February 2010

Dear ,

This issue of the WKBK&Y newsletter addresses:

1. HR 1935 – Character of Tail End Profit Allocation

2. IRS Commissioner Proposed Disclosure of Tax Accrual Workpapers For Certain Taxpayers

3. Gifts of Partnership Interests- Gift Tax Exclusion / Present Interest Issues

1. **HR 1935 - Character of Tail End Profit Allocation**

Introduction

On April 2 of 2009, HR 1935 was introduced into the House and was subsequently referred to the House Ways and Means Committee and has not moved forward down the legislative process. Among other things, HR 1935 would affect many real estate developers and managers who receive a "tail end" allocation by taxing such income as ordinary income as opposed to capital gains.

Discussion

While likely intended for Wall Street partnerships ("investment services partnership"), if HR 1935 is enacted, any real estate developer/manager who receives a "tail end" aka "Capital Interest" would be taxed on gain as ordinary income as to any tail end, priority allocation net profits/net cash upon the sale of the real estate project.

> *Example.* *Don Developer and Irving Investor agree to build a warehouse to provide storage to winegrowers in Napa. Don Developer will acquire the land, do all predevelopment work, obtain zoning approvals and loan funding. Irving Investor agrees to put in $500,000 investor capital. Don Developer will contribute the land purchase contract, predevelopment work and additional credit to more or less match the $500,000. Their LLC agreement provides that while Don and Irving share annual net profits/losses on a 50/50 basis, Don will receive a 20% tail end priority allocation of net cash/net profits upon the sale of the project before the members get their 50/50 profit allocation on any gain. While Don anticipated that a sale in 15-20 years would provide capital*

gains on the tail end allocation, under HR 1935, if enacted, the tail end allocation would be taxed to Don as ordinary income (39%+) rather than at capital gain rates.

As tail end allocations (i.e. developer/manager partner will receive a priority allocation of gain before the general allocation to all partners/members) are common upon the sale of the project, such developer/managers may wish to consider whether prospective partnership/operating agreements should provide an alternative allocation to recognize their risks and development work.

In particular, it presently appears that HR 1935 can be avoided (and a capital gains position maintained upon a future sale if HR 1935 is enacted) by providing the real estate developer/manager simply an additional common partner/member interests/units (with zero starting capital account) rather than a tail end/capital interest in consideration for their development risks/work. For instance, HR 1935 could be avoided if Don Developer (discussed in the above example) instead received a 65% general profit allocation. While far more difficult to sell to investors, this provision for issuing an additional common interest (with zero capital account) appears to avoid the tail end allocation recharacterization of gain on sale as ordinary income rather than capital gain.

For your clients, it is important to be clear that HR 1935 has not yet been enacted and has not left the House Ways and Means Committee since last April; however, solely as a preventative measure, there are concerns that HR 1935 is very attractive as it may be passable on a one party vote of major tax legislation as it responds to public ire about "vengeance" on Wall Street, "loophole" closure, and, for some, increased taxes on the "rich." In addition, due to the multi-year lifespan of real estate projects, the concern to the client is not whether HR 1935 is passed this year but if a version of HR 1935 is passed before the client receives a “tail end” payment.

As to avoidance planning, HR 1935 in its present form presently would acknowledge the common partner/member interest exception to ordinary income treatment as follows:

> IN GENERAL- In the case of any portion of an investment services partnership interest which is a qualified capital interest, all items of income, gain, loss, and deduction which are allocated to such qualified capital interest shall not be taken into account under subsection (a) if--
>
> (i) allocations of items are made by the partnership to such qualified capital interest in the same manner as such allocations are made to other qualified capital interests held by partners who do not provide any services described in paragraph (1) and who are not related to the partner holding the qualified capital interest, and
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> (ii) the allocations made to such other interests are significant compared to the allocations made to such qualified capital interest.

WKBKY Takeaway

While it appears unlikely that HR 1935 will become law this year, practitioners should keep in mind that HR 1935 and similar laws are being contemplated by Congress every year, and, to the extent possible, structure deals in ways to minimize clients' exposure to the potentially devastating consequences of having contemplated capital gains treatment changed into ordinary income. WKBKY will continue to monitor the progress of HR 1935.

2. IRS Commissioner Proposes Disclosure of Tax Accrual Workpapers for Certain Taxpayers

On Tuesday, January 26, 2010, the IRS announced a proposal that, if effective, would require many companies to disclose uncertain tax positions in their annual income tax return filings. IRS Commissioner Douglas Shulman made the announcement during remarks to the New York State Bar Association Tax Section, and indicated that this is a major step in the move towards increased transparency. This proposal is contained in IRS Announcement 2010-9. IRS is accepting public comments on the proposal through March 29, 2010.

This proposal is the next step in the continuing saga between taxpayers and the IRS regarding tax accrual work papers. The "saga" refers to the recent case of Textron v. Comm'r., 577 F.3d 21 (1st Cir. 2009), wherein the First Circuit overruled itself en banc and held that a taxpayer's "tax accrual workpapers" prepared by its accountants to reflect the relative likelihood of uncertain tax positions, were not subject to any privilege (including the work-product privilege) and thus were discoverable by the IRS in litigation.

As proposed, the requirement would apply to business taxpayers who have both: (1) a financial statement prepared under FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48, now contained within FASB Accounting Standards Codification (ASC) 740-10, Income Taxes) or other similar accounting standards reflecting uncertain tax positions (such as International Financial Reporting Standards (IFRS) or country-specific generally accepted accounting standards), and (2) total assets over $10 million.

A schedule or form would be included in applicable business tax returns annually. Each uncertain tax position would require a concise description to determine the nature of the particular issue and would require the taxpayer to determine the maximum amount of potential federal tax liability attributable to each uncertain tax position. The IRS is evaluating additional options for penalties or sanctions for lack of adequate disclosure.

Commissioner Shulman indicated that this proposal was intended to improve the efficiency and effectiveness of tax examinations and that he understands this is information that taxpayers have already prepared for financial reporting purposes. He stressed that taxpayers would not be required to disclose how strong or weak they regarded their tax positions. Per Commissioner Shulman, the new reporting requirements will not applicable to the 2009 filing season. However, it is presumed that the IRS intends to push this proposal forward quickly so taxpayers and practitioners will need to stay tuned for further developments. The IRS has invited comments on the proposal by March 29, 2010.

The application and associated understanding of FIN 48 is still fairly new to many accountants. FIN 48 was generally effective for public companies for fiscal years beginning after December 15, 2006. However, the effective date for private companies was deferred, and these companies are starting to see its application in their financial statements for annual financial statements for periods beginning after December 15, 2008. Therefore, many practitioners may have been seeing and experiencing the application of FIN 48 to financial statements for the first time within the past year - either as an audit or tax practitioner in public accounting, or in an accounting or tax function of a private company.

This proposal also has many implications and will generate much debate. This proposal will have a significant effect on taxpayers if it becomes effective as initially proposed by the IRS. Practitioners are encouraged to read the Announcement and submit their comments to the IRS before March 29.

3. Gifts of Partnership Interests – Gift Tax Exclusion / Present Interest Issues

Introduction

The Tax Court recently issued a decision in Price v. Comm'r., TC Memo 2010-2, in which it held that the gift of a partnership interest did not qualify for the annual gift tax exclusion because it was a gift of a future interest as defined in Code section 2503(b). Price provides an example of the types of restrictions on a partner's right to partnership income will affect the characterization as a present or future interest for purposes of the gift tax exclusion.

Legal Background

Code section 2503 allows a donor to exclude a specified amount of each gift to each donee ($13,000 in 2010), provided that the gift is not of a "future interest". A gift of a partnership interest is a particularly troublesome context in which to analyze the future interest rule because a partner's ability to receive income is subject to the terms and conditions of the partnership agreement. In Hackl, v. Comm'r., 118 TC 279, 293-94 (2002), aff'd 335 F.3d 664 (7th Cir. 2003), the Tax Court articulated a standard by which to evaluate whether a gift of a partnership interest is one of a present interest:

> "[The authorities] require a taxpayer claiming an annual exclusion to establish that the transfer in dispute conferred on the donee an unrestricted and noncontingent right to the immediate use, possession, or enjoyment (1) of property or (2) of income from property, both of which alternatives in turn demand that such immediate use, possession, or enjoyment be of a nature that substantial economic benefit is derived therefrom. In other words, petitioners must prove from all the facts and circumstances that in receiving [a partnership interest], the donees thereby obtained use, possession, or enjoyment of the [interest] or income from the units within the above-described meaning of section 2503(b)."

To satisfy the present interest requirement under Hackl, it must be shown that (1) the partnership would generate income at or near the time of the gifts; (2) some portion of that income would flow steadily to the donees; and (3) the portion of income flowing to the donees can be readily ascertained.

Analysis

The partnership owned rental real estate, and therefore, the court found that the first prong was met. But the court characterized the gift as a future interest because the record failed to show that any ascertainable portion of the income would flow steadily to the donees.

The partnership agreement placed significant restrictions on the partnership's distribution of profits. For instance, partnership profits were distributed at the discretion of the general partner unless directed otherwise by a majority of the interests of all partners. Further, the partnership agreement stated that "annual or periodic distributions to the partners are secondary to the partnership's primary purpose of achieving a reasonable, compounded rate of return, on a long-term basis, with respect to its investments." Though there were potential options for the donees to satisfy the second and third prongs, the court found these contingencies to be extremely unlikely and inconsistent with the nature of the partnership. Accordingly, the court held that the gift was not of a present interest.

WKBKY Takeaway

Price illustrates the importance of the nature and extent of restrictions on partnership assets that will nullify the annual gift tax exclusion. While a Prince result can be avoided through careful planning and ensuring that donees will be entitled to withdraw an ascertainable amount from the partnership, the average partnership agreement will probably not pass muster under Hackl. Use of lapsing Crummey rights (such as is done in the case of a trust) is one way of potentially addressing this concern. Practitioners are advised to be aware of this nuance in filing gift tax returns and to advise clients intending to make such gifts accordingly.

We hope that you find these items of interest to you. If you need further information or would like to discuss a particular issue, feel free to call any one of the lawyers listed below. We will get you to the right person.

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