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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR JOSEPH F. MASELLI
AREA COUNSEL (HEAVY MANUFACTURING,
CONSTRUCTION AND TRANSPORTATION)
CC:LM:MCT:NEW

FROM: Deborah A. Butler
Associate Chief Counsel
CC:PA

SUBJECT: Disallowance of royalty payment to a partnership.

This Chief Counsel Advice responds to your memorandum dated September 25, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =
Partnership =
A =
B =
Corporation X =
Corporation Y =
Bank =
Date 1 =

ISSUES

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- 1) Whether the claimed deductions of a royalty payment from parent Taxpayer to the Partnership is a partnership item, if Corporation X, a subsidiary of Taxpayer is a partner in the Partnership?
- 2) Whether the claimed deduction of a royalty payment is an affected item if the royalty payment is disallowed.
- 3) Whether legal and factual determinations related to the background of the Partnership, and relevant to the disallowance of the royalty payment, are partnership items, or may be determined in a deficiency proceeding against Taxpayer.
- 4) Whether the TEFRA statute of limitations on assessments under section 6229 applies to items that are not partnership items or affected items.

CONCLUSIONS

- 1) The claimed deductions of royalty payments from Taxpayer to the Partnership are non-partnership items because the deductions are not more appropriately determined at the partnership level. Taxpayer would be regarded a partner under TEFRA audit procedures, but is not a partner with regard to section 761(b). TEFRA audit procedures do not apply. Therefore, deficiency procedures are applicable.
- 2) The deduction of a royalty payment is not an affected item because Taxpayer is not a partner.
- 3) Legal and factual determinations related to the background of the Partnership, relevant to the disallowance of the royalty payment, are not partnership items in this case, and may be considered in the deficiency proceeding against Taxpayer.
- 4) Section 6229 provides a minimum period for assessment of any deficiencies resulting from partnership items and affected items only.

FACTS

Taxpayer is the common parent of an affiliated group of corporations which files a consolidated return. From 1993 through 1998 Taxpayer engaged in a "royalty-strip" tax shelter. In 1993, Taxpayer contributed its fully amortized patents in A and B to its wholly-owned subsidiary, Corporation X. At the same time, Taxpayer contributed its stock in Corporation Y, a wholly-owned subsidiary, to Corporation X. Corporation X subsequently contributed the patents and Corporation Y stock to the Partnership for a partnership interest in the Partnership. Bank, a non-U.S. taxpayer, contributed \$ _____ in cash to the Partnership for a partnership

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interest in the Partnership. From 1993 through 1998, Taxpayer continued to use the patents. Taxpayer made and deducted royalty payments of approximately \$ per year to the Partnership for the use of the patents.

The Partnership specially allocated a substantial percentage of its income from the royalty payments to the Bank. The Bank paid no U.S. tax on these allocations. The Partnership's cash distributions to Bank equaled Bank's normal lending rate plus basis points. The Partnership contributed cash, representing the difference between the Bank's distributive share of the Partnership's income and the Partnership's cash distributions to the Bank, to Corporation Y. Corporation Y invested these funds in the notes of Taxpayer which resulted in a circular flow of the funds back to Taxpayer.

Taxpayer's tax returns were audited. Due to an error on the part of the Service, the Forms 872 to extend the statute of limitations for the Partnership and Corporation Y were not properly executed, and the field has concluded that the statute of limitations for these parties expired on Date 1.

The Forms 872 for Taxpayer and Taxpayer's affiliated corporations were properly executed, and the statute of limitations for those parties was extended. The statute, however, was not extended with respect to partnership or affected items. Consequently, any attack on the royalty-strip tax shelter must be directed at Taxpayer.

Prior to the expiration of the Partnership's statute of limitations, the field was considering a number of arguments to attack the royalty-strip, including arguments that (1) the Partnership was a sham, (2) the Bank was a lender rather than a partner in the Partnership, (3) the underlying Partnership transactions lacked economic substance, (4) the royalty payments from Taxpayer to the Partnership were not ordinary and necessary expenses, (5) the allocation of the partnership items did not have substantial economic effect, and (6) the amount of the royalty deductions should be adjusted under section 482.

The IRS still plans to argue that the royalty payments from Taxpayer to the Partnership were not ordinary and necessary expenses. In addition, the IRS would like to make a deficiency argument that the royalty payments were not in substance royalty payments, but were one step in the movement of funds that circled back to Taxpayer. In making this argument, the IRS plans to present factual and legal arguments related to the background of the Partnership, including the arguments previously listed.

LAW AND ANALYSIS

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Issue 1:

Whether the claimed deduction of a royalty payment from parent Taxpayer to the Partnership is a partnership item, if Corporation X, a subsidiary of Taxpayer is a partner in the Partnership?

A) Whether royalty payments are partnership items.

Prior to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), any examination of issues common to all partners, and any resulting adjustment, were accomplished at the partner level, rather than at the partnership level. The Internal Revenue Service was required to audit each partner's return separately and its determination as to the treatment of an issue for one partner was not conclusive for any other partner. With the enactment of TEFRA, however, all adjustments to "partnership items" are determined in a single proceeding at the partnership level rather than at the partner level. The end result is consistent treatment of partnership items on each partner's return.

Section 6221 states that "[e]xcept as otherwise provided in this subchapter, the tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item) shall be determined at the partnership level."

A partnership item means, with respect to a partnership, any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level. I.R.C. § 6231(a)(3). Under section 6231(a)(4), a non-partnership item is an item that is not (or is not treated as) a partnership item.

In the instant case, the proposed adjustments do not impact the tax treatment of a partnership item. The deductions for royalty payments are not found on the partnership return, but on Taxpayer's return. Disallowance of the deductions is not an issue common to the partners in the Partnership. In fact, this issue could not be determined at the partnership level. Because the deduction cannot be determined at the partnership level, it is not a partnership item.

B) Whether Taxpayer is a partner in the Partnership if Corporation X is a partner.

Whether or not Taxpayer is treated as a partner in the Partnership, a partnership proceeding is not necessary to determine the deduction of royalty payments, because, as discussed above, the deduction is not a partnership item. Partnership proceedings, however, generally must also be held prior to the determination of affected items, as defined by section 6231(a)(5). See Roberts v. Commissioner, 94

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T.C. 853, 859-60 (1990). Whether or not the royalty payment deduction is an affected item may depend, *inter alia*, on whether or not Taxpayer is a partner in the Partnership.

The general definition of partner, as found in section 761(b), defines the term “partner” as a “member of a partnership.” As explained below, Taxpayer is not a member of the partnership simply because its subsidiary is a partner in the Partnership.

Under Treas. Reg. § 1.1502-77(a), the common parent, for all purposes, is the sole agent for each subsidiary in a consolidated group. Thus, it is appropriate to treat the affiliated group as a single taxpaying entity for procedural purposes. See J&S Carburetor Co. v. Commissioner, 93 T.C. 166, 168 (1989). The common parent, however, is merely considered the agent for the group. This has no substantive impact on the relationship between the common parent and the individual members of the group. Thus, the fact that Taxpayer is the parent of Corporation X and Corporation X is a partner in the Partnership does not make Taxpayer a partner in the Partnership under section 761(b).¹

Taxpayer would, however, be treated as a partner under section 6231(a)(2)(B). For purposes of the TEFRA unified audit procedures, section 6231(a) defines the term “partner” as, (A) a partner in the partnership, and (B) any other person whose income tax liability under subtitle A is determined in whole or in part by taking into account directly or indirectly partnership items of the partnership.

Each person who has a joint and several income tax liability as the result of income from a partnership is treated as a partner under section 6231(a)(2)(B). See e.g. Callaway v. Commissioner, 231 F.3d 106 (2d Cir. 2000); Dynamic Energy v. Commissioner, 98 T.C. 48 (1992); Dubin v. Commissioner, 99 T.C. 325 (1992). Each member of an affiliated group (the common parent and each subsidiary) is severally liable for the entire amount of any tax liability determined for the consolidated return. Treas. Reg. § 1.1502-6(a). Thus, under section 6231(a)(2)(B), Taxpayer would be a partner in the Partnership.

The definitions found in section 6231(a), however, apply only after a determination that the TEFRA procedures for partnership audits found in sections 6221 through 6234 apply. If the TEFRA procedures are not otherwise applicable, the fact that an individual or entity may be treated as a partner under section 6231(a)(2)(B), is

¹ Section 707(a) generally provides that if a partner engages in a transaction with a partnership other than in his capacity as a member of the partnership, the transaction shall, except as otherwise provided, be considered as occurring between the partnership and one who is not a partner. Taxpayer is not a partner in the Partnership for purposes of subchapter K generally and section 707(a) specifically.

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irrelevant. See generally Callaway v. Commissioner, 231 F.3d 106, 117 (2d Cir. 2000).

Status as a partner by virtue of section 6231(a)(2)(B) merely provides certain notice and participation rights in a partnership proceeding under the TEFRA provisions, when those procedures otherwise apply. Id. at 117. For example if TEFRA procedures are applicable, the definition of partner under section 6231(a)(2)(B) may bring a person into a partnership proceeding, I.R.C. § 6226(c), and bind that person to the outcome of the partnership proceeding. I.R.C. §§ 6222(c); 6230(a)(1). Would-be status as a partner under section 6231(a)(2)(B), however, cannot mandate whether the proceeding is subject to the TEFRA procedures, as discussed further below.

Issue 2:

Whether the claimed deduction of a royalty payment is an affected item if the royalty payment is disallowed.

Under the TEFRA definition, an affected item means any item to the extent the item is affected by a partnership item. I.R.C. § 6231(a)(5). The statutory definition and the definition in the regulations contemplate an adjustment to a partner's return. When an FPAA is issued, deficiency notices directed to affected items must await the outcome of a partnership proceeding. See Roberts v. Commissioner, 94 T.C. 853, 860 (1990). A partnership proceeding cannot be held outside the statute of limitations for partnership items under section 6229. Id. If an FPAA is not issued, and the statute of limitations on assessment of partnership items has expired, the IRS must accept the partnership return as filed, but still may consider affected items in a deficiency proceeding against a partner providing subject matter jurisdiction exists. Id. at 860-861.

In Roberts v. Commissioner, the taxpayers were partners as defined under section 761(b) and section 6231(a)(2)(A). The statute of limitations on assessing partnership items had expired. The Service asserted the taxpayers were not at risk for certain royalty obligations and, consequently, disallowed claimed losses from the partnership. As in this case, the Service made several arguments requiring the court to consider documents and records at the partnership level.

The Tax Court determined that the resolution of the taxpayers' amounts at risk was an affected item. Even so, the Tax Court rejected the taxpayers argument that partnership-level documents and records could not be considered in the context of a deficiency proceeding. Id. at 862. The court held that it lacked jurisdiction only to redetermine partnership items that the partnership was required to take into account at the partnership level.

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Under Roberts an argument can be made that even if the adjustment to the royalty payments is an affected item, it can still be challenged in a deficiency proceeding.

In this case, however, Taxpayer is not a partner in the Partnership under section 761(b). Thus, while the adjustments to the royalty payments may be related to partnership items, they are not affected items. For example, suppose a taxpayer who is not a partner under section 761(b) purchases a service from a partnership. The taxpayer's Schedule C business expenses are adjusted in an audit. The adjustment to the taxpayer's return requires a determination with regard to the partnership's income. Under TEFRA procedures, a determination with regard to the partnership's income is a partnership item. Treas. Reg. § 301.6231(a)(3)-1(a)(1)(i). Because the taxpayer is not a partner, however, the IRS is not required to open a partnership proceeding, but may simply adjust the taxpayer's return. If, however, the taxpayer were a partner under section 761(b), the IRS would be required to open a partnership proceeding to make the adjustment to the partnership's income so that each partner's return would be treated consistently.

As discussed above Taxpayer is not a partner under 761(b). The fact that Taxpayer could be considered a partner under section 6231(a)(5) merely relates to TEFRA procedural rules and cannot mandate a partnership proceeding. The definition of affected item under section 6231(a)(5), like the definition of partner under section 6231(a)(2)(B) is effective only in the context of a TEFRA partnership proceeding. Thus, even assuming that the royalty payment deduction is affected by a partnership item, it is not "an affected item" because the TEFRA definitions are not applicable and because the adjustment does not affect a partner's return.

Issue 3:

Whether legal and factual determinations related to the background of the Partnership, relevant to the disallowance of the royalty payment, are partnership items, or may be determined in a deficiency proceeding against Taxpayer.

The IRS arguments relevant to the disallowance of the royalty payments include, (1) the Partnership was a sham, (2) the Bank was a lender rather than a partner in the Partnership, (3) the underlying partnership transactions lacked economic substance, (4) the royalty payments from Taxpayer to the Partnership were not ordinary and necessary expenses, (5) the allocation of the partnership items did not have substantial economic effect, and (6) the amount of the royalty deductions should be adjusted under section 482.

It is likely that arguments (1), (2), (3), and (5) would be considered partnership items in the context of a partnership proceeding. As we have indicated, however, the court can consider facts and circumstances surrounding partnership transactions in a deficiency proceeding. See Roberts, 94 T.C. at 862.

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It is not necessary to determine whether one or more of these issues must be considered a partnership item. In this proceeding, the IRS is not asking the court to redetermine partnership items that the partnership was required to take into account at the partnership level. Moreover, the IRS is not adjusting a partner's return. Thus, it is not necessary to issue an affected item notice of deficiency based on the determinations of a partnership proceeding. The IRS may simply issue Taxpayer a statutory notice of deficiency with regard to the disallowance of the royalty payment deductions. In a proceeding to redetermine asserted deficiencies, the Tax Court may take into account all facts and circumstances that bear upon the deficiency, including the arguments stated above. See Butler v. Commissioner, 114 T.C. 276, 287 (2000); Estate of Mueller v. Commissioner, 101 T.C. 551, 556 (1993).

Issue 4:

Whether the TEFRA limitations on assessments under section 6229 apply to items that are not partnership items or affected items.

By its terms section 6229(a) provides a limitation period "for assessing any tax imposed by subtitle A with respect to any person *which is attributable to any partnership item or affected item* for a partnership tax year." (Emphasis added).

In view of our conclusion that the tax in this case is not attributable to a partnership item or affected item, the TEFRA limitations on assessments under section 6229 do not apply.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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



CC:PA:APJP:B3 suggests you coordinate the TEFRA issues in this case with the National Office. In addition, CC:PSI strongly suggests that the field request assistance from the National Office regarding the substantive issues of this case.

Please call if you have any further questions.

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