

Internal Revenue Service (IRS) Office of Chief Counsel Treated Collaboration Arrangement as Partnership

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In a newly released Chief Counsel Advice, the Internal Revenue Service (IRS) Office of Chief Counsel treated a collaboration arrangement relating to the development and commercialization of a drug as a deemed partnership for U.S. federal tax purposes. The IRS Office of Chief Counsel also concluded that if the deemed partnership is treated as producing the drug in the United States, the partner may claim the Section 199 domestic production activities deduction with respect to the gross receipts derived by the deemed partnership from the sale of the drug based on its allocable share of the partnership items. A Chief Counsel Advice is not precedential with regard to taxpayers other than the subject of the Chief Counsel Advice, but it does give an indication of IRS thinking.

On June 7, 2013, the Internal Revenue Service Office of Chief Counsel (OCC) issued Chief Counsel Advice 201323015, treating an existing collaboration arrangement between two U.S. companies relating to the development and commercialization of a drug as a partnership for U.S. federal tax purposes, notwithstanding the fact that the

parties had never filed a partnership tax return or otherwise indicated an intent to form a tax partnership. Having concluded that the collaboration arrangement gave rise to a tax partnership, the OCC then concluded that, assuming that the partnership manufactures the drug in whole or in substantial part within the United States, one of the partners was eligible to claim the domestic production activities deduction under Section 199 of the Internal Revenue Code of 1986, as amended (the Code), calculated based on its allocable share of the deemed partnership items.

The Facts

Two U.S. companies (A and B) entered into a written collaboration agreement (the Agreement). A developed the enzyme that serves as the basis for the active ingredient of the drug and the working cell banks that are critical to the large-scale commercial production of the drug. A was also responsible for all clinical trials, scale-up, validation, obtaining U.S. Food and Drug Administration (FDA) approval and the manufacture of the drug during the early years of the collaboration. After A and B entered into the Agreement, A transferred to B a re-amplified drug-producing cell line and licensed to B the technology for B to scale up the drug production process with the re-amplified cell line. B, at its own expense, worked on the scale-up of the re-amplified cell line for commercial production of the drug. The parties charged all costs incurred for development or marketing of the drug against the operating profits of the collaboration.

Under the Agreement, the parties agreed to collaborate in the development and commercialization of the drug in the United States and Canada (collectively, the Territory). The Agreement provides for four committees: management, development, commercialization and finance. Each committee comprised representatives appointed in equal numbers by A and B. The parties charged all development costs incurred for development or marketing in the Territory against the operating profits of the collaboration.

Profits and losses from the collaboration in the Territory are shared by A and B. Specifically, following receipt of regulatory approval in the United States, A and B share profits and losses in a 30-70 ratio until operating profits reach a certain threshold. Thereafter, A and B share profits and losses in a 40-60 ratio. Operating losses are borne 30 percent by A and 70 percent by B.

A and B separately maintain records that are relevant to costs, expenses, sales and payments. Each quarter, A submits its records to B for B to calculate the collaboration's profits and losses, and B pays A for its allocable share of profits and losses. A initially treated amounts received from B as royalty payments, but subsequently claimed that the amounts received from B qualified as production activity income.

A and B did not file a Form 1065, U.S. Return of Partnership Income, for the collaboration arrangement for any taxable year, nor did A and B file a written election under Section 761(a) to elect out of subchapter K of the Code. The Agreement is silent with respect to the parties' intended treatment for tax purposes. However, each of two side agreements between A and B included a provision expressing the parties' intent not to treat their arrangement as a

partnership, agency, employer-employee or joint venture.

The OCC Analysis

The collaboration arrangement is a partnership for U.S. federal tax purposes.

The OCC concluded that the collaboration arrangement between A and B gave rise to a partnership for U.S. federal income tax purposes. In reaching its conclusion, the OCC first reasoned that the arrangement was eligible to be classified as a partnership because (1) it was not a corporation; (2) it had two members; and (3) the two members did not join together merely to share expenses, but instead to make a profit from selling the drug. The OCC acknowledged that the parties had not filed Forms 1065 for the collaboration in any of the preceding years and that the side agreements indicated their intent that the collaboration not be treated as a partnership. Nonetheless, the OCC concluded otherwise. In its analysis, the OCC focused on the principles articulated by the Supreme Court of the United States in *Commissioner v. Culbertson*, 337 U.S. 733 (1949), and by the U.S. Tax Court in *Luna v. Commissioner*, 42 T.C. 1067 (1964).

The focus under the *Culbertson* doctrine is whether the parties in good faith and acting with a business purpose intend to join together in the present conduct of a business. The *Luna* court constructed an eight factor framework for this analysis. Applying this analytical framework to the collaboration, the OCC concluded that the majority of the eight factors supported characterization of the arrangement as a partnership:

First, the parties entered into a written agreement and have consistently complied with its terms.

Second, both parties contributed cash and services to the venture. A developed the technology and obtained the FDA approval; B contributed to the further development, marketing and sale of the drug.

Third, the parties shared in the profits and losses of their operation.

Fourth, both parties maintained records of their respective revenues and expenses, and B calculated the collaboration's profits and losses based on the aggregate amounts.

Fifth, the parties exercised mutual control and assumed mutual responsibilities for the enterprise.

The OCC noted that the parties' failure to file a partnership return was a factor weighing against the treatment of the collaboration as a partnership. The OCC also recognized that two of the factors considered in *Luna*—the parties' control over income and capital and the right of each to make withdrawals, and whether business was conducted in the joint names of the parties—were neutral. Considering the factors together and applying the doctrine articulated by the *Culbertson* court, the OCC reasoned that the relationship between A and B clearly evinced an intent to join together in the present conduct of an enterprise through the sharing of net profits and losses from the manufacture, development and marketing of the drug.

Accordingly, the OCC concluded that the collaboration is a partnership for federal tax purposes.

The OCC also concluded that the deemed partnership was not eligible to elect out of application of the partnership rules. The election out rules have limited application and the collaboration arrangement did not meet the requirements.

The partner may claim Section 199 deduction with respect to its allocable share of partnership items.

Characterization of the collaboration as a partnership has collateral consequences to the partners with respect to the deduction for domestic production activities under Section 199. Although A had been treating the amounts paid to it by B as royalty payments, it now claimed that those amounts should be included in its calculation of qualified production activities income (QPAI) for purposes of determining its Section 199 deduction.

The Section 199 deduction for qualified production activities of a partnership is determined at the partner rather than the partnership level. Each partner is allocated its share of partnership items (including items of income, gain, loss, deduction), cost of goods sold allocated to such items and gross receipts that are included in such items of income. Each partner then aggregates its share of these items with those items it incurs outside the partnership so that it may allocate and apportion deductions to its domestic production gross receipts and compute its QPAI.

In the Chief Counsel Advice, the OCC did not reference the rule under Treas. Reg. § 1.199-5(g), providing that the qualified production activities conducted by a partner generally are not attributable to the partnership. The Chief Counsel Advice also did not state what the deemed partnership was deemed to own or what activity the deemed partnership was deemed to undertake. Instead, the OCC assumed without discussion that the deemed partnership produced the drug in whole or in significant part within the United States. Based on this assumption, the OCC concluded that A must determine its allocable share of partnership items to calculate its Section 199 deduction.

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