



BY RICH SHAVELL

Joint Ventures: Tax Considerations

Contractors use joint ventures for a variety of reasons, including:

- Bidding on work they otherwise could not complete (spreading risk), or jobs requiring minority or other special business enterprises;
- Securing bonding or financing to obtain and perform work;
- Specialization not within the contractor's expertise; and
- Increasing access to local markets and global reach.

This article provides an overview of some tax issues facing joint ventures.

Tax Structure

According to IRC section 761, a "partnership" includes "... a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on." For tax purposes, the typical structure of a joint venture is taxed as a partnership.

If a separate entity is established under state law, it is generally considered to be a "pass-through," similar to a limited liability company (LLC), or a partnership – whether that is a general partnership (GP), a limited partnership (LP), or a limited liability partnership (LLP). If a separate entity is not established, then the code, regulations, and case law provide when a partnership exists.

In 1997, the IRS established the "check-the-box" system, which allows taxpayers to select the methods of taxation by choosing the appropriate entities for tax purposes. In the domestic construction industry, an LLC or partnership is usually established and taxed as a partnership in order to avoid trust or corporation issues. Unlike most pass-through entities, corporations may face two levels of taxation – hence the propensity for partnership taxation.

If no election is filed under the check-the-box regulations, and the venturers have not established a separate entity, then the arrangement would generally default to a partnership.¹

Services vs. Contributions

A joint venture is considered "populated" when the venturers use it to perform services with employees and hold assets in the joint venture; it's considered "non-populated" when each respective venturer performs the requisite work for a fee paid from the joint venture. The question would then be whether or not the joint venture has assets and employees.

In a 2015 Legal Advice Issued by Field Attorneys, the IRS opined that the cost of services provided to a taxpayer's joint venture is a capital contribution. The costs then become deductible expenses of the joint venture, as would be the case in a populated joint venture.

While this situation may not generally apply to construction joint ventures, the takeaway is that a joint venture agreement should clearly specify capital contributions, joint venture expenses, and each respective venturer's expenses.

Eight Identifying Factors of a Joint Venture

In other cases, the IRS has been able to reallocate income from one venturer to another.² For example, in a 2015 opinion regarding a venture engaged in a remediation project, the ninth circuit Court of Appeals concluded that the venture did not operate for tax purposes as a partnership.

The Court reviewed the eight factors identified in a prior case to determine whether there was a joint venture:³

- 1) The agreement of the parties and their conduct in executing its terms;
- 2) The contributions, if any, each party made to the venture;
- 3) The parties' control over income and capital;
- 4) The right of each party to make withdrawals;
- 5) Whether each party was a principal and co-proprietor who shared in profits and losses or is merely an agent or employee of the other under a contingent compensation agreement;

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- 6) Whether the parties filed partnership returns or otherwise represented themselves to IRS or to parties with which they dealt that they were partners;
 - 7) Whether separate books were maintained for the venture; and
 - 8) Whether the parties exercised mutual responsibilities for the enterprise.

Ultimately, the IRS was allowed to reallocate income among the parties, which was not anticipated by the taxpayers. A joint venture agreement should therefore not only be clear, but also respected, maintained, and consistently applied. Assuming that the joint venture is taxed as a partnership, several other tax issues exist.

Domestic Production Activity Deduction

The domestic production activity deduction (DPAD) permits contractors, architects, engineers, manufacturers, and certain other activities to take a special deduction of up to 9% of net income.⁴

For partnerships, DPAD is generally applied at the partner level (aggregating all qualified activities), and each partner takes into account their respective allocated share of the items necessary to compute DPAD,⁵ such as:

- Domestic production gross receipts (DPGR)
- Cost of sales (generally, direct expenses)
- Other expenses, losses, and deductions (i.e., overhead) allocable to those DPGR

Form W-2 wages, a limiting factor of the DPAD computations, are also allocated. Generally, these items are provided to each venturer with the corresponding annual Form K-1 from the partnership.

Under certain circumstances, a partnership may elect to compute the qualified production activity income (QPAI) and the Form W-2 wage limitation at the partnership level.⁶ The eligible entities are generally:

- Widely-held pass-through entities;
- Certain pass-through entities; or
- Partnerships applying certain allocation methodology.

Gross Receipts Tests

Contractors' participation in joint ventures can impact gross receipts computations. This may be important for smaller entities facing certain statutory thresholds.

The small contractor exemption from the required use of the percentage-of-completion method (PCM) is eclipsed when the average annual gross receipts for the entity exceeds \$10 million.⁷

Generally, the following three requirements that impact gross receipts computations should be construed:

- 1) If a venturer directly or indirectly owns 5% or more (but less than 50%), then a proportionate share of the joint venture's construction-related gross receipts is considered by each respective 5% venturer when the venturer is computing its average annual gross receipts;
- 2) If a venturer owns more than 50% (or has "common control"), then 100% of the joint venture's gross receipts must be considered by the "more than 50%" venturer regardless of whether the gross receipts are construction-related; and
- 3) The joint venture itself is also subjected to its own gross receipts computation with the same corresponding rules enabling the joint ventures to be exempted from the PCM.

The PCM is required for most arrangements, with the exception of a joint venture comprised of two smaller contractors. If the completed contract method (CCM) can be elected, then there are certain partnership tax issues to be considered.

Basis in the entity may become an issue if distributions are disbursed before contract completion and corresponding profit is recognized.⁸ This is because the only basis for the distributions for the venturer (before recognizing job profits) would generally be allocating remaining liabilities and the respective venturer's capital investment (less prior distributions). CFMs should exercise care to ensure there are no unintended timing issues resulting in accelerated taxable income because of distributions in excess basis.

These attribution rules can affect other computations, such as the \$5 million threshold permitting small C corporations to use the cash method.⁹ In addition, there is a small C corporation exemption from the alternative minimum tax (AMT), which is also based on average annual gross receipts.¹⁰ Again, care must be exercised to ensure there are no unintended ancillary tax issues resulting from the attribution rules with regard to the joint venture's gross receipts.

Tax Year of Joint Venture

Generally, a joint venture taxed as a partnership follows the tax year of its partners.¹¹ If the partners are all reporting on



the calendar year, this is not an issue. If the partners are on differing years, then the rules strive to limit deferrals with the following criteria:¹²

- 1) First, use the majority partner's tax year.
- 2) Next, use the tax year of the "principle partners" with 5% or more interest in partnership profits or capital, or the "least aggregate tax year" if there is no majority partner or a principle partner tax year (i.e., the tax year resulting in the least tax deferral based on specific computations).

Technically, the partnership could be forced to change its tax year if one partner leaves or a new partner joins.¹³

Another option to consider is to select a permissible tax year under Section 444 in exchange for annually depositing with the IRS an amount representative of the value of the deferred tax.¹⁴ The amounts on balance eventually return to the taxpayer. For example, generally, a calendar year pass-through entity can elect a September, October, or November year-end under these rules.¹⁵

Depreciation

While there is no gain or loss when partners contribute assets into the joint venture, there may be tax adjustments. The fair market value of contributed assets compared to the book value in the hands of the contributing partner must be addressed. Regulations provide multiple options for handling the difference, each of which may or may not be favorable to the contributing versus the non-contributing partner and vice versa.¹⁶

Transfer of Partnership Interests

The Code¹⁷ states that a partnership entity technically terminates for tax purposes if 50% or more of the interests in capital and profits is transferred during a 12-month period. Generally, joint venture agreements will address whether an interest can be transferred. While this technical termination for tax purposes does not result in a taxable gain,¹⁸ it can affect depreciation.

As a result, the Code¹⁹ requires the restarting of depreciable assets reducing the current year expense. In addition, a Section 754 election may be permitted depending on the nature of the change in ownership. A Section 754 election permits a purchaser of a partnership interest to take additional tax depreciation when outside tax basis (generally, the price paid for the interest) is greater than internal tax basis of the depreciable assets.

IRS Audit Technique Guide

The IRS issued a chapter in the Construction Industry Audit Technique Guide (ATG) addressing construction joint ventures for its auditors, which includes 15 potential questions and issues regarding contractors.²⁰

- 1) What are the assets, capital, services, and other resources contributed by each party?
- 2) What was the value and basis of the property contributed?
- 3) Did a partner contribute appreciated property to the venture?
- 4) Was the contributed property encumbered?
- 5) What are the profit, loss, and capital sharing ratios?
- 6) Do the partnership allocations have substantial economic effect within the meaning of IRC Section 704(b)?
- 7) Have there been changes in the ownership structure?
- 8) Have there been distributions or partial liquidations from the joint venture?
- 9) What type of property was distributed and to whom?
- 10) How has the construction company been compensated (cash, increase in capital interest, etc.) for its construction work?
- 11) How does the construction company allocate its overhead or indirect expenses to joint venture projects?
- 12) Are there related transactions (compensation payments, leases, loans, etc.) between the joint venture and its members?
- 13) What method of accounting does the joint venture use?
- 14) What effect do long-term contracts have on the allocation of income to an incoming/outgoing partner?
- 15) Has construction period interest been properly capitalized?

The IRS ATG also recommends auditors review formation, operational, and liquidation or distribution unique tax issues for joint ventures.

Unified Partnership Audit Procedures

The *Bipartisan Budget Act of 2015* replaced the partnership audit rules with a new system effective for tax returns for partnership tax years beginning after December 31, 2017.²¹ Those partnerships, which cannot elect-out of the new rules, will see all adjustments effectuated at the partnership level.²²

Upon audit, any tax owed is to be paid by the partnership (with a few exceptions permitted via election²³).

Any such adjustment is reported on the tax return for the year the adjustment is finalized, not the year under the audit.²⁴ The effect is that the pass-through entity is now a potentially tax-paying entity. Under the current rules, all adjustments are effectuated at the partner level.

Formation Issues

The ATG lists several issues (and provides cite references) for its auditors to construe. While some of these issues are technical in nature and may not be universally applicable, this listing provides insight into the issues an IRS auditor may raise during an audit.

Formation Issues

- 1) Failure to file partnership return. See IRC Sections 761 and 6698.
- 2) Capitalization or amortization of organization and syndication fee. See IRC Section 709.
- 3) Contribution of construction services by the construction company in exchange for a capital interest in the partnership. See Treasury Regulation Section: 1.72-19B0910.
- 4) Contribution of construction services (by the construction company) in exchange for a profits interest in the partnership when a predictable income stream exists. See Revenue Procedure 93-27.
- 5) Deemed cash distributions on the assumption of a partner's liability on property contributed. See IRC Section 752(b).

Operational Issues

- 1) Allocation of income, gains, deductions, and losses not having substantial economic effect. See IRS Section 704(b).
- 2) Cancellation of indebtedness income upon bankruptcy or insolvency. See IRC section 61(a)(12) and IRC Section 108.
- 3) Withholding tax on distributive share of partnership taxable income to a foreign partner. See IRC Section 1446.

Liquidation or Distribution Issues

- 1) Distribution of cash in excess of basis in the partnership interest. See IRC Sections 731, 752, 741, and 751.
- 2) Interest expense deductions in connections with debt financed distributions. See IRC section 163(h).
- 3) Disguised sales. See IRC Section 707(a)(2)(B).

There are opportunities for small partnerships with less than 100 partners to opt-out,²⁵ provided the partners qualify as an individual (or the estate if he or she is deceased), a C corporation, or an S corporation.²⁶

Also, the partnership may opt out while the partners still pay the tax.²⁷ This may be favorable if the imputed tax rate (and therefore the audit assessment) is higher than the actual aggregate tax based on the various marginal rates at the partner level.

Significantly, for all partnerships, the Tax Matters Partner (TMP) is replaced with a Partnership Representative who will have more responsibility. This important issue must be addressed because the new Partnership Representative rules are not subject to any opt-out rules.

The designated Partnership Representative has the authority to bind the partnership (and therefore, the partners) regarding:²⁸

- Audits and other proceedings such as the appeals process;
- Whether to settle the audit;
- Whether to litigate or proceed to Tax Court to appeal an audit assessment; and
- Procedural issues, such as whether to extend the statute of limitations.

The Partnership Representative is not obligated to notify the partners of the audit or to keep the partners informed of any progress. Unlike the TMP, the Partnership Representative does not have to be a partner.²⁹

Construction joint venturers must consider how to adjust their operating agreements to address these new rules. Consider these questions:

- Who will be the Partnership Representative?
- How will it be ensured the Partnership Representative has a level of fiduciary duty to all partners?
- Will the partnership elect to opt-out of the new rules, if that is an option?
- How will it be handled when a Partnership Representative is also a partner and is faced with a conflict of interest?
- What limitations, if any will there be on the Partnership Representative's authority?



- What and when must the Partnership Representative communicate to the partners?
- If assessed, will the partnership opt-out in favor of partner-level tax computations?

Beyond these questions, there are other complex issues arising with these new audit rules that the CFM should address. All joint ventures must revisit their operating agreements in light of the new centralized audit procedures.

Summary

Contractors doing business through joint ventures must be cognizant of various tax issues affecting joint ventures, which are typically taxed or operate as partnerships for tax purposes. Moreover, CFMs should ensure that the joint venture operating agreements are amended as necessary to address the new centralized IRS audit environment. ■

Endnotes

1. Reg § 301.7701-3(b).
2. *DJB Holding Corporation v. Commissioner*, 116 AFTR 2d ¶ 2015-5313, CA9, 10/7/15.
3. *Luna v. Commissioner*, 42 T.C. 1067, 1077-78 (1964).
4. IRC § 199(a).
5. IRC § 199(c)(1); IRC § 199(d)(1)(A).
6. Reg § 1.199-5(b)(1)(ii).
7. IRC 460(e)(1).
8. IRC § 731(a)(1).
9. IRC § 448(c).
10. IRC § 55(e)(1).
11. Reg § 1.706-1(b)(1).
12. Reg § 1.706-1(b)(2).
13. Reg § 1.706-1(b)(8).
14. IRC § 444(c); IRC § 7519.
15. IRC § 444(b)(1).
16. Reg § 1.704-3(b) through (d).
17. IRC § 708 (b)(1)(B).
18. Reg § 1.708-1(b)(4).
19. IRC § 168 (i)(7)(B).
20. www.irs.gov/pub/irs-utl/Construction_ATG.pdf.
21. *2015 Bipartisan Budget Act*, P.L. 114-74, 11/2/2015.
22. IRC § 6221(a); Prop Reg § 301.6221(a)-1(a).
23. IRC § 6226(a).
24. IRC § 6225(d)(2); Prop Reg § 301.6241-1(a)(1).
25. IRC § 6221(b)(1)(B); Prop Reg § 301.6221(b)-1(b)(2).
26. IRC § 6221(b)(1)(C); Prop Reg § 301.6221(b)-1(b)(3).
27. IRC § 6226(a).
28. IRC § 6223(b); Prop Reg § 301.6223-2(a).
29. IRC § 6223(a); Prop Reg § 301.6223-1(b)(1).

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