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Tax Credits

David Burton and Richard Page of Akin Gump Strauss Hauer & Feld break down the Tax Court's ruling in *SWF Real Estate, LLC v. Commissioner*, holding that a partnership formed to disproportionately allocate tax credits actually constituted a disguised sale of the tax credits from one party to the other. The authors offer steps taxpayers can take to reduce the risk of having their transactions recharacterized as disguised sales.

Tax Court Finds Partnership Formed to Share State Credits Constituted a Taxable 'Disguised Sale'

BY DAVID K. BURTON AND RICHARD T. PAGE

Normally when partners enter into a partnership by contributing capital to an entity in exchange for a right to a share of the entity's profits, this is a non-taxable event.[1] Also, property distributed to a partner up to the extent of that partner's basis in the partnership is generally not taxable.[2]

However, the Internal Revenue Code has a series of ''disguised sale'' rules that can make such transactions taxable to unwary taxpayers. The foundation of these disguised sale rules is I.R.C. Section 707: ''If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.''[3]

The purpose of these disguised sale rules is to prevent two transacting parties from being compelled to form a partnership in an attempt to exchange goods or services for cash without generating taxable gain to the seller by taking advantage of the nontaxable nature of contributions to and distributions from a partnership.[4]

Judicial Opinion: 'SWF Real Estate LLC v. Commissioner'

The U.S. Tax Court, on April 2, released an opinion, *SWF Real Estate, LLC v. Commissioner*, finding that a partnership that was formed to disproportionately allocate tax credits actually constituted a disguised sale of the tax credits from one party to the other.[5]

The Facts

The taxpayer, a single-member limited liability company, had earned tax credits pursuant to the Virginia Land Preservation Tax Credit Program.[6] Any unused credits were permitted to be sold or otherwise trans-

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[1] I.R.C. Section 721(a) (''No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.'').

[2] I.R.C. Section 731(a).

[3] I.R.C. Section 707(a).

[4] William McKee, William Nelson & Robert Whitmire, Federal Taxation of Partnerships and Partners para. 14.02(3)(b) (2015) (''The possibility of combining contributions and distributions to achieve the economic substance of a sale without triggering the tax consequences of a sale led to the enactment in 1984 of [I.R.C.] § 707(a)(2)(B) . . . .''); see also Laura E. Cunningham & Noel B. Cunningham, The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships 228-229 (4th ed. 2011) (describing the genesis of I.R.C. Section 707).

[5] *SWF Real Estate LLC v. Commissioner*, T.C. Memo. 2015-63.

[6] Id. at 10.

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ferred to another taxpayer to offset Virginia income tax liability.[7] The taxpayer could have simply sold the credits, but that would have generated taxable gain.

Instead, the taxpayer formed a partnership (operating as a limited liability company) with the Virginia Conservation Tax Credit Fund LLLP (Virginia Conservation), with the explicit contractual understanding that Virginia Conservation would contribute 53 cents per dollar of each Virginia tax credit allocated to Virginia Conservation pursuant to the parties' operating agreement, in return for a nonvoting minority interest in the partnership.[8]

Virginia Conservation was ultimately allocated 92 percent of the credits.[9] Virginia Conservation intended to act as a broker in selling the credits to Virginia taxpayers.[10] The partnership agreement included an indemnity clause that would make Virginia Conservation whole for any Virginia tax credits that were later disallowed or revoked.[11]

The taxpayer asserted that this purported partnership formation with Virginia Conservation wasn't a disguised sale but rather was a nontaxable exchange of capital for a partnership interest and a subsequent allocation of Virginia tax credits.[12]

The partnership's stated purpose was to invest in the long-term appreciation of land and also to preserve Virginia land with a charitable intention.[13] The initial member of the partnership would have the option to purchase all of Virginia Conservation's interest in the partnership on or after Jan. 1, 2010 (i.e., slightly more than four years after the contribution of cash by Virginia Conservation), as a method to ''get[] [Virginia Conservation] out of the deal.''[14] The court didn't provide specific details on how Virginia Conservation's cash investment was immediately spent or invested by the partnership.

The Law

Relying on I.R.C. Section 707, the Tax Court noted that ''[a] disguised sale occurs when (1) a partner directly or indirectly transfers money or property to a partnership, (2) there is a related direct or indirect transfer of money or other property by the partnership to such partner, and (3) the transfers are properly characterized as a sale or exchange of property when viewed together.''[15]

The court elaborated on the third prong by noting that ''a disguised sale has occurred only if, on the basis of all the facts and circumstances, (1) the transfer of money or other consideration would not have been made but for the transfer of property and (2) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.''[16]

Practice Tips

Taxpayers wishing to form a partnership for purposes of sharing state tax credits must be mindful of the disguised sale rules of I.R.C. Section 707. In order to reduce the risk of having transactions recharacterized as disguised sales:

- Have the transaction span a duration of greater than two years, to prevent establishing the legal presumption that it constitutes a sale.
- Avoid or at least limit any indemnity for the loss of the promised tax credits, to reduce the appearance of the tax credits being considered ''secured.''
- Don't contract to have absolute certainty as to the manner in which the tax credits will be transferred (quantity and date for example).
- To demonstrate the relevance of entrepreneurial risk in the partnership, the incoming partner should save detailed due diligence reports created before contributing capital.
- Consider giving the incoming partner a meaningful share of the partnership interests and also consider giving that partner a percentage of voting rights—giving 1 percent of nonvoting rights might not suffice.
- In the partnership agreement, leave open the possibility that the partnership might be able to reclaim tax credits that are allocated to the incoming partner, thus establishing that the incoming partner will continue to have obligations with respect to the partnership.

The court also underscored the importance of considering the substance-over-form doctrine in all cases.[17] To help evaluate the substance of an Internal Revenue Service-purported disguised sale, the court noted the following non-exhaustive list of 10 facts-and-circumstances considerations from the applicable Treasury regulations, adding that the weight to be put on each factor depends on the case[18]:

- that the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;
- that the transferor has a legally enforceable right to the subsequent transfer;
- that the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;
- that any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;

[7] Id. at 12.
[8] Id. at 58. LLLP stands for limited liability limited partnership.
[9] *SWF Real Estate LLC*, T.C. Memo. 2015-63 at 58.
[10] Id. at 16.
[11] Id. at 60.
[12] Id. at 42.
[13] Id. at 21 (citing the operating agreement between the parties).
[14] Id. at 68 n. 47 (quoting negotiation documentation regarding the option agreement between the parties).
[15] Id. at 43 (citing I.R.C. Section 707(a)(2)(B)).
[16] Id. at 44-45 (citing Treas. Reg. Section 1.707-3(b)(1)).
[17] Id. at 43-44 (citing Treas. Reg. Section 1.707-1(a)).
[18] Id. at 45-46 (citing Treas. Reg. Section 1.707-3(b)(1)).

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■ that any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;

■ that the partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);

■ that the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);

■ that partnership distributions, allocation or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

■ that the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and

■ That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

Finally, the court noted that ''transfers made between a partnership and a partner within a two-year period are 'presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale.' ''[19]

Tax Court's Analysis

The court immediately noted that all of the relevant transfers occurred between December 2005 and April 2006—within a two-year window—meaning that the taxpayer would need to overcome the presumption that this was a sale.[20]

In evaluating the three-prong statutory test of I.R.C. Section 707 to determine if there was a sale, the court noted that the first two factors were met (i.e., that a partner transferred money into a partnership and that there was a transfer of property from the partnership to that partner), and then the court turned to an analysis of the more-nebulous third prong—that the ''transfers are properly characterized as a sale or exchange of property when viewed together.''[21]

The third prong requires an analysis of the ''but for'' test and whether, if the transfers weren't simultaneous, the transfer of property to the partner is dependent on the enterprise's entrepreneurial risks. The court sided with the IRS in finding that the capital contribution wouldn't have occurred but for the tax credits exchanged because Virginia Conservation ''promised'' to contribute 53 cents for each dollar of Virginia tax credits it would receive, and Virginia Conservation's rights to these credits were protected by an indemnity clause provided by another partner.[22]

The court further added that entrepreneurial risk for Virginia Conversation didn't appear to be of concern because Virginia Conservation didn't appear to review any relevant records of the taxpayer's business.[23] Neither Virginia Conservation's lead principal nor counsel ''reviewed balance sheets, profit and loss statements, income statements, business plans, or valuations regarding [the taxpayer's] business.''[24]

To be thorough, the court also considered the abovementioned 10 facts-and-circumstances inquiries, focusing on six of them in the opinion[25]:

■ First, the court considered ''whether the timing and amount of the transfer of Virginia tax credits [was] determinable with reasonable certainty at the time of Virginia Conservation's transfer of money'' to the partnership.[26] The court viewed the certainty of the agreed-upon exchange as weighing in favor of this being a disguised sale.[27]

■ Second, the court considered ''whether Virginia Conservation had a legally enforceable right to the later

[19] Id. at 46 (quoting Treas. Reg. Section 1.707-3(c)(1)). The court also briefly summarized two similar cases to the instant case, *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, T.C. Memo. 2009-295, 98 T.C.M. (CCH) 631, 633 (2009), *rev'd and remanded*, 639 F.3d 129 (4th Cir. 2011), and *Route 231, LLC v. Commissioner*, T.C. Memo. 2014-30. Id. at 47-51. *Route 231, LLC v. Commissioner* is now under appeal. Brief of Petitioner-Appellant, *Route 231, LLC v. Commissioner*, No. 14-1983 (4th Cir. April 13, 2015).

[20] *SWF Real Estate LLC*, T.C. Memo. 2015-63 at 52 (citing Treas. Reg. Section 1.707-3(c)(1)).

[21] Id. at 57.

[22] Id. at 58, 60.

[23] Id. at 60.

[24] Id. at 17.

[25] Id. at 61-69. The opinion didn't discuss the following four of the 10 factors from Treas. Reg. Section 1.707-3(b)(1):

■ ''That any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration'';

■ ''That any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations'';

■ ''That the partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt)''; and

■ ''That partnership distributions, allocation or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property.''

[26] Id. at 62.

[27] Id.

transfer of Virginia tax credits.''[28] The court noted that because Virginia Conservation could have pursued breach of contract claims against the partnership, Virginia Conservation did have such a legally enforceable right, and that this was another factor in favor of recognizing this as a disguised sale.[29]

■ Third, the court considered whether Virginia Conversation's rights to the credits were ''secured.''[30] The court defined ''secured'' in this context as meaning that the right to receive tax credits would be buttressed by a guarantee that if the credits weren't delivered, investors' capital would be refunded.[31] The court viewed the indemnity clause as meeting the definition of the transaction being ''secured.''[32] This was another factor in support of finding a disguised sale.

■ Fourth, the court considered whether the partnership held tax credits that were beyond the reasonable needs of its own business.[33] Here, based on the facts, the court concluded that this factor only weakly supported the finding of a disguised sale—unlike the other factors the court analyzed.[34]

■ Fifth, the court considered whether the transfer of credits was disproportionatey large compared to the partnership interest of the partner receiving them, and concluded that a 1 percent partnership interest in exchange for 92 percent of the credits weighed in favor of finding a disguised sale.[35]

■ Sixth, the court considered whether Virginia Conservation had any possible obligation to return credits (once received) to the partnership, and concluded that Virginia Conservation had an irrevocable right to use the allocated credits, without any further obligations owed to the partnership, and that this weighed in favor of finding a disguised sale.[36]

[28] Id. at 64.
[29] Id. at 65.
[30] Id.
[31] Id. (citing *Virginia Historic Tax Credit Fund 2001 LP*, 639 F.3d at 143 and *Route 231, LLC*, T.C. Memo. 2014-30 at 43).
[32] Id.
[33] Id. at 66.
[34] Id. at 67.
[35] Id. at 68.
[36] Id. at 68-69.

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