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United States Tax Court Finds in Favor of State Tax Credit Partnerships

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Would you like to achieve substantial state tax savings and feel good about preserving historic sites at the same time? It seems like a classic win-win, but the Internal Revenue Service has in years past stood in the way. A recent United States Tax Court decision, *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, T.C. Memo. 2009-295 (Dec. 21, 2009), may have eliminated the IRS roadblock for state tax credit partnerships. This decision is also important for proponents of historic preservation, as these partnership investment vehicles are a key source of capital raising for historic rehabilitation projects.

Historic Rehabilitation Projects and Role of State Tax Credits

Lenders are often unwilling to finance the entire cost of a historic rehabilitation project, because the cost often exceeds the fair market value of the structure after rehabilitation is complete. The federal government, Virginia, and 29 other States have enacted historic rehabilitation tax credit programs to assist developers by encouraging capital contributions from investors to cover the "credit gap" between cost and available financing. The state programs are as varied as the States providing the tax credits. While some of the state programs permit transfer of the tax credits (*e.g.*, Kentucky and Louisiana), other States, like Virginia, do not, but do permit disproportionate allocations of historic rehabilitation tax credits to investors (*e.g.*, Georgia, and South Carolina). Some States permit both transfer and disproportionate allocation of refundable historic rehabilitation tax credits (*e.g.*, Massachusetts and Missouri). Among other requirements established by the state agency responsible for historic preservation, certifications that the property is historic, identifying qualified costs of rehabilitation, meeting specified standards of rehabilitation, and obtaining approval of the plans of rehabilitation are usually required depending on the State.

Congress has declared it is a policy of the federal government to encourage and assist organizations and individuals undertaking historic preservation and to assist States in expanding and accelerating their historic preservation programs and activities. See National Historic Preservation Act of 1966, as amended, 16 U.S.C. § 470-1.

IRS Audit and Litigation Position

In a series of Chief Counsel Advice and a Legal Memorandum[1] addressing state historic rehabilitation tax credit partnerships, the IRS presented three alternative positions that it will use to challenge these partnerships. First, the IRS stated it would treat capital contributions to the partnerships by investor limited partners and the subsequent allocations of state tax credits by the partnerships to the investors as non-partner transactions under *Commissioner v. Culbertson*, 337 U.S. 733 (1949) and *Commissioner v. Tower*, 327 U.S. 280 (1946). For a partnership to exist, *Culbertson* and *Tower* require putative partners to join together in good faith with a valid business purpose in the conduct of a business enterprise. The IRS position treated the investor limited partners as not true partners and, instead, re-cast the arrangement as the sale of tax credits. Second, the IRS alternatively stated that, if the investors were true partners, the capital contributions/allocation of tax credits were really "disguised sales" of tax credits under Internal Revenue Code ("IRC") § 707(a)(2)(B). A transaction is treated as a disguised sale between a partner and a partnership when the partner transfers money or other property to a partnership, the partnership transfers money or other property to such partner in return, and these transfers when viewed together are properly characterized as a sale. Last, the IRS stated that the state tax credit partnerships were disregarded under the "anti-abuse rule" of Treas. Reg. § 1.701-2 and the sham transaction doctrine.

In *Virginia Historic Tax Credit Fund 2001 LP*, the Tax Court rejected the first two alternative positions of the IRS. In a significant concession prior to trial, the IRS conceded that the partnership was formed, in part, to reduce its investors' Virginia tax liabilities, and the IRS would not contend that it should be disregarded under the "anti-abuse rule" and sham transaction doctrine.

Virginia's Historic Rehabilitation Tax Credit and Partnership Structure

Under Va. Code § 58.1-339.2, a historic rehabilitation tax credit is provided to reduce income tax, bank franchise tax, and certain other taxes for individuals, corporations, and members of passthrough entities (S corporations, partnerships, and limited liability companies). The credit is equal to 25 percent of eligible rehabilitation expenses. To the extent the credit is not fully utilized in the taxpayer's first taxable year, the excess is eligible for carryover for 10 years or until the credit is fully utilized, whichever occurs first. Virginia's program does not permit the transfer of historic rehabilitation tax credits, but it does allow the disproportionate allocation of credits to partners or other investors in passthrough entities in accordance with their ownership interests or as provided in the partnership agreement. Va. Code § 58.1-339.2.A.

In a published ruling, the Virginia Department of Taxation has not followed the IRS position set forth in the CCAs and Legal Memorandum addressed above.[2]

Virginia Historic Tax Credit Fund 2001 LP involved a typical state tax credit partnership structure. A "source partnership" was formed to provide funding for a diverse selection of other partnerships (aka developer partnerships) engaged in a range of small and large historic rehabilitation projects. The capital of the source partnership was provided by investors, which was then contributed to the developer partnerships to help cover rehabilitation costs. After project plans and standards, costs, and tax credits were certified historic by the Virginia Department of Historic Resources (Virginia DHR), the developer partnerships allocated most of the credits to the source partnership, which in turn allocated them to the investors.

The investors were required to sign partnership agreements, subscription agreements, and option agreements. The partnership agreement provided that investors would share in the source partnership's profits and losses in proportion to their ownership interests (which were nominal) and that investors were entitled to distributions upon liquidation in accordance with positive balances in their respective partnership capital accounts. The option agreements provided that the general partner of the source partnership could purchase an investor limited partner's interest in the source partnership at fair market value after the partnership had fulfilled its purpose.

The Investors Were Partners

In rejecting the IRS's position that the investor limited partners of the source partnership were not partners (and that the source partnership was not a partner in the developer partnerships), the Tax Court relied on six key factors in holding that the *Culbertson/Tower* rule was satisfied:

(1) The investors contributed substantial capital to the source partnership that was used by the developer partnerships to cover the "credit gap" between costs of historic rehabilitation and financing.

(2) The investors received net economic benefits in the form of Virginia historic rehabilitation tax credits.

(3) The investors had a valid business purpose. The state tax savings, that far outweighed any incidental federal tax savings, was a valid business purpose (at least for federal tax purposes). Moreover, the lack of profit distributions to the investors was explained by the nature of historic rehabilitation projects – they are not profitable, a fact recognized by Congress and state legislatures. In fact, the IRS has previously recognized that endeavors involving tax incentives should be held to a different profit-motive standard for purposes of satisfying the business purpose requirement. See Rev. Rul. 79-300, 1979-2 C.B. 112 (low income housing partnerships not subject to normal profit-motive standard for business purpose, as that would frustrate Congressional intent).[3]

(4) Congress has encouraged State historic rehabilitation programs, and Virginia's base-broadening disproportionate tax credit allocation program encouraged capital contributions to these projects and furthered the Congressional purpose.

(5) The investors' capital contributions funded the developer partnerships and were pooled contributions critical to the success of the source and developer partnerships. Further, the investors remained partners in the source partnership until after the partnerships fulfilled their purposes.

(6) The investors' capital contributions were not made in exchange for tax credits that had already been certified by Virginia DHR and allocated to the developer and source partnerships. Thus, investors bore risks that rehabilitation projects and costs would not be qualifying under Va. Code § 58.1-339.2, or that developer partnerships would not complete the rehabilitation projects.

The Capital Contributions and Credit Allocations Were not Disguised Sales

The investors made capital contributions to the source partnership in 2001. The Tax Court found that the Virginia historic rehabilitation tax credits were allocated to the investors when the partnership attached credit certificates to the investors' K-1s in 2002. While transactions between a partnership and partner are presumed a disguised sale when they occur within two years of one another, Treas. Reg. § 1.707-3(c)(1), the Tax Court held that the substance of the investors' capital contributions and credit allocations were not disguised sales. There is no disguised sale when transactions are not simultaneous, and the subsequent transfer to the partner is subject to the entrepreneurial risks of the partnership's operations. Treas. Reg. § 1.707-3(b)(1).

The transfers of credits were not simultaneous with the investors' capital contributions. As noted, the Tax Court found the transfer occurred in 2002 when the credit certifications were attached to investor K-1s. Until then, the Virginia historic rehabilitation tax credits remained inchoate until an investor used them to reduce Virginia income tax liabilities. In addition, although investors were promised certain amounts of credits in their subscription agreements, there was no guarantee that the partnerships would pool sufficient credits. The risks to the investors addressed above also represented risks of the enterprise. As a result, the capital contributions and subsequent credit allocations were not disguised sales.

Virginia Historic Tax Credit Fund 2001 LP is a significant decision for proponents of historic preservation, developers, and investors in state historic rehabilitation tax credit partnerships. Given the points of law and the nature of this case, it would be surprising if the IRS appeals the Tax Court's decision. But, the government has 60 days from the date judgment was entered to file a notice of appeal with the Federal Court of Appeals for the Fourth Circuit.

If you would like to discuss these or any other tax matters, please contact any attorney in the Firm's Tax Department.

[1] CCA 200704028 (Oct. 6, 2006); CCA 200704030 (Oct. 6, 2006); and AM 2007-002 (Jan. 11, 2007).

[2] Ruling of Commissioner, P.D. 07-82 (May 25, 2007).

[3] In the Fourth Circuit, to which the Tax Court's decision is appealable by the IRS, a transaction is treated as a "sham" if the taxpayer was motivated by no business purposes other than obtaining federal tax benefits, and the transaction has no economic substance because no reasonable possibility of profit exists. *Rice's Toyota World, Inc. v. Commissioner*, 752 F. 2d 89, 91 (4th Cir. 1985).