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HISTORY AND THE HILL

Virginia Tax Fund Case a Victory for the Historic Tax Credit Industry

By John Leith-Tetrault, National Trust Community Investment Corporation

It is often said that holiday gifts sometimes come in strange packages. A long awaited U.S. Tax Court ruling, issued December 21, 2009 in *Virginia Tax Credit Fund 2001 vs. Commissioner*, was indeed an unexpected gift and a significant victory for the historic tax credit (HTC) industry that sent many tax lawyers, syndicators and investors home for the holidays with a sigh of relief.

After all, it's not every day that one of the IRS' so-called "Dirty Dozen" tax scams is overturned in such a resounding fashion. Because of the high profile of the case, many in the industry had speculated that the court would decide against the Virginia Tax Credit Fund. However, by the time the case was tried, the IRS had dropped its initial argument that the transaction was abusive.

Here are the facts: Two Virginia state historic tax credit funds formed in the 2001 offered investors the opportunity to purchase a small (1 percent in the aggregate) interest in the funds and exit with significant capital losses in less than 12 months. Investor returns were comprised of a discounted price (74 cents) for the Virginia state HTC and the exit benefits of selling partnership interests for a *de minimis* amount on the original purchase price. The IRS argued that the partners owed $7 million in underpayments because the investors were not true partners and that the purported allocation of credits was a "disguised sale" under Section 707 of the IRC.

The Virginia HTC is an allocated credit that cannot be transferred or sold. The Virginia program does not specify how long an investor in a partnership that receives credits must remain a partner, unlike the federal credit which has a holding period of five years. The state law also differs from the Section 47 federal credit in that recapture is limited to a change in the historic character of the building, and cannot be triggered by a transfer of ownership such as a foreclosure.

In making its argument that the fund investors were not partners, the IRS stated that the investors had no business purpose except the sale of the state HTCs, and did not have a common interest in the profits and losses of the partnership. Judge Diane Kroupa held, however, that the investors signed standard partnership agreements that were properly written and enforceable under Virginia law, and that their conduct was consistent with those documents. The investors contributed significant capital for the purpose of rehabilitating historic buildings, received both tax credits and net economic benefits for their participation, and accepted checks for the sale of their partnership interests when the purposes of the partnership had been achieved. The judge acknowledged that the primary economic benefits were state income tax benefits, but cited earlier IRS rulings related to the low-income housing tax credit that concluded that certain credit programs may be held to a different profit motive standard than what is required by Section 183.

The IRS argued further that the fund investors were not partners because they did not share in partnership risks, especially in light of the fact that their participation lasted less than 12 months. However, the judge cited sufficient risks including the risk that the Virginia State Department of His-

continued on page 2

continued from page 1
toric Resources would not approve the Part 3 and the possibility that construction would not be completed or would be completed late. She also cited the risk of mismanagement or fraud at the operating partnership level, and the risk that additional expenses would need to be borne by the funds for nonperformance by local managing members.

The second key ruling was Judge Kroupa's finding that the transaction was not a disguised sale. A disguised sale under the Internal Revenue Code refers to contributions and distributions in the form of cash or other property to or from a partnership which, when taken together, suggest that the transaction can be characterized as a sale. The judge held that the substance of the transactions was a series of valid contributions and allocations under properly written and executed partnership agreements and not a sale. With regard to two established legal tests of a disguised sale, she found that the transfers (capital contributions and the receipt of the credits) were not simultaneous, and that they were subject to the entrepreneurial risks of the partnership.

So what does all of this mean for state historic tax credits specifically, and the historic tax credit industry generally? According to tax credit law experts we spoke to, quite a lot. Bill Machen of Holland and Knight said that *Virginia Tax Credit Fund 2001 v. Commissioner* is the first Tax Court case to address historic tax credits and the legislative intent behind both federal and state credit statutes. The judge found the intent of historic tax credits very defensible, citing their use to attract private investments to the rehabilitation of historically significant structures that, absent the credits, would not be made. He also said that many of the legal principles cited in the case would apply to federal HTC transactions.

"This ruling appears to bless the structure of any allocated state historic credit, regardless of the size of the investor's ownership interest or the length of time they remain in the partnership," Machen said. "David Aughtry [attorney for the defense] did a tremendous job. His argument was that it didn't matter how long an investor stays in the deal. All that matters is that the real purpose of the partnership was to generate the state credits; once that was done, the purpose had been accomplished."

Jerry Breed of Bryan Cave said that the outcome of the Virginia case should provide real comfort to states that have put allocated historic tax credit programs in place. He said that a different ruling may have caused many states to rethink and redesign existing credit statutes that encourage private capital investment in historic properties. Breed added that investors that have provided capital to state HTC transactions can be comforted that the tax treatment they anticipated for their investments has been upheld. He went on to say that the outcome of this case has significance in the context of proving a profit motive, because "the judge has held that

continued on page 3

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Jane Bowar Zastrow / 415.356.8034

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Emil Bagalso / 415.356.8037

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continued from page 2

state credit investments will count along with other elements of profit when assessing whether the investor has a pre-tax motive."

Both attorneys stressed that there is always the chance that the Tax Court ruling in the Virginia case may be appealed. Neither was comfortable advising future clients to replicate the structure of the Virginia Tax Credit Fund in every respect. Despite the ruling, conventional wisdom in historic tax credit legal circles seems to be leaning toward a more conservative approach of at least a 1 percent ownership interest and remaining in the deal for one to three tax years.

Keep an eye on *History on the Hill* for continued reporting of Tax Court cases affecting the historic tax credit industry.❖

John Leith-Tetrault has 32 years of experience in community development financing, banking, community organizing, historic preservation, training and organizational development. He has held senior management positions with Neighborworks, Enterprise Community Partners, Bank of America and the National Trust for Historic Preservation. Mr. Leith-Tetrault is the founding president of the National Trust Community Investment Corporation and serves as the Chairman of the Historic Tax Credit Coalition. He can be reached at (202) 588-6064 or jleith@ntcicfunds.com.

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