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Internal Revenue Service  
memorandum**

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to:

Associate Area Counsel ( , Group 2)  
(Large Business & International)

from: James A. Quinn  
Senior Counsel, Branch 3  
(Passthroughs & Special Industries)

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subject: Whether Collaboration is a Partnership and Section 199 Consequences

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

A =

B =

C =

State =

Date 1 =

Date 2 =

Year 1 =

Year 2 =

Year 3 =

Product =

a =

b =

### ISSUES

1. Is the collaboration between A and B a partnership for federal tax purposes?
2. If the collaboration is a partnership, is it eligible to elect to be excluded from the application of subchapter K under § 761(a) of the Internal Revenue Code (Code) and § 1.761-2 of the Income Tax Regulations?
3. If the collaboration is a partnership and the partnership produces Product in whole or in significant part within the United States within the meaning of § 199(c)(4)(A)(i)(I), how does A claim the domestic production activities deduction under § 199 with respect to the gross receipts derived by the partnership from the sale of Product?

### CONCLUSIONS

1. The collaboration is a partnership for federal tax purposes.
2. The collaboration is not eligible to elect to be excluded from the application of subchapter K under § 761(a) and § 1.761-2.
3. As a partner in C, A claims the § 199 deduction at the partner level under § 199(d)(1)(A) by including its allocable share of each item described in § 199(c)(1)(A) and (B) for its separate § 199 calculation. Section 1.199-5(b)(1) provides C should allocate A its allocable share, in accordance with §§ 702 and 704, of C's items (including items of income, gain, loss, and deduction), cost of goods sold allocated to such items of income, and gross receipts that are included in such items of income. Furthermore, under § 199(d)(1)(A)(iii) and § 1.199-5(b)(3), A's share of amounts described in § 1.199-2(e)(1) (Paragraph (e)(1) wages) of C for purposes of determining A's W-2 wage limitation under § 199(b)(1) equals A's allocable share of those wages.

### FACTS

A, a State corporation, and B, a State corporation, entered into a written Collaboration Agreement ("Agreement") dated Date 1 (such arrangement between the two entities referred to herein as C), relating to the development and commercialization of Product.

In the Agreement, A granted to B rights to co-promote Product in the United States and Canada and to develop and market it in the rest of the world.<sup>1</sup>

A was responsible for the

and was  
solely responsible for the  
Until A received in Date 2, A bore all of the costs for  
development and obtaining Prior to  
the Agreement, A not only developed the  
but also working that are critical to the  
production of Product. A was responsible for the

Soon after signing the Agreement, A transferred to B  
and transferred to B and provided

B, at its own expense, worked on  
The parties charged  
all development costs incurred for development or marketing in the United States or  
Canada against the operating profits of the collaboration.

According to the Agreement, A and B each agree to collaborate diligently in the  
development of Product and to use commercially reasonable and diligent efforts to  
develop and bring Product to market in Each party also  
agrees to collaborate in the commercialization of Product in the  
in a manner to maximize operating profits, with B playing the primary role.

The Agreement establishes committees that are in charge of the management and  
finances of the collaboration, as well as the development and commercialization of  
Product. Each committee is comprised of representatives appointed in equal numbers  
by A and B.

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<sup>1</sup> The Agreement provides for the parties' arrangement in the  
This CCA only addresses the arrangement in

In the United States and Canada, the parties share in the collaboration's profits and losses. A and B will share in the first \$a in operating profits, % and %, respectively, then % and %, respectively, of operating profits in excess of \$a. To the extent there is an operating loss, such loss is absorbed % by A and % by B.

Under the Agreement, A and B maintain complete and accurate records that are relevant to costs, expenses, sales, and payments. Both parties incur expenses, including

Each , A submits its records to B so B can calculate the collaboration's profits and losses. B subsequently determines if any true ups are necessary, and then typically pays A for its allocable share of profits and losses.

There are accruals and reserves that A and B jointly share.

This accrued expense was deducted for financial accounting purposes in arriving at the collaboration's profit in Year 3 and A's share of the profit was reduced by % of this expense.

A and B sell Product in under trademarks selected by the and owned jointly by A and B. All inventions made under the Agreement jointly by employees of A and B will be owned jointly by A and B. All documentary information, promotional materials, and oral presentations regarding the promotion of Product displayed the names and logos of A and B. Apart from these instances, the Agreement does not grant the right to use in any manner the name A, B or any other trade name or trademark of the other party, or of its affiliates in connection with the performance of the Agreement.

A and B did not file a Form 1065, U.S. Return of Partnership Income, for C for any taxable year or file a written election under § 761(a) of the Internal Revenue Code meeting the requirements in the regulations to elect out of subchapter K. Although the

Agreement does not indicate A and B's intent on whether C should be treated as a partnership for federal tax purposes, side agreements included provisions that stated their intent that their relationship is not to be treated as a partnership, agency, employer-employee, or joint venture.

Although A initially treated amounts from B as royalty payments, A is now claiming the amounts from B should be included in A's calculation of qualified production activities income under § 199(c)(1). A has not received information from C that would allow A to calculate the § 199 deduction separately.

## LAW AND ANALYSIS

### ISSUE 1:

Section 7701(a)(2) provides that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of title 26, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

Section 301.7701-1(a)(2) of the Procedure and Administration Regulations provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. Section 301.7701-1(a)(2) also provides that a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes.

Section 301.7701-1(b) provides that the classification of organizations that are recognized as separate entities is determined under §§ 301.7701-2, 301.7701-3, and 301.7701-4 unless a provision of the Code provides otherwise.

Section 301.7701-2(c) provides that the term "partnership" means a business entity that is not a corporation under § 301.7701-3(b) and that has at least two members.

The Supreme Court in Commissioner v. Culbertson, 337 U.S. 733, 69 S.Ct. 1210, 93 L.Ed. 1659 (1949), provided the foundation for determining when a partnership exists for federal tax purposes. The Supreme Court stated that a partnership exists for federal tax purposes under the following circumstances:

“considering all the facts- the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the

actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent- the parties in good faith and acting with a business purpose intend to join together in the present conduct of an enterprise.”

The principles of Culbertson equally apply where the kind of partnership is an alleged joint venture. Luna v. Commissioner, 42 T.C. 1067, 1077, 1964 WL 1259 (1964). In Luna, the Tax Court provided the following list of factors, none of which is conclusive, which bear on the issue of whether a joint venture exists:

“[1] The agreement of the parties and their conduct in executing its terms; [2] the contributions, if any, which each party has made to the venture; [3] the parties’ control over income and capital and the right of each to make withdrawals; [4] whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; [5] whether business was conducted in the joint names of the parties; [6] whether the parties filed Federal partnership returns or otherwise represented to the [IRS] or to persons with whom they dealt that they were joint venturers; [7] whether separate books of account were maintained for the venture; and [8] whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.”

The regulations under §§ 301.7701-1 and 301.7701-2 require that in order for a joint venture to be considered a partnership, it must not be a corporation, must have at least two members, and cannot be a joint undertaking merely to share expenses. In this case, C is not a corporation described in § 301.7701-2(b). Additionally, if C were considered a partnership for federal tax purposes, it would be comprised of two members, A and B. Finally, A and B did not join together to merely share expenses, but used each other’s unique know-how to make a profit from selling Product. Thus, C is eligible to be classified as a partnership for federal tax purposes.

However, A and B did not file a Form 1065 for the collaboration for any taxable year or file a written § 761(a) election meeting the requirements in the regulations to elect out of subchapter K; thus they did not formally indicate to the IRS that the collaboration is a partnership for federal tax purposes. Although the Agreement does not indicate A and B’s intent on whether their collaboration should be treated as a partnership for federal tax purposes, side agreements included provisions that stated their intent that their relationship is not to be treated as a partnership, agency, employer-employee, or joint venture. Even if A and B intended not to be treated as a partnership, it will nevertheless be held to exist if the agreements and conduct of the parties plainly show the existence of such a relationship. Haley v. Commissioner, 203 F.2d 815 (5<sup>th</sup> Cir. 1953). As a result, we must analyze whether a partnership exists under the principles set forth in Culbertson and Luna. The Supreme Court in Culbertson held that the determination of whether two or more parties create a partnership looks at whether they

in good faith and acting with a business purpose intended to join together in the present conduct of a business. The Tax Court in Luna elaborated on the Culbertson standard by identifying eight factors that aid in the determination of whether a partnership exists for federal tax purposes.

Five of the eight Luna factors support the conclusion that the joint venture is a partnership. First, A and B entered into the Agreement and have not deviated from its terms during the taxable years at issue. Second, both parties contributed cash and services to the venture. A and while B helped with the development, marketing, and sale of the Third, A and B are sharing in the profits and losses of their operation. Although there is a royalty payment B pays A on sales of Product outside of the the Agreement provides profit and loss ratios for sales inside of the two countries. Fourth, both parties maintain records of their respective revenue and expenses. B combines A's amounts with its own to calculate the collaboration's profits and losses each quarter. Lastly, both parties exercised mutual control and assumed mutual responsibilities for the enterprise. Both parties had equal representation on the Committee, which determined how to manage the venture, and how to develop and commercialize Product.

The sixth Luna factor weighs against the conclusion that the collaboration is a partnership. C never filed any partnership returns. In addition, A has reported B's payments to it as royalty income, which is not representative of the parties treating their venture as a partnership.

Two of the Luna factors are neutral. Evidence regarding the third Luna factor is mixed because both parties had control of the income and the capital through the If either party had an issue with the accounting, it could bring the issue to the Because the consists of an equal number of representatives from A and B, it would presumably make an unbiased conclusion. However, neither party had the right to make withdrawals because the parties did not share a bank account. Also, the Agreement was silent on whether A or B could make withdrawals.

The fifth Luna factor is also not conclusive. Documentary information, promotional materials, and oral presentations regarding the promotion of Product displayed the names and logos of A and B. The Agreement, however, provides that neither party has the right to use the name of the other in connection with performance of the Agreement. Further, there is no evidence A and B use the name, C, in their dealings with third parties. The Agreement uses C for identification purposes only and is not a legal entity.

In weighing the Luna factors, we do not treat any one factor as determinative, but we consider and weigh each factor in the overall determination of whether a joint venture exists. In the present case, our consideration of the Luna factors indicates that C is a

joint venture. Considering the facts and circumstances of this case, we further conclude that the overall standard set forth in Culbertson is satisfied. The facts demonstrate that A and B, acting with a business purpose, intended to and did join together in the conduct of a business enterprise. A and B clearly evince this intent through the sharing in the net profits and losses from the manufacture, development, and marketing of Product. Accordingly, C is a partnership for federal tax purposes.

## ISSUE 2:

Section 761(a) provides that under regulations the Secretary may, at the election of all the members of the unincorporated organization, exclude such organization from the application of all or part of subchapter K, if it is availed of for the joint production, extraction, or use of property, but not for the purposes of selling services or property produced or extracted, if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.

Section 1.761-2(a)(1) provides that an unincorporated organization described in §§ 1.761-2(a)(2) or (3) may be excluded from the application of all or a part of the provisions of subchapter K. Such organization must be availed of (i) for investment purposes only and not for the active conduct of a business, or (ii) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted. The members of such organization must be able to compute their income without the necessity of computing partnership taxable income. Any syndicate, group, pool, or joint venture which is classifiable as an association, or any group operating under an agreement which creates an organization classifiable as an association, does not fall within these provisions.

Section 1.761-2(a)(2) provides that where the participants in the joint purchase, retention, sale, or exchange of investment property—(i) Own the property as coowners, (ii) Reserve the right separately to take or dispose of their shares of any property acquired or retained, and (iii) Do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year, then such group may be excluded from the application of the provisions of subchapter K under the rules set forth in § 1.761-2(b).

Section 1.761-2(a)(3) provides that where the participants in the joint production, extraction, or use of property—(i) Own the property as co-owners, either in fee or under lease or other form of contract granting exclusive operating rights, (ii) Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used, and (iii) Do not jointly sell services or the property produced or extracted, although each participant may delegate authority to sell his share of the property produced or extracted for the time being for his account, but not for a period of time in



excess of the minimum needs of the industry, and in no event for more than one year, then such group may be excluded from the application of the provisions of subchapter K of the Code.

Section 1.761-2(b)(2)(ii) provides that if an unincorporated organization described in §§ 1.761-2(a)(1) and either (a)(2) or (a)(3) does not make the election provided in § 761(a) in the manner prescribed by § 1.761-2(b)(2)(i), it shall nevertheless be deemed to have made the election if it can be shown from all the surrounding facts and circumstances that it was the intention of the members of such organization at the time of its formation to secure exclusion from all of subchapter K beginning with the first taxable year of the organization.

C is not the type of unincorporated organization described in § 1.761-2(a)(1) because it fails to meet the requirements of §§ 1.761-2(a)(2) and 1.761-2(a)(3). Under § 1.761-2(a)(2), electing out of subchapter K as an investment partnership requires the joint purchase, retention, sale or exchange of investment property. Although the regulation does not define “investment property,” Product is not the type of property that would meet this requirement. See e.g., §§ 148(b)(2) (definition of “investment property” for purposes of § 148) and 1.148-1(e) (definition of “investment-type property”). Additionally, C is not an investing partnership because it actively conducts the business of producing and selling Product. C fails the requirements set forth in § 1.761-2(a)(3)<sup>2</sup> because A and B jointly sell Product. Even if A and B did not sell Product jointly, A allowed B to sell Product. Thus, because it does not meet the requirements of §§ 1.761-2(a)(2) or 1.761-2(a)(3), C is not eligible to elect out of subchapter K under § 1.761-2(b)(1) or be deemed to have elected out of subchapter K under § 1.761-2(b)(2)(ii).

### ISSUE 3:

Under § 199(a), the domestic production activities deduction is determined by applying a percentage to the lesser of the taxpayer's qualified production activities income (QPAI) or taxable income (determined without regard to the § 199 deduction). The applicable percentage is 3 percent for taxable years beginning in 2005 and 2006, 6 percent for taxable years beginning in 2007 through 2009, and 9 percent for taxable years beginning after 2009.

Section 199(b)(1) limits the deduction for a taxable year to 50 percent of the W-2 wages paid by the taxpayer during the calendar year that ends in such taxable year. Section 199(b)(2)(B) provides that W-2 wages does not include any amount which is not properly allocable to domestic production gross receipts (DPGR).

Under § 199(c)(1), QPAI means an amount equal to the excess (if any) of (A) DPGR for

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<sup>2</sup> Historically, this rule only applied to oil and gas or mineral extraction activities; but it is available to other types of production ventures as well. See Rev. Rul. 68-344, 1968-1 C.B. 569 (participants co-owned power generating facilities).

the taxable year, over (B) the sum of (i) cost of goods sold (CGS) allocable to such DPGR, and (ii) other expenses, losses, or deductions, which are properly allocable to such DPGR.

Section 199(c)(4)(A) provides the term DPGR means the gross receipts of the taxpayer which are derived from (i) any lease, rental, license, sale, exchange, or other disposition of (I) qualifying production property (QPP) which was manufactured, produced, grown, or extracted (MPGE) by the taxpayer in whole or in significant part within the United States.

Section 199(d)(1)(A) provides that, in the case of a partnership or S corporation, (i) § 199 shall be applied at the partner or shareholder level, (ii) each partner or shareholder shall take into account such person's allocable share of each item described in § 199(c)(1)(A) or (B) (determined without regard to whether the items described in § 199(c)(1)(A) exceed the items described in § 199(c)(1)(B)), and (iii) each partner or shareholder shall be treated for purposes of § 199(b) as having W-2 wages for the taxable year in an amount equal to such person's allocable share of the W-2 wages of the partnership or S corporation for the taxable year (as determined under regulations prescribed by the Secretary).

Section 1.199-5(b)(1)(i) provides that the deduction with respect to the qualified production activities of the partnership allowable under § 1.199-1(a) (§ 199 deduction) is determined at the partner level. As a result, each partner must compute its deduction separately. Each partner is allocated, in accordance with §§ 702 and 704, its share of partnership items (including items of income, gain, loss, and deduction), CGS allocated to such items of income, and gross receipts that are included in such items of income, even if the partner's share of CGS and other deductions and losses exceeds DPGR (as defined in § 1.199-3(a)). A partnership may specially allocate items of income, gain, loss, or deduction to its partners, subject to the rules of § 704(b) and the supporting regulations. To determine its § 199 deduction for the taxable year, a partner aggregates its distributive share of such items, to the extent they are not otherwise disallowed by the Code, with those items it incurs outside the partnership (whether directly or indirectly) for purposes of allocating and apportioning deductions to DPGR and computing its QPAI (as defined in § 1.199-1(c)).

Section 1.199-5(b)(3) provides that, under § 199(d)(1)(A)(iii), a partner's share of Paragraph (e)(1) wages of a partnership for purposes of determining the partner's wage limitation under § 199(b)(1) (W-2 wage limitation) equals the partner's allocable share of those wages. The partnership must allocate the amount of Paragraph (e)(1) wages among the partners in the same manner it allocates wage expense among those partners. The partner must add its share of the Paragraph (e)(1) wages from the partnership to the partner's Paragraph (e)(1) wages from other sources, if any. The partner (other than a partner that itself is a partnership or S corporation) then must calculate its W-2 wages by determining the amount of the partner's total Paragraph (e)(1) wages properly allocable to DPGR. If the partner is a partnership or S

corporation, the partner must allocate its Paragraph (e)(1) wages (including the Paragraph (e)(1) wages from a lower-tier partnership) among its partners or shareholders in the same manner it allocates wage expense among those partners or shareholders. See § 1.199-2(e)(2) for the computation of W-2 wages and for the proper allocation of any such wages to DPGR.

Assuming that C produced Product in whole or in significant part within the United States within the meaning of § 199(c)(4)(A)(i)(I), then § 199(d)(1)(A)(i) and § 1.199-5(b)(1) require A to determine its § 199 deduction at the partner level. A must compute its § 199 deduction separately from B. Section 199(d)(1)(A)(ii) provides that A must take into account its allocable share of each item described in § 199(c)(1)(A) and (B). Section 1.199-5(b)(1) provides that in accordance with §§ 702 and 704, C must allocate to A its share of partnership items (including items of income, gain, loss, and deduction), CGS allocated to such items of income, and gross receipts that are included in such items of income. Furthermore, under § 1.199-5(b)(3), A's share of Paragraph (e)(1) wages of C for purposes of determining A's wage limitation under § 199(b)(1) (W-2 wage limitation) equals A's allocable share of those wages. C must allocate the amount of Paragraph (e)(1) wages among the partners in the same manner it allocates wage expense among those partners. A must add its share of the Paragraph (e)(1) wages from C to A's Paragraph (e)(1) wages from other sources, if any. A then must calculate its W-2 wages by determining the amount of the partner's total Paragraph (e)(1) wages properly allocable to DPGR. Thus, because A has not received the specific information necessary for A to separately calculate its § 199 deduction, A and C (or A and B on behalf of C) must determine A's allocable partnership items under § 199(d)(1)(A)(ii) and § 1.199-5(b)(1) and (3) before A can claim the deduction.

## SUMMARY

In sum, we conclude that the collaboration between A and B is a partnership for federal tax purposes. Accordingly, C is treated as a partnership for all purposes of the Code, not just § 199. See, e.g., §§ 761(a) and 7701(a)(2). Furthermore, C is not eligible to elect or be deemed to elect to be excluded from the application of subchapter K under § 761(a) or § 1.761-2(b)(1) or (2)(ii). To claim the § 199 deduction with respect to Product, A must know its allocable share of partnership items. Therefore, A and C (or A and B on behalf of C) must determine A's allocable partnership items in accordance with § 199(d)(1)(A)(ii) and § 1.199-5(b)(1) and (3).

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Please call \_\_\_\_\_ at \_\_\_\_\_ if you have any further questions.