Bloomberg BNA

Tax Management
Real Estate Journal™

Reproduced with permission from Tax Management Real Estate Journal, V. 32, 12, p. 327, 12/07/2016.

Recent Court Guidance on the Federal Treatment of Tax Credits

By Joseph C. Mandarino[1]

This article considers two recent lines of cases and how they analyzed similar issues of tax law. We consider the substantive issues at stake and then consider whether the difference in result can be attributable to notions of judicial federalism.

In Part I, we summarize the federal tax treatment of state tax credits. In Part II, we review several recent tax cases involving state tax credits. In Part III, we review a recent case involving a federal tax credit, along with a predecessor case that involved similar partnership tax issues. Finally, in Part IV, we illustrate the practical import of these cases and attempt to reconcile the two approaches taken by the cases.

PART I — FEDERAL TAX TREATMENT OF STATE TAX CREDITS

Tax credits exist at both the state and federal level. For example, the state of Virginia provides a historic rehabilitation tax credit.[2] This credit can be used to offset a taxpayer's Virginia state income tax liability. The amount of the credit is 25% of the rehabilitation expenditures, subject to numerous restrictions and conditions.[3]

Similarly, there is a federal rehabilitation tax credit for similar undertakings.[4] The federal credit varies between 10% and 20% of the rehabilitation expenditures, and like the Virginia credit, is subject to numerous restrictions and conditions.[5] The federal credit can be used to offset a taxpayer's federal income tax liability.

While state tax credits cannot reduce federal income taxes, they can reduce state income taxes. In general, state income taxes are deductible for federal income tax purposes.[6] Thus, the interaction of state tax credits and federal income tax rules raises several issues. The Internal Revenue Service (IRS) has not issued much guidance on the federal treatment of state tax credits. However, what guidance does exist indicates that the IRS distinguishes between credits that are transferable or assignable and those that are not.

Generally, state law governs whether a state tax credit is assignable. For example, the Virginia rehabilitation credit can be deducted by the owner of a structure that is being rehabilitated, but cannot be assigned to another party. If the owner is a legal entity that is taxed as a partnership, Virginia law permits the credit to be allocated among partners of the partnership, but not assigned.[7] In contrast, for example, the Georgia film production tax credit can be overtly sold by the party otherwise entitled to the credit, on a one-time basis, to third parties.[8]

The main difference is that nonassignable credits are not treated as property, while assignable credits are. Accordingly, nonassignable tax credits are treated as a tax attribute rather than property. For example, assume a partnership generated such a credit, that credit was allocated in whole or in part to a partner, and the credit reduced the partner's state tax liability. Accordingly, such partner is treated as reducing his or her state tax liability. In other words, the main federal tax consequence is that such partner takes a deduction for state taxes on the partner's federal tax return that

[1] Joseph C. Mandarino is a tax and finance attorney in the Atlanta office of Smith, Gambrell & Russell, LLP.

[2] Va. Code Ann. §58.1-339.2.

[3] *Id.*

[4] §47. Except where otherwise indicated, references to "§" or "Section" are to the Internal Revenue Code of 1986, as amended (Code), and references to "Reg. §" are to the Treasury regulations thereunder.

[5] *See* §47(a).

[6] §164.

[7] Va. Code Ann. §58.1-339.2.A.

[8] Ga. Code Ann. §48-7-40.26(f).

reflects the partner's as-reduced state tax liability, not the original liability.[9]

In the case of assignable tax credits, the IRS appears to take a different position. If and when such a credit is assigned, it is treated as property for federal tax purposes.[10] In effect, the state credit is treated as a form of property that can be used to discharge all or part of the owner's state income taxes. This results in at least four significant federal income tax consequences, two for the partnership and two for the assignee.

First, the partnership that generates the state tax credit is treated as having a zero basis in the credit. Second, the partnership is then treated as selling the credit and must recognize gain or loss at that time. Because the partnership has a zero basis, the entire amount received for the credit is taxable income.

For example, assume Newco generates $100 in State X tax credits. Newco sells those credits to Jane Doe for $80. The credits are treated as property for which Newco has a basis of zero. Thus, upon transfer or assignment of those credits to Jane Doe, Newco recognizes $80 in federal taxable income.

On the buyer side, the first consequence is that, 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 computed before the application of the state tax credit. Further, 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 property tendered.

For example, assume the same facts as above: Newco generates $100 in State X tax credits and then sells those credits to Jane Doe for $80. Jane Doe then uses the credits to discharge $100 in State X income tax. For federal tax purposes, Jane is entitled to a $100 deduction for state income taxes, even though her state tax liability was eliminated by the credits. In addition, because the credits are treated as property, Jane acquires the credits with a basis of $80. When she uses the credits to discharge her state tax liability, she is treated as selling property. The amount received is the $100 of state tax that is discharged, and her basis is $80. Thus, she recognizes gain of $20.

Based on this guidance, it appears that the IRS position on state tax credits is as follows:

Nonassignable state tax credits	**Assignable state tax credits**
Person generating the credits recognizes no gain or loss from the allocation or utilization of the credits.	Person generating the credits recognizes gain on assignment of credits.
Person using the state credits to reduce state taxes can deduct only the as-reduced state tax liability.	• Assignee is allowed full federal tax deduction of state tax liability (even if eliminated by credits). • Assignee takes cost basis in the credits. • Assignee recognizes gain on tender of the credits to the extent the amount of state tax that is discharged exceeds the basis of the credits.

Two Chief Counsel Advice memoranda issued in 2007 provide some additional insight in this area.[11] Both memoranda are primarily concerned with the allocation of state rehabilitation credits and are understood to address the facts of what later became the *Va. Historic Tax Credit Fund 2001 LP* case, discussed at greater length below. In general, the memoranda appear to be consistent with the prior guidance and reiterate the distinction — for federal income tax purposes — between assignable and nonassignable state tax credits.

Each memorandum specifically considered a fact pattern in which a partnership was otherwise entitled to a state tax credit and brought in investors who would receive an allocation that consisted of virtually the entire credit, with a de minimis allocation of the partnership's other items.[12] In each memorandum, the IRS Chief Counsel's Office concluded that such investors were not partners for tax purposes. Furthermore, the memoranda determined that the arrangement should be treated as a disguised sale under §707.

Note that, although the credit at issue was specifically not assignable under the relevant state law, the Chief Counsel's Office concluded that the state credit should be treated as property with respect to the investor because the tax credit investor was not a part-

[9] Rev. Rul. 79-315, 1979-2 C.B. 27 (Holding 3).

[10] *See, e.g.*, 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.

[11] CCA 20074028, CCA 20074030.

[12] For simplicity, such an investor is hereinafter referred to as a "tax credit investor" without regard to whether such an investor is determined to be a partner in the partnership for federal income tax purposes.

ISSN 8755-0628

ner in the partnership for federal income tax purposes. Similarly, under the disguised sale analysis, the Chief Counsel's Office concluded that a sale of the state tax credits occurred.

Thus, under either theory, the result is that the state tax credit is effectively treated as an assignable credit. That is, the credit is treated as property, the partnership recognizes income on a deemed sale of the credit, the investor receives a cost basis in the credit, and the investor recognizes income upon tendering the credit to the extent the state taxes that are discharged exceed the amount paid for the credit. This suggests that the state tax treatment of a credit as nonassignable is not dispositive if the tax credit investor is not a partner for federal income tax purposes or if the disguised sale rules apply.

The IRS has not indicated whether the same approach should apply to federal tax credits. Generally, there are no freely assignable federal tax credits. Thus, if the approach in the memoranda were applied to federal credits, it would suggest that the generation, allocation, and utilization of federal tax credits would result in no federal tax consequences other than the reduction of federal income tax liability. However, this result would follow only if the investor were treated as a partner in the partnership and if the arrangement were not treated as a disguised sale.

PART II — STATE TAX CREDIT CASES

There are several cases addressing the allocation of nonassignable state tax credits. These cases involve the federal tax consequences of these credits, not the state tax implications.

Virginia Historic Tax Credit Fund Case

The first in a series of cases that analyze the treatment of state tax credits is *Va. Historic Tax Credit Fund 2001 LP v. Commissioner*.[13] The case involves a partnership that was established to assist in allocating Virginia state historic tax credits to investors. For the years at issue, these credits were not assignable. Accordingly, in order to receive them, a taxpayer had to make the necessary rehabilitation expenditures to qualify for the credit, or had to be a partner in a partnership that carried out such activities.

Like most state credit structures, the arrangements in this case provided for the tax credit investors to own a de minimis interest in the partnership's overall profit and loss (1%), but to receive all the state tax credits. Virginia law specifically permitted an allocation of state rehabilitation credit that was on different terms than a partner's ownership interest in the partnership: "Credits granted to a partnership . . . shall be allocated among all partners . . . in proportion to their ownership interest in such entity or as the partners . . . mutually agree as provided in an executed document . . . ."[14]

In addition to the foregoing allocation provisions, the tax credit investor's interest was subject to a call option under which the partnership could buy out the investor for .001 times the investor's capital contribution.[15]

The partnership in the case at issue, like most other Virginia 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. Interestingly, many projects that generate Virginia historic tax credits also generate federal rehabilitation tax credits. However, investors interested in federal rehabilitation tax credits must be 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 the Virginia tax credit permits.[16]

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.[17] The Tax Court ruled that the tax credit investors were bona fide partners and that the amounts invested were tax-free capital contributions.[18] The government appealed the case to the Fourth Circuit Court of Appeals.

The Fourth Circuit did not address the bona fide partner issue but did hold that the tax credit arrangements were disguised sales under §707.[19] The court specifically noted that even if the Tax Court was correct that the tax credit investors were bona fide partners, it would not change the disguised sale analysis. In a footnote, the court explained that the relevant tax regulations under §707 make clear that a disguised sale can exist even if it is ultimately determined that

[13] T.C. Memo 2009-295, *rev'd*, 639 F.3d 129 (4th Cir. 2011).

[14] Va. Code Ann. §58.1-339.2.A.

[15] *Va. Historic Tax Credit Fund 2001 LP*, 639 F.3d 129, 135 (4th Cir. 2011).

[16] *See, e.g.,* Reg. §1.46-3(f)(2)(i).

[17] *Id.* at 135–36.

[18] *Id.* at 136.

[19] *Id.* at 146.

ISSN 8755-0628

the party in question was not a partner in the partnership.[20]

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 characteristics of property.[21]

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 10 factors set out in the §707 regulations successfully rebutted the presumption. The court determined that only five of the factors were pertinent to the facts of the case, and none of them could be resolved in favor of the partnership. Accordingly, the court concluded that the tax credit transfers were disguised sales.

In summary, because the investments were treated as disguised sales, the partnership was deemed to recognize income from the sale of the credits.[22]

Note that this analysis differs from that laid out in the Chief Counsel Advice memoranda discussed above. Specifically, the memoranda rested on the analysis that a nonassignable credit would be treated as property if there were a disguised sale or if the tax credit investor were not a bona fide partner. Here, the court appeared to find that a state tax credit was property rather than a tax attribute as an absolute matter. It is not clear how this would work if the tax credit investor were treated as a bona fide partner and the transaction were not recast as a disguised sale.

Other State Tax Credit Cases

Following this case, other cases reached nearly identical results. For example, in *SWF Real Estate LLC v. Commissioner*,[23] the Tax Court held that similar state tax credit arrangements were a disguised sale. In *Route 231, LLC v. Commissioner*,[24] similar arrangements structured around state tax credits were also found to be a disguised sale. In both cases, the Tax Court focused on the lack of entrepreneurial risk and cited the Fourth Circuit's opinion in *Va. Historic* extensively.

In contrast, *Gateway Hotel Partners, LLC v. Commissioner*[25] 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.

PART III — FEDERAL TAX CREDIT CASE

While *Va. Historic* and its progeny involved determinations under the disguised sale rules, a recent case involving the allocation of a federal tax credit took a significantly different approach. *Historic Boardwalk Hall, LLC v. Commissioner*[26] involved a partnership arrangement meant to permit an investor to receive federal rehabilitation tax credits. The Third Circuit reversed the Tax Court's decision and found that the tax credit investor was not a bona fide partner in the partnership.

The federal rehabilitation 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.[27] If a credit investor is not a partner, it cannot be allocated any federal rehabilitation credits. As noted, federal tax credit investors typically are 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 *Historic Boardwalk*, the court determined that the aggregate effect of these arrangements was to ensure that the investor had no upside or downside risk. However, instead of using these facts to perform a disguised sale analysis, the court in *Historic Boardwalk* considered whether the tax credit investor was a bona fide partner.

The court considered the standards set forth in *Culbertson*:

> 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 partner-

[20] *Id.* at 137 n. 9 (citing Reg. §1.707-3).

[21] *Id.* at 141–42.

[22] *Id.* at 146.

[23] T.C. Memo 2015-63.

[24] T.C. Memo 2014-30.

[25] T.C. Memo 2014-5.

[26] 694 F.3d 425 (3d Cir. 2012), *rev'g and rem'g* 136 T.C. 1 (2011).

[27] Reg. §1.46-3(f)(2)(i).

ISSN 8755-0628

ship 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.'').[28]

Applying this test, the Third Circuit in *Historic Boardwalk* 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 participate in the upside if the project increased in value).

Ultimately, because the investor was not a partner, it could not be allocated any federal rehab tax credits.

The *Historic Boardwalk* court cited another high-profile case that involved a determination of whether an investor was a bona fide partner. In *TIFD III-E, Inc. v. United States*,[29] the Second Circuit determined that certain foreign banks that 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 *Historic Boardwalk* case, the court found the foreign banks lacked any risk and were not bona fide partners. As with *Historic Boardwalk*, the court aggregated all the arrangements and scrutinized them closely in its evaluation of whether the banks bore any risk.[30]

Significantly, not only did the court find that the banks were not partners, but in a subsequent appeal, 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.[31]

PART IV — RECONCILING THE CASES

Practice Points

In the case of state tax credits, courts are likely to find disguised sales when the tax credit investors lack upside or downside potential 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. The following examples illustrate some of the fundamental points that arise from the decisions in *Va. Historic* and *Historic Boardwalk*.

Example 1: Assignable State Tax Credit

Facts. Assume Filmco is a video production company that makes $1 million in qualifying Georgia expenditures in 2015. Filmco sells $300,000 in Georgia film production tax credits by the end of 2015 to a single investor (John Doe) for $250,000. The credit by its terms is assignable.

Results. Filmco has gain — It sold zero-basis property for $250,000, so it should have taxable income of $250,000. What is the character of this gain? There is little guidance, but often the holding period for assignable state tax credits is less than a year, so this may be moot. John Doe has gain of $50,000 — He discharged $300,000 in state tax liability with ''property'' in which he had a basis of $250,000. John Doe also has a $300,000 federal tax deduction for state taxes.

Example 2: Nonassignable State Tax Credit

Facts. Newco is formed to develop a historic building. It arranges with Investor to become a partner. Investor is entitled to 100% of any state rehabilitation tax credits that Newco generates. In 2016, Newco allocates $300,000 in credits to Investor.

Results. If this transaction is respected, Newco has no tax consequences. Investor uses 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.

Assume instead 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 decided 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

[28] *Historic Boardwalk*, 694 F.3d at 449.

[29] 459 F.3d 220 (2d Cir. 2006).

[30] *TIFD III-E, Inc.*, 459 F.3d at 231.

[31] *TIFD III-E, Inc. v. United States*, 666 F.3d 836, 849 (2d Cir. 2012).

ISSN 8755-0628

rights of Investor under the tax matters partner clause in the partnership agreement may be critical here.

Assume instead 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.

> *Example 3: Federal Investment Tax Credit*
>
> *Facts.* Newco is formed to develop a historic building. Investor is willing to invest if it receives all the federal rehabilitation 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 rehabilitation tax credits. In 2016, Investor Newco allocates \$1 million in credits to Investor.
>
> *Results.* This arrangement will largely fail. The federal rehabilitation credit is within the larger definition of investment tax credits in the Internal Revenue Code. Investment tax credits are required to be allocated in accordance with the residual allocation of partnership profits under §702(a)(8).[32] In the stated facts, the 5% profit/loss percentage is inconsistent with the 95% allocation of rehabilitation credits. Without considering whether Investor is a bona fide partner, it is likely that Investor can be allocated at most 5% of the credits.

Assume the same facts, except that Investor is allocated 95% of profit, loss, and cash. Under these facts, an allocation of 95% of the credits is facially valid. However, even if the allocation conforms to the regulations, Investor can receive the credits only 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 *Historic Boardwalk* would apply: Investor is not a bona fide partner if it has no upside or downside risk.

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 *Historic Boardwalk*, Investor should be viewed as a bona fide partner and entitled to the credits.

[32] Reg. §1.46-3(f)(2)(i).

Reconciling the Cases

The decisions in *Va. Historic* and *Historic Boardwalk* appear to involve similar fact patterns, but the courts took different approaches. For example, in both cases the tax credit investors entered into arrangements that substantially eliminated any risk or reward. However, in *Va. Historic* and its progeny, the courts analyzed the transaction under the disguised sale rules. In contrast, in *Historic Boardwalk,* the court considered whether the tax credit investor was a bona fide partner in the partnership.

The consequences of these approaches is significant. If a tax credit investor is ultimately determined not to be a partner in the partnership that generates the credit, the investor loses the credit entirely. Thus, in *Historic Boardwalk*, the tax credit investor was ultimately denied an allocation of the federal rehabilitation tax credit that it sought.

In the state tax credit cases, the result was less severe. Because the court applied the disguised sale rules, the net effect was to accelerate income through the partnership. For example, assume that Newco generates a \$100 state tax credit. That credit is allocated to a tax credit investor, Doe, who invests \$80 in Newco. Assume further that, as in *Va. Historic*, the arrangement is treated as a disguised sale. The result is that Newco is treated as selling the credits to Doe for \$80. Thus, Newco has \$80 of income that will be allocated to its partners, and Doe has an \$80 basis in the credits. Because state tax credit arrangements generally do not allocate more than de minimis amounts of income to the tax credit investor, the vast majority of the \$80 will be allocated to the Newco partners that are not tax credit investors. Thus, Newco will have to model this additional income in its projections. In some cases, Newco may generate early period losses that will offset this income, but in other cases it will need to provide liquidity for its income partners. For example, if the \$80 of income cannot be offset, then Newco may need to reserve enough of the cash raised from the tax credit investor to provide for a tax distribution to its other partners. If Newco wanted to provide for distributions to cover the tax on this income, and the agreed distribution rate was 50%, it would have to reserve \$40 of the \$80 that it raised from the tax credit investor for later distribution to its other partners. In this example, the tax reserve effectively halves the tax benefit from the use of state tax credits.

While the above fact pattern suggests that there can be a significant impact on the utility of a state tax credit if the arrangement is treated as a disguised sale, this is a middle ground as compared to the result in *Historic Boardwalk*. Because the disguised sale approach in the *Va. Historic* and its progeny avoids a determination of whether the tax credit investor is a

ISSN 8755-0628

bona fide partner, and because few states have evinced any interest in applying the *Historic Boardwalk* approach at the state level, the investor appears to be able to obtain the state tax credits as an allocation from the partnership.

However, if the courts were to address the bona fide partner issue, it would appear that the state tax credit arrangements in *Va. Historic* would fail just as the federal tax credit arrangements in *Historic Boardwalk* failed.

While the application of disguised sale rules in the state tax credit cases can be seen as a middle ground approach, it is not as clear how this approach would work in the context of federal tax credits. In *Historic Boardwalk*, the key question was whether the tax credit investor was a bona fide partner. If the court found sufficient indicia to rule that the investor was a partner (i.e., risk and reward), what effect would the disguised sale rules have? As noted, the disguised sale rules apply regardless of whether an investor is ultimately determined to be a bona fide partner. Thus, these rules can apply even if an investor otherwise meets the test of being a partner.

In applying the disguised sale rules to a federal tax credit, a court would have to address the two main issues that came up in the state tax credit cases: Is the credit ''property'' and is there sufficient entrepreneurial risk to overcome the disguised sale presumption?

On the second point, if a court specifically found that a tax credit investor was a bona fide partner, then it might be difficult to also assert that the same party lacked entrepreneurial risk. While the first finding does not moot the second finding, the court would need to consider many of the same factors.

However, even if a court could conclude that a bona fide partner lacked entrepreneurial risk, it is less clear that a federal tax credit could be treated as property for purposes of the disguised sale rules. The notion that a tax credit could be property rather than a tax attribute owes its origin to the authorities on the federal treatment of state tax credits discussed above. Thus, in the case of an assignable credit, it is reasonable to treat the credit as property because it can be used to discharge an otherwise deductible state tax liability. Thus it makes sense to think of an assignable credit as an in-kind payment mechanism. In the case of a nonassignable credit, it is reasonable to treat the credit as a tax attribute because it cannot be conveyed and can only reduce the state taxes of the recipient. Because of the generally nonassignable nature of federal tax credits, it would be difficult to argue that such a credit is property.

In many respects, complex tax credit arrangements (the ones that draw the ire of the IRS) can be viewed as attempts to transfer nonassignable credits to tax credit investors who would not otherwise qualify as bona fide partners. However, we can distinguish between a situation with a valid allocation of federal tax credits to a bona fide partner and an arrangement in which a tax credit investor does not qualify as a bona fide partner. In the latter case, although the parties may have tried to transfer an otherwise nonassignable credit, the arrangement is blocked because the tax credit investor is not a partner, rather than under the disguised sale rules.

It may be useful to consider the result if the courts had applied the *Historic Boardwalk* approach, instead of the disguised sale rules, to state tax credit arrangements. As noted, many of the flaws in the arrangements reviewed by the courts in the state tax credit cases would equally result in a finding that the tax credit investor was not a bona fide partner. For federal tax purposes, this would suggest, based on the Chief Counsel Advice memoranda, that the state tax credits should be analyzed under the authorities for assignable credits. Thus, the partnership would be treated as having income from the ''transfer'' of the credits, and the tax credit investor would take a basis in the credits equal to the amount ''paid'' for the credit. As discussed above, this would permit the tax credit investor to deduct the full amount of state taxes and would require the tax credit investor to recognize income equal to the difference between the amount paid for the credit and the amount of state taxes discharged.

However, this approach implicates a federalism issue that is not present under the disguised sale approach. If a federal court determines that a tax credit investor is not a bona fide partner, the determination clearly would apply for federal tax purposes, with the result to the partnership and the tax credit investor discussed above. However, it is less clear how this would impact state tax results. Virginia tax law, for example, generally incorporates federal tax law, including definitional issues like partnerships and partners. Thus, it is possible that a federal court decision that a tax credit investor is not a bona fide partner could have effect on the state level. Under this view, the tax credit investor would not be a partner for both state and federal law purposes and, accordingly, could not be allocated any state tax credits.

However, the law that incorporates federal tax terms is a state law, the law that provides for the credits is a state law, and the guidance issued by Virginia on the allocation of state tax credits is also a product of state law or state action. Thus, there may be a competing view that a federal court's tax determinations should have application only for federal tax purposes, even when state law appears to incorporate federal tax terms by reference.

If the *Va. Historic* court had applied the *Historic Boardwalk* analysis and found that the tax credit investors were not bona fide partners, then at one level

ISSN 8755-0628

the results would have been no different from the actual result reached in the case — the partnership would recognize gain on the amount ''paid'' for the tax credits. However, such a decision would also leave open the implication that the tax credit investors were not entitled to the credits altogether. It is unclear how state courts would respond. For example, a state court could find that the federal determination did not resolve whether, under Virginia state law, the tax credit investors were entitled to the Virginia tax credits. Alternatively, a state court could find that because the tax credit investors are not bona fide partners under federal law, and Virginia law appears to incorporate federal tax law definitions, the investors would not be entitled to the credits. That finding would tend to negate the federal decision — if the tax credit investors are not entitled to the credits, then there is no property transfer to tax for federal tax purposes. At a minimum, a federal decision that tax credit investors were not bona fide partners would create significant confusion and could freeze up the state tax credit market.

The approach taken by the *Va. Historic* court avoided this result, but did permit the IRS to tax the investment as a sale.

One way to reconcile the approaches is that the state tax credit cases can be seen as an exercise of judicial federalism. ''Federalism'' encompasses many concepts, and generally is not relevant in the area of federal taxation. However, one aspect of federalism is that the federal judiciary should exercise restraint or deference with respect to state governments.[33] Here, the use of a middle ground position — applying the disguised sale rules — can be seen as an instance of judicial federalism. The main effect of this approach is at the federal level and does not result in a federal court reaching into an area that is inherently a function of state law (state taxation), even when the state law at issue appears to operate by reference to the federal tax law.

The result is that federal tax law is protected with minimum damage to state tax law. Moreover, the deference exercised by the courts on the state tax credit side can be contrasted with the approach taken with respect to federal tax credits. There, the *Historic Boardwalk* court delivered the ultimate sanction in its finding that the tax credit investor was not a bona fide partner. While this was a severe result, it is clear that the federal courts are required to interpret and enforce federal tax laws. Thus, under the principles of judicial federalism, a federal court would feel more muscular in the resolution of a purely federal tax matter than it would in the resolution of a mixed question of federal and state law.

It could be argued, however, that the approach taken by the *Va. Historic* court is simply an example of judicial economy. Judicial economy is a doctrine under which a court strives to resolve a case with the fewest number of factual or legal determinations. Thus, the *Va. Historic* court specifically avoided ruling on whether the tax credit investors were bona fide partners (an issue raised and ruled on in the Tax Court) on the theory that it was unnecessary to the determination of whether the disguised sale rules applied. Because the court concluded that a transaction could be taxed as a disguised sale regardless of whether the investor was a bona fide partner, it was unnecessary to make that determination.

By the same reasoning, the *Historic Boardwalk* court took on directly the issue of whether a tax credit investor was a bona fide partner and therefore did not need to address whether the transaction was a disguised sale. While both approaches could be viewed as consonant with an exercise of judicial economy, in substance the approaches are quite different, and this doctrine does not appear to reconcile them.

Instead, it appears that a more plausible and compelling case can be made that the different approaches taken in these opinions can be attributed to judicial federalism. Both federal and state tax credit arrangements were unlikely to survive judicial scrutiny. The courts in the state tax credit cases adopted an approach that arguably did the least damage to an important area of state law. In contrast, the court in the federal tax credit case took a more severe approach in an area that involved federal law exclusively.

For developers and their advisors who rely on tax credits to finance projects, this approach holds out hope that the federal courts will enforce federal law without destroying the state tax credit market.

---

[33] See Ann Althouse, *On Dignity and Deference: The Supreme Court's New Federalism*, 68 U. Cin. L. Rev. 245 (2005), for a general overview of federalism theories and citations to relevant cases.

ISSN 8755-0628