

State Tax Credit Partnerships: The IRS's Opening Salvo

By Charles Kolstad

On January 29, 2007, the IRS released Chief Counsel Advices (“CCA”) 220704208 and 200704030, each dated October 6, 2006 and each dealing with purported partnerships formed to take advantage of State income tax credits for the rehabilitation of real estate projects located in the State. The two CCAs deal with substantially the same facts. While the CCAs deal with state rehabilitation tax credits, the issues raised by the IRS in those CCAs apply equally to state tax credits based on the production of movies or TV shows.

BACKGROUND

In the CCAs, in summary, a developer (“Developer”) and various investors acting through a promoter (“Investors”) formed a partnership (“PS”) in State X. Under the terms of the partnership agreement, the Investors in PS made a cash contribution to PS in an amount that was determined based solely upon the amount of State X tax credits that were to be allocated to the Investors. None of the State X tax credits was allocated to Developer. The amount of the Investor’s capital contribution was a pre-determined percentage, at a discount, of the State X tax credits. The State X tax credits were allocated to the Investors immediately upon execution of the subscription agreements and contributions of cash by the Investors. The Investors granted PS the option to purchase the Investor’s interests in PS at their fair market value for a period of one year. The CCAs state that, in fact, the Investors held their interests in PS only for a few months, and then sold their interests in PS to the promoter at a small fraction of each Investor’s basis in the partnership interests. The Investors then each claimed a capital loss for federal income tax purposes equal to the difference between their capital contribution to PS and the sales price paid by the promoter for the partnership interest. The marketing materials, and the partnership agreement, provided that (1) the Investors were not to receive any material distributions of cash flow or gain from the sale of the projects, and (2) any return of investment to an Investor was dependent solely upon the

allocations of State X tax credits and the capital loss to be recognize by the Investors on the sale of their interests in PS.

Under the laws of State X, the credit was based upon qualified expenditures in State X, and could be used as a dollar-for-dollar reduction in State X tax liability. In the year(s) in question, the State X tax credits were transferable. In addition, in the case of limited liability companies, partnerships or other flow-through entities, the State X tax credits could be allocated to the partners or shareholders.

In the CCAs, the Chief Counsel made three arguments as to why the allocations of the State X tax credits should not be respected for federal income tax purposes. The first argument, not surprisingly, was that no partnership existed for federal income tax purposes. *Citing Comm’r v. Tower*, 327 U.S. 280, and *Comm’r v. Culbertson*, 337 U.S. 733, the Chief Commissioner concluded that the Investors were not partners in PS. Since the Investors would receive no material cash distributions, no net proceeds from a sale of the projects or operating business, no allocations of federal tax credits, and no allocations of partnership items of income, gain, loss or deduction, they accordingly had no joint profit motive and thus were not partners in PS. As a result, under this approach, the Chief Counsel recast the transactions as a sale of property, *i.e.*, the State X tax credits, by PS to the Investors, so that PS would be required to report gain equal to the difference between the amounts received from the Investors and PS’s basis in the State X tax credits. After some analysis, the Chief Counsel concluded that PS had no basis in the State X tax credits, and thus would recognize the full amount of the proceeds received from the Investors as a taxable gain. Furthermore, since the Investors effectively purchased the State X tax credits at a discount, the Investors would also recognize

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gain in the taxable year they claimed the State X tax credits as a credit on their State X income tax returns; the amount of the gain would be equal to the discount the Investors received in determining their capital contributions.

Alternatively, the Chief Counsel applied the disguised sales rules under Section 707(b), and Regs 1.707-3(b) and 1.707-6. Since there was a transfer of property by the Investors to PS (*i.e.*, their capital contributions) followed by a subsequent transfer of property by PS to the Investors (*i.e.*, the State X tax credits) within a 2 year period from the contribution, the Chief Counsel concluded that the transfers of the State X tax credits were disguised sales under the 2 year presumption in the regulations, so that PS should recognize gain on the transfer of the State X tax credits to the Investors.

Lastly, the Chief Counsel could not resist using the interrum rules the US Treasury gave the IRS under Reg. 1.701-2, and concluded that PS was formed or availed of to engage in a transaction, the principal purpose of which was to reduce the present value of the Investors' aggregate tax liability in a manner inconsistent with the intent of Subchapter K. As a result, again the Chief Counsel concluded the transaction should be recast as a sale of State X tax credits by PS to the Investors, fully subject to gain recognition. In addition, the capital losses claimed by Investors should be disallowed.

The Chief Counsel also concluded, as a technical matter, that the issue of whether the Investors were partners in PS is a partnership item under the TEFRA partnership procedures, and is, accordingly, a matter for determination at the partnership level and not the partner level. The Chief Counsel did note, however, that this issue is not free from doubt.

OBSERVATIONS

The issues raised by the CCAs are not limited to partnerships engaging in transactions that involve the allocation of state rehabilitation tax credits. A number of partnerships have been established to take advantage of state tax credits available for movies and TV shows produced in that state. Based upon our understanding of how such movie and TV partnerships have been structured, many of the same issues raised in the CCA are present in these partnerships as well.

If the IRS is successful when it raises the positions asserted in the CCA, the partnership would recognize a fully taxable gain equal to the amount invested by the investors in the partnership. Since in many cases the investors will sell or have their partnership interests redeemed shortly after they make their initial investment, the developer could be left responsible for paying the federal tax on the gain. In many

of the movie or TV show partnerships, the partnership will also have delivered the movie or TV show to the distributor on or around the time the investors sell or are redeemed, and have no assets left with which to pay any additional federal tax. In such cases, the producer may have to reach into their own pockets to pay the additional federal taxes.

Note that the sale of the partnership interests to the promoter could result in a termination of the partnership under Section 708; alternatively, if the partnership redeems the partnership interests held by the investors, the developer could end up as the sole remaining partner or member, and the partnership could become a disregarded entity for federal tax purposes. The effect of such a sale or termination on the basis of the assets of the partnership should be carefully reviewed.

In addition, the investors in the partnership would recognize a gain for federal income tax purposes equal to the amount of the discount when they claim the state tax credits on their state income tax return. Although not raised in the CCAs, the issue of whether the developer or partnership has an information reporting obligation to report the transfer of the state tax credits to the investors should be carefully reviewed.

The Chief Counsel's conclusions are in large part based upon the premise that the State X tax credits are property which has a zero basis in the hands of PS. In certain, but not all, cases, state tax credits are transferable to the extent not used by the taxpayer to whom they were initially allocated by the partnership. The fact that the State X tax credits are transferable certainly strengthens the Chief Counsel's position, but is not necessarily determinative in each case. If the state tax credits are allocated between the partners in a partnership based upon their respective interests in the partnership, and are used by the partner(s) to whom the credits are allocated, then the Chief Counsel's position is not nearly as strong and may be wrong.

An interesting corollary, but not discussed in the CCA's, is the effect of an allocation of the State X tax credits on the Investor's capital accounts if the State X tax credits are in fact property. Presumably, in such case the allocation would possibly be viewed as a distribution as well, so that book capital accounts should be reduced by the fair market value of the State X tax credits, which would exceed the capital contributions by the Investors, thereby creating a capital account deficit. While many partnership agreements provide that a partner with a deficit capital account does not have an obligation to restore such capital account deficit through payments to the partnership, a developer who entered into a partnership based upon representations of favorable tax

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benefits by a promoter may have grounds for challenging such provision. Since the partnership would have a zero basis in the state tax credits, the allocation would have no effect on the investor's basis in their partnership interests.

Furthermore, if partnership is respected and the transfer of the state tax credits is recast as a disguised sale under Section 707, the partnership would have to allocate the taxable gain between the partners. Typically, such gain would be allocated accordingly to the provisions of the partnership agreement; however, if such allocation of the deemed gain is not in accordance with Reg. 1.704-1(b)(2), then the allocations would not have substantial economic effect and could be reallocated by the IRS between the partners based upon their respective partnership interest percentages under Reg. 1.704-1(b)(3). This could result in the investors being allocated a portion of the partnership level gain, in addition to the discount gain discussed above, which is surely a result the investors did not anticipate.

Lastly, although not raised in the CCAs, the partnership agreement may provide that upon liquidation of the partnership, all remaining assets of the partnership will be distributed, after payment of third party liabilities, to the developer. In such case, under the liquidation analysis provided for in Rev. Proc. 93-27 and the 2005 proposed regulations under Section 721, and without regard to any of the issues raised by the Chief Counsel in the CCAs, the IRS could argue strongly that the developer should recognize gain immediately upon the contribution of funds by investors, since if the partnership were liquidated immediately after such contributions, all of the amounts contributed by the investors would be distributable solely to the developer.

CONCLUSION

In light of the two CCAs, tax matters partners ("TMP") in partnerships formed to allocate state tax credits to third party investors, and promoters of those partnerships, need to carefully review the CCAs to determine the extent to which the arguments raised therein or discussed above, might apply to their respective partnerships. Since the transfer of the state tax credits might result in one or more investors having to recognize gain on their federal income

tax returns, the TMP needs to carefully review its obligation to report this recent development to any third party investors under the terms of the partnership or operating agreement, and the TMP's fiduciary obligations under the applicable state law. If tax opinions were provided to any investors, then such opinions should be carefully reviewed to determine the extent to which the arguments raised by the CCAs were addressed in such opinions.

In addition, if federal tax returns have not been filed, the TMP and promoters should carefully review the facts of their particular transaction to determine whether it would be appropriate to amend the partnership or operating agreement and the underlying transaction to strengthen the position, if audited, that one or more of the arguments raised in the CCA do not apply to that particular partnership.

Lastly, if federal income tax returns have been filed by a partnership and Schedule K-1's issued to its partners, the TMP should carefully review the CCAs and the specific facts of their own partnerships to determine that they had a reasonable filing position and that they and the preparers of the Form 1065 should not be subject to penalties. Depending upon the amount of the gain at the partnership or investor level, there may be a substantial understatement of income resulting in possible accuracy-related penalties and interest being imposed under Section 6662. Such penalties may be avoidable if the partnership or investor had substantial authority for the position taken on the return, or alternatively, the issue is disclosed on the return, there is a reasonable basis for such treatment, and, under Section 6664, the taxpayer acted in good faith in taking that position.

In addition, for investors who prepare financial statements under GAAP rules, new FIN 48 requires that in order to book a tax benefit from the state tax credits, the investor would have to demonstrate that they have a "more likely than not" or greater than 50% chance of being sustained upon challenge by the IRS.

Should you like further information on the CCAs, please feel free to contact Charles Kolstad at (310) 478-5656 ext. 260.

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