IRS views collaboration agreement as partnership, with Section 199 deduction determined at partner level

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In brief

In a recently released Chief Counsel Advice 201323015 (the CCA), the IRS National Office concluded that a written collaboration agreement constituted a partnership for all federal income tax purposes and could not elect to be excluded from the application of subchapter K of the Code. As a result, both parties to the collaboration agreement must determine their respective Section 199 deductions at the partner level under Section 199(d)(1)(A). Taxpayers that enter into a collaboration agreement should consider the potential impact of this CCA not only on their Section 199 deductions but also in determining all of the collaboration's federal income taxation and filing requirements.

In detail

According to the CCA, two corporations (A and B) entered into a written collaboration agreement (Agreement) relating to development and commercialization of a product (Product). Under the arrangement between the two entities, A granted rights to B to co-promote Product in the United States and Canada and to develop and market it in the rest of the world.

Under the Agreement, A and B agreed to collaborate diligently in the development of Product and to use commercially reasonable and diligent efforts to develop and bring Product to market. Each party also agreed to collaborate in the commercialization of Product, with B playing the primary role. The Agreement established committees -- comprising representatives appointed in equal numbers by A and B -- to handle the management and finances of the arrangement (referred to as C in the CCA), as well as the development and commercialization of Product.

The parties charged all development costs incurred for development or marketing in the United States or Canada against the operating profits of the collaboration. A and B shared in the collaboration's profits and losses based on percentages specified in the Agreement.

Although the Agreement does not state whether the collaboration should be treated as a partnership for federal income tax purposes, side agreements included provisions that indicate the intent of A and B 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, the CCA states that A instead was claiming that the amounts from B should be included in A's calculation of qualified production activities income (QPAI) under Section 199(c)(1). In addition, A had not received information from C that allowed A to calculate its Section 199 deduction separately.

The IRS National Office was asked to determine (1) whether

the collaboration was a partnership, (2) whether the collaboration was eligible to be excluded from application of Subchapter K under Section 761(a) and Reg. sec. 1.761-2, and (3) how Corporation A could claim the Section 199 deduction with respect to the gross receipts from sales of Product by a collaboration that is treated as a partnership.

Collaboration seen as partnership

The Code and regulations set forth only brief definitions of the terms partner and partnership (see Sections 761(a) and 7701(a)(2), and Reg. secs. 1.761-1, 301.7701-1, and 301.7701-2). Interpreting these definitions, the courts have created an intent-based system to determine if a partnership exists for federal income tax purposes. The determination of whether a collaboration agreement rises to the level of a partnership often hinges on a facts-and-circumstances test.

In *Commissioner v. Culbertson*, 337 U.S. 733 (1949), the Supreme Court held that there are four elements of a partnership for federal income tax purposes:

- an intent to join together for the purposes of carrying on an enterprise;
- sharing of profits and/or losses from the enterprise;
- joint contribution of capital or services to the enterprise; and
- joint management and control over the enterprise.

Since *Culbertson* was decided, the intent of the parties jointly to own and operate a profit-making entity has been considered the key factor in determining whether a partnership exists for federal income tax purposes. Courts have relied on numerous objective factors in analyzing whether the requisite intent to create a partnership exists.

The Tax Court in *Luna v. Commissioner*, 42 T.C. 1067 (1964), elaborated and expanded on the Supreme Court's four-factor test, listing eight factors, no one of which is deemed conclusive, that it considered relevant in determining whether an intent to establish a partnership exists:

- the agreement of the parties and their conduct in executing its terms;
- the contributions, if any, which each party made to the venture;
- the parties' control over income and capital and the right of each to make withdrawals;
- whether each party was a principal and co-proprietor, 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;
- whether business was conducted in the joint names of the parties;
- whether the parties filed US Federal partnership returns or otherwise represented to the IRS or to persons with whom they dealt that they were joint venturers;
- whether separate books of account were maintained for the venture; and
- whether the parties exercised mutual control over, and assumed mutual responsibilities for, the enterprise.

The IRS has followed these factors. *See*, *e.g.*, FSA 200146025.

In weighing the *Culbertson* and *Luna* factors, the IRS concluded in the recent CCA that the collaboration constitutes a joint venture treated as a partnership for federal income tax purposes.

Observations: Collaboration agreements are flexible arrangements under which the parties agree to share some or all of the costs of researching, developing, commercializing, and marketing one or more products for each party's separate benefit. For federal income tax purposes, depending on how the collaboration agreement is drafted and implemented by the parties, the arrangement may be viewed either as one in which the parties conduct a single business for their common profit as co-proprietors (i.e., as partners) or as separate businesses conducted for the each party's individual profits as a sole proprietor (i.e., merely sharing expenses).

While the IRS concluded in the CCA that the collaboration constitutes a partnership for federal income tax purposes, the facts of the CCA state that neither a Form 1065, nor any other tax return, was filed. The failure to file a return if a partnership exists may create exposure in two ways.

First, the partnership is subject to a failure-to-file penalty under Section 6698. That penalty, which would be applicable for each partnership tax year, is $195 times the number of partners in the partnership during the tax year for each month that the delinquency continues up to a maximum of 12 months unless the taxpayer establishes that the failure was due to reasonable cause.

Second, in the case of a partnership subject to the Unified Audit Proceedings of Sections 6221-6234

(TEFRA), pursuant to Section 6229 the period of limitations for assessing any income tax attributable to a partnership item, or an affected item, does not begin to run because the partnership return was not filed. This means each partner's period of limitations with respect to such items remains open and the IRS may assess additional tax at any time.

Section 761(a) exclusion held not available

Section 761(a) provides that under regulations the IRS, at the election of all the members of the unincorporated organization, may exclude such organization from the application of all or part of Subchapter K. If the organization 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, then the income of the members may be adequately determined without the computation of partnership taxable income.

Generally, Section 199(d) provides that with respect to partnerships Section 199 will be applied at the partner or shareholder level rather than at the partnership level. As a result, each partner takes into account its allocable share of items necessary to compute the Section 199 deduction. (Generally, Sections 702 and 704 provide rules to determine a partner's share of partnership items of income, gain, loss, deduction, and other items necessary to compute the partner's income tax liability.) This is true regardless of whether the partnership has elected under Section 761(a) to be excluded, in whole or in part, from the application of subchapter K (Reg. sec. 1.199-5(b)(5)).

Based on the facts in the CCA, the IRS concluded that the Agreement did not qualify to be excluded from Subchapter K.

Observation: The regulations under Section 199 state that for purposes of applying Section 199 to partnerships, the Section 199 partnership rules apply to all partnerships, including those partnerships electing under Section 761(a) to be excluded, in whole or in part, from the application of Subchapter K. Thus, the same Section 199 analysis applies to an activity regardless of whether an election out of Subchapter K is made.

Computation of section 199 deduction explained

The IRS concluded that it would be necessary to determine A's allocable share of partnership items under Section 199(d)(1)(A)(ii) and Regs. sec. 1.199-5(b)(1) and (3) before A could claim the Section 199 deduction. In accordance with Sections 702 and 704, A must determine its share of partnership items (including income, gain, loss, and deduction), cost of goods sold related to such income items, and gross receipts that are included in such income items.

Then, A must aggregate its distributive share of such items with those items it incurs outside the collaboration (whether directly or indirectly) for purposes of allocating and apportioning deductions to domestic production gross receipts (DPGR) and computing its QPAI. Consistent with Reg. sec. 1.199-5(b)(3), A's share of the wages of the collaboration for purposes of determining its wage limitation under Section 199(b)(1) equals A's allocable share of those wages.

Observation: Because the Section 199 deduction must be determined at the partner level, A would need to know its share of income, deductions, cost of goods sold, and gross receipts related to the Product before calculating its Section 199 deduction. In rejecting A's argument that the amounts received from B should be included in its QPAI, the IRS concluded that A did not have sufficient information to calculate its Section 199 deduction.

Other issues

Taxpayers should consider the state income tax consequences of entering into a collaboration agreement and whether it would be considered a partnership. For state income tax purposes, most states follow the federal treatment of a partnership as found in Subchapter K. Accordingly, if a collaboration agreement results in a partnership for federal income tax purposes, then the agreement likely will be deemed to result in a partnership for state income tax purposes.

If the collaboration agreement is treated as a partnership for state income tax purposes, some states will examine whether the partnership is 'unitary' with its corporate partners. Corporate partners must flow through the income and apportionment factors from unitary partnerships and apportion the income at the corporate partner's level. If the entity is not unitary, the sourcing is determined at the partnership level. Under these rules, sourcing of income from these activities could be affected if the collaboration agreement is considered a partnership for state income tax purposes. Taxpayers also should be aware that while most states follow the federal income tax flow-through nature of a partnership, states that do not follow such federal treatment – such as Texas – instead may subject a partnership to a tax at the entity level.

Taxpayers also must analyze each state's tax rules to determine if it adopts the federal Section 199 deduction. Currently, approximately half of the states either completely or partially 'decouple' from Section 199. Consequently, if a taxpayer qualifies for the Section 199 deduction for federal income tax purposes, then in states that fully decouple from the

Section 199 deduction, the Section 199 deduction must be added back when calculating state taxable income. This is true whether the expenses attributable to the qualifying deductible activities are flowing through a partnership to a corporate partner or whether they were undertaken by the corporate taxpayer itself.

The takeaway

The analysis and arguments set forth in the CCA in determining whether a collaboration agreement is a federal income tax partnership appear consistent with prior tax cases and rulings. Because the determination of whether a collaboration agreement is a federal income tax partnership is based on all relevant facts and circumstances, the analysis and conclusions reached in the CCA may not apply to all collaboration agreements. Accordingly, collaborators should assess carefully their specific facts in determining whether partnership reporting is appropriate and the resulting impact on their Section 199 deductions and other federal income tax determinations.

Let's talk

For a deeper discussion, please contact:

George Manousos
(202) 414-4317
george.manousos@us.pwc.com

Brian Meighan
(202) 414-1790
brian.meighan@us.pwc.com

Denise Dockrey
(202) 346-5097
denise.s.dockrey@us.pwc.com

Colleen Green
(202) 414-1382
colleen.m.green@us.pwc.com

Nadine Holovach
(202) 346-5273
nadine.a.holovach@us.pwc.com