The Virginia Historic Tax Credit Funds Case and The Uncertain Federal Income Tax Treatment of State Tax Credits

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1. **Introduction**

This article will discuss federal income tax issues arising from the allocation and/or transfer of state tax credits. Such credits, which are designed to incentivize investments in various areas such as low-income housing, the rehabilitation of historic properties, and the use of alternative energy, come in many shapes and sizes and can differ significantly from state to state. The discussion that follows will focus on two basic types of state credits:

(i) credits that cannot be transferred or sold and must be allocated to and among the partners or members of the entity that owns the property or otherwise engages in the activity generating the credits (referred to herein as the **Owner**); and

(ii) credits that can be transferred or sold by the recipient.

In some cases, states give the recipient the option of either allocating or selling the credit. The Massachusetts historic tax credit is an example of this approach. Other states mandate either an allocation or a sale but not both. In Virginia, for example, the state historic tax credit must be allocated to the members of the entity that owns the historic property; it cannot be transferred or sold.

Typically, a state credit that may (or must) be allocated can be allocated among the members of the Owner in a manner that differs from the way in which federal tax credits are allocated. For example, in the case of a partnership that owns an historic building, federal historic rehabilitation tax credits arising from the rehabilitation of the building must be allocated to and among the members or partners of the Owner in accordance with their respective shares of "bottom line" profits. If the building is in Virginia, Massachusetts, or certain other states, however, the legislation authorizing state historic credits (and/or rules and regulations interpreting such registration) specifically provide that such credits may be allocated in a totally different manner from federal tax items.1 In such a case, the state credit investor typically is allocated 100% of the state tax credits but only a very small percentage of cash flow and federal tax items (usually between 0.01% and 1%). As a result, the state credit partner has a capital account that is disproportionately large compared to its share of profits and losses, as determined for federal income tax purposes.

From the perspective of the Owner, the advantage of admitting a state credit investor as a partner is that contributions to the capital of a partnership are nontaxable under Section 721 of the Internal Revenue Code of 1986, as amended (the **Code**). Conversely, if a transferable state tax credit is sold to an investor, such sale will generate taxable income to the "seller" (which may be the Owner itself or a partner or member of the Owner to whom the credit has been allocated). Since the seller’s tax basis in the credit typically is zero, the sale of a state credit will generate taxable gain, thereby resulting in fewer net dollars being available to the Owner.

From the perspective of the state credit investor, an allocation of a state credit will generate a dollar for dollar credit against the state tax liability of the investor. However, as discussed below, the IRS has taken the position that a taxpayer to whom a state credit is allocated

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1 See Section 6 below for a discussion of certain technical issues raised by such provisions.
is not entitled to a deduction under Section 164 of the Code for state taxes paid when such taxpayer applies the credit to reduce its state taxes. Consequently, for a taxpayer in the 35% tax bracket, a state tax credit generally is not worth more than $0.65 since the taxpayer is losing a $0.35 deduction for each $1.00 of taxes reduced by the credit. On the other hand, the current position of the IRS is that a taxpayer who purchases a state tax credit receives the benefit not only of the credit against its state taxes but also of a federal deduction for taxes “paid” when it applies the credit to reduce its state taxes. Therefore, at first glance, a “purchased” state credit is worth more than an “allocated” state credit.

In order to level the playing field and to provide an exit strategy for state tax credit investors, most transactions involving the allocation of state credits include put or call provisions under which the interest of the state credit investor may be purchased by the Owner (or an affiliate). Put option prices typically are set at very low levels. Call options must be priced at fair market value but such value may be quite low due to the nominal interest of the state investor in profits, losses, and operating cash flow, the lack of a market for the state investor’s interest, the inability of the state investor to participate in the management and operation of the business, and the inability of the state investor to compel a liquidation of the Owner and the return of its capital.

The federal income tax consequences of the sale of a transferable state tax credit are relatively straightforward (with the possible exception of the issue of whether the gain is ordinary income or capital gain). However, the tax characterization of a state credit investment that is structured as a contribution to the capital of a partnership is far less certain, particularly when, as is true in the vast majority of cases, the state investor’s interest is subject to a put or call option.

The tax consequences of syndicated state tax credit transactions are further complicated by the fact that such transactions frequently involve tiered partnerships. That is, the state credit investor that acquires an interest in the Owner may itself be a partnership. In states where state credits may be allocated by the Owner to one of its partners, the Owner may allocate the credits to its general partner or managing member, which in turn sells the credits to the ultimate state credit investor. Alternatively, the credits may be allocated by the Owner to a state credit partnership (referred to herein as an “SCP”) which in turn allocates the credits to one or more investors who make contributions to the capital of the SCP. The SCP then contributes all or substantially all of the proceeds to the capital of the Owner. Depending on the applicable state law and the creativity of the participants, a number of variations of the foregoing approach are possible.

2. Existing Law

2.1 Overview of the Federal Income Tax Treatment of State Tax Credits.

There is considerable uncertainty concerning the proper characterization of state tax credits for federal income tax purposes. The fundamental issue is whether a state tax credit should be treated as a tax attribute or as property. If a state tax credit is simply a tax item, the only federal income tax consequence to a taxpayer who is allocated such credit and applies it to reduce its state tax liability will be a reduction in such taxpayer’s deduction for state income
taxes paid under Section 164(a)(3) of the Code. On the other hand, if a state tax credit is treated
as property, the federal income tax consequences may be considerably more complicated. In
such a case, the recipient of the credit must determine its tax basis for such “property” and the
receipt or transfer of the state tax credit will generate federal taxable income, which may be
ordinary income or capital gain for federal purposes, depending on whether the state tax credit is
a capital asset in the hands of the taxpayer. See Section 7 below.

Section 61(a) of the Code generally provides that gross income includes all income from
whatever source derived, except as otherwise provided in Subtitle A of the Code. Section 1.61-1(a) of the Treasury Regulations provides, in part, that gross income means all
income from whatever source derived, unless excluded by law. Gross income includes income
realized in any form, whether in money, property, or services. Notwithstanding this broad
definition, the IRS has issued a number of private letter rulings and other advice confirming that
a state tax credit, to the extent that it can be applied only against the recipient’s current or future
state tax liability, is treated for federal income tax purposes as a reduction or potential reduction
in the taxpayer’s state tax liability and is not included in the taxpayer’s gross income for federal
income tax purposes or otherwise treated as a payment from the state and is not deductible by the
taxpayer as a payment of state taxes under Sections 162 or 164 of the Code. See ITA
United States, 894 F.2d 1337 (6th Cir. 1990). ITA 200211042 dealt with the Missouri
remediation tax credit, a state credit that may be applied against one of several Missouri state
taxes or, at the taxpayer’s option, transferred for value. The IRS stated:

Since transferability is one attribute of property, this feature suggests that the
issuance of the credit should be treated, for federal income tax purposes, as the
receipt from the state of property – the fair market value of which, assuming no
exclusion applies, would be includable in income. In our view, however, the
existence of the right of transferability, without more, does not change the tax
treatment relative to the other types of state tax credits described above.
Accordingly, the remediation tax credit retains its character as a reduction or
potentially reduction in state tax liability, unless and until it is actually sold to a
third party. In other rulings, the IRS has taken the position that, if the purchaser of a transferable state
credit applies the credit to reduce its state tax liability, the transaction is treated as a transfer of
property in exchange for the reduction in the taxpayer’s state tax liability. See, for example,
GCM 200445046, dated November 5, 2004, in which the IRS considered the question of whether
purchasers of Massachusetts historic rehabilitation tax credits and low-income housing tax
credits have made a “payment,” for purposes of Section 164(a) of the Code when they file their
state tax returns and use the purchase credits to reduce their state tax liability. The IRS
concluded:

A transferee’s payment to a transferor for the purchase of a transferable state tax
credit is clearly not a payment of tax or a payment in lieu of tax for purposes of

2 See, also, Priv. Ltr. Rul. 200348002 (Aug. 28, 2003); Chief counsel Adv. 200238041 (July 24, 2002); Chief
§ 164(a). See Rev. Ruls. 61-152, 1961-2 C.B. 42; 71-49, 1971-1 C.B. 103; 81-192, 1981-2 C.B. 49. In addition, generally the application of a credit against a tax liability is really a reduction of the tax liability. See Rev. Rul. 79-315, 1979-2 C.B. 27. However, in this situation, a transferee has purchased a credit for value and the credit is "property" in the transferee's hands rather than a factor in the calculation of tax due. The use of the credit to reduce the transferee's state tax is analogous to the transfer of property to the state in satisfaction of the transferee's tax liability. Thus, the transferee of a Massachusetts historic rehabilitation tax credit or low-income housing tax credit will have made a payment, for purposes of I.R.C. § 164(a), when it files its state tax return and uses the purchased credit to reduce its state tax liability.3

Based on the above rulings and other applicable authority, it appears to be clear that neither the allocation of a state tax credit nor the reduction of state taxes resulting from the application of an allocated credit generates income to the taxpayer. However, if a transferable state tax credit is transferred or sold for value, such disposition will generate income to the seller. Since the seller to whom the credit is allocated has paid nothing for it, the seller has no cost basis in the credit because it was not previously includable in gross income when the credit was issued.4 Consequently, the seller has a zero basis in the credit and the gain from the disposition equals the amount realized by the seller.

In many ways, this is an odd result. Normally, whether an item should be treated as "property" for federal income tax purposes depends on the intrinsic characteristics of the item. In the case of state tax credits, however, the IRS apparently considers the credits to be tax items unless and until a taxpayer transfers them, at which point they become property.5 Moreover, it would be difficult to support a conclusion that the initial tax characterization of a state tax credit depends on whether it is received by an individual or by a partnership. In other words, the credit either is "property" or is not "property" when the entitlement to such credit arises (through an allocation by the state or otherwise). Since the IRS has ruled that a credit is not "property" at this point, it should be treated as a tax item if it is received by a partnership. If, as is the case in several states, a state tax credit can either be allocated or transferred, this suggests that the same credit could be allocated by a partnership to one of its partners (at which point it is treated as a tax item) and then sold by that partner to another taxpayer (at which point it is treated as property). Conceptually, a "sale" of a state credit should occur only if the credit is transferable under applicable state law. However, in the Virginia Historic Tax Credit Funds case described in Section 2.3 below, the IRS asserted that the purported allocation of nontransferable Virginia state historic rehabilitation credits by entities formed as limited partnerships under state law was in reality a "sale" of such credits for federal income tax purposes.6

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4 See Treas. Reg. §1.1012-1(a) and ITA 200211042 discussed above.
5 See the discussion of the Virginia Historic Tax Credit Funds case in Sections 2.3 and 2.4 below.
6 Id.
2.2 The Virginia CCAs

In 2007, the IRS addressed the federal income tax consequences of certain transactions involving Virginia state historic rehabilitation tax credits. Under applicable Virginia law, with the exception of a "one time transfer" provision that no longer is in effect, such credits cannot be transferred or sold. If they are received by a partnership, they must be allocated to the partners of such partnership either specially pursuant to an agreement or pursuant to the partners' respective ownership percentages.\(^7\)

Notwithstanding the fact that Virginia state historic tax credits are, by their terms, nontransferable, the Office of Chief Counsel of the IRS determined, in ILM/CCA 200704028 and CCA 200704030, both dated October 6, 2006 and published on January 26, 2007 (the "CCAs"), that a purported allocation of such credits to partners may be recharacterized as a sale for federal income tax purposes.

In the transactions that were the subject of the CCAs, investment partnerships were formed consisting of various investors who intended to acquire nontransferable Virginia state tax credits from different developers who had earned the credits. Citing Commissioner v. Culbertson,\(^8\) (discussed in detail in Section 3.1 below), the IRS concluded that the investors were not partners in the funds. In the transactions in question, the partners held 1% interests in the funds but did not receive any material cash distributions, allocations of federal income tax credits, or partnership items of income, gain, loss or deduction. According to the IRS, the investors entered into the transactions knowing that the only benefits to be received were the distributions of the state tax credits and federal income tax losses. Each investor executed a purchase option agreement to sell his interest for fair market value after a one year holding period with the goal of deducting a loss from the disposal of each investor's partnership interest. In fact, according to the IRS, the investors apparently held their interests in the partnership for an even briefer period of time, usually just a few months. Based on these facts, the IRS concluded that the investors lacked the joint profit motive that is required for partner status, and therefore they were not partners in the respective funds.

The IRS focused on the manner in which the transaction was promoted and the expectations of the individual investors, stating, "[t]he investors subscribed to the transactions with the full knowledge that the only benefits of entering P1, P2, or P3 were the distributions of the State tax credits and federal tax losses to be claimed at the termination of their interests."\(^9\) The IRS concluded that this was clear evidence of the lack of the joint profit motive required for partner classification.

Each of the CCAs also analyzed the transactions under the disguised sale rules of Section 707 of the Code. Section 707(a)(2)(B) provides that if a partner makes a transfer of money or other property to a partnership and the partnership makes a related transfer of property to such partner, the transaction may be recharacterized as a sale or exchange of the property between the partnership and a non-partner. Generally, such a transaction will be recharacterized if (i) the

\(^7\) See Virginia Code §58.1-339.2.
\(^8\) 337 U.S. 733 (1949).
\(^9\) CCA 200704030
partnership would not have transferred the money or property 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 operations. Section 1.707-3(b)(1) of the treasury regulations; see also Section 1.707-6(a) of the treasury regulations (applying rules similar to those in Section 1.707-3 to disguised sales of property by a partnership to a partner).

The CCAs concluded that, because the partnerships in question transferred the state tax credits simultaneously upon the investors’ contributions of cash, the transfers should be treated as sales of state tax credits by the partnerships to the investors for federal tax purposes.

Finally, the IRS applied the partnership anti-abuse rules set forth in the treasury regulations under Section 701 of the Code to assert that the real substance of the transactions was a taxable sale of the state tax credits, arguing:

P1, P2, and P3 were formed or availed of in connection with the transactions a principal purpose of which was to reduce substantially the present value of the partners’ aggregate tax liability in a manner that is inconsistent with the intent of subchapter K.

First, P1, P2, and P3 were used for the specific purpose of allocating the credits to the investors, resulting in substantial federal tax reduction. The use of the partnership form 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” in P1, P2 and P3 to the promoters at a price a fraction (e) of their bases. 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. Additionally, P1, P2, and P3 failed to make § 754 elections and, therefore, had inflated inside bases. This use of the partnership form is inconsistent with the intent of the Subchapter K, which is to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax.

Second, the promoters and the investors entered into the various subscription agreements, option agreements, and partnership agreements for the allocation and gainful disposition of the State tax credits in anticipation of reporting no gain and claiming large amounts of losses for federal tax purposes. Tax avoidance, therefore, was a principal purpose behind the use of the partnerships.¹⁰

The following resulted from the recharacterization of the transactions in the CCAs: (i) the investors were deemed to have purchased property in the form of the state tax credits for a price equal to their respective capital contributions to the partnerships; (ii) the investors were treated as disposing of the state tax credits and paying their state tax liability, thereby generating a deduction under Section 164(a) of the Code; (iii) because they were not “partners”, the

¹⁰ CCA 200704030
investors could not claim a loss from the disposition of their partnership interests; and (iv) the recharacterization of the allocation of the Virginia historic tax credits to a sale of such credits resulted in the recognition of gain from the sale of the credits equal to the amount of the purported capital contributions less the basis (if any) the seller had in the credits.

In addition to releasing the CCAs, it is worth noting that the IRS included certain tax credit transactions on its annual "Dirty Dozen" tax scams list for 2007. Under the heading "Structured Entity Credits," the IRS states that:

Promoters of this newly identified scheme are setting up partnerships to own and sell state conservation easement credits, federal rehabilitation credits and other credits. The purported credits are the only assets owned by the partnership and once the credits are fully used, an investor receives a K-1 indicating the initial investment is a total loss, which is then deducted on the investor's individual tax return. Forming such an entity is not a viable business purpose. In other words, the investments are not valid, and the losses are not deductible.

While the inclusion of "Structured Entity Credit" transactions in the 2007 "Dirty Dozen" list indicates that the IRS is concerned with transactions such as the one described in the CCAs, to date the IRS has not provided any additional guidance or explanation regarding what specific aspects of a transaction would result in its inclusion as a "Structured Entity Credit" transaction.

Following the issuance of the CCAs, there was a concern that the IRS position could have an adverse effect on the availability of Virginia state historic tax credits. As discussed above, under the applicable laws of the Commonwealth of Virginia, state historic tax credits cannot be transferred or sold. State historic tax credits allowable to a partnership are allocated among the "partners" of the "partnership" either in proportion to their ownership interests in such partnership or as the partners mutually agree.11 The terms "partner" and "partnership" are not specifically defined for this purpose. However, the Virginia Code provides that, for purposes of Chapter 3 of the Virginia Code, which includes § 58.1-339.2(A), terms used in that Chapter will have the same meaning as when used in a comparable context in the Code, unless the context clearly requires otherwise.12 Thus, it is clear that a state credit investment partnership such as the Funds will be treated as a "partnership" for Virginia tax law purposes if it is treated as a "partnership" for federal income tax purposes. Similarly, each Fund will be treated as a "partner" of the Owner for Virginia tax law purposes if it is treated as a "partner" for federal income tax purposes and each Fund investor will be treated as a "partner" of the Fund for Virginia tax law purposes if it is treated as a "partner" for federal income tax purposes. The issue is what happens if, as in the case of the CCAs, the IRS recharacterizes the transaction as a "sale" of the state tax credits rather than a partnership investment.

On December 21, 2006, the Department of Taxation of the Commonwealth of Virginia (the "Department of Taxation") issued a memorandum addressing this issue. In the memorandum, the Tax Commissioner stated that even though Virginia generally conforms to the Code and the federal income tax laws, it is not necessarily the case that Virginia would conform

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12 See Virginia Code §58.1-301.
to all actions taken by the IRS. The Tax Commissioner explained that, because the Virginia state
historic tax credit is not determined with reference to a federal credit or deduction, a
recharacterization of the allocation of the State Investor as a sale by the IRS would not
necessarily govern the treatment of such transaction for Virginia state tax purposes. The Tax
Commissioner stated “[s]pecifically, the recharacterization in the anticipated [Chief Counsel
Memorandum] would not require [the Virginia Department of Taxation] to deny a Virginia tax
credit on the grounds that Virginia law would not allow the credit to be sold.”

On May 25, 2007, the Department of Taxation issued a ruling discussing the Tax
Commissioner’s response to the CCAs.\textsuperscript{13} The Tax Commissioner stated that an IRS
determination that an investor is not a partner or the owner is not a partnership does not require a
similar finding for Virginia tax purposes. Because “nothing in Virginia law . . . ties any amount
or determination related to the credit to the federal tax treatment of a related item”, the Tax
Commissioner stated that it appears (under the hypothetical facts and implied assumptions of the
CCAs) that the state historic tax credits would be granted under Virginia law to a partnership
validly created under Virginia law.

Accordingly, subject to the discussion below, it would appear that a determination by the
IRS that, for federal income tax purposes, a state investor is not a partner in a state credit fund or
that the fund is not a partner in the Owner would not affect the ability of the state investor to
receive an allocation of the state historic tax credit for Virginia tax purposes. Of course, there
can be no assurance that the taxing authority of another state would reach the same conclusion if
presented with similar facts.

2.3 The Virginia Historic Tax Credit Funds Case

The transactions that were the subject of the CCAs were the subject of a United States
Tax Court case that was tried in April of 2009.\textsuperscript{14} As of the date of this article, no decision has
been rendered by the court in this case. A number of arguments were advanced by the IRS at the
trial or in post-trial briefs, including the following:

(i) The investors in the state credit funds (the “\textsuperscript{Funds}”) did not qualify as
“partners” for federal income tax purposes. As a result, the Funds recognized income
during taxable years 2001 and 2002 from a “sale” of the Virginia state tax credits to the
investors that was not reported by the Funds on their forms 1065 for such years.

(ii) Alternatively, the IRS argued that even if the investors were partners for
federal income tax purposes, the purported “allocation” of Virginia state tax credits by
the Funds to the investors constituted disguised sales of such state tax credits under
Section 707 of the Code.

(iii) The gain from the sales of the Virginia state tax credits should be
classified as ordinary income rather than capital gain.

\textsuperscript{13} See Virginia Rulings of the Tax Commissioner #07-82.
\textsuperscript{14} See Virginia Historic Tax Credit Funds 2001 LP, Virginia Historic Tax Credit Funds 2001 LLC, Tax Matters
Partner, Et Al, [citation].
(iv) The court should impose the Code Section 6662 penalty for negligence and substantial understatement in the cases.

(v) As a procedural matter, the IRS also asserted that the taxpayers rather than the IRS bore the burden of proving that the investors were partners in bona fide partnerships that were formed for a business purpose and that the form of the transaction accurately reflected its substance.

Interestingly, immediately prior to the commencement of the trial, the IRS withdrew its assertion that the transactions were subject to recharacterization under the anti-abuse regulations contained in Section 701 of the Code, apparently conceding that the Funds were not formed or availed of in connection with a transaction, a principal purpose of which is to reduce the federal income tax liability of the partners.

In its briefs and during the trial, the IRS relied on the facts and circumstances test articulated in *Commission v. Tower* 15, *Commissioner v. Culbertson* 16, and *Luna v. Commissioner* 17, among other things, to support its argument that the investors in the Funds were not partners for federal income tax purposes. Among the factors cited by the IRS was the fact that the investors did not share in the profits of the Funds, which were not intended to produce any profits other than the benefits provided by the state tax credits. In this regard, the IRS pointed out that the “profit” represented by the spread between the amounts contributed by the investors to the capital of the Funds and the amounts contributed by the Funds to the underlying developer partnerships was retained by the principals of the Funds and was never shared with the investors. The IRS also asserted that the investors bore virtually no risk of losing their investment, stating: “Since the purchases of the partnership interests were conditioned upon the availability of the state tax credits, and the investors received the pre-established amount of state tax credits simultaneously with the application of their payments, the investors’ “capital contributions” were never subject to the entrepreneurial risks of a valid partnership.” 18 The IRS discounted testimony at the trial that the investors could experience a potential risk of not receiving state tax credits if the Virginia Department of Historic Resources withdrew its approval of any of the certificates of rehabilitation and would be subject to other risks as well.

With respect to the intent of the parties, the IRS asserted that the weight of the testimony introduced at the trial indicated that the investors did not believe that they were participating as partners in the business activity of a partnership or joint venture. 19 According to the IRS, it was clear from the testimony of the investors who testified at the trial that the purchase of the state tax credits was either their sole or primary purpose for entering into the transaction. In the view of the IRS, there was no evidence presented of other potential economic benefits or profits from the transaction. 20

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15 327 U.S. 280 (1946).
16 337 U.S. 733 (1949).
17 42 T.C. 1067
18 See Opening Brief for Respondent, p. 177.
20 See Opening Brief for Respondent, p. 182.
The IRS also focused on the question of whether the investors intended to engage in a joint business venture, through the Funds, of rehabilitating historic properties with the developers, stating: “Only if this is true can they be treated as members of the tax entity that originally qualified for the historic credit, entitled to treat the credit as a tax attribute for federal tax purposes.”\(^{21}\) The argument apparently was that the Funds were not partners of the underlying developer partnerships and, therefore, the investors derivatively were not partners engaged in a joint business venture. The IRS focused particular attention on the fact that some of the investors were only associated with the Funds for one to two weeks and that none of the rest of the investors were associated for longer than five months. According to the IRS, “[t]he termination of their association with the partnerships was an event planned at the time that the investors purchased the state tax credits, in order to enable the investors to claim a loss on their federal income tax return of virtually the entire amount of their investment. The short duration of the investors’ association with the Virginia Funds is inconsistent with the intent to engage in a joint business venture as partners.”\(^{22}\)

According to the IRS, the call option that enabled one of the principals of the Funds to unilaterally purchase the interests of the investors for a nominal amount prevented the investors from sharing in any of the “spread” described above or any other financial benefits generated from the formation and operation of the Funds.

Since the only benefit obtained by the investors was in the form of the state tax credits, the IRS further argued that the purported “capital contributions” made by the investors to the Funds were not really contributions to capital but should be characterized as purchase price for the credits. Again, the IRS emphasized that none of these Funds were subject to the risks of the business typically associated with the formation and operation of a joint venture.\(^{23}\)

Interestingly, the IRS also asserted that the investors were not limited partners because no fiduciary relationship existed between the general partners of the Funds and the investors. The IRS based this argument on the fact that the general partners did not disclose the fact that the capital contributions required from the investors exceeded by a substantial amount the required capital contributions by the Funds to the underlying developer partnerships. In the view of the IRS, a general partner acting in a fiduciary capacity should have disclosed this fact to the investors. In addition, the nominal amount paid to the investors for their interests under the purported “fair market value” call option totally ignored the large positive capital account balances to which they would have been entitled had the Funds liquidated.\(^{24}\)

While the IRS acknowledged that the Funds had complied with certain formalities of treating the investors as partners by executing partnership documents and filing partnership tax returns, the IRS invoked the substance over form doctrine to argue that, notwithstanding such superficial steps, the investors were mere purchasers of the state tax credits.\(^{25}\)

\(^{21}\) See Opening Brief for Respondent, p. 182.
\(^{22}\) See Opening Brief for Respondent, p. 184.
\(^{23}\) See Opening Brief for Respondent, p. 186.
\(^{24}\) See Opening Brief for Respondent, p. 191.
\(^{25}\) See Opening Brief for Respondent, pp. 192-198.
Even if the court recognized the existence of a true partnership relationship in the case, the IRS argued, alternatively, that the transfer of state tax credits by the Funds in exchange for cash from the investors constituted disguised sales pursuant to Section 707(a)(2)(B) of the Code.

In order for a transaction to fall within the purview of Section 707(a)(2)(B), it first must be shown that there is a direct or indirect transfer of money or other property by a partner to a partnership. The IRS argued that this condition clearly was satisfied because of the transfers of money by the investors to the Funds. 26

The second element under Section 707(a)(2)(B) requires a related direct or indirect transfer of money or other property by the partnership to such partner or another partner. The IRS argued that the purported allocation of the state tax credits by the Funds to the investors clearly constituted a transfer of "property" for purposes of Section 707. This characterization of nontransferable state tax credits as "property" served as the foundation for the IRS's entire case and will be discussed in some detail below.

The third element required to invoke the disguised sale rules of Section 707(a)(2)(B) is that the transfers described in the first two elements, when viewed together, are properly characterized as a sale or exchange of property. This condition is satisfied if, based on all of the facts and circumstances, (i) the partnership would not have transferred the property to the partner but for the transfer of money to the partnership, and (ii) in the case of transfers that are not simultaneous, the subsequent transfer of property by the partnership to the partner is not dependent on the entrepreneurial risks of the partnership operations. 27

Under the regulations, transfers made within two years of each other are presumed to be a sale. 28 The IRS argued that, in the case of the transactions at hand, the transfers occurred simultaneously. Even if the court held otherwise, the transfers absolutely occurred within the two-year presumptive period. With respect to entrepreneurial risk, the IRS once again argued that the investors were basically insulated from any risks at all arising from their investments. 29 As it had done in the case of earlier arguments, the IRS placed particular emphasis on the fact that the cash contributions of the investors were held in segregated bank accounts and were subject to return if the state credits were not available for any reason. 30 Similar agreements between the Funds and the underlying developers of the properties contained credit adjuster provisions intended to likewise protect the Funds (and, derivatively, the investors) from a loss of the state tax credits. 31

In addition to its discussion of the three fundamental elements necessary to invoke the provisions of Section 707(a)(2)(B), the IRS analyzed the transactions in the context of ten nonexclusive facts and circumstances set forth in the treasury regulations that may tend to prove the existence of a disguised sale for the purposes of Section 707. The first factor is whether the "timing and amount of the subsequent transfer are determinable with reasonable certainty at the

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26 See Opening Brief for Respondent, p. 200.
27 See Opening Brief for Respondent, p. 203 and Treas. Reg. §§1.707-3(b)(1); 1.707-6(a).
28 See Treas. Reg. §§1.707-3(c)(1); 1.707-6(a).
29 See Opening Brief for Respondent, p. 208.
30 See Opening Brief for Respondent, pp. 209-211.
31 See Opening Brief for Respondent, pp. 211-225.
time of an earlier transfer.” In the case at hand, the IRS asserted that the timing and amount of the transfers were determined with absolute, not just reasonable, certainty at the time of the contribution by each investor of cash to the Funds.

The second factor set forth in the regulations is whether the “transferor has a legally enforceable right to the subsequent transfer.” The IRS argued that each investor clearly had a legally enforceable right to receive a specified amount of state tax credits upon making his cash contribution to the Fund.

The third element described in the regulations is whether the right to the subsequent transfer is fully secured. Once again, the IRS argued that the investors were guaranteed that they would receive either the state tax credits or a return of their contributions.

The fourth factor is whether “any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration.” The IRS argued that the underlying property developers were legally obligated to transfer state tax credits to the Funds so that the Funds could then transfer the credits to the investors.

The fifth factor is “whether the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets).” The IRS argued that the Funds maintained an “inventory” of state tax credits far in excess of those needed for the conduct of their business.

The sixth factor is whether partnership distributions, allocations or control of partnership operations are designed to effect an exchange of the benefits and burdens of ownership of property. Since the amount of state tax credits that was allocated to each investor was based entirely upon the amount of the payment made by the investor to a Fund, the IRS argued that this condition clearly was satisfied.

The seventh factor is whether “the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner’s general and continuing interest in partnership profits.” The IRS argued that the amount of the state tax credits allocated to each investor bore no relationship to the purported interest of such investor in the profits of the Fund (and underlying developer partnerships).

32 See Treas. Reg. §§1.707-3(b)(2)(i); 1.707-6(a).
Finally, the regulations ask whether there is a potential obligation to return the property. The IRS asserted that, once the state tax credits were transferred to the investors, the investors were under no obligation to return such credits.

The IRS also focused on a number of references by various interested parties, including the principals of the Funds, to the "purchase" and "sale" of state tax credits in various documents relating to the transactions.

Not surprisingly, the taxpayers took issue with all of the foregoing arguments of the IRS. In the first place, the taxpayers argued that the Funds did constitute partnerships for federal income tax purposes and that the investors dealt with the Funds in their capacity as partners and not in a non-partner capacity. In particular, the taxpayers asserted that state statutory or "regulatory realities" dictated the terms and "compelled or encouraged" the use of the partnership structure in a manner consistent with the holding of the U.S. Supreme Court in the Frank Lyon case discussed in more detail below. The taxpayers also pointed out that the IRS relied heavily on the purported "subjective intent" of the investors in arguing that no partnership existed for federal income tax purposes. In the view of the taxpayers, this position was clearly contradicted by the testimony of the witnesses at the trial, who in any event represented only a small sampling of the investor group. The taxpayers also noted that at no time during the 3-year audit period did the IRS interview or contact any of the investors concerning their intent in participating in the program.

The taxpayers strongly objected to the IRS's position that the "sole" purpose of the Funds was to create a vehicle for acquiring the state tax credits. The taxpayers argued that this ignored the "feel good" motivation of many of the participants and failed to take into account that the program was a policy-based statute intended to incentivize investments exactly like those made by the Funds. The taxpayers asserted that the cases cited by the IRS describing the improper use of partnerships did not involve policy-based incentives such as those in the present case, inviting particular attention to the decision of the Ninth Circuit in the Sacks case discussed in Section 4.1.41

The taxpayers pointed out that, for the first time in its post-trial brief, the IRS attempted to change the partner issue from a question of whether the investors were partners of the Funds to the question of whether the investors were somehow partners with the developer partnerships, an issue that was no longer open under the applicable statute of limitations.42

At the core of the taxpayers' argument was the proposition that, in recharacterizing the transactions at hand, the IRS ignored the most important statutory provisions dealing with partnership and partner status, including Section 761 of the Code (with its broad definitions of "partner" and "partnership"), Section 7701 of the Code (which mirrors the Section 761 definitions), Section 704 of the Code (dealing with partnership allocations), and Section 704(e) of the Code (with its per se capital partner rule). In the view of the taxpayers, the Funds were

40 See Reply Brief by 2001 Virginia Historic Tax Credit Funds, pp. 2, 74.
41 See Reply Brief by 2001 Virginia Historic Tax Credit Funds, pp. 10, 19, 87, 93.
42 See Reply Brief by 2001 Virginia Historic Tax Credit Funds, pp. 10, 73.
43 See Reply Brief by 2001 Virginia Historic Tax Credit Funds, pp. 11, 51, 52, 92.
engaged in a “business, financial operation or venture” that (i) supported the Virginia Historic
Rehabilitation Program, (ii) pooled the capital of the investors, (iii) assisted in funding the
rehabilitation of a large number of historic projects, (iv) obtained a diversified pool of the
resulting Virginia state historic tax credits and (v) allocated that pool of credits among the
investors in accordance with applicable state and federal law.\textsuperscript{44}

The taxpayers argued not only that the documents executed by the parties supported the
true partner status of the investors, but also that the IRS has long recognized that the reduction of
state, local and foreign taxes constitutes a legitimate business purpose, even outside the context
of policy-based incentive programs.\textsuperscript{45}

In the view of the taxpayers, the fact that the Funds were formed to take advantage of
state tax incentives and had a short duration was not determinative. In reply to the assertion of
the IRS that the formalities were not always respected in the case of the formation and operation
of the Funds, the taxpayers pointed out that there is ample authority for the proposition that
partnerships can exist for federal income tax purposes without such formalities.\textsuperscript{46}

In response to the argument by the IRS that many of the investors participated in the
Funds for only a very short period, the taxpayers argued that the Funds were special purpose
partnerships that existed only until their purposes had been fulfilled, citing a line of cases that
confirms that a partnership may be created for a single business undertaking or venture.\textsuperscript{47}

With respect to the IRS’s assertion that the state tax credits constituted “property” for
federal income tax purposes, the taxpayers objected strongly, arguing; (i) a tax attribute arises by
an operation of law and generally constitutes neither property nor income;\textsuperscript{48} (ii) an allocation of

\textsuperscript{44}See Reply Brief by 2001 \textit{Virginia Historic Tax Credit Funds}, p. 52.
\textsuperscript{46}See Reply Brief by 2001 \textit{Virginia Historic Tax Credit Funds}, p. 53, citing \textit{Evans v. Commissioner}, 447 F.2d 547, 552 (7th Cir. 1971) (“Partnerships, for tax purposes, have been implied from conduct of the parties, in the absence of
any written agreement and even where parties deny any intent to form one”); \textit{Cohen v. Commissioner}, 19 T.C. 261, 272 (1990) (“The terms of a [joint] venture [taxed as a partnership] may be informal and need not be reduced to
writing”); \textit{Roark v. Hicks}, 362 S.E. 2d 711, 714 (Va. 1987) (“A joint venture exists where two or more parties enter into a special combination for the purpose of a specific business undertaking, jointly seeking a profit, gain, or other
benefit, without any actual partnership or corporate designation”).
\textsuperscript{47}See Reply Brief by 2001 \textit{Virginia Historic Tax Credit Funds}, p. 88, citing S. Rowley, \textit{Rowley on Partnership}
\S 6.5, at 77 (2d ed. 1960) (citations omitted). (“[T]here may be a partnership merely for the consummation of a
single transaction, adventure, or undertaking”); 59 Am. Jur. 2d, \textit{Partnership} \S 47 (“[p]artnerships may be formed for
almost any purpose not violative of declared public policy or express statutory inhibitions”); \textit{Madison Gas and
Electric Co. v. Commissioner}, 633 F.2d 512, 514-515 (7th Cir. 1980) (sharing power plant); \textit{Van Tine v. Hilands}, 131
F. 124, 127-28 (N.Y. Cir. Ct. 1904) (joint venture found where “contract was made between friends meeting
casually in New York to dispose of certain designated stock, owned by a small number of shareholders, for a
particular purpose and \textit{for a necessarily limited period}” (emphasis added); \textit{Hayes v. Irwin}, 541 F. Supp. 397, 415
(N.D. Ga. 1982) (“A partnership may be created for a single venture or enterprise”); \textit{Dawson v. J.G. Wentworth &
Co., Inc.}, 946 F. Supp. 394, 396 (E.D. Penn 1996) (Court honored single purpose partnership for purchasing claims);
partnership formed to buy Gillette stock.).
\textsuperscript{48}See Reply Brief by 2001 \textit{Virginia Historic Tax Credit Funds}, p. 74, citing \textit{Snyder v. Commissioner}, 894 F.2d 1337
partnership tax items constitutes a sharing or division of those items under Sections 701, 702, and 704 of the Code and not a “transfer” of “property” for purposes of Sections 707, 1001, or any other section of the Code;\(^{49}\) (iii) a tax attribute does not constitute “property” in the hands of a partnership or its partners unless it has the characteristics of property in their hands, such as being inheritable, assignable, refundable, and transferable in their hands;\(^ {50}\) and (iv) the Virginia state historic credits could not be refunded, inherited, assigned, sold or transferred in the hands of the Funds or their partners.

If state tax credits or other attributes so “clearly” and “certainly” constitute property, the taxpayers asked why the IRS had been unable to so state in any official published guidance prior to 2002 and why the IRS acknowledged in its 2002 Colorado CCA that it had failed to do so and promised such guidance shortly.\(^ {51}\)

In response to the IRS argument that analogized the state historic tax credits to various other forms of intangibles that did not create income upon receipt but that still constituted “property” when transferred for value, the taxpayers pointed out that none of the examples provided by the IRS involves state or federal policy-based tax incentives or allocations of tax attributes of any nature.\(^ {52}\)

The taxpayers also challenged the IRS reliance on the provisions of Section 1001 of the Code to support its “sale” theory pointing out that Section 1001 was never mentioned in the FPAAs or other pleadings of the IRS. The taxpayers also pointed out that the IRS systematically and deliberately overstated the amount of income allegedly realized by the Funds from the “sale” of state tax credits by failing to take into account the cost of goods sold. In other words, if the allocation by the Funds of the state tax credits to the investors constituted a sale, logically the allocation of credits by the underlying developer partnerships to the Funds also must have constituted a sale, in which case the Funds had a tax basis for the state tax credits they “purchased” from the developer partnerships. Any gain recognized at the Fund level would be limited to the spread between the basis of each Fund for such “purchased” state tax credits and the amount received from the investors as “purchase price.”\(^ {53}\)

In addition, the taxpayers pointed out that, under treasury regulations promulgated in 2007, even an allocation or division of “property” (as opposed to tax items) does not constitute a “transfer” for purposes of Section 1001 of the Code. \(^{54}\)


\(^{50}\) See Reply Brief by 2001 Virginia Historic Tax Credit Funds, p. 75, citing In re Harrell, 73 F.3d 218, 220 (9th Cir. 1996) (season ticket holder’s expectation of renewal of seasons’ tickets could not be property because it was revocable and not sellable) with In re: I.D. Craig Service Corporation, 138 B.R. 490, 495 (Bankr. W.D. Pa. 1992) (transferable right to renew and automatic renewal upon payment of season tickets was property).

\(^{51}\) See Reply Brief by 2001 Virginia Historic Tax Credit Funds, p. 83.

\(^{52}\) See Reply Brief by 2001 Virginia Historic Tax Credit Funds, p. 84.

\(^{53}\) See Reply Brief by 2001 Virginia Historic Tax Credit Funds, p. 63.
recognizing that an allocation/severance of trust assets constitutes a division and not a taxable transfer under Section 1001 (provided the trust authorizes the division or allocation).\textsuperscript{54}

With respect to the IRS assertion that principals of the Funds and others involved in the transactions routinely used terms such as "buy" and "sell" to refer to the allocation of state tax credits, the taxpayers pointed to testimony that such slang is very common in the syndicated tax credit business and simply reflects a "short hand" method of referring to legitimate partnership transactions.\textsuperscript{55}

In response to the IRS argument that Section 707(a)(2)(B) of the Code mandated a recharacterization of the transactions as sales of "property," the taxpayers pointed out that Section 707(a) applies only in cases where a partner is not acting in its capacity as a partner, that partnership allocations do not constitute "transfers," and that there is absolutely no authority for treating non-transferable state tax items as "property" for purposes of Section 707(a).\textsuperscript{56}

In the view of the taxpayers, it was never necessary to analyze or apply the ten factors enumerated in the treasury regulations (and discussed above in the description of the IRS positions) because Section 707(a) applies only to transfers and not to allocations. Even if one mistakenly assumes that a partnership allocation could constitute a "transfer" of "property," the transfers in the present case were subject to substantial entrepreneurial risk and therefore should not have been recharacterized under Section 707(a) in any event.\textsuperscript{57}

Finally (and again, not surprisingly), the taxpayers took great offense at the attempt by the IRS to assert penalties in this case. At the outset, the taxpayers pointed out that there is clear authority for the proposition that taxpayers should not be penalized in situations involving novel issues, citing the opinion by the Tax Court in \textit{Williams v. Commissioner}.\textsuperscript{58} The taxpayers pointed to the efforts by the Funds and their principals in researching relevant state and federal law, consulting regularly with leading tax professionals, studying existing IRS rulings and pronouncements, contacting the IRS national office to discuss the possibility of seeking a private letter ruling, communicating with other representatives of the investors, and adopting a partnership structure that was widely used in other state tax credit transactions as evidence of its good faith efforts to identify the correct tax treatment for the transactions.

\textsuperscript{54} See Reply Brief by 2001 \textit{Virginia Historic Tax Credit Funds}, p. 78, also citing "well over 100 private rulings permitting such divisions on a tax-free basis... [and] it is unlikely the Service would take a contrary position with respect to trust divisions occurring prior to these dates if the conditions in the regulations [i.e., authorization] are satisfied." David Westfall, \textit{et al.}, \textit{Part V. Trust and Beneficiaries: Chapter 17. Noncharitable Trusts: Income Tax Aspects for Grantors, Beneficiaries, and Power Holders}, Estate Planning Law & Taxation, ¶ 17.09[1] n. 298. See e.g., PLR 200904001 ("[D]ivisions of trusts are also not sales or exchanges of trust interests where each asset is divided pro rata among new trusts"); PLR 200717001 (same); PLR 200446019 (same). Similarly, the division or allocation of a joint tenancy in stock does not constitute a taxable transfer. See Rev. Rul. 56-437, 1956-2 C.B. 507 ("The conversion...of a joint tenancy in capital stock of a corporation into a tenancy in common is a nontaxable transaction"). Likewise, the severance of a joint tenancy in stock of a corporation, under a [state] partition action... is a nontaxable transaction").

\textsuperscript{55} See Reply Brief by 2001 \textit{Virginia Historic Tax Credit Funds}, p. 80.

\textsuperscript{56} See Reply Brief by 2001 \textit{Virginia Historic Tax Credit Funds}, p. 101.

\textsuperscript{57} See Reply Brief by 2001 \textit{Virginia Historic Tax Credit Funds}, p. 105.

\textsuperscript{58} 123 T.C. 144, 153-154 (2004):
The taxpayers pointed out that the treasury regulations specifically provide that “substantial authority” for a position can exist, notwithstanding the fact that neither the IRS nor the courts have issued any binding precedent with respect to the issue at hand, citing Treas. Reg. § 1.6662-4(d)(3)(ii), which states: “there may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.”

The foregoing regulation has been construed broadly by the Tax Court, even in cases where the taxpayer’s position is contrary to IRS pronouncements but no binding judicial authority exists. 59

The next two sections of this article will analyze in more detail some of the major cases and rulings cited by the parties in the Virginia Historic Tax Credit Funds case, as well as some other authority that may be relevant in determining the federal income tax consequences of syndicated state tax credit investments.


3.1 Discussion of Relevant Authority

A domestic eligible entity that does not elect otherwise is treated as a partnership if it has two or more members and is disregarded as an entity separate from its owner if it has a single owner. 60 The determination as to whether an organization has more than one member is based on all the facts and circumstances.

Section 761(a) of the Code provides that “the term “partnership” includes a syndicate, group, pool, joint-venture, or other unincorporated organization through or by means of which any business, financial operation or venture is carried on...” A “partner” is defined to include “a member in . . . a syndicate, group, pool, joint venture, or [other unincorporated] organization.” 61 In addition, Section 301.7701-1 through 301.7701-3 known as the “check-the-box” regulations, state that an arrangement may create a separate entity if the participants “carry on a trade, business, financial operation, or venture and divide the profits therefrom.” 62

Under the “check-the-box” regulations, most unincorporated business entities organized in the United States will be taxed as partnerships and, as such, will not be separately taxable entities. An unincorporated business entity that has two or more members is automatically classified as a partnership unless the entity elects to be classified as an association taxable as a corporation. 63 The “default” to partnership classification does not apply to a business entity organized under a federal or state statute if the statute describes or refers to the entity as

60 See Treas. Reg. § 301.7701-3(b)(1); See also, Treas. Reg. § 301.7701-2(e).
61 See § 761(b) 7701(a)(2) of the Code.
63 See Treas. Reg. §§ 301.7701-3(b)(1)(i).
"incorporated" or as a "corporation, body corporate, or body politic" and to certain other specified entities, including unincorporated entities that elect corporate classification.

In a syndicated state tax credit transaction, neither the investment partnership nor the Owner will elect to be treated as an association taxable as a corporation. However, as the case law cited below makes clear, technical compliance with the "check-the-box" regulations does not guarantee that an entity will be treated as a partnership for federal tax purposes.

The landmark case involving the definition of a "partnership" for federal income tax purposes is the decision of the U.S. Supreme Court in Commissioner v. Culbertson.64 In Culbertson, which involved a purported family partnership between a rancher and his four sons, the IRS concluded that no partnership existed and disallowed the division of income between the rancher and his sons. The Tax Court agreed with the IRS, citing Tower,65 and Lusthaus.66

In the view of the Tax Court, in order for a partnership to exist for tax purposes, it was necessary to determine "that each partner contribute to the partnership either vital services or capital originating with him." The Court of Appeals reversed the Tax Court and held that the intent of the sons to contribute time and services to the partnership in the future constituted sufficient grounds for recognizing the partnership for federal income tax purposes.

The Supreme Court reversed the Fifth Circuit, holding that the Tax Court had erred in treating contributions of "original capital" or "vital services" as essential to partner status and stating:

The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the Tower case, but whether, considering all the facts - the agreement, the conduct of the parties in execution of its provision, their statements, the testimony of disinterested persons, the relationship with the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent - the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

Since the Tax Court had made no findings concerning the intent of the parties, the Supreme Court instructed the Fifth Circuit to remand the case to the Tax Court for a determination of whether "there was a bona fide intent that [the sons] be partners . . . either because of services to be performed during those years, or because of contributions of capital of which they were the true owners."

Since the decision in Culbertson, the courts have enumerated other factors that also are important in determining the existence of a partnership for federal income tax purposes.67 In

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64 337 U.S. 733 (1949).
65 327 U.S. 280 (1946).
66 327 U.S. 293 (1946).
67 See Comtek v. Commissioner, 85 T.C.M. (CCH) 1280, 2003 T.C.M. (RIA) ¶ 55,147, which relied on the intent test enumerated in the Culbertson case and the factors cited in Luna in rejecting a claim by the taxpayer that the
for example, the Tax Court cited the following factors as being relevant to such determination:

The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and coproprietor [sic], sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed Federal partnership returns or otherwise represented to [Commissioner] or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibility for the enterprise.

It is interesting that Culbertson, Luna and Tower were among the cases cited by the IRS in the Virginia Historic Tax Credit Funds case to support its position that the investors admitted to the Funds were not engaged in a partnership relationship for federal income tax purposes. The evidence presented at the trial would seem to indicate that many of the factors described in these cases were in fact present in the arrangements that were the subject of the Virginia Historic Tax Credit Funds transactions. For example, it appears to be clear that the Funds substantially complied with state law formalities in forming and operating the partnerships, that they filed partnership tax returns and maintained capital accounts in accordance with the provisions of Section 704(b) of the Code, that they treated the entities as partnerships for accounting purposes, and that most (if not all) of the investors who testified at the trial acknowledged that they knew they were partners for state law purposes. Notwithstanding these facts, the IRS argued that there was no fundamental mutual sharing of profits and losses sufficient to constitute a tax partnership. If one accepts the proposition that the utilization of state tax incentives in a manner that is consistent with a policy-based, socially beneficial state program is a valid business purpose, the IRS position is, at the very least, subject to debate.

There is considerable authority that the definition of "partnership" found in Code Sections 761(a) and 7701(a)(2) "does not require a profit motive; rather it merely requires 'an unincorporated organization, through or by means of which any business, financial organization,
or venture is carried on." The business activity or profit motive test is important in distinguishing partnerships from the mere co-ownership of property. However, this test is not the only test for what constitutes a partnership for federal tax purposes. In the Madison case, the taxpayer ("MGE") entered into a "Joint Power Supply Agreement" with two other power companies, Wisconsin Public Service Corp. ("WPS") and Wisconsin Power & Light Co. ("WPL"). Based on their desire to achieve the benefits of economies of scale, the power companies agreed to share in the ownership and operation of a nuclear power plant. The plant was owned by the power companies as tenants in common and they shared expenses in proportion to their respective ownership shares. Based on its ownership share, each of the power companies was allocated a share of the power generated by the plant. The power companies did not share profits or losses associated with the sale of their respective shares of the power generated by the plant. MGE deducted various expenses relating to the power plant as ordinary and necessary business expenditures.

The IRS took the position that the expenses deducted by MGE constituted pre-operating capital expenditures incurred by a partnership comprised of MGE, WPS, and WPL. The Tax Court agreed with the IRS and concluded that the ownership arrangement constituted a partnership under Section 7701(a)(2) of the Code because it was "an unincorporated organization carrying on a business, financial operation, or venture."

The Tax Court went on to state that "[t]o the extent a profit motive may be required for an unincorporated organization to be a partnership for federal income tax purposes, we hold that it is present in this case with the in-kind distribution of electricity produced by the nuclear power plant."

Reference also should be made to Rev. Rul. 68-344, in which the IRS held that a joint venture to produce electric energy that was shared among the participants but not marketed by the venture was a partnership for federal income tax purposes. In two general counsel memoranda issued in 1975 and 1976, the IRS confirmed its holding in Rev. Rul. 68-344 but called for a study to address the "inconsistencies" between that revenue ruling and the requirement of a "joint profit objective" in Section 301.7701-1(a)(2) of the treasury regulations. Similarly, in a 1990 private letter ruling, the IRS classified an environmental clean-up fund as a partnership and stated that "when classifying an organization that was not created to make a profit, the standard to be used to ascertain the presence of a ‘business purpose’ is whether there is an objective to carry on, jointly, activities in furtherance of the purposes for which the organization was formed.” Section 6110(j)(3) of the Code provides that private letter rulings

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70 Madison Gas & Electric Co. v. Commissioner, 72 T.C. 521, 561-62 (1979), aff’d, 633 F.2d 512 (7th Cir. 1980).
71 Id., at 563.
72 1968-1 C.B. 569.
73 GCM 36,272 (May 16, 1975) and GCM 36,773 (June 28, 1976).
issued by the IRS may not be used or cited as precedent. Such rulings, however, are generally indicative of the IRS’s position on particular issues.\textsuperscript{75}

In a 2005 technical advice memorandum, the IRS explicitly recognized that two parties may engage in a financial transaction and create a business entity for federal income tax purposes even if no entity is established under state law.\textsuperscript{76} In the transaction addressed in this TAM, a counterparty purchased from B newly created “A certificates.” The assets underlying the A certificates were comprised of money market mutual fund shares. A bank purchased money market mutual fund shares through its custodial department in the name and on behalf of B. The investment was allocated among four different money market mutual funds, the assets of which were rated as investment grade or better by major rating agencies in year 1.

The counterparty and B entered into a letter agreement pursuant to which B agreed to deliver to the counterparty four A certificates for custody agreements, and four termination agreements, in return for which the counterparty agreed to transfer funds to B’s account at the bank. Simultaneously, B agreed to sell the four A certificates to the counterparty. The A certificates were related to the shares held by the bank in its role as custodian.

The bank and B entered into four separate custody agreements relating to the shares purchased on behalf of B. The bank agreed to issue A certificates and B certificates to B and, in addition, to receive payments of dividends from the mutual funds and to pay the dividends over to the holder of the B certificates.

The custody agreements also contained provisions describing the rights represented by the A certificates and the B certificates. Each B certificate represented the right to receive dividends paid on the underlying shares through “date nine”. Each A certificate represented the right to receive the underlying shares on date nine, any payments characterized by the issuer of the underlying shares as return of capital, and all dividends paid on the underlying shares after date nine. On date nine, the B certificates were to be cancelled, and the underlying shares were to be transferred to the holder of the A certificates. In addition, the custody agreement would terminate.

Under the terms of the termination agreements, the counterparty agreed to purchase the B certificates from B, if (i) an issuer of an underlying money market mutual fund liquidated the Fund, (ii) an underlying money market mutual fund failed to maintain its status as a money market fund under Rule 2a-7 of the Investment Company Act of 1940, as amended, or (iii) an issuer of an underlying money market mutual fund redeemed a certain percentage of the shares held by the bank. If any of these events occurred, the redemption proceeds were divided between the holders of the A certificates and the B certificates in a manner that resulted in the counterparty retaining an amount approximately equal to the present value of the A certificates, and paying the rest of the redemption proceeds to B, essentially in the form of a return of principal. Under the formula agreed to, the amount received by B would decrease over time but would be reduced to zero only when the B certificates were cancelled on date nine.

\textsuperscript{76} See TAM 200540010.
On its consolidated income tax return for year one, B reported dividend income from the shares and also deducted a short-term capital loss calculated by subtracting its entire basis in the underlying shares from the amount it received for the A certificates. B's theory was that each A certificate represented the entire ownership in the underlying shares, that the B certificates represented only the right to future income, and that, under the assignment of income doctrine, B was required to allocate its entire basis to the A certificates.

The chief counsel disagreed holding that the assignment of income cases cited by the taxpayer only dealt with a taxpayer's assignment of future income, while in the facts at hand the interest retained by B included rights in the underlying assets.

In reviewing the contractual arrangements, the chief counsel concluded that B did not make a full and complete transfer of its interest in the shares, citing a number of factors to support such a conclusion. Chief counsel also cited Treas. Reg. 301.7701-1(a)(1) for the proposition that an organization may be an entity separate from its owners for federal tax purposes even if it is not recognized as an entity under local law. For federal income tax purposes, a separate entity may be created if the participants carry on a financial operation and divide the profits therefrom.77

While acknowledging that mere co-ownership of assets may not create a separate federal tax entity, the contractual arrangements in the transaction under review was determined by the chief counsel to constitute more than mere co-ownership and was more consistent with the formation of a separate entity under Treas. Reg. 301.7701-1(a)(2).

The IRS next considered the issue of whether the A and B certificates created multiple classes of ownership in the “entity,” and, if so, whether the arrangements should be classified as a business entity (and not a trust) under Treas. Regs. § 301.7701-2 and 301.7701-4. The chief counsel concluded that multiple classes did exist in the transaction under consideration but that the existence of such multiple classes was not incidental to any purpose of the arrangement to facilitate direct assessment in the assets. As a result, the contractual arrangements should be classified as a business entity under Treas. Reg. 301.7701-2.

Under the “default” rules set forth in Treas. Reg. 301.7701-3(b)(1), the business entity created by the contractual arrangements would be disregarded for federal tax purposes until B transferred the A certificates to the counterparty, at which time the arrangements would be treated as a partnership, citing Red Carpet Car Wash, Inc.78

It is important to note that the factors enumerated by the courts in Tower, Culbertson, and other decisions as being relevant to the determination of partner status arguably have been rendered moot by the actions of Congress in enacting what is now Section 704(e) of the Code. Section 704(e)(1) of the Code contains the following language that is derived from Section 3797(a)(2) of the pre-1954 Code:

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77 See North American Bond Trust, 27 AFTR 892, 122 F.2d 545(CA-2, 1941), cert. den., and Brooklyn Trust Co., 17 AFTR 133, 80 F.2d 865(CA-2, 1936), cert. den.

78 73 TC 676 (1980), acq.

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A person shall be recognized as a partner for income tax purposes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

When the sentence currently contained in Section 704(e)(1) originally was enacted by Congress in 1951, its purpose was described in the legislative history as follows:

[the amendment] is intended to harmonize the rules governing interests in the so-called family partnership with those generally applicable to other forms of property or business. Two principles governing the attribution of income have long been accepted as basic: (1) income from property is attributable to the owner of property, (2) income from personal services is attributable to the person rendering the services. There is no reason for applying different principles to partnership income . . . your committee’s amendment makes it clear that, however the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, if he is the real owner. If the ownership is real, it does not matter what motivated the transfer to him or whether the business benefited from the entrance of the new partner.

It appears to be clear that, in cases where capital is a material income-producing factor, the language that currently is contained in Section 704(e)(1) of the Code was intended to reject the intent test established by Tower and Culbertson, as well as any qualifiers regarding the type of capital that is necessary to ensure treatment as a partnership. Although Section 704(e) contains a reference to “family partnerships,” it is clear that its provisions are not limited to “family partnerships.” This has been confirmed by every court that has considered the issue. In Evans v. Commissioner, for example, the Seventh Circuit rejected an argument by the IRS based on Culbertson that the corporate assignee of a partnership interest could not be in partnership with another person, because that person lacked the intent to be in a partnership.79 Holding that the Culbertson intent test did not apply to determine the treatment of a person owning a capital interest in a partnership and that such test had not applied since the enactment of the predecessor of Section 704(e)(1) of the Code, the court stated: “The test is no longer whether the partners acted in good faith with a business purpose in joining together to conduct a partnership business. This was the test set forth in Commissioner v. Culbertson, [citation omitted], which was decided before present §704(e)(1) was part of the Code.” The court reviewed the legislative history of the Code and found that, because Section 704(e)(1) of the Code derived from Section 3797(a)(2) of the Code which had general applicability to all partnerships, Section 704(e)(1) of the Code should not be interpreted to be restricted solely to family partnerships, and therefore a “person shall be recognized as a partner for income tax purposes if he owns a capital interest in a partnership in which capital is a material-income producing factor, whether or not such interest was derived by purchase or gift from any other person.”80

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79 447 F.2d 547 (7th Cir. 1971).
80 Id. See also, Madorin v. Commissioner, 84 T.C. 667, 679 (1985); Carriage Square, Inc. v. Commissioner, 69 T.C. 119, 126 n. 4 (1977); and the discussion of Castle Harbour III in Section 4.1 below.
The IRS concurred in the more expansive interpretation of Section 704(e)(1) in a 1976 general counsel memorandum and by acquiescing in the Tax Court decision in Evans. This view was reiterated by the IRS in an Internal Market Segment Specialization Program Guideline as follows:

IRC Section 704(e) is titled, 'Family Partnerships,' but only one subsection applies to family members. Subsection (e)(1) provides that if any 'person' acquires an interest in a partnership from any other 'person' by purchase or gift and if capital is a material income-producing factor, then the person will be considered a partner . . . .” 2002 W.L. 32770029 (IRS).

Reference also should be made to Pflugradt v. United States, in which the court stated:

The test is no longer whether the parties acted in good faith with a business purpose in joining together to conduct the partnership business . . . the emphasis has shifted from 'business purpose' to 'ownership of a capital interest.'

Moreover, in Forman v. Commissioner, the court noted that Section 704(e)(1) was "necessary to curb the Tax Court in its erroneous interpretation."

The treasury regulations promulgated under Section 704(e)(1) reflected the shift in emphasis away from the intent test of Culbertson and Tower to an assignment of income approach. See Treas. Reg. § 1.704-1(e)(i), which provides as follows:

The production of income by a partnership is attributable to the capital or services, or both, contributed by the partners. The provisions of subchapter K, Chapter 1 of the Code, are to be read in the light of their relationship to Section 61, which requires, inter alia, that income be taxed to the person who earns it through his own labor and skill and the utilization of his own capital.

See, also, Treas. Reg. § 1.704-1(e)(2)(x), which provides:

If the reality of the transfer of interest is satisfactorily established, the motives for the transaction are generally immaterial. However, the presence or absence of a tax-avoidance motive is one of many factors to be considered in determining the reality of the ownership of a capital interest acquired by gift.

It also should be noted that there is no requirement that profits and losses from a partnership enterprise be allocated in proportion to the capital contributions of the partners or the value of services provided by the partners. As McKee, Nelson and Whitmire state:

The partnership rules provide for the computation and allocation of income and loss derived from jointly owned capital and pooled services. There is no requirement that income or loss be shared in proportion to capital interests or in

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81 See GCM 36960 (December 20, 1976) and 1978-2 C.B.2.
82 310 F.2d 412 (7th Cir. 1962).
83 199 F.2d 881, 884 (9th Cir. 1952).
proportion to the value of services: instead, partners are free to allocate the risks and rewards of partnership operation flexibly. As discussed ... Congress enacted a broad and inclusive definition of 'partnership' to assure that all multi-party arrangements in which income is produced from capital and services are subject to the partnership rules (unless they are classified as corporations, trusts, or estates), and do not fall into an unregulated twilight zone.84

Reference also should be made to the inclusive approach taken by the so-called "investment trust" regulations in defining when certain multiple-class, fixed-asset pools should be taxed as trusts, corporations, or partnerships. Section 301.7701-4(c) of the treasury regulations provides:

An investment trust with multiple classes of ownership interests ordinarily will be classified as a business entity under Section 301.7701-2; however, an investment trust with multiple classes of ownership interest, in which there is no power under the trust agreement to vary the investment of the certificate holders, will be classified as a trust if the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interest is incidental to that purpose.

The purpose for the foregoing provision is explained in the preamble to the regulations as follows:

Multiple class trusts depart from the traditional form of fixed investment trust in that the interests of the beneficiaries are not undivided, but diverse. The existence of varied beneficial interests may indicate that the trust is not employed simply to hold investment assets, but serves as a significant additional purpose of providing investors with economic and legal interests that could not be acquired through direct investment in the trust assets. Such use of an investment trust introduces the potential for complex allocations of trust income among investors, with correspondingly difficult issues of how such income is to be allocated for tax purposes. These issues are properly foreign to the taxation of trust income, where rules have not developed to accommodate the varied forms of commercial investment, and no comprehensive economic substance requirement governs the allocation of income for tax purposes.85

The upshot of the above is that all multiple-class investments in a single-asset or business pool will be treated as either corporations or partnerships for federal income tax purposes. As McKee, Nelson and Whitmire have pointed out:86

The Service applies these rules to regulate multi-tier investments in fixed-asset pools that create senior interests that are extremely debt-like. For example, investors may acquire a single class of securities that bear tax-exempt interest

84 McKee, Nelson, and Whitmire, supra, at ¶3.02[4].
85 See Preamble to Treas. Reg. §301.7701.
86 McKee, Nelson, and Whitmire, supra, at ¶3.02[4].
under § 103 and use a local law trust or LLC to create multiple interests in those securities, ranging from very senior and bond-like to highly speculative and contingent.

Such arrangements were described by the IRS in Rev. Proc. 2003-84 as follows:

A partnership may be used to create the economic equivalent of a variable-rate tax-exempt bond. To create this instrument, a sponsor purchases a tax-exempt obligation and transfers the tax-exempt obligation to an entity that qualifies as a partnership for federal tax purposes (tax-exempt bond partnership). The tax-exempt bond partnership issues two classes of equity interest: interests that are entitled to a preferred variable return on its capital (variable-rate interest) and interests that are entitled to all of the remaining income of the partnership (inverse interest). The variable return on the variable-rate interest tracks current short-term exempt yields. Under § 702(b), tax-exempt interest income received by a partnership retains its character when the partnership allocates the income to a partner.

Citing the treasury regulations under § 301.7701-4(c), Rev. Proc. 2003-84 treats the arrangements described above as a partnership rather than as a trust.

It is clear that both the IRS and Congress have recognized instruments possessing most of the enumerated qualities of debt as true equity investments. For example, Section 351(g) of the Code treats as equity stock that “is limited and preferred as to dividends and does not participate in corporate growth to any significant extent” and is callable, redeemable, or has a dividend rate based on an external index. See, also, Section 1504(a)(4) of the Code, which treats as stock preferred stock that is non-voting, limited and preferred as to dividends, and does not participate in corporate growth to any significant extent. Similarly, Example (5) of Treas. Reg. §1.305-5(d) describes fixed rate preferred stock that is treated as equity despite being callable, mandatorily redeemable at a fixed price in ten years, and issued by a corporation that “is likely to have the legal and financial capacity . . . to redeem.”

Similarly, in Rev. Rul. 90-27, the IRS characterized so-called “Dutch-auction rate preferred” stock as equity for federal income tax purposes. This type of adjustable rate preferred stock was used as an “investment alternative to commercial paper or other short-term debt.” As McKee, Nelson, and Whitmire have noted:

It was non-voting, provided for no return other than a cumulative dividend that varied with an external interest-rate index, provided for periodic adjustment to the index to ensure that the preferred stock always sold for its issue price, provided the holder with the right to elect members of the board if the corporation failed to pay dividends (thus virtually assuring timely payment), and bore no loss until all equity attributable to junior classes of stock had been completely eliminated.

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87 1990-1 C.B. 50.
88 McKee, Nelson, and Whitmire, supra, at ¶3.05[3].
The willingness of the IRS to accept as equity instruments that functionally serve as debt has not been limited to the corporate area. As noted above, in Rev. Proc. 2003-84, the IRS recognized holders of preferred partnership interests as partners even though their interests were so secure that they were “the economic equivalent of a variable-rate tax-exempt bond.”

In Rev. Rul. 78-142, the IRS went so far as to treat as equity an interest that was required to be repaid on a date certain. The subject of this ruling was preferred stock that was subject to mandatory serial redemption after five years and whose covenants required that (i) the issuer maintain its shareholders’ equity by keeping consolidated net current assets at specified levels, (ii) a corporate subsidiary of the issuer maintain bank deposits established at a minimum specified level, (iii) the issuer not incur any indebtedness or liens, and (iv) the issuer not enter into any transaction other than in the ordinary course of business without the consent of the representative of the preferred shareholders. If the issuer failed to comply with any of these covenants, the holders of the preferred stock could require immediate redemption of the stock.

Also relevant to the determination of partnership and partner status is the question of when an entity will be treated as a “business entity” rather than as some other form of arrangement. The term “entity” is, in fact, the starting point for applying the check-the-box regulations described earlier in determining the classification of various arrangements for federal income tax purposes. Under the check-the-box regulations, “a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation or venture and divide the profits therefrom.” In the case of corporate entities, the landmark decision of the U.S. Supreme Court in Moline Properties, Inc. v. Commissioner, enumerates the factors that are relevant in recognizing the separate existence of corporate entities. Moline Properties involved an attempt by the shareholder of a corporation to disavow the separate existence of the corporation (which was wholly owned by him) in order to avoid entity-level taxes imposed on the corporation as a result of the sale of its real property. The corporation had engaged in only limited business activities, including leasing a portion of its property, defending condemnation proceedings against the property, assuming the obligations of the shareholder with respect to the property, and instituting a lawsuit to remove a restriction imposed on the property by a prior deed. The shareholder had formed the corporation for the purpose of protecting the property from claims of outside creditors of the shareholder. The Supreme Court stated:

Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator’s personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or as followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.

Most courts have interpreted Moline Properties as standing for the proposition that an entity must be respected as separate from its owner if its purpose is either “the equivalent of

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89 1978-1 C.B. 111.
90 See Treas. Reg. § 301.7701-1(a)(2).
91 319 U.S. 436 (1943).
business activity” or the actual “carrying on of a business.” For example, in Daniel E. Rogers, the Tax Court has stated:

In applying the Moline test, courts have looked most frequently to the language following the disjunctive ‘or,’ i.e., the business activity of the corporation. Little emphasis has been placed on business purpose. Courts have recognized, however, that Moline establishes a two-pronged test, the first part of which is business purpose, and the second, business activity. Business purpose or business activity are alternative requirements.

As McKee, Nelson and Whitmire have noted:

Historically, only a minimal quantum of business activity was required under Moline Properties for an entity to be recognized [citations omitted]. Whether an entity meets this threshold business activity is a factual issue [citations omitted]. The ownership of property is neither necessary, nor sufficient, to demonstrate business activity [citations omitted]. Rather, what is required is the actual conduct of some activity related to the production of income.

The authors go on to state:

Under the traditional Moline Properties analysis, a finding of business purpose is unnecessary for entity recognition if the entity conducts business activity. However, where no activity is conducted, business purpose is required. A purpose to reduce federal income taxes will not justify the separate existence of the entity under the business purpose prong of Moline Properties [citations omitted]. An entity must have some other raison d’etre for its existence – whether that reason be evading a state restriction, [citations omitted] avoiding federal estate tax, [citations omitted] or simply conducting a business. [citations omitted]

The test for entity recognition reflected in Moline Properties has effectively been reinterpreted by the Court of Appeals for the D.C. Circuit in the ASA Investerings, Saba, Boca, and Andantech cases described in more detail in Section 4.1 below.

4. Partner Characterization Issues

4.1 Relevant Authority

In addition to the line of cases dealing with when a partnership exists for federal income tax purposes, a number of decisions have addressed the separate (but closely related) issue of

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93 McKee, Nelson, and Whitmire, supra, at ¶3.03[1].
94 34 T.C.M. 1254, 1256 (1975). See also, Elot H. Rafferty Farms, Inc. v. United States, 511 F.2d 1234, 1238 (9th Cir. 1975) (cert. den.); O’Neil v. Commissioner, 271 F.2d 44, 49 (9th Cir. 1959); and Carver v. United States, 412 F.2d 233, 236 (Ct. Cl. 1969).
95 McKee, Nelson, and Whitmire, supra, ¶3.03[1][a].
96 McKee, Nelson, and Whitmire, supra, at ¶3.03[1][b].
when a person’s relationship with a partnership will be deemed to be that of a partner, rather than some other category. Of particular interest in the context of syndicated state tax credit partnerships is the issue of how small an interest a partner may have and still be treated as a partner for federal income tax purposes.

This question has been a controversial one and there is very little judicial authority on point.

A number of states have held that holding a .01% interest in a partnership is sufficient to establish that the holder will be treated as a partner for state income tax purposes.\(^{97}\)

In Rev. Proc. 89-12,\(^{98}\) which predated the promulgation of the “check-the-box” regulations discussed earlier in Section 3.1, the IRS generally required that, for purposes of obtaining an advance ruling as to partnership tax status, the general partners of a limited partnership were required to have (in the aggregate) at least a 1% interest at all times in the capital, profits and losses of the partnership. Nonconformance with this safe harbor rule was permissible in the case of advance rulings relating to highly capitalized partnerships. Specifically, Section 4.02 of Rev. Proc. 89-12 stated that, if a partnership’s capital was at least $250,000,000, the aggregate interest of all the general partners could be as low as 0.2%.\(^{99}\)

In Rev. Proc. 2007-65,\(^{100}\) the IRS established a safe harbor under which allocations of Section 45 wind energy production tax credits by a partnership in accordance with the provisions of Section 704(b) of the Code would be respected. Rev. Proc. 2007-65, which by its terms applies only to partnerships involving Section 45 production tax credits from wind, is effective for transactions entered into on or after November 5, 2007. However, allocations of wind credits by taxpayers who entered into transactions before that date will not be challenged by the IRS if the safe harbor is satisfied for those transactions. See Section 6 of Rev. Proc. 2007-65.

In order to satisfy the safe harbor set forth in Rev. Proc. 2007-65, the developer is required to have a minimum 1% interest in each material item of partnership income, gain, loss, deduction and credits at all times during the existence of the project company. The IRS states that it “generally will closely scrutinize a [wind energy partnership] as a partnership or [its investors as partners] if the partnership agreement does not satisfy” the 1% requirement, together with a requirement that each investor must have, at all times during the period it owns an interest in the partnership, a minimum interest in the income items of the partnership equal to 5% of such investor’s interest in partnership income for the taxable year for which the investor’s percentage share of income will be the largest. In the two examples provided in Rev. Proc. 2007-65, the IRS draws a distinction between the allocation of 99% of a partnership’s income, loss and Section 45 tax credits to the investors in Example 1 and 99.5% of such items to the investors in Example 2. Since, in Example 2, the developer would have only a 0.5% (rather than a 1%) interest in income, loss and tax credits, the classification of the Wind Energy LLC as a valid partnership “would be closely scrutinized by the Service.”

\(^{97}\) See, e.g., Mass. Ltr. Rul. 06-2 (March 8, 2006).

\(^{98}\) 1989-1 CB 798.

\(^{99}\) See, also, Rev. Proc. 95-10, 1995-1 CB 501.

\(^{100}\) 2007-45 IRB (907).
As noted above, Rev. Proc. 2007-65 applies solely to wind energy partnerships. However, it is possible that the promulgation of this revenue procedure indicates that the IRS will closely scrutinize all tax credit partnerships in which such *de minimis* ownership standards are not satisfied.

It is worth noting that earlier letter rulings and judicial decisions support the recognition of partners with very small interests for federal income tax purposes. For example, in a 1979 private letter ruling, for purposes of determining whether a partnership terminates for federal income tax purposes under Section 708(b)(1)(B) of the Code, the IRS recognized as a continuing partner a partner having only a 0.1% interest in the partnership. Similarly, in *Jordan*, the court considered a transaction in which the taxpayer was a limited partner in a limited partnership and was entitled to a 0.0018260 share (i.e., a 0.18260% interest) in the partnership, which itself was a pass-through partner in a number of joint ventures (so that the taxpayer’s effective interest in the underlying ventures was actually less than 0.18260%). The only issue being litigated was whether the taxpayer had standing to sue because of a lack of notice to the IRS. The court implicitly recognized the taxpayer as a partner for federal income tax purposes.

A number of recent cases have addressed the issue of whether transactions structured as partnerships to achieve federal income tax benefits should be recharacterized as debtor-creditor relationships or otherwise should be disregarded as lacking economic substance or a business purpose. In *Hunt v. Commissioner*, the Tax Court, presented with an argument by the IRS that a corporation that purported to be a partner in a limited partnership was instead a creditor, articulated a number of criteria for partnership status that are relevant in determining whether the SCP will be treated as a “partner” of the Owner and whether the State Investor will be treated as a “partner” of the SCP. The Tax Court drew these factors from its prior decision in *Luna*, and the Supreme Court’s decision in *Commissioner v. Culbertson*, both of which are discussed in Section 3.1 above. In the *Hunt* case, the three Hunt brothers, as limited partners, purported to join with a corporation (“PIC”), as general partner, to form a limited partnership (“PIL”). The partnership agreement provided for certain preferential distributions, and the Hunt brothers were obligated to make further capital contributions to PIL in the event that PIL’s cash flow was insufficient to make distributions to PIC equal to 98% of PIC’s capital contributions plus an 18% cumulative return on unrecovered capital. Based on its analysis of the factors described below, the court held that PIC was a partner in PIL.

The court first looked at the formal indicia of partnership, noting the presence of formal, detailed agreements setting forth the rights and obligations of the parties. The court then determined that each of the partners had contributed substantial capital to the partnership and that such contributions were reflected in capital accounts maintained in accordance with the regulations under Section 704 of the Code. The court also took into account the manner in which the parties exercised management and control over partnership affairs and assets. The court next examined “whether each party was a principal and co-proprietor, sharing a mutual proprietary

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102 See, also, Priv. Ltr. Rul. 8404027.
103 74 AFPR 2d. 94-6275, 863 F Sup. 270 (DC N. Car., 1994).
104 59 T.C.M. 635 (1990),

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interest in the net profits and having an obligation to share losses... (quoting Luna v. Commissioner). The court also agreed with the taxpayer that "the limited partners' obligation under the partnership agreement to guarantee a return of 98 percent of [the general partner's] capital contribution plus an 18-percent return thereon by way of the periodic contribution amounts was not inconsistent with the status of the arrangement as a partnership for Federal income tax purposes." (citing Investors Insurance Agency, Inc. v. Commissioner). Rather, such obligation "was a contractual requirement based on a contingency, not a fixed indebtedness to pay a certain amount of money at a certain time.

The final criteria examined by the Hunt court was whether the partnership had a business purpose or was instead a "sham." The court stated that "[t]o treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering into the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists..." Id. at 649 (quoting Rice's Toyota World, Inc. v. Commissioner). In effect, the test set forth in Hunt is two-pronged. To determine that a partnership did not exist, a court must determine that (i) the taxpayer was motivated by no business purpose and (ii) the transaction has no economic substance because no reasonable possibility of profit exists.

Other cases have reached different results. See, for example, ASA Investerings Partnership v. Commissioner which distinguished the Hunt case described above and was cited by the IRS in the Virginia Historic Tax Credit Funds case. The ASA Investerings decision arose from an audit of the return of ASA Investerings Partnership ("ASA"), but the real taxpayer in the case was Allied, Inc., a large manufacturer of aerospace and automotive products ("Allied"). In January of 1990, Allied decided to sell its interest in Union Texas Petroleum Holdings, Inc. ("UTP") in a transaction that was expected to generate a capital gain of approximately $450 million. Merrill Lynch & Co., Inc. ("Merrill Lynch") developed a tax proposal that was intended to create capital losses that would shelter the anticipated capital gain to be realized by Allied. Under this proposal, a partnership created by Merrill Lynch would be formed between Allied and a foreign partner that was not subject to U.S. taxation. The partnership would be capitalized with cash contributions, primarily from the foreign partner, who would own the majority interest in the partnership after the initial contributions were made. The partnership would then purchase high-grade, floating rate, private placement notes ("PPNs"), which would include put options permitting the PPNs to be sold to the issuer at par. The partnership would sell the PPNs for consideration that consisted of 80% cash and 20% indexed installment LIBOR notes. The sale of the PPNs would be reported by the partnership using the installment method under Section 453 of the Code. The gain from the sale would be allocated to the partners in accordance with their respective partnership interests. As a result, the foreign partner would recognize most of the gain. The partnership also would purchase high-grade

105 Id. at 645.
107 Id. at 648.
108 72 T.C. 1027 (1979), aff'd, 677 F.2d 1328 (9th Cir. 1982).
109 59 T.C.M. 635, at 648.
110 at 648-49.
111 752 F.2d 89, 91 (4th Cir. 1985).
112 76 T.C.M. (CCH) 325 (1998), aff'd, 201 F.3d 505 (D.C. Cir. 2000).
financial instruments, the income from which would be allocated among the partners. Allied
would then buy a portion of the foreign partner’s interest and become the majority partner. The
partnership would distribute the LIBOR notes to Allied and cash to the foreign partner. Allied
would sell the LIBOR notes and recognize a tax loss. The partnership would then liquidate.

Subsequently, the parties, under the direction of Merrill Lynch, did in fact undertake a
transaction substantially in accordance with the foregoing plan. Algemene Bank Netherlands,
N.V. ("ABN"), a foreign bank that already had participated in several similar Merrill Lynch
deals, was selected to serve as the foreign partner. ABN formed two corporations to which it
loaned $990 million, which amount subsequently was contributed by the corporations to the
partnership. In processing the transaction, it is noteworthy that ABN followed its standard
procedures relating to loans rather than equity investments. ABN viewed the transaction as
yielding a profit of 75 basis points through interest and fees, resulting in net income of $5.5
million to ABN.

At the initial meeting of representatives of Allied and ABN in Bermuda, the parties
negotiated an agreement (the "Bermuda Agreement"), under which Allied agreed to pay all of
the partnership’s expenses, as well as a return to ABN equal to its cost of money (approximately
LIBOR plus 75 basis points). A few days later, the parties formed ASA. The parties then
engaged in a complex series of transactions substantially similar to those that were the subject of
ACM Partnership v. Commissioner.113

Citing many of the same concerns enumerated in the ACM decision, the Tax Court held
that ASA was not a bona fide partnership. In its decision, the Tax Court focused on several
factors. At the outset, it noted that in order for a partnership relationship to exist, the
participants, Allied and ABN, must have intended to join together in the conduct of a business
enterprise. The court concluded that the two participants had divergent business goals. Allied
entered into the transaction for the sole purpose of generating capital losses to shelter an
anticipated capital gain. In contrast, ABN entered into the venture solely for the purpose of
receiving a specified return, without the possibility of receiving any additional profits. In this
regard, the court emphasized that ABN received only a specified return and that Allied made
direct payments to ABN to maintain the promised yield. The court believed that the payments
made to ABN were amounts received for the use of money, which functionally is the same thing
as interest.

The Tax Court distinguished the Hunt decision on two grounds. In the first place, the
court pointed out that, in Hunt, the provisions for a guaranteed return were contained in the
partnership agreement, while in the transaction in ABN, the payment of ABN’s specified return
was the subject of a side agreement with Allied. Secondly, in Hunt, the partner receiving the
guaranteed return also was entitled to receive partnership profits in excess of such return. By
contrast, ABN was entitled solely to its specified return and nothing more.

The Tax Court also stressed the fact that ABN would not be required to share in any of
ASA’s losses under the terms of the Bermuda Agreement. The court also pointed out that the
Bermuda Agreement obligated Allied to pay all of ASA’s expenses, a provision that was

113 73 T.C.M. (CCH) 2189 (1997).
contrary to provisions in the partnership agreement of ASA obligating each of the partners to bear its own expenses. The court believed that Allied made all of the critical decisions relating to the venture while ABN was simply a passive participant in a packaged transaction that had been pre-planned by Merrill Lynch. As a result, the court concluded that Allied and ABN had divergent, rather than common, interests.

Particularly critical to the decision of the court was the fact that ABN’s return was specified and guaranteed by Allied. Under the terms of the arrangements, ABN was entitled to be repaid according to a specified schedule that established fixed maturity dates. If Allied missed any payment date, ABN was compensated for the delay by Allied. Moreover, by engaging in swap transactions, ABN in effect restricted its ability to earn any rate of return in excess of the rate available on direct investments in the securities that ASA purchased. As a result of all of these arrangements, ABN was precluded from sharing in either profits or losses from the LIBOR notes.

The *ASA Investerings* decision was affirmed by the D.C. Circuit Court of Appeals. The D.C. Circuit flatly rejected a number of positions taken by the Tax Court, including the assertion that partners must have common motives. However, the Court of Appeals ultimately believed that the transaction lacked a legitimate business purpose. The critical factor in the decision of the Court of Appeals was the fact that ABN bore almost no risk from the transaction and that its return was not related to the success of the partnership, but rather to guaranties from Allied and outside swap transactions engineered by Merrill Lynch. The Court of Appeals concluded that these facts indicated a tax avoidance motive rather than a business motive on the part of Allied. The opinion concludes that ASA was the product of a sham transaction. Although the opinion did not specifically hold that a debtor-creditor relationship had been established, it did affirm that the subsidiary corporations used by ABN should be disregarded and that a bona fide partnership was never formed.

The *ASA Investerings* decision is relevant in the context of state tax credit transactions because it goes beyond an analysis of traditional debt-equity criteria in reaching the conclusion that the transaction was a loan (as determined by the Tax Court) or a sham lacking any business purpose (as determined by the D.C. Circuit Court of Appeals). It should be emphasized that the partnership interests acquired by ABN in the transaction did not possess a fixed maturity date or specified yield, the preferred interests were subordinated to the claims of all creditors, there was no collateral or other security granted to ABN, and ABN did not have the legal right to require payment on a fixed date. In short, such partnership interests on their face lacked most of the indicia traditionally associated with debt characterization for federal income tax purposes.

The Merrill Lynch-marketed CINS strategy that was the subject of *ASA Investerings* also was examined by the Tax Court in *Saba Partnership.* The Tax Court initially determined that the partnership was not a sham for federal income tax purposes. Based on its decision in *ASA Investerings*, the D.C. Circuit vacated the Tax Court’s decision and remanded the case for reconsideration, making it clear that a partnership should not be respected for tax purposes if there is no non-tax business purpose for the partnership. Upon remand, the Tax Court concluded that there was no meaningful distinction between the *Saba* transaction and the *ASA Investerings*

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transaction, thus mandating a conclusion that the Saba transaction also was a sham. In its decision, the Tax Court also held that the partnership in Saba was not organized or operated for a non-tax business purpose.

In Boca Investerings Partnership, the Merrill Lynch transaction again was struck down by the D.C. Circuit. In this case, the district court had held for the taxpayer (AHP) and had distinguished the ASA and Saba decisions, finding that the Boca partnership was a valid partnership with a business purpose and an objective potential for profit. Citing Horn v. Commissioner, the court concluded that the transaction had a valid non-tax business purpose and that there was a reasonable possibility for realizing a profit. Accordingly, the court held that the partnership should not be disregarded as a sham because it was not motivated solely by tax avoidance. The court distinguished the Boca situation from ASA Investerings by focusing on the following points:

(i) AHP did not agree to pay a specified amount to its partners.

(ii) AHP did not agree to bear all of the losses of the Boca partnership.

(iii) The transactions in Boca each had substance and were not part of a tax-avoidance scheme.

(iv) AHP did not agree to pay all of the transaction costs incurred by the Boca partnership.

The D.C. Circuit overturned the decision of the district court, holding that a partnership is valid only if there is a “business purpose need” for the partnership. More specifically, the fact that the partnership had a valid business purpose was not determinative; the partnership had to be necessary in order to achieve that business purpose. The court concluded that AHP could have made the investments in question with its own funds and that the partnership was not necessary to achieve the business purpose.

The upshot of the four DC Circuit decisions discussed above appears to be that the recognition of an entity for federal income tax purposes requires evidence of a business need (not just a business purpose). As the court in Boca stated, even if the parties “intended to, and did, organize Boca as a partnership to share the income, expenses, gains and losses from Boca’s investments” that intent would

not satisfy the legal test for recognition of this type of partnership for tax purposes, as we held in ASA Investerings. In order to satisfy the legal test for this type of partnership, the district court must have found a non-tax business need for the partnership in order to accomplish the goals of the partners. In this case, there is no evidence of any need for [the taxpayer/partner] to enter into the Boca partnership with [the foreign partners to whom a large amount of non-economic taxable income had been allocated]. (emphasis added)

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115 314 F.3d 625 (D.C. Cir. 2003).
117 See, also, Andantech, LLC v. Commissioner, 331 F.3d 972 (DC Cir. 2003).
The court in *Boca* went on to concede that a business need requirement will not always be imposed, stating:

We do not, of course, suggest that in every transaction using a partnership a taxpayer must justify that . . . form.

Instead, the court stated that the need requirement will be imposed in those situations in which "taxpayers use an elaborate partnership" with entities created solely for the purpose of the questioned transaction."

McKee, Nelson and Whitmire have commented:

It is one thing to assert, as the DC Circuit did in *ASA* and *Saba*, that business activity will not support recognition of an entity under *Moline Properties* if the sole purpose of the activity is tax avoidance. While this reasoning may not exactly square with the traditional interpretation of *Moline Properties*, it is not an unreasonable refinement. However, it is far more troubling for the DC Circuit to assert, as it did in *Boca*, that even though an entity actually engages in tax-recognized, profit-oriented activities, it will be disregarded for tax purposes unless a business need for its existence can be demonstrated. This new "need" requirement is wrong, dangerous, and should not be adopted by other courts. 118

In *IES Industries, Inc. v. U.S.*, 119 the United States Court of Appeals for the Eighth Circuit reversed a finding by the United States District Court for the Northern District of Iowa and concluded that a transaction undertaken by Alliant Energy Corporation ("**Alliant**") had a business purpose and was not a sham for federal tax purposes. IES Corporation, of which Alliant was the successor, had engaged in a series of transactions involving the purchase and sale of American Depository Rights ("**ADRs**") representing equity interests in foreign corporations on the record date for dividend payments. Alliant purchased the ADRs from a tax-exempt entity such as a pension fund then sold the ADRs after the dividend income accrued. Each dividend was subject to a withholding tax imposed by the foreign corporation's resident jurisdiction. Alliant reported the full amount of dividend income and the related foreign tax credit attributable to foreign withholding taxes on the foreign corporate dividends. In addition, Alliant realized and reported a capital loss on the disposition of the ADRs after the dividend had accrued. Alliant filed a claim for refund carrying back the capital losses incurred in the transaction.

The IRS asserted and the district court agreed that the transactions were a sham and therefore to be disregarded for tax purposes. The district court concluded that a transaction would be treated as a sham if the transaction was not motivated by any economic purpose outside of tax considerations (the "business purpose test") and if the transaction was without economic substance because no real potential for profit existed (the "economic substance test") and found that Alliant failed to meet either test.

118 McKee, Nelson, and Whitmire, *supra* at ¶3.03[2].
119 253 F.3d 350 (8th Cir. 2001).
The Eighth Circuit Court of Appeals reversed the district court concluding that the transaction had both a business purpose and economic substance. The court found that Alliant had made a profit on the transactions and that it had accordingly satisfied the economic substance test. More importantly, the court indicated that, as for the business purpose test, the proper inquiry is to determine whether the taxpayer was induced to commit capital for reasons relating only to tax considerations or whether a non-tax motive or legitimate profit motive was involved. In other words, the business purpose test is a subjective economic substance test. The court went on to indicate that a taxpayer’s subjective intent to avoid taxes does not by itself determine whether there was a business purpose to a transaction.

The court found that Alliant had acted in a businesslike manner with respect to each aspect of the transactions. Alliant had investigated the ADRs to be purchased in order to minimize the risk that a dividend would not be paid and executed some trades after the U.S. markets were closed in order to minimize the risk of price fluctuation. The court said that it was not prepared to say a transaction should be characterized as a sham for tax purposes merely because it does not involve excessive risk.

In addition, the court noted that the transactions were not conducted by alter egos of the principals or straw entities created simply for the purpose of conducting the ADR trades. All entities involved were entities separate and apart from Alliant doing legitimate business before Alliant started these transactions and continuing business after that time.

In *United Parcel Service of America v. Commissioner*, \(^{120}\) the Eleventh Circuit Court of Appeals reversed a Tax Court finding that a transaction lacked economic substance. United Parcel Service ("UPS") had collected insurance premiums directly and used those premiums to pay for losses of shipments valued in excess of $100. UPS had realized income in each year because the premiums collected exceeded the losses paid. UPS revised its method for insuring against excess value losses on packages that it shipped. UPS formed Overseas Partners, LTD. ("OPL"), an insurance company in Bermuda, and distributed its stock to its shareholders. The tax rate on OPL’s income was substantially lower than the rate on UPS. UPS then entered into an insurance contract with National Union Fire Insurance Company ("National Union") pursuant to which UPS would pay all of the premiums received from customers to National Union in exchange for National Union’s assumption of the obligation to pay for any excess losses. National Union then entered into a reinsurance agreement with OPL and paid to OPL a reinsurance premium consisting of substantially all of the premiums received from UPS in exchange for that OPL’s assumption of the obligation to pay for excess losses.

The Tax Court concluded that the payments to National Union were not deductible and that UPS should have reported all income received attributable to the premiums. The Tax Court based its conclusion on its finding that the National Union Insurance Policy was a sham and that it merely provided a mechanism for the transfer of revenue from UPS to OPL to reduce taxes.

The Court of Appeals concluded that the transaction was not a sham and that the transaction had economic consequences and a business purpose. The court based its conclusion of the consequences of the transaction to the participants. National Union had assumed real risk.

\(^{120}\) 254 F.3d 1014 (11th Cir. 2001).
in issuing the insurance policy to UPS. In addition, the Funds received by OPL were no longer available to UPS for its business purposes. Accordingly, the Court of Appeals concluded that there were real economic effects from this transaction on all of its parties.

The court went on to state that because the transaction had real economic effects means that it is not per se a sham. The court rejected the Tax Court’s narrow definition that a business purpose requires that the reason for a transaction must be free of tax considerations. Rather, the court concluded that a transaction has business purpose as long as it figures in a bona fide, profit-seeking business. The court concluded that the real business purpose served the need of UPS’s customers to enjoy loss coverage and UPS’s need to lower its liability exposure.

In 2006, the Court of Appeals for the Second Circuit reversed the District Court’s finding in TIFD III-E, Inc. v. U.S. (the so-called “Castle Harbour I” case).121 In its decision (“Castle Harbour II”),122 the Court of Appeals held that the underlying partnership transaction in Castle Harbour was not a sham, concluding that the District Court erred when it relied on the sham transaction test instead of the “totality of the circumstances” test set forth by the U.S. Supreme Court in Culbertson, when it concluded that the Dutch banks were bona fide equity partners for income tax purposes. Castle Harbour II was one of the cases cited by the IRS in the Virginia Historic Tax Credit Funds case to support the proposition that the investors in the Funds should not be treated as partners for federal income tax purposes.

The Castle Harbour transaction involved a purported partnership between General Electrical Capital Corporation (“GECC”) and two Dutch banks to engage in the aircraft leasing business. GECC contributed $246,000,000 in cash, accounts receivable, and sixty-three airplanes, with a value of $530,000,000, but subject to nonrecourse debt in the amount of approximately $258,000,000 and existing leases with commercial airlines) that were owned by GECC in the ordinary course of its business. The two Dutch banks together contributed approximately $117,000,000 in cash to the partnership. Under the terms of the partnership Agreement, 98 percent of the partnership’s operating income was allocated to the Dutch banks and 2 percent was allocated to GECC. Although the contributed aircraft had a tax basis of zero, their book value in the hands of the partnership was equal to their fair market value. As a result, the aircraft generated large annual depreciation deductions for book purposes but no corresponding tax deductions. Thus, the taxable income of the partnership generally exceeded its book or economic income by an amount equal to the book depreciation deductions. The allocation of 98 percent of the partnership’s operating income to the Dutch banks significantly reduced the tax liability of GECC while shifting very little economic income to the Dutch banks. As a result of the application of the so-called “ceiling rule” under Section 704(c) of the Code (and the Treasury Regulations thereunder), the partnership could not allocate tax depreciation to the Dutch banks to match the book income in question. This resulted in an overstatement of the taxable income of the Dutch banks which essentially allowed GECC to “re-depreciate” the contributed airplanes.

Under the terms of the partnership agreement, the interests of the Dutch banks were to be purchased over an 8-year period through a self-liquidating mechanism based on the income of

the partnership. As the interests of the Dutch banks were bought out, the interest of GECC would correspondingly increase. The partnership agreement provided for the payment of annual distributions to the Dutch banks calculated to produce an internal rate of return of approximately 9% over the 8-year period. Although payments of these amounts by the partnership were at the discretion of the partnership’s general manager, as a practical matter they were mandated since nonpayment would give the Dutch banks the right to demand liquidation of the partnership.

The partnership agreement also called for the creation of investment accounts for the Dutch banks. Although no cash was actually contributed to these accounts, they were initially credited with an amount equal to the investment by the banks and the partnership. They were then adjusted on a hypothetical basis for distributions actually made to the banks. When the banks exited from the partnership, the balance in the investment accounts was to be redetermined as if such accounts had been increased each year by an “applicable rate” and reduced by the 9 percent priority distributions referred to above. Upon exit, the Dutch banks were to receive a guaranteed payment if the hypothetical amount contained in their investment accounts exceeded the sum of operating income and disposition gain, minus operating losses (which were capped at approximately $4,000,000) and disposition losses (which were capped at approximately $3,000,000) previously allocated to them. This guaranteed payment was payable only if the banks had not previously received net allocations of operating income and gain sufficient to provide the specified minimum yield on their investments. In effect, the banks were entitled to the guaranteed payment if the balance in their investment accounts exceeded their book capital accounts as finally determined.

The operating cash flow generated by the partnership generally was applied to fund distributions, to service debt, and to pay expenses. The partnership agreement provided that GECC was entitled to guaranteed payments (the so-called “class B guaranteed payments”) that were treated as operating expenses at the partnership and did not reduce GECC’s capital account. Any cash not needed to pay partnership distributions and expenses was transferred to a U.S. corporation that was a wholly-owned subsidiary of the partnership. Under the terms of the partnership agreement, this subsidiary was obligated to maintain “core financial assets,” consisting of cash and high-grade securities (including GECC’s commercial paper) equal to 110 percent of the current value of the investment accounts of the Dutch banks.

It is noteworthy that the Dutch banks in Castle Harbour treated their interests in the partnership as debt under Dutch law.

In effect, the Court of Appeals concluded that a taxpayer has to be within the terms of the statute it seeks to abuse in order for the economic substance test to apply. In the case of Castle Harbour, if there was no partnership, there was no transaction to evaluate for economic substance. In this regard, the IRS argued that the contributions by the Dutch banks to the purported partnership really should be treated as debt for several reasons, including the fact that the banks treated such advances as debt, the banks had no management role, despite their classification as partners, the partnership could have functioned without the contributions by the banks, the investment by the banks had a target liquidation date, the investment by the banks had stated interest and a repayment schedule, the banks had the right to force a liquidation of the partnership if the schedule was not satisfied, and the repayment of the contributions by the banks did not depend upon the success of the leasing business.
Although the Court of Appeals did not explicitly state that the advances by the Dutch banks should be treated as debt, it did observe that “the Dutch banks’ interest was overwhelmingly in the nature of a secured lender’s interest, which would neither be harmed by poor performance of the partnership, nor significantly enhanced by extraordinary profits.” Addressing the observation by the District Court that the banks would not necessarily receive a sum certain with respect to their investment, the Court of Appeals commented:

while an obligation to pay a sum certain indicates debt, it does not follow that any insignificant deviation from a sum certain indicates equity. The purpose of the test is to determine as a practical matter whether the interest created is more akin to equity or debt. Thus, the closer the amount owed comes to being a sum certain, the more it would tend to indicate debt. Trivial or insignificant deviations from a sum certain would do little to argue against a finding of debt.\(^{123}\)

The fact that 98 percent of the operating income of the partnership was allocated to the Dutch banks was characterized as “window dressing” by the Court of Appeals, which noted that GECC could reclassify what would have been operating income payable to the banks as gain simply by transferring the aircraft out of the partnership.

The opinion of the Court of Appeals emphasizes that the Dutch banks were promised a return of their investment and essentially had no practical risk of loss, standing to lose “a tiny amount in highly exceptional circumstances.” Since the opportunity for the banks to participate in any significant amount of gain also was capped, in effect a “collar” on upside gain and downside loss existed. Although the obligation of the partnership to repay the banks was subordinated, the Court of Appeals was not persuaded that this factor was meaningful because of the guarantees the banks received from GECC. In this regard, the Court of Appeals concluded:

upon consideration of all the facts and circumstances, it is clear that, far from being subordinate to the general creditors, the Dutch banks were secured in such manner that they would be repaid in full with interest from a source to which the general creditors had no access. The apparent subordination found by the District Court was a fiction overridden by GECC’s guaranty.\(^{124}\)

The Court of Appeals also focused on the fact that the right to compel a liquidation of the partnership granted to the Dutch banks ordinarily would be viewed as a creditors’ right, stating: “The position of the Dutch banks was thus very different from an ordinary equity partner’s ability to force liquidation of a partnership.” Also significant to the Court of Appeals was the fact that the partnership agreement granted no management rights to the banks.

Citing, among other things, the decision of the Second Circuit Court of Appeals in *Gilbert v. Court Commissioner*,\(^{125}\) the Court of Appeals concluded that the banks invested “with

\(^{123}\) *Castle Harbour II*, supra, at 5628.

\(^{124}\) *Id.*

\(^{125}\) 248 F.2d 349 (2d. Cir. 1957).
reasonable expectations of repayment regardless of success of the venture and were not meaningfully at the risk of the business."  

Although the Court of Appeals reversed the decision of the District Court in Castle Harbour I, it remanded the matter to the District Court for further proceedings, including consideration of "the taxpayer's argument that the partnership was a family partnership under the provisions of I.R.C. § 704(e)." On October 7, 2009, the District Court issued its Memorandum of Decision ("Castle Harbour III") addressing the Section 704(e) issue, as well as various other related matters.  

After reciting and amending certain prior factual findings relating to the transaction, the District Court held that the Dutch banks were owners of a capital interest in the Castle Harbour partnership, which was a partnership in which capital was a material income-producing factor. Accordingly, the Dutch banks were partners in Castle Harbour, and their interests in that partnership should be treated as such under Section 704(e) of the Code. The District Court reasoned that the holding of the Second Circuit that the interest of the banks did not represent a "bona fide equity participation" did not necessarily distinguish the interests of the banks from other debt-like instruments that are not considered to be debt for federal income tax purposes. Citing Jewel T Co. v. United States and Commissioner v. O.P.P. Holding Corp., the District Court pointed out that the Second Circuit "has long and consistently held that, although preferred stock is debt-like in nature, it should be treated as equity for tax purposes." Emphasizing that the decision of the Second Circuit in Castle Harbour II did not overturn the District Court's determination in Castle Harbour I that the transaction was not a "sham," the District Court, citing Rev. Proc. 2003-84, stated:

Just as limited partners, although they may not control a partnership, are nonetheless partners, the Internal Revenue Service has recognized that parties to a partnership whose interests are "the economic equivalent of a variable-rate tax-exempt bond" may be partners for tax purposes despite the lack of participation in the partnership's income or losses other than a variable-rate return based on an external interest index.

Emphasizing that the fact that the interests of the Dutch banks and Castle Harbour were "debt-like" did not foreclose a conclusion that such interests could be treated as equity for tax purposes, the District Court proceeded to analyze the applicable provisions of Section 704(e)(1) of the Code.

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126 Castle Harbour II, supra, at 5631.
128 Id, at 57.
129 Id, at 28.
130 90 F.2d 451 (2d Cir. 1937).
131 76 F.2d 11 (2d Cir. 1935).
132 Castle Harbour III, supra, at 28.
133 Castle Harbour III, supra, at 31.
At the outset, the District Court made it clear that it believed that Section 704(e)(1), described in more detail in Section 3.1 above, applies to any partnership in which capital is a material income-producing factor, even a non-family partnership.\textsuperscript{134} Section 704(e)(1) of the Code sets forth an objective test for determining the status of a putative partner. Simply stated, if a person owns a capital interest in a partnership in which capital is a material income-producing factor, then that person is a partner and is taxed as such. The District Court proceeded to analyze the applicability of these objective factors to the transaction in question. At the outset, the District Court emphasized that it already had concluded that the transaction was not a “sham” and that there were legitimate non-tax business purposes for such transaction.\textsuperscript{135} The District Court then focused on the issue of whether the banks were the “real owners” of their interests in the Castle Harbour partnership. Under the applicable Treasury Regulations, the resolution of that question depends on whether the banks had “dominion and control” over such interests.\textsuperscript{136}

The District Court concluded that GECC did not control the interests of the Dutch banks in the Castle Harbour transaction. While acknowledging that the participation of the banks in the management of the partnership was minimal, the District Court concluded that there was some participation. Moreover, the banks had the right to force a liquidation of the partnership under certain circumstances, underscoring the lack of control by GECC over the interests of the banks, even if GECC primarily controlled and managed the partnership.

The District Court also focused on the fact that the banks received distributions of their distributive shares of the income of the partnership, that the parties conducted the partnership business consistently with their stated understanding that the banks were partners, that written agreements existed that set forth in great detail the rights and obligations of the parties, and that appropriate tax returns were filed reflecting partnership status.\textsuperscript{137}

After reviewing all the facts, the District Court concluded:

The Banks were not guaranteed a return on their investments in Castle Harbour. They participated in the management of Castle Harbour, and received distributions of their distributive shares in Castle Harbour. Moreover, Castle Harbor’s business was conducted consistently with an understanding that the Dutch Banks owned their interests in the business entity, and consistently with the Castle Harbour partnership agreement that allowed the Banks to force liquidation of the partnership. For these reasons, the Dutch Banks were the real owners of their interests in Castle Harbour for purposes of section 704(e).\textsuperscript{138}

The District Court further concluded that the interests of the Dutch Banks in the partnership were “capital interests” within the meaning of the applicable Treasury Regulations and other authority.\textsuperscript{139} After pointing out that courts traditionally have applied a “hypothetical liquidation” test to determine whether an interest is a capital interest, the District Court addressed not only a

\textsuperscript{134} Castle Harbour III, supra, at 32.
\textsuperscript{135} Castle Harbour III, supra, at 34.
\textsuperscript{136} Treas. Reg. §§1.704-1(e)(1)(iii); 1.704(e)(2)(i).
\textsuperscript{137} Castle Harbour III, supra, at 37.
\textsuperscript{138} Castle Harbour III, supra, at 38.
\textsuperscript{139} Castle Harbour III, supra, at 38.
hypothetical liquidation of the interests of the banks in the Castle Harbour partnership but also the facts of the actual liquidation that occurred in the case. The District Court concluded that the proceeds distributed to the Dutch banks in liquidation were based on their respective capital accounts and, "[a]lthough those capital accounts were in fact positive upon liquidation, that result was not pre-ordained, and the risk of negative capital accounts existed."\textsuperscript{140}

Further, the District Court concluded that "[n]ot only was capital a material income-producing factor in Castle Harbour, capital was the only material income-producing factor."\textsuperscript{141} The District Court rejected the argument by the IRS that, notwithstanding the fact that capital was a material income-producing factor for the partnership, the capital contributions by the Dutch banks were not in and of themselves income-producing.

Finally, the District Court discussed in some detail the relationship between Section 704(e)(1) of the Code and the “totality-of-the-circumstances” test set forth in Culbertson. After analyzing the applicable authority, much of which is discussed in Section 3.1 above, the District Court concluded:

The government has cited to no authority, and I am not aware of any, suggesting that either: (1) where capital is a material income-producing factor in a partnership, Culbertson’s totality-of-the-circumstances test should apply instead of section 704(e)(1) or (2) if a party is not a partner in a partnership under Culbertson, then section 704(e)(1) cannot apply and the party cannot be treated as a partner for tax purposes under that section.

Since the District Court held in the taxpayer’s favor on the Section 704(e)(1) issue, there was no need to address the arguments of the IRS concerning the imposition of penalties on the taxpayer. Notwithstanding such fact, in the interest of avoiding another remand in the event that the Second Circuit overturned the District Court’s decision, the District Court did address the penalty issues and concluded that the partnership’s tax position treating the Dutch banks as partners was supported by substantial authority and a reasonable basis; accordingly, no penalties against the taxpayer were warranted.

The decision of the Fifth Circuit in Compaq Computer Corp. v. Commissioner,\textsuperscript{142} is particularly illuminating for its discussion of the role of tax benefits in applying the economic substance and business purpose doctrines. Compaq Computer involved the purchase of ADRs, the receipt of a dividend on which foreign withholding tax was imposed, a claim for a foreign tax credit, and a sale on which a short-term capital loss was claimed. In effect, the Fifth Circuit concluded that a very significant tax avoidance motive of the taxpayer did not prevent the court from recognizing and respecting a relatively modest business purpose for the transaction. In reversing the holding of the Tax Court that the transaction was a sham, the Fifth Circuit treated the issue of whether there was a business purpose as a legal conclusion rather than a factual question, noting:

\textsuperscript{140} Castle Harbour III, supra, at 40.
\textsuperscript{141} Castle Harbour III, supra, at 42.
\textsuperscript{142} 277 F.3d 778 (5th Cir. 2001).
The fact that the differing tax attributes of investors make ADRs more valuable for some investors than others does not deprive ADR transactions of economic substance for purposes of the tax laws. The possible benefits from ADR transactions for investors with unrelated capital gains and tax liabilities are analogous to the benefits that taxpaying investors (especially investors with high incomes) but not tax-exempt persons, get from the purchase of tax-exempt bonds with lower yields than the pre-tax yields available from non-exempt bonds.\footnote{Id, at 787.}

The decision in \textit{Compaq Computer} went on to conclude that the $3.4 million foreign tax credit obtained by Compaq as a result of the transaction was properly includible in the determination of Compaq’s after-tax profit, stating:

If the effects of tax law, domestic or foreign, are to be accounted for when they subtract from a transaction’s net cash flow, tax law effects should be counted when they add to cash flow. To be consistent, the analysis should either count all tax effects or not count any of them. To count them only when they subtract from cash flow is to stack the deck against finding the transaction profitable. During this litigation, the IRS has consciously chosen to try to stack the deck this way.\footnote{Id. at 783.}

In \textit{Sacks v. Commissioner}, the Ninth Circuit, reversing the Tax Court, held that a taxpayer was entitled to depreciation deductions and investment tax credits arising out of the sale and leaseback of solar water heating equipment, concluding that such transactions were not shams.\footnote{69 F.3d 982 (9th Cir. 1995); see, also, \textit{Rose v. Commissioner}, 88 T.C. 386 (1987), aff’d, 868 F.2d 851 (6th Cir. 1989).}

The Ninth Circuit ruled that the conclusion of the Tax Court was clearly erroneous, citing, among other things, the decision by the U.S. Supreme Court in \textit{Frank Lyon Co. v. United States},\footnote{435 U.S. 561 (1978).} (holding that the taxpayer in a sale-leaseback was the Owner of a property despite the combination of leasing, financing and repurchase option terms that could serve to limit the risks and benefits from the ownership of the property with respect to the taxpayer).

The court’s discussion of the sham transaction doctrine in the \textit{Sacks} case is of particular interest in the context of the present transaction. In concluding that Mr. Sacks’ deal had genuine economic effect and was not a sham, the court focused on the fact that:

1. Mr. Sacks’ personal obligation to pay the price was genuine;
2. he paid fair market value;
3. the tax benefits would have existed for someone, either BFS Solar or Mr. Sacks, so the transaction shifted them but did not create them from thin air;
4. the business of putting solar water heaters on homeowners’ roofs was genuine; and
5. the business consequences of a rise or fall in energy prices and solar energy devices were genuinely shifted to Sacks by the transaction.\footnote{Sacks, supra, at 988.}
The court went on to address the argument by the Tax Court that Mr. Sacks would be unlikely to make money from his solar water heaters but for the tax benefits. Using certain assumptions and comparing the estimated income stream to the investment of Mr. Sacks, the Tax Court determined that the anticipated income from the investment was negative before federal taxes. The Tax Court stated, "[n]either [the 1982 nor the 1983] transaction made economic sense without first taking into account federal tax benefits."

The Ninth Circuit held that this type of analysis was not sufficient to establish that a sale leaseback was a sham. The court stated:

Mr. Sacks' investment did not become a sham just because its profitability was based on after-tax instead of pre-tax projections. It is undisputed that he stood to make money on an after-tax basis. "The fact that favorable tax consequences were taken into account... is no reason for disallowing those consequences." Frank Lyon, 435 U.S. at 580. Where a transaction has economic substance, it does not become a sham merely because it is likely to be unprofitable on a pre-tax basis.\(^{148}\)

The court went on to state that:

[The a]bsence of pre-tax profitability does not show "whether the transaction had economic substance beyond the creation of tax benefits," Casebeer, 909 F.2d at 1365, where Congress has purposely used tax incentives to change investors' conduct. Congress and the Arizona legislature purposely skewed the neutrality of the tax system, even more than the usual tax credits and accelerated depreciation designed to encourage more investment in capital goods than would otherwise be made, because they sought to induce people to invest in solar energy.\(^{149}\)

The court concluded that:

If the Commissioner were permitted to deny tax benefits when the investments would not have been made but for the tax advantages, then only those investments would be made which would have been made without the Congressional decision to favor them. The tax credits were intended to generate investments in alternative energy technologies that would not otherwise be made because of their low profitability. See, H.R. Rep. No. 496 at 8304. Yet, the Commissioner in this case at bar proposes to use the reason Congress created the tax benefits as a ground for denying them. That violates the principle that statutes ought to be construed in light of their purpose. Cabell v. Markham, 148 F.2d 737 (2d Cir. 1945) (L. Hand, J.).\(^{150}\)

In CM Holdings, Inc.,\(^ {151}\) the Court of Appeals for the Third Circuit upheld the decision of the U.S. District Court that a COLI transaction lacked economic substance. The Court

\(^{148}\) Id. at 991.
\(^{149}\) Id.
\(^{150}\) Id. at 992.
\(^{151}\) 90 AFTR 2d 2002-5850 (301 F.3d 96).
distinguished the transaction in question from transactions that were structured to implement Congressional goals, specifically citing the Sacks case:

If Congress intends to encourage an activity, and to use taxpayers’ desire to avoid taxes as a means to do so, then a subjective motive of tax avoidance is permissible. But to engage in an activity solely for the purpose of avoiding taxes where that is not the statute’s goal is to conduct a sham transaction.

In the case of Gregory, the taxpayer made use of a corporate reorganization for the sole purpose of avoiding income tax liability. Because this was not what the corporate reorganization statute had intended, the taxpayer lost. This is what distinguishes Sacks v. Commissioner, 69 F.3d 982 (76 AFTR 2d 95-7138) (9th Cir. 1995), a case Camelot cites, from this case. Appellant’s Br. At 22. Sacks involved the question of whether depreciation and investment credits were allowed on a transaction involving the sale and leaseback of solar energy equipment. Id. at 984-85. The Ninth Circuit reasoned that both federal and state legislatures had specifically encouraged investment in solar energy and thereby "skewed the neutrality of the tax system."

In the Virginia Historic Tax Credit Funds case, the taxpayers placed significant reliance on the Supreme Court’s opinion in Frank Lyon Co. v. United States to support their argument that the syndicated state tax credit transactions at issue in that case must be viewed in the context of the applicable state regulatory requirements and the public policy considerations underlying such requirements. The choice of Frank Lyon is significant because, in that case, the court held that a taxpayer should be treated as the owner of a building notwithstanding the fact that, in the view of the dissent (and of the Eighth Circuit), the taxpayer “incur[red] neither the risk of depreciation, nor the benefit of possible appreciation.”

In Frank Lyon, the taxpayer entered into a sale-leaseback transaction with Worthen Bank & Trust Company pursuant to which, in 1968, (i) Worthen granted a ground lease, expiring in 2044, to Lyon, (ii) Lyon purchased a building from Worthen piece by piece as it was constructed, obtaining permanent financing from New York Life and investing $500,000 of its own money, (iii) Lyon granted a net lease on the building to Worthen for an initial term of 25 years and eight successive 5-year renewal options (extending until 2034), and (iv) Lyon granted Worthen an ongoing option, commencing in 1980, to repurchase the building for an exercise price that declined over time. The rental payments during the 25-year initial term of the lease equaled the principal and interest payments that would amortize the New York Life mortgage loan over the same period. Once the mortgage loan was paid off, the ground lease payments were scheduled to rise while the building rental payments were to decline (assuming the lease was renewed), resulting in net payments due from Worthen to Lyon equal approximately to the amount required to repay Lyon’s $500,000 investment plus interest. The repurchase option prices were calculated to equal the sum of the unpaid balance on the New York Life mortgage and Lyon’s $500,000 investment plus interest.

\footnote{5242794_v7}

\footnote{Id. at 991.}

\footnote{435 U.S. 561 (1978).}
As described by the Supreme Court, the Court of Appeals had rejected Lyon’s contention that it should be treated as the owner of the building entitled to take depreciation for tax purposes, on the grounds that “the benefits, risks, and burdens which [Lyon] has incurred with respect to the Worthen building are simply too insubstantial to establish a claim to the status of owner for tax purposes. Specifically, the Supreme Court noted that the lower court had stressed the following:

The lease agreements circumscribed Lyon’s right to profit from its investment in the building by giving Worthen the option to purchase for an amount equal to Lyon’s $500,000 equity plus 6% compound interest and the assumption of the unpaid balance of the New York Life mortgage. (b) The option prices did not take into account possible appreciation of the value of the building or inflation. (c) Any award realized as a result of destruction or condemnation of the building in excess of the mortgage balance and the $500,000 would be paid to Worthen and not Lyon. (d) The building rental payments during the primary term were exactly equal to the mortgage payments. (e) Worthen retained control over the ultimate disposition of the building through its various options to repurchase and to renew the lease plus its ownership of the site. (f) Worthen enjoyed all benefits and bore all burdens incident to the operation and ownership of the building so that, in the Court of Appeals’ view, the only economic advantages accruing to Lyon, in the event it were considered to be the true owner of the property, were income tax savings of approximately $1.5 million during the first 11 years of the arrangement.\(^\text{154}\)

Notwithstanding the foregoing, the Supreme Court reversed, holding that Lyon was the Owner of the building for tax purposes and rejecting the argument of the IRS that Lyon had simply loaned $500,000 to Worthen. The factors cited by the court in support of its decision included the following:

(i) Lyon, not Worthen, was liable on the New York Life loan, and “[d]espite the facts that Worthen had agreed to pay rent and that this rent equaled the amounts due from Lyon to New York Life, should anything go awry in the later years of the lease, Lyon was primarily liable.”\(^\text{155}\)

(ii) Lyon, a closely-held corporation, had “disclosed the [New York Life loan] liability on its balance sheet for all the world to see.”\(^\text{156}\)

(iii) The transaction was treated as a sale and leaseback for financial accounting purposes.\(^\text{157}\)

(iv) There was “no legal obligation between Lyon and Worthen representing the $500,000 ‘loan’ extended under the Government’s theory.”\(^\text{158}\)

\(^{154}\) Id., at 570-71 (quoting 536 F.2d 752-53).
\(^{155}\) Id. at 576-77.
\(^{156}\) Id. at 577.
\(^{157}\) Id.
\(^{158}\) Id. at 579.
“[I]f Worthen chooses not to exercise its [repurchase] options, Lyon is gambling that the rental value of the building during the last 10 years of the ground lease, during which the ground rent is minimal, will be sufficient to recoup its investment before it must negotiate again with Worthen regarding the ground lease. There are simply too many contingencies, including variations in the value of real estate, in the cost of money, and in the capital structure of Worthen, to permit the conclusion that the parties intended to enter into the transaction as structured in the audit and according to which the Government now urges they be taxed.”

The Government argued that the economics of the deal “made it highly unlikely that Worthen would abandon the building [by not exercising its repurchase option] after it in effect had ‘paid off the mortgage.’” The district court had, however, found it “highly unlikely, as a practical matter, that any purchase option would ever be exercised,” and the Supreme Court “refused to indulge in...speculation” that the option would be exercised in view of the district court’s finding to the contrary.

The Government is likely to lose little revenue, if any, as a result of the shape given the transaction by the parties. No deduction was created that is not either matched by an item of income or that would not have been available to one of the parties if the transaction had been arranged differently.

Lyon was the party “whose capital was committed to the building...."

The structure was created as the result of negotiation and participation by independent parties with independent concerns (notwithstanding the fact that Lyon’s principal shareholder was a director of Worthen).

“In short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes.”

An investment generating state historic rehabilitation taxes is, by its nature, tax-oriented to a far greater degree than the transaction involved in Frank Lyon. Nevertheless, there are a number of important similarities between the Frank Lyon case and transactions such as those that were the subject of the Virginia Historic Tax Credit Funds case. The transaction pursuant to

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159 Id. at 579-80.
160 Id. at 574.
161 Id. at 570, 581.
162 Id. at 580.
163 Id. at 581.
164 Id. at 582.
165 Id. at 583-84.
which the investors acquired their interests in the Funds was the product of arm’s-length negotiations between unrelated parties, the parties held the investors out to the world as partners of the Funds (through the documents they created, the tax returns they filed, etc.), and the investors were treated as partners for accounting purposes. The transactions did not “create” a deduction or credit “that would not have been available to one of the parties if the transaction” had been structured otherwise. In fact, at the Fund level, it can be argued (and was asserted by the taxpayers at the trial) that the investors were deprived of a Section 164 deduction by reason of the use of the partnership structure.

In Frank Lyon, the Supreme Court placed substantial weight on Lyon’s potential equity exposure during the last few years of the 76-year ground lease, notwithstanding the fact that Worthen had the legal right to cut that exposure off through exercise of its repurchase option. While there is no direct analog in the Virginia Historic Tax Credit Funds case to such long-term risk exposure, the taxpayers argued that the investors in that case were in fact subject to some entrepreneurial risk, a proposition that was vigorously opposed by the IRS. Nonetheless, it appears to be incontrovertible that the investors in Virginia Historic Tax Credit Funds were subject to different risks and possessed different rights in their capacity as limited partners than would have been the case had they been characterized as “purchasers” of the state tax credits under state law.\(^{166}\) The court in Frank Lyon was unwilling to disregard the potential consequences of ownership on the basis of “speculation.”\(^{167}\)

When analyzing whether a taxpayer that has purportedly purchased property is, for tax purposes, to be treated as the true owner of that property, the courts have examined how many of the attributes – i.e. benefits and burdens – of full ownership the taxpayer has acquired. See, e.g., Pacific Coast Music Jobbers, Inc., 457 F.2d at 1170; Hart Schaffner & Marx, 44 T.C.M. at 202-205; Gen. Couns. Mem. 34,602 (Sept. 9, 1971). In the Frank Lyon case, the Court of Appeals likened ownership for tax purposes to a “bundle of sticks” and concluded that the taxpayer was not the owner of the property involved on the grounds that it “totes an empty bundle” of ownership sticks.

As the foregoing discussion has suggested, ownership of an interest in a limited liability company that invests, through other limited liability companies and partnerships, in a project that generates state tax credits constitutes a somewhat unusual “bundle of sticks.” First, limited liability interests by their nature typically confer only limited management rights. Second, the very premise of a state tax credit investment is that the investor will not be relying on rental income or appreciation in property value as the principal source of economic profit. Instead, the economic feasibility to the investor is based in large part on the state tax credits generated by such investment. Because these benefits are established by statute and are easily quantifiable, the benefits that an investor in such a transaction can expect to receive from its investment can be calculated with a degree of predictability that normally is unavailable in the case of a conventional real estate investment. Moreover, like many other tax attributes, state tax credits are by their very nature available only for a limited period. Just as a prudent investor in a high tax bracket would pay a substantial premium for an interest in a real estate project (or other investment) generating federal tax credits or other federal tax benefits, so does a state credit

\(^{166}\) See Reply Brief by 2001 Virginia Historic Tax Credit Funds, pp. 96-97.

\(^{167}\) Id. at 579, 581.
investor pay more for an indirect interest in a rehabilitation project than otherwise would be the case in the absence of the state tax attributes. Once the attributes have been allocated and used, the partnership or membership interest acquired by the state credit investor is worth much less. This is not to say that the investor could not receive additional economic benefits through its large capital interest; it simply reflects the fact that tax attributes inherently are temporary in nature.

4.2 Example

The positions advanced by the IRS in the Virginia Historic Tax Credit Funds case pose a significant threat to syndicated state tax credit transactions that involve less complicated (and perhaps less controversial) facts than those that were the subject of the Tax Court case.

Assume for example, that the Owner owns and intends to rehabilitate an existing building in Virginia that is listed in the National Register of Historic Places. Following the rehabilitation, the building will be operated as a commercial office building (the “Project”). The rehabilitation is expected to constitute a “certified rehabilitation” of a “certified historic structure” and thus to be eligible for the federal historic rehabilitation tax credit described in Section 47 of the Code. The rehabilitation also will qualify for Virginia state historic tax credits. Under applicable state law, the state credits must be allocated by the Owner to its partners and cannot be transferred or sold. Assume further that, for state law purposes, the allocation of state credits need not conform to the allocation of federal historic credits or other federal tax items. Upon completion of the rehabilitation, the Owner will master lease the building to a newly formed limited partnership (the “Master Tenant”) that in turn will sublease the building to commercial tenants. In accordance with the provisions of Section 50(d) of the Code, the Owner will elect to pass through to the Master Tenant the federal historic tax credits arising from the rehabilitation.

The general partner of both the Owner and the Master Tenant will be an affiliate of the Owner. An institutional investor (the “Federal Investor”) will be admitted to the Master Tenant as its investor limited partner and will be allocated 99.99% of the federal historic tax credits in exchange for contributions to the capital of the Master Tenant. Under the terms of the Owner’s limited partnership agreement (the “Owner Partnership Agreement”), the Master Tenant will have a 10% equity interest in the Owner and will contribute to the capital of the Owner the portion of the equity contributions of the Federal Investor that is not required to pay costs and expenses of the Master Tenant.

Subject to the satisfaction of certain conditions, a single institutional state credit investor (referred to herein as the “State Investor”) agrees to make substantial contributions to the capital of an SCP that is a limited partnership in exchange for an interest in the SCP (the “Investor Interest”) and the SCP agrees to make substantial contributions to the capital of the Owner in exchange for an interest in the Owner (the “SCP Interest”). The SCP Interest entitles the SCP to receive an allocation of 100% of the Virginia historic tax credits generated by the rehabilitation of an historic building, as well as 1.5% of the operating profits and losses (including each item of income, gain, loss, deduction, and credit), and cash flow, and 5% of any sale or refinancing proceeds of the Owner. The limited partnership agreement of the SCP (the “SCP Partnership Agreement”) will allocate 99% of all of such tax items and cash
distributions to the State Investor. The State Investor is not subject to the alternative minimum tax.

The amount of the State Investor's capital contributions to the SCP and the SCP's capital contributions to the Owner is based largely on the value of the state historic tax credits that the Owner expects to allocate to the SCP (and that the SCP in turn will allocate to the State Investor) as a result of such rehabilitation. As a result, the State Investor's capital contributions to the SCP and the amount of the SCP's capital contributions are disproportionate to their respective interests in the SCP and the Owner. Under the terms of a separate agreement (the "SCP Option Agreement," the general partner of the SCP (the "SCP General Partner") is granted an option to purchase the Investor Interest for an amount equal to the greater of its fair market value, as determined by appraisal, or an amount equal to any exit taxes payable by the State Investor as a result of the exercise of such option. The option is exercisable 5 years after the rehabilitation is contemplated and the Project is placed in service.

The SCP and the Master Tenant have consent and approval rights over certain major decisions of the Owner and are treated by the parties as partners for both tax and state law purposes. In addition, the SCP Partnership Agreement will give the State Investor consent and approval rights over various major decisions affecting the SCP and the parties will treat the SCP as a partnership for both tax and state law purposes.

Based on the above facts and the arguments made in the Virginia Historic Tax Credit Funds case, and in addition to other possible approaches, the IRS could make one or more of the following arguments:

(i) The purported allocation of state historic tax credits by the Owner to the SCP should be recharacterized as a sale of state historic tax credits by the Owner to the SCP under Sections 707(a) and 1001 of the Code. The subsequent allocation of state historic tax credits by the SCP to the State Investor also should be recharacterized as a sale of such credits. In this situation, the SCP presumably would have a cost basis equal to what it had “paid” the Owner for such credits. As a result, the Owner would recognize the bulk of the income from the recharacterized sale of the state tax credits. The SCP would recognize income only to the extent that the “purchase price” paid by the State Investor to the SCP exceeded the “purchase price” paid by the SCP to the Owner. When the State Investor applies the state historic tax credits to reduce its state income taxes, it would be entitled to a federal deduction for state taxes paid under Section 164(a) of the Code in an amount equal to the face value of the state historic tax credits (one dollar per dollar of state historic tax credit). Presumably, the State Investor also would recognize income equal to the difference between its cost basis in such state tax credits (i.e. the amount of its purported capital contribution) and the face value of such state tax credits. For example, if the State Investor contributed $0.80 for each $1.00 of state tax credits, it would receive a federal tax deduction of $1.00 for each $1.00 of credit applied against its state taxes. However, it also would be treated as having paid such taxes with appreciated property (i.e. the credits). Since it has a basis of $0.80 for each $1.00 of credit it purchased, it would have gain of $0.20 when it applies the credit against its taxes. As a result, the “net” deduction under Section 164(c) would be $0.80.
(ii) The purported allocation of state historic tax credits by the Owner to the SCP and by the SCP to the State Investor should be recharacterized as a sale of state historic tax credits by the Owner directly to the State Investor. In other words, the SCP would not be deemed to be a partner in the Owner for federal income tax purposes, nor would the SCP be respected as a partnership for such purposes. In such event, the Owner presumably would realize income equal to the amount "paid" by the State Investor for the state historic tax credits. The spread between the amount contributed by the State Investor to the SCP and the amount contributed by the SCP to the Owner might be recharacterized as a fee paid to the SCP General Partner. As was the case in alternative (i), the State Investor presumably would be entitled to a Section 164(a) deduction for state taxes paid and would recognize income in the amount by which its "purchase price" for each credit dollar was less than $1.00.

(iii) The transaction should be recharacterized as a valid allocation of state historic tax credits by the Owner to the SCP and a sale by the SCP of such state historic tax credits to the State Investor, who would not be treated as a partner for federal income tax purposes. In such event, the SCP would have a zero cost basis for such state historic tax credits and would realize income equal to the face amount of such "property" when it "sold" such property to the State Investor. The State Investor again would be entitled to a federal deduction for state taxes paid under Section 164(a) of the Code when it filed its state tax return claiming the credits and would have income equal to the difference between the amount "paid" for the state historic tax credits and the face amount of such state historic tax credits.

(iv) The transaction should be recharacterized as a valid allocation of state historic tax credits by the Owner to the SCP. The SCP would be characterized as a partnership and the State Investor would be recognized as a true partner for federal income tax purposes. However, under Section 707 of the Code, the purported allocation of state tax credits by the SCP to the State Investor would be recharacterized as a sale of "property". In such event, the consequences to the State Investor would be substantially the same as those in alternative (iii) above, except that the State Investor also would have a basis for its interest in the SCP and would continue to be treated as a partner unless and until its interest is purchased pursuant to the terms of the SCP Option Agreement. At the time of such purchase, the State Investor would recognize gain or loss equal to the difference between its basis for its interest and the amount received pursuant to the exercise of the option. Presumably, its basis would be very low since the bulk of its purported capital contribution would be recharacterized as purchase price for the credits.

(v) The transaction could be recharacterized under Section 707 of the Code as a constructive sale by the general partner of the Owner (the "Owner General Partner") (and perhaps other partners of the Owner) of a portion of its (or their) interest(s) in the Owner to the SCP, which would allocate the state credits to the State Investor. The state historic tax credits would simply be treated as an attribute associated with such interest(s). In such event, the Owner General Partner (and perhaps other partners) would realize income from such constructive sale. When the state historic tax credits are applied by the State Investor to reduce its state taxes, it would not be entitled to a
deduction for state taxes paid under Section 164(a) of the Code since it is an allocatee rather than a purchaser of such state historic tax credits. Accordingly, a recharacterization under this rationale would not result in disallowance of any material portion of the State Investor’s anticipated state or federal tax benefits.

4.3 Application of Existing Law to Facts of Example

4.3.1 Partnership Status

Notwithstanding the possible arguments of the IRS, the authority described in Section 3.1 and 4.1 above suggests that each of the Owner and the SCP should be treated as a partnership for federal income tax purposes. A compelling argument can be made, based on the language and legislative history of Sections 704(e)(1), 761, and 7701 of the Code, as well as Moline Properties and its progeny, that the Owner and the SCP should be treated as business or financial entities in which capital is a material income-producing factor and, therefore, must be respected as either partnerships or corporations. Since each of such entities is organized as a limited partnership, and assuming that no election has been made to select corporate status, the default test of partnership status should apply. Moreover, a majority of the factors cited in Culbertson and Luna indicating partnership status are present. Each of the Owner and the SCP has been formed as a valid limited partnership under applicable state law. The parties have entered into detailed partnership agreements setting forth their respective rights and obligations. The partnership agreements evidence the clear intention of the parties to enter into a partnership relationship. Each of the partnership agreements provides a detailed discussion of the management, consent and voting rights of the partners and allocates the profits, losses and cash flow of the entities to the partners. The partnership agreements also set forth the conditions to the capital contributions of the partners and designate the uses for such capital.

Further, in the case of both the Owner and the SCP, capital is a material income producing factor and the partners of the Owner and the SCP have made or will make substantial capital contributions to such entities. Such partners have a “mutual proprietary interest” in the net profits of the entities and an obligation to share at least some portion of losses. The Owner and the SCP will hold themselves out to third parties as partnerships, will maintain separate books of account, and will file federal and state tax returns based on partnership status.

4.3.2 Recharacterization as Debt

The transaction described in the example described in Section 4.2 above possesses many of the characteristics determined by the Tax Court in Hunt and by the U.S. District Court in Castle Harbour III to be indicative of a true partnership relationship. As in Hunt and Castle Harbour, assume that the SCP Partnership Agreement and the Owner Partnership Agreement are formal, detailed agreements, setting forth the respective rights and duties of the partners. In the case of each of the partnerships, assume further that a certificate of limited partnership is filed with the Virginia State Corporation Commission, and the parties will hold themselves out to the world as partners of the SCP or the Owner, as the case may be, appropriate partnership books and records will be maintained, and federal and state partnership tax returns will be filed, all in accordance with applicable law. Upon the entry of the State Investor to the SCP and of the SCP to the Owner, the State Investor and the SCP, respectively, each will have contributed or will be
obligated to contribute a substantial amount of capital to the SCP and the Owner, respectively. Finally, assume that the SCP Partnership Agreement and the Owner Partnership Agreement provide the State Investor and the SCP, respectively, with substantial voting, consent and other rights, including but not limited to admitting additional partners, amending the partnership agreements, borrowing funds, changing the nature of the business, and distributions.

Similarly, as in *Hunt* and *Castle Harbour*, each of the SCP and the State Investor will share in profits and losses from the operation of the Owner’s business. The Owner partnership agreement allocates 1.5% of the Owner’s profits, losses, and other federal tax items to the SCP, as well as 100% of the state historic tax credits. Under the terms of the SCP Partnership Agreement, 99% of the SCP’s 1.5% share of profits and losses from the operations of the Owner, which translates into 1.485% of such items, and 99% of the SCP’s 5% share of the sale or refinancing proceeds of the Owner, which translates into 4.95% of such items, will be allocated to the State Investor. Cash distributions by the Owner and the SCP are required to be made in accordance with each partner’s allocable share of profits, losses, and federal tax items. In addition to its share of cash distributions, each of the SCP and the State Investor will receive the benefit of the state historic tax credits, which are a non-federal tax benefit that is the functional equivalent of cash. Further, and perhaps most notably, the State Investor has a significant capital interest in the SCP, and the SCP has a significant capital interest in the Owner. Both of the Partnership Agreements require the maintenance of capital accounts in accordance with the Allocation Regulations, including the requirement that liquidating distributions be made in accordance with the partners’ positive capital accounts. Thus, upon any liquidating event, the State Investor, through its indirect interest in the Owner, is entitled to receive a return of the capital it has contributed to the SCP.

With respect to the business purpose requirement articulated in *Hunt* and other cases, Section 1.355-2(b)(2) of the Treasury Regulations provides that, for purposes of determining whether certain corporate distributions are tax-free under Section 355 of the Code, the reduction of state taxes is a business purpose of a distributing corporation (as defined therein) unless the transaction effects a reduction of federal and state tax because of similarities between federal and state tax law and reduction of federal tax is greater than or equal to the state tax reduction. By analogy to this provision of the Treasury Regulations, and in addition to the potential economic return from the operations of the underlying project, a partnership formed to acquire an interest in a real estate project generating state tax credits should be treated as formed for a valid business purpose. In such a case, any federal tax benefits from the state historic tax credits are incidental to the desired state tax benefits. Furthermore, under the terms of the SCP Partnership Agreement described in the example, the SCP also may engage in other unrelated business activities, and the State Investor would receive its allocable share of the cash or other benefits generated by such transactions.

With respect to the *Castle Harbour II* decision, it should be noted at the outset that *Castle Harbour II* is extremely difficult to reconcile with the authorities discussed above in *Section 4.1* that recognize as valid partnership relationships transactions involving equity contributions with varied debt-like features. In any event, there are a number of important differences between the transaction in the example and the facts and intended tax consequences in the *Castle Harbour* transaction. In *Castle Harbour*, the purpose of the transaction essentially was to shift large
amounts of economic taxable income from GECC, a U.S. taxpayer, to tax-indifferent foreign entities by exploiting what was then a loophole in the Section 704(c) Regulations governing allocations attributable to contributions of zero basis, high-value depreciable property. This loophole subsequently was closed as a result of amendments to the Treasury Regulations.

By contrast, in the case of the example, any income generated by the Project and allocated to the partners will be fully taxed. For the reasons discussed in Section 4.3.3 below, the structure of the transaction described in the example will not serve to avoid any federal income taxes and a recharacterization of the transaction under the arguments advanced by the IRS in the Virginia Historic Tax Credit Funds case would only serve to alter the timing of the income and deductions associated with the transaction.

4.3.3 Mandatory Downward Basis Adjustment

In the Virginia Historic Tax Credit Funds case, it appears that neither the investment funds nor the underlying developer partnerships filed Section 754 elections with respect to the years in which the interests of the investors were purchased by one of the principals of the funds. This failure was cited by the IRS in the CCAs as causing the investment funds in question to have “inflated inside bases.”

In the case of the example, if the SCP General Partner elects to exercise the call option, there will be a sale or exchange of the State Investor’s interest in the SCP for federal income tax purposes. Prior to the American Jobs Creation Act of 2004 (the “Jobs Act”), Section 743 of the Code, provided that, if an election under Section 754 of the Code was filed by a partnership, the basis of partnership property with respect to the acquiring partner would be adjusted as a result of a sale or exchange of the partnership interest or as a result of the interest being transferred upon the death of a partner. Section 734 of the Code permitted the basis of partnership property to be adjusted as a result of a distribution of partnership property to a partner either for any gain or loss recognized by the partner receiving the distribution or to reflect any difference between the partnership’s adjusted basis of the distributed property and the basis of the distributed property to the partner receiving a distribution. Section 743 of the Code contains a similar provision that applies to sales of partnership interests. The Jobs Act amended Sections 743 and 734 of the Code to require that such basis adjustments are mandatory in cases where a partnership either has a “substantial built-in loss” immediately after a transfer of a partnership interest described in Section 743(a) of the Code or has a substantial basis reduction due to a distribution of partnership property to a partner. For this purpose, a partnership has a substantial built-in loss if the partnership’s adjusted basis for its property exceeds the fair market value of that property by more than $250,000.

In the case of the transaction described in the example, for purposes of applying the Section 743 basis adjustment rules to the State Investor’s investment, the SCP would be treated as the relevant partnership. At least initially, the SCP’s “property” would consist solely of its interest in the Owner. Its adjusted basis for such interest would be the amount of capital contributed by it to the Owner. If, at the time of the exercise of the call option, the SCP continues to have at least two partners (i.e., the SCP General Partner causes an affiliate or other

168 See CCA 200704030 and Footnote 9.
third party to be admitted to the SCP), and the adjusted basis of the SCP for its interest in the Owner exceeds the then fair market value of such interest by more than $250,000, a mandatory “inside” basis adjustment under Section 743 would appear to be required. In effect, this would mean that the SCP’s “inside” basis for its assets (i.e., its interest in the Owner) would be reduced to equal the amount of the purchaser’s “outside” basis for the purchased interest. The result is that the purchaser would have an “outside” basis for the purchased interest and a share of “inside basis” in the SCP’s property that is significantly less than the amount of the capital account that it acquired from the State Investor upon the exercise of the call option. The purchaser would therefore have a significant indirect interest in the capital of the Owner and, upon a sale or liquidation or other capital event involving the Project, stands to receive a return of such capital. Any amounts received in excess of the SCP purchaser’s basis would be taxable to the purchaser.

If the SCP General Partner causes an affiliate or other third party to be admitted to the SCP at the time of the exercise of the call option, and the State Investor owns a 50 percent or greater interest in the SCP’s capital or profits, the transfer of the State Investor’s interest would cause the SCP to terminate for federal income tax purposes under Section 708(b)(1)(B) of the Code. In such event, the interest that the SCP held in the Owner would be deemed to be exchanged for an interest in a newly formed partnership. That transfer would cause an adjustment to the basis of the Owner’s assets if a Section 754 election were in effect. If the Owner had not filed a 754 election but the assets of the Owner reflected a built-in loss in excess of $250,000, the basis of the Owner’s assets would be reduced to equal their fair market value. Because the value represented by the state tax credits is no longer present, it is entirely possible (if not likely) that such a downward basis adjustment would be mandated.

For purposes of illustration, consider the facts of a simpler version of the example set forth in Section 4.2. In this hypothetical, assume that the State Investor contributes $100 to the SCP and the SCP General Partner contributes $1.00 to the SCP. The SCP contributes the entire $101 to the capital of the Owner. The Owner allocates $150 of state historic credits to the SCP, all of which are allocated by the SCP to the State Investor. The SCP General Partner has an option to purchase the interest of the State Investor for its fair market value in year five. The fair market value of the interest at such time is $25. In year six, the SCP’s interest in the Owner is sold for $101. In all other respects the hypothetical transaction is structured like the transaction described in the example set forth in Section 4.2, but for simplicity it is assumed that no allocations of any partnership items are made.

Assuming that the transaction structure is respected, the contribution of the State Investor to the SCP would be a non-taxable capital contribution of $100. The allocation of the state historic tax credits would not reduce the capital account of the State Investor and would not generate a federal tax deduction under Section 164(a) of the Code. If the call option were exercised, the State Investor would have a loss for federal tax purposes equal to $75, the difference between its $100 basis in its interest at the time of the sale and the $25 call price. The SCP General Partner, as the purchaser under the call option, would then have a basis in the acquired interest equal to the $25 call price and would succeed to the State Investor’s $100 capital account. Upon the sale of the SCP’s interest in the Owner in Year 6, the purchaser would

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receive a return of $101, $75 of which would be taxable. Accordingly, the loss deducted by the State Investor in Year 5 is offset by income to the SCP General Partner in Year 6.

Further, as discussed above, upon the exercise of the call option and the sale of the State Investor’s interest to the SCP General Partner, there would likely be a mandatory basis adjustment to the SCP’s property (consisting of its interest in the Owner) that would align the inside basis of the SCP in its assets to the outside basis of its partners in their interests in the SCP. In addition, assuming that the purchaser under the call option is the SCP General Partner, the SCP would terminate under Section 708 of the Code and the assets of the SCP (the interest in the Owner) would be distributed to the SCP General Partner resulting in the SCP General Partner’s basis in such property being equal to the purchase price paid under the call option, or $25.

If the call option were not exercised and the SCP’s interest in the Owner was sold in year six for $101, all of which was distributed to the partners of the SCP in proportion to their respective capital accounts, the State Investor would report no income or loss from the transaction because its allocable share of the proceeds ($100) would exactly equal its basis for its interest in the SCP.

If the hypothetical transaction were recast in the manner suggested by the IRS in the Virginia Historic Tax Credit Funds case, the $100 capital contribution by the State Investor in Year 1 would be deemed to be “purchase price” for the state historic tax credits and the partners of the SCP would have income totaling $100 (the “purchase price”) minus the zero basis that the SCP has in the state historic tax credits. The State Investor would receive a net federal tax benefit of $100 in Year 1 ($150 of state tax deduction under Section 164(a) of the Code minus the $50 in gain from the disposition of “property” (the state historic tax credits) worth $150 with a basis of $100). Accordingly, once again, the deduction generated by the transaction is offset by a matching amount of income. Because there are no tax-indifferent parties to the transaction as was the case in Castle Harbour, the only federal tax impact of such a recharacterization is the timing of the income and the loss.

The result described in the preceding paragraph is directly contrary to the IRS’s assertion in the Virginia Historic Tax Credit Funds case that a holding that the state tax credits are not property “would provide a clear roadmap for federal tax avoidance – even with respect to state tax credits, whether in Virginia or in other states, that are not subject to the restrictions on transferability that apply here…” The IRS went on to state:

[i]f one were to accept petitioner’s argument – that in the case of a state tax credit no one can look beyond the form of a state partnership transaction to its substance, or apply the disguised – sale provisions in I.R.C. § 707 – then promoters and taxpayers could easily avoid tax on the gain, as petitioner tried to do here, by the simple expedient of drawing up papers casting the transaction as an allocation of tax attributes to putative partners, rather than as a sale to

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170 This assumes that the allocation of the state tax credits by the Owner to the SCP is respected as a true allocation of a tax item. If the IRS asserts that the allocation by the Owner to the SCP should be recharacterized as a sale of the credits, the SCP would have a tax basis equal to the amount of capital it contributed to the Owner.
purchasers. Only the unwary or ill-advised would ever sell or buy state tax credits outright when they could so easily defer the recognition of income indefinitely, convert ordinary income to capital gain - and help purchasers avoid alternative minimum tax restrictions on their I.R.C. § 164 deductions by substituting an I.R.C. § 165 deduction from a paper “loss” on the purported partnership interest buyout passed through such a simple device.\(^{171}\)

Further, the state historic tax credits that will be claimed by the partners in the example described above are intended to implement the legislative purpose of encouraging the rehabilitation of historic properties. Unlike the situation in Castle Harbour, where the Dutch banks treated their investment in the partnership as debt, in the case of the transaction described in the example, each partner presumably will treat its participation in the relevant partnership as an equity investment for both state law purposes and for federal and state income tax purposes. Finally, unlike the transaction that was the subject of Castle Harbour, in the example described herein, there is no stated interest rate or repayment schedule relating to the investment of the SCP or the State Investor, and the parties have no right to force a liquidation of the SCP or the Owner. Moreover, the capital contributions of the SCP and the State Investor typically are needed to complete the rehabilitation of the historic building, as opposed to the situation in Castle Harbour, where the court concluded that the partnership could have functioned without the contributions by the banks.

**4.3.4 Business Purpose and Economic Substance**

The analysis in UPS and IES Industries also would suggest that the transaction described in the example should not be recharacterized. Each partner in the transaction arguably has a legitimate profit motive and there are economic consequences resulting from the transaction. The fact that this profit is delivered largely in the form of state historic tax credits is the result of a deliberate decision by the Virginia legislature to encourage the rehabilitation of historic buildings. If the SCP (or the State Investor) preferred a return on its capital in the form of cash, it would not make this type of investment. The SCP (and the State Investor) has chosen to make the investment in the transaction in a manner that is consistent with the legislative content of using states and federal tax incentives to encourage the rehabilitation of historically significant properties.\(^{172}\)

The transaction described in the example also has real economic effects on the independent parties participating in the transaction. The funds contributed by the SCP (and the State Investor) to the Owner will be used to rehabilitate an historic property and, in the case of the SCP, may subsequently be applied to finance other unrelated real estate transactions. The Owner will undertake substantial business risks in exchange for the contribution of capital by the SCP and the other partners of the Owner. Without the equity infusion from the SCP and such other partners, the rehabilitation of the historic building could not be accomplished. Moreover, the State Investor typically makes its capital contribution in installments. To the extent that any such capital installment is made before the certificate from the Commonwealth of Virginia certifying the rehabilitation’s eligibility for the state historic tax credit is received, the State

\(^{171}\) See Opening Brief for Respondent, p. 167.

\(^{172}\) See Section 4.3.7. below.
Investor is bearing the risk that the rehabilitation ultimately fails to be eligible for the state historic tax credit. Although the State Investor typically will be protected to some extent by credit adjuster provisions set forth in the SCP Partnership Agreement and the Owner Partnership Agreement, the efficacy of such provisions depends upon the continuing financial stability of the Owner and/or the SCP GP.

The fact that the profit involved in the transaction is provided largely in the form of state historic tax credits is based on legislative intent designed to attract capital to address a need while providing the State Investor with a significant benefit in the form of reduced state tax liability. As the court in *Compaq* made clear, any tax benefit that adds to the cash flow of the recipient of such benefit should be accounted for when determining the profit motive of the parties. Here, the reduction of the State Investor’s state tax liability from claiming the state historic tax credit translates into a $0.65 increase in the relevant taxpayer’s cash flow (taking into account the “foregone” deduction for state taxes paid that the taxpayer would have had if it had not made the investment and simply paid its state taxes). Under the rationale expressed in *Compaq*, the taxpayer’s return from the application of the state historic tax credits to reduce its Virginia tax liability should be counted as cash flow from the investment.

The SCP and the State Investor also could receive a profit from the transaction that is not based on federal tax benefits through distributions of operating cash flow and the possibility of sharing in residual proceeds from a sale or refinancing of the Project. In this regard, it is important to note that, under the terms of the partnership agreements, liquidating proceeds are required to be distributed in accordance with the positive capital account balances of the partners. Accordingly, in the transaction described in the example, if the call option is not exercised and the Owner or the SCP is liquidated, the SCP or the State Investor, as the case may be, would be entitled to receive an amount equal to its adjusted capital account balance. Since the SCP’s and (the State Investor’s) share of taxable losses of the partnerships is relatively small, the capital accounts of the SCP (and the State Investor) are likely to be disproportionately high in relationship to the other partners, thereby resulting in a larger share of such proceeds. If the Project generates taxable income for federal income tax purposes that exceeds the share of the SCP (or the State Investor) in operating cash flow or other distributions, the capital accounts of SCP and the State Investor (and their respective shares of any liquidating proceeds) will be correspondingly increased. Even if the call option is exercised, presumably the calculation of the fair market value of the State Investor’s interest will include the potential return of its associated capital account, further evidencing economic substance.

Based on the foregoing, in the transaction described in the example, each of the SCP and the State Investor would appear to have a profit motive in providing capital to the Owner in order to generate state historic tax credits. Thus, there is a business purpose and economic substance to the transaction so that under *Frank Lyon, IES Industries*, and *UPS* the form of the transaction should be respected.

### 4.3.5 Implementation of Legislative Intent

The rationale expressed by the Ninth Circuit in the *Sacks* case also would appear to apply in the case of the transaction described in the example. As was the case in *Sacks*, both Congress and the Virginia legislature have specifically created a tax incentive for investing in an activity
that it deems to be socially desirable (i.e., the rehabilitation of historic buildings). The fact that each partner will obtain, as the most substantial portion of its overall return, such tax benefits simply reflects the very reason that Congress and the Commonwealth of Virginia created the tax benefits in the first place. Any federal income tax benefits (such as a capital loss or the disposition of the partnership interest of the SCP or the State Investor) are incidental to the principal purpose of the transaction, which is to provide equity capital to historic rehabilitation projects in exchange for the state tax benefits afforded by state historic tax credits. To attack the structure of investments that are intended to conform to applicable state requirements arguably is inappropriate. A conclusion that the state historic tax credits are implementing legislative intent and should be treated for federal income tax purposes as the functional equivalent of cash arguably provides the requisite economic substance necessary to classify the investment by the SCP (and/or the State Investor) as the acquisition of a partnership interest rather than a purchase of “property” or some kind of debtor-creditor relationship. The reporting of a capital loss upon the exercise of a the call option arguably is no more “abusive” than the capital loss claimed by Alliant on the disposition of ADRs in IES Industries, particularly in view of the downward basis adjustments discussed in Section 4.3.3.

4.3.6 Impact of Section 707

At the heart of the IRS arguments in the Virginia Historic Tax Credit Funds case was the notion that the purported allocation of state tax credits should be recharacterized as a “sale” of “property” under Sections 707(a)(2)(B) and 1001 of the Code. In order for this argument to prevail in the case of the example, the IRS would first have to establish that the state tax credits allocated by the Owner of the SCP (and by the SCP to the State Investor) are “property” for federal income tax purposes and then would have to show that the transaction will be considered to have occurred between the partnership (i.e., the Owner or the SCP, as applicable) and one who is not a partner (i.e., the SCP or the State Investor, as applicable).

As was the case in Virginia Historic Tax Credit Funds, the Virginia state tax credits in the example are by their terms nontransferable under state law. The issue thus becomes whether, under the facts of the example, the credits, which even the IRS apparently acknowledges constitute tax items when they are awarded to the Owner by the Commonwealth of Virginia, become “property” when they are allocated to direct or indirect partners of the Owner. In this regard, it should be emphasized that the IRS conceded in the Virginia Historic Tax Credit Funds case that these issues might be decided differently under other facts, stating:

Note that the answer to this issue may well differ for other taxpayers on other facts; the promoters of the Virginia Funds transactions could have brought in investors as true partners with the developers conducting the historic rehabilitation activity, but they chose not to. On these facts, the Virginia Funds’ prearranged transfer of purchased credits to the investors for cash was not a true partnership transaction, but instead a sale of property under I.R.C. § 1001, and it should be taxed accordingly. (emphasis added) 173

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173 See Opening Brief for Respondent pp. 165-166.
There is a curious circularity to the IRS position. In effect, the IRS is saying that the state credits in the Virginia Historic Tax Credit Funds case constituted “property” because the investors were not really partners while at the same time arguing that the investors were not partners because the credits were “property” and not tax items. The problem is how to apply this rather amorphous standard to other situations, such as the facts presented in the example. In its Opening Brief, the IRS states:

The key to resolving the tax consequences in these cases is identifying specifically who holds the right to property, how they acquired the right, and how they realize the benefit of the right. For this type of property, the nature of the transaction is what determines the tax consequences. In this light, petitioner’s efforts to obscure the true issues by its claims that state tax credits are not “property” for purposes of I.R.C. § 707 or § 1001, [reference omitted] or that respondent’s position in this respect is unclear, unfounded, or contradictory, are seen for what they are — diversions.\(^{174}\)

The IRS went to great lengths in Virginia Historic Tax Credit Funds to provide authority for the proposition that state tax credits constitute a form of intangible property, citing dictionary definitions, statutory references, examples involving store coupons and discounts, “frequent flyer miles,” the treatment of licenses, patents, copyrights, contract rights, and similar items. However, none of the examples cited by the IRS constituted tax items that, under applicable state law, could not be transferred or assigned. The notion that transferable state tax credits may constitute property is not new; it has been the IRS position in rulings for a number of years. However, when a state consciously creates a tax credit that cannot be transferred or assigned and incontrovertibly is intended to be a tax item, as Virginia did, the IRS position presents an interesting clash between state and federal taxing authorities.

If the state tax credits allocated by the Owner or the SCP in the example in fact constitute “property,” there seems to be little doubt that the transaction presumptively will be treated as a disguised sale under Section 707(a)(2)(B), since there would be a contribution of cash (in the form of the capital contributions of the State Investor to the SCP and by the SCP to the Owner) and a related distribution of “property” (in the form of the state tax credits) within a two-year period. Arguably, however, the facts of the example differ significantly from those in the Virginia Historic Tax Credit Funds case. In the first place, the example involves a single institutional investor that is not subject to the alternative minimum tax and has the sophistication and bargaining power to negotiate the terms of the investment in the manner that it deems most advantageous. Secondly, the State Investor, through its interest in the SCP and the SCP’s interest in the Owner, not only has a large capital interest but also has a significantly larger interest in federal tax items and cash distributions than was the case for the individual investors in the Virginia Historic Tax Credit Funds case. As a result, in addition to the special purpose upper-tier investment argument advanced by the taxpayers in Virginia Historic Tax Credit Funds, there is a stronger argument that the SCP (and the State Investor) actually hold an economic stake in the Owner. Third, the State Investor will remain a partner for at least five years, a marked contrast to the very short investment period of the investors in the Virginia Historic Tax Credit Funds proceedings. Fourth, the SCP is authorized to engage in other

\(^{174}\) See Opening Brief for Respondent, p. 146.
business activities; its purposes are not limited to the acquisition of the SCP Interest (and its attendant right to receive an allocation of state tax credits). Fifth, there is a separately negotiated purchase option covering the interest of the State Investor that requires the payment of not less than the fair market value for the interest upon exercise. While there may be an expectation that the fair market value will be less than the amount of the State Investor’s capital contributions, there certainly is no assurance that the price will be nominal. Moreover, the fact that the exercise of the option could mandate a downward “inside” basis adjustment in the assets of both the SCP and the Owner may affect the likelihood that the option actually will be exercised. Finally, both the SCP Partnership Agreement and the Owner Partnership Agreement give the partners consent and approval rights over certain major decisions that are consistent with the characterization of the State Investor and the SCP as limited partners of the SCP and the Owner, respectively.

While the facts of the example certainly appear to be more supportive of a true partnership relationship than those in the Virginia Historic Tax Credit Funds case, one of the problems with the IRS position is that nowhere in the record of that case do there appear any “bright line” or objective standards that would provide guidance for taxpayers considering such an investment.

5. Impact of Call Option on Partner Status

5.1 Relevant Authority

In the transaction described in the example, we have assumed that the SCP General Partner and the State Investor have entered into an option agreement that gives the SCP General Partner the right to buy the State Investor’s interest for an amount equal to the fair market value of such interest. The existence of such option agreement could have an effect on the determination of the State Investor’s status as a partner of the SCP.

Both the IRS and the courts have taken the view in lease situations that where a lessee has an option to acquire a leased asset at the end of the term of the lease “at a price which is nominal in relation to the value of the property at the time when the option is exercised, as determined at the time of entering into the original agreement,” then, “in the absence of compelling persuasive factors of contrary implication an intent warranting treatment of [the] transaction as a purchase and sale rather than as a lease or rental agreement may be said to exist.”\textsuperscript{175} There also have been a number of cases and rulings dealing with the issue of when the holder of an option to acquire property will be deemed to be the owner of such property for federal income tax purposes. In general, these cases have involved an analysis of who bears the “benefits and burdens” of ownership. See, e.g., Dettmers v. Commissioner,\textsuperscript{176} aff’d sub nom, Johnson v. Commissioner.\textsuperscript{177} While much of the authority in the option area deals with residual purchase or early buyout options granted to lessees in leasing transactions, the same fundamental principles presumably would be applied by a court in analyzing the tax impact of the call option.

\textsuperscript{176} 430 F.2d 1019 (6th Cir. 1970).
\textsuperscript{177} 51 T.C. 290 (1968).
There is considerable authority in the leasing area that even fixed price purchase options are inconsistent with true lease status only where the option price is so nominal as to make its exercise a "virtual certainty." See Transamerica Corp. v. United States,\(^\text{178}\) in which the court observed that "[t]he fact that the parties expected the options to be exercised is not inconsistent with an intent to enter into a lease transaction. Whether the options would be exercised, in the light of future vagaries, was a speculative matter in 1961." Similarly, in Belz Ins Co. v. Comm'r,\(^\text{179}\) the court concluded that the exercise of a fixed price option was not a "foregone conclusion." Similar holdings were issued in New Acceptance Corp. v. Comm'r,\(^\text{180}\) aff'd per curiam,\(^\text{181}\) Valley Paving Co. v. Comm'r,\(^\text{182}\) and Cal-Maine Foods, Inc. v. Comm'r,\(^\text{183}\) all of which focused on the fact that the exercise of the options in questions was not an absolute certainty.

In some cases, courts have determined that the holder of an option is under an economic compulsion to exercise the option because of a below-market price or other facts and circumstances that present the option as the best economic alternative.\(^\text{184}\) The nature and scope of the "economic compulsion" theory, and its application to the facts in the present case, are not clear. Both the courts and the IRS have held that a residual purchase option granted in a leasing transaction that is exercisable at fair market value (or at a fixed price based on a reasonable estimate of fair market value) is per se evidence of true lease characterization, whether or not the lessee is economically compelled to exercise the option. For example, the leveraged leasing guidelines set forth in Rev. Proc. 2001-28, 2001-1 C.B. 1156 (superseding Rev. Proc. 75-21, 1975-1 C.B. 715 and various subsequent rulings) specifically permit fair market value residual purchase options except in the case of limited use property.\(^\text{185}\)

In Rev. Rul. 82-144,\(^\text{186}\) the IRS addressed the question of whether an investor would be treated as the tax owner of tax-exempt bonds when the bonds were subject to a put option. The IRS applied an economic benefits and burdens of ownership standard and held that the investor was in fact the tax owner of the bonds. In reaching this result, the IRS cited the following factors: (i) the right of the investor to dispose of the obligations and to participate in the full benefit of appreciation and the value of the obligations; (ii) the bearing of any risk of loss; (iii) the arm's length price paid for the put option independent of the purchase of the obligation; (iv) the fact that the primary purpose of the put options was to increase liquidity rather than to shift the risk of loss; (v) the shift of the risk of loss for a definite period that was substantially less than the life of the obligations; (vi) the non-assignability of the put options; (vii) the absence


\(^{180}\) 58 T.C. 836, 848 (1972).

\(^{181}\) 1500 F.2d 1222 (9th Cir. 1974), 111.

\(^{182}\) 42 T.C.M. (CCH) 909 (1982).

\(^{183}\) 36 T.C.M. (CCH) 384, 389 (1977).


\(^{186}\) 1982-2 C.B. 34.
of any resale restrictions; and (viii) the absence of call options. Since 1983, the IRS has adopted a no-ruling position on the issue of tax ownership in cases involving put options.\(^{187}\)

There have been several cases in the leasing area that involved both put and call options. In these cases, courts have undertaken an analysis of the likelihood that either option will be exercised prior to the return of the leased property.\(^{188}\) If the put and call options are exercisable at the same time and at the same price, the courts generally have characterized the transaction as a conditional sale, or, in the case of a sale/leaseback transaction, as a loan by the lessor. Different results have been reached in cases involving put and call options that are exercisable at different times or upon substantially different prices or conditions.

In Rev. Rul. 72-543,\(^{189}\) the IRS concluded that put and call options that were exercisable at the same time and at the same price were evidence of an intent to sell the leased property, and, therefore, mandated conditional sale treatment. In effect, the lessee is seen to have all the benefits and burdens of ownership under such circumstances.\(^{190}\)

In *Kwiat v. Commissioner*,\(^{191}\) the Tax Court considered another transaction involving both put and call options. In this case, the IRS argued that the benefits and burdens of ownership of leased property resided with the lessee because there was only "a remote possibility" that both the put and call options would not be exercised when the transaction was closed. The court commented:

> Only a strained exercise of imagination can conceive of a situation where, from the perspective in 1980, neither the [put] nor the [call] would be exercised, (or some economically equivalent substitute agreed to) and the benefits or burdens of ownership would fall upon petitioners. Such situation would come about only if the value of the pallet racking from Oct. 13, 1985, to Dec. 31, 1986, remained above $238,910 and if such value thereafter fell sharply, remaining below $159,452, from Nov. 13, 1987 to Dec. 31, 1987. While such a scenario seems far from impossible, it also seems highly unlikely.

*Id.* at 333 n.5.

The U.S. District Court for the Northern District of Ohio recently addressed the impact of a purchase option on tax ownership in a sale-in-, lease-out, or "SILO" transaction in *AWG Leasing Trust v. United States*.\(^{192}\) The *AWG* case involved the sale and leaseback of a waste-to-energy disposal and treatment plant located in Wuppertal, Germany and owned by a German corporation known as AWG. KSP Investments, Inc., a wholly owned subsidiary of KeyCorp, and PNC Capital Leasing LLC, a wholly owned subsidiary of PNC Financial Services Group,


\(^{188}\) See e.g., *Schaefer v. Commissioner*, 41 T.C.M. (CCH) 100 (1980); *Kinzler v. Commissioner*, 21 T.C.M. (CCH) 341 (1962).

\(^{189}\) 1972-2 C.B. 87.


\(^{191}\) 64 T.C.M. (CCH) 327 (1992).

Inc., formed an entity known as AWG Leasing Trust (the “Trust”) for the purpose of participating in the transaction. Each of the subsidiaries owned a 50% interest in the Trust and the Trust was treated as a partnership for federal income tax purposes.

The Trust paid approximately $423,000,000 under a “head lease” to lease the facility from AWG. This “head lease” was treated as a sale for U.S. federal income tax purposes. AWG then subleased the facility back from the Trust. AWG also was granted an option, exercisable in 2024, to repurchase the balance of the Trust head lease. Of the $423,000,000 payment, all except $28.6 million (an amount determined by the court to be AWG’s “fee” for participating in the transaction) was deposited in escrow to guaranty the obligations of AWG under the sublease and to fund the exercise of the 2024 purchase option.

Under the terms of the transaction documents, if AWG decided not to exercise the Purchase Option, AWG was required to enter into a “service contract” with the Trust in 2024. As a condition to electing the service contract option, instead of the purchase option, however, AWG was required to arrange nonrecourse financing for the Trust. Unless such nonrecourse financing was obtained, AWG was required to exercise the purchase option.

The Trust contributed approximately $55.1 million in cash of the initial $423,000,000 head lease payment and borrowed the remainder from two German banks. AWG retained $28.6 million of the $55.1 million cash head lease payment for itself; the remaining $26.5 million was paid to AIG as a “payment undertaking agreement fee.” Over the 24-year sublease term, the $26.5 million fee to AIG in effect functioned as an investment that would grow to an amount sufficient to permit AWG to repurchase the plant in 2024 if it chose to exercise the purchase option.

AWG also was required to deposit the $368,000,000 obtained from the bank loans into two “payment undertaking accounts”. These accounts acted as “defeasance” accounts created to pay AWG’s obligations under the sublease and to apply such payments to the Trust’s debt incurred in connection with the transaction. The rent payments under the leaseback exactly matched, both in amount and timing, the principal and interest payments due with respect to the Trust’s nonrecourse loans from the German banks.

Under German tax law, the transaction was not treated as a sale of an ownership interest in the facility. In fact, for German tax purposes, AWG was permitted to take depreciation deductions with respect to the facility.

Initially, the court focused on whether the transaction had any genuine economic effect “other than the creation of tax benefits” and, if it did, whether the taxpayers were “truly motivated” to participate in the transaction in order to obtain a pre-tax profit. Noting that, if the purchase option was exercised in 2024, the taxpayers would enjoy an IRR of approximately 3.5%, the court concluded that the transaction “had some practicable economic effects other than the creation of income tax losses.” With respect to the question of whether the taxpayers engaged in the transaction for the primary purpose of making a profit, the court concluded that even a small chance of making a large profit could support a profit motive, and, therefore, that
this test was satisfied, citing Bryant v. Commissioner. In short, the court concluded that the
transaction could not be dismissed as a “complete economic sham.”

Notwithstanding its conclusion that the transaction had some economic substance, the
court then went on to conclude that the Trust never acquired ownership of the facility and that
the form of the transaction did not comport with its “true nature” as a tax avoidance financing
scheme. Citing Frank Lyon, the Court concluded that the taxpayers needed to demonstrate that
they had obtained “significant and genuine” characteristics of ownership with respect to the
facility. That would be the case only if they bore both the burdens and enjoyed the benefits of
ownership.

In the case of the transaction, the Court concluded that virtually every right and
obligation of the Trust under the terms of the head lease was contemporaneously returned to
AWG as a result of the leaseback. The court noted that the Trust did not take legal title to the
facility and was permitted to inspect the facility on only one calendar day during each year.
Under the terms of the transaction documents, moreover, AWG was required to maintain the
facility and to make capital improvements to the facility at its own expense. The Court also
noted that AWG did not treat the transaction as a “sale” for financial reporting purposes and
continued to record the facility as an asset on its balance sheet.

Since AWG retained legal title to the facility, possessed the facility, maintained the
facility, was required to pay all taxes and costs with respect to the facility, operated the facility,
improved the facility, was responsible for maintaining insurance coverage and for the payment of
any property damage, and maintained environmental liability insurance, the court concluded that
the “substantive benefits and burdens traditionally associated with asset ownership” were not
transferred from AWG to the Trust during the initial leaseback period to 2024.

The court also cited a number of other anomalies in the transaction to bolster its
conclusion. For example, it noted that the only money that was ever actually exchanged was the
$28.5 million received by AWG at the closing as its “fee” for participating in the transaction.
The rent and debt payments throughout the term of the initial leaseback were identical both in
timing and amount. The court concluded that these “perfectly offsetting, circular payments from
and then back to the German banks strongly indicate that the transaction had little substantive
business purpose other than generating tax benefits.”

The court also concluded that the taxpayers were effectively insulated from any possible
risk of financial loss as a result of the way in which the transaction was structured. AWG’s rent
payments were guaranteed by the German banks through the creation of the debt “payment
undertaking accounts.” The taxpayers also were able to avoid any residual value risk. When
AWG exercised the fixed purchase option in 2024 – an event that the court considered a practical
certainty - AWG would reacquire ownership of the facility and, therefore, the taxpayers really
were assuming no residual risk. The court also concluded that “it is highly likely that AWG will
exercise the fixed purchase option in 2024.” Although the taxpayers argued that AWG might in
fact choose to exercise the service contract option rather than the purchase option, the court
focused on the “realities and substance” of the transaction rather than on what it considered to be

193 928F 2d, 745 (6th Cir. 1991).
a mere theoretical possibility that the service contract option would in fact be exercised, concluding that it would not be "economically feasible" for AWG to exercise the service contract option because it would be unable to obtain the nonrecourse financing that was a precondition to the exercise of such option. Accordingly, the court concluded that AWG would be compelled to exercise the fixed purchase option and that the parties knew this at the time they entered into the transaction. Since the taxpayers never became the true owners of the facility, they were not entitled to take cost recovery deductions with respect to the facility. The court also held that the loans incurred by the Trust to fund the head lease payment should not be treated as genuine debt for federal income tax purposes. As a result, the taxpayers were not entitled to any interest deductions with respect to such loans.

There is authority outside the leasing area for respecting the form of reciprocal put and call options. In *Penn-Dixie Steel Corp. v. Commissioner*, the Tax Court considered a transaction involving the stock of a corporation formed by two investors in 1968. At the time of the formation of the corporation, Union Tank Car Co., one of the investors ("Union"), contributed the assets and liabilities of an operating business to the corporation in exchange for a debenture and 50% of the stock of the corporation. Continental Steel Corp., the other investor ("Continental"), contributed cash to the corporation in exchange for the other 50% of the stock. The taxpayer succeeded to the interests of Continental. During the period August 1, 1970 to July 31, 1971, Continental could have been required by Union to purchase Union’s stock in the corporation for $8.5 million, together with 125% of 50% of the corporation’s undistributed profits. Continental could have exercised a call option on the stock upon the same terms during the year beginning on August 1, 1971 and ending on July 31, 1972. Union exercised the put option, effective on July 31, 1971. In order to obtain an interest deduction, the taxpayer took the position that the original put and call agreement should be characterized as a deferred payment obligation with respect to Union’s contribution of assets to the corporation in 1968, thus converting that transaction into a sale.

The Tax Court in *Penn-Dixie Steel Corp.* rejected the recharacterization of the transaction by the taxpayer, stating that it was not “convinced that there was sufficient certainty that the put and call would be exercised.” The court stated:

We consider it more than a remote possibility that Phoenix might so prosper in the first three years that Union would forego the exercise of its put and that the economic outlook for the steel industry could then change sufficiently in the following year to lead Continental to decide not to exercise its call. Alternatively, changes in Continental’s own situation might well lead to a change in its position with respect to its call.

*Id.* at 844.

Reference also should be made to *Santa Monica Pictures, LLC v. Commissioner*. The transaction that was the subject of this decision involved the contribution of certain receivables to an LLC taxable as a partnership known as SMP in connection with the acquisition of certain

195 T.C. Memo 2005-104.
assets of MGM Group Holdings by Rockport Capital. Rockport contributed $20 million to SMP, and Generale Bank contributed a $974 million receivable from MGM’s parent company, and Credit Lyonnaise (together with Generale Bank, the “Lenders”) contributed a $79 million receivable from MGM and some MGM stock. The assets contributed by the Lenders had very little value, but had a combined tax basis of about $1.7 million. In addition, the Lenders had put rights with respect to their interests in SMP. Three weeks after the closing of the transactions, the Lenders exercised the put rights, putting their preferred interests in SMP to Rockport Capital. The subsequent disposition of the receivables by SMP triggered significant capital losses. Pursuant to the provisions of the Treasury Regulations under Section 704(b) of the Code, these losses passed through to Rockport Capital.

After an extensive factual analysis, the Tax Court concluded that the sole purpose of the transaction was to transfer the tax benefits associated with the high basis assets to the Ackerman group. In so concluding, the opinion cited both the lack of a subjective business purpose and the lack of objective economic substance to the transaction. It rejected the claimed business purposes of Rockport (the intent to join with the Lenders in a film distribution business) as self-serving and unsupported by contemporaneous expressions of purpose. The Tax Court also concluded that the Lenders were not looking to engage in a partnership with Rockport to develop film assets. Instead, they intended to dispose of the assets as quickly as they could.

Under the objective economic substance prong, the Tax Court concluded that SMP offered no realistic economic benefits to the partners other than tax consequences. The economic reality of the transaction was, in the view of the court, more akin to a sale of the assets. In addition, the Tax Court found a prearranged understanding that the Lenders would exercise their put rights as soon as possible under the side agreement. Applying both the step transaction doctrine and the sham transaction doctrine, the court disregarded the formation of the partnership.

5.2 Application to Example

Assume that, under the terms of the SCP Option Agreement in the example, beginning on and after the last day of the sixty-first full calendar month following the date on which the entire Project is placed in service, the SCP General Partner has the right, through the call option, to purchase the interest of the State Investor for a price equal to the greater of (i) the fair market value of such interest or (ii) the exit taxes payable by the State Investor as a result of the sale of the interest on a grossed-up basis.

The call price if the call option is exercised will not be less than the fair market value of the State Investor’s interest in the SCP. Although such interest does not entitle the State Investor to substantial amounts of cash flow from the operations of the Project once the state historic tax credits have been allocated and applied, the SCP’s share of residual proceeds from a capital event to which the State Investor is entitled and the requirement that liquidation proceeds be distributed in accordance with the positive capital account balances of the partners, coupled with the likelihood that the State Investor’s capital account will be disproportionately large when compared to its interest in profits and losses, adds value to the State Investor’s interest, even when lack of control, illiquidity, and the inability to force a liquidation are considered. Moreover, if the State Investor’s interest is purchased at a substantial loss, the likelihood of a
mandatory downward basis adjustment in the SCP’s property as a result of the application of the provisions of Section 743 of the Code or from the termination of the SCP under Section 708 of the Code if the SCP General Partner is the purchaser, makes the exercise of the call option less likely.\(^{196}\)

Unlike many of the cases cited above, there is no reciprocal option arrangement in the transaction described in the example. The sole option holder is the SCP General Partner. Thus, unlike the circumstances discussed in *Kwiat*, there is no collar on the upside of the State Investor nor any set option price to establish a floor on the downside risk. Further, if a sale of the Project is imminent, or if another capital event involving the Owner is under consideration at the time when the call option is exercisable, the fair market value of the State Investor’s interest would increase and would be reflected in the call price if the call option were exercised. Likewise, if there is a diminution in the value of the State Investor’s interest, the call price will be reduced.

Although, in the transaction described in the example, the likelihood of the exercise of the call option may be high, it cannot be said that such exercise is a “virtual certainty” or a “foregone conclusion”. At the outset, the amount of the call price cannot be calculated because it must equal the fair market value of the interest at the time the call option is exercised, which is more than 5 years from the date of the investment. This assumes, of course, that there is no prearrangement to exercise the call option (as the IRS argued was the case in the *Virginia Historic Tax Credit Funds* transaction).

6. **Partnership Allocation Rules**

6.1 **General**

If a state tax credit is treated as a federal tax item, the allocation of such credit by a partnership to its partners would be governed by the provisions of Sections 701, 702 and 704(b) of the Code and the treasury regulations thereunder. Section 701 of the Code generally provides that a partnership does not pay tax on its income; instead, Section 702 of the Code provides that each partner must report on its own return its distributive share of the partnership’s items of income, gain, loss, deduction and credit. The allocation of such tax items by the partnership to its partners generally will be respected for federal income tax purposes if the allocation has “substantial economic effect” under Section 704(b) of the Code.

Section 704(b) of the Code provides that, for federal income tax purposes, the allocation of partnership income, gains, losses and deductions among the partners will be controlled by the partnership agreement so long as the allocation has substantial economic effect. If the partnership agreement is silent or provides for an allocation that does not have substantial economic effect, a partner’s share of partnership items will be determined in accordance with such partner’s interest in the partnership, determined by taking into account all of the facts and circumstances.

Pursuant to the treasury regulations issued under Section 704(b) of the Code an allocation of partnership income, gain, loss or deduction to a partner will be considered to have “substantial economic effect” if

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\(^{196}\) See Section 4.3.3, Mandatory Downward Basis Adjustment.
An allocation of partnership items among the partners will be considered to have "economic effect" if (i) the partnership properly maintains capital accounts for the partners and such allocation is reflected through an appropriate increase or decrease in such capital accounts, (ii) liquidating distributions are required to be made in accordance with the partners' respective positive capital account balances as determined by taking into account all capital adjustments for the partnership taxable year during which such liquidation occurs, by the end of such taxable year (or, if later, within ninety (90) days after the date of such liquidation), and (iii) any partner with a deficit in its capital account following the liquidation of its interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs, is unconditionally required to restore the amount of such deficit by contributing such amount to the capital of the partnership by the end of such taxable year (or, if later, within ninety (90) days after the date of such liquidation), which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances (clauses (i), (ii) and (iii) above constituting the "economic effect test"). 197

If the first two requirements for economic effect (proper maintenance of capital accounts and the distribution of proceeds of liquidation in accordance with capital accounts) are met but, in lieu of obligating a partner to restore the full amount of any deficit balance in its capital account upon liquidation, the partnership agreement contains a "qualified income offset" provision, then an allocation nevertheless will be considered to have "economic effect" to the extent that such allocation does not cause or increase a deficit balance in such partner's capital account (determined after reducing that account for certain "expected" adjustments, allocations, and distributions specified in the regulations) beyond the amount such partner is obligated to restore. 198 For this purpose, a partner is deemed to be obligated to restore a deficit balance in its capital account to the extent of its share of "partnership minimum gain" as defined in Section 1.704-2(d)(1) of the treasury regulations. Partnership minimum gain is the amount by which the nonrecourse liabilities of a partnership exceed the book value (generally, the adjusted tax basis) of the properties securing such liabilities. Such excess represents the minimum amount of gain that the partnership would realize on account of the relief from such nonrecourse liabilities in the event of a sale or other disposition of such properties, including a foreclosure. In addition, even if an allocation does not satisfy the primary or alternate tests for economic effect, an allocation nevertheless may be deemed to have economic effect if a liquidation of the partnership as of the end of each partnership taxable year will produce the same economic results to the partners as would occur if such requirements were satisfied. 199

A partner's share of partnership minimum gain for a fiscal year generally is increased by the sum of (i) "nonrecourse deductions" as defined in Section 1.704-2(b)(1) of the treasury

regulations allocated to it and (ii) proceeds of a nonrecourse liability distributed to it during such fiscal year. Nonrecourse deductions are deductions attributable to nonrecourse liabilities of the partnership and generally are measured for any fiscal year as any net increase in partnership minimum gain for such year in excess of any proceeds of a nonrecourse liability distributed during such year. Nonrecourse deductions consist first of depreciation or cost recovery deductions with respect to partnership property subject to one or more partnership nonrecourse liabilities and then, if necessary, a pro rata portion of the partnership's other deductions, losses and items described in Section 705(a)(2)(B) of the Code.\(^{200}\) A partner's share of partnership minimum gain for a fiscal year generally is reduced by its share (based on the ratio that its share of partnership minimum gain at the end of the preceding fiscal year bears to the partnership minimum gain at the end of the preceding fiscal year) of any net decrease in partnership minimum gain during such fiscal year.

Allocations of nonrecourse deductions cannot have substantial economic effect because, in the event that there is an economic burden that corresponds to such an allocation, that burden is borne by the creditor, and not by any partner.\(^{201}\) Consequently, nonrecourse deductions must be allocated in accordance with the partners' interests in the partnership. An allocation of nonrecourse deductions is deemed to be in accordance with the partners' interests in the partnership if throughout the term of the partnership (i) the first two requirements for economic effect are satisfied (see above); (ii) beginning in the first taxable year in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, the partnership agreement provides for allocations of nonrecourse deductions among the partners in a manner that is reasonably consistent with allocations of some other significant partnership item attributable to the property securing nonrecourse liabilities of the partnership; (iii) beginning in the first taxable year in which the partnership has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain, and thereafter throughout the full term of the partnership the partnership agreement contains a "minimum gain chargeback" provision; and (iv) all other material allocations are recognized under the regulations. A partnership agreement contains a "minimum gain chargeback" if it provides that a partner will be allocated items of gain or income in an amount equal to the greater of (i) any deficit balance in the partner's capital account which it does not have an obligation to restore (resulting, for example, from a decrease in such partner's share of partnership minimum gain through principal payments on nonrecourse borrowings) and (ii) the portion of such partner's share of any net decrease in partnership minimum gain that is allocable to the disposition of property subject to a nonrecourse liability (whether or not such portion exceeds any deficit in such partner's capital account). When partnership property is subject to more than one liability of unequal priority, minimum gain is determined by allocating the adjusted basis of such property to the liabilities in the order of their priority. In general, conversion of nonrecourse debt to recourse or partner nonrecourse debt will trigger the minimum gain chargeback. Triggering a minimum gain chargeback would, in turn, reduce any deficit in a partner's capital account and accelerate the recognition of income that, but for the minimum gain chargeback, would have been deferred until a sale of the partnership's property.

\(^{200}\) See Treas. Reg. § 1.704-2(c).

\(^{201}\) See Treas. Reg. § 1.704-2(b)(1).
An allocation has economic effect that is substantial under Section 1.704-1(b)(2)(iii) of the treasury regulations if the allocation (i) does not shift tax consequences among partners within a single year, (ii) is not transitory, and (iii) passes an “overall substantiality” test. The overall substantiality test is met if, at the time the allocation is agreed to, there is a strong likelihood that at least one partner will, on a present value basis, suffer a substantial after-tax economic detriment from the allocation, compared to what that partner’s economic consequences would be if the allocation were not contained in the partnership agreement.

6.2 Allocation of Credits

According to Section 1.704-1(b)(4)(ii) of the treasury regulations, allocations of tax credits and tax credit recapture cannot have economic effect because such allocations do not affect a partner’s capital account. Consequently, such allocations will be respected only if they are in accordance with a partner’s interest in the partnership at the time the tax credits or tax credit recapture arises.

In the case of federal low-income housing tax credits and other tax credits that are not attributable to “section 38 property”, the regulations provide that if a partnership expenditure that gives rise to a tax credit also gives rise to valid allocations of partnership loss or deductions (or other downward adjustments to capital accounts), the partners’ interests in the partnership with respect to the credit shall be in the same proportion as the partners’ distributive shares of such loss or deduction. Although the regulations provide no specific guidance on the issue, because the expenditures that give rise to the federal low-income housing tax credit are capital expenditures that also give rise to depreciation deductions, it generally is assumed that federal low-income housing tax credits will be allocated among the partners of a partnership that owns a qualified low-income housing project in the same manner as the depreciation deductions attributable to the project are allocated.

On the other hand, Section 1.46-3(f)(2)(i) of the treasury regulations provides that each partner’s share of the partnership’s “section 38 property” (which includes property eligible for the federal historic rehabilitation tax credit) is determined in accordance with the ratio in which the partners divide the general profits of the partnership pursuant to Section 702(a)(8) of the Code (formerly Section 702(a)(9)), regardless of whether the partnership generates profits or losses during the taxable year in which the investment tax credit property is placed in service. Where the ratio in which the partners divide the general profits of the partnership changes during the taxable year of the partnership, the ratio effective for the date on which the property is placed in service shall apply. When a partner intends to make a qualified progress expenditure election, such partner’s share of qualified progress expenditures will be determined in the same manner as provided in Section 1.46-3(f)(2)(i) of the treasury regulations, except that if the ratio in which general profits are allocated changes during the taxable year, the ratio effective on the date on which the qualified progress expenditures are paid or chargeable to capital account (as applicable) applies.\(^{202}\) General profits represent the taxable income of the partnership, excluding any items subject to a special allocation (described in Sections 702(a)(1) through 702(a)(7) of the Code) under the partnership agreement that differs from the general allocation of partnership

\(^{202}\) See Treas. Regs. Section 1.46-5(p)(2).
taxable income. Excluded from general profits are gains and losses from sales or exchanges of capital assets or property described in Section 1231 of the Code (relating to certain property used in a trade or business and involuntary conversions). Section 1.704-1(b)(4)(ii) of the treasury regulations states that allocations in accordance with the provisions of Section 1.46-3(f) of the regulations are deemed to be made in accordance with the partners’ interests in the partnership.

In a typical state tax credit transaction in which the state credit investor is allocated 100% of the state credits but only a small percentage of federal tax items, the state investor will have a disproportionately large capital account. The partnership or LLC operating agreement almost always will contain provisions designed to comply with the applicable provisions of the treasury regulations. That is, capital accounts will be properly maintained, liquidating distributions will be made in accordance with the adjusted capital accounts of the partners, and qualified income offset and minimum gain chargeback provisions will be included. Because of the state investor’s disproportionately large capital account, depreciation and other losses may have to be allocated to the state investor if the capital accounts of the other partners or members have been reduced to zero and the partnership is not generating partnership minimum gain. This is not merely a hypothetical issue. It has arisen in a number of transactions in which our office has been involved and is particularly problematic if the underlying project is generating federal low-income housing tax credits (which must be allocated in accordance with the partners’ allocable shares of depreciation deductions). Moreover, the state investor’s large capital account (and corresponding share of liquidation proceeds) may have real value in many cases.

The issue becomes whether the rules discussed above relating to the allocation of federal tax credits also apply to the allocation of state tax credits. Such an interpretation clearly would subvert the intent of many state lawmakers who have specifically (and unequivocally) authorized state credits to be allocated in a manner that is different from the allocation of federal tax items. Assuming that the partnership or operating agreement relating to a state credit investment otherwise complies with the treasury regulations, one approach would be that a state credit is a special form of tax item that does not have to be allocated in the same manner as a federal credit (even one based on the same expenses).

\[\text{Under Treas. Reg. § 1.46-3(f)(a)(ii), a federal investment tax credit (such as the historic rehabilitation credit) may be specially allocated only if “all related items of income, gain, loss, and deduction with respect to [the rehabilitated property] are specially allocated in the same manner” and the general allocation rules of Section 704(b) of the Code are satisfied.}\]

\[\text{See Sections 702(a)(1), (2), and (3) of the Code.}\]

\[\text{For example, a recent amendment to the California state low-income housing tax credit program explicitly provides that California low-income housing credits may be allocated by a partnership in the manner provided in the partnership agreement without regard to the technical rules of Section 704(b) of the Code. See S.B. 585, Ch. 382, Statutes of 2008, which provides, in relevant part:}\]

“For a project that receives a preliminary reservation of the state low-income housing tax credit, allowed pursuant to [Cal. Rev. & Tax. Code section 12206(a)] on or after January 1, 2009, and before January 1, 2016, the credit shall be allocated to the partners of a partnership owning the project in accordance with the partnership agreement, regardless of how the federal low-income housing tax credit with respect to the project is allocated to the partners, or whether the allocation of the credit under the terms of the agreement has substantial economic effect, within the meaning of Section 704(b) of the Internal Revenue Code.”
If the Section 704(b) rules relating to the allocation of federal tax credits are applied to
determine the validity of the allocation of state tax credits, the clear intent of many state tax
credit programs will be frustrated.\footnote{206} A number of states other than California, including
Missouri, Massachusetts, Hawaii, and Virginia, specifically permit state tax credits to be
allocated in a different manner than federal tax items.\footnote{207} This raises the interesting possibility
that an allocation would be valid for state tax purposes but invalid for federal purposes.

As discussed earlier, in most syndicated state tax transactions, the investor is primarily
interested in receiving the benefit of the state tax credits; any federal tax benefit, such as a
Section 164 deduction for state taxes paid or a capital loss on the liquidation or sale of the
investor’s interest, is incidental to the reduction in state tax afforded by the credits. It is not clear
how a finding that an allocation of state tax credits lacks substantial economic effect for federal
purposes would adversely affect the state credit investor, particularly if the state statute explicitly
provides that state credits may be allocated in a manner that differs from the allocation of federal
credits.

\footnote{206} Section 4 of S.B. 585 referred to above states:

“The state low-income housing credit is a unique tax credit program in that the credit is based on a federal
income tax credit, and that federal income tax credit is allocated by the California Tax Credit Allocation
Committee, a state agency. Increasing the availability of low-income housing serves an important public
interest. As a result, the state low-income housing credit, under existing law, has several unique aspects not
applicable to other tax credits. The Legislature hereby finds and declares that, in order to enhance the
availability of low-income housing, provisions of this act that provide for an allocation of the state low-income
housing credit in accordance with a partnership agreement that fails to comport with normally applicable rules
serve an important public interest with respect to this unique state tax credit.” (Emphasis added)

Interestingly, the California Franchise Tax Board opposed the amendment contained in S.B. 585, expressing a
concern that the provision could lead to allocations for tax purposes, using the following example: Investors
would be able to “buy” rights to low-income housing credits through the purchase of a partnership interest.
When all of the credits, which could exceed the cost of investment, have been used, the investor could walk
away from the partnership with a partnership loss to apply against other income. As a result, the investor would
benefit twice from the arrangement: first, by use of the credit; second, by the partnership loss (on sale,
abandonment, or other disposition of the partnership interest). \textit{See} FTB, “Summary Analysis of Amended Bill,
S.B. 585, Amended Date: Aug. 8, 2008, Subject: Low-Income Housing Tax Credit Allocation,” page 4, “Policy
Concern.” \textit{See}, also, Sheldon I. Banoff and Richard M. Lipton, “Allocation of California Housing Tax Credits:
Please Ignore 704(b)!” Journal of Taxation, Volume 109, Number 06, December 2008.

\footnote{207} See, for example, Virginia Code §58.1-339.2, which provides, in part:

“Credits granted to a partnership ... shall be allocated among all partners ... either in proportion to their
ownership interest in such entity or as the partners ... mutually agree as provided in an executed document, the
form of which shall be prescribed by the Director of the Department of Historic Resources.” Similarly, Hawaii
Revised Statutes §2.35 - 2.45(d) provides: “Section 704 of the Internal Revenue Code (with respect to a
partner’s distributive share) shall be operative for purposes of this chapter; except that section 704(b)(2) shall
not apply to: (1) Allocations of the high technology business investment tax credit allowed by section 235-
110.9; (2) Allocations of net operating loss pursuant to section 235-111.5; (3) Allocations of the attractions and
educational facilities tax credit allowed by section 235-110.46; or (4) allocations of low-income housing tax
credits among partners under section 235-110.8.” \textit{See}, also, Missouri Private Letter Ruling No. L8659,
12/22/95, which indicated that Mo. Rev. Stat. §135.352.5, as amended in 1994, allowed a partnership to allocate
100% of the credit to one partner even if the allocation was disproportionate to that partner’s interest in the
partnership.
7. **Characterization of Gain**

If a state tax credit is treated as "property" for federal income tax purposes (either because it is a transferable credit that has been sold or because a purported allocation of such credit has been recharacterized as a sale), a further question exists as to whether the credit is a capital asset. If state tax credits are deemed to be capital assets, they must be held for more than one year in order to qualify for favorable long-term capital gains rates. Because of the significant gap between tax rates applicable to long-item capital gain and ordinary income realized by taxpayers who are individuals, the resolution of this issue will have a substantial impact on individual taxpayers to whom state tax credits are allocated who later sell such credits. The issue will be of less importance to corporate taxpayers, who are subject to the same rate on capital gains and ordinary income.\(^{208}\) Section 1222 of the Code provides that capital gain will be realized by a taxpayer on the sale or exchange of a capital asset. Section 1221(a) of the Code defines the term "capital asset" as property held by the taxpayer (whether or not connected with a trade or business) other than property that falls within eight specified categories. The regulations state: "The term 'capital assets' includes all classes of property not specifically excluded by Section 1221."\(^{209}\)

Notwithstanding the expansive definition of capital asset contained in the Code and regulations, the U.S. Supreme Court has held that some categories of property that do not fall within one of the eight enumerated exceptions to capital asset status set forth in Section 1221 of the Code may nonetheless be excluded from capital asset status. The Court stated: "It is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset; rather, the term capital asset is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year."\(^{210}\)

In the *Virginia Historic Tax Credit Funds* case, the IRS argued that the state tax credits constituted "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" within the meaning of section 1221(a) of the Code. In the view of the IRS, the Funds were organized primarily (if not solely) to sell the state tax credits to investors, and the state tax credits in effect constituted "inventory" within the meaning of the foregoing exception. As a result, any gain (or loss) on the sale of the state tax credits was ordinary.\(^{211}\)

Alternatively, the IRS argued that even if the court determined that the state tax credits were allocated by the developer partnerships to the Funds as partners and were not purchased by the Funds, the "sale" of such state tax credits to the investors still would generate ordinary income. The rationale of the IRS was that the credits still would not have constituted capital assets in the hands of the developer partnerships that originally qualified for them, citing *United

\(^{208}\) However, capital gain characterization still may be important to a corporation that has substantial capital losses.
\(^{209}\) See Treas. Reg. §1.1221-1(a).
\(^{211}\) See Opening Brief for Respondent, p. 235.
States v. Maginnis\(^{212}\) (the right to a lottery annuity is not a capital asset in the hands of the original lottery winner) and Commissioner v. Gillette Motor Transport Inc.\(^{213}\). This argument seems questionable at best. By definition, if the credits were properly allocated to the Funds, they must have constituted tax items and therefore were not “property” of any category in the hands of the developer partnerships.

Finally, the IRS argued that, even if the state tax credits somehow were characterized as capital assets, they were not held for more than one year and therefore would have generated short-term capital gain taxed at ordinary income rates.

The categorization of state tax credits as “inventory” seems to be a stretch. On the other hand, the Supreme Court’s more restrictive view of what constitutes a capital asset leaves open the possibility that the sale of state tax credits would generate ordinary income rather than capital gain.\(^{214}\)

Interestingly, in ITA 200211042 discussed in Section 2.1 above, the IRS, after balancing all of the factors it deemed to be relevant, concluded that the Missouri remediation credits that were the subject of that ruling did not constitute “property” for purposes of Section 1221 of the Code. As a result, any gain from the sale of such credits was determined to be ordinary income rather than capital gain. It is not clear how that conclusion can be reconciled with later rulings issued by the IRS and the positions asserted by the IRS in the Virginia Historic Tax Credit Funds case.

8. Section 701 Regulations

8.1 Relevant Authority

The partnership anti-abuse regulations promulgated under Section 701 of the Code (the “Anti-Abuse Regulations”) provide that if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners’ aggregate tax liability in a manner that is inconsistent with the intent of Subchapter K, the IRS can recast the transaction for federal income tax purposes so as to achieve tax results that are consistent with the intent of Subchapter K, taking into account the applicable statutory and regulatory provisions and the pertinent facts and circumstances. The Anti-Abuse Regulations state that:

\[
\text{[E]ven though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on all the particular facts and circumstances, that to achieve tax results that are consistent with Subchapter K} \quad (1) \quad \text{the purported partnership should be disregarded . . .},
\]

\[
(2) \quad \text{one or more of the purported partners of the partnership should not be treated as a partner},
\]

\[
(3) \quad \text{the methods of accounting . . . should be adjusted to clearly reflect . . . income},
\]

\[
(4) \quad \text{the partnership’s items of income, gain,}
\]

\(^{212}\) 356 F. 3d 1179 (9\textsuperscript{th} (in 2004)).

\(^{213}\) 364 U.S. 130, 134 (1960).

loss, deduction, or credit should be reallocated, or (5) the claimed tax treatment should otherwise be adjusted or modified.

The Anti-Abuse Regulations provide that Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. The Anti-Abuse Regulations articulate three requirements that the Treasury Department deems to be necessary in order for a transaction to comport with the intent of Subchapter K: (i) a partnership must be “bona fide” and each partnership transaction or series of related transactions must be entered into for a “substantial business purpose;” (ii) the form of each partnership transaction must be respected under substance over form principles; and (iii) the tax consequences under Subchapter K to each partner of partnership operations and of transactions between the partner and the partnership generally must “accurately reflect the partners’ economic agreement and clearly reflect the partners’ income.”

The “bona fide” requirement of the Anti-Abuse Regulations appears merely to require that the partnership and the transaction be real. The Anti-Abuse Regulations go on to provide that each partnership transaction must be entered into for a “substantial business purpose.”

The “substance over form” requirement articulated in the Anti-Abuse Regulations appears to be a regulatory incorporation of the judicially-developed doctrine of substance over form. This doctrine is well established in judicial decisions over the years.

The third requirement of the intent of Subchapter K test is that the “tax consequences under Subchapter K . . . must accurately reflect the partners’ economic agreement and clearly reflect the partners’ income . . . .” The preamble to the Anti-Abuse Regulations acknowledges that:

[C]ertain provisions of Subchapter K that were adopted to promote administrative convenience or other policy objectives may, under certain circumstances, produce tax results that do not properly reflect income. To reflect the conscious choice in these instances to favor administrative convenience or such other objectives over the accurate measurement of income, the final regulation provides that proper reflection of income will be treated as satisfied with respect to the tax consequences of a partnership transaction that satisfies paragraphs (a)(1) and (2) of the final regulation to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.

8.2 **Application to Facts of the Example**

As discussed above, the Section 701 Anti-Abuse Regulations apply only if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners’ aggregate federal tax liability in a manner that is inconsistent with the intention of Subchapter K. The CCAs did not contain any analysis of how the transactions that were the subject of the CCAs were inconsistent with the intent of Subchapter K (as set forth in Treas. Reg. § 1.701-2(a)). Instead, the IRS simply concluded that the partnerships should be disregarded because, in effect, they were being used to claim a tax
benefit (i.e., losses) that the IRS deemed to be inappropriate. The IRS conclusion was based on the fact that (i) the partnerships were used for the purpose of allocating state tax credits to investors, which also resulted in a substantial reduction in federal income taxes, (ii) by design, the investors in the transactions claimed large capital losses from the sale of their interests, and (iii) the partnerships failed to make elections under Section 754 of the Code and, therefore, had inflated inside bases for their assets. The lack of any critical analysis of why the Section 701 Anti-Abuse Regulations should apply to the facts of the CCAs generated criticism from some commentators.\(^2\)

In the case of the transaction described in the example, the application of the Section 701 Anti-Abuse Regulations appears to be questionable. It is difficult to see how a “principal purpose” of the transaction is to reduce federal income taxes. If the transaction is recharacterized as a sale of state historic tax credits, income would be generated as a result of such sale. However, as discussed in Section 4.3.1 above, if the form of the transaction is respected and the call option is exercised, there would appear to be no overall reduction in the federal tax liabilities of the parties (other than the potential timing differences) for several reasons. In the first place, as discussed in Section 4.4.1, if the SCP General Partner purchases the interest of the State Investor in the SCP, its outside basis for such interest will be the price it pays. If no other partner is admitted to the SCP at that time, the SCP will have only one partner and will terminate for federal income taxes under Section 708(b)(1)(A) of the Code. In such event, the SCP General Partner will take as its basis in the property it receives in liquidation of its interest (i.e., the SCP’s interest in the Owner) an amount equal to its reduced “outside” basis for its interest in the SCP. See Section 732(b) of the Code. Any subsequent distributions received by the SCP General Partner attributable to such interest will be fully taxed. Conversely, if the SCP General Partner causes another person to be admitted to the SCP at the time of the exercise of the option in order to preserve the SCP’s continuing status as a partnership for federal income tax purposes, the SCP almost certainly will have a “substantial built-in loss” in its assets that will mandate a downward “inside” basis adjustment in the SCP’s assets (which at that point will consist of its interest in the Owner). This is in contrast to the situation in the Virginia Historic Tax Credit Funds case, where the lack of a Section 754 election insured that no such downward “inside” basis adjustment would occur. It should be noted that the State Investor may not be able to use a capital loss currently because of a lack of capital gains against which to apply such loss. Furthermore, in the event of a recharacterization of the transaction as a sale, the State Investor presumably would be better off because of the deduction to which it would be entitled for the “purchased” state historic tax credits under Section 164(a) of the Code that would be deductible significantly earlier than any potential loss from the sale of its partnership interest pursuant to the call option. Therefore, from the perspective of the State Investor, a recharacterization presumably would be beneficial rather than detrimental.

Furthermore, although the SCP General Partner may well choose to exercise the call option, it cannot be said that there is an absolute economic compulsion to do so because of the

\(^2\) See, for example, Richard M. Lipton, “IRS Goes ‘Over the Top’ in Attacking State Tax Credit Partnerships,” January-February 2007 Journal of Pass-through Entities. Lipton points out that “the application of the anti-abuse regulations was based on the same reasoning (that there was no partnership in substance) which formed the basis of the IRS’ conclusion that the partnerships should be disregarded under substance-over-form principles. If there were no partnerships, why would the partnership anti-abuse rules apply?”
uncertainty concerning the value of the SCP’s interest in the Owner, the reduced outside basis of the SCP General Partner in the purchased interest (that will result in increased gain or a decreased loss upon a subsequent disposition of such interest), and the potential impact of the mandatory downward basis adjustment required by Section 743 of the Code. See Section 5. If, on the other hand, the SCP General Partner purchases the Interest of the State Investor and does not cause a third party to be admitted to the SCP as a partner, the SCP will have only one partner and will be deemed to terminate for federal income tax purposes under Section 708(b)(1)(A) of the Code. In such event, the assets of the SCP (i.e., the SCP’s interest in the Owner) will be deemed to have been distributed by the SCP to the SCP General Partner in liquidation of its interest. Under the provisions of Section 732(b) of the Code, the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner’s interest shall be an amount equal to the adjusted basis of such partner’s interest in the partnership reduced by any money distributed in the same transaction. Accordingly, the SCP’s basis for the interest in the Owner that has been distributed to it will be reduced to reflect the lower “outside” basis for its interest in the SCP resulting from the purchase of such interest from the State Investor.

9. Conclusion

From a policy perspective, the use of state tax credits to encourage certain investments or activities has been a controversial issue. Many observers believe that direct cash subsidies would be a much more effective tool for such purpose. Nevertheless, state tax credits have been and continue to be a widely used incentive, perhaps, as one commentator has suggested, because state legislatures find it easier to allocate uncollected tax revenues to taxpayers than to pay out money that already has been collected.216 Despite the prevalence of state tax credits, there is remarkably little authority concerning how such credits should be treated for federal income tax purposes. This is particularly true in the case of state credits that may (or must) be allocated rather than sold under state law. The fundamental issue is whether such credits should be treated as tax items or property for federal income tax purposes.

Clearly, many states intend that state credits be treated as tax items that may be allocated to and among the members of a partnership or other passthrough entity. Furthermore, a number of these states explicitly provide that the allocation of state credits does not need to comport with the allocation of federal credits or other federal tax items. This leads to a direct conflict between the federal partnership allocation rules and the state rules. To date, most tax professionals and other industry participants who regularly deal with state credits have adopted what can be viewed as a practical compromise position. As long as the capital account maintenance rules and other applicable provisions of the treasury regulations are satisfied, the position is that state tax credits can be specially allocated to the State Investor(s), notwithstanding the fact that such special allocation might not be respected in the case of a federal credit. This approach seems to provide the best mechanism for balancing the interests of the state and federal governments.

To require the allocation of a state credit to satisfy all of the requirements applicable to the allocation of federal credits would frustrate the goal of the state legislatures that permit and encourage the bifurcation of the credits. Similarly, if all state tax credits (even non-transferable credits) are treated as “property” for federal purposes, it would be impossible to allocate such

216 See Kathleen K. Wright, “Trafficking in State Tax Credits,” State Tax Notes, April 21, 2008.
credits since they would not be tax items. Any purported allocation presumptively would be recharacterized as a distribution and/or constructive sale of property for federal income tax purposes. Since any such sale would generate immediate taxable income (unless the seller is a tax-exempt organization operating within the parameters of its exempt purposes), the dollars available for the project would be substantially diminished, thereby diluting the benefit of the intended state subsidy.

Of course, some of the uncertainty in this area could be avoided by making all state tax credits transferable and building an assumed tax on the gain from the sale of such credits into the budget for the project. Even this approach is not without issues since, as discussed earlier, it is by no means clear whether the sale of state credits will generate capital gain or ordinary income.

The arguments raised by the IRS in the *Virginia Historic Tax Credit Funds* case create even more uncertainty concerning the proper federal income tax treatment of state tax credits and raise a number of questions, including the following:

(i) Is the IRS theory in the *Virginia Historic Tax Credit Funds* case limited to the unique facts of the transactions involved in the case or is it intended to have more general applicability?

(ii) Would the IRS position change if the investor in the SCP had a larger interest in profits and losses or the SCP had a larger interest in the Owner?

(iii) Would it make a difference to the IRS if the state credit investor stayed in the deal longer? If so, how long a holding period is necessary?

(iv) What if any put or call option granted to a state credit investor not exercisable for several years?

(v) Would it matter if the transaction involved one or two large institutional investors who clearly had the sophistication to understand the partner status issues and the bargaining strength to negotiate more favorable terms for the transaction?

(vi) Would it matter if the state credit investor (or investors) are not subject to the alternative minimum tax?

(vii) Do the new mandatory basis adjustment rules set forth in sections 734 and 743 of the Code change the IRS position? If not, why not?

Whatever the outcome in the *Virginia Historic Tax Credit Funds* case, guidance is needed from the IRS on these and other questions relating to the federal income tax treatment of state tax credits, particularly in the context of state programs that require or permit the allocation of state tax credits in a manner that differs from the allocation of federal tax items. A revenue procedure similar to Rev. Proc. 2007-65 (dealing with wind production credits) would be a welcome addition.
Any "member" in any "unincorporated organization through or by means of which ANY business, financial operation or venture is carried on".

Code 6761
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UNITED STATES TAX COURT

VIRGINIA HISTORIC TAX CREDIT FUND 2001 LP, VIRGINIA HISTORIC TAX CREDIT FUND 2001, LLC, TAX MATTERS PARTNER, et al.,

DOCKET NOS. 716-08, 870-08, and 871-08

Petitioners,

JUDGE KROUPA

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

TRIAL MEMORANDUM FOR PETITIONERS

Petitioners offer this Memorandum in hopes of aiding the Court in receiving the evidence. Trial is scheduled to be held before the Honorable Diane L. Kroupa during the Special Session of the Tax Court commencing on April 20, 2009 in Richmond, Virginia.

OVERVIEW

"Doing well by doing good" is how Benjamin Franklin described the relationship between his private life as a printer and his public life as postmaster. That concept captures the Virginia Historic Rehabilitation Tax Credit Program ("Virginia Historic Program") and the extraordinarily principled men and women who take pride in what may be the most effective private sector/public incentive program ever.

The booklet *Prosperity through Preservation* published by the Virginia Department of Historic Resources ("DHR") confirms that this policy-based tax inducement campaign succeeded in:

* Preserving more than 1,200 certified historic structures across Virginia (with more than 500 in the Richmond area, including the Maggie L. Walker High School, the Samuel Pleasants Parsons House, and similar structures rehabilitated by the three individuals who took the initiative of forming these partnerships);
Creating 10,769 new jobs;
* Revitalizing distressed (drug-infested) urban areas;
* Raising property values (and thereby county property tax revenues); and
* Generating $1.31 in increased Virginia income tax revenue for every $1 of Virginia credit. See R. RFA ¶107 and P. Resp. to R. RFA ¶107.

Following the same practical reasoning reflected by Sacks v. Commissioner, 69 F.3d 982, 989 (9th Cir.1995), the Commonwealth of Virginia recognized that it needed to offer substantial economic inducements to encourage Virginians to inject their capital into these otherwise non-economic projects – projects whose construction costs regularly exceed the post-rehabilitation value of the structures. See Stip. ¶¶10, 13-14, 17-19; R. Resp. P. RFA ¶ 90.

The controlling Virginia historic rehabilitation inducement statute plows a practical path:

**STEP 1** Virginia grants developers a State tax credit equal to 25 percent of qualified rehabilitation expenditures.

**STEP 2** The developers can raise capital in two ways: either (i) special allocations of the credits to investor partnerships which contribute capital to the development partnership or (ii) transferring the credits (in exchange for funds) pursuant to the transitional one-time transfer provision. Stip. ¶¶ 28, 31.

**STEP 3** The essential inducement for the downstream investor partnerships is that the credit must exceed the amount the investor partnerships contribute in the first instance or pay in the second instance. Here, the limited partners (and non-managing members in the LLC) shared a net economic inducement of $1 credit for every $75¢ they contributed or paid. See, e.g., Jt. Ex. 37-J.

**STEP 4** That effort, however, would never start unless those who assumed the obligation of funding and organizing the investor partnership stood the (here increasingly dim) prospect of reaping a gain at the end of the day. Setting aside for the moment their policy motivations, the sole economic inducement offered the founding partners arises from the hope that the total contributed by the limited partners will exceed the sum of the debts, plus the amounts contributed to the development entities, plus transfer agreement payments, plus operating costs, plus wind-up costs. Without that inducement, no rational *homo sapien* would ever undertake the administrative agony of organizing an investor partnership with 280 partners.

---

1 For purposes herein, note that any reference to "partner" or "member" may be used interchangeably.
As confirmed by the common component of their names, the Virginia Historic Tax Credit Funds ("Virginia Historic Funds") were formed for two dominant, specific purposes – (i) to contribute to the Virginia Historic Program with all its laudable community revitalization goals (that at least one partner/investor described as the "feel good" motivation), and (ii) to obtain and allocate the pool of Virginia Historic Rehabilitation Tax Credits among their partners pursuant to the partnership credit allocation provisions in VA. CODE § 58.1-339.2. The Commonwealth is thrilled with all that these Virginia Historic Funds have done to promote Virginia's interests. By formal ruling, the Commonwealth recognizes these partnership creatures of State law which allocated the State credit to their partners pursuant to the "partner allocation" provisions that Virginia incorporated into the historic rehabilitation statute to broaden support to partners like these.

For reasons that evade everyone outside the Internal Revenue Service, Respondent cripples the goose that laid the golden egg – that is, this program that, due to rate differentials, generates at least six times the increased Federal income tax revenue as the increased income tax revenue that Virginia reaps. Indeed, Respondent's retroactive reversal renders greater aggregate partner Federal tax refunds than deficiencies. Respondent bottoms that reversal on three FPAA contentions designed to ignore the one immutable reality of this case:

These partners derived their primary benefit based solely on their status as partners under the partnership allocation provisions that deliberately broaden the controlling State historic rehabilitation statute to non-owner partners like these.

As the Supreme Court held in Frank Lyon v. United States, 435 U.S. 561, 584 (1978), "the Government should honor" such relationships "compelled or encouraged by...regulatory [or statutory] realities" – especially here where those realities fulfill badly needed community-economic revitalization policies.
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YEARS, ADJUSTMENTS, AND PENALTIES

On October 11 2007, Respondent issued FPAAs to the following three Virginia Historic Funds:

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<td></td>
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<td>Virginia Fund 2001 SCP LLC</td>
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<tr>
<td></td>
<td>2002</td>
<td>$1,541,370</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td>Virginia Fund 2001 SCP LP</td>
<td>2001</td>
<td>$1,494,000</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2002</td>
<td>$1,494,000</td>
<td>20%</td>
<td></td>
</tr>
</tbody>
</table>

Recognition of the partners as partners eliminates these untimely claims in their entirety.

STIPULATION OF FACTS

The First Stipulation of Facts is being filed Monday, April 6, 2009. Supplemental stipulations may be submitted at the commencement of trial. Please note that the Respondent objects to the paragraphs relating to the Virginia DHR Prosperity through Preservation booklet and the VCU Study that documents the success by the supporters of the Virginia Historic Rehabilitation Program. The Partnerships will address those objections through the witnesses.

PROJECTED TRIAL TIME

The trial should take no more than five days. Provided that all documents are stipulated, Petitioner anticipates calling no more than 15 witnesses. Please note that the Director of the Virginia DHR has offered to provide the Court and Counsel with a tour of the historic projects.

2 Unless indicated otherwise, all section references are to the Internal Revenue Code of 1986 (as amended through December 31, 2001).
QUESTIONS PRESENTED

The facts and law frame these five issues:

1. Where the partners pooled their capital for the primary purpose of participating in the special-purpose, policy-based, capital-intensive, Virginia Historic Rehabilitation Partnerships, may Respondent recharacterize the partners into buyers and their capital into income – much less a 25 percent omission of gross income?

2. Did Respondent properly amputate the most significant word in his Treas. Reg. § 1.701-2(b) quote in an effort to recharacterize the partners into buyers and their capital contributions into income by alleging these State-incentive partnerships were "formed or availed of for the principal purpose of reducing the aggregate [FEDERAL] tax of the partners"?

3. Where the partners contributed their capital to the partnerships for the purpose of sharing the State tax incentives pursuant to the partnership provisions of the Virginia historic rehabilitation statute (VA. CODE § 58.1-339.2), should tax attributes arising by operation of law be recharacterized into "property" somehow sold in exchange for capital contributions recharacterized into gross sales proceeds via a recharacterized "disguised sale" – as opposed to the conspicuous disclosure of the partnership allocation by the Virginia Historic Funds?

4. Under Section 704(b), Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2), and Section 18 of the Limited Partnership Agreement for Virginia Historic Tax Credit Fund 2001 LP, should the partnership losses for 2001 and 2002 be allocated first to those partners with positive capital accounts?

5. Should these 2001 partnerships and their partners be punished for following the only guidance Respondent had provided at the time – guidance the IRS explicitly recognized needed clarification in light of Respondent's failure to ever issue a revenue ruling or regulation relating to the Federal tax treatment of State tax credits?
BURDEN OF PROOF

Respondent bears the burden of proof with respect to these eight-year-old facts on five independent grounds. First and foremost, Respondent bears the burden of proof because his FPAAs are demonstrably excessive, erroneous, unfair, unreasonable, arbitrary, and capricious – as he established during his most recent argument for a continuance.\(^3\) See, e.g., Helvering v. Taylor, 293 U.S. 507, 513-15 (1935); Caracci v. Commissioner, 456 F.3d 444, 457 (5th Cir. 2006); Shea v. Commissioner, 112 T.C. 183, 187 (1999). Those FPAAs reflect the "disturbingly increased frequency" of the IRS claiming "a grossly exaggerated amount" as condemned by the controlling precedent in McCord v. Commissioner, 461 F.3d 614, 625, n.22 (5th Cir. 2006) and Dunn v. Commissioner, 301 F.3d 339 (5th Cir. 2002). Respondent's alteration of Treas. Reg. § 1.701-2(b) and deliberate overstatement of his own credit-sale-gain theory (through the systematic exclusion of the cost component) renders the FPAAs "excessive and erroneous."

Two, an adverse inference arises from Respondent withholding 240 documents. Three, Respondent bears the burden of proving a 25 percent omission of income (and the absence of adequate disclosure) for 2001 under his six-year limitations contention. See, e.g., Hoffman v. Commissioner, 119 T.C. 140, 146-147 (2002) (upon proof that IRS issued the notice beyond normal three-year period, Respondent bears burden of proving limitations exception). Four, Respondent bears the burden of proving omitted income for any year. See, e.g., Portillo v. Commissioner, 932 F.2d 1128, 1134 (5th Cir. 1991) (IRS bears burden of proving unreported income). Five, Section 7491(a) and (c) also shift the burden on the adjustment and the penalties to Respondent. Thus, Respondent bears the burden of proof as to all matters.

\(^3\) During the argument on March 26, 2009, Respondent established that he based his non-partner assertion in the FPAAs (i) on the subjective motives of the partner/investors (ii) without interviewing or contacting a single partner/investor. Instead, he only contacted Mr. Gecker, a principal in the General Partner which Respondent admits is a partner. In short, his investor/partner assertion is baseless – i.e., arbitrary and capricious.
SUMMARY OF FACTS

The General Partner formed and the limited partners joined the policy-based, special-purpose 2001 Virginia Historic Tax Credit Funds for two reasons. One, they wanted to support the goals of the Virginia Historic Program— the responsible citizen "feel good" motivation. And two, these partnerships and their partners hoped to benefit from the economic inducements available through allocating the shared Virginia Historic Tax Credits among the partners under the partnership provisions in the Virginia historic rehabilitation statute, VA. CODE § 58.1-339.2.

A. THE VIRGINIA HISTORIC REHABILITATION PROGRAM – PURPOSE, FUNCTION, AND SUCCESS.

Both the Virginia Legislature and the Virginia Department of Historic Resources (like Congress and the U.S. Department of Interior—National Park Service) encourage Virginians to contribute their capital to this community/economic revitalization program. The controlling Virginia statute first took effect in 1997 and, like the Virginia Historic Funds, improved through the years. That statute encourages those Virginians who are interested in supporting the Program but who do not own historic structures to help fund these projects through one avenue—the explicit partnership provisions in VA. CODE § 58.1-339.2:

A. Effective for taxable years beginning on and after January 1, 1997, any individual, trust or estate, or corporation incurring eligible expenses in the rehabilitation of a certified historic structure shall be entitled to a credit against the tax imposed by Articles 2, in accordance with the following schedule:

<table>
<thead>
<tr>
<th>Year</th>
<th>% of Eligible Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>10%</td>
</tr>
<tr>
<td>1998</td>
<td>15%</td>
</tr>
<tr>
<td>1999</td>
<td>20%</td>
</tr>
<tr>
<td>2000 and thereafter</td>
<td>25%</td>
</tr>
</tbody>
</table>

If the amount of such credit exceeds the taxpayer's tax liability for such taxable year, the amount that exceeds the tax liability may be carried over for credit

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4 R. RFA ¶¶ 213, 217, 221; P Resp. R. RFA ¶¶ 213, 217, 221.
5 R. Resp. P. RFA ¶ 90.
6 Stip. ¶¶ 28-35.
against the taxes of such taxpayer in the next five taxable years or until the full credit is used, whichever occurs first. 

Credits granted to a partnership or electing small business corporation (S corporation) shall be passed through to the partners or shareholders, respectively. Credits granted to a partnership or electing small business corporation (S corporation) shall be allocated among all partners or shareholders, respectively, either in proportion to their ownership interest in such entity or as the partners or shareholders mutually agree as provided in an executed document, the form of which shall be prescribed by the Director of the Department of Historic Resources. (Emphasis added).

At the very time the partners were being encouraged to join the Virginia Historic Funds, the Virginia Department of Historic Resources published a concise description of the program incident to the October 2001 explanation of proposed regulations.

Since the passage of the enabling legislation for the Virginia Historic Rehabilitation Tax Credit program in 1996, the Department of Historic Resources has been operating the program under draft regulations.

The rehabilitation of historic buildings benefits not only individual property owners, developers, and investors, but entire communities. Through the tax credit program, private dollars are invested in preservation, resulting in enormous public advantage. This money represents costs paid into the construction industry to architects, contractors, craftsmen, and suppliers, as well as to professionals in related fields such as banking, legal services, private consulting, and real estate. The capital improvement to the buildings can result in dramatic increases in local property taxes, enhanced commercial activity, and community revitalization. The rehabilitated buildings provide needed housing (in many cases, low- and moderate-income housing), and office, retail, and other commercial space. Communities benefit from property improvement, blight removal, and increased occupancy of buildings in historic core neighborhoods.

Revenue impact and economic implications: The credit claimed by applicants for certified rehabilitations is 25% of eligible rehabilitation expenses. The impact on state revenue is therefore a direct function of how many projects are submitted and approved in a given year. Direct impacts on revenue, however, are more than offset by economic benefits attributable to rehabilitation projects. Because rehabilitation projects tend to be labor-intensive, they generally create more jobs than new construction projects of comparable size. In addition to construction industry jobs, rehabilitation projects create jobs for architects and consultants, and in the financial, legal, and real estate industries. Studies have shown that $1 million spent in rehabilitating old buildings creates 15.6 construction jobs and 14.21 ancillary jobs – 3.4 more jobs than $1 million spent in new construction. Moreover, $1 million spent in rehabilitation adds $779,800 to household incomes – $53,000 more than $1 million spent on new
construction. For projects completed in 2000, $108.3 million in rehabilitation costs were certified. This translates to over 3,200 jobs for Virginians, and $84.5 million in household income. Studies have also shown that rehabilitation projects often result in increased retail and new business activity, that the economic benefits of rehabilitation projects tend to be locally concentrated, and that historic preservation projects can stabilize local economies during economically volatile times. The revitalization of blighted areas can reduce crime and vandalism, and increase the local property tax base. Because rehabilitation tax credits are often combined with low income housing tax credits, they contribute to the preservation and enhancement of the Commonwealth's housing stock – particularly for low- and middle-income citizens. In addition, because the state tax credit can be combined with the federal tax credit, and because the disproportionate allocation provisions of the state credit make it a flexible and useful financing device, out-of-state investors are increasingly seeking opportunities to become involved in Virginia projects. Although these economic benefits are difficult to quantify, they clearly result in considerable financial advantage to Virginia. . . . (Stip. ¶¶ 32; Jt. Ex. 18- J; emphasis added).

Due in no small part to the contributions by the 2001 Virginia Historic Funds, their predecessors and successors, and their principals, the Commonwealth fulfilled those goals. By our calculation, the Virginia Funds and their principals have contributed to approximately one-out-of-five of the 1,200 structures restored in Virginia under the Virginia Historic Program – a level of participation made that much more remarkable by the reality that single-family private residences rehabilitated by their owners constitute approximately 65 percent of the universe. Hence, the Virginia Funds may account for one-half or more of the remaining historic structures, in addition to the contributions by the Virginia Funds to residences in distressed neighborhoods.

The Center for Public Policy at Virginia Commonwealth University ("VCU"), in conjunction with the Virginia DHR, conducted a study of the results from the first ten years of the Virginia Historic Program ("VCU Study"). The VCU Study confirms that the Virginia Historic Program as a whole succeeded in fulfilling the partners' non-Federal tax purpose in joining these partnerships. Both as a matter of pride and the heart of the partnerships' purpose, one cannot stress often enough the goals and accomplishments Respondent admits:
Since the creation of the Virginia Historic Program in 1997, about $1.6 billion in private funds has been expended to rehabilitate historic structures, resulting in the creation of an estimated 10,769 in-state jobs, $444 million in wages and benefits, and $46 million in State tax revenue.\(^7\)

Over 1,200 historic rehabilitation projects have been completed under the Virginia Historic Rehabilitation Program, more than 500 of which are located in the metropolitan Richmond, Virginia area.\(^8\)

Of the property owners who received State tax credits for rehabilitation projects, 93 percent responded that the State tax credits were "very important" or "somewhat important" in their decision to rehabilitate historic structures, and 58 percent indicated that they would not have rehabilitated properties without State tax credit assistance.\(^9\)

The Virginia Historic Program has made neighborhoods safer and restored dilapidated schools into institutions of pride.\(^10\)

The Virginia Historic Program delivers other intangible effects as well, including increased availability of housing, urban redevelopment and revitalization, open space preservation through the reduction of sprawl, efficient development, reduced need for new infrastructure, reduced dependence on automobiles, energy conservation, reduction of traffic, and environmentally friendly development.\(^11\)

Through increased taxable income among Virginia taxpayers, the Commonwealth of Virginia reaped increased tax revenues of $1.31 for every $1 of credit granted. The United States government reaped these same benefits – except that, due to differences in marginal rates, increased Federal income tax revenues should be SIX TIMES GREATER THAN VIRGINIA’S INCREASE.\(^12\)

The Court should be aware that these benefits may not continue in the future due to this litigation. Over one-half of the Virginians who supported this Program in 2001 no longer wish to be involved as the consequence of the IRS notices and contacts.
B. THE 2001 VIRGINIA HISTORIC TAX CREDIT FUNDS – FORMATION AND STRUCTURE

Just as the Virginia Historic Program improved its operations each year (until Respondent attacked its supporters), so too the Virginia Historic Funds improved each year through this start-up period. Still, the core structure remains essentially the same.

On April 6, 2001, the principals in the General Partner (Virginia Historic Tax Credit Fund 2001 LLC) formed the General Partner and the three investor partnerships – Virginia Historic Tax Credit Fund 2001 LP, 2001 SCP LP, and 2001 SCP LLC – under Virginia law by limited partnership and limited liability company filings with the Virginia Corporation Commission. Stip. ¶¶5, 48, 59, 89, 107. Virginia Historic Tax Credit Fund 2001 LP served as the "mothership," with its partners including the General Partner, 181 direct limited partners, and the other two Virginia Historic Funds as second-tier partner/partnerships. Stip. ¶¶1-4, 62, 93, 121. Note that the principals frequently referred to the mothership as the "state credit program" which sometimes resulted in confusion between the sub-tier partnership Virginia Historic Tax Credit Fund 2001 SCP LP and the actual mothership, Virginia Historic Tax Credit Fund 2001 LP. The 181 direct partners largely constituted clients of one of the most respected Virginia CPA firms, Witt Mares & Co. The eight limited partners in Virginia Historic Tax Credit Fund 2001 SCP LP consisted of customers of Legg Mason, a brokerage firm. Stip. ¶94. And the 93 non-managing members in Virginia Historic Tax Credit Fund 2001 SCP LLC came either from the Biegler & Associates CPA firm or Witt Mares. Stip. ¶¶114-5. The limited partners generally invested with the

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13In addition to assisting the Virginia DHR in drafting its regulations, the principals in the General Partner developed the partnership summary schedule that the Virginia Department of Taxation ultimately adopted (with some modifications) as a means of tracing credits from developers through partnerships to the partners - order that would be reduced to absolute chaos by Respondent throwing the limited partners out of the partnership. Imagine the confusion from 280 (or even the continuing 134) uncoordinated separate Schedule C filings by the would-be partners resolving doubts in their favor depending upon each person’s peculiar situation.
expectation that the Virginia Historic Funds would allocate $1 of credit for every 75¢ they contributed.

During 2001, the mothership obtained credits in two ways. Stip. ¶¶143-4. Under the preferred method that spans the entire history of the Virginia Historic Funds, the mothership contributed most of the capital it received from the limited partners to developer partnerships in order to obtain an allocation from that upstream developer partnership of the Virginia Historic Tax Credit. Jt. Ex. 216-239-J. The alternative method that the 1999 Virginia Acts permitted on a short-term basis allowed owner/developers to make a "one-time transfer" of the credits. Stip. ¶31. The general practice during 2001 and 2002 (the years in question) generally involved a transfer on the order of 55¢ to 67¢ for every $1 of credit, thereby leaving a 7-20¢ gap to cover expenses, any claims, and hopefully some remaining net capital balance for the risks assumed by the General Partners. As a result, the structure can best be demonstrated by this graph:
The partners knew they were partners. They contributed their capital, incident to signing their own separate Subscription Agreements, conveying partnership interests that carry substantive rights, obligations, and risks – due solely to their partner status. Stip.¶¶ 53-4, 97-104, 116-120, 122, 126, 130. They and their partnerships presented the partners as partners to unrelated third parties such as the Internal Revenue Service, the Commonwealth of Virginia, and others. Stip.¶¶ 56, 60, 90, 111, 148-9, 151-2, 154-5. What these partners hoped to receive (beyond supporting the policies embedded in the Virginia Historic Rehabilitation Program) was a partnership allocation, by the partnership, from the partnership's pool of shared Virginia Historic Tax Credits, pursuant to the partnership allocation provisions in the controlling Virginia historic rehabilitation statute, Va. Code § 58.1-339.2. That tax attribute arose by operation of law – provided the credits met the statutory and regulatory contingencies (e.g., pre-certification qualified expenditures, certification, and no post-certification revocation from subsequent alterations). As non-owners, these partnerships and their partners - unlike the owners of the property - could engage in no one-time transfer even during this peculiar transitional period. And their share of the credits their partnership obtained by Credit Transfer Agreement faced absolute certainty: no one-time transfer capacity survived the first transfer by the original owner.

Notably, the Commonwealth of Virginia recognized these 2001 partnerships and their partners by way of a sua sponte ruling that Virginia issued in response to the IRS retroactive reversal of position in this case. Jt. Ex. 150-J, 151-J. Either by tracking the substantive property rights the partners obtained in their partnership interests, the absence of any State property rights in the tax attributes, or balancing the preponderance of the partner status evidence against any post-hoc factors cited by Respondent – the result remains: objectively and subjectively, the partners constituted partners.
C. JOINT FUNDING OF 16 HISTORIC PROJECTS AND ALLOCATION OF SHARED VIRGINIA HISTORIC REHABILITATION CREDITS.

The direct and indirect partners in Virginia Historic Tax Credit Fund 2001 LP pooled their capital, jointly supported rehabilitation of 16 certified Virginia historic structures, and jointly shared the allocation of the partnership's resulting pool of policy-based economic incentives bestowed by the partnership provisions in VA. CODE § 58.1-339.2.

Virginia Historic Tax Credit Fund 2001 LP, on behalf of itself and its partners, funded the following 16 projects that qualified under the Virginia Historic Rehabilitation Program:

<table>
<thead>
<tr>
<th>Date Cert. Issued</th>
<th>Completion Date on Cert.</th>
<th>Recipient/Development Entity</th>
<th>Description of Property</th>
<th>Virginia Historic Funds - Funding</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/11/01</td>
<td>11/01</td>
<td>Sweet Briar College</td>
<td>Sweet Briar College Historic District</td>
<td>$759,060.00</td>
</tr>
<tr>
<td>8/17/01</td>
<td>3/2/01</td>
<td>Scott A. Graeff &amp; Quinn Graeff</td>
<td>1825 Monument Ave. Richmond, Virginia</td>
<td>$60,118.00</td>
</tr>
<tr>
<td>11/01/01</td>
<td>9/01</td>
<td>Rising Tide Holding Company</td>
<td>Norva Theatre 320-328 Granby Street Norfolk, Virginia</td>
<td>$472,750.00</td>
</tr>
<tr>
<td>10/22/01</td>
<td>7/01</td>
<td>Parsons Row LP</td>
<td>Samuel Pleasants Parson House 601 Spring Street Richmond, Virginia</td>
<td>$179,950.00</td>
</tr>
<tr>
<td>2/11/02</td>
<td>6/01</td>
<td>Randolph Macon Women's College</td>
<td>Smith Hall Randolph Macon Women's College</td>
<td>$370,887.00</td>
</tr>
<tr>
<td>1/9/2002</td>
<td>10/31/01</td>
<td>Richmond Dairy Associates LP</td>
<td>Richmond Dairy Building 312-314 Jefferson Richmond, Virginia</td>
<td>$761,535.28</td>
</tr>
<tr>
<td>10/22/01</td>
<td>5/1/01</td>
<td>Winthrop Development LLC</td>
<td>Winthrop Hall Residence Cary School Richmond, Virginia</td>
<td>$827,322.29</td>
</tr>
<tr>
<td>10/22/01</td>
<td>5/1/01</td>
<td>Shockoe Place Apartments LLC</td>
<td>Grant Tobacco Factory 1900 E. Franklin Street Richmond, Virginia</td>
<td>$650,829.71</td>
</tr>
<tr>
<td>3/21/02</td>
<td>12/3/01</td>
<td>ICM Enterprises</td>
<td>Watkins-Cottrell Building</td>
<td>$243,036.00</td>
</tr>
<tr>
<td>Date Cert. Issued</td>
<td>Completion Date on Cert.</td>
<td>Recipient/Development Entity</td>
<td>Description of Property</td>
<td>Virginia Historic Funds - Funding</td>
</tr>
<tr>
<td>------------------</td>
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<td>-------------------------</td>
<td>----------------------------------</td>
</tr>
<tr>
<td>11/6/01</td>
<td>7/01</td>
<td>NIC, LLC</td>
<td>Valley View, 416-418 E. Main St. Charlottesville, Virginia</td>
<td>$ 30,808.00</td>
</tr>
<tr>
<td>8/3/01</td>
<td>5/15/01</td>
<td>Ten East Church Avenue LP</td>
<td>10 E. Church Ave.</td>
<td>$ 73,647.00</td>
</tr>
<tr>
<td>3/15/02</td>
<td>12/10/01</td>
<td>Hotel Norton Rehabilitation, LLC</td>
<td>Hotel Norton</td>
<td>$440,221.00</td>
</tr>
<tr>
<td>4/3/02</td>
<td>9/11/01</td>
<td>Prestons Grove LP</td>
<td>The Grove, Bristol</td>
<td>$ 70,073.00</td>
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<tr>
<td>3/1/02</td>
<td>1/8/01</td>
<td>Randolph-Macon College</td>
<td>Old College Chapel, Ashland</td>
<td>$169,215.25</td>
</tr>
<tr>
<td>3/15/02</td>
<td>12/24/01</td>
<td>The Hanson Company</td>
<td>506 W. Marshall 411 Gilmer Street</td>
<td>$ 22,249.38</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$ 17,711.00</td>
</tr>
</tbody>
</table>

The Virginia Department of Historic Resources website has long heralded one particular project funded by the 2001 Virginia Historic Funds as a major "success story" – the Samuel Pleasants Parsons House located in the historic neighborhood of Oregon Hill in Richmond. Thanks to the funding by the Virginia Historic Fund 2001 LP and its partners, that deteriorated historic building was restored into a complex of 12 upscale apartments. As noted by the Virginia DHR website, this project served as "the catalyst" for the revitalization of the distressed neighborhood by prompting development of 21 new homes behind the historic structure. The website points to the funding of that project by these partnerships as "an interesting example of combining tax credit-aided historic rehabilitation with new construction" resulting in the "truly unique change" by way of the first new residential construction project in the heart of Virginia's capital in 30 years. In the words of the Virginia DHR, that project "helped to fuel growth and revitalization taking place in the downtown [Richmond] area."

Virginia Historic Fund 2001 LP pooled the credits from this and 15 other projects and, following the final certification of the last of the projects in the Spring of 2002, allocated them among its direct partners, including the two sub-tier partner/partnerships which in turn allocated
their distributive share of the credits among their partners. Stip.¶ 148-156. The 2001 Virginia Historic Funds allocated those credits by sending Schedules K-1 to each of their respective partners containing the allocation amount and attaching most (if not all) of the Virginia Fund 2001 LP's pool of Virginia DHR Certificates. Id.

After the partners reaped the benefit of their participation in these special-purpose Virginia Historic Tax Credit partnerships, the General Partner assigned its rights under the option agreements to one of its principals, Mr. Gecker, who exercised those options. Stip. ¶¶157-169. They injected a substantial portion of the residuary capital into the 2002 program to capitalize the continuing support of the Virginia Historic Program. Jt. Ex. 25-J. Most of the balance was distributed to two of the principals, who reported the distributions on their returns. From girls' soccer coach to County Commissioner, however, all three continue to devote their lives to their communities and this community-revitalization program.

D. ADEQUATE DISCLOSURE OF PARTNER STATUS SUPPORTED BY SUBSTANTIAL AUTHORITY AND REASONABLE CAUSE.

The Partnerships thoroughly disclosed all aspects of their partnership activities on their U.S. partnership returns for 2001 and 2002. That includes their role as special-purpose, policy-based partnerships so conspicuously broadcast by the names of these 2001 Virginia Historic Tax Credit Funds. The numerous Schedules K-1 attached to those returns clearly reflected the names, partner-status, contributions, beginning "capital account" balances, and the distributive percentages and shares of each of the partners.

At the time the Partnerships filed their returns, Respondent had, as the parties now stipulate, issued no revenue rulings and adopted no regulations relating to State historic rehabilitation credits. Stip. ¶ 172. Indeed, Respondent admitted during this general timeframe
that he needed to issue comprehensive guidance to affected taxpayers and that he would do so shortly. Jt. Ex. 247-J (CCA 200238041). Seven years later, we await that ruling or regulation.

As a result, the leading authorities across the country, including Mr. Gecker and the de facto dean of that group (William Machen), conferred regularly. Messrs. Machen, Gecker, and everyone in the industry were keenly aware of Respondent's Brownsfield, Missouri CCA 200211042 confirming—just 30 days before the Partnerships filed their 2001 returns—that credits generated no income. Based on the collective views of that group, the bundle of supportive private letter rulings and pronouncements, and the extensive research by his firm, Mr. Gecker advised his fellow principals and the Partnerships to continue to pursue the course that comported with the Missouri ruling. Indeed, Mr. Gecker and Witt Mares debated certain points and chose the more conservative path than that urged by others active in this area.

When Respondent began its audit of 2001 in December of 2004, the Partnerships cooperated fully (by producing all available documents and with Mr. Gecker providing the agent with his cell phone number which she used when questions arose). Above all else, the Partnerships stressed one point: they needed to know the correct treatment as soon as possible.

The audit stretched out for three years. In 2007, the IRS National Office issued a Chief Counsel Advice which retroactively recharacterized the partner/partnership relationship into a credit-sale theory six years after the fact and thereby shifted the capital loss reported by the partners into a Section 164 ordinary deduction. While that reversal impacts the limited partners differently, it results in a net refund of Federal income tax for those partners as a whole.

In response to that CCA, the Virginia Department of Taxation issued a ruling on May 25, 2007 (Ruling 07-82; Jt. Ex. 251-P), rejecting the CCA and reaffirming the partner/partnership relationship of these same partnerships—a relationship supported by ample authority.
DISCUSSION

A. RESPONDENT'S FPAA POSITION WOULD DAMAGE, IF NOT DESTROY, EVERY STATE HISTORIC REHABILITATION, LOW-INCOME HOUSING, ENERGY, COMMUNITY-ECONOMIC REVITALIZATION, AND OTHER POLICY-BASED PARTNERSHIP.

Policy-based partnerships ought to be protected and applauded, not punished. Based on the very State incentives adopted to encourage citizens to "do good," the FPAs recharacterize the partners into buyers and their capital contributions into income. That approach creates an impractical State/Federal schism. These partnership creatures of State law would report their partners to their State, but the IRS would prohibit the same partnerships from reporting the same partners on their U.S. Partnership returns. How would distributive shares, capital accounts, and the like work? What impact would that have on all the States that depend upon IRS returns and the frequent use of State return information by the IRS? Above all else, does the IRS really want the 280 partners here and the tens of thousands of State credit partners elsewhere filing uncoordinated Schedule C's resolving all partner-specific doubts in their favor – with no Schedule K-1 instruction or Section 6222 partnership duty of consistency?

Worst of all, the FPAs refuse to apply the same (erroneous) credit-sale theory to the contributions these partnerships were required to make to the upstream developer partnerships in order to obtain the credits in the first instance – contrary to the IRS National Office instructions.\(^{14}\) If the contributions to the Virginia Historic Funds somehow constituted receipt of sale proceeds, then the contributions by the Virginia Funds to the developer partnerships

\(^{14}\) Six years after the fact, the IRS National Office retroactively recharacterized the partners and their contributions as non-partner credit-buyers paying sales proceeds. Even the IRS National Office, however, recognized that the same theory necessarily applies to the contributions these investor partnerships made to the upstream developer partnerships as the source for the historic credits. Hence, one must subtract those costs from the gross receipts to calculate the gain under Respondent's theory.
constitute sale costs. By excluding that cost component from the fundamental Section 1001 gain calculation, Respondent reaps his windfall taxes on gross receipts of capital contributions.

Both Respondent's retroactive recharacterization and his windfall application defy the practical reality of State policy-based inducement partnerships, threaten their destruction, and even damage the corresponding Federal policy-based programs. The concept of "credit gap" drives the structure of these programs. That concept arises from the reality that the rehabilitation costs generally exceed the post-rehabilitation property value. Stip. ¶14. Congress and State legislatures adopt credits as an inducement to citizens to inject the capital needed to fill that gap. The inducement thereby converts a non-economic venture into an economic venture. Id.

The Federal rehabilitation rules allocate the Federal credits based on profit percentages. Thus, the Federal credit partnerships take 98 percent of the developer partnership's profits interest. That leaves one percent for the developer and one for the State credit partnership. The State credit contributions fund the lost-value gap between the rehabilitation cost and the lower value — the credit gap funding that makes these projects work. Worse, the no-value costs are capitalized into a 27.5 or 39-year depreciable life. Hence, Respondent's recharacterization taxes the "no-accretion-of-wealth" that does not even rise to the level of phantom income.

That position would destroy virtually every State policy-based partnership and logically drive the tax on that non-existent phantom income into the Federal credit partners who hold a 98 percent profits interest in the developer partnership. If Respondent were correct, what fool would invest in a State or a Federal historic or other policy-based credit partnership?

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15 Respondent changes the subject every time this distortion arises. Respondent seeks to shift the problem from the universal condition of developer partnership contributions to the transitory credit-transfer agreement payments that Respondent also excluded from cost-of-goods-sold but left unadjusted as part of the suspended loss on the returns. The universal developer contribution exclusion remains the instrument of Respondent's overstatement of his theory.
The law protects these States and their policy-based partnerships in at least five ways:

(i) For 2001, the FPAA recharacterizations issued six years after the fact not only attempt to manufacture non-existent income, they must manufacture a 25% omission of non-existent income to extend the limitation periods under Section 6229(c)(2). As a result, Respondent bears the burden of proving each and every element of that omitted non-income under Hoffman, et al. – a burden Respondent cannot possibly carry.

(ii) Respondent also bears the burden of proof for 2001 and 2002 for several other reasons. One, he generally bears the burden of proving omitted income under Portillo, et al. And two, his inconsistent application of his own (erroneous) theory, disregard of the IRS National Office instructions, and systematic exclusion of the Section 1001 cost component all combine to yield an "excessive and erroneous" FPAA – again imposing a burden Respondent cannot carry.

(iii) For these State-inducement partnerships, Respondent cannot satisfy the prerequisites for his unilateral retroactive recharacterizations. Seventy years of consistent case law prohibits Respondent from spinning facts into fiction absent a SOLE purpose of Federal tax avoidance. Even Treas. Reg. § 1.701-2 (which improperly seeks to substitute the "principal purpose" test for the Supreme Court's "sole purpose" test) memorializes the object of the requisite purpose – FEDERAL tax avoidance. One conspicuous fact stands out above all others: the Virginia Historic Program constituted the laudable/altruistic/financial/State tax reason the partners formed and joined the four 2001 Virginia Historic Tax Credit Funds.

(iv) The all-encompassing definition of partner/partnership relationships in Section 761 includes both the subset of State common law partnerships and a wide range of other multiple party relationships. These partners and their special-purpose, policy-based, financially and altruistically motivated, community-revitalization partnerships fall well within the broad parameters of Section 761.

(v) By regulation, the Section 707 "disguised sale" rule bears no application to these partners acting in their capacity as partners who receive non-property tax attributes subject to significant risk. Respondent must defeat all three of these essential elements and can carry his burden as to none.

One fact disposes of all of these points: the partners derived their primary (non-Federal-tax) benefit based solely on their partner status under the partnership allocation provisions that the Commonwealth deliberately incorporated into the Virginia Historic Rehabilitation statute to broaden the support to non-developer/owner partners like these.
B. **THE PARTNERS’ CAPITAL CONTRIBUTIONS TO THEIR SPECIAL-PURPOSE, STATE POLICY-BASED, COMMUNITY-REVITALIZATION PARTNERSHIPS SHOULD BE HONORED.**

The Supreme Court described this case better than the sale-leaseback encouraged by banking regulations in *Frank Lyon v. United States*, 435 U.S. at 583-4, when it said:

> [W]e hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. (Emphasis added).

A moment’s reflection upon the line of cases cited by the Supreme Court in *Frank Lyon* and consistently followed since, confirms that Federal law only disregards the existence of real entities and transactions where **FEDERAL** tax avoidance constitutes the **SOLE** purpose.

Perhaps no more profound punctuation of the essential **FEDERAL** tax component could be imagined than the care Respondent took in amputating the word **FEDERAL** from his recitation of Treas. Reg. § 1.701-2(b) in the FPAAs he issued to the **STATE** historic tax credit 2001 and 2002 Virginia Historic Funds:

... the partnership was formed with a principal purpose to reduce substantially the present value of the partners' aggregate [**FEDERAL**] tax liability in a manner that is inconsistent with the intent of subchapter **K**. Accordingly, the partnership should be disregarded pursuant to Treas. Reg. § 1.701-2(b). (Bracketed word stricken; italicized words lifted from Treas. Reg. § 1.701-2(b))

No accident created that surgical exclusion, for Respondent amputated "**FEDERAL**" in every one of the **TWELVE** FPAAs he issued to the 2001 and 2002 Virginia Historic Funds.

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16 *Compare* the actual language of Treas. Reg. § 1.701-2(b):

> [I]f a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate **FEDERAL** tax liability in a manner that is inconsistent with the intent of subchapter **K**, the Commissioner can recast the transaction for federal tax purposes. (Emphasis added)
Such a pattern proves (i) that Respondent knew even his own regulation bars him from recharacterizing these partnerships and these partners absent proof of at least the principal purpose of reducing the partners' aggregate *FEDERAL* tax obligations, and (ii) that he knew he cannot prove that in these policy-based *STATE* credit cases.

State policy-based tax inducements constitute an important non-Federal-tax motive that gives financial meaning and substance to the relationships chosen by the parties. Both under the letter and spirit of the Tenth Amendment to the Constitution, the Federal government should respect such State policies, rather than cripple them as Respondent has here. Indeed, the Courts and Respondent recognize the reality that legislative bodies frequently use tax incentives as the essential economic benefit that prompts citizens to fund otherwise non-economic policy-based endeavors. Consider the common sense reasoning by the Court in *Sacks v. Commissioner*, 69 F.3d 982, 992 (9th Cir. 1995):

> A tax advantage such as Congress awarded for alternative energy investments is intended to induce investments which otherwise would not have been made . . . If the Commissioner were permitted to deny tax benefits when the investments would not have been made but for the tax advantages, then only those investments would be made which would have been made without the Congressional decision to favor them. The tax credits were intended to generate investments . . . that would not otherwise be made because of their low profitability. Yet the Commissioner in this case at bar proposes to use the reason Congress created the tax benefits as a ground for denying them. That violates the principle that statutes ought to be construed in light of their purpose. (Internal citations omitted.)

Even Respondent recognizes that legislatively encouraged, policy-based endeavors should be honored. See, e.g., Rev. Rul. 79-300, 1979-2 C.B. 112 (policy-based programs like the low-income housing credit should not be subjected to normal profit motive standards). The constitutionally imbued comity owed to the States and the Federal government's adoption of these same historic rehabilitation policies corroborate the conclusion required by both the practical approach to tax administration and Section 761.
1. **Section 761 Includes Common Law Partnership/Partner Relationships Like These Within the Federal Catch-All Definition.**

Federal tax law includes within the realm of partnership/partner relationships both those partnerships recognized under State common law and a broader range of other multiple-party relationships. *McManus v. Commissioner,* 583 F.2d 443, 447 (9th Cir. 1978). For that reason, Section 761(b) simply defines a "partner" as a "member of a partnership" and Section 761(a) then broadly defines "partnership" as:

> A *syndicate, group, pool, joint venture, or other unincorporated organization* through or by means of which *any business, financial operation, or venture is carried on,* and which is not, within the meaning of this title, a corporation or a trust or estate.\(^{17}\) (Emphasis added).

The leading partnership treatise describes this all-encompassing definition as "equally clear that the intent of Congress as expressed in Sections 761(a) and 7701(a)(2) was that the partnership classification apply to *any* business, financial operation, or venture that involves multiple participants." *MCKEE, NELSON, AND WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS,* Sec. 3.02[2] (4th ed. 2007) (emphasis in original). As a tribute to their breadth, partnerships require no writing and can arise by implication. *See, e.g., Evans v. Commissioner,* 447 F.2d 547, 552 (7th Cir. 1971) ("Partnerships, for tax purposes, have been implied from conduct of the parties, in the absence of any written agreement and even where parties deny any intent to form one"); *Cohen v. Commissioner,* 19 T.C. 261, 272 (1990) ("The terms of a [joint] venture [taxed as a partnership] may be informal and need not be reduced to writing"). *See also, Roark v. Hicks,* 362 S.E.2d 711, 714 (Va. 1987) ("A joint venture exists where two or more parties enter into a special combination for the purpose of a specific business undertaking, jointly seeking a profit, gain, or other benefit, without any actual partnership or corporate designation").

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\(^{17}\) Section 7701(a) parrots these definitions of "partner" and "partnership."
Courts and scholars alike also recognize that even the common law subset of this broad Federal tax definition of "partnership" necessarily includes special-purpose partnerships like these. See, e.g., S. ROWLEY, ROWLEY ON PARTNERSHIP § 6.5, at 77 (2d ed. 1960)(citations omitted)("[T]here may be a partnership merely for the consummation of a single transaction, adventure, or undertaking"); 59 Am. Jur. 2d, PARTNERSHIP § 47 ("[p]artnerships may be formed for almost any purpose not violative of declared public policy or express statutory inhibitions"); Hayes v. Irwin, 541 F.Supp. 397, 415 (N.D. Ga. 1982) ("A partnership may be created for a single venture or enterprise"); Dawson v. J.G. Wentworth & Co., Inc., 946 F.Supp. 394, 396 (E.D. Penn. 1996) (Court honored single purpose partnership for purchasing claims); Gillette Company v. RB Partners, 693 F.Supp. 1266, 1271 (D. Mass. 1988) (Court honored a single purpose partnership formed to buy Gillette stock). That comports with the broad statutory concept of "ANY business, financial operation, or venture." Section 761(a).

The Courts and the Commissioner recognize that more attenuated relationships than the 2001 Virginia Historic Funds constitute partnerships. See, e.g., Bergford v. Commissioner, 12 F.3d 166, 169 (9th Cir. 1993) (Affirmed where "Tax Court found the economic benefits to the individual participants were not derivative of their co-ownership of computer equipment, but rather from their joint relationship toward a common goal"); Wheeler v. Commissioner, T.C. Memo. 1978-208 (Partnership found where taxpayer retained authority to manage the day-to-day business affairs with no share of income or losses); Rev. Rul. 54-84, 1954-1 C.B. 284 (Partnership despite properties in one partner's name and no sharing of losses). While loss sharing is not required, the Virginia Fund 2001 LP Agreement allocates losses, expenses, income, liquidation proceeds, etc. among the partners. See Va. Fund 2001 LP Ag'm't ¶¶12-3, 18. Hence, these policy-based, special-purpose, partner/partnership relationships should be honored.
2. **Section 704(e)(1) Also Treats These Partners in These Capital-Intensive Partnerships as Partners.**

By statute and case law, these partners should also be recognized as partners because they hold a capital interest in a capital-intensive (as opposed to service) business. That analysis begins with Section 704(e)(1) which states:

> [A] person shall be recognized as a partner . . . if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person. (Emphasis added).

When litigants attempted to restrict this rule to family partnerships, the Courts confirmed its transcendent nature. *Evans*, 447 F.2d at 550 (Section 704(e)(1) is the "general definition applicable to all partnerships"); *Atlas v. United States*, 555 F. Supp. 110 (N.D. Ill. 1982) (where the Court found that even though Section 704(e)(1) speaks in terms of family partnership, "its scope encompasses all partnerships for purposes of tax law").

While the peculiar nature of public sector/private inducement tax attributes yields no taxable income, it undeniably represents a legislatively endowed economic incentive directly extracted by this capital-intensive partnership investing the partners' pooled capital. Moreover, as the Court held in *Spiesman v. Commissioner*, 260 F.2d 940, 947-948 (9th Cir. 1958), this principle elevates "ownership of a capital interest" over "business purpose." Of course, the financial inducements offered by the Commonwealth supply the business/investment purpose. With or without a conventional business purpose, however, these capital account holding partners should be recognized as partners under Section 704(e)(1).
3. **At Least 20 Factors Prove That the Partners Were Partners.**

Various cases balance various factors in determining the existence of a partnership/partner relationship, but no real doubt exists about the overwhelming evidence here. Consider the facts largely "conclusively established" by Rule 90 admissions:

(i) In comparison to the *Frank Lyon* structure "compelled or encouraged by . . . regulatory realities," the General Partner formed and the limited partners joined these partnerships pursuant to the *PARTNERSHIP ALLOCATION PROVISIONS* in the controlling Virginia Historic Rehabilitation *STATUTE*, VA. CODE § 58.1-339.2. See, *e.g.*, R. Resp. P. RFA ¶¶ 20-25. Those partnership allocation provisions constituted the only mechanism for participation by those who, like the partners, wished to support the Program but owned no historic structures. *In short, the primary benefit derived by the limited partner/members DEPENDED ENTIRELY ON THEIR STATUS AS PARTNERS.*

(ii) The partnerships (including the one limited liability company treated as a partnership)\(^8\) were all three undeniably formed under Virginia law as limited partnerships/LLCs by obtaining limited partnership/LLC certificates from the Virginia State Corporation Commission. R. Resp. P. RFA ¶ 47.

(iii) The partners joined their partnership by executing separate Subscription Agreements that designated them as partners. R. Resp. P. RFA ¶ 93; P. Resp. R. RFA ¶¶ 186-188.

(iv) As noted, the partners formed the 2001 Virginia Historic Funds for the special purpose conspicuously reflected by their names – to participate in the Virginia Historic Rehabilitation Program and to share the resulting pooled Virginia Historic Tax Credits among their partners. Neither that good-citizen, policy-based, completely non-tax purpose nor the *STATE* tax inducement constitutes a "principal purpose" of *FEDERAL* tax avoidance under Respondent's unaltered version of Treas. Reg. § 1.701-2 statute, VA. CODE § 58.1-339.2.

(v) That policy-based State economic inducement renders a net economic benefit to the partners (a net return of approximately 33 percent) that provides meaning and substance to their joining their partnership. *See, e.g.*, *Sacks*, 69 F.3d at 989; Rev. Rul. 79-300, 1979-2 C.B. 112.

(vi) Both under the partnership agreements and Virginia law, the partners obtained meaningful liquidation, termination, management replacement, partnership record inspection, and other substantive rights and obligations *purely because of their partner status*. VA. CODE § 50-73.26.

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\(^8\) Section 7701(a) parrots these definitions of "partner" and "partnership."
(vii) Each partner contributed (by wire or check) a specified amount to the capital of his or her partnership. R. Resp. P. RFA ¶¶ 87, 91.

(viii) The partnership books and records confirm that those capital contributions constitute capital the limited partners contributed, not sale proceeds. The consolidated General Ledger recognizes those contributions as "equity" while the U.S. Partnership Returns and Schedules K-1 separately record them as beginning "Capital Account" balances – treatment critical to any creditor or other third party dealing with the partnership.

(ix) The consolidated General Ledger, other partnership books and records, and now the Stipulation confirm that the Virginia Historic Funds pooled the Virginia Historic Tax Credits from many sources. See, e.g., R. Resp. P. RFA ¶ 95-6; Stip. ¶¶143-4.

(x) The partners shared in that partnership pool based on their agreed allocated shares, as again provided by the partnership provisions in the Virginia Historic Rehabilitation statute, VA. CODE § 58.1-339.2. Stip. ¶¶151-2, 154-5.

(xi) The partnerships obtained the Virginia Historic Rehabilitation credits through the investment of substantial capital, not services.

(xii) These capital-intensive partnerships allocated that policy-based State economic inducement among the partners by agreement in proportion to their capital accounts. See, e.g., Section 704(e)(1); Treas. Reg. § 1.704-1(e)(1)(iv) (person shall be recognized as a partner if he owns a capital interest in a capital-intensive partnership); Evans, 447 F.2d at 550 (Section 704(e)(1) capital account definition of partner applies to all capital-intensive partnerships); R. Resp. P. RFA ¶¶ 106, 107, 109 (Virginia credits allocated based on amount of partner's contribution).

(xiii) The partners in the 2001 Virginia Historic Funds undoubtedly owned capital interests in these capital-intensive partnerships. Indeed, the liquidation provisions in the Virginia Fund 2001 LP Limited Partnership Agreement mandate that "[a]ny remaining assets shall be distributed to the Partners in accordance with the positive balances in their respective capital accounts." See Virginia Historical Tax Credit Fund 2001 LP Partnership Agreement, ¶ 18.

(xiv) The partnerships and their partners represented to third-parties such as the Internal Revenue Service, Commonwealth of Virginia, and others, that the partners were partners. As noted, each of the partnerships filed U.S. Partnership Returns (Forms 1065) for 2001, reporting both the net results from their activities and allocating those results among their separately named partners on separate Schedule K-1s – schedules that again attested to the same beginning "capital account" balances as the Virginia Historic Tax Credit Fund 2001 LP General Ledger separately reflected as "equity" for each of them. R. Resp. P. RFA ¶¶ 65, 71.
(xv) For purposes of reporting to the Commonwealth of Virginia, each of the partnerships provided each of their partners with a Schedule K-1 package that contained the partnerships' collection of rehabilitation credit certificates from the Virginia Department of Historic Resources and a designation of the partner's aliquot share of that pool. See R. Resp. P. RFA ¶¶ 108, 110.

(xvi) Every known partner filed his¹⁹ Virginia income tax return for 2001 under penalties of perjury attesting to his status as a partner entitled to his aliquot share of the partnership's pool of credits. R. Resp. P. RFA ¶ 110.

(xvii) And every known partner filed U.S. income tax return for 2001 under penalties of perjury attesting to his status as a partner reporting his distributive share of partnership income, losses, deductions, etc. R. Resp. P. RFA ¶ 110.

(xviii) Most (if not all) of the partners later sold their partnership interests incident to an Option Agreement that specified their partner status and their partner interests. R. Resp. P. RFA ¶ 94; R. RFA ¶¶ 186-188.

(xix) Again for 2002, the partnerships' consolidated General Ledger, the partnerships' U.S. Partnership Returns, the Schedules K-1 distributed to the partners, and their U.S. and Virginia returns all confirm their partner status. See Jt. Ex. 27-J, 29-J, 36-J.

(xx) After the IRS mistakenly questioned the partner status in these cases in a Chief Counsel Advice released to the public, the Department of Taxation for the Commonwealth of Virginia took the extraordinary sua sponte step of issuing a ruling rejecting the IRS' contention and recognizing these policy-based partnerships and their partners under Virginia law. R. Resp. P. RFA ¶¶ 118-119.

With no real consideration of these factors, Respondent nonetheless contends that the limited partner/members somehow never subjectively intended to be limited partners. Of course, the objective evidence of their contemporaneous agreements provides the best evidence of their subjective intent.

¹⁹ Generic masculine pronoun used for the men, women, families, and entities who joined these partnerships.
4. **Against These 20 Factors, Respondent Offers Little Beyond His *Ipse Dixit*.**

As Respondent confirmed during his recent motions argument, he bottoms his case on the 60-year-old *Commissioner v. Culbertson*, 337 U.S. 733, 740-741 (1949) that defines "partnership" in terms narrower than Sections 761(a) and 7701(a)(2) — terms that would repeal Section 704(e)(1). In short, Respondent contends that the subjective intent of the 280 partners governs. Fortunately, no conflict between the statute and this case need be resolved because any balancing of the contemporaneous objective evidence of subjective intent satisfies all tests.

Against the 20 factors consisting in large measure of legally enforceable contracts and the substantive rights they create, Respondent relies upon four items. One, Respondent seeks to exploit the colloquial references in the world of low-income credits, energy credits, GoZone credits, rehabilitation credits, and other policy-based credits to "buying" and "selling" these policy-based credits as if one cannot acquire and apply credits through a partnership. The temporary ability of developers — but not these investment partnerships or their partners — to sell credits *vis-à-vis* "one-time transfers" contributed to those colloquialisms here. The credit world holds no monopoly over this loose language because people regularly refer to the buildings, or land, or race horses they "bought" when they actually bought a partnership interest. The Partnerships invite the Court to weigh not only the number of partnership/partner references against these colloquialisms but also their securities and contract-law significance. The dispositive fact remains — these partners derived their primary benefit of the State inducement *SOLELY* because of their status as partners under the partnership allocation provisions in the controlling statute, VA. CODE § 53.1-339.2. That is, this Virginia statute — not any Federal tax consideration — forced the partnership choice. Two, Respondent seems to rely heavily on the Option Agreements that most of the partners executed. Those options, however, specify a "fair
market value" exercise price at an unspecified date in the future. They also repeatedly reinforce that the subject property consists of a partnership interest held by a partner. Moreover, they punctuate one more instance where these partnerships chose the most conservative path that increased the partners' Federal tax. Many in the credit world believe that the partners should abandon their partnership interests and report an ordinary Section 165 loss. The general partner and the accounting firm debated that proposition and rejected it as too aggressive. Three, Respondent cites the excess capital percentage (one percent) without mentioning that (i) those partners held liquidation interests on the order of 99 percent until they recovered their positive capital accounts, (ii) Section 704(b) and its regulations allocate 99 percent of the losses to those partners, and (iii) those partners reaped allocations of 98 percent of the State inducements for which the partners formed these special-purpose partnerships. And four, Respondent tries to trip the Partnerships at every turn on either the occasional confusion between two of these commonly named 2001 Virginia Historic Tax Credit Funds and on their ability to locate executed documents — many of which were previously produced on audit and all of which are evidenced by copies. Even today after Respondent has made so much of it, confusion between the two names remains almost unavoidable and one question answers Respondent's copy criticism — what percentage of the cases do we handle based on unsigned "preparer copies" of returns because Respondent cannot locate the originals three years after the fact — AS OPPOSED TO EIGHT YEARS AFTER THE FACT?

With all due respect, Respondent advances these red herrings because the mountain of objective partner-intent evidence looms so high.
C. AS FULLY DISCLOSED AT ALL TIMES, THE PARTNERS ACTED SOLELY IN THEIR CAPACITY AS PARTNERS - AS OPPOSED TO SOME "DISGUISED SALE" OF NON-PROPERTY STATE TAX ATTRIBUTES IN EXCHANGE FOR CAPITAL CONTRIBUTIONS.

At all times, the partners fully disclosed their roles as partners who contributed their capital to the conspicuously-named, special-purpose, policy-based, community-revitalization Virginia Historic Tax Credit partnerships. Nonetheless, Respondent accuses them and their partnerships of "disguising" a sale of those tax attributes under Section 707.

Tax attributes, especially policy-based tax attributes, are sui generis. They arise by operation of law, often as an inducement by Congress or State legislatures encouraging citizens to "do well by doing good." Examples range from funding economic stimulation, to combating energy dependence upon OPEC, to providing housing for the poor, to rebuilding disaster ravaged areas, and to any number of other laudable legislative goals. Neither Congress nor State legislatures meant to encourage responsible citizens to support these policies, so that the IRS can punish them for their good deeds. For that reason and others, the receipt of these sui generis statutory tax benefits does not constitute income, any more than using net operating losses, depreciation, charitable contributions, and the like constitute income. See, e.g., Snyder v. Commissioner, 894 F.2d 1337 (Table), 1990 WL 6953, at *4 (6th Cir. 1990) ("The case at bar does not involve any right on the part of [taxpayer] to receive an amount of money from the State of Ohio; it simply involves a right to start paying the State less in taxes than would have to be paid in the absence of the right . . . [T]here is no 'income' from the State of Ohio for the partnership to accrue"); Rev. Rul. 91-36, 1991-2 C.B. 17. That is especially true where, as here, the credits are not transferable or refundable in the hands of the Partnerships or their partners.

Above all else, these Virginia community-revitalization partnerships and their partners disguised no sales, for at least three independent reasons.
1. The Partners Acted in Their Capacity as Partners.

Respondent's regulations establish both (i) that Section 707 only applies to those who do not act in their capacity as a partner, and (ii) that "transfers of money . . . by a partner to a partnership as contributions . . . are not included within the provisions of this section."

Specifically, Treas. Reg. § 1.707-1(a) demonstrates that the Virginia Fund partners engaged in none of the disguised sale categories:

Partner not acting in capacity as partner. A partner who engages in a transaction with a partnership other than in his capacity as a partner shall be treated as if he were not a member of the partnership with respect to such transaction. Such transactions include, for example, loans of money or property by the partnership to the partner or by the partner to the partnership, the sale of property by the partner to the partnership, the purchase of property by the partner from the partnership, and the rendering of services by the partnership to the partner or by the partner to the partnership. Where a partner retains the ownership of property but allows the partnership to use such separately owned property for partnership purposes (for example, to obtain credit or to secure firm creditors by guaranty, pledge, or other agreement) the transaction is treated as one between a partnership and a partner not acting in his capacity as a partner. However, transfers of money or property by a partner to a partnership as contributions, or transfers of money or property by a partnership to a partner as distributions, are not transactions included within the provisions of this section. In all cases, the substance of the transaction will govern rather than its form.

Hence, the prior discussion in Section B as to why the partners constitute partners under Section 751 and the 20 factors dispose of the Section 707 allegation as well.

So, too, the "contribution" exclusion disposes of that assertion. State law undeniably determines the existence and nature of property rights, while Federal law determines their tax consequences. See, e.g., Morgan v. Commissioner, 309 U.S. 78, 82 (1940). Virginia law defines a capital contribution with all the attendant rights, obligations, and capital risk that carries:

[A]ny cash, property, services rendered, or a promissory note or other binding obligation to contribute cash or property or to perform services, which a partner contributes to a limited partnership in his capacity as a partner.

Not surprisingly, Virginia law determines property rights based on the objective intent of contracting parties reflected in the contract terms they expressed at the time. According to the Virginia Supreme Court, the Court's duty is to:

construe the contract made between the parties, not to make a contract for them, and [t]he polestar for the construction of a contract is the intention of the contracting parties as expressed by them in the words they have used. The facts and circumstances surrounding the parties when they made the contract, and the purposes for which it was made, may be taken into consideration as an aid to the interpretation of the words used, but not to put a construction on the words the parties have used which they do not properly bear. . . It is the court's duty to declare what the instrument itself says it says.


...the form of a contract is the considered and chosen method of expressing the substance of contractual agreements between parties and the dignity of contractual right cannot be judicially set aside simply because a tax benefit results either by design or accident. Form, absent exceptional circumstances, reflects substance.

Lewis and Taylor, Inc. v. Commissioner, 447 F.2d 1074, 1077 (9th Cir. 1971), quoting Edwards v. Commissioner, 415 F.2d 578, 582 (10th Cir. 1969); Imperial Car Distributors, Inc. v. Commissioner, 427 F.2d 1334, 1336 (3d Cir. 1970).

The contemporaneous Subscription Agreements, Limited Partnership Agreements, and representations to Virginia and Federal authorities all confirm that the partners contributed their funds as capital – partnership capital contributions recognized by Virginia statute. VA. CODE §§ 13.1-1002, 13.1-1023(A)(1), 13.1-1027(B) and (E), 50-73.1, 50-73.33(A), and 50-73.81. The partnership capital contributions preclude any suggestion that the partners "disguised" anything.
2. **As Even Respondent Recognizes, Tax Attributes Do Not Constiute "Property" or "Income."**

The Supreme Court described the peculiar posture of tax attributes in its ruling under the securities laws in *Randall v. Loftsgaarden*, 478 U.S. 647, 657 (1986):

> [T]ax benefits . . . take the form of tax deductions or tax credits. These have no value in themselves; the economic benefit to the investor—the true "tax benefit"—arises because the investor may offset tax deductions against income received from other sources or use tax credits to reduce the taxes otherwise payable on account of such income.

Consistent with the *Morgan* doctrine that State law defines property rights, the Commonwealth of Virginia generally recognizes the non-property status of Virginia credits. Cf., VA. CODE § 58.1-513(E). ("[T]he transfer of the [conservation] credit and its application against a tax liability shall not create gain or loss for the transferor or the transferee of such credit").

Federal tax authorities follow similar reasoning in concluding that tax attributes do not constitute income. *See* Snyder 1990 WL 6953, at *4 (the Sixth Circuit determined a tax attribute in the form of a pari-mutuel tax reduction does not constitute income to the partnership from the state). Respondent has repeatedly ruled that tax attributes do not constitute income. *See, e.g.*, Rev. Rul. 91-36, 1991-2 C.B. 17 (where a taxpayer participates in an energy conservation program for which she receives a rate reduction or nonrefundable credit, "the amount of the rate reduction or nonrefundable credit is not includible in the [taxpayer's] gross income"); Rev. Rul. 79-315, 1979-2 C.B. 27 (where Respondent treated the amount credited from a rebate as a reduction of the outstanding liability, it was not includable in the individual's gross income); Rev. Rul. 66-226, 1966-2 C.B. 239 ("If the amount of such gasoline tax credits or refunds for any taxable year exceeds the 'allowable deductions' attributable to the mineral property for the taxable year, such excess is not includible in 'gross income from the property'”). In the Missouri
CCA 200211042 Respondent issued just before the Partnerships filed their 2001 returns *in this case*, Respondent admitted:

[A] state tax credit . . . is treated for federal income tax purposes as a reduction or potential reduction in the taxpayer's state tax liability. The amount of the credit is not included in the taxpayer's federal gross income.

Respondent again recently admitted in an instructive, albeit non-precedential, Coordinated Issue Paper that "*tax benefits are not 'money or property'" I.R.S. Coordinated Issue Paper, State and Local Location Tax Incentives, LMSB-04-0408-023, 2008 WL 2158109 (May 23, 2008)(internal citations omitted). In this Coordinated Issue Paper, the IRS conceded that ("[a] state or local tax benefit of this type [i.e. tax abatement, credit, deduction, rate reduction, or exemption] is applied against the taxpayer's current or future State tax liability, and is treated for federal income tax purposes as a reduction or potential reduction in the taxpayer's state or local tax liability") – not income or property.

Several of Respondent's pronouncements through the years point to refundability and transferability as an indicator of property status. While those references lack a cite to any authority, they do emphasize the reality that the Virginia Historic Tax Credits were neither refundable nor transferrable in the hands of the Virginia Historic Funds or their partners. The parties now stipulate that these inducements are non-refundable. Stip. ¶41. Similarly, neither the Partnerships nor their partners could transfer these credits. As Respondent admits and now stipulates, even the owner/developer "one-time" transfer provisions required approval by the Virginia Department of Historic Resources (Stip. ¶31), and the Department never permitted a one-time transfer by a downstream partnership or partner. And obviously, the "one-time" transfers in the Credit Transfer Agreements barred any subsequent transfer. This "non-property" status of tax attributes independently disposes of Respondent's "disguised sale" contention.
3. **Even If Tax Attributes Somehow Constituted "Property," the Risks Preclude Recharacterizing the Partners' Interests as a "Disguised Sale."**

Respondent's regulations also confirm that entrepreneurial risks bar application of Section 707 to non-simultaneous partnership/partner dealings. Treas. Reg. § 1.707-3(b). That raises a two-pronged inquiry. First, the Virginia partnership credits by their very nature could not have been simultaneously exchanged with the contributions. To be sure, the Subscription Agreements contained the *promissory* commitment to allocate a specified amount from the pool of partnership credits, in order to satisfy the provision in VA. CODE § 58.1-339.2 regarding partnerships allocating credits by written agreement. That promissory commitment to allocate credits in the future, however, does not and could not constitute a simultaneous exchange of money and "property." The Virginia Historic tax credits only ripen in the developer partnerships as of December 31, many historic credits are not certified until the following Spring, the allocation does not occur until the Partnerships distribute the Schedules K-1 to the partners (in the case of both the developer partnerships to the Partnerships or from the Partnerships to the partners), and the credits remain inchoate until the partners claim their allocable shares on their returns.

Moreover, the risks preclude both any simultaneous exchange contention and the "disguised sale" contention as a whole. As leading authorities note:

> The general rule of Section 1.707-3(b)(1) simply requires a showing that a subsequent transfer is dependent on the entrepreneurial risk of partnership operations. There is no requirement that such entrepreneurial risk be significant or meaningful, just that it be present.

**Barksdale Hortenstine and Gregory Marich, An Analysis of the Rules Governing Disguised Sales to Partnerships: Section 707(a)(2)(b), 830 PLL/Tax 969 (October-December, 2008).** However, the partnerships and their partners faced significant ongoing risks
here—ongoing risks that corroborate their continuing relationship and that would be borne solely by the buyer under a disguised or a declared sale. Among the risks tied to the public sector/private inducement nature of these special-purpose policy-based partnerships, both the partnerships and their partners faced the shared financial risk that:

* The developer could fail to complete the project in a qualified way;
* The developer could fail to complete the project on time;
* Virginia DHR could decide not to certify the rehabilitation;
* The partnership could fail to acquire adequate credits; and
* Any credits granted could be retroactively revoked for a two-year period if—for whatever reason inside or out of the partnership's control—the owner makes disqualifying changes to the structure.

As in every other genuine partnership, the partners also faced continuing management risks mitigated only by prescribed terms for management removal for cause, etc. Worse yet, the partnerships and their partners shared the continuing risk of defalcation by anyone up and down the line—a risk that the Virginia Historic Funds and their partners actually suffered when a developer took their money on the false representation that he held title to the underlying property. As further proof of the shared nature of the risks, the General Partner assured some of the partners that the General Partner would refund their capital to the extent the partnerships failed to obtain adequate Virginia credits. As a practical matter, the General Partner is a limited liability company whose assurance is only as strong as its financial wherewithal, and the risk of defalcation destroys both the General Partner's ability to deliver and its ability to refund monies previously paid over to the culprit. As both the partnerships and their partners were told at the time, any retroactive changes in the law also posed serious risks to them. And let us not forget, the partnerships and their partners also faced greater litigation risks than they would in a simple sale. These and all of the other risks attendant to partnership relationships reinforce the absence of any disguised sale and the role of the partners as partners.
D. PURELY AS A COMPUTATIONAL MATTER, SECTION 704(b) REQUIRED ALLOCATION OF THE PARTNERSHIP LOSSES BASED ON THE POSITIVE CAPITAL ACCOUNTS.

The FPAAs seek to recharacterize the partners, their contributions, and their allocations. As a prerequisite for recharacterizing fact into fiction, Respondent must prove that Federal tax avoidance constituted the sole purpose of the partners and their partnerships. In response, the Partnerships will demonstrate to the Court's satisfaction that they handled their affairs in a conservative manner that often resulted in their partners reporting greater Federal taxes. One of those examples, however, is simply wrong.

The Partnerships allocated most of their losses for 2001 and 2002 to partners who could not use those losses due to basis and similar limitations. For years, those losses have stacked up in a perpetual state of suspension with the General Partner and its three principals responsibly abstaining from applying them. As it turns out, they should have been allocated to the limited partners as a matter of law — limited partners who could use these losses.

One point of law and one stipulated fact dictate the result. Section 704(b), Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2), and Section 18 of the Virginia Historic Tax Credit Fund 2001 LP Partnership Agreement required that those losses be allocated to partners with positive capital accounts. Respondent previously admitted the amounts of the capital accounts. See, e.g., P. Resp. RFA ¶¶ 115-6, 119, 121, 124, 127, 130, 184, 205, 221-3; R. Resp. P. RFA ¶¶ 87, 91. Under Respondent's regulations, no other fact remains relevant to this statutory allocation.

For that reason, the Partnerships will seek leave to conform the pleadings to the proof as soon as the Court deems it appropriate.
E. THE PARTNERSHIPS REPEATEDLY TOOK THE MORE
CONSERVATIVE COURSE AND DID SO BASED ON SUBSTANTIAL
LEGAL AND SUBSTANTIAL FACTUAL AUTHORITY FOR THE
ADEQUATELY DISCLOSED DISPUTED PARTNER POSITION — ALL
OF WHICH WAS SUPPORTED BY REASONABLE CAUSE.

On Friday, April 3, 2009, Counsel for Respondent orally communicated to Counsel for
the Partnerships that Respondent conceded his abusive partnership contention under Treas. Reg.
§ 1.701-2(b). That concession — upon which the Partnerships rely herein by striking their two-
pronged attack on the validity of that untested regulation — proves several profound points:

(i) Given the vagaries of these amorphous partnership concepts, how can Respondent
simultaneously admit that he erred in his Treas. Reg. § 1.701-2(b) assertion and
still accuse the Partnerships of negligence and the like for treating their partners
as partners?

(ii) The concession memorializes the obvious: the partners did not form or join the
Partnerships for the "principal purpose" of Federal tax avoidance. That
necessarily concedes that the partners did not form or join the Partnerships for the
"sole purpose" of Federal tax avoidance — the judicial prerequisite for
recharacterizing the partners as buyers, their contributions as sales proceeds, and
their tax attributes as property. That 70 years of judicial precedent stands as more
than substantial authority.

(iii) For all its flaws, Treas. Reg. § 1.701-2 does not override policy-based statutes.
This concession reinforces that basic precept.

Nonetheless, Respondent persists with his Section 6662 twenty percent penalty claims for
the moment. As the Court is well aware, Section 6662 represents a compilation of alternative
justifications for penalties (substantial understatement, negligence, and valuation) but, like all
penalties, they must be narrowly construed against their application and broadly construed in
Within its four corners, Section 6662 confirms what we all learned in kindergarten — no one
should be punished for doing something that was not prohibited by the rules at the time (i.e., the
antithesis of negligence), for doing what she had reason to believe was right under the rules (i.e.,
substantial authority), or where she told the teacher what she was doing (i.e., adequate
disclosure). Section 6664(c) then bolsters these fundamental principles of fairness by confirming that no penalty may be imposed where the citizen proceeds in good faith based on reasonable cause.

This case implicates all of these statutory concepts of fundamental fairness:

(i) The Partnerships and their partners should not be punished for taking the correct position.

(ii) *Exactly 30 days before the Partnerships filed their 2001 returns*, Respondent issued the Brownsfield, Missouri CCA 200211042 (March 15, 2002) confirming that receipt of credits generates no income. That pronouncement validated what these Partnerships believed to be true. The Court must ask itself, how could the Partnerships be negligent or lack reasonable cause for following the same conclusion drawn by the IRS National Office one month earlier?

(iii) As this Court has held, novel questions of law, not to mention retroactive changes in interpretation, provide an unfair basis for punishing someone.

(iv) To this day, Respondent has never issued a revenue ruling or a regulation providing the much needed guidance for State historic rehabilitation credits – as the parties now stipulate. Stip. ¶172.

(v) *Respondent admitted in the subsequent Colorado ruling that he had failed to provide the guidance needed in this area.* The most startling aspect of the State historic area arises from the contrast between the breadth of inducements across so many States and the desert of Federal precedent. From its genesis through the filing of these returns in 2002, the State policy-based credit world was forced to read the non-precedential tea leaves of PLRs and the like. To his credit, Respondent admitted in the second Colorado CCA that better guidance was needed and that comprehensive guidance would be issued shortly. CCA 200238041. Seven years later, the State policy-based credit world still waits.

(vi) The leading authorities across the country regularly conferred throughout this period. Included in that group and those conferences was Mr. Gecker. Other participants in the group, including the *de facto* dean of this area, Mr. Machen, will confirm that the structure of the Virginia Historic Funds represented the accepted norm within the industry.

(vii) The Partnership returns themselves could not have more clearly disclosed the now disputed position of the Partnerships:

* Nothing subtle existed about the names and nature of the four "Virginia Historic Tax Credit Funds."
* The Partnerships fully disclosed the identities, Virginia addresses, beginning capital account balances, partnership percentages, distributive shares, and partner status of every partner on the separate Schedules K-1.

(viii) Frank Lyon, Section 761, Section 7701, the Section 707 regulations, the "check-the-box" regulations, and all of the other previously discussed Federal authorities represent both substantial authority and reasonable cause.

(ix) VA. CODE §§ 53.1-339.2 (partnership allocation under controlling historic rehabilitation statute), 50-73.11, et seq. (limited partnership formation statute), 13.1-1003, et seq. (limited liability company statute), 50-73.1 and 13.1-1002 (the contribution statutes), and the many partnership and joint venture cases also supply both substantial authority and reasonable cause.

(x) Each of the 20 factors represents legal and/or factual substantial authority and thereby reasonable cause.

(xi) Kutak Rock, one of the leading law firms in the country with respect to State policy-based partnerships, not only rendered the same honest opinion it provided every other participant in this area, but the managing partner of its Richmond office handled the administration of these partnerships with the assistance of one of the leading CPA firms in the Commonwealth of Virginia.

(xii) While the relationship between the advisor and the entity undoubtedly impacts the weight accorded the advice, the participation by Mr. Gecker (a graduate of Princeton and the William & Mary School of Law and an elected member of ALI), Witt Mares, et al., underscores why their advice should carry greater weight than a detached opinion by someone unwilling to participate.

(xiii) The principle behind Sacks and Rev. Rul. 79-30 requires that these policy-based, special-purpose, community-revitalization partnerships be encouraged, not punished.

Threatening penalties here seems especially capricious and mean-spirited when, until recently, no one knew which partners would be favorably affected by Respondent's (mistaken) contention and which partners may owe a small deficiency -- deficiencies for the most part, below the Section 6662 numerical thresholds. To continue to threaten these policy-based partnerships and their partners only serves to alienate additional supporters of this valuable community-revitalization program at a time when Virginia needs them most.
WITNESSES

The Partnerships are narrowing their witnesses from the following individuals:

1. **Present and past representative(s) from the Virginia Department of Historic Resources.** One or more of these representatives may be called to testify with respect to the operation, function, purposes, and successes of this Department and the rehabilitation program that supplied an important part of the motivation for the partners forming and joining these agencies. They may also be asked about normal industry structures and practices during 2001 and 2002. The representatives may include the then Director (H. Alexander Wise), the current Director and then Deputy Director (Kathleen E. Kilpatrick), and the then Head of the Virginia Rehabilitation Program (Virginia E. McConnell).

2. **Present and past representative(s) from the Virginia Department of Taxation.** One or more of these representatives may be called to testify about the operation of the Program, the memorandum and ruling it issued relating to these partnerships, and practical difficulties created by Respondent's reversal in position. These representatives may include Janie E. Bowen or other representatives of the Virginia Department of Taxation.

3. **Present and past representative(s) from Witt Mares, PLC.** One or more of these representatives may be called to testify about all aspects of the Virginia Historic Tax Credit Funds from the initial consultation relating to investments through return preparation to the audit. These representatives may include John W. Stewart, Michael E. Mares, Elizabeth A. Llewellyn, and Wanda Ortwine.

4. **Present and past representative(s) from Kutak Rock and Biegler & Associates.** One or more of these representatives may be called to testify with respect to their and their clients' involvement in the Virginia Historic Tax Credit Funds and the Virginia Historic Rehabilitation Program. These representatives may include Fiona Tower (former Kutak Rock attorney), Mr. Gecker, and Steven Biegler, CPA (with Biegler & Associates, P.C.).

5. **Former representatives of Legg Mason.** One or more of these representatives may be called to testify with respect to that partnership's formation, purposes, and operations. These representatives may include David Gray (former Legg Mason coordinator for Virginia Historic Tax Credit Fund 2001 SCP LP), and/or Lee A. Sheller (former counsel for Virginia Historic Tax Credit Fund 2001 SCP LP).

6. **Principals of the General Partner.** Robert W. (Robin) Miller, Daniel A. Gecker, and George E. Brower may be called to testify about all aspects of the Virginia Historic Tax Credit Funds, as well as their complementary efforts to promote community-revitalization. For example, all three gentlemen have received recognition from various communities and related organizations. Messrs. Miller and Gecker taught as adjunct professors on the subject at VCU for a number of years (with Mr. Miller previously teaching at West Point). Their
general division of labor delegates responsibility for finding projects and dealing with developers to Mr. Brower (who, with experience in rehabilitation construction, largely initiated this effort while at Legg Mason), the administration to Mr. Gecker (a Princeton and William & Mary graduate who redirected his law practice and later his entire life into community activities), and construction to Robin Miller (a graduate of West Point and Harvard who developed the Parsons House and other projects). Administrative personnel may also be called to describe challenges and efforts in locating documents after the audit.

7. Present and past representative(s) from Developer Partnerships. One or more of these representatives may be called to discuss various aspects of the developments and partnerships that enabled receipt of the state tax credits. These representatives may include Alex Alexander, Kelvin Hanson, Fred Ramey, Jr. (City Manager of Norton, Virginia), Gabriel Laufer, Steven Stats, and any other developer who may be helpful to the Court.

8. State Policy-Based Credit Group. William Machen (with Holland & Knight), Jerome Breed (formerly with Powell Goldstein, and now with Bryan Cave LLP), and other individuals with whom the General Partner regularly discussed these and related issues may be called to testify with respect to discussions with Mr. Gecker, as well as industry norms as to structure.

9. Limited partners and non-managing members of the Virginia Historic Rehabilitation Funds. One or more of these partners may be called to testify as to their partner status in their respective special-purpose partnership/LLC. These individuals may be called to testify as to their intent to be partners based on their desire to help their State and receive economic incentives, their contributions to their respective partnerships, their signing of Subscription Agreements, their filing of both Federal and State Tax returns declaring their partner status, their receipt of FPAAs, and other contacts.\footnote{Due to unavailability resulting from Spring Break conflicts, the Partnerships may need to substitute two partners.}

Robert Barber, Jr.  
Harvard R. Birdsong II  
Barbara J. Bjerke  
William S. Davidson  
Kenneth D. Dockery  
Derrick Lynn Dunlap  
John H. Hager  
Susan P. Jefferson  
Stephen J. Leibovic  
Leopold (Lee) A. Schmidt  
Kimber A. Smith  
Lawrence Smith  
David A. Stosch  
Kenneth R. Zaslav
10. **Expert/Summary Witnesses.**

Paul M. Young, CPA. Mr. Young is a CPA in Virginia with extensive experience in handling Virginia Historic Rehabilitation and associated Virginia tax credit incentives. Mr. Young may be called to provide a summary of the sales costs under Respondent's (erroneous) credit-sale theory. Petitioner tendered his Report to the Court and Respondent on March 20, 2009.

Michael S. Haigh, CPA. Mr. Haigh is the Tax Director at Witt Mares PLC who may be called to compare the aggregate federal tax impact of Respondent's position on the partners with the position originally filed by those partners in the Virginia Historic Tax Credit Fund 2001 LP whose files are available to Witt Mares. Petitioner tendered his Report to the Court and Respondent on March 20, 2009.

11. **Agents of Respondent.** One or more of these Agents (with whom representatives of the Partnerships, Messrs. Gecker, Brower and/or Miller spoke) may be called to testify about the cooperation by the Partnerships, the documents produced, and the "excessive and erroneous" nature of the FPAAAs.

George Pelikan. Mr. Pelikan was the IRS TEFRA Reviewer who assisted in creating the FPAAAs for the Partnerships and may be able to shed light on how and why the FPAAAs altered Treas. Reg. § 1.701-2(b) and overstated the claims, even under the (erroneous) position outlined in the IRS National Office instructions.

Aretha Smith. Ms. Smith was an IRS Revenue Agent during the relevant period. Ms. Smith was assigned to the Partnerships' examination. Ms. Smith may be called to testify about her role in that examination, including correspondence and conservations with Dan Gecker, responses to IDRs related to the examination, and the "excessive and erroneous" nature of the FPAA.

Unidentified Author of FPAA. For almost a year, Petitioner has been asking Respondent to identify the person who drafted the explanation, removed the word "FEDERAL" from the Treas. Reg. § 1.701-2(b) quote, and directed the gross receipts position in the FPAAAs. Respondent has yet to identify that person and has withheld 240 documents — at least some of which would answer these questions. Hence, Petitioner will be forced to ferret out that person through other witnesses at trial.

12. **John Leith-Tetrault with the National Trust for Historic Preservation.** This gentleman may be asked to testify about the goals and activities of his organization in connection with Federal and State historic rehabilitation credit industry practices during the years in question.
EVIDENTIARY ISSUES

1. **Hearsay Objection to Virginia DHR *Prosperity through Preservation* and VCU Study.** Four days ago, Respondent first objected on hearsay grounds to the previously admitted facts drawn from two documents maintained by the Virginia Department of Historic Resources: *Prosperity through Preservation* and the study conducted by the VCU Center for Public Policy in conjunction with the Virginia DHR. Through the Director of the Virginia DHR, we will lay the Partnerships' foundation that the Department maintains these two documents as part of its regularly conducted activity, that they constitute public records and reports of that agency, and that they therefore constitute exceptions to the hearsay rule under FED. R. EVID. 803(6) and (8).

2. **Evidence Corroborating Motive.** Respondent also reserves a relevance objection (Stip. ¶¶ 17-25) to evidence as to the existence and fulfillment of the goals that motivated the partners to form and join the Partnerships. As noted, the partners formed and joined these partnerships for two interrelated reasons. Like those who only invest in "green"/environmentally sensitive stocks, these partners chose to support the laudable goals of the Virginia Historic Rehabilitation Program. Secondly, they sought the financial inducement offered by the Commonwealth to those who supported the program. Evidence as to the existence and fulfillment of those goals exceeds the "more likely" standard for admissibility under FED. R. EVID. § 401 and 402 and is essential to proof of motive and an understanding of the heart of this case.

3. **Evidence as to Section 7491 Cooperation by the Partnerships and as to the "Excessive, Erroneous, Arbitrary, and Capricious" Nature of the FPAAs.** Initially, the Partnerships opposed being drawn into litigation of the facts preceding the issuance of the PFAAs but when Respondent insisted, we investigated the matter and discovered extensive evidence as to both extraordinary cooperation by the Partnerships (e.g., Mr. Gecker gave the
agent his cell phone number, promptly returned her calls, provided extensive explanations, etc.) and as to the "excessive, erroneous, arbitrary, and capricious" nature of the FPAAAs. That evidence, especially when reviewed through the spectrum of Respondent withholding 240 documents, renders "more likely (under the FED. R. EVID. 401 and 402 relevance standard) that Respondent knowingly issued FPAAAs that were erroneous, excessive, and baseless in two different respects. Respondent now seeks to exclude much of his own agent's (stipulated) work papers on grounds of relevance. Section 7491 renders audit cooperation relevant, and attacking the notice constitutes an established exception to the Greenberg's Express aversion to "going behind the notice." Compare Greenberg's Express, Inc. v. Commissioner, 62 T.C. 324, 327 (1974) with Capitol Federal Savings & Loan Assoc. v. Commissioner, 96 T.C. 204, 214-15 (1991). The Court will need this evidence to ultimately determine the burden of proof.

CONCLUSION

The Partnerships stand ready for trial.

Respectfully submitted,

Date: April 16, 2009

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CERTIFICATE OF SERVICE

I hereby certify that the foregoing TRIAL MEMORANDUM FOR PETITIONERS was sent via United-Parcel Service on this 6th day of April, 2009, addressed to:

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