the renderer had “a large investment in the [equipment used in rendering the services]” is among the factors considered in reaching this result. There is no suggestion in this example that the investment was made within a particular taxable year, nor is it likely that such an investment would have been made in the same taxable year as that in which the services were rendered.

Accordingly, for purposes of applying the facts and circumstances test of Treas. Reg. § 1.482-2(b)(7)(ii)(A), we believe all facts that are relevant and material to the issue should be considered, not just those that pertain to a particular taxable year. We view the time relationship of a fact or event to activities that involve the rendering of services as a factor that may affect the relevance or materiality of that fact or event for purposes of making the overall determination of whether the facts and circumstances, in total, support a finding that the activities involved in rendering the services in question were one of the renderer’s principal activities.

In conclusion, we believe USCorpA’s Project A development activities, considered as a whole, constituted a “construction activity” for purposes of Treas. Reg. § 1.482-2(b)(7)(ii). We therefore believe the 25-percent test cannot be applied to determine whether USCorpA’s Project A development activities are integral to USCorpA’s business activities and that this can only be determined under the facts and circumstances test of Treas. Reg. § 1.482-2(b)(7)(ii)(A). We do not believe the facts and circumstances to be taken into account in applying this test are limited to a particular taxable year. In view of our conclusion in this regard, we do not reach the issue of which taxable years would be relevant for purposes of applying the 25-percent test under Treas. Reg. § 1.482-2(b)(7)(ii).

5. Whether USCorpA’s Project A development activities were an integral part of the business activity of USCorpA, within the meaning of Treas. Reg. § 1.482-2(b)(7)(iii).

Treas. Reg. § 1.482-2(b)(7)(iii) provides that services are integral “where the renderer is peculiarly capable of rendering the services and such services are a principal element in the operations of the recipient.” A renderer is “peculiarly capable” of rendering services where it “makes use of a particularly advantageous situation or circumstance such as by utilization of special skills and reputation, utilization of an influential relationship with customers, or utilization of its intangible property (as defined in § 1.482-4(b)).” *Id.* However, a renderer is not considered “peculiarly capable” of rendering services unless the value of the services is “substantially in excess of the costs or deductions of the renderer attributable to

such services." *Id.* Treas. Reg. § 1.482-2(b)(7)(iii) does not include any presumptions or any references to a taxable year.

As discussed below, we believe USCorpA was "peculiarly capable" of rendering the Project A development services at issue in this case. In support of this view, we believe (1) the term "peculiarly capable" was not intended to mean "uniquely capable;" (2) that use of a particularly advantageous situation or circumstance that is identified in the regulation is not the only basis on which a renderer may be found to be "peculiarly capable;" (3) that the Project A development services were a principal element in the operations of the recipient; and, (4) that the value of USCorpA's Project A development services was substantially in excess of the costs or deductions of USCorpA attributable to those services.

The word "peculiar" may, in some contexts, be understood to mean "belonging characteristically or exclusively to some person." Webster's New Collegiate Dictionary (9th ed. 1990). However, we do not believe that use of the term "peculiarly capable" in this part of the regulation was intended to limit application of the regulation to those situations in which the renderer of services is uniquely capable of providing a service. "Peculiar" may also mean "uncommon" or "unusual." *Id.* The fact that the regulation uses the term "peculiarly" in this latter sense is shown by the fact that "peculiarly capable" is further explained by the regulation to exist when the renderer makes use of a "particularly advantageous situation or circumstance." "Particularly" may be defined as "to an exceptional degree" or as "especially." *Id.* Thus, we do not believe that the language of this part of the regulation should be read to restrict its application to those instances in which a renderer of services is the only entity capable of rendering the services in question.

Treas. Reg. § 1.482-2(b)(7)(v), *Example 10*, is consistent with this conclusion. In this example, a company in the business of making automobile loans requires its borrowers to have life insurance in the amount of their loans and suggests to them that they obtain the insurance from a related party, which almost all of them do. The example concludes that the lending company is peculiarly capable of rendering selling services to its related insurance company. The example does not discuss, and therefore apparently does not deem relevant, whether or to what extent other lending companies might have had similar customer relationships enabling them to refer customers to a related insurance companies. The influential relationship with customers described in this example was apparently sufficiently unusual among businesses in general to allow the lending company to be considered peculiarly capable of rendering a selling service to a related party, without regard to whether other lending companies might have had similarly unusual capabilities with respect to their customers.

Treas. Reg. § 1.482-2(b)(7)(v), *Example 11*, is also consistent with this conclusion. In this example, a company manufactures and sends a product to a related party, which uses its exclusive patented process to detect and remove imperfections in the product. The example concludes that the related party is peculiarly capable of rendering the inspection services because it used its patented process. As in Example 10, this example does not discuss, and therefore apparently does not deem relevant, whether or to what extent other companies might have been able to detect and remove imperfections in the same product in a similarly efficient manner, whether by use of a different patented process or otherwise. The example also does not discuss whether, with respect to other products, other companies might have been capable of rendering similarly efficient inspection services. Thus, as in Example 10, the use of a patented process owned by the inspecting company in this example was apparently sufficiently unusual among businesses in general to allow the inspecting company to be considered peculiarly capable of rendering inspection services to a related party, without regard to whether other inspecting companies might have had similarly unusual capabilities with respect to providing product inspection services.

The fact that a renderer may be considered peculiarly capable of rendering services even though other renderers may possess similar but not identical capabilities is illustrated also by the following portion of a discussion of this issue by the Tax Court in *H Group Holding, Inc. v. Commissioner*, T.C. Memo. 1999-334, 128:

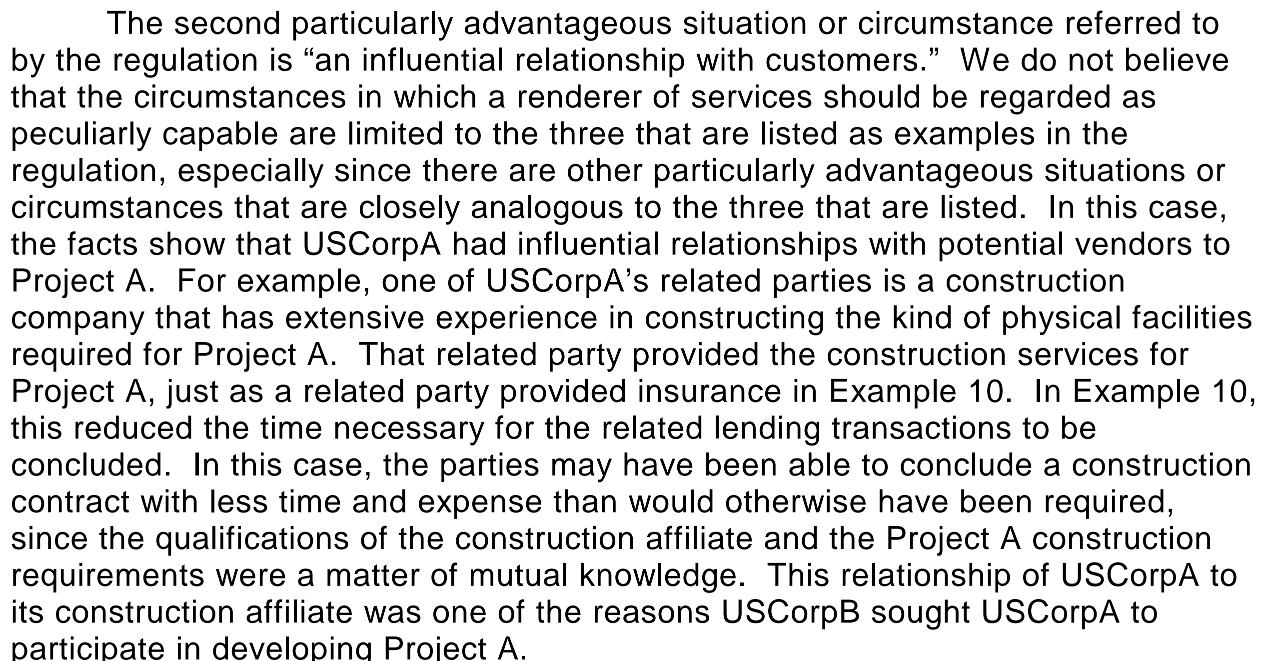
> Petitioner's expert conceded that the services of IPS were integral in that those services were provided to unrelated parties . . . . It appears that IPS was uniquely capable of providing its services since the design manuals and area programs, although tailored to suit a particular hotel, were intended to exemplify how a Hyatt International hotel should be constructed or operated. No other company would have access to this information. Thus, we find the activities of IPS are integral.

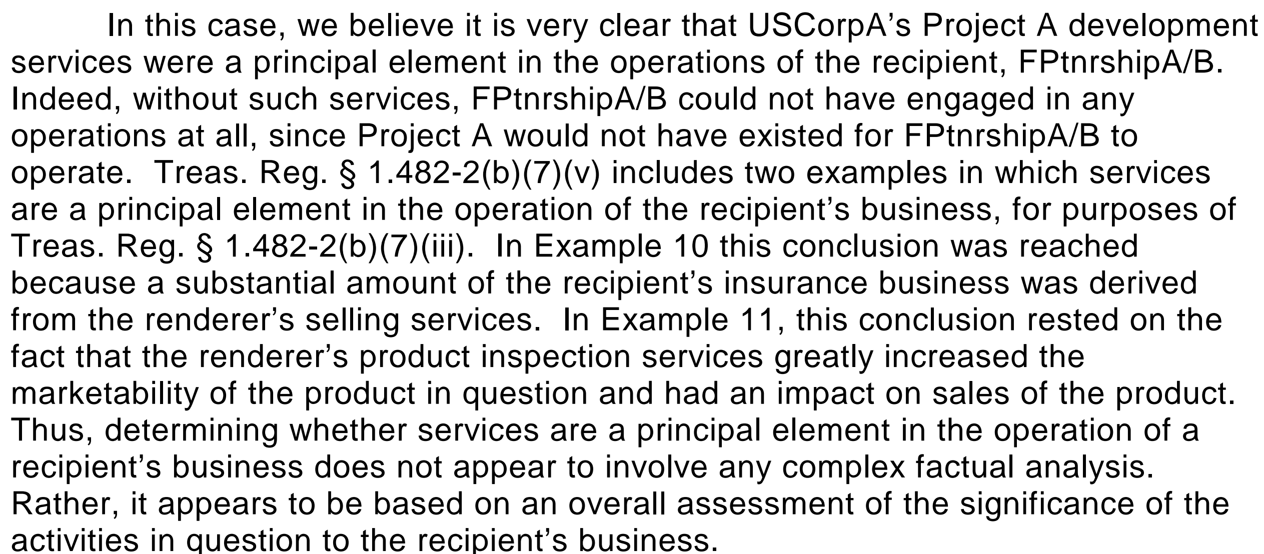
We understand that numerous Projects-Type A have been developed throughout the world by a various project developers. USCorpA is, therefore, apparently not the only company capable of providing Project-Type A development services. However, we believe that the terms "peculiarly capable" and "use of a particularly advantageous situation or circumstance," as used in this part of the regulation, refer to the use of an "especially, unusually, or extraordinarily" advantageous situation or circumstance, rather than to a renderer that is uniquely capable of providing a particular service. We believe the facts that are known or that could be developed will show that USCorpA was unusually capable of rendering the Project A development services at issue in this case.

In considering the specific particularly advantageous situations or circumstances that are identified in the regulation, we believe USCorpA used its "special skills and reputation" in developing Project A. As we understand the facts, before the joint venture between USCorpA and USCorpB was formed, USCorpA had acquired special skills and a superb reputation for its capabilities with respect to the development of Projects-Type A, as a result of its successful development of such projects in countries throughout the world. That its skills and reputation with respect to project development were not generally available is shown by the fact that USCorpB, which had developed the initial aspects of Project A, sought out USCorpA to participate with it in further attempts to carry the development of Project A forward. The fact that the USCorpA/USCorpB consortium was selected to develop Project A by Country A Concession Authority from among other applicants also reinforces the conclusion that USCorpA and USCorpB together were especially well-qualified to provide the development services necessary to create Project A.

Treas. Reg. § 1.482-2(b)(7)(v) does not contain any examples to illustrate this aspect of the regulation. However, we believe the facts outlined above, and others that could be developed, will show that USCorpA's skills and reputation in this regard were sufficiently unusual to support a finding that its use of those skills and that reputation in developing Project A constituted use of a particularly advantageous situation or circumstance, within the meaning of Treas. Reg. § 1.482-2(b)(7)(iii).

The second particularly advantageous situation or circumstance referred to by the regulation is "an influential relationship with customers." We do not believe that the circumstances in which a renderer of services should be regarded as peculiarly capable are limited to the three that are listed as examples in the regulation, especially since there are other particularly advantageous situations or circumstances that are closely analogous to the three that are listed. In this case, the facts show that USCorpA had influential relationships with potential vendors to Project A. For example, one of USCorpA's related parties is a construction company that has extensive experience in constructing the kind of physical facilities required for Project A. That related party provided the construction services for Project A, just as a related party provided insurance in Example 10. In Example 10, this reduced the time necessary for the related lending transactions to be concluded. In this case, the parties may have been able to conclude a construction contract with less time and expense than would otherwise have been required, since the qualifications of the construction affiliate and the Project A construction requirements were a matter of mutual knowledge. This relationship of USCorpA to its construction affiliate was one of the reasons USCorpB sought USCorpA to participate in developing Project A.





In this case, we believe it is very clear that USCorpA's Project A development services were a principal element in the operations of the recipient, FPtnrshipA/B. Indeed, without such services, FPtnrshipA/B could not have engaged in any operations at all, since Project A would not have existed for FPtnrshipA/B to operate. Treas. Reg. § 1.482-2(b)(7)(v) includes two examples in which services are a principal element in the operation of the recipient's business, for purposes of Treas. Reg. § 1.482-2(b)(7)(iii). In Example 10 this conclusion was reached because a substantial amount of the recipient's insurance business was derived from the renderer's selling services. In Example 11, this conclusion rested on the fact that the renderer's product inspection services greatly increased the marketability of the product in question and had an impact on sales of the product. Thus, determining whether services are a principal element in the operation of a recipient's business does not appear to involve any complex factual analysis. Rather, it appears to be based on an overall assessment of the significance of the activities in question to the recipient's business.

We also believe that the facts in this case demonstrate that the value of USCorpA's Project A development services was substantially in excess of the costs or deductions attributable to such services. This is most directly demonstrated by USCorpB's sale of its interest in Project A for an amount that was vastly more than the costs or deductions attributable to its Project A development services, which created the interest that it sold.

Examples 10 and 11 of Treas. Reg. § 1.482-2(b)(7)(v) conclude that the value of services is substantially in excess of the costs incurred by the renderer, for purposes of Treas. Reg. § 1.482-2(b)(7)(iii). In Example 10, the basis for this conclusion is not stated. However, since the selling services in question appear to have consisted of suggesting to borrowers that they take out life insurance from a related party, the costs associated with providing such services were probably insignificant. In Example 11, there also is no basis stated for the conclusion that the value of the inspection services was substantially in excess of the cost incurred by the renderer, other than that because the inspection services greatly increased the marketability of the inspected product, the services were "extremely valuable."

The facts in this case do not resemble those of Example 10 because USCorpA and USCorpB incurred substantial costs in rendering Project A

development services. However, as in Example 11, the services in this case were extremely valuable.

We believe, therefore, that there is a reasonable basis on which to maintain that USCorpA's Project A development activities were an integral part of the business activity of USCorpA, within the meaning of Treas. Reg. § 1.482-2(b)(7)(iii).

6. Whether FPtnrshipA/B "received the benefit of a substantial amount of services from one or more related parties during its taxable year" as a result of USCorpA's Project A development activities, within the meaning of Treas. Reg. § 1.482-2(b)(7)(iv).

The general rule under Treas. Reg. § 1.482-2(b)(7)(iv) is that "[s]ervices are an integral part of the business activity of a member of a controlled group where the recipient has received the benefit of a substantial amount of services from one or more related parties during its taxable year."

For purposes of this general rule, a "25-percent test" provides that services

> shall be considered substantial in amount if the total costs or deductions of the related party or parties rendering services to the recipient during its taxable year which are directly or indirectly related to such services exceed an amount equal to 25 percent of the total costs or deductions of the recipient during its taxable year. For purposes of the preceding sentence, the total costs or deductions of the recipient shall include the renderers' costs or deductions directly or indirectly related to the rendition of such services and shall exclude any amounts paid or accrued to the renderers by the recipient for such services and shall also exclude any amounts paid or accrued for materials the cost of which is properly reflected in the cost of goods sold of the recipient.

Id.

And, for purposes of applying this 25-percent test, an "alternate taxable year option" provides as follows:

> At the option of the taxpayer, where the taxpayer establishes that the amount of the total costs or deductions of a recipient for the recipient's taxable year are abnormally low due to the commencement or cessation of an operation by the recipient, or other unusual circumstances of a nonrecurring nature, the costs or deductions referred to in the preceding two sentences [describing the 25-percent test] shall be the total of such amount for the 3-year period

> immediately preceding the close of the taxable year of the recipient (or for the first 3 years of operation of the recipient if the recipient had been in operation for less than 3 years as of the close of the taxable year in which the services in issue were rendered).

Id.

After due consideration, we have found it difficult to apply subsection (iv) of Treas. Reg. § 1.482-2(b)(7) to the facts of this case. In view of our belief that the Project A development activities of USCorpA are appropriately treated as integral to the business activities of USCorpA under both subsection (ii) and subsection (iii) of the regulation, we have not analyzed this issue any further.

7. Whether some or all of USCorpA's Project A development activities were "stewardship" activities for purposes of section 482.

The taxpayer in this case has argued that the Project A development activities performed by USCorpA cannot be characterized as a service and that section 482 therefore does not apply to its transactions with FPtnrshipA/B regarding these activities because the activities were intended primarily to benefit USCorpA and were not performed on behalf of, or intended to benefit, a controlled entity. May 22, 2000 Memorandum of Individual B on Integral Services, p.3.

Under the section 482 regulations on transfer pricing for services, there are only two situations in which the Project A development activities of USCorpA might be considered not to have been performed on behalf of, or intended to benefit, FPtnrshipA/B. One is if the activities were to fall under Treas. Reg. § 1.482-2(b)(2)(i), which provides that "[n]o allocations shall be made if the probable benefits to the other member were so indirect or remote that unrelated parties would not have charged for such services." The other is if the activities were to fall under Treas. Reg. § 1.482-2(b)(2)(ii), which states that "[a]llocations will generally not be made if the service is merely a duplication of a service which the related party has independently performed or is performing for itself." We do not believe that either of these provisions applies in this case.

We believe the facts in this case demonstrate that the benefits FPtnrshipA/B received as a result of the Project A development activities were very substantial and direct. Having the package of contracts that USCorpA and USCorpB developed placed in the name of FPtnrshipA/B enabled FPtnrshipA/B to draw upon a loan that covered the entire cost of Project A, gave FPtnrshipA/B ownership of all of the tangible and intangible property of Project A, and provided FPtnrshipA/B with a predicted flow of net future income that had a present value of $l. These are benefits for which we believe unrelated parties would have charged substantial amounts.

We also believe there is no basis on which one can conclude that the Project A development activities of USCorpA were a duplication of anything FPtnrshipA/B performed for itself. The facts indicate that the activities were performed only once, *i.e.*, by USCorpA for the benefit of FPtnrshipA/B.

Thus, we believe the argument that USCorpA's Project A development activities were performed for its own benefit means only that USCorpA stood to benefit indirectly from having an ownership interest in FPtnrshipA/B that would be valuable because of the income attributable to USCorpA's Project A development activities that USCorpA shifted to FPtnrshipA/B.

The taxpayer in this case has also argued that the expenses related to the services of USCorpA executives that were performed in connection with USCorpA's Project A development activities are "stewardship expenses," to which section 482 does not apply, because these activities were performed to establish and protect USCorpA's investment in FPtnrshipA/B. May 22, 2000 Memorandum of Individual B on Stewardship Expenses, p. 3.

The section 482 transfer pricing regulations do not use or refer to the term "stewardship." However, the section 861 regulations with respect to the allocation and apportionment of deductions in computing taxable income from sources within the United States and from other sources provide, in part, that

> the regulations under section 482 (§ 1.482-2(b)(2)(ii)) recognize a type of activity which is not considered to be for the benefit of a related corporation but is considered to constitute "stewardship" or "overseeing" functions undertaken for the corporation's own benefit as an investor in the related corporation, and therefore, a charge to the related corporation for such stewardship or overseeing functions is not provided for. Services undertaken by a corporation of a stewardship or overseeing character generally represent a duplication of services which the related corporation has independently performed for itself.

Treas. Reg. § 1.861-8(e)(4).

We do not believe there is any basis for applying this regulation because, as discussed above, the circumstances show that the Project A development activities of USCorpA benefitted and were intended to benefit FPtnrshipA/B and were not services that FPtnrshipA/B could independently perform for itself.

In summary, we do not believe that there is any basis on which to find that the Project A development activities of USCorpA were not rendered for the benefit of FPtnrshipA/B. Nor do we think that the expenses related to the activities of

USCorpA's top executives in connection with those activities should be characterized as "stewardship expenses."

8. Whether USCorpA's Project A development activities and related transactions with FPtnrshipA/B may, in the alternative, be characterized as the development of intangible property and the transfer of that property to FPtnrshipA/B.

Your request is based on the assumption that, for purposes of applying the section 482 transfer pricing regulations, USCorp's Project A development activities were services. Although you have not raised the issue, you may wish to consider whether USCorpA's Project A development activities may, in the alternative, be appropriately characterized as the development and transfer of intangible property. The basis for our suggestion in this regard is set out below.

a. Character of Transactions. Treas. Reg. § 1.482-1 contains general guidance on the application of section 482. Treas. Reg. § 1.482-1(b)(2)(ii) provides that "the method or methods most appropriate to the calculation of arm's length results for controlled transactions must be selected." The regulations provide transfer pricing methods for use in specific situations, including controlled transactions involving loans or advances, services, and property, both tangible and intangible. Treas. Reg. § 1.482-1(a)(1). To use a particular transfer pricing method, controlled transactions must therefore first be characterized as one or more of the specific situations for which the use of a particular method is appropriate.

Treas. Reg. § 1.482 -1(d)(3)(ii)(B) provides that contractual terms agreed to by taxpayers in writing before transactions are entered into will generally be respected by the Service if they are consistent with the economic substance of the transactions. For the reasons set out below, we believe the Service has considerable discretion in characterizing the transactions in this case according to their economic substance.

First, USCorpA has not been consistent in the way it has characterized its Project A development activities. USCorpA and USCorpB initially provided that "all Development Costs, for tax and accounting purposes, shall be considered as expended by the Joint Venture and as funded by capital contributions of the Parties or their affiliates, and the fruits and results of such expenditures shall belong to the Joint Venture." JV Agreement, ¶ 9.f. However, although USCorpA and USCorpB may have considered the results of their Project A development activities to belong to FPtnrshipA/B, we do not have any evidence that they treated the costs of those activities as capital contributions, nor do we believe that such treatment would have been consistent with the economic substance of the transactions. We doubt, for example, that the purported capital contributions could be "deemed to bear

interest," as provided for by the JV Agreement, or be reimbursed out of financing proceeds, as also provided by the JV Agreement. *Id*.

Second, although there is a contract between USCorpA and FPtnrshipA/B that characterizes USCorpA's Project A development activities as services, it appears that this contract was not entered into before the Project A development activities took place. Rather, it appears that this contract was prepared shortly before the Financial Close, in order to complete the package of contracts that was necessary to support the financing of Project A. As noted, Treas. Reg. § 1.482-1(d)(3)(ii)(B) does not require the Service to respect the terms of a contract if the contract was not entered into before the transactions in question take place.

Finally, USCorpA has also argued that its Project A development activities are "performed solely in the capacity of an equity investor, in order to establish and protect its equity interest in the project," and that "[a]s a consequence, [USCorpA] itself, rather than [FPtnrshipA/B], receives the primary benefit of these activities." May 22, 2000 Memorandum of Individual B on Stewardship Expenses, p. 4. Such statements seem to indicate that the taxpayer in this case did not regard USCorpA's Project A development activities as constituting services for the benefit of FPtnrshipA/B.

Thus, in this case, it appears that the controlled parties have not spelled out the terms of their transactions in advance, or have done so ambiguously, in an inconsistent manner, or in ways that are inconsistent with the economic substance of the transactions. The Service therefore has the authority to impute terms that are consistent with the economic substance of the transactions. Treas. Reg. § 1.482-1(d)(3)(ii)(B)(1). We note in this regard that legal ownership of intangible property may be acquired by operation of law or by contract and the Service's authority to impute contractual terms that conform with substance includes the authority to "impute an agreement to convey legal ownership if the conduct of the controlled taxpayers indicates the existence in substance of such an agreement." Treas. Reg. § 1.482-4(f)(3)(ii)(A).

b. Transactions Involving Intangible Property. One means of determining whether activities or transactions should be characterized as relating to the development or transfer of intangible property is to determine the extent to which intangible property is involved in those activities or transactions. Treas. Reg. § 1.482-4(b) defines "intangible" for this purpose as follows:

> For purposes of section 482, an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual –

(1) Patents, inventions, formulae, processes, designs, patterns, or know-how;

(2) Copyrights and literary, musical, or artistic compositions;

(3) Trademarks, trade names, or brand names;

(4) Franchises, licenses, or contracts;

(5) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and

(6) Other similar items. For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.

We believe the comprehensive package of interdependent contracts that was developed by USCorpA and USCorpB to finance, construct and operate Project A, including long term contracts for the purchase of its Input and the sale of its Output, constituted intangible property within the meaning of this regulation.

c. Developer or Owner of an Intangible. When activities are performed that result in the creation of an intangible, the regulations contemplate a determination of the owner of a legally protected intangible, or of the developer/owner of a non-legally-protected intangible, as a means of evaluating whether an allocation of income under section 482 is necessary or appropriate with respect to a transfer, license, or use of the intangible. *See* Treas. Reg. § 1.482-4(f)(3)(ii).

For legally protected intangible property, the legal owner is "ordinarily" considered the owner for purposes of section 482. Treas. Reg. § 1.482-4(f)(3)(ii)(A). The term "legal owner" is broadly defined, and consists of the holder of formal legal title to the intangible (*e.g.*, formal patent, trademark, copyright, or similar interest), as well as the holder of rights obtained pursuant to contract (*e.g.*, a license to use intellectual property). In this context, contractual rights may be either express or implied, and the regulation specifically cross-references Treas. Reg. § 1.482-1(d)(3)(ii)(B), which deals with imputation of contractual terms in accordance with the substance of the controlled parties' dealings. Treas. Reg. § 1.482-4(f)(3)(ii)(A).

In the circumstances of this case, USCorpA and USCorpB may be regarded as the owners of legally protected intangible property that was the result of their Project A development activities. This legally protected intangible property was

primarily in the form of the Project A contracts that USCorpA and USCorpB had developed to the point that all of the numerous parties involved in Project A were prepared to execute the contracts at the Financial Closing. We believe USCorpA and USCorpB would have had legal recourse against any unrelated party that might have sought to obtain any of the rights or benefits that USCorpA and USCorpB had arranged to obtain under these contracts. Given the fact that USCorpA and USCorpB had been able to develop these contracts through use of their own resources and expertise and were committed to provide capital contributions to FPtnrshipA/B when Project A began commercial operation, it appears likely that ownership of the contracts, until the time they were made effective in the name of FPtnrshipA/B, could be imputed under Treas. Reg. § 1.482-4(f)(3)(ii)(A), if such ownership were not otherwise found to exist. The fact that the contracts were formally concluded at Financial Closing in the name of FPtnrshipA/B would then be viewed as, in substance, the transfer of legal ownership from USCorpA to FPtnrshipA/B.

For intangible property that is not legally protected, the developer of the intangible is considered the owner. Treas. Reg. § 1.482-4(f)(3)(ii)(B). For this purpose,

> [o]rdinarily, the developer is the controlled taxpayer that bore the largest portion of the direct and indirect costs of developing the intangible, including the provision, without adequate compensation, of property or services likely to contribute substantially to developing the intangible. A controlled taxpayer will be presumed not to have borne the costs of development if, pursuant to an agreement entered into before the success of the project is known, another person is obligated to reimburse the controlled taxpayer for its costs. If it cannot be determined which controlled taxpayer bore the largest portion of the costs of development, all other facts and circumstances will be taken into consideration, including the location of the development activities, the capability of each controlled taxpayer to carry on the project independently, the extent to which each controlled taxpayer controls the project, and the conduct of the controlled taxpayers.

Id.

We believe that, in the circumstances of this case, USCorpA and USCorpB may also be regarded as the joint developers/owners of intangible property, if it is regarded as not legally projected. Such intangible property was in the form of the rights they developed and that were ultimately afforded to their foreign controlled entity, FPtnrshipA/B, under the package of contracts they caused to become effective in the name of FPtnrshipA/B. As noted above, as far as we are aware, USCorpA and USCorpB are the taxpayers that bore all of the direct and indirect

costs of developing these intangibles so that, if their rights in the contracts are regarded as not legally protected, they would be regarded as the developer/owners of the intangible property that comprised those rights, within the meaning of Treas. Reg. § 1.482-4(f)(3)(ii)(A).

We do not regard the arrangements among USCorpA, USCorpB and FPtnrshipA/B regarding reimbursement of development costs and payment of development fees out of the Project A financing proceeds to constitute "an agreement entered into before the success of the project is known" under which "another person is obligated to reimburse the controlled taxpayer for its costs," within the meaning of Treas. Reg. § 1.482-4(f)(3)(ii)(B). Unless the development activities of USCorpA and USCorpB were successful and Financial Close was accomplished, FPtnrshipA/B had neither the ability nor the obligation to make any payments to USCorpA or to USCorpB. Reimbursement that is entirely contingent on the successful development of an intangible cannot be regarded as the unconditional type of obligation for cost reimbursement that would entitle FPtnrshipA/B to be considered the owner of these intangibles because it had borne the risk associated with their development. In this case, FPtnrshipA/B bore no risk with respect to the development of the comprehensive package of contacts in question.

d. Transfer of Intangible. In general, an arm's length consideration is payable to the owner or developer of an intangible in the event of a transfer of the intangible or of a right to use the intangible from the owner/developer to a controlled party. Treas. Reg. § 1.482-4(f)(3)(i).

We believe that it may be appropriate to view USCorpA and USCorpB as having effectively transferred their jointly developed high-profit intangible to a foreign related party by causing the package of contracts, after all the contracts had been fully developed and agreed to by all of the other parties, to become effective in the name of FPtnrshipA/B.

We are aware that in *Hospital Corp. of America v. Commissioner*, 81 T.C. 520, 590 (1983), the court held that discovering a business opportunity and making it available to a related party was a service and not a transfer of property for purposes of sections 351 and 367 of the Internal Revenue Code, as then in effect. However, the facts in this case are different than those in the *Hospital Corp. of America* case. In that case, the court was "satisfied that [the related party that received the business opportunity in question] negotiated and executed the contract and later performed the contract . . ." *Id.* at 589. In this case, an entire package of contracts was developed, which created the entire business of FPtnrshipA/B and provided FPtnrshipA/B with a predicted and reliable net future income from that business. USCorpA and USCorpB incurred large expenses and took considerable risks in developing these contracts. FPtnrshipA/B, on the other hand, performed no

activities with respect to the development of these contracts, incurred no expenses, and took no risks, at least until all of the elements of its business had been arranged and all foreseeable contingencies had been provided for.

Thus, we believe it is appropriate to view the intangibles developed and owned by USCorpA and USCorpB to have been transferred to FPtnrshipA/B when USCorpA and USCorpB caused those contracts to become effective in the name of FPtnrshipA/B upon the Financial Close, at which point FPtnrshipA/B became their legal owner.

We do not believe the way in which the intangibles are described while they were in the hands of the developers and initial owners is controlling. For example, one might take the view that when all of the parties had agreed to the terms of all of the contracts and only the formality of having the contracts become effective in the name of FPtnrshipA/B upon Financial Close remained, the contracts themselves existed, in substance, as legally protected intangibles and the intangible property that USCorpA and USCorpB transferred to FPtnrshipA/B at the instant these contracts became effective in the name of FPtnrshipA/B therefore consisted of the rights under the contracts. This is consistent with the way in which the intangible rights in a patent may be transferred from the developer to the legal owner when the owner/developer of a patentable invention causes the patent to be issued in the name of a related party.

Alternatively, one might take the view that the contracts, before they became effective in the name of FPtnrshipA/B, were trade secrets or know-how that may not have been legally protected. Certainly, USCorpA and USCorpB would not have made all of the information contained in these contracts available to an unrelated third party or caused the contracts to become effective in the name of an unrelated party without substantial compensation. We note in this regard that the agreements between USCorpA and USCorpB regarding their development of Project A included confidentiality requirements and were subject to an overall confidentiality agreement between the parties. *See, e.g.*, JV Agreement, ¶ 16.

No matter how the intangible that was developed by USCorpA and USCorpB is described, we believe an alternative argument could be made that USCorpA and USCorpB were responsible for having created a set of relationships and prospective agreements that they could cause to be entered into with an entity of their mutual choice. This appears to fall within the Treas. Reg. § 1.482-4(f)(3) definition of "intangible property," which includes any item that "derives its value not from its physical attributes but from its intellectual content or other intangible properties."

e. <u>Commensurate with Income Standard for the Transfer of Intangibles</u>. Section 482 expressly requires that the income reported from the transfer or license of intangible property to a controlled party be "commensurate with" the income

attributable to that intangible. This requirement, contained in the second sentence of section 482, was added by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2562-63 (1986). By this provision, Congress primarily intended to prevent U.S. taxpayers from transferring high-profit intangibles to foreign related parties, in exchange for lump-sum payments or royalty streams that were unrelated to the underlying profit potential of the intangibles. *See generally* H.R. Rep. No. 831, Vol. II, 99th Cong., 2d Sess. 637-38 (1986). Treasury and the Service view this 1986 amendment to section 482 as a "clarification of existing law," rather than as a significant amendment of prior law. *See, e.g.*, Study of Intercompany Pricing Under Section 482 of the Code, Notice 88-123, 1988-2 C.B. 458, 472. Treas. Reg. § 1.482-4(f)(3) provides generally that, where the owner of the rights to exploit an intangible transfers such rights to a controlled taxpayer, the owner must receive an amount of consideration determined in accordance with the rules of that section.

We believe the fact pattern in this case falls within the area of concern that Congress sought to address in its 1986 amendment to section 482. USCorpA and USCorpB used their combined resources and expertise within the United States to develop, at their own risk, a high-profit intangible. The profitability of the contracts was known at the instant the contracts became effective in the name of FPtnrshipA/B, as projected future net income from their performance was the basis on which Banks made $k in construction financing available. This same projected future net income under the contracts was the basis on which USCorpB was able to sell its one-half interest in FPtnrshipA/B for $n. This sale was made before USCorpA or USCorpB had made any contribution to the capital of FPtnrshipA/B and when the assets of FPtnrshipA/B consisted entirely of the rights it had acquired under the contracts for Project A or of physical assets that had been acquired or constructed pursuant to those contracts.

Where one controlled party bears the risk and expense of developing intangible property, section 482 and Treas. Reg. 1.482-4(f)(3) require that controlled party to receive arm's length consideration in the event of a full or partial transfer to another controlled party of rights to exploit the intangible. The methods for determining the appropriate arm's length amount in this case may therefore be those specified by Treas. Reg. § 1.482-4(a) (the comparable uncontrolled transaction method, the comparable profits method, the profit split method, or unspecified methods) with such arm's length consideration for the transfer of an intangible required to be commensurate with the income attributable to the intangible. *Id.*

Accordingly, we believe the development activities and transactions that took place in this case may be characterized, in the alternative, as involving the development and transfer of intangible property. You may, however, choose to

proceed with your case exclusively on the basis of characterizing the activities and transactions in question as the rendering of services.

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

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