



Virginia Historic Tax Credit Fund Decision

Yes Virginia, the Federal Tax System Matters, Too

WHITE PAPER

Prepared by:

Joel Cohn, CPA
Reznick Group

Thomas Nice, CPA
Reznick Group

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In a U.S. Tax Court case watched closely by many active in the U.S. tax credit investment industry, the Federal Fourth Circuit Court of Appeals recently issued its decision in *Virginia Historic Tax Credit Fund 2001 LP v Commissioner*, No. 10-1333 (Virginia Historic). This appeal came on the heels of a separate but favorable decision in the case of *Historic Boardwalk Hall vs. Commissioner*, 136 T.C. No.1 (Historic Boardwalk) handed down in January, 2011. The result of all this court activity was that shortly after the tax credit industry found itself celebrating the Boardwalk decision, the industry found itself holding its head over the Virginia Historic decision. The Virginia Historic decision is very sobering.

The subject matter of the Virginia decision is the federal tax treatment of state income tax credits. State tax credits are often used for historic rehabilitation, Brownfield clean-up activities, movie production and for many other economic development purposes. Unfortunately, because such state tax credits are so valuable, they do not exist in a vacuum and thus, they are not immune from the impact of the federal income tax regime. The interplay between the two tax systems has often been a subject worthy of lengthy discussion.

Again, because the IRS generally seeks to tax transactions where value is transferred, as it relates to the federal tax treatment of transactions involving state tax credits, there was some, but previously limited guidance IRS guidance on the federal tax classification of state tax credit with respect to their federal taxability. Therefore, prior to these two legal decisions, practitioners had only a collection of private letter rulings, Field Service Advice, and Chief Counsel's Advices to use as guideposts for the proper federal tax treatment of state tax credits.

State tax credits come in many varieties and the technical variations among the various state tax credit programs is pronounced, but what is most relevant here is a way that state tax credits can be classified as falling into essentially two categories or types.

The first type of state tax credit is the type of state credit that is allocated among partners of a partnership, including those that may be again allocated through tiered partnerships, ultimately making their way to state taxpayers.

The second type is known generically as "certificated" tax credits. This type of state tax credit is not allocated, but rather, it is literally transferred from one state taxpayer to another, often (but not always) in the form of a piece of paper or "certificate" from one party to another.

Some states offer both options, and numerous other elements can be unique to a specific state's income tax credit program, such as the maximum amount of credit and the credit percentage. In any case, state tax credits are not mentioned in the Internal Revenue Code. So all that practitioners have for guidance is their understanding of general federal income tax principles, and the limited IRS guidance. Up until the Virginia Historic case, tax practitioners were generally in agreement with existing IRS guidance and they applied that guidance accordingly.

The focus of the traditional analysis is whether state tax credits are either tax attributes or property. Generally, under the prior guidance, practitioners took the view that a partner that intended and agreed to receive from a partnership an allocation of state income tax credits would make a capital investment into a partnership in the form of a contribution to capital, and in exchange, later receive their share of the state tax credit allocation on the investor's state tax Form K-1. The partner receiving the allocation would reduce its state income tax payments by using their allocated state tax credit and consequently they

would generally also have to reduce their federal income tax deductions for state taxes paid under Section 164 of the Internal Revenue Code of 1986, as amended (the Code). Again, the advance of funds to the partnership was structured to be a capital contribution to the partnership and this partner would be treated as a partner of this partnership for federal tax purposes.

Alternatively, a taxpayer purchasing a certificated state income tax credit (as well as the entity selling the certificate) would treat the transfer of the certificated income tax credit as the purchase and sale of property. Typical federal tax results would apply to the buyer and seller in a property transaction of a non-capital asset.

The Commonwealth of Virginia is one of a few states that have enacted legislation providing for historic rehabilitation income tax credits. The Virginia Historic Rehabilitation program was enacted in 1996 and provides State tax credits to individuals and businesses to encourage the preservation of historic residential and commercial buildings (see Va. Code Ann. Sec. 58.1-339.2).

Since some state statutes (including Virginia) do not specifically require that a partner retain its partnership interest for any minimum period of time, tax-equity transaction structures evolved such that a buyer of allocated state tax credits could choose to stay in a partnership for a limited period of time to manage risk and avoid reporting requirements for taxpayers who no longer wish to account for their interest in the partnerships.

The Virginia statute in this case provided that State tax credits that are granted to a partnership are to be allocated among all partners whether in proportion to their ownership interest in the partnership or as the partners mutually agree. In other words, the State allocation provision allows a partnership to allocate a disproportionate share of the state tax credits to specific limited partners that may own 1% or .01% of a partnership. This appealed to certain buyers not interested in purchasing economic benefits such as cash flow distributions or to participate in the appreciation of the underlying property, were that to occur. These credit investors simply had the twin goals of reducing in state tax liability and encouraging historic preservation.

As described in the Virginia Historic Tax Court decision, while the Virginia program was efficient in providing capital to larger scale projects, smaller projects had difficulty obtaining financial support. As a result, a number of investment funds (Funds) were created to pool capital to provide funding for smaller projects. The resulting State tax credits generated from the rehabilitation projects were intended to then be allocated to the Funds, and ultimately, allocated to users of these State tax credits (the investors).

The partnership agreements for the Funds included traditional limited partnership provisions that limited the investors' liability for partnership debts to their individual capital contributions. The partnership agreements also included language that the investors would receive a part of their contribution back, less expenses, if the partnerships failed to pool sufficient State tax credits. The Funds balanced this risk by including provisions in its agreements with the developer partnerships that the developer partnerships would compensate the Funds if the developer partnerships failed to obtain State tax credits or if the State tax credits were revoked. The partnership agreements for the Funds also provided that the general partner could purchase the investor's limited partnership interest for fair market value after the partnership had fulfilled its purpose.

These transactions mostly likely surfaced in the public realm with IRS Chief Counsels Advices (CCAs) 200704028 and 200704030. These two CCAs deal with substantially the same facts, though CCA 200704028 deals with transactions in which the Funds made investments in development partnerships, while CCA 200704030 deals with transactions in which the Funds acquired transferable tax credits. As a result of an IRS tax audit, the Internal Revenue Service issued Final Partnership Administrative Adjustments. These FPAAAs claimed that

1. The investors were not partners, for federal tax purposes, and that the investors' capital contributions to the partnerships and their receipt of State tax credits in return were instead sales of State tax credits.
2. Alternatively, the claim was that, if the investors were partners, the transactions were disguised sales of State tax credits.
3. The Funds had unreported income from the sales, in the amount of its investors' contributions, and
4. The Funds were formed with principal purpose to reduce substantially the present value of the partners' aggregate tax liability in a manner inconsistent with Subchapter K of the IRC.

As the facts are described in the CCAs, the investors in the Funds contributed cash based solely on the amount of credits they were to receive. The amount of the State tax credits were fixed based on the amount of the capital contribution of the investor, and the tax credits were transferred simultaneously with the execution of the subscription documents, or were carried out within a few months time. The investors granted option agreements to the general partner to purchase the investor's interests at their fair market value, but the investors typically held on to their investments for less than one year and sold their interests at what was described as a small fraction of their tax basis. Then the investors claimed large capital losses for the difference between their capital contributions and the sales price of their interests.

The CCAs concluded that the investors were not partners, because they were, as stated in the marketing materials, likely to receive no material distributions of cash, no net proceeds from sale of the projects or operating partnerships, no allocations of federal income tax credits and no partnership items of income, gain, loss, or deduction, there was no joint profit motive and therefore the investors were not partners. Further, the CCA describes that the marketing materials provided that any return on investment is dependent entirely on the allocations of the State credits and the capital loss for federal tax purposes.

Note that the CCAs pointed out that..."By itself, the fact that a state tax credit is transferable should not cause it to lose its character as a reduction or potential reduction in liability in the hands of the tax payer who originally qualified for the credit. *However, if and when a transferable credit is in fact transferred to another taxpayer for value, it is generally appropriate to treat the transaction as a sale and purchase of property under IRC Section 1001 [emphasis added].*"

Accordingly, the Chief Counsel, using this and other reasoning, concluded that the transactions should be re-characterized as the direct sales and purchases of property. This was the conclusion despite the form of the transaction, with documents executed indicating that the investors were to be treated as partners, and that the parties involved accounted for the transactions in the form intended, including filing tax returns treating these investors as partner. Further, the Chief Counsel indicated that, while the partners

may be treated as partners for state law purposes, they should not be treated the same for federal tax purposes.

The Chief Counsel also applied the disguised sales rules under IRC Section 707.

A “disguised sale” for federal income tax purposes is a transaction between a partner and a partnership when a partner transfers money or other property to the partnership, the partnership transfers money or other property to such partner in return, and the transfers when viewed together are properly characterized as a sale, despite what documents may otherwise indicate.

Since the transfers of tax credits and the contributions of cash were simultaneous the transactions were presumed to be disguised sales and therefore the Funds should recognize gain on such sales. Because the transactions were re-characterized as the purchases and sales of property, the CCAs concluded that the sellers should have recognized gain on these sales.

Finally, on the issue of using the partnership form to reduce taxes, the CCAs focused on the capital losses that the investors recognized when they disposed of their partnership interests. Since many of the buyers may have been subject to alternative minimum tax and may not have been able to deduct their state taxes paid under Code Section 164, the Chief Counsel concluded that the purpose of these capital losses was to provide the investors a federal tax deduction where otherwise they would not have had one. Therefore the CCAs concluded that tax avoidance was the principal purpose of the transactions and the transactions should be re-characterized.

In effect, the CCAs re-characterize the State credit allocation as the sale of a certificated credit, or property, despite the tax payer’s intent for the treatment to be that of an allocated credit.

The Legal Case – U.S. Tax Court

This exact matter was then appealed by the taxpayers to the Tax Court and it was ruled in favor of the taxpayers (Virginia Historic Tax Credit Fund 2001 LP v. Commissioner, T.C. Memo 2009-295). The IRS persistently focused on two issues, the investors were not partners in the Funds for federal tax purposes, that the transactions were disguised sales.

In Tax Court, the IRS argued that the amounts of the contributions, the timing of the transactions, and the investors’ lack of risk suggest that the transactions were in substance sales.

However, the Tax Court found in favor of the Taxpayer on this point, in part because the contributions were pooled to facilitate numerous investments and to manage risks, and that the partnerships existed until they fulfilled their purpose.

Further, the Tax Court noted that that the Funds investments were exposed to many entrepreneurial risks, including that the projects would not be completed, or would not meet the architectural standards. The Court found the fact that the Funds managed their risks or even insured against them simply reflected good business practices. Because the parties joined together as partners, to participate in an enterprise of pooling capital to further invest in the development partnerships, the Tax Court concluded the investors were partners.

As to the separate issue of whether the transactions were disguised sales, the Tax Court also ruled in

favor of the Taxpayer, based on its finding that the investors made capital contributions to the Funds, and since the Funds allocated the tax credits according to the partnership documents they were in substance valid contributions of capital to partnerships, rather than sales.

Further, the Tax Court said that the transactions were not simultaneous, because the investors contributed capital at various times. The investors, while promised a certain amount of credits, did not have a guarantee that the partnerships would pool a sufficient amount of tax credits. Given these risks of an enterprise, the Tax Court concluded that it was not a disguised sale.

The Tax Court handed down another decision regarding the statute of limitations, but that subject is outside the focus of this white paper.

The Federal Appeal

This decision was appealed further by the IRS, to the United States Court of Appeals for the Fourth Circuit, and the Tax Court decision was reversed, with a ruling in favor of the IRS. Generally, the Appeals Court determined that the transactions were disguised sales and that the capital contributions were includable in taxable income.

The Appeals Court first reviewed some facts. For example, the decision noted again that some of the marketing materials explained that investors should expect to receive no material amounts of partnership income or loss.

As to managing the risk of the Fund's investments in the development partnerships, the decision noted that the Funds promised investors not to make material capital contributions until the projects were completed, thereby eliminating certain risks. Also, the developers would reimburse the Funds if they could not deliver the credits or were later revoked.

The subscription agreements specified the dollar amount to be contributed by each investor and stated that the amount was paid for an allocation of State credits *simultaneously* with the investor's admission [emphasis added in the opinion].

The Funds reported the money paid to the development partnerships in exchange for tax credits as partnership expenses and reported the investors' contributions to the Funds as non-taxable contributions to capital. The Funds therefore reflected as losses on their tax returns.

The Appeals Court decision first reviewed the Treasury Regulations which define a disguised sale. The decision emphasized the language in one part, stating:

Section 1.707-3 calls for an evaluation of "all of the facts and circumstances" surrounding the transaction to determine whether

- (i) The transfer of money or other consideration would not have been made *but for* the transfer of property; and
- (ii) In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

In order for a disguised sale to occur, there must be a transfer of property. The Tax Court did not decide as to whether these tax credits were property for purposes of IRC Section 707, as it did not find this essential to its opinion, and property is not defined for purposes of IRC Section 707. The taxpayers argued that these State credits were not property because they are non-transferable and non-inheritable.

In making this analysis, the Appeals Court applied a subjective analysis, and cited several cases for the description of property including that it is a collection of a number of rights, including the right to use property, to receive income produced by it, whether a taxpayer could exercise control over the property and whether the right in question was valuable.

The Appeals Court concluded that the credits were valuable, as they induced people to advance funds to be able to use them and that the Funds exercised control by allowing certain taxpayers to use the credit and could exclude others from doing so. The decision went on to discuss the legislative history of IRC Section 707, and that Congress strengthened it in 1984 to allow for a flexible evaluation of the facts and circumstances.

There are however two footnotes in this part of the Appeals Court opinion to which one should pay close attention.

The first is Footnote 15 where the Appeals Court tell us that it was "...not deciding whether tax credits always constitute property in the abstract. Rather, we are asked to decide only whether the transfer of tax credits acquired by a non-developer partnership to investors in exchange for money constituted a "transfer of property" for purposes of Section 707". This footnote appears to apply this reasoning only to upper tier funds and not to project partnerships.

However, footnote 16, sites a Supreme Court decision stating that the receipt of tax benefits in and of itself was not a taxable event, the last two sentences of which might have a broader meaning. Specifically, the footnote reads, "As we have explained, we are not asked in this case to decide whether tax credits in general constitute "property" or income." Instead, we are asked only to determine whether a party's decision to exchange its tax credits for money, rather than utilize them, means that the "payment in cash" the party receives should be categorized as "income."

Next the Appeals Court analyzed whether a sale occurred. The Appeals Court applied five of the ten tests in the disguised sale rules, and evidently found the rest of the tests not relevant to this analysis. The factors noted were the simultaneous nature of the of the funding and the transfer of the tax credits, that the investors were reasonably certain to get the amount of credits and when they would get them, the investors could enforce their rights, the investors capital contributions were disproportionate to their interests.

Applying these factors it was ruled that a sale occurred. The decision emphasized the transitory nature of the investors in the Funds, and that all investors were bought out for a "proverbial pittance".

The Appeals Court also noted that it disagreed with the Tax Court decision that the investors were subject to entrepreneurial risks, because the investors received assurances that their contributions would be refunded if the anticipated credits could not be had or revoked, and that the Funds were structured to render the possibility of insolvency remote. As to entrepreneurial risk, the Appeals Court noted that the investors were promised a fixed rate of return rather than any share in partnership profits ties to their

partnership interests. Further, the investors were told that they wouldn't receive material allocations of partnership income and that their investments were secured by guarantees and structure.

The Appeals Court noted that to the extent a partners profit from a transaction is assured without regard to the success or failure of the joint undertaking, there is not the requisite profit motive. The Appeals Court stated that the notion put forth by the Tax Court that the investors were exposed to entrepreneurial risk, was dismissed because it ruled the risks were "both speculative and circumscribed."

Readers should note that the Circuit Court of Appeals decision is more authoritative than that of the preceding U.S. Tax Court opinion, and while as a matter of law, this appellate court decision only applies to actions in the Fourth Circuit, all taxpayers should be mindful and consider this decision when structuring future transactions.

Conclusions

With its analysis, the Appeals Court concluded that the investors were not partners and the money received by the Funds should be reported as income.

While this case is about the federal income tax reporting of the tax credit Fund, it also sheds some considerable light on the federal tax treatment in transactions where state income tax credits are monetized.

But also leaves issues open.

This case places great emphasis on the facts in determining the proper treatment of the State tax credits, so of course different facts could yield different results.

For example, if the investors stayed in the partnerships for a longer period maybe they would be treated as partners, but it is not clear what length of time is sufficient. Also, if the investors were to receive some operating cash flow, or the potential for cash flow, losses or income, one should question what amounts would be sufficient to make a determination that they are properly treated as partners.

Other open questions include whether the transfer of state credits for money could be characterized as a property sale at a project partnership as well as an investor tier? Also, do what degree does the management of risk through insurance or guarantees call into question whether one is a partner?

The IRS, possibly emboldened by the Virginia decision, quickly filed an appeal of the Historic Boardwalk case cited above. Reznick Group will keep you posted as we hear more about the results of both of these cases and how they may impact you.

For more information, please contact your Reznick Group tax professional or visit us online at <http://www.reznickgroup.com/tax>.