



## Credit Denied—IRS Attacks Partnership State Tax Credit Shelter



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### IRS Dislikes State Tax Credit Partnership Arrangement

The IRS recently issued Chief Counsel Advice 200704028 that criticized an arrangement being marketed involving state tax credits and partnerships that promoters claimed allowed a taxpayer to both recover virtually all of their original investment via a reduction in their state income taxes and obtain a capital loss deduction that effectively shifted the expenditure from state income taxes below the line (and not deductible in computing alternative minimum tax) to an above the line capital loss (that would be potentially recoverable against alternative minimum tax. Quite a useful trick if it works—but the IRS, in the memorandum noted above, has indicated reasons why they believe it doesn't work.

Such transactions are useful to study for a couple of reasons. First, going through why the promoters claim the transaction gives the benefits that they claim is a good review of a number of partnership concepts. And the IRS reasoning for why it doesn't work

reminds you of the tools the IRS has to attempt to counteract results that appear too good to be true.

Personally I have a bit of an extra reason for interest in these partnership rulings—I've gotten my list of CPE courses to lead in the following year and it turns out I'll be doing the "advanced partnership" session a number of times (along with a couple of advanced passthrough days) so I now pay more attention to these partnership issues.

## **The Wonders of Partnerships and State Tax Credits**

The IRS memorandum outlines the basic shelter being promoted. The shelter arose because a state tax credit that previously had been transferable was changed to one that no longer could be directly sold. However, the state law did allow the credit to be specially allocated among partners in a partnership, so the market shifted to creating partnerships to enable these credits to be used. The credit related to rehabilitation expenditures incurred.

In the transactions being marketed, a new partnership would be formed that would join with the partnership of the developers of the project who had "excess" state tax credits. The outside investors would buy into the partners, paying a fixed per dollar of credit that they were told would be allocated to them. The new partnership allocated the state tax credits to the individual investors who would use the credit to reduce their state income tax.

The taxpayers in question generally were not concerned with deducting the state income taxes under §164 since, due to the alternative minimum tax or other reasons, they would not obtain a federal income tax benefit from the state income tax deduction. Thus the fact that their state income deduction was reduced wasn't a relevant issue to them.

The investors executed subscription agreements that indicated they anticipated the receipt of the credits. Once the agreement was executed and the cash paid over, the credits were immediately allocated to the investor, with any additional credits allocated to the investor within a relatively few months. The investors also executed option agreements that allowed the partnerships to buy back their interests at their fair market value for a period of one year. In reality, most investors sold their interests back to one of the key promoters for a fraction of their original purchase price. The agreements also provided that these investors would not receive any material cash distributions from the partnership, nor would they share in the results of the sale of the projects—essentially, they received the tax credits as the only result of joining the partnership.

## **Claimed Tax Results**

So what would the tax results be to the investors? Well the hoped for results went something like this:

- The taxpayers would receive state income tax credits that would give them back most of their original investment as reductions in their state income taxes. Since they received no tax benefit from deducting federal income taxes, there was no offsetting increase in federal tax from the reduced state income tax deduction.
- Since no “partnership items” that affect basis were allocated to the partner, when they sold back their partnership interest at the fair market value (which now would be close to zero with no more credits to be allocated) they would have a capital loss for the difference between what the investor had originally paid and the minor amount now being received—which would decrease their federal tax.

Thus many taxpayers with the right tax situation before entering into these transactions could end up walking away from the partnership with tax benefits well in excess of the amounts that had been invested.

Obviously the first prong of the benefit is a state law issue alone—but the second advantage (the capital loss on sale) is a federal issue that deserves some study. Gain or loss generally is determined under §1001(a) which provides:

(a) Computation of gain or loss

The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

Section 1011 that governs basis provides the following:

(a) General rule

The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016.

Basis under subchapter K is generally governed by §707 which provides the following for partnership basis adjustments:

(a) General rule

The adjusted basis of a partner's interest in a partnership shall, except as provided in subsection (b), be the basis of such interest determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests)--

- (1) increased by the sum of his distributive share for the taxable year and prior taxable years of--
- (A) taxable income of the partnership as determined under section 703(a),
  - (B) income of the partnership exempt from tax under this title, and
  - (C) the excess of the deductions for depletion over the basis of the property subject to depletion;
- (2) decreased (but not below zero) by distributions by the partnership as provided in section 733 and by the sum of his distributive share for the taxable year and prior taxable years of--
- (A) losses of the partnership, and
  - (B) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account; and
- (3) decreased (but not below zero) by the amount of the partner's deduction for depletion for any partnership oil and gas property to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such partner under section 613A(c)(7)(D).

Note that none of these items would decrease the partners' basis for the tax credits that were allocated to the partners.

The provisions dealing with distributions don't seem to cause a basis problem either. If we view the credits as distributed to the partner, then §733 would apply—and that provides:

- In the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by--
- (1) the amount of any money distributed to such partner, and
  - (2) the amount of the basis to such partner of distributed property other than money, as determined under section 732.

Since the credit isn't money, we look to section 732 which provides generally:

- (a) Distributions other than in liquidation of a partner's interest
- (1) General rule
- The basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest shall, except as provided in paragraph (2), be its adjusted basis to the partnership immediately before such distribution.

Since the credit has no basis to the partnership, there would be no reduction in the basis of the partnership interest.

So we have a bit of magic here—the partner’s interest is now virtually worthless since the only right it gave the partner was the right to be allocated the credits, and that has taken place. Thus when the taxpayer sold his interest back to the promoter for a fair price, which would be close to zero, a capital loss would be triggered.

## **IRS Objections**

So what could the IRS object to given the above analysis that seems to clearly follow the Internal Revenue Code? Well, as it turns out, quite a bit.

The IRS has a number of weapons with which to attempt to attack such a “too good to be true” result.

### ***Investors Are Not Partners***

The IRS first attacks the arrangement by saying the above analysis fails because it presumes that in the above arrangement the investors are partners. The IRS quotes the Supreme Court’s decision in *Culbertson* (337 US 733, 742) where the Court said:

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 provisions, their statements, the testimony of disinterested persons, the relationship of 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.

The memorandum then analyzes the transaction and comes to the following conclusion:

Under this inquiry, it is clear that the investors in the instant case were not partners in the relative partnerships. The transactions were promoted as ones in which the investors would receive no material cash distribution, no net proceeds from a sale of the projects or operating partnerships, no allocations of federal income tax credits, and no partnership items of income, gain, loss or deduction. The 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 income tax losses to be claimed at the termination of their interests. These interest were held for a brief period of time (typically, d months). This obvious lack of joint profit motive is fatal to their classification as partners in P1, P2, or P3. Therefore, the investors were not partners in the partnerships.

If they aren't partners, then the provisions cited above are not the ones that would govern this transaction—so the IRS then tells us what they see as the “real” transaction that took place.

Applying these principles to the present situation, as recast under the Tower/Culbertson substance-over-form analysis, the investors were not partners in the partnerships. Accordingly, the transfers of the credits for cash between P1, P2, or P3 and the investors should be recharacterized, in accordance with their substance, as direct sales and purchases of the credits. This treatment applies whether or not the credit is transferable under state law and whether or not the transaction is treated as a partnership allocation for state law purposes. After D, although the credit is not transferable under state law, and the transaction is in form a partnership allocation, P1, P2, and P3 in substance transferred the credits to the investors for cash. The partnership/LLCs generating the credits through the projects performed by the developers as partners must also report gains from the sale of the credits, which have a basis of zero in the partnership's hands, to the investors. These gains, then, should be allocated to the developers, the promoters, and other partners of the partnership/LLCs. When the investors use the credits to reduce their state tax liability, they are treated as having satisfied their liability with property, resulting in a disposition of the credits under § 1001 and payments of state tax for purposes of § 164(a). See Rev. Rul. 86-117.1 Further, the losses claimed by the investors upon the sale of their purported "partnership interests" in P1, P2, or P3 are disallowed.

The issue of whether an entity truly is a partnership is a crucial one, because the IRC provisions governing partnerships give very different results in many cases than would any analysis of the same effective transaction outside a partnership context. It's also an issue that, many times, practitioners glance over so it's important to remember the IRS has this weapon with which to attempt to attack a result obtained by forming a partnership—especially a partnership that seems to exist primarily to obtain the tax benefit in question.

### ***Disguised Sale Rules***

The IRS raises next the issue that even if we accept the partnership as an entity, the disguised sales rules would apply to these transactions—and they would invalidate the claimed result.

IRC §707(a)(2)(B) contains the basic disguised sales rules, which provide:

(B) Treatment of certain property transfers  
If--

(i) there is a direct or indirect transfer of money or other property by a partner to a partnership,

(ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and

(iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property,

such transfers shall be treated either as a transaction described in paragraph (1) or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

In the memorandum, the IRS goes on to analyze the issue based on the regulations under §1.707 and finds:

Section 1.707-3(b) provides generally that a transfer of property (other than money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration by the partnership to the partner is treated as a sale of property, in whole or in part, by the partner to the partnership only if, based on all of the facts and circumstances, two conditions are satisfied: (1) The partnership would not have transferred money or property to the partner but for the transfer of the property, and (2) in cases of transfers that are not simultaneous, the subsequent transfer is not dependent on the entrepreneurial risks of the partnership's operations. § 1.707-3(b)(1). Further, § 1.707-3(c)(1) creates a presumption that, if the transfers above occur within a two-year period (without regard to the order of the transfers), the transfers will be treated as a sale of the property to the partnership unless the facts and circumstances clearly establish otherwise.

Section 1.707-6(a) provides that rules similar to those provided in § 1.707-3 apply in determining whether a transfer of property by a partnership to a partner and one or more transfers of money or other consideration by that partner to the partnership are treated as a sale of property, in whole or in part, to the partner.

The IRS view is that, clearly, the investors transferred property to the partnership in order to obtain “property”—that is, the state tax credits that were going to be allocated to them. Thus, via the IRS’s view, this would be enough to invoke the disguised sales rule.

The IRS also would presumably view the fact that the partnerships are likely to argue that this was an “allocation” of a tax credit rather than a “distribution” of property to be a difference without any real world distinction. Thus, in the IRS view, we have a sale of the property (the tax attribute) to the investor in exchange for their cash that transferred to the venture. Thus there is no basis in a partnership interest on which to claim a capital

loss, and those entities that provided the tax credits to be transferred have a taxable gain on the sale of those interests.

### ***Partnership Anti-Abuse Rules***

Of course, it's possible the courts might see these entities as partnerships and might reject the disguised sale analysis. In that case, the IRS brings out their second theory to attack these entities—the partnership anti-abuse rules found in Reg. §1.701-2. These regulations claim broad authority for the IRS to recharacterize transactions that do not “fit the spirit” of Subchapter K and are meant to be a tool the IRS would like to use to attack partnership arrangements that technically meet the requirements of the law and regulations but are getting a result that does not appear to one intended by the law and regulations—at least in the IRS's view.

The regulation starts out by describing what, for purposes of this regulation, the “intent” of Subchapter K is:

(a) Intent of subchapter K.

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. Implicit in the intent of subchapter K are the following requirements –

(1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.

(2) The form of each partnership transaction must be respected under substance over form principles.

(3) Except as otherwise provided in this paragraph (a)(3), the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, PROPER REFLECTION OF INCOME). However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the proper reflection of income requirement of this paragraph (a)(3) is treated as satisfied with respect to a transaction that satisfies paragraphs (a)(1) and (2) of this section 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. See, for example, paragraph (d) EXAMPLE 6 of

this section (relating to the value-equals-basis rule in section 1.704-1(b)(2)(iii)(c)), paragraph (d) EXAMPLE 9 of this section (relating to the election under section 754 to adjust basis in partnership property), and paragraph (d) EXAMPLES 10 AND 11 of this section (relating to the basis in property distributed by a partnership under section 732). See also, for example, sections 1.704-3(e)(1) and 1.752-2(e)(4) (providing certain de minimis exceptions).

If the partnership does not comply with the intent of Subchapter K, the IRS explains the consequences in Reg. §1.702-2(b):

(b) Application of subchapter K rules.

The provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K as set forth in paragraph (a) of this section (INTENT OF SUBCHAPTER K). Accordingly, 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 intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K --

- (1) The purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners;
- (2) One or more of the purported partners of the partnership should not be treated as a partner;
- (3) The methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income;
- (4) The partnership's items of income, gain, loss, deduction, or credit should be reallocated; or
- (5) The claimed tax treatment should otherwise be adjusted or modified.

As you might expect, the IRS analysis decides that the structure they are looking at does not meet the “intent” test and so decide they have the authority under Reg. §1.701-2(b) to recast the transactions as described above.

The IRS outlined two reasons why the transaction didn't meet the "intent" of Subchapter K. The first analysis concentrated on the fact that there was no business activity conducted by the partnership, only reallocation of tax attributes:

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.

The IRS also claims the fact that it appears tax benefits were the only motivation for the partnership also allowed them to invoke Reg. §1.701-2(b):

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.

The IRS then analyzes what the result will be after Reg. §1.701-2(b) is applied—and, not surprisingly, it sounds a lot like the result in the IRS's substance over form analysis:

Accordingly, the Service should apply § 1.701-2 to disregard P1, P2, and P3 and recast the transactions for federal tax purposes. After D, the transactions should be treated as ones in which the promoters purchased the credits from the developers at \$ b per dollar of credit and, then, sold them to the individual investors at \$ c per dollar of credit. As P1, P2, and P3 are disregarded, the losses claimed by the individual investors for the sale of their "partnership interests" in P1, P2, and P3 are disallowed.

### ***What Does This All Mean?***

The IRS goes on to analyze an additional issue related to whether the issue is a partnership item for purposes of TEFRA—an issue we'll not deal with today. Because the real issue here is a reminder of the ways that Subchapter K is used (and, in the view

of the IRS, sometimes abused) from time to time to accomplish various goals. While the specific situation here presented is a but unique (a state law change that forced a change in how these credits were marketed), the methods used by the promoters are methods that have shown up before in various shelter structures. However, outside a marketed shelter it's important to remember that there are some unique results that occur when transactions take place in a partnership. Practitioners need to be aware of the issues that arise in this context, and be prepared to properly report these transactions.

Another issue that the IRS did not consider, but which likely is important—it would seem that the state in question might similarly wish to question the “partnership” and whether it serves to legitimately transfer the credits when it appears the state was trying to remove the option to sell the tax credits to unrelated entities. So a taxpayer who was considering investing in such a shelter should be aware of the need to get independent counsel not only on the federal tax results, but also on whether the transaction would be viewed as valid for the basic purpose it was created for—to transfer the credits.