

## Message From The Firm

*Anytime an entity incorporates a division as a subsidiary, the division—which was formerly a disregarded entity for tax purposes—becomes a separate entity for tax purposes. David Schwartz's article advises entities to take special care if there are existing loans between the division and the entity. Otherwise, it is possible that, through incorporation, the parent company could be treated as receiving the promissory note in the exchange, resulting in the incorporation being considered a taxable event.*

*The Internal Revenue Service has provided proposed regulations with respect to the compensatory transfer of partnership interests. Robin Gilden and James Chapman discuss the proposed regulations in their article.*

*Joe Faucher and Max Sank review a recent case from the Ninth Circuit that reminds employers of the need to maintain a strong anti-harassment policy. Such a policy can serve the dual purpose of preventing sexual harassment in the workplace and providing the employer with a defense which can limit the employer's liability should a sexual harassment lawsuit arise.*

*Rich Luftman's article provides a summary of the changes in the law as a result of the Non-Profit Integrity Act of 2004.*

*Along with this newsletter we are sending you an article, "Labor Law Update: What's New for 2006 and How to Make Sure You're in Compliance" written by the head of our Employment Law Practice Group, Mark Terman.*

*As always, if you have a question about an article in this newsletter, please contact the author or me.*

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## Tax Risk in Disregarded Entity Becoming a "Regarded" Entity

By David Schwartz (DavidSchwartz@Reish.com)



In 2004, the IRS issued a private letter ruling which confirmed that a spin-off of an "S" corporation subsidiary constituted a tax-free reorganization, notwithstanding that there was an intercorporate debt payable from the "S" corporation subsidiary to its parent company. Under the facts of Private Letter Ruling 200406008 (February 6, 2004), "S" corporation owned all of the stock of its subsidiary (QSub), which was also an "S" corporation. As a result of this ownership structure, QSub was considered a "disregarded entity" for tax purposes. S Corp then determined to spin off QSub to its shareholders in a purported tax-free reorganization. However, in order to qualify for tax-free reorganization treatment, QSub was required to be converted into a corporation, which was deemed to occur as a result of the distribution of the QSub shares to S Corp's shareholders.

In the deemed conversion of QSub into an "S" corporation, QSub was treated as a new corporation, having acquired all of its assets (and assuming all of its liabilities) from S Corp, in exchange for QSub stock. Depending on the analysis applied, the receipt of the note—in what was otherwise a nonrecognition exchange—should have been treated as taxable "boot." However, the IRS determined

otherwise in the ruling, and concluded that neither S Corp nor QSub would recognize gain or loss in connection with the transaction.

Similarly, in *Wham Construction Co., Inc. v. U.S.*, 600 F.2d 1052 (4th Cir. 1979), a corporation incorporated one of its divisions, which had a book payable to the corporation. That payable became an intercompany debt in the transaction, and that IRS asserted that the payable was taxable "boot." However, the Court took the position that the parent corporation already owned the note, and did not get it in the exchange.

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***"However, in order to qualify for tax-free reorganization treatment, QSub was required to be converted into a corporation..."***

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Notwithstanding the outcome of Private Letter Ruling 200406008 (which may only be relied on in any event as precedent by the taxpayer for whom the ruling was issued), published authority states that the IRS will generally view obligations of the type described above as taxable "boot," and, in Revenue Ruling 80-228, 1980-2 C.B. 115, asserted

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## Proposed IRS Regulations to Change Existing Law for Grants of Nonvested Partnership Profit Interests



By Robin Gilden ([RobinGilden@Reish.com](mailto:RobinGilden@Reish.com)) and James Chapman ([JamesChapman@Reish.com](mailto:JamesChapman@Reish.com))



In the past, business owners who operate their businesses as partnerships or as limited liability companies treated as partnerships for tax purposes (both referred to in this article as “partnerships”) have been reluctant to issue equity compensation to their employees because of the uncertainty regarding the tax treatment to both the employer partnership (the “Employer”) and the recipient employee (the “Employee”) on the grant of those equity interests.

On May 24, 2005, the Internal Revenue Service (the “IRS”) issued Proposed Treasury Regulations under Section 83 of the Internal Revenue Code of 1986, as amended (the “Code”) that provide much needed guidance regarding the tax treatment to the Employer and to the Employee on the grant of a compensatory partnership interest. However, under the Proposed Treasury Regulations, an Employee that receives a compensatory “profits” interest in a partnership that is subject to a substantial risk of forfeiture and is non-transferable at the time of the grant (a “Non-Vested Interest”) will be required to make an election under Code Section 83(b) at the time the partnership interest is granted, or the Employee will be required to recognize as ordinary income the excess of the fair market value of the Non-Vested Interest and the amount, if any that the Employee paid for the Non-Vested Interest at the

time when the Non-Vested Interest is no longer subject to a substantial risk of forfeiture or becomes transferable (a “Vested Interest”).

### Background

Under current interpretations of the tax law, a partner who receives a capital interest in a partnership is required to recognize income equal to the fair market value of the partnership interest on the date of a grant. Under Revenue Procedure 2001-43, 2001-34 I.R.B. 191, an Employee that receives a “profits” interest in a partnership is generally not required to recognize any gain if certain conditions set forth in the Revenue Procedure are met.

### Changes Made by the Proposed Regulations

The new Proposed Regulations provide that a partnership interest granted in return for services is subject to the rules contained in Code Section 83.

Under Code Section 83, an Employee who receives a Non-Vested Interest is not subject to income tax at the time of the grant. Rather, the Employee is required to recognize ordinary income at the time the Non-Vested Interest becomes a Vested Interest. At that time the Employee is subject to tax, at ordinary income tax rates on the excess of the fair market value of the Vested Interest over the amount, if any, that the Employee paid for the Vested Interest.

For this purpose, property is subject to a substantial risk of forfeiture if the Employee is required to return the prop-

erty for less than the fair market value of the property on the occurrence of certain events, such as the termination of the Employee’s employment. Property is not transferable if it cannot be transferred without the restriction.

However, where an Employee receives a Non-Vested Interest, the Employee can elect to include the fair market value of the Non-Vested Interest on the date of the grant in the Employee’s income.

An Employee would make this election if the Employee believes that the fair market value of the Non-Vested Interest will increase substantially by the time that the Non-Vested Interest becomes a Vested Interest.

Under the Proposed Treasury Regulations, where an Employee receives a Non-Vested Interest and the Employee elects to include the fair market value of the Non-Vested Interest in income on the date of the grant of the Non-Vested Interest, the proposed regulations allow the Employer partnership and the Employee

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***“Until the proposed regulations are finalized, the recipient of a pure profits interest in a partnership generally need not make a section 83(b) election...”***

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to value the Non-Vested Interest based on the liquidation value of the Non-Vested Interest, provided that certain requirements are satisfied. For this purpose, the liquidation value of a Non-Vested Interest is the amount of cash that the holder of the Non-Vested Interest would receive with respect to the Non-Vested Interest if, immediately after the grant of the Non-Vested Interest, the partnership sold all of its assets (in-

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## Tax Risk

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that it would not follow the Court's decision in *Wham*. In particular, in Revenue Ruling 80-228 (which may be relied on by taxpayers other than the taxpayer who is the subject of the ruling), under facts similar to those in *Wham* and in Private Letter Ruling 200406008, the IRS reasoned that, when the division at issue was organized as a separate corporation, and an account payable from the new corporation to the parent corporation was established (and, correlatively, an account receivable was reflected by the parent corporation on its books), a real liability on the part of the new corporation (and a real asset on the part of the parent corporation) came into being. In the estimation of the IRS, that liability did not simply "carry over" to the books of the new corporation. Instead, the parent corporation received an asset other than the stock of the new corporation, and because only stock may be received in the exchange in order to qualify for tax-free reorganization treatment, at least a portion of the transaction was taxable.

**Conclusion.** Because of the disconnect between the position of the fourth circuit and the position of the IRS (as well as the disconnect between the IRS position in Private Letter Ruling 200406008 and the IRS position in Revenue Ruling 80-228), Companies will need to structure around the intercompany debt issue if it is determined that the company will either incorporate a division, or otherwise if a disregarded entity becomes a separate taxable entity as a result of, e.g., a spin-off of an "S" corporation subsidiary. ❖

## Harassment Claims: A Lesson in Maintaining a Strong Written Policy

By Joseph Faucher ([JoeFaucher@Reish.com](mailto:JoeFaucher@Reish.com)) and Max Sank ([MaxSank@Reish.com](mailto:MaxSank@Reish.com))



A long and arduous sexual harassment lawsuit can take a tremendous toll on a company on many levels. Potentially crippling defense costs, combined with adverse publicity and the inevitable low morale of employees make it imperative to minimize the risk of

these claims. Unfortunately, no company can guarantee that acts of sexual harassment will never occur, and therefore, eliminate the possibility of lawsuits. Even if lawsuits cannot be avoided, a recent holding in the United States Court of Appeals for the Ninth Circuit, *Hardage v. CBS Broadcasting Inc.*, teaches that there are three effective tools to limit the adverse effects of litigation: (1) strict company policies aimed at the prevention and elimination of sexual harassment, (2) well publicized procedures for harassed employees to report the harassment to management, and (3) swift and vigilant action on the part of the company's management to eradicate sexual harassment once it is detected.

In *Hardage*, plaintiff filed a claim against his employer, based on alleged sexual harassment by his supervisor. The harassment had allegedly been going on for months leading up to plaintiff notifying his employer. The same day that plaintiff made his complaint of sexual harassment to his supervisor, a representative of the employer's human resources department contacted plaintiff and arranged to meet with him in person the following week. At the meeting, the human resources representative informed plaintiff of his

options, offering to talk to plaintiff's supervisor and to treat plaintiff's complaint as an anonymous complaint. Plaintiff, however, informed the human resources representative that he wanted to handle his problem by himself. Approximately two weeks later, the human resources representative contacted plaintiff to follow up on their initial meeting, but plaintiff maintained that he did not want the representative to intervene on his behalf.

The court also found that the employer established as a matter of law that it had exercised reasonable care to prevent sexual harassment in its workplace since it: (1) had adopted an anti-harassment policy, and (2) promoted awareness of its anti-harassment policy. The employer also established as a matter of law that it met its duty to take reasonable remedial measures as to the sexual harassment committed against plaintiff. The court also found that plaintiff unreasonably failed to take advantage of preventative or corrective opportunities provided by the employer. Relying on the fact that plaintiff was a local sales manager in charge of supervising approximately ten employees and his testimony that he understood that all actual sexual harassment in his workplace was dealt with in a serious manner, the court concluded that he knew of the company's policy against harassment and the procedure for initiating a complaint. The court also found it unreasonable that plaintiff first complained to his supervisor regarding the harassment approximately half a year after the harassment began. The court held that by specifically asking the employer to not utilize its remedial and preventative procedures, plaintiff unreasonably failed to make use

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## Harassment

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of the employer's anti-harassment policies and procedures.

Employers are wise to follow the preventative and remedial actions of the employer in *Hardage*:

- 1) Adopt a strict written anti-harassment policy.
- 2) Make sure that all employees are aware of the anti-harassment policy.
- 3) Contact and arrange to meet with the harassed employee immediately upon notification of the alleged misconduct.
- 4) Act on all reports of sexual harassment immediately by conducting a thorough investigation of all claims.
- 5) Inform the employee of his or her options with regard to actions taken by the employer to remedy the situation.
- 6) Follow up with the employee after the first meeting to inform the harassed employee of the actions taken by the company to remedy the situation and inquire of the employee as to further actions the employee wishes to take regarding the options available under company anti-harassment policy.

The employer should carefully document all of its actions regarding the incident, including communications with the employees involved.

While the *Hardage* decision resulted in a happy ending from the employer's standpoint, the outcome may depend in large part on where a lawsuit is filed. In a California court, for instance, the facts that led the Ninth Circuit to find in favor of the employer in *Hardage* would not necessarily guarantee victory for the employer. That is, under California law, regardless of the strictness of an employer's written anti-harassment policy and the diligence with which the employer educates its employees and investigates alleged sexual harassment,

there is significant economic risk almost any time a sexual harassment lawsuit is filed by an employee. Thus, the real lesson for employers is to consider obtaining employer practices liability insurance.

Most employer practices liability insurance covers sexual harassment claims against the employer, including claims against supervisors and fellow employees. In addition to sexual harassment claims, among the risks covered by most employer practices liability insurance are wrongful termination, discrimination, whistle-blower and other employment-related claims.

Generally, the insurance company issuing the policy has a "duty to defend." That is, the insurance company must provide the employer with legal representation upon presentation of a legal claim, even if the allegations are entirely without merit. The policy usually will provide coverage for any written notice the employer receives or any administrative proceeding initiated against the employer regarding an alleged wrongful employment practice. When it comes to harassment claims, an ounce of cure (insurance) may be worth a pound of prevention (adopting a policy against harassment, and promptly and seriously investigating any claim).

**Conclusion.** The primary goal of an employer's written anti-harassment policy is to prevent workplace sexual harassment. In the event an employee initiates a sexual harassment claim, a strong anti-harassment policy (including a thorough investigation of all claims of sexual harassment), diligently published to employees and enforced, is imperative to the defense. Regardless of the strength of the defense, workplace sexual harassment litigation can be an extremely expensive endeavor, and employers should investigate the added layer of protection that employer practices liability insurance provides. ❖

## Partnership

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cluding goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets, and then liquidated. If the Non-Vested Interest is a "profits" interest, then this liquidation value will generally be equal to zero.

If the Employee elects to include a Non-Vested Interest in income at the date of the grant, then the Employee is treated as a partner on the date that the Non-Vested Interest is granted to the Employee. If no election is made, the Employee is not treated as a partner until the Non-Vested Interest becomes a Vested Interest.

The Proposed Regulations will apply to transfers of partnership interests on or after the date final regulations are published in the Federal Register. Until such time as the final regulations are issued or until the IRS issues other rules, the principles of Revenue Procedure. 2001-43, supra, will continue to apply.

### Conclusion

Even though the Proposed Treasury Regulations would change existing law to require an Employee to make a Code Section 83(b) election upon the receipt of a non-vested profits interest, the Proposed Treasury Regulations nonetheless provide important insight into the IRS's view of partnership interest and Code Section 83. Unfortunately, the goal of simplification has been sacrificed in the name of clarification. Hopefully future guidance in this area will reclaim the simplification goal. ❖

## New Audit Requirement for Non-Profit Corporations



By Richard Luftman ([RichardLuftman@Reish.com](mailto:RichardLuftman@Reish.com))

Effective January 1, 2005, California law changed significantly with respect to non-profit corporations that are required to register with the California Attorney General's Registry of Charitable Trusts (the "AG"). The name of the act is the Nonprofit Integrity Act of 2004 (hereinafter, "Act"), and it was signed into law on September 30, 2004.

The major changes to California law based on the Act are as follows:

1) Nonprofit corporations have thirty days (instead of 6 months) within which to register with the AG. The event that begins the running of the thirty day time period is the initial receipt of property by the corporation.

2) Nonprofit corporations (with certain exceptions, including an exception for a corporation organized and operated primarily as a religious organization) with gross revenues of \$2,000,000 or more must:

- a) Prepare annual financial statements that are audited by an independent CPA according to generally accepted auditing standards.
- b) The audited financial statements must be made available for inspection by the AG and the public no later than 9 months after the end of the subject fiscal year.
- c) Maintain an audit committee.
- d) The Board of Directors must review and approve the compensation, including benefits, of the

President and Chief Financial Officer, to assure it is just and reasonable. This review and approval must be done when the person is hired, whenever the term of employment is renewed or extended, and whenever the compensation is modified.

- e) New rules are implemented regarding commercial fundraisers and solicitations.
- 3) The \$2,000,000 "gross revenue" threshold is determined in the same way that "total revenue" is determined for purposes of the completion of IRS Form 990-PF.

If you have any questions regarding the foregoing or if you believe a nonprofit organization with which you are affiliated might fall within the audit requirement rules, please contact me or the attorney at the firm with whom you normally communicate. ❖

## Around the Firm

The firm welcomes the addition of Steve Halper as a partner in the Business department. Steve focuses on a broad range of corporate and transactional matters, with emphasis on the formation, organization, financing and operation of corporations, limited liability companies and partnerships. With over 25 years of experience in the Silicon Valley as well as Los Angeles, Steve's clients include closely-held businesses in numerous industries, investment funds, and early-stage technology and other growth companies.

We are also pleased to announce that David Schwartz, in the firm's Tax Department, was recently named partner. David works with clients on corporate, partnership and individual taxation as well as transactional business matters.

Robin Gilden is a member of the planning committee for the USC Gould School of Law 2006 Tax Institute, taking place January 23-25 in Los Angeles. Jon Karp is speaking at the Institute on "S Corp Traps and Tips." On December 13th, Jon was a guest speaker at the "Year End Tax Planning" discussion held by the Los Angeles Chapter of the California Society of CPAs. Mark Terman's article entitled "Labor Law Update: What's New for 2006 and How to Make Sure You're in Compliance" was published in the December 2005 issue of *California CPA* magazine.

Mark guest lectured for a UCLA Extension course on November 29th on "Technology and Privacy in Today's Workplace: Protecting Confidentiality and Trade Secrets." Mark also spoke on "Privacy in the Workplace - Is There Any?" at the California CPA Education Foundation's Employment Practices Conference in Los Angeles on November 15th. Brad Cohen and Mike Foster spoke on "Entertainment Tax Update" to the Business Managers Committee of the Los Angeles Chapter California Society of CPAs on November 16th. James Chapman presented "Tax Update for Talent" at the California Society of CPAs and Los Angeles County Bar Association's Annual Tax Night on November 8th. Jon Karp taught an all day course in Los Angeles on November 8th for the California CPA Education Foundation on the subject of "Succession Planning for the CPA Firm."

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