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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, AREA 1
CC:SB:1:HAR

FROM: Elizabeth U. Karzon
Branch Chief
CC:INTL:BR1

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated December 18, 2000. In accordance with I.R.C. § 6110(k)(3). This Chief Counsel Advice should not to be cited as precedent.

LEGEND

A =

Corporation B =
Corporation C =

Corporation D =
Corporation E =
Corporation F =
Country G =
Country H =

TL-N-467-00

Country I	=
k	=
m	=
$n	=
$o	=
$p	=
$q	=
$r	=
$s	=
$t	=
$u	=
$v	=
w%	=
x%	=
y%	=
z%	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=
Date 14	=
Date 15	=
Date 16	=
Date 17	=
Date 18	=
Date 19	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=

ISSUES

1. Whether A properly abandoned his status as a lawful permanent resident of the United States on Date 13 before receiving the $s and $v payments in Year 4?

2. Whether the section 83(b) election purportedly made by A on Date 3 was valid, and if so, whether the $s and $v payments received by A on Dates 14 and 15, respectively, should be treated as compensation?

3. Whether A is subject to tax upon the receipt of the $s and $v payments in Year 4 under sections 864(c)(6) and 871(b), as deferred payments attributable to the sale or exchange of property or the performance of services in a prior taxable year while a resident of the United States?

4. Whether the organization formed by A and Corporation B should be characterized as a partnership or joint venture, rather than as a corporation, for U.S. tax purposes? If so, whether A's receipt of the $s and $v payments should be recharacterized as a distribution of profits from that partnership, with the result that such amounts may be taxed under section 871(b)?

CONCLUSIONS

1. A appears to have properly abandoned his status as a lawful permanent resident of the United States upon exiting the United States on Date 13. However, this fact should be determined with certainty. His residency termination date is the last day of Year 3, unless A establishes that, for the remainder of the calendar year, his tax home was in Country I and he maintained a closer connection to Country I than to the United States. Treas. Reg. § 301.7701(b)-4(b)(2).

2. Assuming the election under section 83(b) was actually filed as claimed, it appears to be valid. Nonetheless, the exact date of the transfer of property under section 83(a) is in question. It was either on Date 3 or Date 7. The fact that the election may have occurred prior to the date of transfer should not invalidate the election. However, if the taxable year of the transfer for which the election is made is other than Year 1, the amount required to be included in such other year as compensation should be adjusted accordingly. Further, the $s amount paid to A in Year 4 with respect to his stock in Corporation E that is not compensation income should be reduced by any additional amount treated as compensation.

3. A is not subject to tax under sections 864(c)(6) and 871(b) in Year 4 on the portion of the $s payment treated as non-compensation by reason of his section 83(b) election because the payment was received in the same taxable year as the sale or exchange of A's holdings in Corporation E. If the

$v payment is part of a settlement agreement in consideration of a lower amount received upon the exercise of the put and call options, it may be treated as non-compensation by reason of the section 83(b) election as well. However, A may be subject to tax on the receipt of the $v payment in Year 4 under sections 864(c)(6) and 871(b) if the payment is treated as additional compensation.

4. We do not believe, based on the facts as developed, that the organization formed between A and Corporation B should be characterized as a partnership for U.S. tax purposes. Therefore, we also do not believe that the sale of the stock should be recharacterized as a distribution of profits from a partnership.

FACTS

A, a citizen of Country G, and Corporation B, a company organized under the laws of Country G, executed a letter of understanding on Date 1 (“Date 1 letter”). The Date 1 letter provided the following terms:

1. A and his family would relocate from Country G to the United States for at least 5 years.
2. A and Corporation B would form a new company in which A would invest $r in exchange for a x% interest. Corporation B would own the remaining y% in the new company.
3. The purpose of the new company would be to acquire new businesses in the United States.
4. There would be put and call options for Corporation B to acquire A’s interest between fixed dates to be agreed upon in the future. A would be entitled to x% of the value of the company.
5. A’s interest in the new company would be valued by mutually agreed upon independent advisors who would value the entire company on the basis of public flotation.
6. A and Corporation B would work together to establish a tax effective structure for the venture.

A emigrated to the United States on Date 2. He lived in the United States as a lawful permanent resident alien, and appears to have worked for Corporation C, a U.S. subsidiary of Corporation B, from Date 2 through Date 13. During this time, A investigated various business opportunities for Corporation B, and assisted in purchasing several large companies, including Corporation D, on Date 3, for $p. Two other significant acquisitions were completed in later years for $o and $n.

On Date 4, A and Corporation B entered into a Subscription Agreement. The Subscription Agreement referenced the intentions of A and Corporation B that were originally set forth in the Date 1 letter. It further provided that Corporation B was going to form Corporation E in Country H, with y% “A” shares and x% “B” shares. The “B” shares were to have restricted rights. All shares were to be worth the same value, regardless of whether they were “A” or “B” shares. In addition, the Subscription Agreement provided that Corporation B would acquire Corporation C, and Corporation B’s shares of Corporation C would be contributed to Corporation E.

The terms of the Subscription Agreement indicated that, upon the incorporation of Corporation E, A would contribute $r in exchange for m “B” shares of Corporation E, with a par value of $q. Corporation B would receive k “A” shares for its contribution of its shares in Corporation C. At the time the Subscription Agreement was entered into, Corporation C wholly owned Corporation D, which was valued at $p.

Also on Date 4, A and Corporation B entered into an Option Agreement, which granted a call option to Corporation B and a put option to A. As a result, after certain events occurred, and certain amounts of time passed, Corporation B attained the right to purchase all of A’s “B” shares, and A attained the right to require Corporation B to purchase all of its “B” shares. The period within which the call and put options could be exercised began on the date of the Relevant Event, and ended 90 days later. The Relevant Event was defined as the earliest of:

1. A failing to take up full time employment with Corporation B or any of its subsidiaries or affiliated companies (“Corporation B group”) within 3 months after the subscription of the “B” shares.
2. A ceasing to be employed by the Corporation B group.
3. The holders of either the “A” shares or the “B” shares giving written notice to Corporation B between Date 11 and Date 19.

The Option Agreement further provided that if A did not take up full time employment with the Corporation B group, or he was terminated for cause, or he resigned before Date 9, he would receive par value for his “B” shares, which was $q. However, if A was employed with the Corporation B group after Date 9, he would receive fair value for his “B” shares, which was to be defined as an amount equal to the Relevant Percentage of the aggregate sum that could have been realized by the shareholders of Corporation E as a result of a public offering of all the shares of Corporation E on the New York Stock Exchange. The Relevant Percentage was defined as the percentage which the shares represented in terms of nominal value, of the total issued equity share capital of Corporation E on the date of the Relevant Event.

A’s interest in the “B” shares were restricted under the Subscription Agreement and the Option Agreement. A could not transfer, pledge, encumber, or dispose of his

“B” shares without approval from Corporation B. Additionally, he was required to grant Corporation B all voting rights in the “B” shares.

Also on Date 4, A and Corporation B entered into a Side Agreement, in which A agreed to permit Corporation B to alter the capital structure of Corporation E at any time, so long as A’s financial entitlement in Corporation E remained the same.

On Date 5, A and Corporation B entered into a Supplemental Agreement, which indicated that Corporation B may employ additional executives to assist A in administering the U.S. operations. The Supplemental Agreement further provided that such executives may be offered “B” shares of Corporation E as part of an incentive package. A agreed to this, provided that A’s financial entitlement was not reduced.

Corporation B incorporated Corporation E on Date 6, several months after Corporation D was acquired. Corporation B contributed a nominal value of shares of Corporation C, two long term notes of Corporation C to Corporation B worth $t each, and one long term note of Corporation C to Corporation B worth $u in exchange for k “A” shares. This amount represents Corporation B’s y% of Corporation E. A subscribed to m “B” shares at this time. The subscription price of $r was paid on Date 7 through bearer nominees, representing A’s x% of Corporation E.

On Date 8, Corporation B effected a recapitalization of Corporation E, and transferred all of its shares to Corporation F, one of Corporation B’s subsidiaries in Country H. After the recapitalization, Corporation F owned approximately z% of Corporation E, and A owned almost w% of the “B” shares. As a result, Corporation F was able to file a consolidated return with Corporation E.

A filed a Year 1 income tax return in the United States, for the period from Date 2 through the end of Year 1. The return reflected no wages or income from Corporation B or any of its subsidiaries. It only indicated income from passive activities. A reportedly attached an election under section 83(b) to his return, for the purpose of including the excess of the fair market value of his m “B” shares in Corporation E over the cost basis as compensation in Year 1. However, the election indicates that the fair market value equaled the cost basis of $r, resulting in no compensation to report.

On Date 12, A and Corporation B amended the Option Agreement to change the manner in which the fair value of A’s “B” shares was to be measured, because, inter alia, (i) subsequent changes to the legal entity structure and issued share capital of Corporation B meant the earlier method was no longer appropriate, (ii) a public offering via the New York Stock Exchange, as contemplated by the Option Agreement, was not practical, and (iii) the contributions by the respective parties to the success of the defined U.S. business had been different than those envisaged. They agreed to the simultaneous exercise of the put and call options early in Year 4. As a result of the changes, the amount that A would receive for his shares in Corporation E would be significantly less than the x% of the value of Corporation E that he had been promised. In consideration for A agreeing to accept the changes and to exercise his put option, Corporation B agreed to pay A a lump-sum payment of $v at the time the options were exercised.

On Date 13, A left the United States. He asserts that he properly abandoned his status as a lawful permanent resident by relinquishing his Alien Registration Receipt Card (green card) at the time of departure. A subsequently received a payment of $s from Corporation B on Date 14, due to exercising his put option, and a payment of $v on Date 15, per the Date 12 agreement. Both of these payments were received while residing in Country I. A claims that these payments were not taxable in the United States because he was a nonresident alien on Date 14 and Date 15 and nonresident aliens are not taxable on capital gains.

After Date 16, A returned to Country G, taking up a new position with Corporation B.

LAW AND ANALYSIS

A. A's Status as a Lawful Permanent Resident

Alien individuals who are treated as residents of the United States under section 7701(b)(1)(A) are subject to U.S. taxation on their worldwide income. An individual is treated as a resident of the United States if he is a "lawful permanent resident" of the United States. Section 7701(b)(1)(A)(i). For purposes of section 7701(b), an individual is a lawful permanent resident of the United States if (A) such individual has the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, and (B) such status has not been revoked (and has not been administratively or judicially determined to have been abandoned). Section 7701(b)(6).

An administrative or judicial determination of abandonment of permanent resident status may be initiated by the alien individual, the Immigration and Naturalization Service (INS), or a consular officer. If the alien initiates the determination:

> resident status is considered to be abandoned when the individual's application for abandonment (INS Form I-407) or a letter stating the alien's intent to abandon his or her resident status, with the Alien Registration Receipt Card (INS Form I-151 or Form I-551) enclosed, is filed with the INS or a consular officer. . . . [A]n alien individual shall

> be considered to have filed a letter stating the intent to abandon resident status with the INS or a consular office if such letter is sent by certified mail, return receipt requested (or a foreign country's equivalent thereof). A copy of the letter, along with proof that the letter was mailed and received, should be retained by the alien individual.

Treas. Reg. § 301.7701(b)-1(b)(3).

An individual who is a United States resident during the current year but who is not a United States resident at any time during the following calendar year will cease to be a resident for tax purposes on the individual's residency termination date, which is generally the last day of the calendar year, unless an exception applies. Treas. Reg. § 301.7701(b)-4(b)(1). The residency termination date for an alien that meets the green card test is the first day during the calendar year that the alien is no longer a lawful permanent resident if the individual establishes that, for the remainder of the calendar year, his or her tax home was in a foreign country and he or she maintained a closer connection to that foreign country than to the United States. Treas. Reg. § 301.7701(b)-4(b)(2).

A asserts that he relinquished his green card when he left the United States for Country I on Date 13. However, A has not provided any documentation to prove he actually gave up his lawful permanent residence status. We recommend that you request A to provide a copy of his Form I-407 or other statement filed with the INS or consular officer showing his intent to abandon his status as a lawful permanent resident. Alternatively the INS may be able to provide confirmation of such date. If for any reason he failed to properly abandon lawful permanent residence when he left the United States and did not do so prior to Date 15, he would still be subject to worldwide taxation in the United States when he received the $s and $v payments while living in Country I.

Even if A did properly relinquish his green card on Date 13, based on Treas. Reg. § 301.7701(b)-4(b)(2), A may have remained a resident of the United States through the last day of the calendar year of Year 3 if he cannot establish that his tax home was in Country I for the remainder of the calendar year. However, because the payments at issue were made in Year 4, this would not affect the taxation of these payments.

B. <u>The Section 83(b) Election</u>

Section 83(a) provides that if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of such property at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture (whichever occurs earlier) over the amount paid for such property is included in the gross income of the person performing the services.

Section 83(b) provides that any person who performs services in connection with which property is transferred to any person may elect to include in his gross income, for the taxable year in which such property is transferred, the excess of the fair market value of the property over the amount paid for such property. If such an election is made, section 83(a) shall not apply with respect to the transfer of that property. The election must be made not later than 30 days after the date of the transfer.

Treas. Reg. § 1.83-2(c) provides that the election is made by filing one copy of a written statement with the Internal Revenue office with which the person who performed the services files his return. In addition, one copy of such statement shall be submitted with the income tax return for the taxable year in which such property was transferred. Treas. Reg. § 1.83-2(b) provides that the election must be filed no later than 30 days after the date the property was transferred.

Treas. Reg. § 1.83-2(e) provides that the statement shall be signed by the person making the election and shall indicate that it is being made under section 83(b) of the Code. The statement shall include the following (among other) information:

(2) A description of each property with respect to which the election is being made;

(5) The fair market value at the time of transfer (determined without regard to any lapse restriction, as defined in Treas. Reg. § 1.83-3(i)) of each property with respect to which the election is being made.

Treas. Reg. § 1.83-2(a) provides that if the election is made, any subsequent appreciation in the value of the property is not taxable as compensation to the person who performed the services. Thus, property with respect to which this election is made shall be includible in gross income as of the time of transfer, even though such property is substantially nonvested (as defined in Treas. Reg. § 1.83-3(b)) at the time of transfer. In addition, the fact that the transferee has paid full value for the property transferred, realizing no bargain element in the transaction, does not preclude the use of the election.

Treas. Reg. § 1.83-3(b) provides that property is substantially nonvested when it is subject to a substantial risk of forfeiture. Treas. Reg. § 1.83-3(c)(1) states that a substantial risk of forfeiture exists when rights in property that are transferred are conditioned, directly or indirectly, upon the future performance of substantial services.

Treas. Reg. § 1.83-3(i) provides that a lapse restriction is a restriction other than one which by its terms will never lapse and includes a restriction that is a substantial risk of forfeiture.

The transaction between A and Corporation B clearly included a transfer of property under section 83. The first determination to be made is whether the transfer occurred upon the execution of the Date 3 Agreements or upon the issuance of the "B" shares of Corporation E on Date 7.

There is an argument that there was no transfer of property on Date 3 because A did not truly bear the risk of loss of a decline in the value of Corporation E. A's subscription price was $r, however the x% share of Corporation E he received was worth significantly more in Year 1, due to the acquisition of Corporation D, which subsequently became a subsidiary of Corporation E. Treas. Reg. § 1.83-3(a)(6) provides that an indication that no transfer has occurred is the extent to which the transferee does not incur the risk of a beneficial owner that the value of the property will decline substantially.

Rather, it can be argued that the issuance of the "B" shares to A was the actual transfer of property under section 83 on Date 7. But see Theophilos v. Commissioner, 67 T.C.M. 2106, rev'd, 85 F.3d 440 (9th Cir. 1996) (holding that taxpayer received property in the form of a binding contract to acquire GSM stock when a shareholder agreement was adopted to effect a plan of recapitalization, even though the contract was still executory, quoting Estate of Ogsbury v. Commissioner, 28 T.C. 93 (1957), aff'd, 258 F.2d (2nd Cir. 1985), which held that contracts to buy stock are taxable as employee compensation because the "binding commitment" marks the time at which the employee "first realizes measurable economic benefit").

However, even if the Service were successful in arguing that the issuance of "B" shares to A was the actual transfer of property on Date 7, rather than on Date 3, the election could still be valid, provided he filed the requisite statement within 30 days following the actual date of transfer of property with the appropriate Internal Revenue office as well as attached a copy of the statement to his income tax return for the taxable year in which such property was transferred. There is nothing that specifically bars a taxpayer from filing the election before the transfer has occurred. A can argue that he filed in good faith, and the fact that the Service delays the timing of the actual transfer should not invalidate his 83(b) election. The fact that there still existed on Date 7 a substantial risk of forfeiture does not, of course, invalidate the election. This is the essence of an election under section 83(b).

The amount of compensation income required to be included by reason of the section 83(b) election should be determined as of the actual date of transfer, if other than Date 3. This computation would require the valuation of A's x% interest in Corporation E at the time of the actual transfer, if other than Date 3.

However, even assuming A is correct regarding the date of transfer, the Service should contest A's valuation of the property he received, as the fair market value of his x% interest in Corporation E seems to far exceed the $r subscription price.

If, on the other hand, the section 83(b) election is found to be invalid for some reason, or it is determined that no election was made, a transfer of the "B" shares was made to A. This transfer was subject to the requirement that A remain employed with Corporation B or the Corporation B group until Date 9. This requirement is a substantial risk of forfeiture under section 83(a). Therefore, on Date 9, A should have received compensation income equal to the value of the "B" shares on Date 9 less $r. Thus, regardless of whether there was a valid election under section 83(b), there was a transfer of property. The ultimate question is the value of compensation that should have been recognized by A at the time of that transfer.

Moreover, regardless of the date of transfer, under Treas. Reg. § 1.83-2(a), the subsequent appreciation in the value of the transferred property, as adjusted depending on the preceding paragraphs, is not taxable as compensation to A, the individual who performed the services.

C. Application of Sections 864(c)(6) and 871(b)

Assuming the preceding analysis is correct, the issue remains as to whether A is taxable on all or a portion of the $s payment and the $v payment in Year 4.

In order to make that determination it is necessary to determine both the character and the source of the payments. The $s payment that A received on Date 14 was for exercising his put option with respect to the "B" shares in Corporation E. It seems relatively clear that the exercise of the put option should result in gain from the sale of a capital asset. However, the character of the lump-sum payment of $v that A received on Date 15 is less clear. If the $v payment was in the nature of a settlement payment, then it appears the payment should be characterized in the same manner as the $s payment, i.e., as gain from the sale of a capital asset. See Rev. Rul. 83-177, 1983-2 C.B. 112 (holding that payments received in a settlement agreement are sourced in the same manner as payments made in satisfaction of the underlying contract). However, it may be possible to establish that the $v payment was, in substance, deferred compensation for services performed by A in acquiring U.S. businesses. Cf. Lewis and Taylor, Inc. v. Commissioner, 447 F.2d 1074 (9th Cir. 1971) (realistic reduction in the value of closely held stock, the value of which was originally established pursuant to a buy-sell agreement, was respected by the court and the remaining payment was treated as compensation), rev'g T.C. Memo 1969-82. We believe the fact that the Date 12 agreement states that one of the reasons for the amendment to the Option Agreement was that the contributions by the respective parties to the success of the U.S. businesses have been different than those envisaged supports an argument that A was receiving additional compensation for his services in the United States.

With respect to the $s payment treated as gain from the sale of a capital asset, under section 871(a)(2), a nonresident alien who is not engaged in a U.S. trade or business is not taxable on gains from the sale or exchange of capital assets unless the gain is derived from sources within the United States and the individual is present in the United States for a period or periods aggregating 183 days or more during the taxable year. Section 871(a)(2). Under section 865(a), income from the sale of personal property by a nonresident alien is sourced outside the United States. Therefore, assuming that at the time of the payments A was a nonresident alien and that he was no longer engaged in any U.S. trade or business after he left the United States, the gain is not taxable in the hands of A pursuant to section 871(a)(2).

Notwithstanding section 865(a), a nonresident alien may have income from sources within the United States from the sale of personal property under section 865(e)(2) if the nonresident alien is engaged in a U.S. trade or business, if he or she maintains a fixed place of business in the United States, and if the gain from the sale of the asset is attributable to the office or fixed place of business using the principles of section 864(c)(5). The U.S. source gain is not necessarily taxable under section 871(b) unless the gain is otherwise effectively connected with the conduct of a U.S. trade or business under section 864(c)(2). In order for gain to be effectively connected with the conduct of a trade or business there must be a trade or business conducted during that taxable year and the gain must be either derived from the assets used or held for use in the conduct of such trade or business or the activities of such trade or business must be a material factor in the realization of the income, gain or loss. Section 864(c)(2)(A) and (B).

Gain from the sale of personal property by a nonresident alien may alternatively be sourced in the United States under section 865(g)(1)(A)(i)(II) if the nonresident alien has a tax home (as defined in section 911(d)(3)) in the United States. Because A is a nonresident alien for Year 4, he may be treated as a resident of the United States for purposes of section 865 if he had a tax home in the United States in Year 4. At this point there are insufficient facts to make that determination.

Even if it is established that A had a tax home in the United States in Year 4, that does not result in immediate taxation of the gain. Being treated as a resident solely for purposes of the sourcing rules of section 865 does not make A a resident alien for purposes of section 7701(b). Thus, A remains a nonresident alien who, for tax purposes, has merely, by reason of section 865(g), derived gain from sources within the United States as opposed to outside the United States. That gain, however, as in the case of gain resourced to the United States under section 865(e)(2), is not taxable to A under section 871(b) unless the gain is otherwise effectively connected with the conduct of a U.S. trade or business in that taxable year.

In this case, neither of these resourcing rules, even if applicable, will result in taxation under section 871(b), since A was no longer engaged in a trade or business at the time of the payment, a prerequisite to the income being taxable in Year 4 as effectively connected with the conduct of a trade or business in the United States.

Absent the resourcing rules of section 865(e)(2) and (g)(1)(A)(i)(II), the gain would be foreign source gain under the general source rule for gain from the sale of personal property in section 865(a). Under section 864(c)(4), such gain could not be effectively connected with the conduct of a trade or business within the United States unless the gains were described in section 864(c)(4)(B)(iii) (relating to gains from the sale or exchange of inventory property outside the United States through an office or other fixed base in the United States). Again, since A was no longer engaged in a trade or business, and since the gain from the sale of the “B” shares was not inventory property in the hands of A, the gain may not be taxable under section 864(c)(4)(B).

Gain may also be taxable, however, in the hands of a nonresident alien if that person was formerly engaged in a trade or business and the gain is attributable to the sale or exchange of property by such person when that person was so engaged. Section 864(c)(6) provides in part that if a payment is received by a nonresident alien individual in one taxable year and is attributable to a sale or exchange of property or the performance of services in another taxable year, the determination of whether such income or gain is taxable under section 871(b) is made as if such income or gain were taken into account in such other taxable year, without regard to whether the taxpayer was engaged in a trade or business in the United States during the year in which the payment was taken into account.

Thus, section 864(c)(6) does not take into account the fact that the taxpayer is no longer engaged in a U.S. trade or business when making the determination of whether the income would be taxable under section 871(b). Therefore, the gain may be taxable so long as it would have been taxable had it been received by the taxpayer in the year of the sale. In this case, however, section 864(c)(6) does not apply to the $s payment because it is not attributable to a sale or exchange of property taken into account in another taxable year. Both the sale of the “B” shares by A and the receipt of the $s payment occurred in Year 4.

Gain may also be taxed under section 864(c)(7) if property is initially used or held for use in connection with the conduct of a trade or business within the United States and then such property ceases to be held for that purpose and is disposed of within 10 years after such cessation. The gain on the disposition is taxable under section 871(b) to the extent it would have been taxable if the disposition had occurred immediately before such cessation, without regard to whether the taxpayer is engaged in a U.S. trade or business in the year the gain is taken into account.

In this case, the property, the stock of Corporation E, was not used in, or held for use by, A in the conduct of his U.S. trade or business as defined in section 864(c)(2)(A). A was an employee of Corporation B and his trade or business was the performance of services on behalf of Corporation B. Even had A sold his shares prior to the cessation of his performing services, the gain would not have satisfied the requirements of Treas. Reg. § 1.864-4(c)(2), the rules that govern when gain or loss from the sale or exchange of a capital asset is used in, or held for use in, the conduct of a trade or business in the United States. The Service's position, as reflected in Treas. Reg. § 1.864-4(c)(2)(iii), is that stock is not an asset used in, or held for use in, the conduct of a trade or business, and it would not be possible in any event to establish that A's owning the stock of Corporation E was necessary for him to perform his services. Although the language of section 864(c)(7)(A) is arguably broader than the language used in section 864(c)(2)(A), in that it encompasses property that was used or held for use "in connection with" the conduct of a trade or business, not merely used or held for use in the conduct of a trade or business, it does not seem appropriate to impose a tax on the disposition of property that would not otherwise have been taxable had the property continued to be used or held for use in the conduct of a trade or business at the time of disposition. Thus, the $s payment is not taxable under section 864(c)(7).

If the $v payment is in the nature of a settlement payment, then to the extent that the payment is made in consideration for A accepting a lower amount upon the exercise of the put and call options, the $v payment should be characterized and sourced in the same manner as the $s payment. Thus, the $v payment, similar to the $s payment, should be treated as gain from the sale of a capital asset received by a nonresident alien and not subject to tax in the United States. Sections 864(c)(2) and 871(a)(2).

To the extent that the $v payment, for any reason, is characterized as additional compensation, the source of the payment would be within the United States, assuming A performed his services during Years 1 through 3 exclusively in the United States. Section 861(a)(3). Applying section 864(c)(6) to this payment, if the $v payment was received by A in Year 4 with respect to services on behalf of Corporation B that occurred prior to his terminating employment with Corporation B in Year 3, then the $v payment would be attributable to the performance of services in another taxable year. The $v payment would also be treated effectively connected with the conduct of a U.S. trade or business under section 864(b), since the term “trade or business within the United States” includes the performance of services within the United States. Thus, the $v payment would be taxable to A by reason of section 864(c)(6) under section 871(b).

D. Joint Venture Between A and Corporation B

Alternatively, the issue has been raised as to whether the organization formed by A and Corporation B, Corporation E, should be characterized as a partnership or joint venture, rather than as a corporation, for U.S. tax purposes. If so, whether A’s receipt of the $s and $v payments should be recharacterized as a distribution of profits from that partnership. The analysis that follows focuses on Corporation E’s Articles of Incorporation. If any other agreements between A and Corporation B contradict the Articles of Incorporation, this may affect the characterization of the enterprise.

Sections 761(a) and 7701(a)(2) provide 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 a trust or estate or a corporation.

Section 7701(a)(3) provides that the term "corporation" includes associations, joint-stock companies, and insurance companies.

Year 4, the year in issue, precedes the effective date of the “check-the-box” regulations. Accordingly, the classification of any particular organization is determined under the tests and standards set out in Treas. Reg. §§ 301.7701-2, 301.7701-3, and 301.7701-4. Treas. Reg. § 301.7701-2(a)(2) provides that an organization that has associates and an objective to carry on business and divide the gains therefrom may be classified as a partnership or an association taxable as a corporation. That classification, which is determined based on the totality of the circumstances, depends on whether the entity has the corporate characteristics of (i) centralization of management, (ii) continuity of life, (iii) free transferability of interests, and (iv) limited liability. Treas. Reg. § 301.7701-2(a)(3) provides that if an unincorporated organization possesses more corporate characteristics than non-corporate characteristics, it constitutes an association taxable as a corporation. The Tax Court, in Larson v. Commissioner, 66 T.C. 159 (1976), interpreted Treas. Reg. § 301.7701-2 and concluded that equal weight must be given to each of the four corporate characteristics.

Corporation E’s Articles of Incorporation suggest the existence of at least two corporate characteristics (centralized management and continuity of life). An organization has the corporate characteristic of centralized management if any person (or any group of persons that does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed. Treas. Reg. § 301.7701-2(c)(1). Article 11 of Corporation E's Articles of Incorporation, which provides that the Board of Managing Directors is in charge of the management of the company, tends to show that Corporation E has the corporate characteristic of centralized management.

An organization has the corporate characteristic of continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause dissolution of the organization. Treas. Reg. § 301.7701-2(b)(1). Article 3 of Corporation E's Articles of Incorporation, which provides that the term of the company is indefinite, tends to show that Corporation E has the corporate characteristic of continuity of life.

Corporation E's Articles of Incorporation, however, suggest that there is no free transferability of interests. An organization has the corporate characteristic of free transferability of interests if each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of the other members, to substitute for themselves in the same organization a person who is not a member of the organization. Treas. Reg. § 301.7701-2(e)(1). Article 9 of Corporation E's Articles of Incorporation, which provides that members are required to obtain prior approval at the general meeting of shareholders before transferring their shares, tends to show that the organization formed by the parties lacks this corporate characteristic.

An organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of, or claims against, the organization. We cannot determine from the information provided whether A and Corporation B enjoyed limited liability as members of Corporation E. If it is found that the members do enjoy limited liability, then there would appear to be a preponderance of corporate characteristics.

Courts have looked at various factors in considering whether a partnership exists. In determining whether a partnership exists for federal income tax purposes, the Supreme Court stated:

> The question is . . . whether, considering all the facts -- the agreement, the conduct of the parties in execution of its provision, 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 intended to join together in the present conduct of the enterprise.

Commissioner v. Culbertson, 337 U.S. 733, 742 (1949).

The hallmarks of a partnership are the sharing of profits, the contribution of capital and its risk of loss, and the sharing of control over the enterprise. Reinberg v. Commissioner, 90 T.C. 116, 137 (1988). In Luna v. Commissioner, 42 T.C. 1067, 1077-1078 (1964), the Tax Court articulated the following particular factors, none of which is conclusive, which tend to indicate whether a partnership or joint venture has been formed:

> [t]he agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has 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 Federal partnership returns or otherwise represented to respondent 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 mere fact that parties share in profits and enjoy some control over the venture does not necessarily mean the relationship is a partnership. Agents, independent contractors, and employees, as well as partners, may be entitled to a percentage of a venture's net profit. Even if substantial managerial discretion is vested in a person, he may nevertheless be held an employee, agent or independent contractor if he has no substantial interest in the capital of the venture and if he has no real liability for a proportionate share of the losses of the venture. See, e.g., Mayhew v. Commissioner, T.C. Memo 1992-68 (the court found no partnership even though taxpayer's compensation was solely based on a share of net profits and taxpayer enjoyed considerable control over the work).

Further, if the factual development supports a determination that the parties formed a partnership, it appears that the event in Year 4 would be more appropriately characterized as a sale of a partnership interest under section 741 rather than a distribution under section 731. Gain on the sale of a partnership interest is not treated as U.S. source effectively connected income unless the partner's distributive share of unrealized gain or loss of the partnership would be attributable to assets of the partnership that produce United States source effectively connected income. Rev. Rul. 91-32, 1991-1 C.B. 107. Thus, it would be necessary to determine if the partnership was in fact engaged in a U.S. trade or business and whether the assets of the partnership on the date of sale produced U.S. source effectively connected income. Given the fact that the “partnership” acted as a holding company rather than as an operating company, that would not support a position that the assets of the partnership, stock of subsidiary companies, produced U.S. source effectively connected income.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call (202) 622-3880 if you have any further questions.

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