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Opportunities and Pitfalls When Doing Business in Pass-Through Entities

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The entity taxed as a pass-through for income tax purposes is pervasive in the modern business climate. Numerous types of entities may be treated as pass-through entities; the classic examples are corporations that have elected to be taxed under Subchapter S of the Internal Revenue Code and partnerships. In addition, entities such as limited liability companies that have been created under state law, may elect to be taxed as partnerships.

The “check the box” rules established by Treasury Regulations, effective Jan. 1, 1997, transformed the process of how an entity is classified for income tax purposes from an expensive and involved process into a far simpler exercise involving the completion of Internal Revenue Service (IRS) Form 8832. The choice of conducting business under the pass-through regime can create numerous opportunities and (often unintended) obstacles on both the federal and state level.

A recent Federal Claims Court case suggests that individuals conducting business using pass-through entities

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will be afforded great leeway when taking advantage of certain tax elections. *Morton v. U.S.* involved the founder of the Hard Rock Cafe and Hotel chain. 2011-1 U.S. Tax Cas. ¶50,346 (April 27, 2011). The taxpayer, Morton, established Hard Rock Hotel Inc. (HRH), a C corporation. He also established several S corporations. One S corporation (Lily Pond) owned all voting shares and 94 percent of all other shares of HRH. Another S corporation (RWB) owned the real estate upon which the hotel stood, while yet a third S corporation (510 Development) existed to employ the taxpayer's staff and perform management functions for the other S corporations.

The taxpayer sold various cafes while retaining the right to use the Hard Rock name and trademark. His salary from HRH was a fixed percentage of HRH's profits. He purchased two airplanes, which were titled in the name of RWB for liability protection purposes, and he advanced funds to 510 Development in order to pay the salaries of the flight crew. The planes were used by the taxpayer for both personal and business purposes, including business flights to promote the enterprises of HRH and the Hard Rock brand.

Although the aircrafts were titled in the name of RWB, and the business trips were to further the direct interests of entities other than RWB, the taxpayer

sought business expense and depreciation deductions on his personal federal income tax return. The IRS rejected his position with the argument that corporations and their owners must be viewed separately for tax purposes. Under this view, the purpose of the trips was to further the taxpayer's, not RWB's, business interests. The IRS claimed the cost of the trips was not a valid business expense for RWB and was not an available deduction for the corporation (or the taxpayer to whom the deductions would flow).

The Federal Claims Court distinguished the case law cited by the government and held in favor of the taxpayer. The court noted that many of the authorities cited by the government dealt with C corporations, not pass-through entities such as S corporations, and emphasized that since the tax attributes of the S corporation are passed on to the taxpayer, “the outcome would have been the same” regardless of whether he titled the aircraft in the name of the corporation or the taxpayer individually. The court held that all of the entities involved were “alter egos of [the taxpayer]; they all have the same business purpose.” The court reserved judgment, however, on whether the depreciation deductions would be allowed pending the taxpayer's substantiation of the business purpose of the flights.

The *Morton* decision was quite favorable to the taxpayer. It was also surprising given the general rule that: "once chosen, ... taxpayers are bound by the consequences of the transaction as structured, even if hindsight reveals a more favorable tax treatment." *Rumsfeld v. United Techs. Corp.*, 315 F.3d 1361, 1376 (Fed. Cir. 2003) (citing *Grojean v. Comm'r of Internal Revenue*, 248 F.3d 572, 576 (7th Cir. 2001)).

This line of reasoning, however, can cut both ways. A court following the *Morton* approach could also reach holdings unfavorable to taxpayers. For example, an individual who is the sole owner of a "dealer" entity may find personal dispositions of property being imputed to the dealer activities of the entity (which is viewed as an alter ego). An entity or individual holding property primarily for the purpose of selling it to others (rather than holding it for investment) will be considered a dealer of that property. While gain from the sales of certain types of property can generally qualify for tax at capital gains rates; sales by a dealer generate ordinary income. Additionally, most courts are not as loose in their construction of taxpayer activities as the *Morton* court. Often the formal structure and manner in which transactions are labeled can be determinative of the tax outcome. This is evident in a recent New York Tax Appeals Tribunal decision.

In the *Matter of Tosti* dealt with an attorney domiciled in New Jersey who worked as a nonequity "partner" for a law firm that maintained offices in both New York and New Jersey, although he worked exclusively in the New Jersey office. DTA No. 822915 (May 12, 2011). When the taxpayer, Tosti, commenced his employment with the firm, he entered into a "partnership" agreement which

specifically stated that as a nonequity partner he did not have any interest in the assets or profits of the law firm. Although the taxpayer's salary was set by the firm's executive committee, and he was a nonequity partner, the firm called him a "partner" and issued a Form K-1 to him. The K-1 reflected that Tosti had no share in the profit, loss or capital of the firm, and characterized the payments made to him as "guaranteed payments."

The taxpayer filed New York State nonresident tax returns for years 2004, 2005 and 2006. On the 2004 returns, he initially characterized all of his income as New York source income. For 2005, he initially allocated income between New York and New Jersey based on the allocation percentages used by the law firm. Subsequently, he amended both of these returns to reflect that none of his income was New York source income. For the year 2006, the taxpayer took the position that none of his income was New York source income. The New York Division of Taxation examined the returns and determined deficiencies for 2004 and 2006 and denied the taxpayer's request for refund on the 2005 amended return. The taxpayer appealed the Division of Taxation's determinations.

The distinction of whether the taxpayer was a "partner" or "employee" was determinative in this case. If the taxpayer was found to be an employee who performed legal services only in New Jersey, he would have no New York source income. However, if the taxpayer was a partner, then under New York law he would be required to allocate his income between New York and New Jersey.

The Tax Appeals Tribunal gave great weight to the fact that the taxpayer was called a "partner" by the firm, that his employment agreement was captioned

"partnership" and that he had the managerial duties of overseeing at least one associate. The tribunal did not find it determinative that the taxpayer was in essence employed at will and had no ownership rights in the law firm, and was unwilling to look beyond the formal structure and labels given by the law firm to the employment arrangement. Instead, the tribunal concluded that "Tax Law treats partners differently than employees [and in] choos[ing] to become a partner ... [the taxpayer] must bear the consequences."

Tosti emphasizes the importance of being aware of the way various jurisdictions will treat income, and whether income will be considered as sourced from within or without the particular jurisdiction. Generally, if an item of the pass-through entity's income is sourced from outside the state, nonresident partners will not be liable to the state for that portion of the income. They will only owe income tax to the jurisdiction from where the income was sourced and the jurisdiction where they are resident taxpayers. However, it should be noted that various states often have stringent rules regarding what income can be considered sourced from other states.

There are a number of issues individual taxpayers must consider when entering into business transactions, particularly when using pass-through entities. They should be careful in the ways they structure their business relationships and give careful consideration to the way transactions are labeled. Additionally, careful consideration should be given to the laws of the various jurisdictions where business will be conducted. Doing so will not only allow for the most efficient business planning, but will also minimize the possibility of an undesired tax result. ■