The IRS Identifies Pitfalls In State Tax Credit Deals

by Carolyn Joy Lee

Theory and Practice is a column by Carolyn Joy Lee, a partner with Roberts & Holland LLP, New York.

The Internal Revenue Service recently released a chief counsel advice (CCA) that offers an interesting — and chastening — analysis of state tax credit transfer structures and why they can spell trouble on the federal income tax front.[1] On first encounter one might wonder why the IRS would be interested in partnerships designed to transfer state tax credits from, say, a developer, to an individual who has a desire to minimize state income taxes. However, after looking at the CCA, it becomes apparent that those kinds of plans not only raise state tax issues regarding whether they effectively transfer state tax credits, but also, gone wrong, the plans raise the potential for federal income recognition and inconsistent audit outcomes.

The CCAs considered state income tax credits allowed for rehabilitation projects and measured by qualified expenditures. (As is usual in these situations, neither the state nor any of the affected parties were identified.) The credit, equal to x percent of eligible rehabilitation expenses, could be used as a dollar-for-dollar reduction in state income taxes. It also was allowed to be carried forward for a specified number of years.

In one CCA,[2] the state tax credit was transferable. Presumably that meant that a developer who was able to establish to the satisfaction of third-party investors the existence of a specific dollar amount of available tax credit, could transfer, for a price, the right to apply that credit against the investors' income taxes. In the other CCA,[3] the credit was not transferable, so the problem was somewhat more complex. In both cases, promoters, developers, and investors sought to use partnership structures through which the investors could claim state income tax credits for the developer/partnerships' expenditures. The CCAs noted that the investors generally were individuals interested in reducing their state income tax exposure because, due, for instance, to the federal alternative minimum tax, they "were indifferent to the state taxes deduction under section 164 for federal tax purposes."[4]

The partnership structures considered in the CCAs generally entailed the following events. Individual investors would subscribe for partnership interests, making cash contributions to partnerships that, directly or through tiers, had purchased credits from developers or had incurred, or were incurring, qualified rehabilitation expenditures. On the admission of the investors as partners, or shortly thereafter, the partnerships would allocate[5] to the investors

[1]Chief counsel advice represents, generally, the advice of IRS attorneys responding to questions raised by auditors in the field. CAAs may not be used or cited as precedent. *See* Internal Revenue Code section 6110. These new CCAs are similar in several ways to Rev. Rul. 61-152, 1961-2 Cum. Bull. 42 and PLR 200348002.

[2]CCA 200704030, dated Oct. 6, 2006, and released Jan. 26, 2007. *See also* AM 2007-002, dated Jan. 11, 1007.

[3]CCA 200704028, also dated Oct. 6, 2006, and released Jan. 26, 2007.

[4]CCAs, at page 2.

[5]The manner in which credits are allocated among partners is itself a complex question, not addressed herein. Treas. Reg. section 1.704-1T(b), promulgated in 2004, sets forth temporary rules for allocating federal credits for foreign income taxes among partners in a bona fide partnership. Those rules generally require that "credits be allocated in proportion to the partners' distributive shares of the partnership income to which the creditable foreign tax relates." Treas. Reg. section 1.704-1T(b)(4)(xi)(a)(2). However, that concept is difficult to apply in the context of credits generated from partnership expenditures. In those cases, the long-standing, if relatively unenlightening, general federal rules may apply: Credits are to be allocated "in accordance with the partners' interests in the partnership as of the time the tax credit or credit recapture arises. With respect to the investment tax credit [which is based on qualified expenditures] . . . allocations of costs or qualified investment [based on 'the ratio in which the partners divide the general profits'] shall be deemed made in accordance with the partners' interests in

(Footnote continued on next page.)

the state income tax credits earned as a result of the rehabilitation activities. The investors would also enter into option agreements under which the partnerships had the option to reacquire the investors' partnership interests at fair market value within a short period. In most cases the investors sold their interests back to the partnership within a few months, reporting capital losses on those sales. In other words, the investors were partners for a short while, during which time state income tax credits were allocated to them, and then they were redeemed out of the partnerships for an amount less than their initial investment.

According to the CCAs, the marketing materials relating to those credit transfer transactions said that the individuals would not receive "any material distributions of cash flow or net proceeds from the sale of the projects," nor would they be allocated any material amounts of income, gain, loss, or deduction for federal income tax purposes. Also, the CCAs described the marketing materials as saying that the return to the investors for their investment in the partnerships would be realized solely through the application of the state tax credits and the tax benefit of the capital losses generated on the sales of their partnership interests.

The IRS analyzed those transactions under four different rubrics and articulated four reasons why the transactions did not work as the parties had intended, at least not on the federal level. First, the IRS applied the principles of the substance-over-form doctrine to evaluate whether the investors should be respected as partners for federal income tax purposes. Citing *Culbertson*,[6] the IRS said that "[t]he critical inquiry is the parties' intent to join together in conducting business activity and sharing profits." In concluding that the individual investors were not true partners, the IRS found it important that the transactions were promoted as ones in which the investors would receive no material cash or partnership allocations; the investors subscribed "with full knowledge" that their only benefit would be the state tax credits and federal capital loss deductions; and the interests were held only briefly.

Because the investors were not partners, they did not receive the allocations of state income tax credits as partners. Instead, the IRS viewed the individuals' cash investments as the purchase of property, in the form of a state tax credit.[7] In essence, the developers[8] sold the credits to the promoters and investors. Because the developers had no basis in the credits,[9] the developers recognized gain on the receipt of the cash from the promoters and/or investors.

When the investors then applied the credits against their state income taxes, they too recognized gain, equal to the difference between their cost basis for the credits (the amounts they paid into the partnership) and the amount of state income taxes satisfied through application of the credits. Between the developers and the investors, there would be gain equal to the full amount of the credits. And presumably because the investors were "indifferent" to federal income tax deductions for state taxes paid, the federal deduction for the state taxes they were deemed to have paid through the application of the credits they purchased would be of no use to the investors in offsetting their income. Finally, because the investors were not respected as partners, their claimed capital losses on the sales of their partnership interests back to the partnerships were disallowed.

The IRS also analyzed the credit transactions under the disguised sales rules of IRC section 707. Generally, transactions that in form appear to involve partners and their partnerships may be recharacterized under section 707 as transactions between a partnership and someone who is not a partner, thereby turning tax-free transactions into taxable transactions. Using the authority of section 707, the IRS treated the transactions as taxable

the partners." Treas. Reg. sections 1.704-1(b)(4)(ii) and 1.46-3(f)(2). *See also* N.Y. Advisory Opinion TSB-A-06(8)I, which allocated a brownfield credit based on the partners' 99:1 respective interests when the property was placed in service, despite their "flip" shortly thereafter to 1:99 respective interests.

[6]*Comm'r of Internal Revenue v. Culbertson*, 337 U.S. 733 (1949); *see also Comm'r of Internal Revenue v. Tower*, 327 U.S. 280 (1946).

[7]The IRS made clear that the transferability of the credits as a matter of state law was not relevant to its analysis of the transactions.

[8]"Developers" is used loosely here to encompass both the developers who were principals in the partnerships that undertook the rehabilitation work and the partnerships themselves. In some cases the developers sold to promoters, who resold to the investors.

[9]The credits were earned by making qualified rehabilitation expenditures. Those expenditures presumably gave the developer basis in the rehabilitated properties, not in the credits. That raises another interesting line of analysis, which is the federal income tax treatment of various types of state tax credits that are not sold, but are instead applied against the taxes of the persons earning the credits. That subject is beyond the scope of this article, but for insight into some of those questions, see e.g., Rev. Rul. 79-315, 1979-2 Cum. Bull. 27 (discussing Iowa income tax rebates); Rev. Rul. 86-134, 1986-2 Cum. Bull. 104 (discussing the Netherlands investment incentives); PLR 8208111 (discussing Wisconsin rebates and credits for property taxes paid on homesteads); PLR 8829051 (addressing income tax credits for expenditures on revitalization projects); PLR 200046014 (discussing state rebates in respect of property taxes on personal residences); PLR 200348002 (discussing rehabilitation credits); and PLR 200519002 (discussing rebates for various taxes given as development incentives).

sales of the state tax credits by the developer partnerships to the individuals.

In both CCAs, the IRS also applied the partnership antiabuse rule.[10] That rule, which from time to time terrifies[11] tax practitioners with its vagueness and scope, permits the IRS to recharacterize a transaction involving a partnership if the partnership has been formed or availed of in connection with a transaction a principal purpose of which is to reduce federal tax liability in a manner inconsistent with the intent of subchapter K (the partnership provisions of the IRC). Here, the IRS found that the developer partnerships were formed or availed of for a prohibited purpose — specifically, they "enabled the promoters of the transactions to effect the sale of large numbers of credits at a profit of $f per dollar of credit without incurring gain at any level. Moreover, by design the investors claimed large amounts of capital losses from the sale of their purported 'partnership interests.' These manufactured deductions effectively substituted for state tax payments the investors could not otherwise benefit from, typically because such payments would not have been deductible for AMT purposes." Based on that analysis, the IRS again concluded that the transactions should be treated as taxable sales of the credits.

Finally, analyzing the technical rules of the IRC that specify procedures for partnership audits (1982 Tax Equity and Fiscal Responsibility Act), the IRS determined that the question whether the individuals would be respected as partners was a "partnership item," and thus could be audited at the partnership level, rather than through the much more cumbersome process of identifying and auditing each individual investor. Although the IRS acknowledged that that conclusion was controversial, it concluded that the issue of the investors' treatment as partners (or not) would be pursued at the partnership level, with the IRS then having an additional year following the conclusion of that process to assess the partners individually for the capital losses they claimed.

In sum, the IRS saw those credit transfer partnerships as too thin and lacking in substance to be respected as such, and instead recast the transactions as taxable sales of the state income tax credits by the developers, followed by a second taxable transaction occurring when the investors applied the purchased credits to satisfy their state tax liabilities.

Putting numbers to the theory, suppose an individual investor contributed $6 to a developer partnership in the expectation of being allocated $10 of state income tax credits. The parties planned that the investor would claim a $10 credit, offsetting $10 of state income tax liability. On the redemption of his partnership interest a short while later for $0, the investor would claim a capital loss of $6. Instead of paying $10 of state income taxes, which he could not effectively deduct because of the AMT, the plan was for the investor to recognize no income when applying the state tax credit against his state income tax liability and to recognize $6 of capital loss on the redemption of his partnership interest, which capital loss could be used to offset capital gains for both federal and state income tax purposes.

What the IRS held, by contrast, was that the $6 that was in form contributed to the partnership was in reality $6 of sales proceeds realized by the developer from the sale of an asset that had a zero basis. That produced $6 of gain to the developer. When the investor then applied the credit against his taxable income, he realized another $4 of gain by satisfying a $10 liability with an asset in which he had a basis of $6. The $10 deemed payment of state income tax would give rise to a federal deduction for regular tax purposes, but because the investor was subject to the federal AMT, that deduction was of no use to him. Overall, therefore, the investor would not be entitled to the $6 capital loss reported; would recognize $4 of gain on the deemed payment of $10 of state income taxes with the credit purchased for $6; and would have a $10 deduction for the state income taxes deemed paid, which deduction would be disallowed under the AMT.

The IRS did not address, logically enough, what might happen next, on the state level, at least in cases in which the state credits are not intended to be transferable. If the federal recharacterization of the transaction is correct, and means that the investors are not considered to have been partners for state income tax purposes either, and if the state tax credit could properly be allocated only to persons who are bona fide partners in the developer partnerships, then the investors' claimed state income tax credits would presumably be disallowed. The $4 gain the IRS posits the investor as having recognized through the satisfaction of his state tax liability with the partnership's $10 credit would not exist, because the state would disallow the investors' claimed credits. Instead, the investor would owe the state $10 in income tax. The $6 paid to invest in the partnership would be money lost, rather than the purchase price for a valuable asset.

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[10] Treas. Reg. section 1.701-2.

[11] An example of what terrifies in that regard can be found in the statement in CCA 200704028 that, in addition to the perhaps valid deconstruction of the underlying transactions as lacking in bona fides, the transaction also violated the antiabuse rule because the developer partnerships "failed to make section 754 elections and, therefore, had inflated inside bases." Practitioners bristle at the notion that a taxpayer's failure to make an *election* can be considered abusive. The statute to which the IRS here refers was amended, effective in 2004, effectively to mandate an inside basis adjustment in situations involving a substantial loss. *See* IRC sections 734(a) and 743(a), last clause.

In short, the investor would end up with a state tax bill of $10, plus interest and perhaps penalties, as well as a $6 economic loss, of uncertain tax character, from his purchase of a credit he could not use. Meanwhile the developers, who should still have $6 of gain regarding the money received from investors, presumably would not have claimed the $10 state tax credits because they believed the credits were sold to the investors. Whether the developers could still claim the $10 credit, or instead that claim is time-barred, would depend on the facts.

A federal audit can unravel state tax planning techniques.

The CCAs are of course only an early installment, a litigation-oriented one at that, in the audit and analysis of those particular structures. They are only an indication of the issues identified by the IRS in those audits and of the types of challenges other credit transfer plans, with other fact patterns, might face. And as with any dispute, the taxpayers still have their side to tell — the conclusions expressed by the IRS in these particular CCAs may not stand up to impartial analysis.

The CCAs are nonetheless important for highlighting the federal income tax consequences of a plan driven largely by state tax considerations. They serve to demonstrate how a federal audit can unravel state tax planning techniques, and they stand as examples of cases in which coordinating the federal and state audits may be of considerable practical importance. It would make no sense for investors to pay federal tax on the profit enjoyed in applying a credit purchased for $6 to pay $10 of state income tax, if the state believes that the investors cannot legitimately claim the credit. ✰