Nos. 10-1333 (L), 10-1334, 10-1336

IN THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

VIRGINIA HISTORIC TAX CREDIT FUND 2001, LLC, Tax Matters Partner of Virginia Historic Tax Credit Fund 2001 LP,

Petitioner-Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant

VIRGINIA HISTORIC TAX CREDIT FUND 2001, LLC, Tax Matters Partner of Virginia Historic Tax Credit Fund 2001 SCP, LLC,

Petitioner-Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant

VIRGINIA HISTORIC TAX CREDIT FUND 2001, LLC, Tax Matters Partner of Virginia Historic Tax Credit Fund 2001 SCP, LP,

Petitioner-Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant

ON APPEAL FROM THE DECISION OF
THE UNITED STATES TAX COURT

FINAL REPLY BRIEF FOR THE APPELLANT

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TABLE OF CONTENTS

Table of contents. i

Table of authorities. iii

Argument:

I. The Tax Court erred as a matter of law in holding that the so-called investors were, in substance, as well as form, *bona fide* limited partners of the Funds for federal tax purposes 1

A. It is well-settled that the characterization of the investor transactions, for federal tax purposes, as *bona fide* equity contributions or purchases of Virginia tax credits is reviewed *de novo* 1

B. Undisputed facts establish that the investor transactions were, in substance, purchases of Virginia tax credits 6

C. The Commissioner may recharacterize, for federal tax purposes, a transaction according to its substance, even where the parties adopted the form for purposes other than the avoidance of federal tax.. 12

D. The investor transactions, for federal tax purposes, are required to be characterized according to their substance whether or not the Commonwealth of Virginia recognizes purely formal arrangements as satisfying its precondition to the transfer of tax credits.. 20

II. Regardless whether the investors were *bona fide* partners for federal tax purposes, I.R.C. § 707(a)(2)(b) requires their transactions with the Funds to be treated as sales of tax credits 24

Page(s)

A. Section 707(a)(2)(B) and the regulations thereunder define the circumstances under which a transaction between a partnership and a partner will be treated as occurring between a partnership and a non-partner. 24

B. The Funds' transfers to the investors of the right to claim Virginia tax credits were "transfers" of "property" for purposes of I.R.C. § 707. 26

C. The Funds' arguments with respect to the simultaneous transfer of credits and the entrepreneurial risk of an investor are not supported in the record.. 32

Conclusion. 35

Certificate of compliance with Rule 32(a).. 36

Certificate of service. 37

TABLE OF AUTHORITIES

Cases: **Page(s)**

Allison v. Comm'r, T.C. Memo 1976-248,
1976 Tax Ct. Memo LEXIS 153, 30 (T.C. 1976). 9
ASA Investerings Partnership v. Commissioner,
201 F.3d 505 (D.C. Cir. 2000). 10
American Realty Trust v. United States, 498 F.2d 1194
(4th Cir. 1974). 2
BB&T Corp. v. United States, 523 F.3d 461
(4th Cir. 2008). 15, 16
Black & Decker v. United States, 436 F.3d 431
(4th Cir. 2006). 13
Charley v. Commissioner, 91 F.3d 72 (9th Cir. 1996). 30
Commissioner v. Culbertson, 337 U.S. 733 (1949). 5, 9
Commissioner v. Tower, 327 U.S. 280 (1946). 4, 21
Dow Chemical Co. v. United States, 435 F.3d 594
(6th Cir. 2006). 2
Frank Lyon Co. v. United States,
435 U.S. 561 (1978). 2, 4, 15, 16, 18
In re G-I Holdings, Inc., 2009 U.S. Dist. LEXIS 115850
(D.N.J. Dec. 14, 2009). 5
Gouldman v. Commissioner, 165 F.2d 686 (4th Cir. 1948). 21
Neonatology Associates, P.A. v. Commissioner, 299 F.3d 221. . . . 16
Randall v. Loftsgaarden, 478 U.S. 647 (1986). 29
Rice's Toyota World v. Commissioner, 752 F.2d 89
(4th Cir. 1985). 13
Rogers v. United States, 281 F.3d 1108 (10th Cir. 2002). . . . 16-18
Saba Partnership v. Commissioner, 273 F.3d 1135
(D.C. Cir. 2001) 11
Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982). 2
TIFD III-E, Inc. v. United States ("Castle Harbour"),
459 F.3d 220 (2d Cir. 2006). 9
United States v. Kintner, 216 F.2d 418 (9th Cir. 1954). 22

Statutes:

Internal Revenue Code (26 U.S.C.):

§ 61(a)(3). 31
§ 707. . . . . 15, 24, 26
§ 707(a)(2)(B). 24

Statutes (cont'd): **Page(s)**

Internal Revenue Code (26 U.S.C.) (cont'd)

§ 761.. 4
§ 7701(a)(2). 4
§ 1001(a). 30, 31
§ 1012....................................... 30, 31
§ 6221... 15
§ 6225... 15
§ 6330... 15

Revenue Act of 1932, ch. 209, § 1111(a) (3), 47 Stat. 289 (1932)....... 5

Va. Code Ann. § 55-210.2 (emphasis added)........................ 29

W. Va. Code § 11-21-8h(a).. 23

Rules and Regulations:

Treasury Regulations (26 C.F.R.):

§ 1.703-3(b)(1). 32
§ 1.707-3(b)(2). 25
§ 1.761-1(a). 4
§ 301.7701-1(a)(1). 21
§ 301.7701-1(a)(2). 4
§ 301.7701-3...................................... 4

Miscellaneous:

Staff of Joint Comm. on Tax'n, 98th Cong., 2d Sess.,
General Explanation of the Revenue Provisions of the
Deficit Reduction Act of 1984, *reprinted in*
1984 U.S.C.C.A.N. 1445................................ 28

ARGUMENT

I

THE TAX COURT ERRED AS A MATTER OF LAW IN HOLDING THAT THE SO-CALLED INVESTORS WERE, IN SUBSTANCE, AS WELL AS FORM, *BONA FIDE* LIMITED PARTNERS OF THE FUNDS FOR FEDERAL TAX PURPOSES

A. It is well-settled that the characterization of the investor transactions, for federal tax purposes, as *bona fide* equity contributions or purchases of Virginia tax credits is reviewed *de novo*

The Funds argue at the outset of their response brief that the Tax Court's findings of fact are reviewable for clear error, and that they should be respected so long as they are supported by substantial evidence. (Ans. Br. 18-20.)[1] That fundamental tenet of the law does nothing, however, to advance the Funds' cause, because the undisputed facts in the record compel the conclusion that the so-called investors in the Funds were limited partners in form only, and that the amounts

[1] The terms "Funds," "2001 LLC," and "2001 LP" have the meanings ascribed to them in the opening brief. (Op. Br. 2-3.) "Ans. Br." references are to the appellee's answering brief, "Op. Br." references are to the Commissioner's opening brief, and "Amicus Br." references are to the *amicus* brief filed by the Commonwealth of Virginia. "A." references are to the unsealed volumes of the joint appendix. "S.A." references are to the sealed volumes of the joint appendix.

they transmitted to the Funds represented simply the purchase price of the state tax credits sold to them by the Funds.

The Funds appear to ignore the Supreme Court's statement, in *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 (1978), that "the general characterization of a transaction for tax purposes is a question of law." In *American Realty Trust v. United States*, 498 F.2d 1194, 1198-99 (4th Cir. 1974), this Court reviewed *de novo* whether a transaction was a *bona fide* sale-and-lease-back of property, or was, in substance, a secured loan.[2] *See also Dow Chem. Co. v. United States*, 435 F.3d 594, 599 (6th Cir. 2006) (the "ultimate conclusion that a transaction is or is not an economic sham is reviewed de novo"); *Swift Dodge v. Comm'r*, 692 F.2d 651, 652 (9th Cir. 1982) (whether an agreement "is a 'sale' or a 'lease' for federal tax purposes is a question of law and is therefore fully reviewable on appeal"). Thus, although this Court reviews for clear error any *relevant* factual findings supporting the Tax Court's conclusion that the investors were *bona fide*

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[2] The Court did so "notwithstanding that the government ha[d] . . . consistently treated the pivotal issue in this case as a factual one." 498 F.2d at 1198-99.

limited partners in the Funds, the Tax Court's ultimate conclusion itself is subject to *de novo* review.

Moreover, the Funds' discussion of the investors' "intent" to be partners (Ans. Br. 29-30) is besides the point. Obviously, because Virginia law did not permit a direct sale of the credits to the investors (except under the one-time transfer provision), the investors intended the result that they would be treated as partners, for purposes of the Virginia program, as expressed in the offering memoranda:

> Because of the limited interest that an Investor acquires in the Partnership's cash items . . . some question may be raised whether the Investor is a partner in the Partnership . . . for federal tax purposes. However, the Partnership will receive an opinion of counsel . . . which opines that the allocation of the Virginia Historic Credits to the Investors will be respected *for Virginia income tax purposes*.

(A. 1587, 2077) (emphasis added). Clearly, the parties to the tax credit transactions intended to adopt the partnership *form*, so that the investors would be able to use the credits they acquired to reduce their Virginia income taxes. But the relevant inquiry is whether the investors constituted limited partners for *federal tax purposes*. The resolution of that question, as even the Tax Court recognized (A. 4339-40), depends on whether, in substance, the relationship between the

investors and the Funds was that of limited partners and their partnerships, or instead, was that of purchasers of tax credits and their sellers. In this regard, it is entirely irrelevant that, for Virginia state tax purposes, Virginia was content to accept the investors' formal status as limited partners without regard to whether there was any substance to that status. The proper inquiry, rather, is whether there are "significant and genuine attributes" of partner status that correspond with the form, *Frank Lyon*, 435 U.S. at 584, or, more specifically, whether the investors and the general partners "join[ed] together . . . for the purpose of carrying on a . . . business" with a "community of interest in the profits and losses." *Commissioner v. Tower*, 327 U.S. 280, 286 (1946).[3]

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[3] The Funds correctly note (Ans. Br. 25-26) that the Internal Revenue Code's definition of "partner" and "partnership" expressly includes certain joint ventures that may not satisfy state-law definitions of "partner" and "partnership." I.R.C. §§ 761, 7701(a)(2). But such joint ventures only satisfy the federal definition if they are between joint venturers who "carry on a trade, business, financial operation or venture and divide the profits therefrom." 26 C.F.R. (Treas. Reg.) § 301.7701-1(a)(2). Co-ownership or expense-sharing arrangements, for instance, do not suffice. Treas. Reg. §§ 1.761-1(a), 301.7701-3. The statutes add nothing to the substance-over-form analysis that is necessary here, or to the Supreme Court's *Tower/Culbertson* formulation, which was phrased in terms of a joint
(continued...)

Because whether putative partners have "join[ed] together in the present conduct of the enterprise" is primarily a matter of contract, established through the parties' written agreements, course of dealing, and the like, *Commissioner v. Culbertson*, 337 U.S. 733, 738-42 (1949), the parties' intent is relevant to the analysis. But it is bootstrapping, to say the least, to argue that, because the investors intended to and wanted to be treated as partners for Virginia state tax purposes, they must be treated as partners for federal tax purposes. Thus, the Funds' repeated citations to testimony they contend establish that the investors "knew [they] invested as a partner" (Ans. Br. 29) only demonstrates adherence to the partnership form, and begs the ultimate question in the case, *i.e.*, whether there was any substance to their purported status as limited partners. *See*, *e.g.*, *In re G-I Holdings, Inc.*, 2009 U.S. Dist. LEXIS 115850, at **38-39 (D.N.J. Dec. 14, 2009) (parties' intent that interest be treated as equity is "not probative" of whether transfer was, in substance, an equity investment). As we

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[3](...continued)
enterprise for profit, and articulated after the enactment of the definitions to which the Funds refer. *See* Revenue Act of 1932, ch. 209, § 1111(a) (3), 47 Stat. 289 (1932).

demonstrated in our opening brief (Op. Br. 31-44), the undisputed facts in the record compel the conclusion that, in substance, the investors were simply purchasers of the tax credits sold by the Funds.

B. Undisputed facts establish that the investor transactions were, in substance, purchases of Virginia tax credits

This is not a case which turns on the credibility of witnesses, or the resolution of inconsistent versions of the events that occurred. What actually occurred between the Funds and the investors is undisputed. The parties only disagree on how the transactions between the Funds and the investors should be treated for tax purposes. Notably, the Funds have not identified a single fact in the Government's statement of facts in the opening brief that is contradicted by the record.[4] Our argument rests on these undisputed facts. Because the Tax Court's conclusion that the investors were *bona fide* limited partners in substance, as well as in form, flies in the face of

[4] The closest they come is to take the Government to task for asserting that the undisputed evidence establishes that the only reason investors made their purported capital contributions was to receive credits in return. (Ans. Br. 39-40.) Obviously, we were referring to tangible benefits. Whether the investors received some vague "feel good" benefit in providing a market for the excess tax credits earned by owners of rehabilitated historic properties is immaterial to this appeal.

undisputed facts to the contrary, it makes no significant difference whether the Tax Court's ultimate conclusion is classified as "factual" and thus subject to the clearly erroneous standard of review, or as "legal" and thus reviewable *de novo*. In either case, the Tax Court committed reversible error.

The undisputed facts establish, for several reasons, that the investor transactions lack "significant and genuine" attributes of *bona fide* partnership investments but, instead, carry the attributes of a simple purchase of state tax credits.

First, the amounts paid by the investors to the Funds bore no correlation to the size of their purported partnership interests (which was minuscule in any event). Instead, these amounts correlated precisely to the amount of credits they were to receive in return. Investors paid 74, 76 or 80 cents (depending on the price charged by the Funds) for every $1 in credits they were to receive. But no matter how much they paid in purported capital contributions, they could not, and did not, acquire more than a fraction of a 1% interest in the Funds (A. 262-70, 2074, 3226), as the remaining 99% was beneficially owned by Gecker, Miller and Brower (A. 1006, 1009, 1012, 1461-87, 1561). For

instance, one investor (William Randall) paid $222,000 to the 2001 LP, purportedly in exchange for a partnership interest of 1/100 of 1%. (A. 242, 248, 2323.) But that investor would have received exactly the same, minuscule "partnership interest" had he made a "capital contribution" of $5,920, instead of $222,000. (*See* A. 2321.) Because the investor paid $222,000 to the 2001 LP, however, he was allocated $300,000 in tax credits (A. 268, 2323), whereas if he had paid only $5,920 he would have been allocated only $8,000 in tax credits (A. 268, 2321). It is therefore apparent that, in substance, the purported capital contribution made by each investor represented nothing more than the agreed purchase price for the credits that the investor acquired.[5]

Second, like in a simple purchase, and unlike in a *bona fide* partnership investment, the investors' benefit-of-the-bargain was fixed when they signed their subscription agreements. They would either receive $1 of credits for every (depending on the price charged) 74, 76 or 80 cents they paid, or get their money back. (A. 262-70, 2074, 3226.)

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[5] Indeed, investors were permitted (James McGlothlin, for example) to buy additional credits, weeks after the initial subscription, without any corresponding increase in their partnership "interest." (A. 244, 270, 2432-33).

See, *e.g.*, *TIFD III-E, Inc. v. United States (“Castle Harbour”)*, 459 F.3d 220, 236-237 (2d Cir. 2006) (unconditional promise to repay a sum certain suggests that subscriber is not a *bona fide* equity investor); *Allison v. Comm’r*, T.C. Memo 1976-248, 1976 Tax Ct. Memo LEXIS 153, *30 (T.C. 1976) (“specificity and certainty . . . of the amount to be distributed” was significant in concluding arrangement was not a joint venture).

Third, as in a simple purchase, but unlike in a *bona fide* partnership investment, the investor’s return was in no way tied to the Funds’ income, expenses or operating capital. Each investor was promised a definite amount of tax credits, based on the amount of money he paid to the Funds, whether or not the Funds produced a profit or loss, and whether or not they received any additional amounts from other investors. Thus, contrary to the Funds’ contention (*e.g.*, Ans. Br. 14), there was no “pooling” of capital in any meaningful sense, and the investors were not in the same “business boat,” *Culbertson*, 377 U.S. at 754. On the contrary, each investor transaction stood on its own and was in no way dependent on other investor transactions.

Fourth, unlike in a *bona fide* equity investment, the purported partnership interests given to the investors could not grow in value.[6] Indeed, the partnership interests were rendered essentially valueless, at the moment they were acquired, by the investors' simultaneous execution of option agreements that permitted the Funds to redeem the interests, almost immediately, for a nominal payment, the amount of which would be unilaterally determined by the Funds. (A. 2183.) In this regard, Mr. Gecker, acting on behalf of the Funds, determined that the redemption value of each investor's purported partnership interest was 1/10 of 1% of the investor's "capital contribution," and each investor's interest was, in fact, redeemed for this nominal price within weeks or months after the purported interest was acquired. (A. 262-70, 3757.) These option agreements served to wholly negate the liquidation rights that the investors otherwise would have been entitled to under the partnership agreements.

Fifth, like many purchases, but unlike *bona fide* equity investments, *cf. ASA Investerings Partnership v. Commissioner*, 201

[6] The investors were advised that they would not be allocated any material amounts of partnership gain or income or receive any material distributions of cash. (A. 1579, 2070, 3222.)

F.3d 505, 513-514 (D.C. Cir. 2000); *Saba Partnership v. Commissioner*, 273 F.3d 1135, 1141 (D.C. Cir. 2001), the amounts paid by the investors were subject to a money-back guarantee if the Funds were unable to deliver the promised tax credits. (A. 1579, 2070, 3222.)

In short, the undisputed evidence, ignored by the Tax Court, establishes that the investors' purported capital contributions were nothing but the agreed purchase price for the tax credits, that the investors had no possibility of realizing any meaningful economic benefit from the transactions, other than acquiring the credits at a discount, that their payments were fully refundable to the extent they did not receive the credits, and that the investors were required to agree to an immediate buyout of their interests in return for a token payment (which served to wholly negate their negligible ownership interest and liquidation rights). As a result, in substance, the investors were not *bona fide* partners, but purchasers of the tax credits sold by the Funds.

C. The Commissioner may recharacterize, for federal tax purposes, a transaction according to its substance, even where the parties adopted the form for purposes other than the avoidance of federal tax

Ultimately, the responses of the Funds and of the Commonwealth to the Commissioner's argument that the investor transactions should be taxed on the basis of their substance (a purchase of tax credits) and not on their form (an acquisition of limited partnership interests) are based upon an erroneous legal premise. The Funds argue that the Commissioner must tax the investor transactions according to the form the parties have adopted, regardless of substance, "*unless* it is motivated *solely* by federal tax avoidance *and* carries *no* economic substance because *no* reasonable possibility of a profit exists." (Ans. Br. 38) (emphasis in original). Continuing with that premise, the Funds and *amicus* make various iterations of the same argument: that the partnerships in issue were formed for the "legitimate" purposes of "reducing non-Federal taxes" (Ans. Br. 23) and "supporting Virginia's historic preservation," (*id*. at 30 n. 8) and that Virginia's tax incentives

"inject financial meaning and substance" (*id*. at 22) into the arrangement.[7]

The test that the Funds have used to defend the Tax Court's decision, however, is not applicable to this case. The test that the Funds describe – under which transactions with a legitimate, non-tax purpose or that are imbued with economic substance will be respected for federal tax purposes – is the "sham transaction" or "economic substance" test that this Court applied in *Rice's Toyota World v. Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985). Under "sham transaction" or "economic substance" doctrine, the Commissioner may "disregard a transaction that literally complies with the terms of the IRC but that is devoid of any legitimate business purpose." *Black & Decker v. United States*, 436 F.3d 431, 441 (4th Cir. 2006).

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[7] *See also* Ans Br. 24 (attempting to distinguish cases which the Funds claim involve ventures "motivated solely by Federal tax avoidance") (emphasis omitted); Ans. Br. 36 ("the Tax Court properly confirms the economic substance injected by the economic inducements"); Amicus Br. 7-10 (arguing that partnerships like the Funds should be respected because they were formed "to accomplish beneficial ends" and not as a "sinister, aggressive manipulation of the tax code").

But, in the instant case, the Commissioner is *not* claiming that the transactions between the Funds and the investors served no purpose other than the avoidance of federal income tax. On the contrary, the Commissioner recognizes that the Funds' objective was to make an economic profit by transferring to the investors state tax credits at a price that exceeded the cost to the Funds of acquiring those credits. Similarly, the investors' principal purpose was to acquire, at a discount, state tax credits that would serve to reduce their state income tax liability. The Commissioner, accordingly, is *not* seeking to have this Court disregard the transfer of credits from the Funds to the investors or the transfer of money from the investors to the Funds (or from the Funds to the developers).[8] Rather, the Commissioner is seeking to recharacterize, for federal tax purposes, the investor transactions according to their substance. As discussed in detail above

[8] Accordingly, as we explain further at pp. 20-23, *infra*, the Commonwealth's suggestion (Amicus Br. 12) that the Commissioner's position could damage its historic preservation program is misconceived. Virginia is free to continue its practice of allowing its rule against the direct transfers of state tax credits to be circumvented by purchasers of credits masquerading as limited partners in partnerships formed for the sole purpose of transferring such credits to them.

and in the Commissioner's opening brief, that substance was nothing more than the sale of tax credits by the Funds to the investors. Thus, the amounts transmitted to the Funds by the investors are to be treated as taxable sales proceeds, rather than non-taxable capital contributions.[9]

Under the doctrine of "substance over form," the Commissioner may recharacterize a transaction according to the "'objective economic realities of a transaction rather than to the particular form the parties employed.'" *BB&T Corp. v. United States*, 523 F.3d 461, 472 (4th Cir. 2008) (quoting *Frank Lyon*, 435 U.S. at 573 (1978)). The proper

[9] The Funds' suggestion (Ans Br. 2) that the Commissioner is seeking to subject the three individuals who are the beneficial owners of 2001 LLC (Gecker, Miller and Brower) to double taxation on the same items of gross income is disingenuous. This partnership-level proceeding concerns only the Commissioner's adjustments to the partnership tax returns. In this regard, the parties stipulated that, in the event that the Commissioner prevailed on either of his credit-sale arguments (*i.e.*, his substance-over-form or I.R.C. § 707 disguised-sale arguments), the 2001 LP realized net gain from the sale of tax credits in 2002 of approximately $1.5 million. (A. 301-02.) Accordingly, in the event this Court were to reverse the decision of the Tax Court, the parties' stipulation would become operative, resulting in a decision that the 2001 LP realized a net gain of approximately $1.5 million in 2002. The individual tax liabilities of Gecker, Miller and Brower would then be determined by means of computational adjustments made by the Commissioner or, if necessary, in new partner-level judicial proceedings. *See* I.R.C. §§ 6221, 6225, 6330.

inquiry, in resolving a dispute over the Commissioner's recharacterization of a transaction under "substance over form" principles, is whether the transaction has "significant and genuine" attributes of the form employed, or rather, in light of the "objective economic realities" of the transaction, the transaction is, in substance, something else. *Frank Lyon Co.*, 435 U.S. at 573, 584; *see BB&T*, 523 F.3d at 472.

The "substance over form" doctrine, on the one hand, and the "economic substance" or "sham transaction" doctrine, on the other, are separate and distinct. *Neonatology Assoc., P.A. v. Comm'r*, 299 F.3d 221, 230 n. 12 (3d Cir. 2002); *Rogers v. United States*, 281 F.3d 1108, 1118 (10th Cir. 2002). The substance over form doctrine does not require that the Commissioner prove that a transaction was entered into solely for the purpose of federal tax avoidance in order to recharacterize the transaction according to its true substance.[10] *Castle*

[10] Nor must the Commissioner prove that the transaction lacked any economic substance *at all*. Indeed, such a requirement would make no sense. "Substance over form" analysis starts with the premise that a particular transaction has economic substance, in that the Commissioner seeks to treat it, for federal tax purposes, *according to that substance*. Because the transactions at issue, in this case, "clearly (continued...)

Harbour, 459 F.3d at 232 ("The IRS's challenge to the taxpayer's characterization is not foreclosed merely because the taxpayer can point to the existence of some business purpose or objective reality in addition to its tax-avoidance objective."). In *BB&T*, this Court determined that a transaction that was, in form, a leasing transaction was, in substance, a financing arrangement, only after assuming that the transaction was motivated by business purposes other than tax avoidance. 523 F.3d at 471-72 ("Given the procedural posture of this case, we take BB&T at its word that the transaction meets the criteria for economic substance set forth in *Rice's Toyota World*."). Accordingly, applying the substance over form doctrine, the Court held that the Commissioner had properly denied the tax benefits that were dependent on the transaction being regarded as a *bona fide* leasing arrangement.

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[10](...continued)
had real-world economic consequences, application of the economic substance doctrine is not appropriate." *Rogers*, 281 F.3d at 1118. But because the economic substance of the investor transactions was the purchase of tax credits by the investors from the Funds, the Commissioner properly treated the transactions as such for federal tax purposes.

Similarly, in *Rogers*, the Tenth Circuit determined that what was, in form, a loan by the Kansas City Royals to one of its owners, given in exchange for an option to purchase the owner's stock for an option price equal to the outstanding balance of the loan, was, in substance, a stock redemption, even though the parties adopted the form of the transaction, not for tax benefits, but out of the owner's genuine expectation that he would pay off his debts and remain the owner of the team. *See* 281 F.3d at 1125 (stating that the owner's desire in this regard was "irrelevant"); *see also Frank Lyon*, 435 U.S. 561, 573 ("Nor is the parties' desire to achieve a particular tax result necessarily relevant").

Thus, the Funds' effort (Ans. Br. 38-39) to graft onto the "substance over form" analysis a requirement that the Commissioner demonstrate, as a predicate to recharacterizing the investor transactions as purchases of tax credits, that the form they adopted was solely to avoid federal taxes is foreclosed by the decisions of this Court and, quite simply, misstates the law.[11] The Funds' and the

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[11] Even the Supreme Court's isolated statement in *Frank Lyon* that a transaction "compelled or encouraged by business or regulatory (continued...)

Commonwealth's repeated discussions of the business and/or regulatory purposes for the form the parties adopted (Ans. Br. 22-24, 30-31, 36, 39-40; Amicus Br. *passim*) are, therefore, a red herring. The Tax Court, apparently confused by the Funds' improper fusing of two distinct doctrines, rested its decision, in part, on the fact that there were non-tax motivations for the form adopted by the parties. (A. 4336-39, 4342, 4346.) In so doing, the court erred as a matter of law: a transaction that is, in substance, a sale is treated as a sale for federal tax purposes, whether or not the parties to the transaction had non-tax reasons for structuring it to appear as something else.

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[11](...continued)
realities . . . [and] not shaped solely by tax-avoidance features" should be honored for tax purposes, 435 U.S. at 583-84, a statement on which the Funds so heavily rely (*e.g.*, Ans. Br. 21-22, 36), was made only after the Court observed that the putative owner and lessor in the sale-and-leaseback transaction that the Commissioner sought to disregard had incurred genuine liabilities and risks associated with the form the parties adopted, 435 U.S. at 576-77.

D. The investor transactions, for federal tax purposes, are required to be characterized according to their substance whether or not the Commonwealth of Virginia recognizes purely formal arrangements as satisfying its precondition to the transfer of tax credits

A second objection the Funds raise in opposition to the Commissioner's recharacterization of the investor transactions according to their substance, *i.e.*, the purchase of tax credits, is that the transfer of the credits to the investors, under Virginia law, is conditioned upon the investors' status as partners. (Ans. Br. 31.) The Funds state that the Commissioner's position is thus "self-defeating" in that it "convert[s] partners into buyers who could not qualify for credits." (Ans. Br. 37.) On this premise, the Funds imply (Ans. Br. 23) and *amicus* declares (Amicus Br. 12) that the Commissioner's recharacterization of the investor transactions according to their substance would "needlessly damage" Virginia's historic rehabilitation objectives. The argument of the Funds and the *amicus*, however, is plainly misconceived, inasmuch as the Commonwealth of Virginia is free to accept *for Virginia state law purposes* the investors' formal status as limited partners, without regard to the Commissioner's

refusal to do so for federal tax purposes.[12] Whether an investor in the Funds is a *bona fide* partner for federal tax purposes and whether that same investor is a "partner" who may be allocated credits under Virginia law are two separate inquiries. Neither result is dependent on the other. *Cf.* 26 C.F.R. (Treas. Reg.) § 301.7701-1(a)(1) (stating that the recognition of an entity for federal tax purposes "is a matter of federal tax law and does not depend on . . . local law"). In *Commissioner v. Tower*, 327 U.S. 280, 287-88 (1946), the Supreme Court held that, although an arrangement between a husband and wife may have been sufficient to grant the wife a partnership interest under Michigan law, such a state-law determination does not dictate recognizing the partnership for federal tax purposes. *Accord*, *Gouldman v. Comm'r*, 165 F.2d 686, 688 (4th Cir. 1948) ("[T]he validity of a transaction under state law is not conclusive of its bona fides for the purpose of federal taxation."). Thus, although the Commonwealth

[12] Indeed, the Virginia Tax Commissioner opined that individuals who acquire rehabilitation tax credits in the manner that the investors did here would be recognized as the lawful owners of the credits without regard to whether, for federal tax purposes, such individuals were deemed to have purchased the credits. Historic Rehabilitation Credit, Op. Va. Dept. Tax'n No. 07-82, 2007 Va. Tax LEXIS 89 (Jun. 13, 2007).

of Virginia is free to facilitate the transfer of its historic rehabilitation tax credits from owner/developers to third parties by recognizing as "partners" individuals who are, in substance, nothing but purchasers of tax credits, the decisions of this Court and other courts establish that the Commissioner is not required to follow suit.

Such a result is necessary to the uniformity of the federal tax system. States may recognize, for state tax purposes, a myriad of business arrangements of varying complexity, while the federal government is charged with the uniform, nationwide application of the tax laws to those arrangements. As the Court explained in *United States v. Kintner*, 216 F.2d 418, 424 (9th Cir. 1954):

> [I]t would introduce an anarchic element in federal taxation if we determined the nature of associations by State criteria rather than by special criteria sanctioned by the tax law, the regulations and the courts. It would destroy the uniformity so essential to a federal tax system, -- a uniformity which calls for equal treatment of taxpayers, no matter in what State their activities are carried on. For it would mean that tax incidences as to taxpayers in the same category would be determined differently according to the law of the State of residence.

For example, under West Virginia law, historic rehabilitation tax credits may be directly transferred or sold, without the need for a

partnership form. *See* W. Va. Code § 11-21-8h(a). A person in West Virginia who acquires the credits at one price and sells them at a higher price clearly would recognize taxable income on that gain. But, if the form of the transaction controlled for federal tax purposes, a Virginia resident who, like Gecker, Brower, and Miller here, acquires the credits at one price and transfers them for a higher price to putative partners of a partnership he beneficially owns would be permitted to defer tax on his gains, and then to treat those gains as capital gains, even though the Virginia and West Virginia transactions were economically identical.

State law, of course, does not control and, hence, the investor transactions with the Funds are to be taxed according to their true substance, *i.e.*, that of sales of Virginia tax credits by the Funds to the investors.

II

REGARDLESS WHETHER THE INVESTORS WERE *BONA FIDE* PARTNERS FOR FEDERAL TAX PURPOSES, I.R.C. § 707(a)(2)(B) REQUIRES THEIR TRANSACTIONS WITH THE FUNDS TO BE TREATED AS SALES OF TAX CREDITS

A. Section 707(a)(2)(B) and the regulations thereunder define the circumstances under which a transaction between a partnership and a partner will be treated as occurring between a partnership and a non-partner

With respect to the Commissioner's alternative argument – that the transactions are to be treated as sales under I.R.C. § 707 – the Funds contend (Ans. Br. 42) that the argument is "redundant" in light of the Tax Court's conclusion that the investors were "partners." But this argument ignores the very statute on which the Commissioner relies – I.R.C. § 707(a)(2)(B) – and which sets forth the circumstances in which a partner will be treated as acting in a capacity other than as a member of the partnership. Specifically, under § 707(a)(2)(B), the investor transactions are required to be treated as transactions between the Funds and non-partners if the investor "contributions" and the related allocation of tax credits are, "when viewed together . . . properly characterized as a sale or exchange of property."

Determining whether an investor is or is not acting in his capacity as partner cannot be determined without reference to § 707(a)(2)(B). Because that subsection applies to transactions between a partner and his partnership, the Commissioner's § 707 argument is not "redundant;" indeed, it presumes the opposite of our first argument, that is, that the investors *are* partners in the Funds for federal tax purposes.

As we have discussed in our opening brief (Op. Br. 45-49), determining whether the investor transactions are "properly characterized as a sale or exchange of property" under § 707(a)(2)(B) requires reference to the applicable regulations. Treas. Reg. § 1.707-3(b)(2) sets forth a list of facts and circumstances to be considered in evaluating whether the transactions should be so characterized. The Funds, like Tax Court, fail to discuss or even mention these factors, even though nearly all of the factors directly support the conclusion that the investor transactions with the Funds were to be treated as disguised sales under § 707. (*See* Op. Br. 51.)

B. The Funds' transfers to the investors of the right to claim Virginia tax credits were "transfers" of "property" for purposes of I.R.C. § 707

1. Rather than address the regulatory factors under which a transaction is "properly characterized as a sale or exchange of property," I.R.C. § 707(a)(2)(B), the Funds argue points not decided by the Tax Court. First, the Funds argue (Ans. Br. 46-49) that their allocations of historic rehabilitation tax credits to the investors were not "transfers" within the meaning of I.R.C. § 707. This argument ignores the realities of the transactions and the obvious intent of Congress in enacting Section 707.

It is undisputed that the right to use the credits passed from the developers who earned the credits, to the Funds, and then to the investors. The Department of Historic Resources (DHR) granted the right to the credits, in the first instance, to the developers themselves, by certifying the developer projects as a "certified rehabilitation." (A. 2458-72.) The right to use the credits, then, were acquired by the Funds, either by way of (1) a "Tax Credit Transfer Agreement," under which a developer who "desires to transfer" the credits elects the one-time transfer permitted by Va. Code § 58.1-339.2 and the Funds agree

to "purchase" credits (A. 2798-2813) or (2) putative partnership transactions with the developers in which the Funds "commit[] to purchase Virginia Rehabilitation Tax Credits" from developers by exchanging an amount equal to some percentage of the total value of the credits purchased for the allocation of such credits. (A. 2796.) Thereafter, the Funds passed the credits onto the investors by "agree[ing] to allocate" credits"simultaneously with [the] investor's admission" to the Funds. (A. 2182-2457.)

It is nonsensical for the Funds to contend that, although the investors acquired the right to use tax credits that the Funds acquired from developers, there was no transfers of the credits from the Funds to the investors. As is apparent, the allocations by the Funds to the investors of the credits due them under their respective subscription agreements was simply the means of transferring the credits to the investors. Indeed, the very fact that the investors acquired the right to use tax credits that originally were awarded to owners of rehabilitated historic property establishes that credits were transferred to the investors.

Moreover, it is apparent that Congress enacted § 707 due, in part, to the practice of "making allocations of income and corresponding distributions in place of direct payments for property or services." Staff of Joint Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 225. Congress intended that a *quid pro quo* exchange of property for the allocation of partnership income would fall within the ambit of Section 707. Consequently, the Joint Committee Report describes that section as applying where, in exchange for property (including money), there is "a related direct or indirect partnership allocation and distribution to the partner" and the exchange of property for "the allocation/distribution are properly characterized" as a third-party transaction. *Id*. at 226. It is beyond cavil, then, that Congress intended the term "transfer" in Section 707(a)(2)(B) to encompass "allocations" of partnership items in return for payments of money or property.

2. The Funds further argue (Ans. Br. 50-53) that, in any event, the Virginia historic tax credits are "tax attributes" that, as a matter of law, do not constitute "property" for the purposes of Section 707. That

argument is misconceived. Property, broadly, is "something that is or may be owned or possessed … the exclusive right to possess, enjoy, and dispose of a thing … a valuable right or interest primarily a source or element of wealth … ." Webster's Third New International Dictionary at 1818 (unabridged 3d Ed.) More specifically, Black's Law Dictionary defines "personal property" as including: "*credits*, savings-bank deposits, notes, bonds, the proceeds arising from the sale of realty, and the right to a certificate in foreclosure, the time of redemption having passed" (emphasis added). Similarly, Virginia state law defines "intangible property" as "includ[ing], by way of illustration, … (ii) *credits*, customer overpayments, gift certificates, security deposits, refunds, unpaid wages, and unidentified remittances … ." Va. Code Ann. § 55-210.2 (emphasis added). Certainly, the right to use Virginia tax credits fits within these broad definitions of property.

The Funds cite *Randall v. Loftsgaarden*, 478 U.S. 647 (1986) and various IRS Revenue Rulings for the proposition that "tax benefits" do not have any value in themselves, such that they do not constitute income to the taxpayer when earned. It is true, that a taxpayer who, for example, earns a $1,500 tax credit does not thereby realize $1,500

in additional income, thereby negating the value of the credit. But the fact that a taxpayer who becomes entitled to a tax credit does not thereby realize any taxable income does not mean that such a taxpayer would not realize a taxable gain if the taxpayer were permitted to, and did, in fact, sell the credit to a third party. Thus, in the example above, if the taxpayer who earned the credit did not have any taxable income against which the credit could be offset but was able to sell it to his neighbor for $1,000, he would realize a gain of $1,000, assuming his basis in the credit was zero. I.R.C. §§ 1001(a), 1012. Thus, although earning tax credits is not regarded as a taxable event for federal income tax purposes, the transfer of credits by the taxpayer to a third party in return for consideration is treated as a taxable disposition of property. *Cf. Charley v. Comm'r*, 91 F.3d 72 (9th Cir. 1996) (exchange of airline frequent flyer miles for cash constituted taxable disposition of property).

An analogous situation arose in *Charley v. Comm'r*, 91 F.3d at 74, regarding the tax treatment of airline "frequent flyer miles" - *i.e.*, the right to a rate reduction or other benefit earned by traveling with an airline. There, a taxpayer who had created a scheme to convert

frequent flyer miles to cash argued that these "travel credits" raised the question whether, in the abstract, the receipt of frequent flyer miles constitutes gross income. The court disagreed that the case presented that issue and declined to reach it. Instead, the Court held that (91 F.3d at 74):

> the transaction can be viewed as a disposition of [taxpayer's] own property. Gross income includes "gains derived from dealings in property." IRC § 61(a)(3). A gain from the disposition of property is equal to the "amount realized" from the disposition minus the property's adjusted basis. IRC § 1001(a). . . . The adjusted basis is generally determined by reference to cost. IRC § 1012.
>
> Because [taxpayer] received the frequent flyer miles at no cost, he had a basis of zero. He then exchanged his frequent flyer miles for cash, resulting in a gain of $3,149.93.

There is no reason why the exchange of a state tax credit for cash should receive different treatment. State tax credits are just as much property as the frequent flyer miles at issue in *Charley*, and the Funds here realized an economic gain on their disposition of the tax credits, like the taxpayer in *Charley* did on the disposition of his frequent flyer miles.

The Funds repeatedly assert (Ans. Br. 51-53) that the credits were nontransferable because the Funds did not have the right to

directly transfer them under Virginia's one-time transfer provision. But the credits obviously *are* transferable, albeit only indirectly. As we have explained (*supra* pp. 22-23), the credits are as transferable in Virginia as they are in West Virginia: Virginia just requires a little more paperwork. As Gecker himself put it:

> … the "sale" of the state tax credit is accomplished by the admission of a .01% limited partner in exchange for a capital contribution equal to approximately $.55 per credit (the state credit market has settled around a price of about $.50 per credit.)

(A. 3212.)

C. The Funds' arguments with respect to the simultaneous transfer of credits and the entrepreneurial risk of an investor are not supported in the record.

Finally, the Funds argue (Ans. Br. 55-59) that the investor transactions may not be disregarded under Treas. Reg. § 1.703-3(b)(1) because the transfers of cash for credits were not "simultaneous," and the subsequent transfer was subject to the "entrepreneurial risks" of the enterprise.

1. Although acknowledging that the subscription agreements for each of the investors expressly provide that the Funds would

allocate the investor's share of the tax credits *simultaneously* with his admission to the partnership (A. 2182-2457), the Funds contend (Ans. Br. 55) that such simultaneous exchange was a "calendar impossibility." The record belies the Funds' argument in this regard. The record shows that approximately one-third of the credits had been certified as of November 6, 2001, approximately one-half had been certified by December 19, 2001, and approximately 80% by February 11, 2002. (A. 254-55.) By contrast, investor payments did not begin until November 26, 2001 (A. 226), and many investors did not "contribute their capital" until March and April, 2002 (A. 229-32, 244). Thus, in nearly every case, the Funds' argument that a "simultaneous" transfer was a calendar impossibility is contradicted by stipulated facts.

2. As for its argument with respect to the "entrepreneurial risks of the enterprise," the Funds restate the same "risks" identified by the Tax Court – *viz.*, that the developers might not complete their projects, that the Funds would not secure the credits, or that the DHR would revoke the credits. These "risks" are irrelevant, however, because the investors' "contributions" were fully refundable to the

extent the Funds, *for any reason*, were unable to provide the investors with the credits due them under their respective subscription agreements. Thus, the investors were clearly *not* subject to the entrepreneurial risks of the enterprise. Indeed, the "risks" the Funds identify are precisely the same risks borne by the Funds when they purchased credits under "Tax Credit Transfer Agreements" with various non-profits (A. 2798-2813) – transactions which, undoubtedly, constitute sales.[13] These "risks" are not the risks of an entrepreneur, but those of an ordinary buyer – *i.e.*, the risk that the seller will default on his obligation to make a refund if the purchased items are not delivered.

[13] The Funds' analogy (Ans. Br. 57) to the risk of a depositor in the midst of a banking crisis only illustrates the point. A depositor in a bank is not engaged in a joint enterprise with the bank and hence his deposit is not subject to the entrepreneurial risk of any joint enterprise between himself and the bank.

CONCLUSION

For the reasons stated above and in our opening brief, this Court should reverse the decision of the Tax Court.

Respectfully submitted,

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It is hereby certified that on this 1st day of September, 2010, eight copies of this reply brief were mailed to the Clerk of the Court via first class mail, and an electronic version thereof was filed with the Clerk using the CM/ECF system, which will send notice of such filing to the following attorneys for the appellees, who are registered CM/ECF users:

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