May
2010
Volume 10
Issue 3

BEAN KINNEY & KORMAN PC
ATTORNEYS

Business Law Newsletter

Inside This Issue:

Our Practice Areas:

BUSINESS & CORPORATE

- Appellate Practice
- Business Services
- Construction Law
- Copyright/Trademark
- Creditors' Rights
- Criminal Defense
- e-Commerce
- Employment Law
- Government Contracts
- Immigration
- Land Use, Zoning, & Local Government
- Landlord/Tenant
- Lending Services
- Litigation
- Mergers and Acquisitions
- Nonprofit Organizations
- Real Estate Services
- Title Insurance

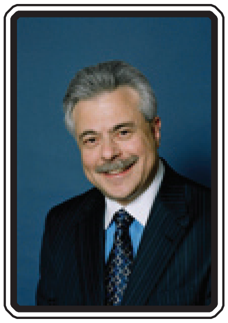
INDIVIDUAL SERVICES

- Alternative Dispute Resolution
- Domestic Relations
- Negligence/Personal Injury
- Wealth Management & Asset Protection

TAX LAW

"Economic Substance" Test Enacted as Part of Health Care Law

By: Ronald A. Feuerstein, Esquire



Many of our clients may be surprised to learn that as part of the new health care law, there are numerous non-health care related revenue raising tax provisions. One of the most far-reaching is new Internal Revenue Code section 7701(o), which codifies the "economic substance" doctrine and enacts new companion penalty provisions. Under new Code section 7701(o), in the case of any transaction to which the economic substance doctrine is relevant, the transaction will be treated as having economic substance only if:

(i) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's ***economic position, and***

(ii) the Taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

Thus, the new economic substance rule requires a ***conjunctive*** analysis. As such, it requires an inquiry regarding the objective effects of the transaction on the taxpayer's ***economic position***, as well as an inquiry concerning the taxpayer's ***subjective motives*** for entering into the transaction. Under the new provision, a taxpayer must satisfy ***both*** tests.

In analyzing the first prong of the economic benefit test, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer's economic position or that the taxpayer has a substantial non-Federal income tax purpose for entering into such transaction. The provision does not require or establish a minimum return in order to satisfy the profit potential test. However, if a taxpayer relies on profit potential, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

Under the second prong of the test, a taxpayer's non-Federal income tax purpose for entering into a transaction must be "substantial." In making such analysis, any state or local income tax effect that is related to a Federal income tax effect is treated in the same manner as a Federal income tax

2300 Wilson Boulevard, 7th Floor, Arlington, Virginia 22201
703·525·4000 fax 703·525·2207
www.beankinney.com

"Economic Substance" Test Enacted as Part of Health Care Law
Continued from Page 1

effect. Furthermore, a purpose of achieving a favorable accounting treatment for financial reporting purposes is not taken into account as a non-Federal income tax purpose if the origin of the financial accounting benefit is a reduction of Federal income tax.

A most significant aspect of the new provision is its special penalty regime. Under Code section 6662, there is imposed a new ***strict liability*** penalty for an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance as defined in Code section 7701(o) or failing to meet the requirements of any similar rule of law. The penalty rate is 20 percent (increased to 40 percent if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return). It is important to note that no exceptions (including for reasonable cause) to these new penalties are available. Moreover, outside opinions or in-house analysis will not protect a taxpayer against the penalty. The same 20 percent penalty (without any reasonable cause exception) will be applied to claims for refund or credit deemed excessive under Code section 6676(b).

If you would like to discuss this new tax law provision and how it might affect your transaction, please contact Ron Feuerstein at rfeuerstein@beankinney.com.

PERSONAL GUARANTEES
by
James V. Irving, Esquire

Small business owners and employees sometimes carelessly endorse business documents without fully considering the possible ramifications of that action. The case of Cape Fear Publishing Co., Inc. v. Marie D. Phillips, decided in the Circuit Court of Henrico County in April, reminds us of the risk corporate signatories run if they fail to clearly indicate their limited authority.

By way of a written contract dated November 26, 2006, California Closets ("California" or the "Advertiser") entered into a written contract to buy magazine advertising from Cape Fear. Marie D. Phillips, California's Marketing Manager, signed the contract for her employer. After the space for the corporate signature, the Contract closed with the following language: "I hereby personally guarantee the performance of the Contract and payment of any obligation by the Advertiser." Apparently without giving it too much thought, Phillips, an employee making $12 per hour, signed the guarantee "Marie D. Phillips, Marketing Manager."

When California defaulted on the contract, Cape Fear sued Phillips personally under the guaranty. Ms. Phillips denied liability and testified without contradiction that she was an hourly employee who had not been authorized to sign the Contract without the approval of her employer.

Cape Fear took the position that Phillips was liable in accordance with the plain and unambiguous language of the guaranty. Phillips argued that the guaranty was unenforceable.

Judge Catherine C. Hammond first determined that the Contract was not unambiguous, as Cape Fear had claimed, because Phillips had signed as the agent or "Marketing Manager" for California, and appended the same phrase to her signature on the guaranty. Then the Court carefully reviewed Agency law and the application of the Statute of Frauds before coming to its ruling.

Applying general Agency law, the Court noted that a disclosed Agent is generally not individually liable under a contract unless the agency and the third party specifically agree otherwise. There was no evidence that they had.

The Court also considered the principal that the Plaintiff has the burden of demonstrating consideration to support a contract to pay for the debt of another. The consideration must be

Personal Guarantees
Continued from Page 2

separate from that supporting the underlying contract. There was no evidence that Ms. Phillips had benefited individually from the Contract, such as, for example, that she was required to extend her personal credit as a condition for keeping her job.

As a result, the Court dismissed Cape Fear's claim and entered a final judgment in favor of Ms. Phillips.

One gets the sense from the opinion that Judge Hammond recognized a fundamental unfairness in this claim, but she ruled strictly on the law. And even though Ms. Philips prevailed, her cost in both money and anguish were likely high. Cape Fear reinforces an often-repeated mantra: read a document very carefully before you sign it.

For more information on this topic, please contact Jim Irving at jirving@beankinney.com.

EMPLOYEES and INDEPENDENT CONTACTORS

by

James V. Irving

Because businesses can avoid certain tax obligations by utilizing independent contractors in place of employees, business owners sometimes casually mischaracterize their personnel as contractors. However the IRS makes a clear distinction between the two. Mislabeling an employee as a contractor can result in serious repercussions to a business owner.

Federal law requires an employer to withhold income tax as well as an employee's Social Security and Medicare tax contribution. Also, an employer must pay Social Security, Medicare, and unemployment taxes on wages. In contrast, no such employer withholding obligations attach to the independent contractor. The contractor is responsible for paying his or her own income tax and self-employment tax.

There is no black letter test for distinguishing between an employee and an independent contractor. Instead, the IRS looks at the totality of the facts and circumstances. There are, however, a number of benchmarks that the IRS considers in making its analysis. Most can be best stated and understood as alternative business models.

Professional Control. An employee is told what to do, when to do it, and generally uses company tools and resources to perform his or her job. An independent contractor is charged with completing a task. He or she provides his or her own tools, equipment and facilities. How the task is accomplished is generally left up to the contractor.

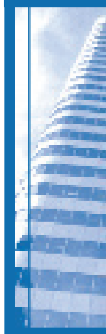
Staffing. Employees are assisted by other company employees at the express or implicit direction of the business owner. Contractors provide their own assistants (often sub-contractors) at their own cost.

Independence. While the employee works solely for his or her employer, contractors can and do accept multiple tasks from multiple businesses. As such, they may not be restricted through the device of non-competition agreements.

Financial control. An employer controls job cost and expense and the assignment of other resources to the project. The employer is paid a wage for his services. An independent contractor assumes the risk of loss on the project and also has the right to seek a profit through careful planning and financial control. An employee's pay is reflected on his or her annual W-2 form. An independent contractor gets a 1099.

President Obama's 2011 fiscal budget allocates significant resources to a joint Department of Labor - IRS effort to investigate and penalize employee mischaracterization. With the federal government facing significant financial pressures, this could be a fruitful area for federal inquiry, and a costly one for careless employers. Employers are well advised

Contact Us
2300 Wilson Boulevard, 7th Floor
Arlington, Virginia 22201
703·525·4000 fax 703·525·2207
www.beankinney.com



EMPLOYEES and INDEPENDENT CONTRACTORS
Continued from Page 3

to carefully consider their professional relationships with members of their work force.

It is prudent practice to memorialize all working relationships in an appropriate contract. However all employers, whether or not they chose to take this step, should consistently maintain the appropriate professional distinction among their personnel. Treat employees like employees and contractors like contractors. Don't offer employment benefits, company credit cards, or the use of computers to contactors. Don't ask them to sign non-competition agreements, and don't allow them to hold themselves out to the public as employees (such as through the use of business cards). Carefully keep clear business records that include copies of such contractor indicia as tax payer ID numbers and professional licenses. Such documentation will be critical if the IRS questions a relationship.

We urge you to give careful thought to this important business issue. Upon request, we will be happy to assist you in evaluating the proper status of your workers.

For more information on this topic, please contact Jim Irving at jirving@beankinney.com.

BEAN KINNEY & KORMAN PC
ATTORNEYS

2300 WILSON BOULEVARD, 7TH FLOOR
ARLINGTON, VA 22201

GETTING IT DONE®