Forbes

Robert W. Wood

THE TAX LAWYER

TAXES 2/16/2016

How Kanye West Can Get $1 Billion From Mark Zuckerberg Tax Free

The bombshell news that Kanye West has $53 million worth of debt is a little overwhelming. No matter his talents, Kanye's personal debt is well, scary. Yet, everything is relative. Perhaps $53 million isn't too much to Mark Zuckerberg. The Facebook billionaire is being urged to invest a cool $1 billion in Mr. West's musical ambitions. Perhaps it is a publicity stunt, but the @KanyeWest account was issuing direct pleas to Mr. Zuckerberg. It seems as real as Kanye's response to Taylor Swift lyrics, which is fueling some speculation of its own.

Still, money is money, and Mr. West's requests for funding also didn't leave out ~~Google's~~ Alphabet Inc.'s Larry Page. These are heady requests for cash, and from heady sources. Having these elites funnel some cash into Kanye's ideas could help in multiple ways. And whatever happens, you can figure on some press coverage. Mr. West is rather Trump-like in his ability to make headlines.

But the details of the funding matter, even if we aren't yet being told how–or indeed whether–any of this could transpire. If a deal is actually struck, how should this money come in? Loan, purchase, joint venture, or something else? Let's start with the easiest to figure, a straight loan. If Mr. Zuckerberg hands Kanye West $1 billion as a loan, is it taxable income?

Nope, loan proceeds aren't income, provided that it's a real loan. That's a key distinction that lands many taxpayers in trouble with the IRS. The $1 billion in loan proceeds would not be income to Kanye, and he should be able to deduct the interest payments. Mr. Zuckerberg just would report the interest as income.

If Mr. Zuckerberg should ever forgive the debt, it would be income to Mr. West then. That's cancellation of debt income, often shortened to COD income. The tax code generally taxes you when you are relieved of paying back a debt, treating it like cash paid to you. It is just one of the key things about COD income. This unpleasant rule might seem easy to ignore, except that when a loan is forgiven, you'll generally receive a Form 1099-C reporting income to you—and telling the IRS.

But Mr. Zuckerberg is probably too clever–with both tax and business savvy–to make a straight loan. Some kind of purchase or joint venture seems more likely. If it's a purchase, of what? Rights to some of Mr. West's intellectual property, perhaps? Depending on the details, a sale might be ordinary income or capital gain to Mr. West. The tax rate difference can be 20% vs. 39.6%, so the stakes matter plenty.

Sometimes the loan v. purchase dichotomy can become blurred. For example, if Mr. Zuckerberg made Kanye a loan, can the IRS claim the "loan" money he received isn't actually a loan and was really a sale? Sometimes, yes. That's exactly what happened to Jonathan Landow. Landow took out a 90% loan against securities he put up as collateral. The loan was non-recourse—meaning that Landow could not be sued personally if he defaulted.

Yet the securities were pledged as collateral. The lender had the ability to sell the securities, and that's just what the lender did, even though Landow later claimed he had no idea his securities would be sold. Landow didn't pay off any of the $13.5 million principal amount of the loan. He also didn't report the "loan proceeds" as income.

The IRS claimed the loan wasn't a loan and was a sale. The Tax Court agreed, saying that everyone *knew* the transaction would be documented as a loan but really was a sale. How real is the danger that will IRS will treat loans as sales? Very. The moral is that if Mr. West sells some property to Mr. Zuckerberg, he should report it as a sale.

But is there a middle ground, with tax advantages for Mr. Zuckerberg and Mr. West? There may be. Joint ventures are often put together between a money partner and a property or services partner. The tax rules are complex, but it is often possible to get tax treatment that you can't get elsewhere.

For example, Mr. Zuckerberg might get an equity stake, and yet also get a preferred return, not unlike a high interest rate. And Mr. West, who surely doesn't want a big tax hit now on top of his other financial woes, may be able to put off reporting a gain. In effect, something that looks rather like a sale might be structured as a joint venture. How you structure a transaction is important, as is how the transaction actually plays out.

Is there any other possibility for this deal? Well, it seems unlikely, but Mr. Zuckerberg could always make a gift to Mr. West. Gifts may not trigger income tax, but they can trigger gift tax. Gifts are not income to the recipient. If there is a gift tax, the donor is the one who must pay it. Of course, gifts are usually made in a family context, and a gift seems unlikely here.

Whatever happens, in one sense at least Mr. Zuckerberg and Mr. West should be like all the rest of us. They should think about taxes up front, and document what they intend. Everyone will be better off, even Taylor Swift.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.