Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: 200704030

Release Date: 1/26/2007

CC:PSI:B01
POSTS-166022-04 (WLI-5)

UILC: 701.00-00, 701.01-00, 707.00-00

date: October 6, 2006

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subject: State Tax Credit Transfers

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LEGEND

State =

D =

P1 =

P2 =

P3 =

a =

b =

c =

d =

e =

f =

g =

ISSUES

1) Whether the investors in the transactions described below are respected as partners in the partnerships under the principles of the Substance-over-Form doctrine;
2) Whether the transactions described below should be recharacterized as a disguised sale of partnership property under §707(a)(2)(B) of the Internal Revenue Code and the regulations thereunder;
3) Whether the transactions described below are respected under the partnership anti-abuse rule (§ 1.701-2 of the Income Tax Regulations); and
4) Whether the issue of whether an investor is a partner in a partnership constitutes a partnership item.

CONCLUSIONS

Based on the materials submitted and representations made within, we conclude that:

1) the investors involved in the transactions described below are not partners in the partnerships and therefore, the transactions should be recast under the principles of the Substance-over-Form doctrine;
2) the transactions described below should be recharacterized as a disguised sale of partnership property under § 707(a)(2)(B) and the regulations thereunder;

3) the transactions described below should be recast under the partnership anti-abuse rule (§ 1.701-2);
4) The issue of whether an investor is a partner in a partnership is a partnership item.

FACTS

State allows State income tax credits for the rehabilitation of State property based on qualified expenses. The credit equals a% of eligible rehabilitation expenses and can be used as a dollar-for-dollar reduction in State income tax liability. The credit must be identified and used for the year earned, but the credit can be carried forward for g years. Prior to D, State allowed a one time transfer of the credit. After D, the credit could no longer be transferred.

Before D, the credit at issue was a transferable tax credit. The promoters of the transactions formed P1 with investors to purchase the credits from various developers who had earned the credits, but could not use them on their state tax returns. P1 paid $ b per dollar of credit.[1]

P1 allocated all of the credits to a group of individual investor partners (with a combined interest of 1% in P1), P2, and P3 (both 1% partners of P1). P2 and P3, then, allocated their distributive shares of the credits to their respective 1% individual investors. The individual investors were taxpayers who were interested in reducing their state taxes, but, for reasons such as being subject to the Alternative Minimum Tax (AMT), were indifferent to the state taxes deduction under § 164 for federal tax purposes. In exchange for partnership interests in P1, P2, or P3, each of the investors contributed cash at $ c per dollar of credit (the total amount of $ c times the number of credits allocated (and/or to be allocated)).

The individual investors executed subscription agreements with P1, P2, or P3, which provided that P1, P2, or P3 anticipated the receipt of the credits and agreed to allocate a fixed number of the credits to the investors. Upon the execution of the subscription agreements and contribution of cash, P1, P2, and P3 transferred credits simultaneously. Future allocations of credits, if any, were carried out typically within d months of time. Further, the investors executed option agreements granting P1, P2, or P3 options to purchase back the investors' interests for their fair market value for a period of one year. In fact, it appeared that most of the investors held onto their partnership interests for a period of only d months and, thereafter, sold their interests to

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1 P1 purchased and allocated the credits within the same tax year. P1 deducted the purchase price of the credits as "acquisition fees" and did not report income from the disposition of the credits.

one of the key promoters of the transactions for a small fraction (e) of their bases. On their federal income tax returns, the investors claimed large capital losses ((e -1) times $ c) times the number of credits).

The marketing materials of the transactions provide that the investors will not receive any material distributions of cash flow and will not be allocated material amounts of federal income tax credits or partnership items of income, gain, loss or deduction. Further, the marketing materials provide that any return on investment or of an investment in P1, P2, or P3 is dependent entirely upon the allocations of the State credits and the capital loss for federal income tax purposes generated upon the sale of the investors' interests in P1, P2, or P3.

LAW AND ANALYSIS

I. The Investors Are Not Partners in the 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.

Under this inquiry, it is clear that the investors in the instant case were not partners in the relative partnerships. The transactions were promoted as ones in which the investors would receive no material cash distribution, no allocations of federal income tax credits, and no partnership items of income, gain, loss or deduction. The investors subscribed to the transactions with the full knowledge that the only benefits of entering P1, P2, or P3 were the distributions of the State tax credits and federal income tax losses to be claimed at the termination of their interests. These interests were held

for a brief period of time (typically, d months). This obvious lack of joint profit motive is fatal to their classification as partners in P1, P2, or P3. Therefore, the investors were not partners in the partnerships.

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 generally appropriate to treat the transaction as a sale and purchase of property under § 1001.

In the hands of the taxpayer who originally qualified for the credit and transfers it for value, the credit has a basis of zero, 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 in the transferee's hands constitutes property, the basis of which is the cost incurred. The use of the credit to reduce the transferee's state tax liability is analogous to the transfer of property to the state in satisfaction of the liability. 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). *Cf. Rev. Rul. 86-117*, 1986-2 C.B. 157.

Applying these principles to the present situation, as recast under the *Tower/Culbertson* substance-over-form analysis, the investors were not partners in the partnerships. Accordingly, the transfers of the credits for cash between P1, P2, or P3 and the investors should be recharacterized, in accordance with their substance, as direct sales and purchases of the credits. This treatment applies whether or not the transaction is treated as a partnership allocation for state law purposes. Prior to D, P1 acquired the credits for $ b per dollar of credit and must report gains from the sale of the credits at a price of $ c per dollar of credit to the investors, measured by the difference between their basis in the acquired credits and the amount realized on the transfer to the investors.[2] When the investors use the credits to reduce their state tax liability, they

2 Pre-D, the developers who qualified for and then sold the credits to the partnerships would also report

are treated as having satisfied their liability with property, resulting in a disposition of the credits under § 1001 and payments of state tax for purposes of § 164(a). *See Rev. Rul. 86-117*.[3] Further, the losses claimed by the investors upon the sale of their purported "partnership interests" in P1, P2, or P3 are disallowed.

II. Disguised Sale of Property

Section 707(a)(2)(B) provides that if (1) there is a direct or indirect transfer of money or other property by a partner to a partnership, (2) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (3) the transfers in (1) and (2), when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated either as occurring between the partnership and one who is not a partner, or as a transaction between two or more partners acting other than in their capacity as members of the partnership.

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

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

In this case, P1, P2, and P3 transferred credits simultaneously upon the investors' execution of the subscription agreements and contributions of cash. Future allocations of credits, if any, were carried out typically within d months of time following the subscription. Pursuant to § 1.707-6(a), therefore, the transfers are presumed to be

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gains, in the full amount of the $b sales price, since they had no basis in the credits.

3 If the tax benefit of a cash payment of the state tax liability would have been reduced or eliminated by factors such as AMT, the same result applies to this payment.

sales of credits from P1, P2, and P3 to the investors and should be treated as such for federal tax purposes.

III. Sec. 1.701-2 Partnership Anti-Abuse Rule

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 the existence of an impermissible tax reduction purpose.

P1, P2, and P3 were 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.

First, P1, P2, and P3 were used for the specific purpose of allocating the credits to the investors, resulting in substantial federal tax reduction. The use of the partnership form enabled the promoters of the transactions to effect the sale of large numbers of credits at a profit of $ f per dollar of credit without incurring gain at any level. Moreover, by design, the investors claimed large amounts of capital losses from the sale of their purported "partnership interests" in P1, P2, and P3 to the promoters at a

price a fraction (e) of their bases. These manufactured deductions effectively substituted for state tax payments the investors could not otherwise benefit from, typically because such payments would not have been deductible for AMT purposes. Additionally, P1, P2, and P3 failed to make § 754 elections and, therefore, had inflated inside bases. This use of the partnership form is inconsistent with the intent of the Subchapter K, which is to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax.

Second, the promoters and the investors entered into the various subscription agreements, option agreements, and partnership agreements for the allocation and gainful disposition of the State tax credits in anticipation of reporting no gain and claiming large amounts of losses for federal tax purposes. Tax avoidance, therefore, was a principal purpose behind the use of the partnerships.[4]

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

IV. 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 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).

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4 In the pre-D transactions, the partnerships appeared to have no business activities other than the purchase and allocation of the credits.

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).

The Service faces litigation hazards on this issue in some cases, because the Tax Court has held that a partner's identity is not a partnership item where there is a dispute as to whether a person not listed as a partner on the partnership return is a

partner. *See Hang v. Commissioner*, 95 T.C. 74 (1990) (addressing the issue in the context of an S corporation subject to the TEFRA partnership procedures); *Grigroraci v. Commissioner*, T.C. Memo. 2002-202 (holding that partner identity was an "affected item" under the facts of that case).

In *Blonien v. Commissioner*, 118 T.C. 541 (2002), however, the Tax Court found that to the extent a listed partner's claim that he was not a partner would affect the distributive shares of the other partners, the taxpayers' claim is a partnership item rather than a partner-level determination. *Blonien* makes partner identity a partnership item in the present case since the taxpayers at issue here were listed as partners. If the investors in the instant case were not partners, there should be no allocations to them and that issue must be decided at the partnership level.

Further, § 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 forgoing issues must be raised in a TEFRA partnership proceeding. In the event a court holds that a partner's identity is not a partnership item, raising the issue of partner identity at the partnership level will protect the government by extending the period for assessment with respect to the issue as an affected item. § 6229(d)(2). 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. *Id.; see G.A.F. v. Commissioner*, 114 T.C. 519 (2000).

Please call (202) 622-3050 if you have any further questions.