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Tax Court Rejects IRS Recharacterization of Tax Credit Transaction

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Economically equivalent transactions may take different forms, which can have vastly divergent tax implications. As a result, the Internal Revenue Service will sometimes contend that the form of a transaction that was selected by a taxpayer lacks economic substance and should not be respected. In a recent case, *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*,[1] the Tax Court wrestled with what the appropriate characterization of a transaction should be in a situation where investors contributed money to a partnership and received allocations of tax credits. Were these investors really partners, or should they be more appropriately viewed as merely purchasers of tax credits?

Background

The Supreme Court has held that whether a partnership exists depends on whether, considering all of the facts and circumstances, "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."[2]

The Internal Revenue Code provides for various Federal tax credits in order to encourage certain activities, which generally promote the public welfare but have limited profitability. A partnership that obtains Federal tax credits may allocate them to its partners. However, such an allocation generally must be made in accordance with the partners' interests in the partnership. Many State governments have also enacted legislation providing for certain State tax credits.

Virginia Historic Tax Credit Fund 2001 LP v. Commissioner

Virginia Historic Tax Credit Fund 2001 LP v. Commissioner involved a limited partnership (the "Partnership") that was formed in order to invest in partnerships dedicated to the rehabilitation of historic structures ("Developer Entities"), through which the Partnership would receive Virginia State historic rehabilitation tax credits. A partnership that received 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).

In order to obtain the State tax credits, the Partnership collected approximately $7 million of capital contributions from a large number of limited partners (the "Investors"), approximately $5 million of which it contributed to various Developer Entities. The Partnership's arrangements with the Developer Entities were structured such that the Partnership received small interests in the Developer Entities, but would be allocated most or all of their State tax credits. The Partnership, in turn, would allocate a share of both its State tax credits and its profits to the Investors. However, the Partnership anticipated negligible profits, if any.

The IRS contended that, for Federal income tax purposes, the Partnership should be considered to be a retailer that acquired State tax credits from the Developer Entities for $5 million and sold them to the Investors for $7 million (i.e., incurring net income in the amount of $2 million, less the Partnership's expenses). The IRS justified its characterization of the transaction by contending that the Investors did not intend to be partners, but rather desired only to purchase State tax credits. In addition, the IRS argued that the arrangement lacked business purpose since the Investors did not expect to receive any profits and should be disregarded under the substance-over-form doctrine since the Investors incurred little risk and received their entire share of the tax credits within only approximately one year.

In holding for the Partnership, the Tax Court found that the Investors intended to be partners, noting that both their formal agreements with the Partnership and statements that they had made were consistent with their status as partners. The Tax Court also found it worthy of note that it had concluded that most of the Investors shared the desire to support historic rehabilitation (although as a practical matter the tax credits were clearly their primary objective).

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In addition, the Tax Court also concluded that the Investors' objective of obtaining State tax savings constituted a legitimate business purpose for the transaction. The Tax Court then held that the transaction's substance was in accordance with its form, explaining that the Investors did incur certain risks (relating to the possibility that the Partnership, notwithstanding certain guarantees from the Developer Entities, might receive neither the anticipated tax credits nor sufficient funds to otherwise compensate the Investors). Bearing this risk, the Tax Court held, was characteristic of partners in a partnership, not "simple purchasers."

Federal Tax Credits

What if the tax credits had instead been Federal tax credits? On the one hand, reducing Federal tax liabilities would not be a valid business purpose. On the other hand, however, since a partnership generally must allocate its Federal tax credits pro rata in accordance with the interests of its partners, investors in the Federal tax credit context likely would have had a significant share of the profits and losses of the rehabilitation projects. Moreover, if the tax credits had been Federal tax credits, one could argue that implicit in the legislation enacting such tax credits is greater latitude to structure transactions to further the Congressional policy behind the credits. Although it is unclear how the holding in this case would carry over to Federal tax credit transactions, it clearly is helpful for tax credit investors.

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[1] 2009 T.C.M. (RIA) ¶ 2009-295.

[2] *Commissioner v. Culbertson*, 37 AFTR 1391 (U.S. 1949).