

Partnership Allocations of Rehabilitation, New Market and Other Tax Credits: Navigating Complex 704(b) Rules

THURSDAY, JANUARY 5, 2017

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Structuring Allocations of Tax Credits

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January 5, 2017

Allocations

One of the key benefits of a partnership is the flexibility in allocating partnership items among the partners.

Allocations of a partner's distributive share of partnership income, gain, loss, deductions or credit will be respected if they

- (1) are either in accordance with the partners' interests in the partnership or
- (2) if they have substantial economic effect.

Allocations are not the same as distributions.

Partners' Interest in the Partnership

Allocations are generally in accordance with the partners' interests in the partnership if all allocations are being made in accordance with the respective contributions of the partners.

For example, if A and B each contributed \$100, allocations would be in accordance with the partners' interests in the partnership if all partnership items are shared 50-50.

Liquidating distributions can be made in accordance with the partners' respective interests in the partnership.

Substantial Economic Effect

AB is a partnership that owns 3 properties. All income allocated 50% to A, except 60% of income from property 1 is allocated to A. This is a special allocation.

Special allocations will be respected if they have substantial economic effect. Substantial economic effect is a safe harbor.

Two part analysis. Allocations must

- (1) Have economic effect; and
- (2) The economic effect must be substantial.

Economic Effect

General principle: If there is an economic benefit or burden that corresponds to an allocation, the partner to whom the allocation is made must receive the economic benefit or burden.

More simply, if a partner gets the benefit of an allocation of \$100 of tax loss, the partner must suffer the \$100 economic loss. If a partner suffers the burden of \$100 of tax gain, the partner must get the \$100 of cash.

This is accomplished by maintaining capital accounts and liquidating in accordance with those accounts.

Basic Test for Economic Effect

There are three requirements to satisfy the basic economic effect test:

- (1) Capital account requirement
- (2) Liquidation requirement
- (3) Deficit make up requirement

Capital Account Requirement

To have economic effect, the partnership must maintain its capital accounts in accordance with the rules of Reg. §1.704-1(b)(2)(iv).

Generally, this is accomplished with a provision in the partnership agreement stating that “a capital account will be established and maintained for each partner in accordance with Treasury Regulation §1.704-1(b)(2)(iv).”

What does this do? A partner’s capital account tracks and reflects the partner’s equity investment in the partnership.

Capital Account Maintenance Rules

A partner's capital account equals

- FMV of contributions
- Plus allocable share of partnership income
- Less FMV of distributions
- Less allocable share of partnership loss

Partnership liabilities generally are not taken into account in calculating capital account balances.

Liquidation Requirement

For economic effect, liquidating distributions to the partners must be made based on positive capital accounts. In other words, no waterfall distributions.

If allocations have gone awry, positive capital account balances will not be the same amount as what would be received under the waterfall distributions. Consider including a savings clause in the partnership agreement to avoid/minimize this risk.

Deficit Make Up Requirement

If a partner has a deficit in his capital account upon liquidation of the partnership, the partner must have an unconditional obligation to restore the deficit. This deficit restoration obligation (“DRO”) may be provided for in the partnership agreement or by state law.

A DRO may come from a partner contributing a promissory note to the partnership or having an obligation (whether imposed by the partnership agreement or state law) to make subsequent contributions to the partnership.

A partner can have a limited DRO.

Example

A and B contribute \$100 each to AB partnership. The partnership agreement provides that 60% of partnership items are allocated to A and 40% are allocated to B. AB has a \$200 loss.

	<u>A's CA</u>	<u>B's CA</u>
Contribution	100	100
Income	<u>(120)</u>	<u>(80)</u>
	(20)	20

For the entire allocation to have economic effect, A must have a DRO. Otherwise, B is bearing the economic risk for \$20 of the losses.

Planning Opportunity

Treas. Reg. §1.761-1(c) provides a “partnership agreement” can be modified or amended with respect to a taxable year after the close of the taxable year, provided the amendment occurs on or before the due date for the partnership return (without extension).

This gives partners a planning opportunity to amend how they allocate income and losses after the close of the year. In particular, to provide for a limited DRO to the extent necessary to support a loss allocation.

Alternate Test for Economic Effect

- (1) Capital account requirement.
- (2) Liquidation requirement.
- (3) Partnership agreement has a qualified income offset (“QIO”) provision. The QIO must require that any partner with an unexpected negative capital account be allocated all of the next items of partnership income so as to eliminate the negative balances as quickly as possible.
- (4) The allocation does not create or increase a deficit in a partner’s capital account in excess of the partner’s obligation to restore a deficit.

Substantiality

The economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.

In short, an allocation lacks substantiality if the allocation has favorable tax consequences to one partner without corresponding detrimental tax consequences to the other partners and no overall change on the partners' capital accounts.

Substantiality

If the only effect of an allocation is to reduce taxes without substantially affecting the partners' pre-tax distributive shares, the economic effect is not substantial.

Substantiality

Even if the general rule is satisfied, the economic effect is not substantial in the following cases:

- (1) Shifting Tax Consequences
- (2) Transitory Allocations
- (3) After-Tax Effect

Shifting Tax Allocations

Occurs if there is a strong likelihood that:

- (1) the net increases and decreases that will be recorded in the partners' respective capital accounts for such taxable year will not differ substantially from the net increases and decreases that would be recorded in the partners' capital accounts if the allocations were not contained and
- (2) the total tax liability of the partners will be less than if the allocations were not contained in the partnership agreement (taking into account the tax consequences that result from the interaction of the allocation with the partner's tax attributes even if unrelated to the partnership).

Example

A and B are equal partners, but A is a tax exempt entity. AB has \$100 of ordinary income and \$100 of tax exempt income.

The partnership agreement allocates A the \$100 of ordinary income and B the \$100 of tax exempt income. The economic effect to both partners is the same, but the total tax liability for the partners is \$0. Without the special allocation, the total tax liability would be \$17.5 (\$50 x 35%).

This allocation lacks substantiality under the shifting tax consequences rule.

Shifting Allocations

Exception: Value equals basis rule.

A partnership's assets are irrebuttably presumed to have a value equal to their basis (or book value if different from basis).

So, even if there is appreciated or depreciated property in the partnership that could be used to make future allocations, the appreciation or depreciation is ignored.

Transitory Allocations

If a partnership agreement provides for a possibility that one or more allocation (“original allocation”) will be largely offset by one or more allocation (“offsetting allocation”) and there is a strong likelihood that:

- (1) the net increases and decreases that will be recorded in the partners’ respective capital accounts for such taxable year will not differ substantially from the net increases and decreases that would be recorded in the partners’ capital accounts if the allocations were not contained and

Transitory Allocations

- (2) the total tax liability of the partners will be less than if the allocations were not contained in the partnership agreement (taking into account the tax consequences that result from the interaction of the allocation with the partner's tax attributes even if unrelated to the partnership.)

Example

A and B are equal partners, but A has \$100 of NOLs that are expiring in the next 2 years. AB has \$50 of income each year. AB allocates all \$100 of income to A in years 1 and 2, and then \$100 of income to B in years 3 and 4. Thereafter, income is shared equally.

The economic result is unchanged by this special allocation, but the allocation allows A to take advantage of expiring NOLs. The total tax liability is \$17.5 ($\$50 \times 35\%$), instead of \$52.5 ($\$150 \times 35\%$).

This is a transitory allocation and lacks substantiality.

Transitory Allocations

Exceptions:

- Value equals basis rule.
- 5 year rule: If at the time of allocation, there is a strong likelihood that the original allocation will not be largely offset within 5 years, presumption that economic effect of allocation is not transitory.
- Risky ventures. Because a risky venture is speculative in nature, there is not a strong likelihood that the offsetting profits/income will ever materialize.

After-Tax Rule

An allocation does not have substantial economic effect if, at the time the allocation is added to the partnership agreement,

- (1) the after-tax economic consequences of at least one partner may be enhanced compared to such consequences if the allocation were not contained in the partnership agreement, and
- (2) there is a strong likelihood that the after-tax consequences of no partner will be substantially diminished compared to the consequences if the allocation were not in the partnership agreement.

Example

Same as prior example, but AB allocates \$90 of income to A in years 1 and 2, and \$110 to B in years 2 through 4.

This allocation passes the other two tests, because there is a material effect on capital accounts (A gets \$10 less). But, on an after-tax basis, A's economic position is improved, and B's economic position is not substantially diminished (it is actually better).

	A		B	
	<u>Tax</u>	<u>After-Tax</u>	<u>Tax</u>	<u>After-Tax</u>
With	\$0	\$90	\$38.5	\$71.5
W/O	\$17.5	\$82.5	\$35	\$65

This allocation violates the after-tax rule and lacks substantiality.

After-Tax Rule

The focus of this rule is on after-tax consequences, not pre-tax capital accounts. Thus, you cannot avoid lack of substantiality by using an unequal number of years.

Exceptions:

- Value equals basis rule.
- Risky venture.

No Substantial Economic Effect

If no substantial economic effect, a reallocation will occur in accordance with the partners' interest in the partnership. Presumption that partners share per capita (i.e., 50-50 if 2).

Factors to consider in rebutting this presumption:

- the partners' relative contributions to the partnership;
- the interests of the partners' in economic profits and losses (if different from taxable income and loss);
- interests in cash flow or other nonliquidating distributions; and
- rights to distribution on liquidation.

Tax Credit Example

A and B contribute \$100 each to AB partnership. AB has \$50 of tax credits all of which are allocated to A.

	<u>A's CA</u>	<u>B's CA</u>
Contribution	100	100
Credit	<u>--</u>	<u>--</u>
	100	100

Because the credit allocation does not impact capital accounts, it cannot have economic effect. So what do the regulations require?

Treas. Reg. § 1.704-1(b)(4)(ii)

Allocations of tax credits and tax credit recapture are not reflected by adjustments to the partners' capital accounts (except to the extent that adjustments to the adjusted tax basis of partnership section 38 property in respect of tax credits and tax credit recapture give rise to capital account adjustments under paragraph (b)(2)(iv)(I) of this section). Thus, such allocations cannot have economic effect under paragraph (b)(2)(ii)(b)(1) of this section, and the tax credits and tax credit recapture must be allocated in accordance with the partners' interests in the partnership as of the time the tax credit or credit recapture arises...

Treas. Reg. § 1.704-1(b)(4)(ii).

Investment Tax Credit Special Rule

With respect to the investment tax credit provided by section 38, allocations of cost or qualified investment made in accordance with paragraph (f) of §1.46-3 and paragraph (a)(4)(iv) of §1.48-8 shall be deemed to be made in accordance with the partners' interests in the partnership.

Treas. Reg. § 1.704-1(b)(4)(ii).

Other Credits

With respect to other tax credits, if a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership taxable year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustments) for such year, then the partners' interests in the partnership with respect to such credit (or the cost giving rise thereto) shall be in the same proportion as such partners' respective distributive shares of such loss or deduction (and adjustments).

Safe Harbors for Certain Credits

- Section 45 Wind Energy Production Tax Credits. See Rev. Proc. 2007-65.
- Section 47 Rehabilitation Tax Credits. See Rev. Proc. 2014-12.

Partnership Allocations of Rehabilitation, New Market and Other Tax Credits Case Law and Examples

January 5, 2017

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Overview

- Federal Tax Treatment of Tax Credits
- Case Law
- Examples

Federal Tax Treatment of Tax Credits

Federal Tax Treatment of Tax Credits

- The IRS has not issued much guidance on federal or state tax credits.
- Two Chief Counsel Advice memoranda issued in 2007 provide some guidance on state tax credits: CCA 20074028 and CCA 20074030.
- The CCA's are primarily concerned with the allocation of state rehabilitation credits and are understood to address the facts of what became the Virginia Historic Tax Credit Fund 2001 LP case, discussed below.

Federal Tax Treatment of Tax Credits

- In the CCAs, the IRS distinguishes between assignable and non-assignable state tax credits.
- In the case of non-assignable tax credits, the CCAs take the position that such a credit is a tax item, rather than property. Accordingly, if a partnership generated such a credit, and if that credit was properly allocated in whole or part to a partner, and if the credit reduced the partner's state tax liability, then that partner is treated as reducing that liability.
- In other words, the partner gets a state tax deduction on the partner's federal tax return only for the as-reduced state tax liability, not for the original liability.

Federal Tax Treatment of Tax Credits

- In the case of assignable tax credits, the CCAs take a different position.
- If and when such a credit is assigned, it is treated as property for federal tax purposes – essentially it is treated as a cash substitute that can be used to pay state income taxes.
- This results in at least four significant federal income tax consequences.

Federal Tax Treatment of Tax Credits

seller-side tax consequences:

1. The partnership that generates the state tax credit is treated as having a zero basis in the credit.
2. The partnership is treated as selling the credit and has to recognize gain or loss at that time. Because the partnership has a zero basis, the amount received for the credit is taxable income.

Example: Newco generates \$100 in State X tax credits. Newco sells those credits to Jane Doe for \$80. Newco recognizes \$80 in federal taxable income.

Federal Tax Treatment of Tax Credits

buyer-side tax consequences:

3. Because the credit is treated as a property item to the buyer, the buyer is then treated as tendering that item as payment in kind to discharge all or part of the buyer's state income tax burden. Thus, the buyer is entitled to a state tax deduction as computed before the application of the state tax credit.
4. Because the buyer made a payment in kind, the buyer has to recognize the difference between the amount discharged and the buyer's basis for the credit.

Federal Tax Treatment of Tax Credits

buyer-side tax consequences:

Example: As above, Newco sells \$100 in State X tax credits to Jane Doe for \$80. Jane uses the credits to discharge \$100 in State X income tax.

For federal tax purposes, Jane is entitled to a \$100 state income tax deduction. In addition, Jane takes an \$80 basis in the credits. The FMV of the credits is \$100. Accordingly, Jane recognizes \$20 in gain at the time she uses the credits to offset her State X tax liability.

Federal Tax Treatment of Tax Credits

Comparison of Results:

- Non-assignable state tax credits:
 - The partners of a partnership generating the credits recognize no gain from the allocation or use of the credits.
 - No state tax deduction for state tax liability eliminated by credits.
- Assignable state tax credits:
 - Partnership recognizes gain on sale of credits -- in example above , this was \$80 gain which is then included in the partners' income
 - Buyer allowed full deduction of state liability prior to application of the credits (\$100 deduction), but recognizes gain on tender of the credits (\$20 gain), for net benefit of \$80 deduction.

Federal Tax Treatment of Tax Credits

- The IRS has not indicated whether the same approach should apply to federal tax credits.
- Because there are no assignable federal tax credits, the application of the CCA approach would be that the generation, allocation and utilization of federal tax credits should generate no federal tax consequences.
- BUT – the fact that there are no assignable federal tax credits means that implicit in the forgoing is that the allocation of federal tax credits has to be respected.

CASE LAW

CASE LAW

- There are a number of cases addressing the allocation of non-assignable state tax credits and a recent case that addresses the allocation of federal tax credits.
- We first discuss the state tax credit cases and then spend time on the recent federal tax credit case and on the federal case law addressing whether a taxpayer is a bona fide partner.
- Note that all of these cases focus on the federal tax consequences of these credits, not on the state tax implications.

State Tax Credit Cases

Virginia Historic Tax Credit Fund case

- The first in a series of cases that analyze the treatment of state tax credits is Virginia Historic Tax Credit Fund 2001 LP, RIA TC Memo 2009-295, *rev'd* 639 F.3d 129 (4th Cir. 2011).
- The case involves a partnership that was established to assist in allocating Virginia state historic tax credits to investors.
- These credits are not assignable – the recipient must be a partner in the partnership which generates the credits or to which the credit is allocated.

Virginia Historic Tax Credit Fund case

- Like most state credit structures, the tax credit investor owns a small interest in the underlying partnership (typically 0.01%), and receives no significant distributions, or profit/loss allocations.
- However, 100% of the state tax credits are allocated to the tax credit investors.
- The partnership in the case at issue, like most other VA historic tax credit arrangements, relied on the fact that the credit can, by its terms, be allocated by agreement of the partners, rather than in accordance with a partner's interests in the partnership or by reference to the expenditures that generate the credit.

Virginia Historic Tax Credit Fund case

- In addition, the tax credit investor's interest is often subject to put and call arrangements. After the credit is allocated, the investor can put its interest back to the partnership for a formula price, or the partnership can buy out the investor, also for a formula price.
- The formula price is often quite small, especially compared to the amount invested.
- This arrangement ensures that, once the credits are allocated, the underlying operating partnership can move forward free of any burden with respect to the tax credit investors.

Virginia Historic Tax Credit Fund case

Sidebar:

- Interestingly, some of these transactions also generate federal historic tax credits. In that case, the investors interested in federal rehab tax credits are allocated substantially all the economics (i.e., 99.98% of the profits, losses and distributions).
- This is because the federal rules do not permit the type of special allocation that, apparently, the VA tax credit permits.

Virginia Historic Tax Credit Fund case

- In the cited case, the partnership was audited and the IRS asserted, among other theories, that the tax credit investors were not bona fide partners for federal income tax purposes and/or that the investments were disguised sales between the partnership and the investors.
- The partnership disagreed and the case went to the Tax Court.
- The Tax Court ruled that the tax credit investors were bona fide partners and that the amounts invested were tax-free capital contributions.

Virginia Historic Tax Credit Fund case

- The government appealed the case to the Fourth Circuit Court of Appeal.
- The Fourth Circuit did not address the bona-fide partner issue but did hold that the tax credit arrangements were disguised sales under IRC §707.
- The Court noted that Treas. Reg. §1.707-3 provides that the disguised sale rules apply even if a person is not a partner, so it was not necessary to address this issue after determining that a disguised sale occurred.

Virginia Historic Tax Credit Fund case

- The partnership argued that the credits were not property and, hence, that no disguised sale occurred because there was no sale of property.
- The Court held that state tax credits are property because they embody some of the most essential property rights.
- Note that this appears to conflict with the CCA approach that non-assignable state tax credits are not property.

Virginia Historic Tax Credit Fund case

- Having concluded that the credits were property, the Court analyzed whether the disguised sale rules applied.
- Because the credits were transferred to the investors within the two-year presumption period, the Court considered whether the ten factors set out in the §707 regulations successfully rebutted the presumption.
- The Court determined that only five of the ten factors were pertinent to the facts of the case.

Virginia Historic Tax Credit Fund case

The five factors that the Court analyzed:

- (i) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;
- (ii) That the transferor has a legally enforceable right to the subsequent transfer;
- (iii) That the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;
- (ix) That 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; and
- (x) That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

Virginia Historic Tax Credit Fund case

For completeness, the other five factors in the 707 regulations are:

- (iv) That 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;
- (v) That any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;
- (vi) That the partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);
- (vii) That 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);
- (viii) That partnership distributions, allocations or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

Virginia Historic Tax Credit Fund case

- After going through the relevant factors, the Court determined that none of them could be resolved in favor of the partnership .
- Accordingly, the Court concluded that the tax credit transfers were disguised sales.

Virginia Historic Tax Credit Fund case

- Because the investments were treated as disguised sales, the partnership was deemed to recognize income from the “sale” of the credits.
- Note that this was the result advocated in the CCA for assignable credits.
- Because the Court applied the disguised sale rules, the tax credit investors could still be treated as partners for federal income tax purposes.
- This result does less damage to the tax credit market than a finding that the investors were not partners.

Virginia Historic Tax Credit Fund case

- Assume, instead, that the Court made a specific finding that the transaction failed because the tax credit investors were not partners in the partnership. The VA credits at issue, like most non-assignable state credits, can only be allocated to partners. VA, like most states, relies on the federal definitions of partnership status.
- If the investors were not partners for federal tax purposes, they arguably would lose their credits. This would result in a flurry of lawsuits and could freeze up the VA state tax credit market.
- The approach taken by the Fourth Circuit avoided this result, but did permit the IRS to tax the investment as a sale.

Virginia Historic Tax Credit Fund case

- This approach may reflect a view of federalism – because a federal court was determining the federal tax consequences of a state tax credit transaction it may have adopted the disguised sale analysis out of a sense of federalism.
- Recent Court Guidance on the Federal Treatment of Tax Credits, 32 Journal of Real Estate 327 (December 2016).

Virginia Historic Tax Credit Fund case

- Following this case, other cases reached nearly identical results:
 - SWF Real Estate LLC, TC Memo 2015-63 (state tax credit arrangements were a disguised sale).
 - Route 231, LLC, TC Memo 2014-30 (state tax credit arrangements were a disguised sale)
- In contrast, Gateway Hotel Partners, LLC, TC Memo 2014-5, involved a complex set of facts and ultimately found that a transfer of assignable credits could be treated as a tax-free distribution rather than a disguised sale, in part because of the entrepreneurial risk in each partner's capital contribution.

Historic Boardwalk Hall case

- Historic Boardwalk Hall, LLC, 694 F.3d 425 (CA-3, 2012), rev'g and remanding, 136 TC 1 (2011), involves a partnership arrangement meant to permit an investor to receive federal rehabilitation tax credits.
- Here the Third Circuit reversed the Tax Court and found that the tax credit investor was not a bona fide partner in the partnership.
- The federal rehab credit is subject to the allocation rules applicable to the investment tax credit – the credit must be allocated in accordance with a partner's interest in the partnership.
- If a credit investor is not a partner, it cannot be allocated any federal rehab credits.

Historic Boardwalk Hall case

- As noted, federal tax credit investors are typically allocated most of the economics of a partnership while state tax credits are allocated almost none of the economics (i.e., 99.9% vs. 0.01%).
- However, in both cases, the investor's partnership interest may be subject to put and call arrangements that provide for a near-guaranteed and risk-free return.
- In Boardwalk, the Court determined that the aggregate effect of this arrangements was to ensure that the investor had not upside or downside risk.

Historic Boardwalk Hall case

Third Circuit subjected the various arrangements to the Culbertson test:

A partnership exists when, as the Supreme Court said in Commissioner v. Culbertson, two or more “parties in good faith and acting with a business purpose intend[] to join together in the present conduct of the enterprise.” 337 U.S. at 742; see also Comm’r v. Tower, 327 U.S. 280, 286-87 (1946) (“When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both.”); Southgate Master Fund, L.L.C. ex rel. Montgomery Capital Advisors v. United States, 659 F.3d 466, 488 (5th Cir. 2011) (“The sine qua non of a partnership is an intent to join together for the purpose of sharing in the profits and losses of a genuine business.”).

Historic Boardwalk Hall case

- Applying this test, the Court determined that the investor was not a bona fide partner because the investor was not exposed to any risk (either risk of loss or a chance to participated in the upside if the project increased in value.).
- Because the investor was not a partner, it could not be allocated any federal rehab tax credits.
- Note that the Court did not apply the disguised sale rules. That approach might have reach a middle ground that taxed the partnership, but still allowed the investor to obtain the credits.

Castle Harbor case

- The Castle Harbor cases do not involve state or federal tax credits, but do address the bona fide partner issue.
- In TIFD III-E Inc. v. United States, 666 F. 3d 836 (CA-2, 2012), the Second Circuit determined that certain foreign banks who were allocated large amounts of income from a partnership were not bona fide partners.
- The Court dismissed most of the arrangements surrounding the purported partners – as with the Boardwalk Hall case, the Court found the foreign banks lacked any risk and were not bona fide partners.

Castle Harbor case

- As with Boardwalk Hall, the Court aggregated all the arrangements and scrutinized them closely in its evaluation of whether the banks bore any risk.
- Significantly, not only did the Court find that the banks were not partners, it also determined that the parties lacked substantial authority to treat the banks as partners – thus, the partnership was liable for the substantial understatement penalty.
- The imposition of this penalty under these facts makes the stakes very high!

CASE LAW -- SUMMARY

- In the case of state tax credits, courts are likely to find disguised sales when the tax credit investors lack upside or downside in their investments.
- But, so far, courts have not ventured further to determine whether tax credit investors are true partners.
- In the case of federal tax credits, courts are highly skeptical of arrangements that limit risk and benefit and are likely to find the beneficiaries are not true partners.
- In Boardwalk Hall the court did not apply a middle ground approach that might have assisted the federal tax credit market.

EXAMPLES

- Example 1: Assignable State Tax Credit
- Example 2: Non-Assignable State Tax Credit
- Example 3: Federal Investment Tax Credit

Ex. 1: Assignable State Tax Credit

- Filmco is a video production company that makes \$1 million in qualifying GA expenditures in 2016.
- Filmco sells \$300,000 in GA film production tax credits by the end of 2017 to a single investor (John Doe) for \$250,000.
- The credit by its terms is assignable.
- Results?

Ex. 1: Assignable State Tax Credit

- Filmco has gain – it sold zero basis property for \$250,000, so should have taxable income of the same amount.
- Is this capital or ordinary income? No guidance and often holding period is less than a year so may be moot.
- John Doe has gain of \$50,000 – he discharged \$300,000 in state taxes with “property” in which he had a basis of \$250,000.
- John Doe also has a \$300,000 state tax deduction.

Ex. 2: Non-Assignable State Tax Credit

- Newco is formed to develop an historic building. It arranges with Investor to become a partner. Investor is entitled to 100% of any state rehab and historic tax credits that Newco generates.
- In 2017, Newco allocates \$300,000 in credits to Investor.
- Investor utilizes the credits and offsets \$300,000 of state tax liability. Investor has no other tax consequences, except that Investor's state tax deduction is now \$300,000 less than it would have been otherwise.

Ex. 2: Non-Assignable State Tax Credit

- Assume, now that the IRS audits Newco and scrutinizes the arrangements around Investor. Investor has a 0.01% interest in the economics, and is subject to a put and call arrangement at a formula price of \$1.
- Likely, the IRS and the courts would follow the lead of the cases and determine that this was a disguised sale.
- Note that this creates a conflict between Newco and Investor – Newco generally will resist the disguised sale position, but Investor may benefit from it.
- The rights under the TMP clause in the partnership agreement may be critical here.

Ex. 2: Non-Assignable State Tax Credit

- Assume now that the put and call arrangement is set at “fair market value” as determined by a qualified appraiser.
- Now it appears that Investor may actually have some upside potential.
- Although not clear, this could result in a finding that the disguised sale rules do not apply, as in the Gateway case.

Ex. 3: Federal Investment Tax Credit

- Newco is formed to develop an historic building. Investor is willing to invest if it receives all the federal rehab tax credits that Newco generates.
- Investor pays \$1 million to Newco. In exchange, Investor is granted a partnership interest in Newco entitled to 5% of profit, loss and cash distributions, and is specially allocated 95% of the federal rehab tax credits
- In 2017, Investor Newco allocates \$1,000,000 in credits to Investor.

Ex. 3: Federal Investment Tax Credit

- This allocation will largely fail.
- The federal rehab credit is within the larger definition of investment tax credits in the IRC. Investment tax credit are required to be allocated in accordance with the residual allocation of partnership profits under section 702(a)(8). Treas. Reg. §1.46-3(f)(2)(i).
- In the stated facts, the low P/L percentage conflicts with the high percentage allocation of rehab credits.
- Without considering whether Investor is a bona fide partner, it would seem that the most that Investor can be allocated is 5% of the credits.

Ex. 3: Federal Investment Tax Credit

- Same facts, except now assume that Investor is allocated 95% of profit, loss and cash.
- Under these facts, an allocation of 95% of the credits is valid. However, even if the allocation conforms to the regulations, Investor can only receive the credits if it is a bona fide partner.
- If Investor's interest in the partnership is subject to a put and call arrangement at a formula price of \$1, the analysis in Castle Harbor and Boardwalk Hall would apply: Investor is not a bona fide partner if it has no upside or downside risk.

Ex. 3: Federal Investment Tax Credit

- Assume now that the put and call arrangement is set at “fair market value” as determined by a qualified appraiser.
- Provided that there are no other caps, collars, or other protective devices, Investor now appears to have a meaningful risk of loss and/or profit.
- Under the analysis in Castle Harbor and Boardwalk Hall, Investor should be viewed as a bona fide partner and would be entitled to the credits.

Food for Thought

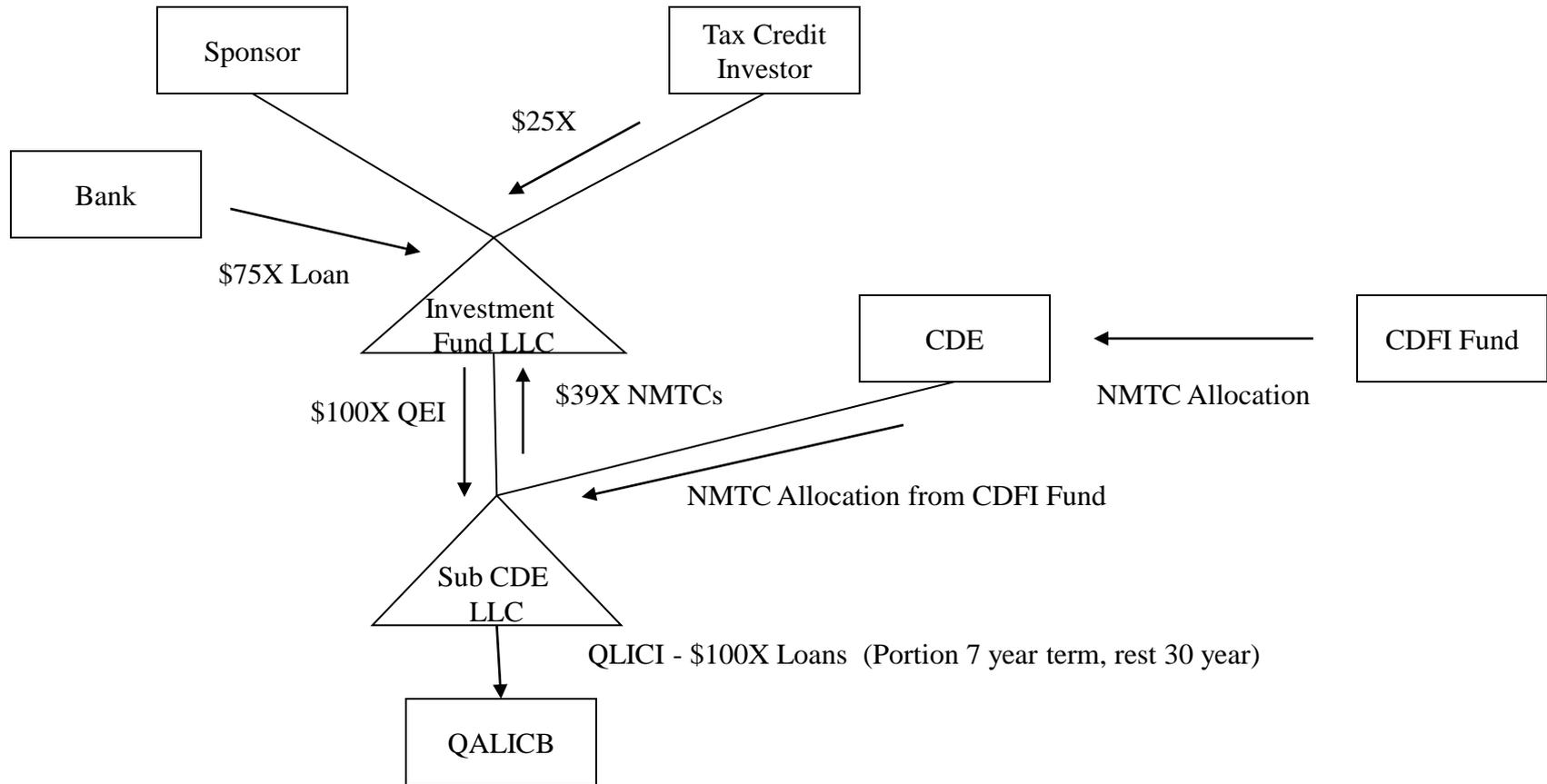
- In Boardwalk Hall, the key question was whether the tax credit investor was a bona fide partner. Assuming a tax credit investor meets this test, is that enough?
- Could the arrangement be undone by claiming it is a disguised sale?
- Not clear, but arguably if meet the bona fide partner test then disguised sale approach should not apply:
 - None of the authorities suggest that federal tax credits are property (no property = no disguised sale).
 - The items that create risk and true partner status probably also prevent application of disguised sale rules.

Thank You

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Typical New Market Tax Credit Structure



List of NMTC Abbreviations

- CDE: Community Development Entity
- CDFI Fund: Community Development Financial Institutions Fund (US Treasury)
- LCI: Low-income community (tract has at least 20% poverty rate under census)
- QALICB: Qualified Active Low-Income Community Business
- QEI: Qualified Equity Investment
- QLICI: Qualified Low-Income Community Investment (can be equity or loan)

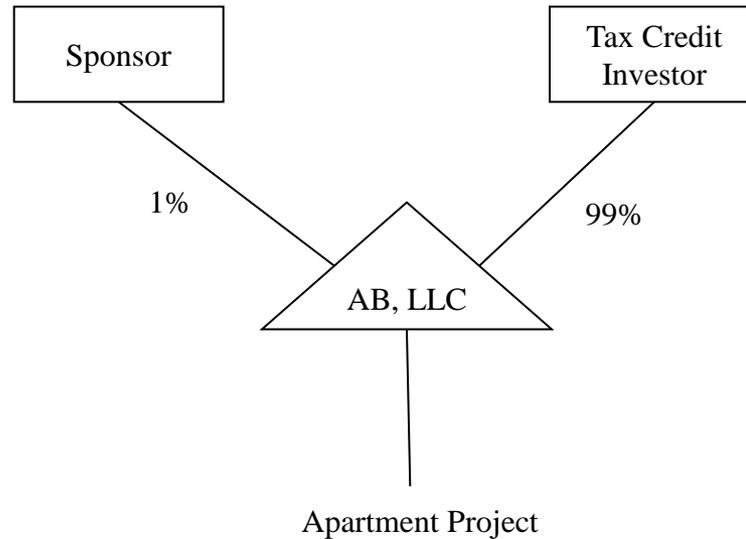
Calculation of NMTC

- New Market Tax Credits
 - Credit of 5% of qualified equity investment (“QEI”) at time of investment for first 3 years
 - Credit of 6% of QEI at time of investment for next 4 years
- Extended by Protecting Americans from Tax Hikes Act of 2015 through 2019

NMTC Allocations

- For allocation of NMTCs to be respected, the allocation must be in same proportion as partner's interest in the partnership. Safest approach is for credit allocation to be the same as allocation of Net Income or Net Loss.
- For example, 99% of Net Income, Net Loss and NMTCs allocated to Tax Credit Investor, with Sponsor receiving 1%.
- Consider case law. If Sponsor's interest is too nominal, is Sponsor a partner?

Low Income Housing Tax Credits



LIHTCs

- Under Section 42, LIHTC calculated based on applicable percentage (70% new buildings, otherwise 30%) of qualified basis in low-income building.
- Because partnership expenditure giving rise to LIHTC also gives rise to partnership loss or deduction (i.e., depreciation of building), allocate credits in same proportion as building depreciation is allocated. CCA 200812023.
- What if depreciation changes every year? Allocation of LIHTCs should also change accordingly. Tax Credit Investor will not like this.

LIHTCs

- So returning to structure slide, for Tax Credit Investor to get 99% of LIHTCs, Tax Credit Investor should be allocated 99% of depreciation. Safe approach is to allocate 99% of AB's Net Income to Tax Credit Investor.
- Deal typically provides first for payment of developer fee note and/or management fee.

Thank You

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