ROBERTS & HOLLAND LLP

February 17, 2011

Substance Over Form: "WB Acquisitions"

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Where the substance of a transaction differs from its form, the tax liabilities of the participants must be determined in accordance with the substance of the transaction.[1] Under this "substance over form" doctrine and related principles, the purported conducting of a business within a joint venture or partnership arrangement does not compel the Internal Revenue Service to give effect to the arrangement or to the taxpayers' allocations of income thereunder.

The continued vitality of the substance over form doctrine and the tax authorities' ability to challenge the existence of a partnership for tax purposes is reflected in the Tax Court's recent decision in *WB Acquisition, Inc. v. Commissioner*.[2]

Facts

Watkins Contracting Inc. (WCI) conducted an asbestos removal and environmental remediation contracting business. Prior to 1997, WCI was owned by two individuals, Daren Barone and Gregory Watkins.

Barone and Watkins sold the stock of WCI in 1997 to Rexx Environmental Corp. (REXX), but continued their involvement in the business as employees of WCI. By 1999, REXX was encountering financial difficulties in operating WCI and encouraged Barone and Watkins to provide the personal guaranties that were needed for WCI to bond projects.

When Barone and Watkins provided such a guarantee in connection with a WCI project, they received a share of profits from the project in exchange. In one case, involving work for the U.S. Navy in San Diego, REXX agreed to pay to Barone and Watkins as much as 66.66% of the profits from the project in exchange for their personal guarantees.

Because of the continued financial problems of WCI, REXX approached Barone and Watkins regarding a reacquisition of WCI by them. Barone and Watkins ultimately agreed to repurchase the business, and the purchase of the stock was finalized on June 10, 1999. In connection with the purchase, Barone and Watkins consulted with an attorney who ultimately recommended an ownership structure for WCI that was intended, among other things, to maximize the principals' protection from WCI-related liabilities; to permit them to invest separately or together in properties unrelated to the contracting business; and to create qualified retirement plans.

In accordance with the attorney's recommendations, on September 19, 2000, Barone and Watkins assigned their ownership interests in WCI to WB Acquisitions, Inc. (Acquisitions), a corporation wholly owned by a partnership known as WB Partners. WB Partners in turn had two equal partners, each an S corporation, the stock of each of which was wholly owned by an employee stock ownership plan (ESOP). Each of Barone and Watkins was the sole participant in the ESOP pertaining to one of the S corporations.

Each of Barone and Watkins also entered into an employment agreement with the S corporation in which he had an indirect interest as an ESOP participant. The employment agreement obligated him to provide construction management, indemnity, and financing services. These services included services related to the business of entities related to the S corporation, such as WCI, but each employment agreement also required the individual to provide his services for the exclusive benefit of the S corporation that employed him. The employment agreements also stated that the services of the principals were to be contributed by the S corporations to WB Partners.

In practice, the principals continued to perform management, business development, and other services for WCI in the same manner as they had done while WCI was owned by REXX, without any involvement on the part of, and without obtaining express consent from, the S corporations or WB Partners.

On September 29, 2000, WCI entered into an agreement (the Subcontract) to perform demolition and environmental remediation work on a large redevelopment project involving the San Diego Naval Training Center (the NTC project) as a subcontractor for a

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price of approximately $17 million. The Subcontract was obtained on the basis of a "lump-sum bid," meaning that WCI bore the risk of unexpected additional costs. A $17 million bond was required to obtain the work, and Barone and Watkins provided personal guarantees demanded by the issuer of the bond.

A few days before the Subcontract was executed, WCI and WB Partners entered into a joint venture agreement (JV agreement), for the purpose of performing the Subcontract and, allegedly, to protect the anticipated proceeds from the Subcontract from potential claims of creditors of WCI.

Under the JV agreement, profits from the subcontract were allocated 70% to WB Partners and 30% to WCI. The JV agreement provided that WCI was responsible for management and performance of the Subcontract work and would be paid by the JV amounts equal to all direct costs incurred by WCI under the Subcontract, plus an additional amount equal to 5% of the direct costs. WB Partners agreed to provide the necessary indemnity and financing services.

The JV obtained its own employer identification number, opened a bank account, and had its financial statements, but did not file any tax return. Moreover, and notwithstanding the JV agreement, the Subcontract was executed by WCI, and not by the JV, and the Subcontract was never subsequently amended to reflect the JV as the provider of services. Also, WCI, and not the JV, had the contracting licenses needed to perform the work required by the NTC project.

By September 30, 2002, the subcontractor had incurred costs of approximately $5.8 million and the construction manager (the counterparty under the Subcontract) had been billed approximately $14.1 million, resulting in a profit to that point of $8.3 million. Notwithstanding the previously agreed 70/30 division of profits under the JV agreement, Barone and Watkins decided to allocate only 50.4% of the profits from the NTC project to WB Partners, with the balance of the profits being allocated to WCI and reported on its return.

In 2003 WCI entered into an agreement to sell substantially all its assets for $5.4 million, paid in the form of cash of $4.9 million and a $500,000 promissory note bearing interest at 10% per annum. The note was payable to Watkins (for reasons not made clear in the opinion). In connection with the sale of assets, Barone, Watkins, WCI, WB Partners, and the S corporations entered into a noncompetition agreement for the benefit of the purchaser, under which each agreed not to perform various types of environmental remediation work, and the asset purchase agreement allocated $3.4 million of the consideration to the noncompetition covenants. The portion of the proceeds allocated to the noncompetition agreement, and the interest on the $500,000 note, were included as income on the 2003 and 2004 income tax returns of WB Partners.

Following an audit, the IRS alleged underpayments of tax by Acquisitions and WCI on their consolidated returns for the tax years 2002 through 2006. Adjustments were also made by the IRS with respect to WB Partners. The taxpayers timely filed petitions in the Tax Court for review of the asserted tax deficiencies.

Discussion

The principal substantive issues addressed in the memorandum opinion of the Tax Court were: (i) whether the JV formed to complete the NTC project, and the income allocations made by it, should be given effect, or disregarded (with the effect that all the income from the Subcontract would be taxable to WCI); and (ii) whether the income from the noncompetition agreement and interest on the $500,000 note, both relating to the sale of the assets of WCI in 2003, were properly reported on the WB Partners tax returns or should have been included in the income of the Acquisitions group.

With respect to the first issue, the opinion discusses at length the factors that the case law has deemed relevant in determining whether a partnership or joint venture exists for federal tax purposes. One relevant factor is whether the partners entered into an agreement and then conduct themselves in accordance with the terms of the agreement.

Although there was a written JV agreement, the court noted that the parties to the agreement (WCI and WB Partners) disregarded the terms of that agreement by allocating income in a proportion different from that specified in the JV agreement (without there being any evidence of an amendment to that agreement), and by failing to file any income tax return for the JV, even though the JV agreement required that such returns be filed.

The court further noted that it was not apparent that WB Partners made any significant contribution to the JV. Although employment agreements provided that the financing and indemnity services of Barone and Watkins were to be rendered to the S corporations, and contributed by the corporations to WB Partners, the parties themselves did not respect other aspects of those agreements. For example, the management and supervisory services of Barone and Watkins were provided directly to WCI, notwithstanding that, under the employment agreements, the S corporations (and not WCI) had the exclusive rights to the individuals' services as corporate officers.

Taking into account that the parties did not fully respect their own agreements, the court was apparently unwilling to give effect to the purported contribution, under those agreements, of the principals' financial support services to WB Partners. The opinion also notes that, although Barone and Watkins provided personal guarantees that were presumably meaningful in obtaining the necessary bond for the NTC project, they were not members of the JV and no portion of the profits from the JV was allocated to them.

The court further found that the decision to allocate a smaller share of profits from the JV to WB Partners than that called for under the JV agreement, without identification of any "legitimate reason" why WB Partners (or a party acting at arm's length) would

have agreed to this, weighed against a finding of a true joint venture, as did WCI's failure to contribute any capital to the venture. Overall, the court found that the JV arrangement was not indicative of an arm's length negotiation between unrelated parties.

Further, the circumstances that the JV did not enter into the Subcontract and did not issue bills to the counterparty for work performed under the Subcontract, and that the executive of the counterparty who had primary responsibility for the Subcontract was not aware of the existence of the JV, were unhelpful to the taxpayers' position. Ultimately, the court sustained the government's view that the JV was nothing more than an artifice to improperly assign income of WCI to other parties, where it would apparently be taxed at a lower rate.

The court also held against the petitioners with respect to the question of whether income attributable to the noncompetition covenants and interest on the note relating to the sale of assets of WCI was properly reported by WB Partners. The court applied the same substance over form analysis as with respect to the JV issue and concluded that only WCI, and not WB Partners or its members, had the proper licenses and permits and was otherwise capable of performing the services that were restricted under the noncompetition agreement -- and thus that WCI should be allocated all the consideration paid under that agreement. Similarly, the court concluded that the interest with respect to the note should be included in the income of WCI and not that of WP Partners.

Observations

There may well have been facts and circumstances unknown to the authors of this article and not recited in the Tax Court's opinion that led the taxpayers to adopt the ownership structure and implement the transactions described in the opinion. In any event, it seems likely that the personal guarantees and management and operational services provided by Barone and Watkins were critical to their contracting business. Thus, if direct payments had been made by WCI to the individuals for the financial guarantees that they provided, and if payments had been made to those individuals by the purchaser of assets for the noncompetition agreement, the income resulting from those payments would probably not have been included in the income of WCI (the "C" corporation at the bottom of the ownership chain) and thereby subjected, at least potentially, to multiple levels of tax.

In the face of a complex structure, however, where the parties' conduct did not fully comport with their elaborate documentation, the court refused to give credence to key provisions of the agreements entered into by Barone and Watkins and entities controlled by them that purported to provide grounds for allocation of the bulk of these profits to WB Partners. Once those provisions were disregarded, the result to the taxpayers was likely worse than what could have been achieved through more conservative tax planning.

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[1] *See*, *e.g.*, *Knetsch v. United States*, 364 U.S. 361(1960) and *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); see also Treas. Reg. § 1.701-2(a)(2) ("Implicit in the intent of subchapter K are the following requirements -- . . . (2) The form of each partnership transaction must be respected under substance over form principles."

[2] T. C. Memo 2011-36 (Feb. 8, 2011). *See also Robucci v. Commissioner*, T.C. Memo 2011-19 (Jan. 24, 2011).

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