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## Court Recharacterizes Tax Credit Transfers: What Went Wrong?

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Common parlance in the real estate industry is to talk about buying and selling tax credits. In reality, though, tax credits generally cannot be sold. However, as we discussed in our last column, arrangements can be structured in which a “tax credit investor” owns an interest in a partnership that earns tax credits, gets at least some return on its investment, and receives the lion’s share of the tax credits. The problem is that there often is a fine line in determining whether the partnership is allocating tax credits to its partners or the whole arrangement is really just a sale of the tax credits. In a recent decision of the Court of Appeals for the Fourth Circuit, a transfer of State historic rehabilitation tax credits by a partnership to its partners found itself on the wrong side of the line. What does this mean for the ability of real estate developers to engage in tax credit transactions?

### Background

#### *Historic Rehabilitation Tax Credits*

In order to encourage the rehabilitation of historic structures, Congress provided that taxpayers could receive Federal tax credits by engaging in these restoration projects. Internal Revenue Code section 47 entitles a taxpayer to Federal tax credits in an amount equal

to 20% of qualifying rehabilitation expenditures incurred with respect to a certified historic structure. Certain States have also enacted provisions enabling taxpayers to receive State tax credits upon rehabilitating historic structures.

#### *Disguised Sales Between Partners and Partnerships*

A contribution of property to a partnership is generally tax-free, and a distribution of cash from a partnership to a partner is generally tax-free to the extent of the partner’s basis in its partnership interest. However, Internal Revenue Code section 707 provides that a partner’s contribution of property to a partnership and a related distribution of money or other consideration from the partnership to the partner will be treated as a sale of property by the partner to the partnership (commonly referred to as a disguised sale) under certain circumstances. Specifically, these reciprocal transfers will be treated as a sale if, when viewed together, they are “properly characterized as a sale or exchange of property.” Section 707 also covers reciprocal transfers of property from a partnership to a partner and of money or other consideration from the partner to the partnership. Transfers between a partner and a partnership within two years of each other are presumed to be a disguised sale.

#### *Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*

*Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*,<sup>1</sup> a case recently decided by the Court of Appeals for the Fourth Circuit, involved Virginia State historic rehabilitation tax credits. Under the Virginia statute, a partnership that earned these State tax credits could allocate them to its partners and, unlike most Federal tax credits, such an allocation could be made in any agreed-upon manner (i.e., even if different from the partners’ interests in the partnership).

The case involved a limited partnership (the “partnership”) that was formed in order to invest in other partnerships dedicated to the rehabilitation of historic structures (“developer entities”), through which the partnership would be allocated Virginia State historic rehabilitation tax credits. The partnership received an aggregate amount of approximately \$7 million from 282 investors (the “investors”), approximately \$5.5 million of which it transferred to various developer entities and used to pay certain costs. The arrangement was structured so that the developer entities would earn tax credits and allocate them to the partnership, which in turn would allocate them to the investors. The partnership guaranteed its investors that they would receive \$1 in tax credits for every \$0.74 contributed (and promised that, if it did not receive the anticipated amount of tax credits, it

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would refund their contributions). The partnership minimized the risk of it not receiving the anticipated tax credits from the developer entities by investing only in projects that had already been certified as qualifying for the State historic rehabilitation tax credits. The partnership told its investors to expect no allocations of material amounts of income, gain, loss, or deduction and, after approximately one year, the partnership had an option to buy out the investors' interests for a nominal amount of money.

The partnership reported its receipt of the \$7 million from the investors as a tax-free partnership contribution. The IRS argued that (1) the investors were not bona fide partners in the partnership for Federal tax purposes but instead were "mere purchasers" and (2) even if the investors were partners, the transaction involved a disguised sale of tax credits by the partnership to the partners. Either way, the IRS determined that the partnership should be considered to be a retailer that acquired State tax credits from the developer entities for approximately \$5.5 million (including certain costs) and sold them to the investors for approximately \$7 million (i.e., incurring \$1.5 million of net income).

The Tax Court agreed with the taxpayer, holding that the investors were partners in a partnership and that there was no "disguised sale" of the tax credits from the partnership to the investors since the investors faced "entrepreneurial risks."<sup>2</sup> Examples of these risks cited by the Tax Court included the risk that the historic rehabilitations would not be completed on time, the risk that the State authorities would not be satisfied with the rehabilitations, and the risk that no tax credits would be received or that tax credits that would be received might be revoked in the future.

The Court of Appeals for the Fourth Circuit recently overturned the Tax Court's decision and held that the transaction involved a disguised sale of State tax credits from the partnership to the investors. The Court based its deci-

sion on its determination that, considering all the facts and circumstances, the partnership had failed to rebut the presumption of a disguised sale resulting from reciprocal transfers occurring within two years of each other between a partnership and its partners. It found the entrepreneurial risks cited by the Tax Court to "appear both speculative and circumscribed" and that "the only risk there was that faced by any advance purchaser who pays for an item with a promise of later delivery." Since the Court agreed with the IRS that there was a disguised sale of property, it did not consider whether the partnership should be treated as a bona fide partnership for tax purposes.

#### Analysis

As we discussed in our last column, the Tax Court in *Historic Boardwalk Hall, LLC v. Commissioner*<sup>3</sup> (decided shortly before the Court of Appeals' decision in *Virginia Historic*) respected the tax-free form of a transaction in which investors contributed money to a partnership and received the partnership's Federal historic rehabilitation tax credits along with a 3% preferred return. Is that case compatible with the Fourth Circuit's decision in *Virginia Historic*? Absolutely.

One significant difference is that *Virginia Historic* involved State tax credits, whereas *Historic Boardwalk Hall* involved Federal tax credits. In *Virginia Historic*, the Court of Appeals held that the State tax credits were "property" for purposes of section 707, explaining that they had value and that, since the partnership could allocate them to its partners in any manner, they in effect were transferrable. In contrast, under the Internal Revenue Code, Federal tax credits are not property. Therefore, in *Historic Boardwalk Hall*, there was no transfer of property from a partnership to its partners that could be part of a disguised sale under section 707.

In addition, the fact that the tax credits in *Virginia Historic* were State tax credits may also have been significant in that courts have recognized that Congress' enactment of Federal tax

credits reflects a Federal policy of encouraging certain activities. In light of the fact that the developer which earns historic rehabilitation tax credits often has nowhere near enough income to take advantage of them, courts considering Federal tax liability may be more willing to be deferential toward arrangements that further this Congressional purpose.

Perhaps even more important to the Court of Appeals' decision in *Virginia Historic*, though, were the numerous details which were at odds with the desired tax treatment and supported characterization of the transaction as a sale. When the investors contributed their money to the partnership, they were promised a specific amount of tax credits in exchange for their contributions and were told to expect no allocations of material amounts of income, gain, loss, or deduction. The partnership engaged in only rehabilitation projects that had already been certified as qualifying for the tax credits and the Court of Appeals considered there to have been only minimal risk of the tax credits not being received. The investors obtained their tax credits in the same year in which they made their contributions, at which time they were redeemed for a nominal amount of money. Also harmful was the fact that the 282 investors received allocations of tax credits that were far in excess of what would have been commensurate with their aggregate interest in the partnership of only approximately 1%. In fact, the Court of Appeals almost seemed to take pleasure in the fact that the magnitude of the partnership interests assigned to each investor wasn't even consistent with the amount of capital that the investor contributed. Put simply, the situation smelled like a sale of property.

In sum, *Virginia Historic* is not an attack on typical tax credit structures (such as the one in *Historic Boardwalk Hall*), but is a reminder of how critical it is to seek out effective tax planning in structuring tax credit arrangements -- and the perils of not doing so.

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<sup>1</sup> 107 AFTR 2d 2011-1523 (4th Cir. 2011).

<sup>2</sup> *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, T.C. Memo 2009-295.

<sup>3</sup> 136 T.C. No. 1 (2011).

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