Bloomberg BNA

Tax Management
Weekly State Tax Report™

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Community-Oriented Credits

State Tax Credit Planning: Consider Partnership Risk Allocation, Guarantees

Partnerships receiving federal historic rehabilitation tax credits may take comfort that their partnership arrangements will be respected if they heed guidance issued within the last year by the IRS, and partnerships in which other tax credits are in play could use the same guidance in an advisory capacity, a practitioner said.

Many times tax credit generators and tax credit investors join together via a business entity to maximize use of tax credits—but what does it take for partnership or business entity arrangements involving tax credit allocations to withstand audit or challenge?

Guidance issued by the IRS within the last year (Rev. Proc. 2014-12) officially applies only to business entity arrangements related to the federal historic rehabilitation tax credit, but practitioners involved in any tax credit transaction would be well advised to consider that guidance in an advisory capacity as they structure other tax credit deals, said Philip Karter, attorney at Chamberlain Hrdlicka in Philadelphia, in a phone interview with Bloomberg BNA on Dec. 4. Karter led the trial team in *Gateway Hotel Partners v. Commissioner*, T.C. Memo 2014-5, in its successful defense of an alleged sale by a partnership of state historic tax credits distributed to another partner.

In light of Rev. Proc. 2014-12, along with a 2012 Third Circuit Court of Appeals decision in which the court disallowed an investor from receiving federal tax credits based on a finding that the investor was not a bona fide partner in the partnership, Karter said that parties involved in these kinds of federal and state tax credit transactions may have to adjust expectations—that maximizing tax benefits and monetizing credits comes at a cost and with risks.

Planning for State Tax Credit Transactions. State tax credit transfers can give rise to federal tax liability, Karter said. States might also tie a piece of their own state tax credits to a federal tax credit provision—whether it incorporates a federal definition from the I.R.C. or links receipt of the state credit to receipt of a corresponding federal tax credit. For example, New York provides a historic rehabilitation credit equal to 100 percent of the federal credit allowed under I.R.C. §47, up to $5 million. [See chart.]

The disallowance of the federal tax credits to the investor in *Historic Boardwalk Hall LLC v. Commissioner*, 694 F.3d 425, 2012 BL 219402 (3d Cir. 2012), *cert. denied*, U.S., No. 12-901, May 28, 2013, definitely had a chilling effect in the tax credit community, Karter said. ''People in this field are talking about it and are worrying about it.''

In the case, Karter said that the putative partner had so many protections in place that it was hard to argue it had a meaningful stake in the partnership's entrepreneurial risks and reward potential. However, he said a silver lining of the case is that all the worrying taxpayers are doing is good—because it forces them to think about ways to avoid or successfully defend an audit when they plan their transactions, which was not always a priority in the past.

''People are worried about it and thinking about what they can do to make their transactions more audit proof,'' Karter said. ''The takeaway from these tax credit cases is what can we do differently? What can we do better?''

With any deal, the devil is in the details and interpretations of the law in this area are very fact specific. There's a demarcation line beyond which a partner's putative equity contribution in a tax credit deal becomes a disguised sale or is not reflective of a partnership arrangement at all. Now, on the heels of recent court decisions and administrative pronouncements, those in the tax credit equity markets are figuring out how to structure tax credit transactions that previously had not been subject to higher levels of scrutiny. Karter views this as a favorable trend.

Without proper planning ''it's the old cleaning-up-after-elephants-in-the-parade routine,'' Karter said.

Chilling Effect From 'Historic Boardwalk Hall.' In *Historic Boardwalk Hall LLC v. Commissioner*, the Third Circuit Court of Appeals shook up the historic rehabilitation tax financing market when it found that an investor in a partnership was not a bona fide partner and could not receive the federal historic rehabilitation tax credits that it expected to receive via the partnership. Essentially, the court held that the taxpayer did not have a '' 'meaningful stake in the success or failure' of the enterprise.''

The IRS challenged what it characterized as the prohibited sale of the credits via the partnership arrangement.

The Third Circuit found that the investor had no meaningful downside risk in the partnership, in part because the investor was certain to recoup its contributions that it made to the partnership and to receive the primarily sought benefit—the historic rehabilitation tax credits or their cash equivalents—and an effectively

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guaranteed preferred return, among other partnership provisions.

The court also found that the investor had no meaningful upside potential in the partnership, because based on the structure of the arrangement, the investor could never expect to share in any upside of the business.

''It was sort of like an annuity when you think about it,'' said Mayer Brown partner Robert Mendenhall on Nov. 21, because of the investor's lack of risk. Mendenhall and Mayer Brown partner Jeffrey Davis spoke in a joint presentation about tax credit products at a Bloomberg BNA conference in New York City on U.S. taxation issues dealing with financial transactions.

''It (the Third Circuit decision) threw the historic tax credit community into a tailspin,'' Mendenhall said.

Mendenhall and Davis said that the decision had a chilling effect on historic rehabilitation tax credits projects and transactions, raised investor concerns about increased risk in the historic rehabilitation tax credit market and sowed uncertainty regarding how to structure tax credit transactions so as to avoid disallowance of the credits.

But as of December 2013, the case that brought a wave of uncertainty for investors has been partially tempered with a revenue procedure that details ''safe harbor'' provisions—ways for taxpayers to structure their transactions so as to not trigger an IRS challenge.

Reassurance Via Rev. Proc. 2014-12. In response to the chilling effect stemming from *Historic Boardwalk Hall*, the IRS issued guidance regarding when the IRS will not challenge a tax credit investor's status as a partner of a partnership that receives historic rehabilitation tax credits. It provided guidelines regarding:

- investment timing: requiring an investor to invest at least 20 percent of its total expected capital contributions required under partnership agreements as of the date the building is placed in service and requiring that at least 75 percent of an investor's total expected capital contributions are fixed before the building is placed in service;
- permissible versus impermissible guarantees to tax credit investors;
- purchase and sale rights; and
- an investor's minimum partnership interest and related requirements, among other provisions.

Considering Allocation of Risk. A principal feature inherent in transactions involving state tax credits is that they often implicate the sale of those credits by an investor to a third-party buyer because the investor has insufficient state income tax liability to utilize the credits itself, Karter said in a Dec. 10 e-mail. States routinely set up their tax credit programs to allow the transfer (i.e., sale) of unused credits to third-party buyers.

These sales can be made by the partnership itself or by a partner to whom the credits are allocated. Because the sales are most often taxable events, a seller's tax basis in the credits to be sold is important in measuring the taxable gain on the sale.

A sale by a partnership typically results in a gain equal to the entire sale price because the partnership holds a zero basis in the credits. This is not always the case for a partner allocated the credits, which is the more typical way in which transferable credits are sold, according to Karter.

When the credits are allocated to a partner who then intends to sell them to a third party, ''that's where the rubber often meets the road, because an IRS challenge to that transaction can result in an unanticipated gain to the partnership, the tax effect of which is to impose the tax burden on the partner to whom partnership income is principally allocated,'' Karter said.

In transactions where a tax credit earner forms a business entity with a tax credit investor, an open question remains about whether buyers and sellers of state tax credits are pricing these transactions while taking into account the entrepreneurial risk that the credits originally expected will be the credits ultimately received, Karter said.

''If they are not thinking about that, the parties ought to be. If there's not enough of a risk for presumably knowledgeable arm's-length parties to factor into pricing the amount by which the credits should be discounted, it is likely to be more difficult to argue that the risk is real. Of course, the converse of that proposition is also true, assuming that the risk is genuine and the pricing reflects that,'' Karter said.

The risk that expected tax credits will not be awarded can arise several ways. Beyond the normal risk involved in any construction or rehabilitation project, including the risk that a completed project may fail to satisfy credit criteria, there are legislative risks as well. A state legislature could repeal or scale back its tax credit program, possibly retroactively. In Colorado, for instance, the historical property preservation credit is available provided that the state's general fund has enough money—otherwise, the credit will be available in the next year that funds are available. And in a recent Massachusetts case, two universities and a college have challenged the state revenue department's interpretation of a credit provision that they argue is an unlawful retroactive change in long-standing department policy. *Northeastern University et al. v. Massachusetts Comr. of Rev.*, Mass. Super. Ct. 2014) (*filed*) .

Karter said the safe harbor provisions that the IRS issued for federal historic rehabilitation tax credits provide some level of comfort to parties engaging in these kinds of partnerships that their expected tax treatment from these credit transactions will be respected. He said it would be better if Rev. Proc. 2014-12 explicitly extended beyond rehabilitation credits and also encompassed state credit transactions (it expressly excludes both) but it is an arrow in one's audit-defense quiver for any tax credit transaction structured in a manner that takes these considerations into account.

''At bottom, there are common elements that extend beyond §47 in determining whether a bona fide partnership exists or whether one is acting in the capacity of a partner in transferring property to a partnership,'' Karter said. ''For that reason, people are well-advised to look at the safe harbor guidance so as to reduce the chances they cross into the 'nether world' of a disguised sale or are challenged as to whether there is even a bona fide partnership in the first instance.'' Any transaction will be more efficient when parties pay attention to the law as well as the interpretive guidance of the law, he said, ''because that is the best way to reduce the likelihood that taxpayers and the government become embroiled in costly tax disputes.''

By Rebecca Helmes

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☐ *For a discussion of state taxation of partnerships generally, see 1500-2nd T.M., State Taxation of Pass-Through Entities: General Principles, at 1500.03.B. For a discussion of the credit for rehabilitation of historic properties in New York, see 1470-2nd T.M., Credits and Incentives: MO Through OK, at 1470.13.B.28, and Individual Income Tax Navigator, at New York 3.6.5. For a discussion of the historical property preservation credit in Colorado, see 1450-2nd T.M., Credits and Incentives: AL Through HI, at 1450.11.E.1, and Individual Income Tax Navigator, at Colorado 3.6.5.*

State Historic Rehabilitation Credits Related to Federal Credit Provisions

State	Tax Credit	Examples of State Historic Rehabilitation Credit Provisions Related to Federal Credit Provisions
Louisiana	Rehabilitation Tax Credit	Considered a federal disaster credit, the Louisiana rehabilitation tax credit provides an increase in the credit for certified historic structures and qualified rehabilitated buildings located in a Gulf Opportunity Zone. The credit is increased from 20 percent to 26 percent for certified historic structures and increased from 10 percent to 13 percent for qualified rehabilitated buildings. The increase in the rehabilitation tax credit, with respect to the rehabilitation of buildings is the allowed credit for purposes of modifying the Louisiana federal income tax deduction. La. Admin. Code tit. 61, §601.
Maine	Credit to Rehabilitate Historic Buildings	Taxpayers may take a Maine credit for the amounts expended to restore historic buildings of 25 percent of the qualified rehabilitation expenditures for which a tax credit is claimed under I.R.C. §47. Alternatively, if taxpayers do not take the federal credit, they may still take a credit equal to 25 percent of the certified rehabilitation expenditures in the amounts of $50,000-$250,000 used to restore historic structures in Maine. Me. Rev. Stat. Ann. tit. 36, §5219-BB(2).
Minnesota	Matching Historic Structure Rehabilitation Tax Credit	Taxpayers who are eligible for the federal historic structure rehabilitation credit for improving a historic structure in Minnesota also qualify for a matching credit from Minnesota. The credit is equal to 100 percent of the federal credit received and is taken in the year that the project is placed in service. Minn. Stat. §290.0681.
Montana	Historic Rehabilitation Tax Credit	Montana allows a percentage of the federal credit allowed for qualified rehabilitation expenditures made with respect to any certified historic building in Montana as provided in I.R.C. §47 as a credit against the Montana personal income tax. Mont. Code Ann. §15-30-2342(1); Mont. Code Ann. §15-31-151. Currently, the federal credit is equal to 20 percent of the qualified rehabilitation expenditures for a certified historic structure. I.R.C. §47.
New York	Rehabilitation of Historic Properties Credit	For tax years beginning on or after Jan. 1, 2010, but before Jan. 1, 2020, a credit is available equal to 100 percent of the federal credit allowed under I.R.C. §47, not to exceed $5 million, for the same tax year for the rehabilitation of the same certified historic structure located in New York State for which the federal credit is claimed. N.Y. Tax Law §606(oo)(1)(A); New York TSB-M-13(2)I (July 11, 2013) (explaining the 2013 changes to the credit).

State Historic Rehabilitation Credits Related to Federal Credit Provisions – Continued		
Oklahoma	Historic Rehabilitation	Oklahoma grants a credit for qualified rehabilitation expenditures incurred in connection with any certified historic hotel or historic newspaper plant building located in an increment or incentive district. Okla. Stat. Ann. tit. 68, §2357.41(A). The amount of the credit is 100 percent of the federal rehabilitation credit provided for in I.R.C. §47. Okla. Stat. Ann. tit. 68, §2357.41(B); Okla. Admin. Code §710:50-15-108(a).
South Carolina	Rehabilitation of a Certified Historic Structure Credit	South Carolina offers the following income tax credits to taxpayers with historic rehabilitation expenditures: (1) the rehabilitation of a certified historic structure credit is available to taxpayers that qualify for the federal rehabilitation credit under I.R.C. §47; and (2) the rehabilitation of a certified historic residential structure credit is available to individual taxpayers that do not qualify for the federal rehabilitation credit. S.C. Code Ann. §12-6-3535.

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