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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, CC:LM:CTM:LA:1
Attention: RONALD M. ROSEN, Attorney

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

SUBJECT:

This memorandum responds to your request for Field Service Advice, dated March 16, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be used or cited as precedent.

LEGEND:

Entities:
FSC1 =
Hybrid Entity =
Individual =
S Corporation =
Tax-Exempt Entity =
U.S. Corporation 1 =
U.S. Corporation 2 =
U.S. Partnership =

Amounts:
a =
b =
c =
d =
e =
f =
g =
h =
i =
j =
k =
l =
m =

Other:

Area	=
Calendar Year 0	=
Calendar Year 1	=
Calendar Year 2	=
Calendar Year 3	=
Calendar Year 4	=
Country1	=
Country2	=
Equity Interest 1	=
Equity Interest 2	=
Equity Interest 3	=
Equity Interest 4	=
Equity Interest 5	=
Licensing Fee Interest 1	=
Licensing Fee Interest 2	=
Month A	=
Month B	=
Partnership Interest 1	=
Partnership Interest 2	=
Product	=
State1	=
State2	=

ISSUES:

1. Whether U.S. Corporation 1's contribution to U.S. Partnership of the right to receive licensing fees in exchange for an interest in the partnership was a contribution of property subject to sections 721 and 704(c).
2. Whether U.S. Corporation 1's contribution to U.S. Partnership of the right to receive licensing fees was an impermissible assignment of income.

3. Whether section 482 permits reallocation to U.S. Corporation 1 of licensing-fee income that it contributed to U.S. Partnership.

4. Whether the licensing transactions at issue generated foreign trading gross receipts (FTGR) under section 924.

5. Whether U.S. Partnership and Hybrid Entity may file amended U.S. Partnership Returns of Income (Forms 1065) and/or Requests for Administrative Adjustment, (Forms 8082) to reflect special allocations of FSC-commission deductions.

6. Whether special allocations by U.S. Partnership of FSC-commission deductions have substantial economic effect under section 704(b).

CONCLUSIONS:

1. The contribution to U.S. Partnership of licensing fees that had already accrued is properly viewed as an after-tax contribution of cash, which would be considered property under section 721. Cash is not property for purposes of section 704(c). The contribution to U.S. Partnership of the right to receive licensing fees in the future (i.e., licensing fees that had not yet accrued at the time of contribution) is not a transfer of property under section 721.

2. U.S. Corporation 1 made an ineffective assignment of income by purportedly contributing to U.S. Partnership the right to receive licensing fees.

3. Section 482 would permit allocation to U.S. Corporation 1 of income from licensing fees that U.S. Corporation 1 contributed to U.S. Partnership.

4. In order to generate foreign trading gross receipts (FTGR) under section 924, FSC1's activities in connection with the licensing transactions must satisfy the requirements of the FSC provisions of the Code, including the foreign economic processes requirement. The information available at present does not establish that these requirements were satisfied.

5. U.S. Partnership and Hybrid Entity are subject to the unified audit and litigation procedures of I.R.C. §§ 6221 through 6234 ("TEFRA"). Unless a valid extension was filed, amended partnership returns to reflect the proposed special allocation of FSC commission deductions would be barred by the three-year statute of limitations of I.R.C. § 6227. If U.S. Partnership and Hybrid Entity, as related suppliers of FSC1, are barred from amending their respective returns with respect to FSC commissions, then FSC1 would also be barred from making corresponding adjustments, under Temp. Treas. Reg. § 1.925(a)-1T(e)(4).

6. Based on our resolution of Issue 5, we do not reach this issue.

FACTS:

Parties

Individual is a U.S. citizen who ultimately owns the entities described in this memorandum (except that Tax Exempt Entity has a minority interest in one of the entities).

U.S. Corporation 1 is a corporation organized pursuant to the law of State1 and (after revocation in Calendar Year 1 of a previous subchapter S election) was subject to tax as a subchapter C corporation. U.S. Corporation 1 designs and licenses Product. U.S. Corporation 1 uses the accrual method of accounting.

U.S. Corporation 2 is a corporation organized pursuant to the law of State1. At all relevant times, U.S. Corporation 2 owned Equity Interest 1 in Hybrid Entity.

S Corporation is a corporation organized pursuant to the law of State1, and elected to be taxed as a subchapter S corporation for Federal income tax purposes.

U.S. Partnership is a limited liability company (LLC) organized pursuant to the law of State2. For Federal income tax purposes, it is treated as a partnership. The only partners of U.S. Partnership are U.S. Corporation 1 and S Corporation.

Hybrid Entity is a corporation organized pursuant to the law of Country1 and subject to tax on an entity basis in that country. For U.S. Federal income tax purposes, Hybrid Entity elected to be taxed as a partnership. Hybrid Entity sub-licensed Product to end-users in Area.

Tax-Exempt Entity is a domestic charitable association, which qualifies as a tax-exempt entity for Federal income tax purposes. At all relevant times, Tax-Exempt Entity owned Equity Interest 2 in Hybrid Entity.

FSC1 is a corporation organized pursuant to the law of Country2. FSC1 has elected to be taxed as a foreign sales corporation (FSC) pursuant to I.R.C. § 927(f). We assume that, at all relevant times, FSC1 qualified for treatment as a FSC. U.S. Corporation 1 owned all the stock of FSC1.

Business Activities and Restructuring

Foreign Business Activities

U.S. Corporation 1 licenses Product to end-users through intermediaries, including Hybrid Entity. U.S. Corporation 1 entered into a licensing agreement with Hybrid Entity providing it a limited, non-transferable, non-exclusive right to sub-license Product to end-users within Area. Hybrid Entity obtains no rights in Product other than the right to sub-license to end-users, and a limited right to demonstrate it. The sub-license authorizes end-users to use Product in their own operations.

U.S. Corporation 1 ships Product directly to the end-user. Hybrid Entity pays U.S. Corporation 1 a license fee equal to 50% of the sub-license fee charged to the end-user. For example, if an end-user sub-licenses Product from Hybrid Entity for $100, Hybrid Entity pays U.S. Corporation 1 a license fee of $50, and keeps the remaining $50. From this $50, Hybrid Entity pays its own expenses. Hybrid Entity's net income consists of sub-license revenues less licensing fees, expenses, and taxes in Country1. Hybrid Entity's fee arrangement is similar to that between unrelated third parties and U.S. Corporation 1.

Revocation of S Corporation Election

Effective at the end of Calendar Year 0, Individual revoked the election of U.S. Corporation 1 to be taxed as an S corporation. Individual stated that he intended to reinvest most of that entity's earnings back into U.S. Corporation 1, and did not wish to be taxed at individual rates on earnings retained by the corporation.

Formation of U.S. Partnership

Separately, Individual apparently sought to avoid Federal corporate-level income tax on income that U.S. Corporation 1 actually distributed to Individual. Because income of an S corporation is not subject to corporate-level Federal income tax, S Corporation's income would not be subject to tax at the entity-level. Thus, by directing a portion of licensing income from Product to S Corporation, Individual sought to eliminate, for that portion of the income, one of the two levels of Federal income tax potentially applicable to a C corporation and its shareholders.[1] Individual took the following steps to accomplish this objective.

On or about December 1 of Calendar Year 1, U.S. Corporation 1 and S Corporation formed U.S. Partnership, which was intended to serve as a holding company between Hybrid Entity and the partners of U.S. Partnership. S Corporation and U.S. Corporation 1 made nominal capital (cash) contributions to U.S. Partnership, and received Partnership Interest 1 and Partnership Interest 2, respectively. These ownership interests remained unchanged in the years at issue herein.

Prior to Calendar Year 1, S Corporation held Equity Interest 3 in Hybrid Entity. U.S. Corporation 1, Tax-Exempt Entity, and U.S. Corporation 2 collectively owned the remaining equity interest in Hybrid Entity.

When U.S. Partnership was formed in Calendar Year 1, S Corporation contributed to it Equity Interest 4 in Hybrid Entity, and retained Equity Interest 5 in Hybrid Entity. Subsequently, in Calendar Year 2, S Corporation contributed to U.S. Partnership Equity Interest 5 in Hybrid Entity. These contributions took place in two stages, to prevent a termination of Hybrid Entity's status as a partnership for Federal income tax purposes, which would have resulted if a more-than-50% interest had been transferred within a twelve-month period.

Also, when U.S. Partnership was formed in Calendar Year 1, U.S. Corporation 1 contributed to it Licensing Fee Interest 1 in fees generated by Hybrid Entity's licensing of Product. Subsequently, in Calendar Year 2, U.S. Corporation 1 contributed to U.S. Partnership Licensing Fee Interest 2, which was the remaining interest in licensing fees on Product that were generated by Hybrid Entity. The evidence developed to date does not indicate that U.S. Corporation 1 transferred to U.S. Partnership any underlying

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[1] S Corporation elected to be a C corporation for purposes of taxation by State1. This election allegedly reduced the amount of state tax payable on income from Hybrid Entity.

intellectual-property rights in Product. Rather, the interests transferred, i.e., Licensing Fee Interests 1 and 2, apparently consisted of the income-stream from sub-licensing Product under the distribution agreement.

Licensing Fee Interests 1 and 2 purported to affect fees for the entire taxable year in question (i.e., Calendar Years 1 and 2, respectively). The underlying documents evidencing the contributions, however, were executed on December 15 of Calendar Year 1 for Calendar Year 1 licensing fees, and in mid-January of Calendar Year 3 for Calendar Year 2 licensing fees.

Allocation of Income from U.S. Partnership

In Calendar Years 1 and 2, S Corporation and U.S. Corporation 1, as the sole partners of U.S. Partnership, received allocations of income based on Partnership Interests 1 and 2, respectively. U.S. Partnership timely filed U.S. partnership returns of income (Forms 1065) reflecting such allocations, and the partners included the income on Schedule K-1 of their timely-filed U.S. income tax returns.

Allocation of Income from Hybrid Entity

Hybrid Entity timely filed U.S. partnership returns of income (Forms 1065), which reflected allocations of income to its partners, and the partners included the partnership income reflected on Schedule K-1 of their timely-filed U.S. income tax returns. Because Hybrid Entity was not a partnership under the law of Country1, it was not party to a formal (written) partnership agreement.

U.S. Partnership's Income and Distributions

The contributions to U.S. Partnership of equity interests and licensing-fee interests were arguably part of a plan to shift licensing income from U.S. Corporation 1 to S Corporation. This shifting of income is demonstrated below.[2]

In Calendar Year 1, Hybrid Entity paid licensing fees of $a. U.S. Corporation 1's contribution to U.S. Partnership of Licensing Fee Interest 1 thus amounted to $b. Hybrid Entity had net income of $c. S Corporation's contribution to U.S. Partnership of Equity Interest 4 in Hybrid Entity yielded $d. U.S. Partnership's total income for Calendar Year 1 was thus $b plus $d, or $e. Of this amount, U.S. Corporation 1 received a distribution of $f, in accordance with Partnership Interest 2.

In Calendar Year 1, whereas U.S. Corporation 1 contributed licensing fees of $b to U.S. Partnership, it received a distribution of profits from U.S. Partnership of only $f. Thus, in Calendar Year 1, U.S. Corporation 1 shifted $g to S Corporation.

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[2] These figures are derived from the incoming memorandum. We have not independently reviewed the accuracy of these data.

In Calendar Year 2, Hybrid Entity paid licensing fees of $h. U.S. Corporation 1 contributed its entire interest in this amount to U.S. Partnership. Hybrid Entity had net income of $i. S Corporation's contribution to U.S. Partnership of Equity Interest 3 in Hybrid Entity yielded $j. U.S. Partnership's total income for Calendar Year 2 was thus $h plus $j, or $k. Of this amount, U.S. Corporation 1 received $l, in accordance with Partnership Interest 2.

In Calendar Year 2, whereas U.S. Corporation 1 contributed licensing fees of $h to U.S. Partnership, it received a distribution of profits from U.S. Partnership of only $l. Thus, in Calendar Year 2, U.S. Corporation 1 shifted $m to S Corporation.

Foreign Sales Corporation Commissions

Agreements

In Month A, Calendar Year 4, FSC1 executed two agreements with U.S. Corporation 1: (1) Foreign Sales Corporation Franchise Agreement; and (2) Economic Process Agency Agreement. These agreements, both of which recited that they were "made as of" the first day of Month B, Calendar Year 1, purported to formalize oral agreements that were allegedly in effect during the years in issue. It does not appear that any similar agreements were in effect between U.S. Partnership and FSC1, or between Hybrid Entity and FSC1.

Income Tax Returns Filed by FSC1

For Calendar Year 1, FSC1 timely filed an income tax return (Form 1120FSC) showing commission income equal to a portion of the income generated by Hybrid Entity from licensing of Product, based on the fractional ownership interest of U.S. Corporation 1 in Hybrid Entity.

For Calendar Year 2, FSC1 timely filed an income tax return (Form 1120FSC) showing commission income equal to a portion of the income generated by Hybrid Entity from licensing of Product. This amount was based on the fractional ownership interest of U.S. Corporation 1 in Hybrid Entity, but it also reflected U.S. Corporation 1's indirect ownership interest in Foreign Hybrid, i.e., via status as a partner in U.S. Partnership.

In Calendar Years 1 and 2, FSC1 determined the commissions paid by its related supplier under the administrative-pricing rules of I.R.C. § 925(a) and the regulations thereunder.

New Methodology; Amended Forms 1120FSC

During Calendar Year 4, U.S. Corporation 1 proposed to change U.S. Partnership's method of reporting its income. Under the proposal, U.S. Corporation 1 would pay FSC commissions to FSC1 in connection with the licensing of Product from U.S. Partnership to Hybrid Entity. U.S. Corporation 1 would be deemed to fund these FSC commissions via transfers to U.S. Partnership, and U.S. Partnership would in turn pay FSC commissions to FSC1. Then, by means of a special allocation, U.S. Partnership would allocate to U.S. Corporation 1 100% of the FSC-commission deductions. The proposed methodology would increase the amount of income reported by FSC1 and the amount of the FSC-commission deductions claimed by U.S. Corporation 1 over the amounts on the timely-filed Forms 1120FSC and 1120, respectively.

FSC1 filed with the applicable IRS Service Center amended income tax returns (Forms 1120FSC) for Calendar Years 1 and 2. On these amended returns, FSC1 applied the administrative-pricing rules of I.R.C. § 925(a) and the regulations thereunder to determine commission income. The amended returns reflected additional FSC income, as described above, and they made other adjustments not directly relevant here.[3] For purposes of this memorandum, we assume that the amended Forms 1120FSC met the procedural filing requirements of Temp. Treas. Reg. § 1.925(a)-1T(e)(4) in effect on the date of filing.

The increased FSC-commission deductions were not reflected on timely-filed U.S. partnership returns of income (Forms 1065) filed by U.S. Partnership. Nor has any partner of U.S. Partnership to date filed an amended partnership tax return or a Request for Administrative Adjustment with respect to these items. Rather, the deemed payment of FSC commissions and the proposed special allocation to U.S. Corporation 1 of FSC-commission deductions will be reflected on amended partnership returns, proposed to be filed.

No evidence indicates that U.S. Partnership had an agreement with FSC1 authorizing it to act as a commission agent for U.S. Partnership in connection with the licensing of Product to Hybrid Entity.

Special Allocation of FSC-Commission Deductions by Hybrid Entity

In Calendar Year 4, U.S. Corporation 1 proposed to change Hybrid Entity's method of reporting its income.[4] The proposed methodology would be substantially identical to that employed by U.S. Partnership, as described above. That is, Hybrid Entity would make special allocations to U.S. Corporation 1 of FSC-commission deductions, based on an alleged oral agreement substantially identical to the written agreement between

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[3] The amended Forms 1120FSC also included revised allocations of the related supplier's expenses to particular products, based on St. Jude Medical, Inc. v. Commissioner, 34 F.3d 1394 (8th Cir. 1984). We do not consider the merits of this methodology, except to note that the Service does not agree with the methodology for companies outside the jurisdiction of the U.S. Court of Appeals for the Eighth Circuit. See Boeing Co. v. United States, 2001 U.S. App. LEXIS 17168 (9th Cir. Wash. Aug. 2, 2001), reversing and remanding, 1998 U.S. Dist. LEXIS 16212 (W.D. Wash. 1998).

[4] The proposed methodology would also apply to controlled foreign entities other than Hybrid Entity. For simplicity, this memorandum refers only to Hybrid Entity.

U.S. Corporation 1 and U.S. Partnership. (Because Hybrid Entity was not a partnership, no formal partnership agreement was in effect.)

The proposed FSC commissions were not reflected on the timely-filed U.S. partnership returns of income (Forms 1065) of Hybrid Entity. Nor has any partner of Hybrid Entity to date filed an amended partnership tax return or a Request for Administrative Adjustment with respect to these items. Rather, the additional FSC commission deductions are proposed to be reflected on amended partnership returns, yet to be filed.

No evidence indicates that Hybrid Entity had an agreement with FSC1 authorizing it to act as a commission agent for Hybrid Entity in connection with the sub-licensing of Product to end-users.

DISCUSSION:

Introduction

Your memorandum identifies several issues regarding U.S. Corporation 1's contributions to U.S. Partnership of licensing-fee interests. In our view, the income-tax effect of these contributions is, as an initial matter, based on whether the underlying licensing-fee interests constitute "property" interests. If so, the contribution of those interests to U.S. Partnership in exchange for partnership interests would normally be entitled to nonrecognition treatment under section 721 (subject to the limitations imposed by section 704(c)). See generally Hempt Bros., Inc. v. United States, 490 F.2d 1172 (3rd Cir. 1974), cert. denied, 419 U.S. 826 (1974) (section 351 transfer context); see also Rev. Rul. 80-198, 1980-2 C.B. 113 (same).

If the licensing-fee interests constitute "property" under section 721, then notwithstanding the nonrecognition treatment accorded by that provision, the contributions of those interests to U.S. Partnership may constitute impermissible assignments of income. Cf., Brown v. Commissioner, 40 B.T.A. 565 (1939), aff'd, 115 F.2d 337 (2d Cir. 1940) (in section 351 context, in the absence of a valid business purpose, the transfer to a corporation of interest in claim for legal services performed is taxable to the transferor under assignment of income doctrine). Similarly, if the contributions improperly separate income from associated expenses or give rise to tax avoidance, then income may be subject to allocation pursuant to section 482. E.g., National Securities Corp. v. Commissioner, 137 F.2d 600 (3rd Cir. 1943), aff'g, 46 B.T.A. 562 (1942), cert. denied, 320 U.S. 794 (1943); Rooney v. United States, 305 F.2d 681 (9th Cir. 1962).

We first address the substantive partnership issues identified above, then consider application of the assignment of income doctrine and section 482. Finally, we consider additional issues concerning the calculation of FSC commissions and associated deductions.

Issue 1: Whether U.S. Corporation 1's contribution to U.S. Partnership of the right to receive licensing fees in exchange for an interest in the partnership was a contribution of property subject to sections 721 and 704(c).

Section 721 provides that no gain or loss is recognized to a partnership or any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. One issue presented here is whether U.S. Corporation 1's contribution to U.S. Partnership of the right to receive licensing fees is properly classified as "property" for purposes of this provision.

Section 704(c) and the regulations thereunder apply to a contribution of property if the contribution is one that is subject to I.R.C. § 721. Section 704(c) prevents the shifting of tax consequences -- in particular, pre-contribution gain or loss from contributed property -- among partners as a result of the contribution to the partnership. See Treas. Reg. § 1.704-3.

Section 704(c)(1)(A) provides that income, gain, loss, and deductions with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution. A partnership's basis in property contributed to it by a partner is the adjusted basis of the contributing partner at the time of the contribution. I.R.C. § 723 and Treas. Reg. § 1.723-1.

Section 1.704-3(a)(3)(i) provides that property contributed to a partnership is section 704(c) property if at the time of contribution the book value of the property differs from its adjusted tax basis in the hands of the contributing partner. Book value, subject to adjustments not applicable in this case, consists of fair market value at the time of contribution. Treas. Reg. § 1.704-3(a)(3)(i).

In early December of Calendar Years 1 and 2, U.S. Corporation 1 contributed to U.S. Partnership Licensing Fee Interests 1 and 2, respectively, in fees from Hybrid Entity. For both years, documents evidencing the contributions were executed after the date of the alleged contribution. Because the contributions occurred near the end of the respective calendar years, the majority of the underlying licensing fees had likely accrued before the alleged transfers to U.S. Partnership took place.

Because it used the accrual method of accounting, U.S. Corporation 1 should have included in its gross income the income from licensing fees that had already accrued at the time of contributions in Calendar Years 1 and 2. For purposes of the partnership provisions of the Code, U.S. Corporation 1's contribution to U.S. Partnership of licensing fees that had already accrued should be treated under section 721 as an after-tax, cash contribution of licensing proceeds. Because cash is not section 704(c) property, section 704(c) would not apply to such contributions to U.S. Partnership.

Non-accrued licensing fees that U.S. Corporation 1 contributed to U.S. Partnership would not be classified as "property" under section 721. Because a future right to receive licensing fees is not property for that purpose, neither would such a right be considered property for purposes of section 704(c). Licensing fees to be earned after the date of contribution should be included in U.S. Corporation 1's income under a method of accounting that clearly reflects income, pursuant to section 446.

You also raised the related issue of whether S Corporation's contributions to U.S. Partnership of Equity Interest 4 and Equity Interest 5 in Hybrid Entity constituted section 704(c) property. We cannot express an opinion on this issue, because it is unclear whether the adjusted basis of the interests in the hands of the contributing partner differed from their fair market value at the time of contribution. We note that the Federal tax returns of U.S. Partnership for Calendar Years 1 and 2 do not reflect the value of any contributed property other than the nominal cash contributions made when the partnership was formed. We suggest that you obtain additional information to determine whether a discrepancy existed, at the time of contribution, between the basis of the interest in Hybrid Entity and the fair market value of that interest.

Issue 2: Whether U.S. Corporation 1's contribution to U.S. Partnership of the right to receive licensing fees was an impermissible assignment of income.

We determined above that the rights to licensing income that U.S. Corporation 1 purported to contribute to U.S. Partnership are not properly classified as "property" for purposes of section 721. Assuming arguendo that such rights constitute property for that purpose, and also assuming that their contribution is subject to nonrecognition treatment, they are also subject to assignment of income principles of Lucas v. Earl, 281 U.S. 111 (1930).

A basic tenet of tax law is that "income must be taxed to [the party] who earns it." Commissioner v. Culbertson, 337 U.S. 733, 739-740 (1949). In order to determine the income-tax effect of a purported transfer, the Service must analyze whether the transfer involved property or merely the income generated by the property. The key factor in this analysis is whether an interest in the underlying property may be transferred separately from the associated right to receive income from the property.

One principal line of authority in this area involves cases such as Blair v. Commissioner, 300 U.S. 5 (1937). In Blair, the life beneficiary of a testamentary trust assigned to his children specified amounts of trust income on an annual basis. The Supreme Court held that this transfer did not violate the assignment of income doctrine. In so ruling, the Court gave conclusive effect to the prior holding of a state court, to the effect that the life beneficiary of the trust owned not merely an income-interest, but an equitable interest in the trust corpus. Blair, 300 U.S. at 12. The Court concluded that the beneficiary's assignment to his children constituted an actual transfer of property, as opposed to a mere assignment of the income generated by it. Id. See also Rev. Rul. 54-599, 1954-2 C.B. 52.

A competing line of authority involves transfers of interests that do not rise to the level of "property," as found in Blair. For example, in Lewis v. Rostensies, 61 F. Supp. 862

(E.D. Pa. 1944), aff'd, 150 F.2d 959 (3d Cir. 1945), an author assigned to his children royalties payable on books that he had written. Distinguishing Blair, the court concluded that the author's literary property interest "has been transmuted into a chose in action – a contract with his publisher." 61 F. Supp at 862. Accordingly, the purported assignments were not transfers of interests in the contracts themselves, but rather of the income interests therein. The court concluded that these assignments did not change the incidence of tax from the author to his children. 61 F. Supp. at 863. See also Strauss v. Commissioner, 168 F.2d 441 (2nd Cir. 1948), rev'g 8 T.C. 1058 (1947), cert. denied, 335 U.S. 858 (1948) (transfer of contractual right to receive percentage of royalties on Kodachrome process held an invalid assignment of income); Brown v. Commissioner, 40 B.T.A. 565 (1939), aff'd, 115 F.2d 337 (2d Cir. 1940) (assignment of income doctrine applies to section 351 transfer of interest in claim for legal services performed by transferor).

The evidence developed to date does not indicate that U.S. Corporation 1 transferred to U.S. Partnership any rights in Product. U.S. Corporation 1 apparently transferred only the licensing fees that it was entitled to receive, making this case distinguishable from Blair on the basis that no underlying property right was conveyed in conjunction with the transfer of the right to income from the property. Applying the rationale in Rostensies, we conclude that U.S. Corporation 1 made an ineffective assignment of income to U.S. Partnership. On its Calendar Year 1 tax return, U.S. Corporation 1 should report the $b of licensing-fee income assigned to U.S. Partnership. On its Calendar Year 2 tax return, U.S. Corporation 1 should report the $h of licensing-fee income assigned to U.S. Partnership.

Issue 3: Whether section 482 permits reallocation to U.S. Corporation 1 of licensing-fee income that it contributed to U.S. Partnership.

Again, assuming arguendo that the rights to licensing income that U.S. Corporation 1 purportedly contributed U.S. Partnership are property and that the contributions were subject to nonrecognition treatment under section 721, the resultant shift of licensing-fee income (i.e., $g in Calendar Year 1 and $m in Calendar Year 2) from U.S. Corporation 1 to S Corporation may give rise to an allocation of income under section 482.

Section 482 provides:

> In any case of two or more organizations, trades, or businesses . . . 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.

Under section 482, the term "evasion of taxes" is synonymous with "tax avoidance." Foster v. Commissioner, 80 T.C. 34, 157-158 (1983), aff'd in part, vacated in part, 756 F.2d 1430 (9th Cir. 1985).

The purpose of section 482 is "to prevent evasion [of taxes] (by the shifting of profits . . . and other methods frequently employed for the purpose of 'milking'), and in order to arrive at their true tax liability." S. Rep. No. 960, 70th Cong., 1st Sess. (1928), reprinted in 1939-1 (Part 2) C.B. 409, 426. Section 482 is not limited to cases of "improper accounting," or "fraudulent, colorable, or sham transaction[s]," but may also apply when inaccurate reflection of income is inadvertent or unintentional. See Treas. Reg.§ 1.482-1(f)(1).

The first requirement for applying section 482 is that the taxes or income of two "organizations, trades, or businesses" be involved. These terms are defined broadly in the regulations. Treas. Reg. § 1.482-1(i)(1) and (2). For example, section 482 can be applied to reallocate income from a partnership to a corporate partner of the partnership. See, e.g., Aladdin Industries, Inc. v. Commissioner, T.C. Memo. 1981-245. The fact pattern presented in this case meets the multiple "organizations, trades, or businesses" requirement of section 482.

The second requirement for applying section 482 to a transaction is that the transaction must involve entities that are "owned or controlled" by the same interests. As the first requirement, this control requirement is construed broadly. Treas. Reg. § 1.482-1(i)(4). Any kind of control, whether direct or indirect and whether or not legally enforceable, satisfies the control requirement. Id.

In this case, Individual owned 100% of the only two partners of U.S. Partnership. Those two partners, S Corporation and U.S. Corporation 1, held all managerial power within the partnership and all voting power. Control of the partnership by the domestic partners and ultimately by Individual, satisfies the "ownership and control" requirement of section 482. See also Charles Town, Inc. v. Commissioner, 372 F.2d 415, 419-20 (4th Cir. 1967), cert. denied, 389 U.S. 841 (1967) (management control of an entity, rather than legal ownership interests, may constitute "actual and effective control" under section 482).

Section 482 may apply to prevent the avoidance of taxes or clearly reflect income even where property is transferred in a nonrecognition event such as a section 721(a) transfer. For example, section 482 may allocate income and deductions arising from disposition of built-in-loss (and gain) property, acquired in a nonrecognition transaction, to the shareholder (or partner) that contributed it in the nonrecognition transaction. See Treas. Reg. § 1.482-1(f)(1)(iii) (1994). One case demonstrating use of section 482 in such a nonrecognition transaction is National Securities Corp. v. Commissioner, 137 F.2d 600 (3rd Cir. 1943), aff'g, 46 B.T.A. 562 (1942), cert. denied, 320 U.S. 794 (1943).

In National Securities, a parent corporation contributed the stock of an unrelated corporation, which had declined substantially in value from the time the parent corporation purchased the stock. Approximately 10 months after receiving the stock from its parent, the subsidiary sold the stock and claimed a substantial loss. The Service determined that the subsidiary was only entitled to the loss from the decline in value during the period it held the stock. The Service allocated the remaining loss to the parent under section 45 of the Internal Revenue Code of 1936 (the predecessor to section 482).

The Third Circuit agreed with the Service:

> Section 45 is directed to the correction of particular situations in which the strict application of the other provisions of [the Code] will result in a distortion of the income of affiliated organizations . . . . The parent made the investment in Standard stock in 1929 and held on to the stock as an investment until 1936 [when it was contributed to the capital of the subsidiary and sold 10 months later] . . . . It seems most reasonable to treat the loss as one which had in fact been sustained by the parent rather than by its subsidiary. The shifting of the loss to the subsidiary gives an artificial picture of its true taxable income and one which it was unnecessary for the Commissioner to accept.

137 F.2d at 602-03. The Tax Court has interpreted the National Securities line of authority to apply in instances where a tax avoidance purpose is present. Eli Lilly & Co. v. Commissioner, 84 T.C. 996, 1119 (1985), aff'd in part, rev'd in part, 856 F.2d 855 (7th Cir. 1988).

Numerous other cases follow the National Securities approach of allocating pre-contribution gain (or pre-distribution gain, before the repeal of the General Utilities doctrine) or loss to the transferor upon a subsequent disposition of contributed or distributed property. See, e.g., Ruddick Corp. v. United States, 643 F.2d 747 (Cl. Ct. 1981), on remand, 3 Cl. Ct. 61, 65 (1983), aff'd without opinion, 732 F.2d 168 (Fed. Cir. 1984); Northwestern Nat. Bank of Minneapolis v. United States, 556 F.2d 889, 892 (8th Cir. 1977), aff'g, 37 A.F.T.R.2d P76-1400 (D. Minn. 1976); Dolese v. Commissioner, 811 F.2d 543 (10th Cir. 1987), aff'g, 82 T.C. 830 (1984); Foster v. Commissioner, 80 T.C. 34, 160, 172-77 (1983), aff'd in relevant part, 756 F.2d 1430, 1433-4 (9th Cir. 1985), cert. denied, 474 U.S. 1055 (1986).

In Foster v. Commissioner, expenses incurred by a partnership to develop land for sale as residential property were used by the partners to reduce their individual income taxes. Then, “as the land was developed, certain lots were transferred from the Partnership to its controlled corporations, in an effort to shift income,” and “to split it among taxpayers subject to a lower rate of tax.” 756 F.2d at 1433. “[O]nly highly appreciated inventory pregnant with income was conveyed.” Id., citing 80 T.C. at 179. Under these circumstances, the Ninth Circuit held that the transfers had no business function and their purpose was tax avoidance. 756 F.2d at 1436.

As in Foster, the licensing-fee interests that U.S. Corporation 1 contributed to U.S. Partnership were "pregnant with income" -- income derived from the activities of U.S. Corporation 1, and subject to accurate determination as of the date of contribution. As in Foster, the purported contribution of these interests in a nonrecognition transaction does not preclude application of section 482.

Also, the fact that the distortion or shifting of income occurred over time, i.e., as the license payments were made and income flowed to the partners, is analogous to the facts in Foster. There, income allocated to the partnership that developed the land was recognized over time after the transfer of property, i.e., as the individual lots were sold by the transferee corporations. The Ninth Circuit held in Foster that, "[u]nder section 482, the Commissioner may allocate income earned subsequent to the income evading event or transfer. The fact that some of it is attributable to a time following the transfers makes no difference." 756 F.2d at 1436.

In Rooney v. Commissioner, 305 F.2d 681 (9th Cir. 1962), individuals contributed all the assets of their farming business, including a growing crop, to their newly-formed corporation, in a nonrecognition transaction under section 351. The individuals took deductions for crop-related expenses on their individual Federal income tax returns and reported income from sale of the crop on the tax return of the newly-formed corporation. The Ninth Circuit upheld the use of section 482 to allocate the crop-related expenses from the individuals to the corporation, to prevent the distortion of true taxable income and to clearly reflect taxpayer's income. Rooney, 305 F.2d at 685. Similarly, Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2nd Cir. 1952), cert. denied, 344 U.S. 874 (1952) dealt with the transfer of a crop that was about to be harvested. Although the transfer in that case was for valid business reasons not primarily related to tax savings, the Second Circuit upheld the section 482 allocation of the expenses related to the crop to the successor corporation, under the clear reflection of income standard.

In Eli Lilly, the Commissioner allocated to a U.S. corporation income attributable to intangibles that had been transferred in a nonrecognition transaction to the corporation's Puerto Rican subsidiary. The income subject to allocation was that earned by the subsidiary's use of the intangibles in the manufacture and sale of products in years after the transfer. In disallowing the allocation, the Tax Court contrasted Rooney and Central Cuba Sugar, where the transferor incurred the crop-related expenses and the transferee had only to sell the crop to realize income, 84 T.C. at 1124, with that in Eli Lilly, where "all expenses related to [the transferred intangibles] were recovered by [the transferor in a taxable year] prior to the transfer of the intangibles." Id. at 1124-25.

Even if Eli Lilly were properly interpreted as limiting the clear-reflection-of-income standard of section 482 to mismatching of income and expenses in a single taxable year, no similar argument can be made to limit the use of the tax-avoidance standard of section 482. The U.S. Court of Claims in Ruddick Corp. v. United States, 643 F.2d 747, 751 (Cl. Ct. 1981), on remand, 3 Cl. Ct. 61, 65 (1983), aff'd without op., 732 F.2d 168 (Fed. Cir. 1984), determined that, absent the "taint" of tax avoidance, section 482 would not apply to prevent a distortion of income that was “contemplated and authorized” by Congress in affording nonrecognition treatment to particular types of transactions. 643 F.2d at 752.

We conclude that the shifting of income from U.S. Corporation 1 to S Corporation, an entity under the common control of Individual, resulted in a distortion of income of a type not contemplated by Congress when it enacted section 721. The shifting of income and the resultant change in tax consequences confirm that tax-avoidance goals were predominant in this transaction. Based on the foregoing authorities, the Service may allocate income to U.S. Corporation 1, under the tax-evasion or clear-reflection-of-income principles of section 482.

Issue 4: Whether the licensing transactions at issue generated foreign trading gross receipts under section 924.

U.S. Partnership and Hybrid Entity propose to file amended U.S. partnership returns. Such returns, if timely, would, inter alia, give effect to: (1) deemed contributions by U.S. Corporation 1 to U.S. Partnership of amounts sufficient to pay FSC commissions with respect to licensing and sub-licensing of Product, and (2) special allocations by both U.S. Partnership and Hybrid Entity to U.S. Corporation 1 of the resulting FSC-commission deductions. These proposals presume that the licensing income meets the substantive and procedural requirements under the FSC provisions. As discussed below, it is not clear that these provisions are satisfied in this case.

The FSC provisions provide a partial exclusion for income attributable to “foreign trading gross receipts.” I.R.C. §§ 921(a), 923(a), 923(b). Subject to satisfaction of the foreign economic processes requirements, discussed below, foreign trading gross receipts generally include gross receipts received by a principal for whom a FSC acts as a commission agent on the sale, lease, exchange, or other disposition of export property (and services related and subsidiary to such sale). I.R.C. §§ 924(a)(1), 924 (a)(3)(A), 925(b)(1); Temp. Treas. Reg. § 1.924(a)-1T(a), (b).

The temporary Treasury regulations specifically address the situation where a contract or other right is assigned to another taxpayer that claims the FSC benefit:

> Foreign trading gross receipts of a FSC include gross receipts from the sale of export property by the FSC, or by any principal for whom the FSC acts as a commission agent (whether or not the principal is a related supplier), pursuant to the terms of a contract entered into with a purchaser by the FSC or by the principal at any time or by any other person and assigned to the FSC or the principal at any time prior to the shipment of the property to the purchaser.

Temp. Treas. Reg. § 1.924(a)-1T(b) (emphasis added). A similar provision also appears, almost verbatim, in the Treasury Regulations issued under the Domestic International Sales Corporation (DISC) regime that preceded the FSC regime. See

Treas. Reg. § 1.993-1(b). The Technical Memorandum prepared in connection with the DISC regulation stated that shipment date was adopted as a cut-off after careful consideration and over the objection of commentators, "because, without it, a DISC might be allocated income only as an afterthought after a transaction occurred." 1977 TM LEXIS 65 (T.D. 7514) (June 10, 1975).

Thus, where a FSC or its principal receives income as the assignee of a contract or as the transferee of contractual rights, the receipts constitute FTGR only if the assignment or transfer took place prior to the shipment of the export property and if, at that time, an agreement was in place between the assignee or transferee of such contract and the FSC, providing that the FSC would act as a commission agent of the assignee or transferor for such transaction. In the present case, we understand (but you should confirm) that most or all shipments of Product to end-users had occurred before the transfers to U.S. Partnership of Licensing Fee Interest 1 and Licensing Fee Interest 2 took place. Also, no evidence indicates that a commission arrangement existed between U.S. Partnership and FSC1 (or between Hybrid Entity and FSC1) for transactions that occurred during the taxable years at issue. Consequently, the taxpayer-initiated re-allocation in this case appears to result from an ex post facto reconstruction of transactions that had already taken place in another form.

The transactions must also satisfy the remaining requirements of the FSC provisions, including the foreign economic processes requirements. Section 924(b)(1)(B) provides that "a FSC has foreign trading gross receipts from any transaction only if economic processes with respect to such transaction take place outside the United States as required by subsection (d)."

Section 924(d)(1)(A) requires the FSC "or any person acting under a contract with" the FSC to participate in the solicitation (other than advertising), negotiation or making of the sales contract. Treas. Reg. § 1.924(d)-1(c)(4) defines the "making of a contract" as performing any of the elements necessary to complete a sale, such as offer or acceptance. Making of a contract includes written confirmation by the FSC to the customer of an oral or written agreement that confirms variable contract terms, such as price, credit terms, quantity, or time or manner of delivery, or that specifies (directly or by cross-reference) additional contract terms. Id.

Sections 924(d)(1)(B) and 924(d)(2) state that FSC must incur outside the United States a minimum percentage of direct costs attributable to the activities enumerated in section 924(e). In determining whether the FSC meets these percentage-of-direct-cost tests, a FSC itself is considered itself to perform activities that are performed by "any person acting under a contract with such FSC." I.R.C. § 924(d)(3)(A). Thus, the issue is whether FSC1 or a person acting on its behalf performed the foreign economic processes in the manner prescribed. These facts need to be further developed.

Issue 5: Whether U.S. Partnership and Hybrid Entity may file amended U.S. Partnership Returns of Income (Forms 1065) and/or Requests for Administrative Adjustment (Forms 8082), to reflect special allocations of FSC-commission deductions.

As stated above, whether the deemed funding of FSC commissions and the special allocations of FSC-commission deductions achieve their intended results depends on whether the underlying transactions satisfy the requirements for FSC benefits. In this section, we assume arguendo that these requirements are satisfied, and consider whether amended partnership returns or requests for administrative adjustment may now be filed to achieve these results. Whether such documents may be filed depends on whether the partnership item in question, i.e., the FSC-commission deduction, is subject to TEFRA.[5] As a related matter, whether such adjustments may be claimed on an amended FSC return depends, in part, upon whether the related suppliers, i.e., U.S. Partnership and Hybrid Entity, may amend their respective returns, or otherwise claim adjustments to income. See Temp. Treas. Reg. § 1.925(a)-1T(e)(4) (statute of limitations for refunds must be open for both the FSC and its related supplier at the time of a FSC “redetermination” initiated by taxpayer).

Before turning to the TEFRA provisions, we briefly review the provisions governing calculation of FSC commissions. Section 925(a), which is in subtitle A, provides that in the case of a sale of export property to a FSC by a person described in section 482, the taxable income of the FSC and such person are based on the relevant transfer price. Section 925(a) refers to "sale[s] of export property to a FSC," (emphasis supplied), because it is drafted in terms of a "buy-sell" FSC, which takes title to the merchandise and re-sells it to an unrelated purchaser. Section 925(b)(1) provides that the Secretary shall prescribe regulations setting forth "rules that are consistent with the rules set forth in subsection (a) for the application of this section in the case of commissions, rentals, and other income " (emphasis added). The regulations under this section are in Temp. Treas. Reg. § 1.925(a)-1T(d)(2). Thus, the FSC rules apply to commission FSCs, such as FSC1 in this case.

When a FSC acts on a commission basis, Temp. Treas. Reg. § 1.925(a)-1T(d)(2) governs the transfer price, i.e., the commission, that may be paid to the FSC and deducted by the related supplier. Temp. Treas. Reg. § 1.927(d)-2T(a) defines “related supplier” to include a “related party” that uses the FSC as a commission agent in the disposition (including a lease) of any property or services producing foreign trading gross receipts. "Related party" is defined in Temp. Treas. Reg. § 1.927(d)-2T(b) as a person owned or controlled directly or indirectly by the same interests as the FSC within the meaning of section 482 and Treas. Reg. § 1.482-1(a).

A partnership is a “person” for purposes of the Internal Revenue Code, including the FSC related-party definition above. See I.R.C. § 7701(a)(1) (term “person” includes

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[5] U.S. Corporation 1 claims that U.S. Partnership and Hybrid Entity are not subject to TEFRA because they had no U.S.-source income. Because both entities actually filed U.S. Partnership tax returns (Forms 1065), both are subject to TEFRA, regardless of the source(s) from which they derived income. See I.R.C. § 6233; Temp. Treas. Reg. § 301.6233-1T.

partnerships). Furthermore, a partnership is an organization, trade or business within the meaning of section 482.

Section 6221 states that "partnership items" must be determined under TEFRA procedures. Partnership items are items required to be taken into account for the partnership's taxable year under Subtitle A, to the extent provided by regulations. I.R.C. § 6231(a)(3). These regulations state that the amount, character, and allocation of partnership income and deductions are partnership items. Treas. Reg. § 301.6231(a)(3)-1(a)(1)(i) (income and deduction) and -1(b)(characterization of item). Cf. Treas. Reg. § 301.6231(a)(3)-1(c)(3)(i) (character of amount distributed to a partner is a partnership item).

The items enumerated above are partnership items if the provisions of subtitle A of the Code require the partnership to make this determination. As a general matter, I.R.C. § 703, Treas. Reg. § 1.703-1(a)(1), and I.R.C. § 702(a)(8) (all provisions under subtitle A of the Code) require a partnership to state separately on its return those items which the partner is required to take into account separately in determining the partner's income tax. The FSC provisions of subtitle A, above, provide for the computation of the licensing income and FSC commissions by U.S. Partnership. Assuming that U.S. Partnership is required to take these items into account under subtitle A, and that they are therefore items of income and deduction of U.S. Partnership, because U.S. Partnership was entitled to the income (under the form of transaction reported by the taxpayer), the items are "partnership items," as defined in Treas. Reg. § 301.6231(a)(3)-1(a)(1). Section 702(b) provides that, for these purposes, the character of a partner's distributive share of such items shall be determined as if the item were realized directly from the source realized by the partnership.

When "tiered" TEFRA partnerships are present, the character of an item is determined in a TEFRA proceeding for the "source" partnership in which the item originated. Sente Investment Club v. Commissioner, 95 T.C. 243 (1990). In this case, because Hybrid Entity generated the licensing income, any redetermination of the character of that income would occur in a TEFRA proceeding (or via request for administrative adjustment) with respect to Hybrid Entity.[6] Because the allocation of income between S Corporation and U.S. Corporation 1 as well as the FSC-commission deductions arose within U.S. Partnership, any redetermination of these items would take place in a separate TEFRA proceeding (or through a request for administrative adjustment) relating to U.S. Partnership. Nothing in the relevant Code provisions or attendant regulations would appear to prohibit such determinations in the context of a TEFRA proceeding.[7]

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[6] U.S. Partnership and Hybrid Entity generated distinct portions of the total licensing income. Thus, U.S. Partnership is a "source" partnership for the fees that it separately earned.

[7] Several Code sections in subtitle A prevent an item from being determined at the partnership level. See, e.g., I.R.C. § 108(d)(6) (insolvency exception to

If any further limitation affects the deduction of FSC commissions at the partner level, then those commissions would constitute an "affected item." An item is an "affected item" under I.R.C. § 6231(a)(5) to the extent that it is affected by a partnership item. Affected items that generally require determinations at the partner level include a partner's amount at risk, the partner's basis in the partnership interest, application of the passive loss rules, insolvency for purposes of determining cancellation of debt income, and additions to tax.

Where affected items consist of partner-level determinations that the partnership is not required to make under Subtitle A, these items are not included in a notice of final partnership administrative adjustment ("FPAA") or a partnership-level Request for Administrative Adjustment ("RAA"), but are instead contained in an affected item statutory notice of deficiency or partner-lever refund request. Such affected item determinations may not be made until the completion of the partnership proceeding. G.A.F. v. Commissioner, 114 T.C. 519, 528 (2000). Partnership items determined in a TEFRA partnership proceeding are res judicata in a proceeding that arises from an associated, affected-item notice of deficiency. Dial USA v. Commissioner, 95 T.C. 1 (1990).

Based on the above analysis, we conclude that the licensing income and the related FSC-commission deductions in this case constitute partnership items, subject to TEFRA audit and litigation procedures. U.S. Partnership and Hybrid Entity, as TEFRA entities, are required to compute the amount and character of licensing-fee income and the related deductions for commissions on these licensing fees paid to FSC1. Thus, these items may be adjusted through issuance of an FPAA by the Service, or by the timely filing of an RAA, assuming the period for assessment under I.R.C. § 6229 and the period for the partnership to file an RAA under I.R.C. § 6227, respectively, remain open. Section 6227 provides that partnerships subject to TEFRA procedures may file RAAs if they do so within three years of the date the partnership returns were filed or within an extension of this period under I.R.C. § 6229. If, as we understand, no such extensions were filed in this case by either U.S. Partnership or Hybrid Entity, then any RAAs would be untimely under I.R.C. § 6227.

We also note that FSC1's amended returns, which claimed changes to the administrative pricing method used on timely-filed returns, are valid only if the statute of limitations remains open for the affected related suppliers, i.e., Hybrid Entity and U.S. Partnership. See Temp. Treas. Reg. § 1.925(a)-1T(e)(4). See also Union Carbide Corp. v. Commissioner, 110 T.C. 375 (1998).

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cancellation-of-debt income determined at partner level); I.R.C. § 613A(c)(7)(D) (although initial basis in depletable property is determined at the partnership level, depletion deduction and resultant adjustment to a partner's share of basis computed at partner level); I.R.C. §§ 465 and 469 (loss-limitation rule applies to C corporations and individuals; by negative implication excludes partnerships). These provisions are not relevant here.

Issue 6: Whether special allocations by U.S. Partnership of FSC-commission deductions have substantial economic effect under section 704(b).

Because we understand that no amended partnership returns or RAAs have been filed, and because such returns or RAAs would now be untimely, we do not reach this issue.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

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

If you have any additional questions, please contact Branch 6 at (202) 874-1490.

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