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HISTORY AND THE HILL



IRS Guidance a Step in the Right Direction on Application of Economic Substance Doctrine to the HTC

By John Leith-Tetrault, National Trust Community Investment Corporation

The Internal Revenue Service (IRS) and Treasury indicated in recent guidance to field auditors that they intend to follow the principles outlined in Footnote 344 of the Joint Committee on Taxation (JCT) explanation of the application of the codification of the economic substance doctrine (CESD) to tax credit transactions included in the Health Care and Education Reconciliation Act of 2010. The guidance, in the form of a directive from the IRS's Large Business & International (LB&I) Division dated July 15, 2011, states that the doctrine would likely not be applied to "transactions that generate targeted tax incentives in form and substance consistent with congressional intent in providing the incentives." This directive is the first new guidance on this topic from the IRS since it issued Notice 2010-62 on September 13, 2010. The directive to auditors applies to all transactions entered into after March 31, 2010. Law firms across the historic tax credit (HTC) industry applauded this news as a step in the right direction for all congressionally mandated social investment credits.

Background

The Historic Tax Credit Coalition (HTCC) has long contended that the HTC should enjoy an exemption from the application of the for-profit requirements of section 183 of the Internal Revenue Code similar to that which is provided to the low-income housing tax credit (LIHTC) by Treasury Regulation §1.42-4. New markets tax credit (NMTC) advocates often point to the May 11, 2004 colloquy between Sens. Jay Rockefeller and Max Baucus as protection for NMTC investors. HTCC representatives met with the JCT in the fall of 2009 to make their case, and in 2010 after additional meetings with the congressional committees of jurisdiction, Footnote 344

was added to a technical explanation of President Obama's health-care legislation. However, because there was no House/Senate conference committee to iron out differences between the two bills, there was no legislative report language on which to base a legal opinion. As a result, the scope and application of Footnote 344 were left in limbo.

Following the inclusion of CESD in the Health Care and Education Reconciliation Act of 2010, tax credit industry letters were sent to U.S. Treasury officials requesting that the application of Footnote 344 be further clarified. These letters and at least one meeting with Treasury and the IRS were followed by Notice 2010-62 which stated that there would be no further guidance and that no "angel list" of exempt transactions would be issued. While the July 15 directive to auditors falls well short of the impact of a Treasury Regulation, the directive is at least a good indication that Treasury is paying attention to congressional intent on this issue.

Reactions of HTC Legal Experts

Ever optimistic, History and the Hill posed the question to HTC legal experts about whether the LB&I directive would finally relieve HTC investors of their need to demonstrate a pre-tax return and a business purpose for their federal historic tax credit investments. Investors demonstrate their profit motive through the requirement of an annual priority return expressed as a percentage (typically 2 to 3 percent) of their equity investment. The answer unfortunately and uniformly has been "no."

"This guidance provides significant comfort to participants in historic rehabilitation tax credit transactions that are

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structured consistently with the requirements of the program," said Jerry Breed, a partner in the Washington, D.C. office of Bryan Cave. "The guidance should not be interpreted, however, as a repeal of the profit motive requirement similar to the regulatory provisions applicable to the low-income housing tax credit. Such an exemption would require an explicit regulation or published ruling similar to Treasury Regulation 1.42-4."

Gregg Yeutter, a partner in the Omaha office of Kutak Rock, was similarly cautious in his reaction to the notice. "Most tax credit counsel will find the guidelines to be only marginally helpful," Yeutter said. "Although there is favorable language in Steps 1 and 3 of the guidelines, which indicates that application of the economic substance doctrine should be the exception rather than the rule in most tax credit transactions, there is not a blanket prohibition against application of the doctrine to tax credit deals. Furthermore, the guidelines themselves are not treated as official pronouncements of law and do not carry any precedential value. Accordingly, while the guidelines are helpful, they are unlikely to change how HTC deals are structured."

On a recent HTCC monthly call, Bill Machen, a partner in the Boston office of Holland and Knight commented that despite the LB&I directive, and even if the economic substance doctrine is determined not to be applicable, the IRS still may challenge tax credit transactions on other grounds. For example, as it did in the Virginia Historic Tax Credit Fund and Historic Boardwalk Hall cases, the IRS could assert that an investor should not be respected as a partner for federal income tax purposes or that a transaction should be recharacterized under the substance over form, step transaction, or other applicable doctrines.

All industry observers agreed that while the instructions to auditors on the application of CESD to congressionally enacted tax credit incentives were helpful, more regulatory and legislative action will be necessary to provide the level of exemption to the HTC that is currently enjoyed by the LIHTC. ♦



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