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Partnership Agreements: *Do* Sweat the Small Stuff

By Christopher Karachale • Wood & Porter • San Francisco

The U.S. Tax Court regularly wages metaphysical battles. Like good Platonists, the Tax Court judges try to measure an ordinary and necessary business deduction or a worker status controversy against the idealized form of these particular transactions. Indeed, the Tax Court almost always begins its analysis of such transactional questions by quoting the United States Supreme Court's own Platonic utterance: "It is well established that the tax consequences of transactions are governed by substance rather than form." [*Frank Lyon Co.*, SCt, 78-1 USTC ¶9370, 435 US 561, 573 (1978).]

Despite the Tax Court's lofty goals, the court is often reduced to sifting through myriad tests, most of which ultimately depend on whether the documents presented to the court match the alleged tax character of the transaction. This is not the fault of the Tax Court. Often, taxpayers' hopes and tax goals when entering a transaction are markedly different from the position the taxpayers later assert. However, if adherence to contractual minutiae is all that matters, then discussions of substance versus form, like the discussion of the number of angels that can dance on the head of a pin, should be consigned to the Platonic dustbin.

Howdy Partner

The recent Tax Court case, *WB Acquisitions, et al.*, TC Memo. 2011-36 (2011) serves as a prime example of the Tax Court's desire to analyze the true substance of the transaction, but finding itself bound by the documents before it. Tax Court Judge Haines invokes the *Frank Lyon* imperative not once, but twice, in this memorandum opinion. However, in the end, the court has no choice but to slog through the *Luna* factors [*H.M. Luna*, 42 TC 1067, 1077, Dec. 26,967] to determine whether the taxpayers were truly joint venturers.

ALSO IN THIS ISSUE

WB Acquisitions concerns two taxpayers, Barone and Watkins, who worked in environmental remediation. Given the large liabilities involved, they formed a corporate structure involving a variety of interlinking entities, the first of which was a corporation called WCI. WCI was owned by WB Acquisitions, Inc., a C corporation, which in turn was wholly owned by a partnership, WB Partners. WB Partners itself had S corporation partners whose ultimate owners turned out to be Barone and Watkins. These S corporations had employment agreements with Barone and Watkins requiring them to provide services exclusively to the S corporations.

In 2000, the city of San Diego solicited bids for work on a redevelopment project involving the San Diego Naval Training Center (the "NTC Project"). WCI won the right as a subcontractor to perform the environmental remediation for $17 million. However, the city of San Diego required a bond and indemnity agreement to guarantee completion. That meant Barone and Watkins would have to personally guarantee the amount.

To ensure that the cash flow for the NTC Project was protected, WCI and WB Partners entered into a joint venture (the "NTC Joint Venture"). This essentially left WB Acquisitions, Inc. out of the corporate link. The NTC Joint Venture between WCI and WB Partners was memorialized with a joint venture agreement (the "Agreement"). The Agreement provided that 30 percent of the profits from the NTC Project would be allocated to WCI and 70 percent would be allocated to WB Partners.

The allocation of the profits was based on a transaction involving Barone and Watkins prior to the formation of the corporate structure in which they were personally allocated 66 percent of the profits for assuming the financing risk. Significantly, although WCI had gotten the subcontracting bid, Barone and Watkins did not substitute the NTC Joint Venture for WCI in the subcontracting agreement. Likewise, only WCI, not the NTC Joint Venture, possessed the requisite contracting licenses to perform the environmental remediation.

JV Raison D'être

According to the Agreement, WCI's role in the joint venture was to provide management and performance of the subcontracting work, while WB Partners' role was to indemnify and provide financing for the project. The Agreement indicated that WCI was protected from losses incurred in the NTC Project since it would be reimbursed for any expenses from a joint account shared by WCI and WB Partners as part of the NTC Project. The Agreement also provided that NTC Joint Venture would maintain its own books, records and file an income tax return.

The NTC Joint Venture appears to have behaved much like a genuine partnership. It obtained its own EIN and used it to open a bank account for the NTC Project. The NTC Joint Venture prepared its own income statements, work progress schedules and other financials. However, in order to

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get indemnity agreements from a variety of insurers, Barone, Watkins, WCI, WB Partners *and* NTC Joint Venture signed as indemnitors. Additionally, a performance bond issued to ensure that the project was completed required that WCI—not NTC Joint Venture—compete the project.

As the NTC Project progressed, payment was made to WCI (rather than NTC Joint Venture) as provided in the subcontracting bid. NTC Joint Venture's CPA accounted for the profits under the terms of the Agreement and filed tax returns for WCI and WB Partners, but not for NTC Joint Venture. According to the CPA, since NTC Joint Venture was jointly controlled there was no need to file a return for NTC Joint Venture under generally accepted accounting principles.

In the end, the NTC Project went rather well for NTC Joint Venture. Although the initial subcontracting bid was $17 million, they billed $14.1 million. The NTC Joint Venture incurred $5.8 million in costs, resulting in a profit of $8.3 million. Pursuant to the Agreement, 70 percent of the profits were allocable to WB Partners (or $5.7 million). However, Barone and Watkins decided to institute a profit cap limiting WB Partners' share to 50 percent of the profits. The IRS subsequently issued notices asserting the NTC Joint Venture was not a joint venture for federal tax purposes.

Eidos of Transaction

The Tax Court sized up its job as determining whether the Agreement created a legitimate joint venture between WCI and WB Partners "or was merely a vehicle to divert income from the NTC Project to WB Partners and away from WCI." The Tax Court recognized that "it may not substitute its judgment for that of the parties in determining the value of their contributions." [*W.O. Culbertson, Sr.*, SCt, 49-1 USTC ¶9323, 337 US 733, 744–45 (1949).] Like the *Frank Lyon* citation, this idealistic statement is quoted twice for good measure.

When pressed to determine whether the parties "really truly intended to join together for the purposes of carrying on business and sharing profits or losses or both" [*F.E. Tower*, SCt, 46-1 USTC ¶9189, 327 US 280, 287 (1946)], the court's only recourse was to compare the facts of the NTC Project to the *Luna* factors. The *Luna* factors, like the 20 factors used to determine whether a workers in an employee [Rev. Rul. 87-41, 1987-1 CB 296], provide facts and circumstances koans to be balanced, weighed and contemplated to determine whether a partnership or joint venture exists. They include the following:

- The 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
- Whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise [*See Luna, supra,* 42 TC, at 1077–78.]

Balancing Act

The Tax Court diligently tested each of these factors to determine if they weigh plus, minus or neutral regarding whether WCI and WB Partners were engaged in a joint venture. Regarding the Agreement, the court found that the joint venturers did not comply with its terms. First, by imposing a profit cap on WB Partners, WCI and WB Partners did not adhere to the 70-percent and 30-percent profit split contained in the Agreement. Second, despite the fact that the Agreement provided for a tax return to be prepared for the NTC Joint Venture, no such return was prepared.

Concerning the mutual contributions of WCI and WB Partners to the NTC Joint Venture, the court found that WB Partners did not materially contribute. First, although the S corporations controlling WB Partners had exclusive employment contracts with Barone and Watkins, the court found that Barone and Watkins violated the exclusivity provision, so WB Partners could not have contributed their services to the NTC Joint Venture. Second, WB Partners did not contribute a genuine financial guarantee since WB Partners *and* Barone, Watkins, WCI and WB Partners served as indemnitors for the NTC Project.

The Tax Court concedes that the NTC Joint Venture had its own EIN, used it to open a bank account for the NTC project, signed indemnity agreements and conducted business as a joint venture according to its CPA. However, the court found that the *Luna* factor involving whether business was conducted in the joint names of the parties "is mixed." After all, WCI entered the subcontractor agreement, not NTC Joint Venture.

The court seemed particularly concerned that the interrelationship between Barone, Watkins, WCI and WB Partners prevented the entities from operating at arm's length. The financial guarantees of the NTC Project by entities other than WB Partners indicated that WB Partners' role as indemnitor and financier was not genuine. Likewise, the fact that WB Partners decided to forgo its contractual right to 20 percent of the NTC Joint Venture profits indicated that the parties were not functioning at arm's length.

Tax Court as Formal Arbiter

The Tax Court's analysis leads it to hold there was no joint venture between WCI and WB Partners because "[f]ive of the eight Luna factors weigh against a finding of a joint venture and three Luna factors are neutral." Like a symphony orchestra conductor reduced to keeping time rather than interpreting great works, the Tax Court simply adds up the *Luna* factors to reach its conclusion.

The Tax Court's reasoning on the *Luna* factors did seem to reveal fundamental inconsistencies in the treatment of the parties to the NTC Joint Venture. However, did WCI and WB Partners *really* not form a joint venture? That's a rhetorical question. After all, a joint venture is awfully easy to create.

Indeed, the Tax Court has ruled that a joint venture can be formed even if the parties did not know they were functioning as joint venturers. [*See R.W. Holdner*, 100 TCM 108, Dec. 58,297(M), TC Memo. 2010-175 (2010), where the Tax Court ruled that seven of the eight *Luna* factors evidenced a joint venture, despite the fact that no tax return was filed for the entity.] Had WCI and WB followed the terms of their Agreement slightly more closely or NTC Joint Venture filed a tax return, would the Tax Court have ruled the other way? It is hard to say.

Conclusion

What do we learn from *WB Acquisitions*? First, the minutiae of the transaction seem to be paramount. If you enter a partnership or joint venture, make sure to draft an agreement and adhere to each and every one of its terms. If you have interrelated entities or individuals involved in the joint venture, make sure those relationship are supported by arm's-length negotiating.

Second, for better or worse, the Tax Court is only as good as the material it has before it. Even if its goal is to find the true essence of the transaction (a Platonic goal to be sure), the Tax Court's mean to this end is almost always the documentation. That means as the transaction is structured, taxpayers need to consider how the IRS or a court will view the terms of the agreements and relationships of the parties.

Thus, apart from mere adherence to the contracts, be mindful of how *others* will interpret the underlying rationale for the documents. Make sure your documents not only reflect the relationships of the parties, but also serve to justify and substantiate those relationships. Sweat the small stuff.

In all fairness, the Tax Court has the exceedingly difficult job of divining the true purposes and intent of taxpayers and the transactions they undertake. The IRS will surely be whispering—or yelling—in one ear how dastardly it all was. The Supreme Court's lofty pronouncements have left the Tax Court no other choice but to divine what really happened and why. However, until we can find the true Platonic forms of tax transactions, remember that the small stuff matters!