PERSPECTIVE

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Kanye West's Tax-Free $1 Billion From Mark Zuckerberg

By Robert W. Wood

If you owe anyone money, thinking about Kanye West and his $53 million of debt is a little overwhelming. No matter his talents, Kanye's personal debt is well, scary. But everything is relative. Perhaps $53 million isn't too much if you have the bank balance of Mark Zuckerberg.

When the news broke that the Facebook billionaire was being urged to invest $1 billion in West's musical ambitions, it hardly seemed serious. Yet West probably was, even inviting other tech billionaires to make competing bids. Money is money, and West asked Larry Page — cofounder of Alphabet Inc., the company formerly known as Google — to invest, too.

These are heady requests for cash, and from heady sources. Having these elites funnel cash into Kanye's ideas could help in multiple ways. And whatever happens, you can figure on press coverage. West is Trumpesque in his ability to make headlines, not all of them positive.

Lawyers and financial advisers should look to the mechanics and to the inevitable taxes. But are taxes inevitable? It depends. If a deal is 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 Zuckerberg hands Kanye West $1 billion as a loan, is it taxable income? No, loan proceeds are not income, provided that it's a *bona fide* loan. That is a key distinction that lands many taxpayers in trouble with the Internal Revenue Service.

Explaining that you received money from a client not as fees but as a loan, for example, can be tough. But $1 billion in *bona fide* loan proceeds would not be income to Kanye, and Kanye should be able to deduct the interest payments. Zuckerberg just would report the interest as income.

If Zuckerberg should ever *forgive* the debt, it would probably be income to 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.

This unpleasant rule might seem easy to ignore, except that when a loan is forgiven, you will generally receive an IRS Form 1099-C reporting income to you. As with any other Form 1099, the IRS gets a copy in case you forget to put it on your tax return.

Fortunately, there are a few exceptions, including if Kanye is bankrupt or insolvent when the debt is forgiven.

Of course, Zuckerberg is probably too clever — with both tax and business savvy — to make a straight loan to West. Some kind of purchase or joint venture seems more likely. But if it is a purchase, a purchase of what? Rights to some of West's intellectual property, perhaps?

Depending on the details, a sale might be ordinary income or capital gain to West. The tax rate difference can be 20 percent vs. 39.6 percent, so the stakes matter plenty.

Sometimes the loan v. purchase dichotomy can become blurred.

For example, if 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. *See Landow v. Commissioner*, T.C. Memo. 2011-177. Landow took out a 90 percent 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. So, 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 the IRS will treat loans as sales? Very.

If West sells some property to Zuckerberg, he should report it as a sale.

But is there a middle ground, with tax advantages for Zuckerberg and 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, Zuckerberg might get an equity stake, and yet also get a preferred return, not unlike a high interest rate. And 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.

Another possibility might be a prepaid forward contract. This is a sale done for a flexible return rather than a fixed price, so it cannot be reported as a current sale. Properly done, the proceeds are not income to the seller until the other end of the transaction closes.

Such prepaid forward contracts have become the vehicle of choice for the litigation funding industry to make investments in litigation. Everyone gets the best of both worlds between loan and sale. Plus, the investors can also qualify for capital gain treatment when they eventually cash out.

Is there any other possibility for this deal? It seems unlikely, but Zuckerberg could always make a gift to West. Gifts are not income to the recipient. Gifts may not trigger income tax, but they can trigger gift tax. 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 Zuckerberg and West should be like all the rest of us. They should think about taxes up front, and document what they intend. How you structure a transaction is important, as is how the transaction actually plays out.

Robert W. Wood *is a tax lawyer with www.WoodLLP.com, and the author of "Taxation of Damage Awards & Settlement Payments" (www.TaxInstitute.com). This is not legal advice.*