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What *WB Acquisition* Says About Attorney-Client Partnerships

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The Tax Court's recent decision in *WB Acquisition* reviews the factors used to determine the existence of a joint venture or partnership. The authors consider *WB Acquisition* and what it reveals about the argument that a lawyer and client in a contingent fee case may be able to sidestep the result in *Banks* by establishing a partnership.

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A partnership is not a taxpaying entity. It allocates income and loss to its partners who themselves pay tax. There are myriad reasons partnerships are formed. The most basic flow-through tax character of partnerships is often at least part of the reason, typically explaining why another entity such as a C corporation is not formed in its stead.

Paradoxically, however, in the normal choice-of-entity debate, partnerships arguably pose at least one definitional difficulty not associated with other entities. Namely, what is a partnership — or put differently, what is enough to form one? True, there may be few cases in which a salient question is whether a putative corporation is a corporation or whether a putative limited liability company is an LLC. Because of the election and qualification requirements applicable to S corporations, there are perhaps more cases in which the status of a putative S corporation is debated.

Yet the "what is a partnership" debate is even more elusive. Our myopic interest is not with the grand scale of business and investment partnerships, but rather with lawyers and clients. The latter must routinely deal with questions surrounding the tax treatment of settlements and judgments. One of the most nettlesome and yet most basic questions is how clients can deduct contingent attorney fees and not end up paying tax on them despite their deduction.

We can eliminate from consideration cases:

- in which the recovery is 100 percent excludable from income under section 104, since there would be no need to deduct attorney fees;
- involving employment, civil rights, or Federal False Claims Act claims entitling the plaintiff to deduct the legal fees above the line under section 62(a)(20); or
- arising out of a trade or business, so the legal fees can be deducted by the entity above the line under section 62(a)(1), as would occur with a corporation, partnership, or even a sole proprietorship on Schedule C.

Outside those cases are many lawsuits in which plaintiffs receive recoveries in tort, contract, or other disputes and face miscellaneous itemized deduction treatment for their legal fees and costs.[1] As noted on numerous occasions in these pages, those attorney fees issues are pervasive and the dollars involved can be huge.[2] They even reach into the territory of personal physical injury cases, in which some of the damages (and therefore also some of the attorney fees) are attributable to interest or punitive damages.

In those situations, if an attorney-client relationship can be a partnership for federal income tax purposes, any recovery should be allocated to the partners in accordance with their respective interests in the partnership. Some lawyers suggest that ethics rules prevent partnering with clients. Yet a valid partnership under state law is not a prerequisite to a partnership for federal income tax purposes.[3]

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[1]*See* Robert W. Wood, "Attorney Fee Deduction Problems Remain," *Tax Notes*, Feb. 7, 2011, p. 707, *Doc 2011-749*, or *2011 TNT 28-10*.

[2]*See* Wood, "Attorney and Client as Partners," *Tax Notes*, Oct. 13, 2008, p. 167, *Doc 2008-19753*, or *2008 TNT 200-43*; Wood, "Attorney-Client Partnerships With a Straight Face," *Tax Notes*, Oct. 18, 2010, p. 355, *Doc 2010-20564*, or *2010 TNT 203-6*.

[3]*See Wheeler v. Commissioner*, T.C. Memo. 1978-208.

Problems With Partnerships

Some disagree that a partnership of lawyer and client could allocate income to the partners, thus altering the gross income landscape created by *Commissioner v. Banks*.[4] For example, Prof. Gregg Polsky has argued that an attorney-client partnership could not obviate the *Banks* problem absent a section 83(b) election.[5] The general rule of *Banks* is that the client has 100 percent of the gross income, followed by a deduction (presumably only miscellaneous itemized) of the fees and costs paid to the lawyer.

Polsky suggests that the *Banks* result can't be avoided, even with a partnership, since the attorney is only contributing services and section 83 applies. He concedes that this result may be avoided if the lawyer makes a section 83(b) election.

Arguably, however, the real question is whether the rudiments of partnership taxation trump section 83 or section 83 trumps the rudiments of partnership taxation.

The lawyer is likely to contribute cash in addition to services, since advanced costs are almost never paid by the client. That means the lawyer is probably not a service partner in toto. But even if he is, isn't there still a partnership? Regardless of how or when the lawyer partner is taxed on his partnership interest or partnership income, if there is a partnership interest or partnership, the client is not taxed on 100 percent.

If the partnership is formed, it is entitled to the money. Whether or not the lawyer is a service partner, can it be said that the lawyer has nothing and that there simply is no partnership without a section 83(b) election? A section 83(b) election might be something a clever lawyer would file in an attempt to change the timing of income or its character as capital or ordinary. But that all concerns only the lawyer, not the client.

In short, while the section 83 issue seems of academic and technical interest, the grassroots issue is whether there is a partnership. If there is, by definition, the lawyer and client could each be taxed only on their respective shares. The attorney-client partnership may be formed only to facilitate the client avoiding the lawyer's portion of the income, as was argued in *Allum v. Commissioner*.[6]

Although *Allum* failed, under the right facts a partnership can surely exist, and it is doubtful section 83 would be mentioned. In the workaday world of contingent fee lawyers and their tax advisers, the analysis seems straightforward: The lawyer is agreeing to a partnership because he perceives he isn't disadvantaged and the client may be advantaged. If there is a partnership, whether or not it files a return, each partner is taxed on his share of partnership income.

How Much Is Enough?

It still seems relevant to ask how much is enough for an attorney-client partnership. Albeit in a different context, the Tax Court in *WB Acquisition Inc. v. Commissioner*[7] recently engaged in metaphysical musings over just what constitutes a partnership for tax purposes. The Tax Court did its best to analyze the transactions before it and rightly asserted that its analysis was intended to reach the true character of the transaction. As in other cases, the court quoted from the Supreme Court's Delphic utterances, such as this one from *Frank Lyon*: "It is well established that the tax consequences of transactions are governed by substance rather than form."[8]

Rudimentary Partnerships

WB Acquisition exemplifies the Tax Court's desire to identify the true substance of a transaction. The hopes and tax goals of parties when entering a transaction may be markedly different from those they later assert. Since the Tax Court and other courts must deal with competing explanations of the transaction, they are often reduced to sifting through various tests to determine if the transaction actually conforms to the position advocated. Despite the courts' highfalutin goals, most of those tests depend on whether the documents presented match the putative tax character of the transaction. Indeed, adherence to contractual minutiae may turn out to be more important than substance over form.

In *WB Acquisition*, Tax Court Judge Harry A. Haines invoked the *Frank Lyon* imperative not once, but twice. Ultimately, however, the court found itself bound by the documents before it. The court had no choice but to slog through the *Luna* factors[9] to determine whether the taxpayers were truly joint venturers.

WB Acquisition concerned two taxpayers, Daren Barone and Gregory Watkins, working in environmental remediation. Given the large liabilities involved, they formed a corporate structure of interlinking entities, the first of which was a corporation called Watkins Contracting Inc. (WCI).

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[4]543 U.S. 426 (2005), *Doc 2005-1418, 2005 TNT 15-10*.

[5]*See* Polsky, "Professor Questions Tax Partnership Structure," *Tax Notes*, Nov. 29, 2010, p. 1029, *Doc 2010-24898*, or *2010 TNT 228-5*.

[6]T.C. Memo. 2005-177, *Doc 2005-15466, 2005 TNT 139-9*, *aff'd*, 231 F. Appx. 550 (9th Cir. 2007), *Doc 2007-10844, 2007 TNT 86-16*.

[7]T.C. Memo. 2011-36, *Doc 2011-2761, 2011 TNT 27-11*.

[8]*Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978).

[9]*Luna v. Commissioner*, 42 T.C. 1067, 1077 (1964).

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WCI was owned by WB Acquisition Inc., a C corporation, which 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. Those 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 required a bond and indemnity agreement to guarantee completion. That meant Barone and Watkins would have to personally guarantee the amount.

To protect the cash flow for the NTC project, WCI and WB Partners entered into a joint venture (the NTC joint venture), which was memorialized in a joint venture agreement (the JV agreement). That essentially left WB Acquisitions out of the corporate link.

The JV 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 before 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's *Raison D'être*

According to the JV 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 JV agreement indicated that WCI was protected from losses incurred in the NTC project since it would be reimbursed for expenses from a joint account shared by WCI and WB Partners as part of the project. The JV agreement also provided that the NTC joint venture would maintain its own books and records and file an income tax return.

The NTC joint venture behaved like a genuine partnership. It obtained its own employer identification number, using 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, to get indemnity agreements from a variety of insurers, Barone, Watkins, WCI, WB Partners, *and* the NTC joint venture signed as indemnitors. A performance bond was issued to ensure that the project was completed. It required that WCI — not the NTC joint venture — complete the project.

As the NTC project progressed, payments were made to WCI (rather than the NTC joint venture) as provided in the subcontracting bid. The NTC joint venture's CPA accounted for the profits under the terms of the JV agreement and filed tax returns for WCI and WB Partners, but not for the NTC joint venture. According to the CPA, since the NTC joint venture was jointly controlled, there was no need under generally accepted accounting principles to file a return for it.

In the end, the NTC project went well for the 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. Under the JV agreement, 70 percent of the profits were allocable to WB Partners (or $5.7 million). However, Barone and Watkins instituted a profit cap that limited WB Partners' share to 50 percent of the profits. The IRS later issued notices asserting that the NTC joint venture was not a joint venture for federal tax purposes.

Form of Transaction

The Tax Court sized up its job as determining whether the JV 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.''[10] Like the *Frank Lyon* citation, that 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,''[11] the court's only recourse was to compare the facts of the NTC project with the *Luna* factors. The *Luna* factors, like the 20 factors used to determine whether a worker is an employee,[12] provide facts and circumstances to be balanced, weighed, and contemplated to determine whether a partnership or joint venture exists. They include:

- the agreement of the parties and their conduct in executing its terms;

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[10]*Commissioner v. Culbertson*, 337 U.S. 733, 744-745 (1949).

[11]*Commissioner v. Tower*, 327 U.S. 280, 287 (1946).

[12]Rev. Rul. 87-41, 1987-1 C.B. 296.

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- the contributions, if any, that 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 its 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 the IRS 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.[13]

Balancing Act

The Tax Court diligently tested each factor (plus, minus, or neutral) to assess whether WCI and WB Partners were engaged in a joint venture. Regarding the JV 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 JV agreement.

Second, the JV agreement provided that a tax return would be prepared for the NTC joint venture. Yet, 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. Plainly, the S corporations controlling WB Partners had exclusive employment contracts with Barone and Watkins. In fact, 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. Further, WB Partners did not contribute a genuine financial guarantee, since WB Partners *and* Barone, Watkins, and WCI served as indemnitors for the NTC project.

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

The court seemed particularly concerned with the interrelationship among Barone, Watkins, WCI, and WB Partners. Their relationship 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. Similarly, that WB Partners decided to forgo its contractual right to 20 percent of the NTC joint venture profits indicated the parties were not functioning at arm's length.

Tax Court as Arbiter

The Tax Court's analysis led it to hold that there was no joint venture between WCI and WB Partners because ''five of the eight *Luna* factors weigh against a finding of a joint venture and three *Luna* factors are neutral.'' Like a symphony conductor reduced to keeping time rather than interpreting great works, the Tax Court seemed to add up the *Luna* factors like a metronome to reach its conclusion.

The court's reasoning on the *Luna* factors does 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? It seems purely a rhetorical question, for 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.[14] In *Holdner v. Commissioner*, the Tax Court found that a father and son were partners for tax purposes. They each reported half the gross income from their farming operation but did not split the expenses equally or file federal partnership returns. On those facts, the Tax Court ruled that seven of the eight *Luna* factors evidenced a partnership. Had WCI and WB Partners followed the terms of the JV agreement a little more closely or had the NTC joint venture filed a tax return, would the Tax Court have ruled the other way?

Partnership Precedent

Of course, the chief (and quite unfortunate) reference point for attorney-client partnerships is *Allum*. In *Allum*, the Tax Court observed that the taxpayer could not show that even the most basic elements of a subchapter K partnership existed. Therefore, the Tax Court quite understandably did not delve into the *Luna* factors.

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[13]*See Luna*, 42 T.C. at 1077-1078.

[14]*Holdner v. Commissioner*, T.C. Memo. 2010-175, *Doc 2010-17437, 2010 TNT 150-16*.

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First, the taxpayer produced no documentary evidence that he had intended to form a partnership with his lawyer. Second, the taxpayer's testimony showed he did not view his attorney as a co-owner of his legal claims, but as a legal representative receiving compensation for his services. Finally, the taxpayer could not demonstrate that his lawyer had intended to partner with him.

The *Allum* court, while mentioning the *Luna* factors, clearly was not even convinced that the taxpayer had shown that the potential for a partnership existed. That has caused some observers to misread the case, suggesting that it establishes a high burden for attorney-client partnerships. All the court really did was enumerate what was relevant, without saying how many or which of the *Luna* factors are necessary for a lawyer and client to form a partnership.

Attorney-Client P'ships After *WB Acquisition*

WB Acquisition is only a memorandum opinion. As such, it may not be worth much as authority.[15] However, the case is both worrisome and heartwarming *viz*. the likelihood of a attorney-client partnership obviating alternative minimum tax problems in a particular case.

It is worrisome because Judge Haines ticked through the *Luna* factors with a kind of numeric rigidity. After finding five out of eight met, the court reached what hardly seems an inevitable conclusion. That is all the more surprising since the court's putative goal was to determine whether the joint venture between WCI and WB Partners was a vehicle to divert income from the NTC project to WB Partners and away from WCI.

However, the analysis of the first *Luna* factor centers on the fact that money was diverted *to* WCI and *away from* WB Partners. WB Partners was supposed to receive 70 percent of the profits from the NTC project. Instead, Barone and Watkins ended up capping WB Partners' share of the profits at 50 percent. If the issue of the case was profit diversion to WB Partners, a cap on those profits hardly seems to militate for finding a vehicle for that diversion.

In the end, WB Partners received a *smaller* portion of profits than it should have under the terms of the JV agreement. They didn't follow their documents! The Tax Court does not appear to reconcile the putative issue of *WB Acquisition* with the results of its *Luna* litmus analysis.

For lawyers and clients, it is even more worrisome in a large and landscape-covering way. *WB Acquisition* suggests that ''was it a partnership?'' musings can occur even when there are unambiguous documents (a partnership or joint venture agreement, an EIN for the entity, and financial and bank accountant information). These items plainly all indicate that a partnership was intended by the parties. That one can question the existence of a partnership in such a case does not bode well for attorney-client partnerships.

Yet it is heartwarming that *WB Acquisition* shows how much weight will be afforded to the *Luna* factors. The minutiae of the transaction seem to be paramount. Lawyers and clients who wish to form partnerships should review each of the *Luna* factors and do their best to have their documents and actions conform to those factors. If the lawyer and client have enough of these factors in the ''yes'' box, and especially if their actions conform to their documents, *WB Acquisition* suggests that the partnership should be respected.

Conclusion

The vast army of partnership-oriented tax lawyers may find different facets of *WB Acquisition* to be most important. Within the limited context of the attorney-client *Banks* fee debate, however, *WB Acquisition* could actually be helpful. Provided you cross your Ts and dot your Is on the *Luna* factors, a partnership of lawyer and client (like any other partnership) may be respected.

The Tax Court often has the exceedingly difficult job of divining the true purpose and intent of taxpayers and the transactions they undertake. With attorney-client partnerships, the IRS may well argue how dastardly the particular taxpayers were in attempting to obviate lawyer fee income. As it presumably argued in *Allum*, the IRS will assert that the lawyer and client have not even reached the threshold at which the *Luna* factors can be tested.

However, if lawyers and their clients form and conduct their partnerships with the *Luna* factors in mind, those partnerships may be respected and the clients may be able to avoid the sometimes onerous results of *Banks*.

[15]*See Nico v. Commissioner*, 67 T.C. 647, 654 (1977), *aff'd in part, rev'd in part on other grounds*, 565 F.2d 1234 (2d Cir. 1977) (''we consider neither Revenue Rulings nor Memorandum Opinions of this Court to be controlling precedent'').

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