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Memorandum

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subject: State Tax Credit Transfers

This memorandum responds to your request for advice with regard to a partnership structure, described below, that is being used to market transferable and nontransferable state income tax credits ("credits") to generate federal income tax losses. This memorandum addresses the treatment of these transactions for federal income tax purposes.[1]

ISSUES

1) Whether the investors in the transactions described below are respected as partners in the partnerships;
2) Whether the transactions described below should be recast under the partnership anti-abuse rule (§ 1.701-2 of the Income Tax Regulations); and
3) Whether the issue of whether an investor is a partner in a partnership constitutes a partnership item.

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[1] This advice may not be used or cited as precedent.

CONCLUSIONS

1) The investors involved in the transactions described below are not partners in the partnerships and, therefore, the Service should recast the transactions under the principles of the substance-over-form doctrine;
2) The transactions described below should be recast under the partnership anti-abuse rule (§ 1.701-2); and
3) The issue of whether an investor is a partner in a partnership is a partnership item.

FACTS

The transactions have taken place in a state that allows a credit against state income tax, such as one for qualified expenditures to rehabilitate certain property within the state. The transactions were cast in two basic forms, depending on whether the credits were transferable. If the credits were transferable, the promoters of the transactions formed a partnership (promoter partnership) to purchase the credits from taxpayers that earned the credits, but that, for various reasons, could not use the credits for state income tax purposes. If the credits were nontransferable, the promoters generally formed a partnership (promoter partnership) to become a partner with the taxpayers that earned the credits.

In either form, the promoter partnerships solicited investors to join the partnership, usually investors who were interested in reducing their state taxes but, for reasons such as being subject to the federal Alternative Minimum Tax (AMT), were indifferent to the state tax deduction under § 164 for federal tax purposes. The promoter partnership, itself or through its upper-tier partnership partners, allocated all of the credits it acquired to the investors in exchange for their cash contributions, at a rate per credit that was higher than the promoter partnership's acquisition cost of the credits. The promoter partnership interests were marketed to the investors as ones in which the investors would not receive any material distributions of cash flow and would not be allocated material amounts of partnership items of income, gain, loss or deduction. Further, the investors were informed that their sole return, if any, on their investment was the allocation of the credits and the capital loss to be claimed for federal income tax purposes upon the sale of their interests in the promoter partnership.

The transactions were usually structured so that the investors were allocated the credits immediately following their contribution of cash to the promoter partnership. Future allocations of credits, if any, were carried out within a short period of time. Further, the partnership held an option to purchase back the investors' interests for their "fair market values" when the investors decided to terminate their interests. After holding onto the partnership interests for a brief period of time to receive the allocation of the credits, the investors sold their interests back to the promoter partnership or the promoters for a small fraction of their bases. On their federal income tax returns, the investors claimed large capital losses on the sale of their partnership interests.

The promoter partnership did not engage in any substantial business activity other than the allocation of the credits. Although it may have taken an "acquisition fees" deduction in transactions involving transferable credits, the promoter partnership and its partners did not report any income related to the disposition of the credits to the investors.

LAW AND ANALYSIS

I. The Investors Are Not Partners in the Promoter Partnership under the Substance-over-Form Doctrine

The standards for ascertaining the existence of a partnership for federal income tax purposes are well-established in the decisions of *Commissioner of Internal Revenue v. Tower,* 327 U.S. 280, 287-288 (1946) and *Commissioner of Internal Revenue v. Culbertson,* 337 U.S. 733, 742 (1949). Whether an entity or contractual arrangement is a partnership for federal income tax purposes requires a facts and circumstances analysis under the *Tower/Culbertson* standard. The Supreme Court in *Culbertson* stated that there is a partnership for federal tax purposes when,

> 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 to 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.

Culbertson at 742. The critical inquiry is the parties' intent to join together in conducting business activity and sharing profits.

Recently, the court in *TIFD III-E, Inc. v. U.S.*, 459 F.3d 220 (2^{nd} Cir 2006), in finding that an investor's investment did not constitute a partnership interest, looked to whether the investor had a "meaningful stake in the success or failure" of the partnership to determine whether the investor was a partner in the partnership. The court held that the "mere appearance" of a meaningful interest in the potential profits of the partnership was nullified by a limitation on the participation in profits.

Under this inquiry, it is clear that the investors in the transactions described above were not partners in the partnerships formed by the promoters for the transactions. The transactions as promoted are ones in which the investors would receive no material cash distributions, no allocations of partnership items of income, gain, loss or deduction. The investors lacked a joint profit motive and paid cash to the promoter partnerships with the full knowledge that the only benefits of entering into the partnerships are the distributions of the state tax credits and the federal income tax losses to be claimed at the termination of their interests. They typically held the partnership interests for only a brief period of time for the specific purpose of receiving the allocation of the credits. Therefore, the investors were not partners in the partnerships.

Generally, a state tax credit, to the extent that it can only be applied against the original 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, not as a payment of cash or property to the taxpayer. *Cf. Rev. Rul. 79-315*, 1979-2 C.B. 27, Holding (3) (Iowa income tax rebate). Consequently, the federal tax effect of such a state credit is normally to reduce any deduction for payment of state tax the taxpayer may otherwise have had under § 164. By itself, the fact that a state tax credit is transferable should not cause it to lose its character as a reduction or potential reduction in liability in the hands of the taxpayer who originally qualified for the credit. However, if and when a transferable credit is in fact transferred to another taxpayer for value, it is usually appropriate to treat the transaction as a sale and purchase of property under § 1001.

The taxpayer who originally qualified for the credit and transfers it for value has a basis of zero in the credit, and the full sales price is gain. With respect to the transferee of the credit, a payment for the purchase of a transferable tax credit is not a payment of tax or a payment in lieu of tax for purposes of § 164(a). *See Rev. Rul. 61-152*, 1961-2 C.B. 42; *Rev. Rul. 71-49*, 1971-1 C.B. 103; *Rev. Rul. 81-192*, 1981-2 C.B. 49. Rather, the transferee has purchased a valuable right, which constitutes property, the basis of which is the cost incurred by the transferee. The use of the credit to reduce the transferee's state tax liability is analogous to the transfer of other types of property to the state in satisfaction of the liability. *Cf. Rev. Rul. 86-117*, 1986-2 C.B. 157. Generally, therefore, when the transferee uses the credit to reduce a state tax liability, the transferee will have gain or loss under § 1001 on the use of the credit and will be treated as having made a payment of state tax, for purposes of § 164(a).

Applying these principles to these transactions, as recast under the *Tower/Culbertson* substance-over-form analysis, the investors were not partners in the promoter partnerships. Accordingly, the transfers of the credits to the investors for cash investments should be recharacterized, in accordance with their substance, as sales and purchases of the credits. This treatment applies whether or not the credits were transferable under state law, and whether or not the transaction is treated as a partnership allocation for state law purposes. 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 a payment of state tax for purposes of § 164(a). *See Rev. Rul. 86-117*. Further, the losses claimed by the investors on their federal income tax returns upon the sale of their purported "partnership interests" in the partnerships are disallowed.

II. <u>Section 1.701-2 Partnership Anti-Abuse Rule</u>

Section 1.701-2 provides that Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. Section 1.701-2(a) provides that there are three implicit requirements in subchapter K:

> (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 § 1.701-2(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).

Section 1.701-2(b) provides that partnership rules are to be applied in a manner that is consistent with the intent of subchapter K as set forth in § 1.701-2(a). 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 to achieve tax results that are more consistent with the intent of subchapter K. Section 1.701-2(c) provides guidance on the facts and circumstances that will be relevant in determining whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K.

The partnerships involved in the transactions are 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. The promoters and investors entered into the transactions 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, resulting in substantial federal tax reduction. The partnerships were formed or availed of to sell large numbers of credits at a profit without incurring gain at any level. Moreover, the investors claimed large amounts of capital losses from the sale of their purported "partnership interests" in the partnerships to the partnerships or promoters at a price that was a fraction of their bases.

Accordingly, the Service should apply § 1.701-2 to recast the transactions for federal tax purposes. The transactions should be treated as an acquisition by the promoters of the credits followed by a sale of the credits to the investors. The promoters' acquisition costs are equal to the purchase price the promoters or their partnerships paid in cases involving transferable credits, and the cash contributions their relative partnerships made to the taxpayers that earned the credits in cases involving the nontransferable credits. The sale of the credits to the investors should be treated as at a price based on the investors' cash contributions. As the investors are not partners in the partnerships, the losses claimed by the investors for the sale of their "partnership interests" are disallowed, and the other tax consequences described in the first section above apply.

III. Whether the Issue of Whether an Investor in a Partnership is a Partner Constitutes a Partnership Item

The issue that arises under the TEFRA partnership procedures is whether the issue of "whether an investor is a partner in a partnership" constitutes a partnership item. We conclude that it is a partnership item. We also conclude that disregarding the partnership utilizing the partnership anti-abuse regulation must be determined in a partnership proceeding.

Under the TEFRA partnership procedures, the identity of a partnership's partners and their allocable share of and character of partnership income and loss are partnership items subject to partnership level proceedings. Partnership items are limited to items required to be taken into account for the partnership's taxable year under Subtitle A to the extent that regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level. § 6231(a)(3).

Under the regulations, the partnership's aggregate and each partner's share of income, gain, loss, deduction or credit of the partnership are partnership items. § 301.6231(a)(3)-1(a) of the Procedure and Administration Regulations. In essence, the regulations mandate that the identity of a partner and his percentage interest in the partnership are partnership items by stating that "each partner's share" of partnership items are partnership items. A partner's share cannot be determined without first determining the identity of the partner and his percentage interest in the partnership.

Further support for this reading is found in § 301.6231(a)(3)-1(b), which states that the term "partnership item" includes the accounting practices and the legal and factual determinations that underlie the determination of the amount, timing, and characterization of items of income, credit, gain, loss, deduction, etc. (emphasis added). Thus, the identity of a partner is included as a partnership item under this portion of the regulation, as well, because a partner's identity underlies many of the legal and factual determinations a partnership must account for under Subtitle A.

For example: (1) a partnership must know the identity of its partners for purposes of determining its taxable year. § 706; (2) a partnership's basis and holding period in its assets will depend on whether a partner contributed the assets and on whether the partner recognized any gain on the contribution pursuant to § 723; (3) the character of gain or loss on the sale of unrealized receivables will depend on whether the assets were unrealized receivables in the contributing partner's hands; (4) the partnership must scrutinize every transaction it undertakes to determine if a partner was on the other side of the transaction so that the partnership knows how to account for the transaction under § 707(a) and, in the case of sales or exchanges, whether the loss limitations of § 707(b) will apply; and (5) the partnership must know the partners (and their interests in capital and profits) in order to track whether a sale or exchange of more than 50% has occurred so as to trigger termination under § 708. There are many more examples that could be found where the partnership must make an initial determination as to the identity of the partners in order to account for partnership income, gain, loss deductions etc. In short, the partnership must account for the identity of its partners for reasons that will affect the character, timing, and amount of income gain, loss, deductions etc. for many reasons even when it does not affect the allocation of items among the partners. Since a partner's identity underlies these determinations of partnership items, a partner's identity and percentage interest is also a partnership item.

Moreover, § 6226(f) provides that a court is authorized to determine partnership items and the proper allocation of items among the partners, which necessarily must include jurisdiction to determine the identity and percentage interest of the partners. *See Katz v. Commissioner*, 335 F.3d 1121 (10th Cir. 2003) (identity of a partner is a partnership item).

Section 6233(b) and § 301.6233-1(b) require that a determination that no partnership exists must be made exclusively in a partnership proceeding. *Andantech v. Commissioner*, 331 F.3d 972 (D.C. Cir. 2003); *see also Frazell v. Commissioner*, 88 T.C. 1405 (1987). This further supports our argument that the identity of partners is a partnership item because to the extent there are no partners, there is no partnership.

Thus, the foregoing issues must be raised in a TEFRA partnership proceeding. § 6221. We note that the ultimate loss incurred by the purported partners upon the disposition of their partnership interests is an affected item, rather than a partnership item, that will have to be disallowed through an affected item notice of deficiency. The Service has one year after the completion of the partnership proceeding to issue an affected item notice of deficiency. § 6229(d)(2)*; see G.A.F. v. Commissioner*, 114 T.C. 519 (2000).

The above analysis regarding the application of TEFRA applies to any partnership having more than 10 partners or a pass-thru partner under § 6231(a)(1) and § 301.6231(a)(1)-1.

In addition to the discussion above, the Service may, alternatively, recharacterize the transactions as disguised sales of partnership property under § 707(a)(2)(B) and the regulations thereunder.

Please call Jian H. Grant at (202) 622-3050 if you have any questions about this memorandum.