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THE MONETIZATION OF BUSINESS TAX CREDITS

by

Thomas W. Giegerich[*]

ABSTRACT

This Article examines the history of the development of federal incentive tax credits, from the enactment of the investment credit in 1962 to the cash grant in lieu of credits regime introduced as part of the American Recovery and Reinvestment Act of 2009, and methods for "monetizing" tax credits developed in the context of state tax credits as well as federal tax credits (and associated taxation issues). The principal thesis of the Article is that (1) the current array of federal business tax credits addressed in the Article are in the nature of subsidies rather than structural components of the computation of a "correct" tax; and (2) therefore constraining the monetization of these tax credits through the imposition of normative-based substantive requirements is inappropriate. As the Article states in conclusion, if the judgment is that tax expenditures of this kind play a useful role (i.e., they should not simply be repealed), then the articulation of the underlying goals and intended beneficiaries of current tax-based subsidies should be sharpened and our existing "delivery mechanisms" closely examined and possibly overhauled.

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I. INTRODUCTION

Within the last year or so, two cases have been handed down addressing partnership allocations of tax credits. In *Virginia Historic Tax Credit Fund 2001 v. Commissioner*,[1] the question was whether a purported allocation of Virginia historic rehabilitation tax credits under the terms of the governing operating agreement should be respected as such or instead should be recast as a sale of the state tax credits by the partnership[2] to the state tax credit "investors." Many states allow for outright transfers of state tax credits (with associated, if somewhat muddled, federal tax consequences), but Virginia is not among them, and the question before the court was whether the substance of the transaction entered into by the Virginia state tax credit investors, the partnership and the project developer was — under the section 707[3] disguised sale rules or otherwise — a sale of tax credits, notwithstanding the facial impossibility of such a sale in light of the fact that the state tax credits at issue were by the terms of the enabling legislation "nontransferable."

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1. 639 F.3d 129 (4th Cir. 2011), *rev'g* 98 T.C.M. (CCH) 630 (2009).

2. References to "partnership" and "partner" include state law partnerships and limited liability companies classified as partnerships for U.S. federal tax purposes, and their members.

3. Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended, or the Internal Revenue Code of 1954, as amended, as the context makes clear, or the Treasury regulations promulgated thereunder.

In *Historic Boardwalk Hall, LLC v. Commissioner*,[4] the question was whether a purported allocation of federal historic rehabilitation tax credits under the terms of the operating agreement among the parties should be respected or set aside effectively as an impermissible attempt to "sell" tax credits (the federal historic rehabilitation tax credit not being transferable within the intendment of its enabling legislation). According to the government, the overall transaction amounted to a scheme to transfer tax credits (for a price) to a party whose participation in the project lacked the characteristics of an equity investment necessary for it to lay claim to the tax credits.

In *Virginia Historic Tax Credit*, under the applicable Virginia legislation the credits in question could not be sold, but could be allocated among the partners of a partnership in whatever manner the partners agreed. When the Internal Revenue Service ("IRS") first adopted the position in Chief Counsel Advice[5] that the allocation scheme adopted by the parties in that case was tantamount to, and should be treated as, a *sale* of the tax credits for federal tax purposes (arguing that the state tax credit investors were not partners in the partnership and, in any event, the purported allocation of state tax credits was a disguised sale under section 707), the State of Virginia weighed in to re-confirm that for Virginia tax purposes the allocation of credits among the parties would be respected.[6]

Federal tax law does not permit federal tax credits to be allocated among partners in whatever manner they agree. In fact, it seems readily apparent that an attempt to allocate federal tax credits in the manner used by the parties in *Virginia Historic Tax Credit* to allocate the Virginia tax credit would be impermissible under section 704 and would not be given effect.

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4. 136 T.C. 1 (2011).

5. I.R.S. Chief Couns. Adv. 2007-04-028 (Jan. 26, 2007); I.R.S. Chief Couns. Adv. 2007-04-030 (Jan. 26, 2007).

6. VA DEP'T OF TAXATION, RULINGS OF THE TAX COMMISSIONER, NO. 07-82 (May 25, 2007)

> [I]t appears that the historic rehabilitation credits would be granted under Virginia law to a partnership validly created under Virginia law. The statute, VA. CODE ANN. § 58.1-339.2, refers to various determinations by Virginia agencies and values assessed by local tax authorities. It expressly requires that credits granted to a partnership be passed through to the partners. There is nothing in Virginia law that ties any amount or determination related to the credit to the federal tax treatment of a related item.
>
> Therefore, the IRS action based upon a deemed purchase of state tax credits, which by its terms is limited to the calculation of federal income tax, does not require the Virginia agencies administering the credit to similarly ignore actions otherwise valid under Virginia law and revoke the credit because of the deemed purchase.

Under section 704, a partner's distributive share of income, gain, loss, deduction, or credit is generally determined by the partnership agreement.[7] If, however, a particular allocation to a partner in the partnership agreement does not have "substantial economic effect,"[8] the allocation of partnership items to a partner is re-determined based on the "partner's interest in the partnership,"[9] so that the allocation corresponds with the manner in which the partners have agreed to share the economic benefit or burden corresponding to the income, gain, loss, deduction, or credit that is allocated.[10] The allocation of credits cannot have substantial economic effect[11] and therefore must be allocated based on the partners' interests in the partnership. In the case of the investment tax credit, allocation of the credit based on allocations of cost or qualified investment in accordance with Regulations section 1.46-3(f) (generally, in accordance with the ratio in which the partners divide general profits) satisfies this requirement. In the case of other tax credits, if a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership taxable year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustments) for the year, then the partners' interests in the partnership with respect to the credit (or the cost giving rise to it) are in the same proportion as the partners' respective distributive shares of the loss or deduction (and adjustments).[12] Regulations section 1.704-1(b)(4)(ii) further provides that identical principles apply in determining the partners' interests in the partnership regarding tax credits, such as the credit under section 45 (the production tax credit), that arise from receipts of the partnership (whether or not taxable).

Returning to *Virginia Historic Tax Credit*, parties putatively making substantial equity contributions to a partnership and yet receiving only a one percent interest in partnership profits and losses in the aggregate were allocated *all* of the state tax credits — an allocation scheme that clearly would be impermissible if tested under standards such as those described above (i.e., federal tax credits could not be allocated that way). Further, these parties (1) were due to have their contributions refunded if the tax credits

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7. I.R.C. § 704(a).

8. That is, the allocation is not "consistent with the underlying economic arrangement of the partners." *See* Reg. § 1.704-1(b)(2)(ii)(a).

9. Reg. § 1.704-1(b)(1)(i).

10. Reg. § 1.704-1(b)(3)(i).

11. *See* Reg. § 1.704-1(b)(4)(ii) ("[A]llocations of tax credits . . . are not reflected by adjustments to the partners' capital accounts (except to the extent that adjustments to the adjusted tax basis of partnership section 38 property in respect of tax credits . . . give rise to capital account adjustments under paragraph (b)(2)(iv)(l) of this section). Thus, such allocations cannot have economic effect under paragraph (b)(2)(ii)(b)(1) of this section.").

12. *See* Regs. §§ 1.704-1(b)(4)(ii), 1.46-3(f).

were not received or were revoked; and (2) agreed to a buy-out of their partnership interests following receipt of the credits for less than a penny on the dollar.[13]

Interestingly, the Tax Court sided with the taxpayer in *Virginia Historic Tax Credit* and found that the arrangement did not constitute a sale of the state tax credits. Although the Tax Court acknowledged that "investors received assurance that their contributions would be refunded" if the tax credits were not received or were revoked, the court concluded this was offset by the risk the investors took "that the resources would [not] remain available in the source partnership" to back up that assurance.[14] Further, the quid pro quo nature of the exchange — suggesting as it did the possible invocation of a section 707 disguised sale argument — was downplayed on the basis of a finding that the transactions were "not simultaneous" and the investors were "subject to the entrepreneurial risks of the partnership's operations."[15]

Although, in the main, the decision of the Tax Court honed to technical considerations such as these, policy considerations played a role in the court's reasoning as well, the court noting at one juncture: "[I]t is a policy of the Federal Government to give maximum encouragement to organizations and individuals undertaking preservation by private means and to assist States in expanding and accelerating their historic preservation programs and activities."[16]

The Fourth Circuit, on the other hand, was neither swayed by considerations of policy nor sympathetic to the taxpayer's technical arguments, finding that:

> [T]he only risk here was that faced by any advance purchaser who pays for an item with a promise of later delivery [rather than] . . . the risk of the entrepreneur who puts money into a venture with the hope that it might grow in amount but with the knowledge that it may well shrink.[17]

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13. The investors all were bought out for a small percentage of their original contribution amounts within months of their initial investments after receiving the tax credits (receiving collectively approximately $7,000 in respect of approximately $7,000,000 contributed by them to the capital of the partnership). *See infra* note 393 and accompanying text.

14. 98 T.C.M. (CCH) 630, 640 (2009), *rev'd*, 639 F.3d 129 (4th Cir. 2011).

15. *Id*. at 641.

16. *Id*. at 632 (referencing the National Historic Preservation Act of 1966, 16 U.S.C. § 470-1 (2006)).

17. Virginia Historic Tax Credit Fund 2001 v. Commissioner, 639 F.3d 129, 145–46, *rev'g* 98 T.C.M. (CCH) 630 (2009).

The broader backdrop against which the *Virginia Historic Tax Credit* case was decided includes the highly variable state tax systems for addressing tax credits, with some states having instituted refundable tax credits[18] and others transferable tax credits[19] and still others non-transferable tax credits,[20] in some cases with lenient rules for partnerships as to the allocation of the credits[21] and in other cases requiring allocation in

18. Examples include Michigan's Brownfield Redevelopment Credit, MICH. COMP. LAWS § 208.1437 (2010) (repealed effective on contingency by 2011 Mich. Pub. Acts 39) (refundable provision, MICH. COMP. LAWS § 208.1437(18) (2010)); Arizona's Renewable Energy Operations Credit, ARIZ. REV. STAT. ANN. § 43-1164.01(2011) (West) (refundable provision, ARIZ. REV. STAT. ANN. § 43-1164.01.F (2011) (West)); and New Mexico's Renewable Energy Production Tax Credit, N.M. STAT. ANN. § 7-2A-19 (West 2011) (refundable provision, N.M. STAT. ANN. § 7-2A-19(K) (West 2011).

19. Examples include Iowa's Wind Energy Production Tax Credit, IOWA CODE ANN. § 476B (2011) (West) (provision allowing transfers at IOWA CODE § 476B.7 (West 2011)); Oklahoma's Credit for Electricity Produced From Zero-Emission Facilities, OKLA. STAT. tit. 68, § 2357.32A (2011) (provision allowing transfers at OKLA. STAT. tit. 68, § 2357.32A(F) (2011)); Connecticut's Urban and Industrial Site Reinvestment Credit, CONN. GEN. STAT. ANN. § 32-9t (West 2011) (provision allowing transfers at CONN. GEN. STAT. ANN. § 32-9t(n) (West 2011)).

20. Examples include Mississippi's Equity Investment (New Markets) Tax Credit, MISS. CODE ANN. § 57-105-1 (West 2011) (provision prohibiting transfer at MISS. CODE ANN. § 57-105-1(2) (2011)); Ohio's Historic Building Rehabilitation Credit, OHIO REV. CODE ANN. § 149.311 (West 2011) (provision prohibiting transfer at OHIO ADMIN. CODE 122:19-1-06(D) (West 2011); however, the credit is refundable).

21. A case in point, of course, is Virginia's Historic Rehabilitation Tax Credit, VA. CODE ANN. § 58.1-339.2 (West 2011) ("Credits granted to a partnership or electing small business corporation (S corporation) shall be allocated among all partners or shareholders, respectively, either in proportion to their ownership interest in such entity or as the partners or shareholders mutually agree as provided in an executed document. . . ."). Other examples include Illinois' new markets tax credit, 20 ILL. COMP. STAT. ANN. 663/15 (West 2011) ("No tax credit claimed under this Act shall be refundable or saleable on the open market. Tax credits earned by a partnership, limited liability company, S corporation, or other "pass-through" entity may be allocated to the partners, members, or shareholders of that entity for their direct use in accordance with the provisions of any agreement among the partners, members, or shareholders. Any amount of tax credit that the taxpayer, or partner, member, or shareholder thereof, is prohibited from claiming in a taxable year may be carried forward to any of the taxpayer's 5 subsequent taxable years."); and New Mexico's Renewable Energy Production Tax Credit, N.M. STAT. ANN. § 7-2A-19(H) (West 2011) ("A taxpayer may be allocated all or a portion of the right to claim a renewable energy production tax credit without regard to proportional ownership interest if: (1) the taxpayer owns an interest in a business entity that is taxed for federal income tax purposes as a partnership; (2) the business entity [would otherwise qualify for the credit]; [and] (3) the taxpayer and all other taxpayers

proportion to the parties' ownership interests in the partnership or in accordance with similarly restrictive requirements.[22]

In *Historic Boardwalk* — involving the federal historic rehabilitation tax credit — the parties purported to live within the strictures of section 704(b), and in fact the IRS never challenged the validity of the allocation of the tax credit as such (all items of income, gain, loss, deduction and credit were allocated 99.9 percent to Pitney Bowes and 0.1 percent to the New Jersey State Exhibition Authority ("NJSEA")).[23] Rather, the IRS argued in the alternative that (1) the partnership was a sham; (2) the taxpayer (Pitney Bowes) was not a partner in the partnership; (3) the partnership never took ownership of the property that underwent rehabilitation; and (4) the claimed tax benefit should be denied pursuant to the partnership anti-abuse rules set forth in section 1.701-2. In support of its arguments, the IRS pointed to competing call and put options held by NJSEA and Pitney Bowes, respectively, that it argued were structured to lock in Pitney Bowes' return without regard to the success of the venture; the protection of Pitney Bowes' preferred return via a guaranteed investment contract and bargained-for tax benefits via a Tax Benefits Guaranty Agreement; the fact that NJSEA alone was responsible for operating deficits and that the partnership's debt all was nonrecourse to Pitney Bowes; the absence of a pre-tax profit motive on the part of Pitney Bowes, according to the IRS's characterization of the facts and law; and, in the IRS's view, the absence of participation by Pitney Bowes in upside potential and downside risk and the retention by NJSEA of the benefits and burdens of ownership following the purported transfer of ownership of the property from NJSEA to the partnership, among other things.

Here too the Tax Court rejected the government's arguments and held for the taxpayer. In doing so, again the Tax Court seemed attracted by policy considerations:

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allocated a right to claim the renewable energy production tax credit pursuant to this subsection own collectively at least a five percent interest in a qualified energy generator . . . .").

22. *See, e.g.*, Arizona's Credit for solar energy devices, ARIZ. REV. STAT. ANN. § 43-1164(F) (2011) (West) ("Co-owners of a business, including corporate partners in a partnership, may each claim only the pro rata share of the credit allowed under this section based on the ownership interest or financial investment in the system."); Montana's Credit for preservation of historic buildings, MONT. CODE ANN. § 15-31-151(3) (2011) ("If the credit under this section is claimed by a small business corporation . . . or a partnership, the credit must be attributed to shareholders or partners, using the same proportion used to report the corporation's or partnership's income or loss for Montana income tax purposes.").

23. Historic Boardwalk Hall, LLC v. Commissioner, 136 T.C. 10 (2012). In addition, Pitney Bowes was entitled to a preferred return payable out of available cash flow equal to 3 percent of its investment per annum. *Id*.

> Respondent's contention that Pitney Bowes was unnecessary to the transaction because NJSEA was going to rehabilitate the East Hall without a corporate investor overlooks the impact that Pitney Bowes had on the rehabilitation: no matter NJSEA's intentions at the time it decided to rehabilitate the East Hall, Pitney Bowes' investment provided NJSEA with more money than it otherwise would have had; as a result, the rehabilitation ultimately cost the State of New Jersey less.
>
> . . .
>
> The legislative history of section 47 indicates that one of its purposes is to encourage taxpayers to participate in what would otherwise be an unprofitable activity. Congress enacted the rehabilitation tax credit in order to spur private investment in unprofitable historic rehabilitations. As respondent notes, the East Hall has operated at a deficit. Without the rehabilitation tax credit, Pitney Bowes would not have invested in its rehabilitation, because it could not otherwise earn a sufficient net economic benefit on its investment. The purpose of the credit is directed at just this problem: because the East Hall operates at a deficit, its operations alone would not provide an adequate economic benefit that would attract a private investor. Further, if not for the rehabilitation tax credit, NJSEA would not have had access to the nearly $14 million paid to it as a development fee for its efforts in rehabilitating the East Hall.[24]

This case currently is on appeal to the Third Circuit.[25]

The broader backdrop against which to consider the significance of *Historic Boardwalk* includes the many transactions that have been consummated that can be said to have some of the same structural elements as *Historic Boardwalk* and the enactment of section 7701(o), codifying the economic substance doctrine. Section 7701(o), in brief, requires that for the intended tax consequences of a transaction for which the economic substance doctrine is "relevant" to be respected, the transaction must have a meaningful economic effect and substantial purpose apart from federal income tax

24. *Id*. at 15–17. It would appear that absent the investment by Pitney Bowes final project costs simply would have been $14 million lower.

25. Notice of Appeal, Historic Boardwalk Hall, LLC v. Commissioner, No. 11-1832 (3d Cir. Apr. 14, 2011). The government filed its opening brief on October 27, 2011. The petitioner filed its brief on December, 15, 2011.

effects for the tax consequences to be respected.[26] On this latter score, although the tax years before the court in *Historic Boardwalk* predate the enactment of section 7701(o), tax advisors practicing in the area have taken some comfort from the Tax Court's opinion in *Historic Boardwalk* and its support for taking the tax credits into account — given the congressional mandate — as part of the taxpayer's economic return in evaluating the substance of the transaction.[27] The argument on legislative policy grounds is that incentive tax credits should be taken into account in testing for pre-tax profit because Congress enacted the credits to incentivize investment in projects it understood otherwise would be uneconomic, and to do differently would defeat legislative intent. The current cash grant program instituted in 2009 by the American Recovery and Reinvestment Act ("ARRA")[28] that provides grants in lieu of the federal production tax credit and energy credit undergirds this reasoning by laying bare the essential nature as subsidies of the credits for which cash grants are an alternative. However, even if one accepts the thrust of the argument, as discussed below, the issues in *Historic Boardwalk* extend well beyond this.

Historic Boardwalk shows the machinations that parties will go through to extract a federal tax credit and related tax benefits — while concurrently limiting exposure to the underlying project to the greatest extent possible — and leads to a question: What if federal business tax credits (the investment credit,[29] including the energy credit[30] and historic rehabilitation

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26. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), 124 Stat. 1029, 1067–68 [hereinafter HCERA 2010] (adding I.R.C. § 7701(o)). Section 7701(o)(2) provides that potential for a profit only factors into meeting these requirements if the present value of the "reasonably expected pre-tax profit" is substantial when compared against the present value of expected net tax benefits.

27. *See* Michael Bauer & Kevin Juran, *The Economic Substance of Tax Credits*, 131 TAX NOTES 499, 503 (May 2011) (concluding "the Tax Court's opinion appears to provide additional support for respecting some transactions that have the effect of transferring tax credits between parties as compensation for investing, at least when the transaction appears to be congressionally sanctioned."). The authors also offer a cautionary query as to "What, if anything, should be made of the fact that the Tax Court had the opportunity to hold that the economic substance doctrine was irrelevant to the instant case and opted not to?" *Id*.

28. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, §§ 1602–03, 123 Stat. 115, 362–66 [hereinafter ARRA 2009].

29. The investment credit as originally enacted under section 46 is currently only available in the case of: (1) the rehabilitation credit (section 47); (2) the energy credit (section 48); (3) the qualifying advanced coal project credit (section 48A); (4) the qualifying gasification project credit (section 48B); (5) the qualifying advanced energy project credit (section 48C); and (6) the qualifying therapeutic discovery project credit (section 48D).

credit,[31] production tax credit,[32] low-income housing tax credit,[33] and new markets tax credit[34]) were made transferable (or, alternatively, refundable) as many state tax credits are? What are the factors that would need to be taken into account? What precedents exist? What lessons can we learn from the cash grant program?

Returning to the already malleable world of state tax credits, *Virginia Historic Tax Credit* highlights the uncertain federal tax effects of varying ways to deal with state tax credits. Another case that will be considered below, *Tempel v. Commissioner*,[35] considers the question of the *character* of the gain realized upon a sale of a state tax credit for federal tax purposes and reaches a conclusion at odds with earlier IRS pronouncements on the subject. It seems curious that the federal tax treatment of state tax credits — and, in turn, effectively, the *value* of state tax credits — should vary based on whether the state tax credit is transferable or non-transferable or is transferred to another party, or simply used by the original recipient of

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30. As noted in the preceding footnote, the energy tax credit is a component of the investment credit. Section 48 generally provides a credit equal to a percentage of the basis of each "energy property" placed in service during a taxable year. Currently, the applicable percentage is 30 percent for solar property, fuel cell property, and small wind property and 10 percent for all other energy property, including geothermal and microturbine sources. Prior to 2005, the applicable percentage for all energy property (at that time, only solar property and geothermal property were eligible) was 10 percent.

31. Section 47 provides a 10 percent credit for the rehabilitation of buildings placed in service before 1936 and a 20 percent credit for the rehabilitation of certified historic structures. Like the energy tax credit, the historic rehabilitation tax credit is a component of the investment credit. *See supra* note 29.

32. Section 45 provides a tax credit based on the kilowatt hours of electricity produced by the taxpayer from certain "qualified energy resources." The credit amount is adjusted for inflation. I.R.C. § 45(b)(2). Currently, the credit is 2.2 cents per kilowatt hour on the sale of electricity produced from the qualified energy resources of wind, closed-loop biomass, geothermal energy, and solar energy and 1.1 cent per kilowatt hour on the sale of electricity produced in open-loop biomass facilities, small irrigation power facilities, landfill gas facilities, trash combustion facilities, qualified hydropower facilities, eand marine and hydrokinetic energy facilities. *See* Notice 2011-40, 2011-1 C.B. 806. In general, the credit is only available with respect to electricity produced during the period of ten years starting on the date the qualified facility was originally placed in service.

33. Section 42 provides ten yearly credit installments that have a present value equal to 70 percent of the cost of new low-income housing units and 30 percent of cost of used or federally subsidized units.

34. Section 45D provides a credit equal to 5 percent of a "qualified equity investment" for the first 3 years and 6 percent for the next 4 years.

35. 136 T.C. 341 (2011).

the credit to reduce its own taxes, and should be as generally uncertain as it is. What would a unifying set of rules look like?
This Article will explore these topics in depth.

II. HISTORY AND OVERVIEW OF FEDERAL BUSINESS TAX CREDITS AND OFFICIALLY- SANCTIONED MONETIZATION STRUCTURES

A. *The Early Years*

1. *The Investment Credit*

In 1962, Congress enacted the investment credit — the first federal tax credit aimed at encouraging capital investment.[36] A taxpayer generally was permitted to reduce its federal income tax by 7 percent of the amount it invested in qualifying property (generally new capital equipment with tax lives greater than three years) placed in service during the year.[37] Under the original statute, a taxpayer claiming the credit was required to reduce its tax basis in the property in respect of which the credit was being claimed by the full amount of the credit.[38] If the taxpayer disposed of the property before the end of its useful life, the taxpayer was required to recapture a portion of the credit.[39]

The rationale for the tax credit was explained by President Kennedy, in an Economic Report submitted to Congress along with his budget proposals, as follows:

> The tax credit increases the profitability of productive investment by reducing the net cost of acquiring new

36. Revenue Act of 1962, Pub. L. No. 87-834, § 2, 76 Stat. 960, 962–73. The other component of the stimulus plan was the Treasury Department's reduction in the useful lives of capital assets for depreciation purposes. S. REP. NO. 87-1881, at 12 (1962), *reprinted in* 1962 U.S.C.C.A.N. 3304, 3314 ("[F]aster depreciation . . . [shares with tax credits the characteristic] of giving the investor in equipment a monetary reward beyond what he would receive on the basis of realistic accounting.").

37. The portion of the investment taken into account was one-third in the case of property with a useful life of four to five years, two-thirds in the case of property with a useful life of six to eight years, and 100 percent for property with longer lives. I.R.C. § 46(c)(2) (1962). The rate was increased from 7 percent to 10 percent in 1975. Tax Reduction Act of 1975, Pub. L. No. 94-12, § 301(a), 89 Stat. 26, 36 [hereinafter TRA 1975].

38. I.R.C. § 48(g) (1962).

39. I.R.C. § 47 (1962). The recapture regime was established in order "to guard against a quick turnover of assets by those seeking multiple credit." S. REP. NO. 87-1881, at 18 (1962), *reprinted in* 1962 U.S.C.C.A.N. 3304, 3320; H.R. REP. NO. 87-1447, at 13 (1962).

> equipment. It will stimulate investment in capacity expansion and modernization, contribute to growth of our productivity and output, and increase the competitiveness of American exports in world markets.[40]

The legislative history accompanying the enactment explains that the provision requiring a reduction in the basis of the property in respect of which the credit is claimed (by the amount of the credit) was included because "there is no reason to allow the taxpayer depreciation with respect to the portion of the investment in effect paid for by the Government."[41] A mere two years later, in 1964, the requirement was removed[42] on the ground that it "severely restricted the incentive effect of the investment credit."[43]

Two years subsequent to that, in 1966, the investment credit was suspended — from October 1966 to March 1967.[44] The investment credit was repealed from April 1969 to August 1971,[45] reinstated, increased in 1975 to 10 percent,[46] significantly expanded in 1981 (see discussion in Part I.B.1. below) and repealed with finality as part of the Tax Reform Act of 1986 (subject to grandfather provisions). Vestiges remain in the form of various credits hung under the rubric of "investment credit" pursuant to section 46, such as the historic rehabilitation credit under section 47 and the energy credit under section 48.[47]

The history of enactment, suspension, repeal, and reintroduction of the investment credit in the early years indicates a legislative attempt to manage the *pace* of economic growth through the giving or withholding of

40. PRESIDENT JOHN F. KENNEDY, ECONOMIC REPORT OF THE PRESIDENT (Jan. 1962).

41. S. REP. NO. 87-1881, at 19 (1962).

42. Revenue Act of 1964, Pub. L. No. 88-272, § 203, 78 Stat. 19, 33–35.

43. S. REP. NO. 88-830, at 40 (1964). According to the Senate Report accompanying Public Law 88-272, the basis reduction provision

> [i]n effect . . . converted the 7-percent credit into a 3½-percent credit for corporations, plus a 7-percent initial depreciation allowance. This result occurs because the decrease in basis of the asset which may be written off means that the equivalent of approximately one-half of the investment credit is recouped over the life of the asset in substantially the same manner as an initial depreciation allowance. This effect substantially reduces the incentive effect of the credit, since it means that approximately half of the benefits must be restored over the useful life of the asset. In effect, this transforms one-half of the credit into an interest-free loan. *Id*.

44. Act of Nov. 8, 1966, Pub. L. No. 89-800, 80 Stat. 1508.

45. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.

46. TRA of 1975, *supra* note 37, § 301(a), 89 Stat. at 36.

47. *See infra* note 125–29, 187–91 and accompanying text.

tax incentives — to accelerate or slow, as opposed to *cause*, in absolute terms, economic investment. Reportedly, the suspension of the credit in October 1966 was in direct response to an overheated economy and a boom in new investments. Announced to last through December 1967, the suspension was meant to restrain the pace of investment outlays. However, when the economy began to sag early in 1967 the suspension of the investment credit was lifted after only five months in March 1967. Economists since have noted that the lag between enactment (or suspension) of such stimulus to investment activity and actual marketplace response as measured by investment outlays is such that legislative actions like the one in 1966 are destined to miss the mark.[48]

The investment credit was neither transferable nor refundable, thereby generally restricting its value to taxpayers with current tax liabilities.[49] However an element of the investment credit, dating back to first enactment, is the ability of a lessor to "cede" its investment credit to "the party actually generating the demand for the investment" — the lessee.[50] The provision was explained in the Senate Report as follows:

> If the lessor makes this election, then the lessee is treated for purposes of this provision as if he had acquired the property himself, that is, generally he will be treated as if he had acquired the property for the lessor's cost or other basis for the property. However, if the lessor constructed the property (or a corporation controlled by or which controlled the lessor did so) the lessee is treated as having acquired the property for its fair market value. The useful life of the property in the hands of the lessee in such cases is to be its useful life in the hands of the lessor for purposes of computing the size of the credit available. This is true whether or not the lease itself is for a shorter period of time. Of course, in such cases if the lessee does not renew the lease and hold the property for the estimated useful life of

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48. *See* John Lintner, *Do We Know Enough to Adopt a Variable Investment Tax Credit?*, *in* FEDERAL RESERVE BANK OF BOSTON CONFERENCE SERIES 11, CREDIT ALLOCATION TECHNIQUES AND MONETARY POLICY 113, (1973).

49. The Senate report notes that "[t]he tax credit, under the bill, as amended by your committee (sec. 46(a)(2)) may not exceed the tax liability, or if the tax liability is in excess of $25,000, may not exceed $25,000 plus 25 percent of the tax liability over this amount. *This . . . is designed to prevent [the credit] from relieving the taxpayer from any substantial contribution*." S. REP. NO. 87-1881, at 17 (1962) (emphasis added). The inclusion of credit carry backs and carry forwards was seen as ameliorative. *See* H.R. REP. NO. 87-1447, at 10 (1962).

50. S. REP. NO. 87-1881, at 19 (1962).

> the property in the hands of the lessor, then a downward adjustment will be made in his investment credit.
>
> Where the lessee is allowed the investment credit there is no adjustment of the lessor's basis for depreciation . . . but a reduction of the lessee's deduction for rent is provided.[51]

Under the current formulation, a lessor may elect to treat the lessee of property eligible for the historic rehabilitation credit under section 47 or the energy credit under section 48 (both discussed below) as having purchased the property for its fair market value,[52] thus allowing the lessor to shift the credit to the lessee.[53] Generally, only corporate lessors may elect to cede the credit.[54] The lessor is not required to reduce its basis in the property; rather, the lessee must ratably include 50 percent of the amount of the credit (or the entire amount of the credit in the case of the rehabilitation tax credit) in its gross income over the shortest recovery period applicable to the property.[55]

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51. *Id*. at 19–20.

52. In the case of a short-term lease (i.e., where the lease is for a period of less than 80 percent of the property's useful life if such useful life is over 14 years, and the lease is a not a "net lease" where the lessor is guaranteed a specified return), the lessee is treated as having acquired a portion of the property for an amount equal to a fraction, the numerator of which is the term of the lease and the denominator of which is the class life of the property, multiplied by the fair market value of the property. Reg. § 1.48-4(c)(3)(i). Likewise the lessor is treated as having retained a qualified investment in the property. Reg. § 1.48-4(c)(3)(ii).

53. I.R.C. § 48(d) (repealed in 1990). Current section 50(d)(5) provides that "rules similar to the rules of . . . [pre-1990] Section 48(d)" shall apply for credits listed in current section 46. Therefore, these rules also apply to the qualifying advanced coal project credit under section 48A, the qualifying gasification project credit under section 48B, the qualifying advanced energy project credit under section 48C, and the qualifying therapeutic discovery project credit under section 48D.

54. I.R.C. § 46(e)(3) (repealed in 1990) (as made currently applicable by I.R.C. § 50(d)(1)). Exceptions, however, are provided if: (1) the lessor manufactured or produced the property itself; or (2) if the term of the lease is less than 50 percent of the useful life of the property and if, during the first twelve months after the property is transferred to the lessee, the lessor's deductions under section 162 (exclusive of rents and reimbursed amounts with respect to such property) exceed 15 percent of the rental income.

55. I.R.C. § 48(d)(5) (repealed in 1990) (as made currently applicable by I.R.C. § 50(d)(5)). The lessee's rent deduction is no longer reduced by the amount of the credit.

2. *Historic Rehabilitation Tax Credit*

The first expansion of federal incentive credits came in 1978. The Revenue Act of 1978 added section 48(g) (since renumbered section 47),[56] providing an investment tax credit equal to 10 percent of qualified expenditures for rehabilitating properties 20 years or older.[57] The credit was increased in 1981 to 15 percent for 30-year buildings, 20 percent for 40-year buildings, and 25 percent for certified historic structures.[58] Section 47 currently provides a 10 percent credit for qualified rehabilitated buildings placed in service before 1936 and a 20 percent credit for the rehabilitation of certified historic structures. The taxpayer must reduce its basis in the property by the full amount of the credit[59] and is required to recapture a percentage of the credit if it disposes of the property with five years of the date the property is placed in service.[60]

In enacting the rehabilitation tax credit, Congress explained as follows:

> Buildings and their structural components have not been eligible for the investment tax credit since it was enacted in 1962. At that time, the Congress was primarily concerned about the substantially greater average age of machinery and equipment in domestic manufacturing facilities than in the facilities of major foreign producers of the same products.
>
> Presently, there is a similar concern about the declining usefulness of existing, older buildings throughout the country, primarily in central cities and older neighborhoods of all communities. The pattern of change, in part, reflects basic demographic and economic trends. The

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56. Section 48(g) was re-designated section 47 by section 11813 of the Revenue Reconciliation Act of 1990. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11813, 104 Stat. 1388–400, 1388–556 (1990) [hereinafter RRA 1990].

57. Revenue Act of 1978, Pub. L. No. 95-600, § 315(b), 92 Stat. 2763, 2828–29.

58. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, §212, 95 Stat. 172, 235–40 [hereinafter ERTA 1981]. In 1986, the credit was reduced to 10 percent for buildings placed in service before 1936 and 20 percent for certified historic structures. Tax Reform Act of 1986, Pub. L. No. 99-514, § 251, 100 Stat. 2085 2183–89 (1986) [hereinafter TRA 1986].

59. I.R.C. § 50(c)(1).

60. I.R.C. § 50(a). The taxpayer must recapture 100 percent of the credit if the property is disposed of in the first year. The amount of recapture is reduced by 20 percent in each subsequent year, and there is no recapture after five years. *Id*.

> pattern also is a response to changing architectural and engineering designs of buildings and the internal placement and flow of activities in manufacturing and commercial enterprise.
>
> *The committee believes that it is appropriate now to extend the initial policy objective of the investment credit to enable business to rehabilitate and modernize existing structures.* This change in the investment credit should promote greater stability in the economic vitality of areas that have been developing into decaying areas.[61]

3. Energy Tax Credit

The Energy Tax Act of 1978 added a 10 percent energy tax credit available to business taxpayers for investment in certain forms of energy property, including solar and wind energy property, but also including property such as shale oil equipment.[62] It was available in combination with the regular investment credit. Qualifying energy property was to be subject to quality and performance standards to be issued by the IRS after consultation with the Department of Energy.

In enacting the energy tax credit, Congress explained as follows:

> In reviewing the use of energy by the various sectors of the economy, the committee was informed that in 1975, industry used 20.5 quadrillion Btu's, or 36 percent of the total 56.5 quadrillion Btu's consumed for all purposes. The committee noted that industry has relied increasingly on oil and natural gas in the past two decades, rather than on coal, and that conservative use of all energy sources has been a rare practice. In view of the vulnerability of the economy to possible disruptions in the supply of natural gas and oil, and

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61. H.R. REP. NO. 95-1445, at 86 (1978) (emphasis added).

62. Energy Tax Act of 1978, Pub. L. No. 95-618, § 301, 92 Stat. 3174, 3194–3201. *See* STAFF OF JOINT COMM. ON TAXATION, 112th CONG., PRESENT LAW AND ANALYSIS OF ENERGY-RELATED TAX EXPENDITURES AND DESCRIPTION OF THE REVENUE PROVISIONS CONTAINED IN H.R. 1380, THE NEW ALTERNATIVE TRANSPORTATION TO GIVE AMERICANS SOLUTIONS ACT OF 2011, at 29 (Comm. Print 2011), [hereinafter JCT, ENERGY-RELATED TAX EXPENDITURES], http://www.jct.gov/publications/.html?func=startdown&id=4360 ("As the rationale for many of the tax incentives for renewable energy and conservation is to reduce the use of fossil fuels, many have questioned the rationale for tax subsidies for fossil fuel production. The principal argument in favor of the tax incentives for fossil fuel production is that a healthy domestic fossil fuels production base serves national security goals, by reducing our dependence on foreign sources of oil.")'

> in view of potential savings of oil and gas through more prudent use, the committee believes it is essential to encourage industry to conserve oil and natural gas and to convert, when economically and technically feasible, to sources of energy other than oil and natural gas. Accordingly, the committee has provided for a limited period of time, a series of tax credits which are designed to encourage conservation and conversion and the development of advanced energy technology.
>
> Consistent with these objectives, the committee bill denies the regular investment tax credit and accelerated depreciation methods for the purchase of new oil or natural gas fueled boilers and combustors . . . . The committee believes that in providing a positive incentive for conversion and conservation in the form of additional tax credits, and a disincentive in the form of the denial of certain current tax advantages, industry will be motivated to make significant efforts to conserve its use of scarce oil and natural gas as well as convert to other forms of fuel.[63]

Interestingly, the energy credit as originally enacted was refundable in the case of wind and solar projects.[64] The refundable element was accomplished by treating the credit as if it were allowed by then section 39 (since redesignated section 34),[65] rather than by section 38.[66] In addition, stacking rules were structured to allow a refund of excess credits when applying the nonrefundable investment credit (i.e. the regular investment credit and the energy credit for energy property other than solar or wind energy) and the (refundable) energy credit in tandem. The rationale for making the credit refundable was to "allow all businesses, irrespective of their income tax liability, to receive the full incentive effect."[67]

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63. H.R. REP. NO. 95-496, pt. 3, at 117 (1977).

64. *See* I.R.C. § 46(a)(10)(C) (1978). In instances where nonrefundable, the energy credit was available to be applied against 100 percent of tax liability. Contrast the limitation on use of the investment credit as originally enacted. *See supra* note 49 and accompanying text.

65. At the time of the Energy Tax Act of 1978, the provisions currently located in section 34 were located in section 39. Section 39 was re-designated as section 34 by section 471(c) of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 471(c), 98 Stat. 494, 826, 198-D [hereinafter DRA 1984].

66. To the extent a credit allowed under section 34 exceeds the taxpayer's income tax liability, section 6401 treats such excess as an overpayment.

67. S. REP. NO. 95-529, at 71 (1977), *reprinted in*, 1978 U.S.C.C.A.N. 7942, 8003 ("The committee believes that the urgency of the energy problem

The Crude Oil Windfall Profits Tax Act of 1980, without explanation, simultaneously repealed the refundable element of the energy credit and increased the energy credit for solar, wind, and geothermal properties to 15 percent.[68]

4. *Alcohol Fuels Credit*

The Crude Oil Windfall Profits Tax Act of 1980 also added section 44E, the Alcohol Fuels Credit,[69] which provided a 40-cent-per-gallon credit for the production of alcohol and alcohol blended fuels (in the case of blended fuels, the credit would only apply to the alcohol portion of the fuel).[70] Simultaneously, section 86 (since renumbered section 87)[71] was enacted, which required the taxpayer to include in gross income an amount equal to the amount of the Alcohol Fuels Credit allowed.[72] The Energy Tax Act of 1978 had provided an exemption from the 4-cent-per-gallon Federal excise tax on motor fuel for motor fuel that was comprised of at least 10 percent alcohol. Concerned that this exemption provided no incentive to producers to produce fuel with greater than 10 percent alcohol (or, indeed, with *any* alcohol if *less* than 10 percent alcohol), Congress adopted the Alcohol Fuels Credit described above and required its inclusion in

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requires a power measure designed specifically to reduce the consumption of oil and natural gas by industrial, utility, and institutional users.").

68. Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 221, 94 Stat. 229, 260–61 (1980) [hereinafter COWPTA 1980]. *See infra* notes 188–227 and accompanying text (discussing the current iteration of energy credits).

69. Section 44E was re-designated section 40 by section 471(c)(1) of the Deficit Reduction Act of 1984. DRA 1984, *supra* note 65, § 471(c)(1), 98 Stat. at 826.

70. COWPTA 1980, *supra* note 68, § 232(b)(1), 94 Stat. at 273.

71. Section 86 was re-designated as section 87 by section 121(a) of the Social Security Amendments of 1983. Social Security Amendments of 1983, Pub. L. No. 98-21, § 121(a), 97 Stat. 65, 80.

72. COWPTA 1980, *supra* note 68, § 232(c), 94 Stat. at 276–77. The question presents itself as to the implication to *state* taxes of such federal credit regimes. For example, as noted, section 87 requires that a taxpayer claiming the federal cellulosic biofuels credit take the credit into income. If "state follows federal," could a taxpayer be faced with paying additional state taxes due to an income inclusion triggered by a credit against federal taxes producing no state tax benefit and not reflecting an "accretion to wealth" for state tax purposes? Anecdotal evidence suggests that a number of States are advancing such a position (rendered all the more dubious when one considers the derivation of the income inclusion requirement). *See infra* note 73 and accompany text.

in income to coordinate the credit with the excise tax exemption.[73] Currently, the Alcohol Fuels Credit is the sum of the alcohol mixture credit, the alcohol credit, the small ethanol producer credit, and the cellulosic biofuel producer credit.[74] The Alcohol Fuels Credit (other than the cellulosic biofuel producer credit) expired on December 31, 2011.[75] The cellulosic biofuel producer credit will expire after December 31, 2012.[76]

5. Nonconventional Source Fuels Credit

Finally, the Nonconventional Source Fuels Credit (originally located at section 44D, then section 29, and now section 45K) was established under the Crude Oil Windfall Profit Tax Act of 1980[77] and provided a production tax credit for the production of fuels derived from nonconventional sources equal to $3 multiplied by barrel-of-oil equivalent of qualified fuels sold by the taxpayer.

In enacting the nonconventional source fuels credit, Congress explained as follows:

> The committee believes that a tax credit for the production of energy from alternative sources will encourage

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73. *See* STAFF OF JOINT COMM. ON TAXATION, 97th CONG., GENERAL EXPLANATION OF THE CRUDE OIL WINDFALL PROFIT TAX ACT OF 1980, at 92 & n.3 (Comm. Print 1981):

> The reason for this income inclusion is that the benefit is intended to be generally the same as the benefit of a 4-cent-per-gallon excise tax exemption for a gallon of gasohol which is comprised of 10 percent alcohol and 90 percent otherwise taxable motor fuels.
>
> . . .
>
> Because the excise tax is a deductible expense for the person on whom it is imposed (the producer in the case of gasoline or the retailer in the case of diesel fuel or special motor fuels), it is necessary to have an amount equivalent to the income tax credit (or refund) includible in income to produce the same net tax effect. Thus, for a taxpayer in the 40 percent marginal tax bracket, a 40 cent excise tax exemption is worth 24 cents after income tax since the loss of the deduction will increase income tax liability by 16 cents. Similarly a 40 cent income tax credit plus the inclusion in income of 40 cents will result in a benefit of 24 cents after income tax.

74. I.R.C. § 40(a).

75. I.R.C. § 40(e)(1).

76. *See* I.R.C. § 40(b)(6)(H), (e)(1).

77. COWPTA 1980, *supra* note 68, § 231, 94 Stat. at 268–72.

> the development of these resources by decreasing the cost of their production relative to the price of imported oil.
>
> These alternative energy sources typically involve new technologies, and some subsidy is needed to encourage these industries to develop to the stage where they can be competitive with conventional fuels. The information gained from the initial efforts at producing these energy sources will be of benefit to the entire economy.
>
> Thus, the production credit in the committee substitute is designed to apply only for a limited period of time, after which the committee expects that no special incentive will be needed.[78]

This credit was allowed to expire at different times for different fuels and was fully phased out in 2010.[79]

A section 29 credit monetization structure that was in vogue for a time relied on a retained production payment technique: The property owner "S" would sell the property producing the qualified fuel to the purchaser "P" for (i) cash; (ii) a retained production payment equal to not more than 95 percent of the estimated present value of the production from the entire property; (iii) a contingent interest in any reserves that may exist after the production of all the currently estimated reserves; (iv) a percentage of the value of the section 29 credits generated from the property; and (v) an option to reacquire the property at a date certain for its then fair market value. In addition, S entered into a management contract with P to manage the property for a fee. This transaction effectively transferred the credits from S to P because (i) P was treated as holding the full economic interest in the property and owning the qualified fuel at the time of production and sale; and (ii) S's retained production payment was not treated as an economic interest but as a purchase money mortgage under section 636.[80]

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78. S. REP. NO. 96-394, at 87 (1979).

79. *See* I.R.C. §§ 45K(e) (credit generally applies only to fuel produced from a well or in a facility placed in service after December 31, 1979 and before January 1, 1993, and which is sold before January 1, 2003); § 45K(f) (extension for biomass and liquid, gaseous, or solid fuels produced from coal: production facility must be placed in service before July 1, 1998 and fuel must be sold before January 1, 2008); § 45K(g) (extension for coke and coke gas: facility must be placed in service before January 1, 1993 or after June 30, 1998 and before January 1, 2010; and fuel must be sold during four year period beginning on the later of January 1, 2006, or the date the facility is placed in service).

80. *See*, *e.g.*, I.R.S. Priv. Ltr. Rul. 2001-03-009 (Jan. 22, 2001); I.R.S. Priv. Ltr. Rul. 2001-02-010 (Jan. 16, 2001), I.R.S. Priv. Ltr. Rul. 2000-50-004 (Dec. 18, 2000).

B. *The Tax Benefit Transfer Rules*

1. *Enhanced Incentives for Capital Investment*

The Economic Recovery Tax Act of 1981[81] (ERTA) ushered in significant reductions in the federal income tax payable by capital-intensive businesses via the enactment of the Accelerated Cost Recovery System (ACRS), significantly shortening the recovery periods for capital investments, and the enhancement of the investment credit.[82] By comparison to the Asset Depreciation Range (ADR) system that preceded it, under which an asset's cost basis (less salvage value) was recovered over its estimated useful life, the new ACRS allowed for depreciation of the cost of many types of assets (without reduction for salvage value) over as little as five, or, in certain cases, even three years[83] using statutory percentages based on the 150 percent declining balance method (markedly faster than economic depreciation of the asset). Furthermore, a full 10 percent investment credit was allowed for eligible property in the 5-year and 10-year recovery classes and 15-year public utility property class.[84] Finally, under ERTA it continued to be the case that the basis of the property was not required to be reduced by the amount of the investment credit.[85] The combined effect of these changes in certain cases was to eliminate tax, or even establish a *negative* tax rate, on income from qualifying capital equipment.[86] The allowance of an interest

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81. ERTA 1981, *supra* note 58, 95 Stat. at 172.

82. *See* H.R. CONF. REP. NO. 97-215, at 289–90 (1981), *reprinted in* 1981 U.S.C.C.A.N. 285, 377–78 (over $140 billion in tax savings predicted for the period through 1986 on the basis of these provisions).

83. The cost of eligible property was recovered over a three-year, five-year, ten-year or fifteen-year recovery period, depending on the recovery class of the property as classified with reference to the ADR system of prior law.

84. ERTA 1981, *supra* note 58, § 211(a), 95 Stat. at 227. For property with a useful life of 3 years, however, the credit was limited to 60 percent. The amount of income tax liability that could be reduced by investment credits in any year was limited to $25,000 plus 85 percent of the tax liability in excess of $25,000. Unused credits could be carried back three and forward fifteen years.

85. The requirement that basis be reduced by the amount of the investment tax credit was repealed in 1964. *See supra* note 42 and accompanying text. The basis reduction requirement was not reinstated until 1982. *See* Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 205(a)(1), 96 Stat. 324, 427–28 [hereinafter TEFRA 1982].

86. This is a function of comparing the present value of taxes to be incurred in respect of the income to be generated by the asset over its economic useful life to the present value of the tax benefit to be generated by ACRS deductions and the investment credit. A provision permitting 100 percent expensing of the cost of a capital asset has a similar effect. *See* Alvin C. Warren, Jr. & Alan J. Auerbach, *Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing*, 95 HARV.

expense deduction in connection with the financing of such equipment only increases the likelihood of a negative tax rate on such income.[87]

2. *The Safe Harbor Leasing Rules*

ERTA also included in newly enacted section 168(f)(8) a "safe harbor leasing" regime, apparently in part in response to the perception that the enhanced incentives for capital investment enacted as part of ERTA otherwise would not be exploited to fullest advantage, as many taxpayers could lack a sufficient base fully to take, current advantage of them.[88] Under the safe harbor leasing rules, an owner of "new section 38 property" qualifying for accelerated cost recovery deductions and investment credit (other than a qualified rehabilitated building), via an election, could transfer "federal tax ownership" of the property to a second party under the auspices of a sale-leaseback or other form of putative lease without giving up substantive ownership of the property. Thus, the purchaser of federal tax ownership of the property would be entitled to the associated tax benefits of ownership even though it were to possess none of the benefits or burdens of ownership and without doubt would flunk the modern "economic substance" standard of section 7701(o).

The "federal tax owner" could then cede the investment credit to the "lessee," if the parties so agreed, under the mechanism discussed above. Assuming that under "true lease" principles the "lessee" is the substantive owner of the property, the substantive owner in such a case accomplishes a sale of the ACRS deductions while retaining the investment credit. Otherwise (i.e., absent the election to cede the credit) the transaction effects a sale of both the ACRS deductions and the investment credit to a purchaser lacking the traditional hallmarks of an owner of the property.[89]

The Senate Committee Report explained the rationale for enacting the safe harbor leasing rules as follows:

L. REV. 1752, 1754–56 (1982) [hereinafter Warren & Auerbach, *Fiction of Safe Harbor Leasing*]. *See also* H.R. REP. NO. 99-426, at 145 (1985) (under law prior to 1986 Act changes "a corporation in the top tax bracket can now write off about 110 percent of the cost of a new car in just three years, even though the car . . . will on average remain in operation for an additional seven or eight years").

87. Warren and Auerbach, *Fiction of Safe Harbor Leasing*, *supra* note 86, at 1757 & n.22. In theory, just as interest expense on a borrowing to acquire an asset that generates a tax-exempt return is disallowed under section 265, so too should interest expense on a borrowing to acquire a "deductible" asset.

88. I.R.C. § 168(f)(8). An argument reportedly strongly advanced at the time by lobbyists for the transportation, steel, and paper-making industries. *See* Richard S. Koffey, *Safe Harbor Leasing*, 34 U.S.C. ANN. INST. ON FED. TAX'N, 2-1, 2-20 & n. 47 (1982) [hereinafter Koffey, *Safe Harbor Leasing*].

89. *See infra* note 96 (illustrating the mechanical operation of the rules).

> The committee recognizes that some businesses may not be able to use completely the increased cost recovery allowances and the increased investment credits available for recovery property under ACRS. ACRS will provide the greatest benefit to the economy if ACRS deductions and investment tax credits are more easily distributed throughout the corporate sector. *Under present law, three-party financing leases ("leverage" leases) are now widely used to transfer tax benefits to users of property who do not have sufficient tax liability to absorb those benefits. The committee has decided to facilitate the transfer of ACRS benefits through these types of transactions.* Under current administrative practice, however, lease characterization is subject to specific IRS guidelines. Moreover, court decisions have not prescribed clear guidelines as to the appropriate tax characterizations of financing leases. Since the committee has decided that lease characterization should be more available, the committee bill establishes an exception to current judicial and administrative guidelines dealing with leasing transactions.
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> . . .
>
> The committee bill creates a safe harbor that guarantees that a transaction will be characterized as a lease for the purposes of allowing investment credits and capital cost recovery allowances to the nominal lessor. Lessors will be able to receive cost recovery allowances and investment tax credits with respect to qualified leased property, while *it is expected that lessees will receive a very significant portion of the benefits of these tax advantages through reduced rental charges for the property (in the case of finance leases) or cash payments and/or reduced rental charges in the case of sale-leaseback transactions*.[90]

Thus, the tax characterization of the transaction as a lease was a matter of stipulation by agreement. Such factors as pre-tax profit, location of title to the property, and the benefits and burdens of ownership of the property (as between lessor and lessee) were not taken into account. Under the terms of the lease, the lessee could have a bargain purchase option to acquire the property. The property could be of a kind such that its value and use is specific to the lessee (so-called "limited use property"); moreover, a party could act as lessor solely for a percentage of the property (and be permitted a parallel percentage of the tax benefits).

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90. S. REP. NO. 97-144, at 61–62 (1981) (emphasis added).

There were certain vestiges of the IRS "true lease" guidelines referred to in the Committee Report above that remained in place but for the purpose of preventing parties from "gaming the system" rather than out of some notion that any remnant of economic substance should be retained as a predicate for tax ownership.[91] These vestiges included a minimum "at risk" investment by the nominal lessor of 10 percent of its adjusted basis in the property (one author speculates this was included to give the lessor an incentive to ensure transactions met the requirements of the rules, thereby taking on some of the IRS's audit burden and safeguarding against fraud and abuse)[92] and a maximum lease term generally equal to 90 percent of the asset's useful life (to put an end point on the income deferral opportunity embedded in the lease structure).[93] The safe harbor leasing provisions also required a minimum lease term equal to the recovery period for the asset (to

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91. Rev. Proc. 75-21, 1975-1 C.B. 715, *modified by* Rev. Proc. 76-30, 1976-2 C.B. 647, Rev. Proc. 79-48, 1979-2 C.B. 529, and Rev. Proc. 81-71, 1981-2 C.B. 731, *modified and superseded by* Rev. Proc. 2001-28, 2001-1 C.B. 1156. Revenue Procedure 75-21 provided that the IRS will consider the lessor in a leverage lease transaction to be the owner of property if: (1) the lessor maintains a minimum unconditional "at-risk" investment of 20 percent throughout the entire lease term, including extensions; (2) the lessee does not have a contractual right to purchase the property from the lessor at a price less than its fair market value or have a contractual right to cause any other party to purchase the property; (3) the lessee does not furnish any part of the cost of the property or any improvements or additions to the property, except for severable additions or improvements that are owned by the lessee and are "readily removable without causing material damage to the property;" (4) the lessee does not lend to the lessor any of the funds necessary to acquire the property or guarantee any indebtedness created in connection with the acquisition of the property by the lessor; and (5) the lessor represents and demonstrates that it expects to receive a profit from the transaction apart from tax benefits. Revenue Procedure 75-21 has been modified and superseded by Revenue Procedure 2001-28, which is generally the same as Revenue Procedure 75-21, but (1) allows the lessee to furnish amounts to pay for certain severable *and* nonseverable improvements; (2) clarifies that the "uneven rent test" of Regulations section 1.467-3(c)(4) will not affect the ability of a taxpayer to obtain an advance ruling under Revenue Procedure 2001-28; and (3) clarifies that the Service will not issue advance rulings with respect to the lease of "limited use property," i.e., property for which at the end of the lease term there will probably be no potential lessees or buyers. *See also* Rev. Proc. 75-28, 1975-1 C.B. 752, *modified and superseded by* Rev. Proc. 2001-29, 2001-1 C.B. 1160 (setting forth information and representations required to be furnished by taxpayers in requests for advance rulings on leveraged lease transactions within the meaning of Revenue Procedure 75-21); Proc. 2007-65, 2007-45 C.B. 967 (providing a safe harbor for wind farm partnerships between project developers and investors if certain conditions are met). *See infra* Part II.F.2.c. (discussing Revenue Procedure 2007-65).

92. *See* Koffey, *Safe Harbor Leasing*, *supra* note 88, at 2–14.

93. *Id.*

preclude a "lessee" from securing rent deductions at a faster pace than cost recovery deductions under section 168 that otherwise would be available to it if it retained "federal tax ownership") and included rules regulating the maturity of the debt, the setting of the interest rate, and the timing of rent and interest.

In light of the fact that under the safe-harbor leasing rules, the "tax owner" did not need any real connection to the asset generating the tax benefits (it simply claimed the tax benefit), the safe harbor leasing rules were set up to visit the consequences of a recapture event on the lessee-user rather than the nominal tax owner.[94] If the lessee-user acquired the property and subsequently disposed of it, it was subject to the recapture rules of sections 47 and 1245 "as if the lessee had been considered the owner of the property for the entire term of the lease."[95]

As can be seen, the effect of section 168(f)(8) was to render both the investment credit and the cost recovery deductions available in respect of purchases of new equipment *transferable*, but only *separately* transferable via the ceding mechanism. The construct was not such as to allow sales of tax credits in the manner that some of the state tax systems of today do (the topic taken up in Part VI below). To the contrary, in a "wash lease" structure (which was the paradigmatic form of safe harbor lease) the nominal lessor was charged with an accrual of rent offset by matching amounts of principal and interest deemed owing under a purchase money loan from the lessee, and the lessee was permitted a rental deduction.[96] Even though the lease

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94. The regulations promulgated under section 168(f)(8) ensured that *one* of the parties to a safe harbor lease had a connection to the asset, whereas on the face of the statute arguably the transaction could be entirely notional (neither party having any connection to the asset being "leased"). Regulations section 5c.168(f)(8)-1(d) provided as follows:

> Notwithstanding any other section, if neither the lessor nor the lessee would be the owner of the property without regard to section 168(f)(8), or, if any party with an economic interest in the property (other than the lessor or lessee or any subsequent transferee of their interests) claims ACRS deductions or any investment tax credit with respect to the leased property, an election under section 168(f)(8) with respect to such property shall be void as of the date of the execution of the lease agreement.

95. STAFF OF JOINT COMM. ON TAXATION, 97th CONG. COMM. PRINT GENERAL EXPLANATION OF THE ECONOMIC RECOVERY ACT OF 1981, at 107 (1981), http://www.jct.gov/publications.html?func=startdown&id=2397. Any credit or depreciation recapture by the lessor will not be again recaptured by the lessee. *Id*.

96. To illustrate: Corporation A purchases "5-year recovery property" eligible for the investment credit for $100,000. Corporation A has significant net operating loss carryovers and therefore decides to sell the ACRS deductions and investment credit to Corporation B. To accomplish this, Corporation A, in form, sells the property to Corporation B for $20,000 in cash plus an $80,000 amortizing

effectively was a fiction, the required tax reporting flowed from the tenets of a true lease.[97]

In their article on the safe harbor leasing regime, Warren and Auerbach comment: "[T]he ITC and ACRS deductions can be seen either as structural components of the income tax that reduce the effective tax rate or as government subsidies that are located in the Internal Revenue Code merely as a matter of convenience."[98] Of course, if viewed in the former light, as incident to the computation of the "normal tax" of the taxpayer, these tax benefits should be no more transferable than the deduction for any other expense incurred in the conduct of a taxpayer's business.[99] When expenses outstrip current income, the carryover provisions of the Code ensure that, over time, taxes are normalized as an asset produces revenue. By contrast, if the ACRS/ITC benefits are viewed instead as a subsidy, transferability of the benefits can be justified as a mechanism for delivering the subsidy.[100] A transfer of tax benefits via the safe harbor leasing rules

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purchase money nonrecourse note ("Note") payable over ten years, calling for level payments. Corporation B leases the property back to Corporation A pursuant to a 10-year lease, calling for rent payments precisely matching the payments due under the Note. The documentation for the transaction includes an explicit set-off provision, exonerating the parties from any obligation to make any actual payments of rent or principal and interest, respectively. Finally, under the terms of the lease, Corporation A has the right to "repurchase" the property at the end of the lease for $10.

If the parties make a joint election under section 168(f)(8), in exchange for its up-front payment of $20,000, Corporation B will be entitled to claim $100,000 in ACRS deductions over five years (no basis reduction for the investment credit was required at the time) and a $10,000 investment credit with respect to the property. Corporation B also will end up with $80,000 in net income (rental income less interest expense will equate to the principal amount of the Note). Over the term of the lease, Corporation A will end up with $80,000 in net deductions (gross rent expense less interest income under the Note should equal the principal amount of the Note).

In the foregoing example, the putative lessee has defrayed the cost of acquisition of the property by $20,000, the amount of the putative lessor's up-front payment. In this way, the lessor can be seen as a vehicle of the U.S. Treasury Department. In light of the $20,000 "government" subsidy, which reduced the lessee's net investment from $100,000 to $80,000, the lessee will be entitled to only $80,000 in deductions. Having "fronted" the $20,000 to the lessee, the lessor is "reimbursed" by the Treasury via the net transferred tax benefits.

97. *See infra* note 105 and accompanying text.

98. *See* Warren & Auerbach, *Fiction of Safe Harbor Leasing*, *supra* note 86, at 1756.

99. *See* Koffey, *Safe Harbor Leasing*, *supra* note 88, at 2–4.

100. As Warren and Auerbach remark:

> [I]f the purpose of ACRS and the ITC is to reduce capital income taxation, loss companies should not be included among the beneficiaries of these provisions, because such companies are

operated to de-link the tax benefits from the asset upon which predicated and deliver a cash benefit to the transferor divorced from any future production of income by the asset — the hallmark of a subsidy.[101]

Interestingly, in the period leading up to enactment of ERTA, prior to turning to the safe harbor leasing solution, Congress gave some consideration to making the investment credit *refundable*[102] in order that start-up companies and loss companies not otherwise in a position to take advantage of the credit on a current basis would be on par with profitable companies able to make full use of the credit.[103] The portion of the credit in excess of the company's current tax liability would trigger a right on the part of the company to a cash payment (subsidy) from the government. As discussed above, refundability already had been experimented with in the context of the energy credit in 1978 and was newly repealed at this juncture.

The idea of making the credit refundable reportedly was set aside due to concerns as to the potential for fraud and abuse and, perhaps more pointedly, the possible requirement for an appropriation and involvement of the Appropriations Committee in the tax legislative function.[104] In addition, it

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> already effectively exempt. If, however, ACRS and the ITC are considered subsidies rather than a means of reducing capital income taxation, the principle of competitive neutrality supports extending these subsidies to loss companies. . . .

Warren & Auerbach, *Fiction of Safe Harbor Leasing*, *supra* note 86, at 1760–61 (footnote omitted). The transfer mechanism, of course, is a way of extending the subsidy to loss companies.

101. So viewed, ACRS and the ITC "constitute an expenditure program by which the government intends to reduce the price of recovery property in order to encourage its purchase, capital formation, and the economic benefits that are thought to ensue." Id. at 1758.

102. *See* Koffey, *supra* note 88, at 2–3 (recounting that Senator Danforth, a member of the Senate Finance Committee, endorsed this idea).

103. *See supra* note 100 and accompanying text (alluding to the concept of "competitive neutrality").

104. *See* 127 CONG. REC. 30,916–17 (1981) (statement of Senator Russell B. Long) [hereinafter Statement of Senator Long]:

> Mr. President, this Senator has always felt that it would have made even better sense to say with the investment tax credit that it was refundable.
>
> . . .
>
> Some years ago Senator Kennedy joined me in offering just such a bill. I see my friend from New Jersey (Mr. Bradley) finds some appeal in that approach. I say you would not have to have a leasing arrangement.
>
> . . .
>
> That would be the logical way or the most logical way to do it. But if you seek to do it that way, you run into a problem. The

was perceived that a refundable credit would not have allowed for sufficient flexibility as to the party to be allocated ACRS deductions with respect to qualified property (whereas the safe harbor leasing rules effected a transfer of the right to these deductions via election).[105]

The concern about fraud and abuse is often cited by those opposed to liberal use of refundable credits as a mechanism for implementing social goals.[106] The fact that refundability was perceived as encroaching on the province of the Appropriations Committee, whereas transferability was not, perhaps underscores a failure of the system.[107]

> Appropriations Committee feels that we might use a refundable tax credit, even though it might be a good device in certain situations it might tend to be used in lieu of an appropriation to do something. And so our friends on the Appropriations Committee tend to resist very bitterly, in a determined fashion, to use of a refundable tax credit to achieve such a purpose.
>
> . . .
>
> Now, if we are not going to use that, then there are ways the taxwriting committee can achieve the same purpose in ways that fall entirely within the jurisdiction of the taxwriting committee; hence, the leasing rule. . . .

Senator Long credits the safe harbor leasing idea, not to the Senate Finance Committee or the House Ways & Means Committee, but to a suggestion made by the Treasury Department and, in particular, to an article appearing in the *Wall Street Journal* written by John E. Chapoton of the Treasury.

105. *See* Koffey, *Safe Harbor Leasing*, *supra* note 88, at 2–3. *Cf.* STAFF OF JOINT COMM. ON TAXATION, 97th CONG., SAFE HARBOR LEASING PROVISIONS UNDER ACCELERATED COST RECOVERY SYSTEM 2 (Comm. Print 1981), http://www.jct.gov/publications.html?func=showdown&id=2366:

> During consideration of the tax bill, three options were considered: (1) a refundable investment tax credit, (2) a pure sale of tax benefits, and (3) a safe harbor guarantee of lease treatment. The first two options were not adopted primarily because of administrative difficulties in determining whether the property has been disposed of by the user in a transaction requiring recapture of investment credit or depreciation. Instead, the leasing rules were chosen as a means of introducing a form of transferability of tax benefits that differs from pure transferability in that the lessor must pick up an income stream from the transaction in the form of rent payments.

106. This objection to the use of a refundable credit was raised in the context of the discussion leading to the enactment of the safe-harbor leasing rules. *See* Koffey, *Safe Harbor Leasing*, *supra* note 88, at 2–3. *See also* Lily L. Batchfelder, Fred T. Goldberg, Jr. & Peter R. Orzag, *Efficiency and the Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 65–66 (2006).

107. The current director of the Congressional Budget Office, Douglas W. Elmendorf, has taken the position that certain tax expenditures are "more similar to

3. *Revision and Repeal of the Safe Harbor Leasing Rules*

The safe-harbor leasing rules were short-lived. Within six months of enactment, there were calls for either repeal of the provision or sweeping changes to it. As reported in the February 19, 1982, edition of The New York Times, "Senator Dole, chairman of the Senate Finance Committee, today in effect halted one of the most disputed aspects of last year's sweeping tax cut: the sale of unused business tax credits. . . ."[108] Nonprofit governmental agencies, such as New York's Metropolitan Transit Authority, were benefiting from it, as were "profitable companies, such as Occidental Petroleum Corporation and the LTV Corporation."[109] Senator Dole commented that "[h]owever desirable many tax theorists find the current safe harbor leasing rules in the abstract, they are indefensible in a year in which the Federal deficit will reach nearly $100 billion," and he vowed "to see that this hemorrhage to the Treasury is halted today."[110]

The immediate upshot was the replacement of the safe harbor leasing rules with the "finance leasing rules" enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982.[111] Under these new rules, the fact that the lessee had an option to purchase the property from the lessor at a fixed price of 10 percent or more of its original cost or that the property is "limited use property" was not to be taken into account in determining if the lease is a true lease.[112] The rules were generally to be effective for agreements entered into beginning in 1984, subject to certain specified restrictions.[113] However,

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entitlement programs than to discretionary spending because they are not subject to annual appropriations and any person or entity that meets the requirements can receive the benefits." DOUGLAS W. ELMENDORF, CONG. BUDGET OFFICE, CONFRONTING THE NATIONS FISCAL POLICY CHALLENGES 45 (2011), http://www.cbo.gov/ftpdocs/124xx/doc12413/09-13-FiscalPolicyChallenges.pdf. One commentator has suggested that this statement is a

> "gross generalization" as many tax expenditures, commonly referred to as "extenders," including the new markets tax credit, are subject to annual renewal, much like annual appropriations . . . [and] many tax expenditures cannot be claimed by any person or entity that simply meets the requirements; the LIHTC, tax-exempt bond financing and NMTC are such examples.

Michael J. Novogradac, *Super Committee Takes Center Stage*, NOVOGRADAC J. OF TAX CREDITS, Oct. 2011, at 3, http://www.novoco.com/journal/2011/10/novogradac_jtc_2011-10_ww_pg4.pdf.

108. Jonathan Fuerbringer, *Business Tax Cut Affecting Leasing Appears Near End*, N.Y. TIMES, Feb. 20, 1982, at 11.

109. *Id*.

110. *Id*.

111. TEFRA 1982, *supra* note 85, § 209, 96 Stat. at 442–47.

112. *Id*. at § 209(a).

113. *Id*. at § 209(d).

the Tax Reform Act of 1984 postponed the effective date so as to generally apply to agreements entered into after December 31, 1987.[114] The Tax Reform Act of 1986, in turn, repealed the finance leasing rules altogether, effective for agreements entered into after December 31, 1986.[115]

4. *The* Friendship Dairies *Case*

The repeal of the safe harbor leasing rules, of course, marked a return to the *status quo ante* under which the eligibility of a lessor to claim accelerated depreciation deductions and the investment credit was dependent on the lease qualifying as a "true lease" under administrative guidance and judicial decisions.

Friendship Dairies, Inc. v. Commissioner[116] serves as an appropriate counterbalance to the foregoing discussion of the safe harbor leasing rules. The tax year involved was 1980, thus pre-dating the liberalizations under ERTA. The taxpayer was the lessor under a sale-leaseback of computer equipment that had "no possibility of economic profit without taking the investment tax credit into account."[117] The taxpayer conceded it would not have entered into the transaction but for the promised investment credit, and the court found that the tax objective was the only real purpose of the transaction.

The interesting facet of the case is the court's consideration of whether, as the taxpayer urged, the investment credit could be considered in evaluating the profit potential of the transaction. It did so with reference to congressional intent. Based on its examination of the legislative history of the Revenue Act of 1962, the court concluded that "[t]he credit was not intended to serve as a substitute for economic profit":[118]

> The House Report states that the credit "will stimulate additional investments since it *increases* the expected profit" from the use of depreciable assets. H. Rept. No. 1447, *supra*, 1962-3 C.B. at 412. The Senate Report states that the credit "will stimulate investments, first by reducing the net cost of acquiring depreciable assets, which in turn *increases* the rate of return after taxes arising from their acquisition." S. Rept. No. 1881, *supra*, 1962-3 C.B. at 717. *At no point do the committee reports indicate that the credit was intended to transform unprofitable transactions into profitable ones.*[119]

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114. DRA 1984, *supra* note 65, § 12, 98 Stat. at 503–05.
115. DRA 1986, *supra* note 58, § 201(a), 100 Stat. at 2121–37
116. 90 T.C. 1054 (1988).
117. *Id*. at 1061.
118. *Id*. at 1065.
119. *Id*. at 1065–66 (emphasis in last sentence added).

The court therefore concluded that the investment credit cannot be considered in analyzing a lease transaction for economic substance.

> *Simply put, O.P.M. was selling, and petitioner was buying an investment tax credit* . . . . It would be a distortion of congressional intent to conclude that it was intended that petitioner be induced to engage in a paper transaction that did not in any way affect the demand for computer equipment.[120]

Accordingly, the taxpayer's deductions for depreciation and its claimed investment tax credit were disallowed.

The conclusion of the court in *Friendship Dairies* is consistent with the view of the investment credit and accelerated depreciation deductions as "structural components" of the Code incident to the computation of the normal tax of the taxpayer and, as such, not appropriately "transferable." For these tax benefits to be incident to the computation of the taxes of a lessor, the lessor should have sufficient indicia of ownership of the underlying assets to warrant it.

C. The Tax Reform Act of 1986: Neutrality and Targeted Tax Credits

The Tax Reform Act of 1986 ("1986 Act") famously broadened the tax base and reduced tax rates — an idea actively under consideration today and in accord with the thinking reflected in the Simpson-Bowles Report.[121] In 1986, the top corporate tax rate was reduced from 46 percent to 34 percent and the top individual tax rate was reduced from 50 percent to 28 percent. "Loopholes" were closed through the enactment of such provisions as the passive activity loss rules. Among the goals of base broadening was to take the Internal Revenue Code out of the business of picking "winners" and "losers" in business by eliminating tax incentives that favored certain types of businesses over others and in doing so allowing for a dramatic cut in tax rates while achieving revenue neutrality. This, in part, was achieved by repealing the investment credit:

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120. *Id*. at 1067 (emphasis added).

121. NAT'L COMM'N ON FISCAL RESPONSIBILITY AND REFORM, THE MOMENT OF TRUTH 15 (2010) [hereinafter NAT'L COMM'N, MOMENT OF TRUTH], http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf (Plan is designed to "[s]harply reduce rates, broaden the base, simplify the tax code, and reduce the deficit by reducing the many 'tax expenditures' — another name for spending through the tax code.").

> Under present law, the tax benefits arising from the combination of the investment tax credit and accelerated depreciation are more generous for some equipment than if the full cost of the investment were deducted immediately — a result more generous than exempting all earnings on the investment from taxation. At the same time, assets not qualifying for the investment credit and accelerated depreciation bear much higher effective tax rates. The output attainable from our capital resources is reduced because too much investment occurs in tax-favored sectors and too little investment occurs in sectors that are more productive, but which are tax-disadvantaged. The nation's output can be increased simply by a reallocation of investment, without requiring additional saving.
>
> The committee believes the surest way of encouraging the efficient allocation of all resources and the greatest possible economic growth is by reducing statutory tax rates. A large reduction in the top corporate tax rate can be achieved by repealing the investment tax credit without reducing the corporate tax revenues collected. One distorting tax provision is replaced by lower tax rates which provide benefits to all investment. A neutral tax system allows the economy to most quickly adapt to changing economic needs.[122]

At the same time sustaining and improving global competitiveness was an articulated concern. Thus, the Modified Accelerated Cost Recovery System established by the 1986 Act in certain instances enhanced the already generous cost recovery system under ACRS, changing the rate of acceleration under the cost recovery schedules for property in the 5-year and 10-year classes from the 150-percent declining balance to the 200-percent

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122. S. REP. NO. 99-313, at 96 (1986). The "Blue Book" put it this way:

> Congress desired to make the tax treatment of diverse economic activities more even. Neutral taxation promotes the efficient allocation of investment and yields productivity gains without requiring additional saving. The Act repeals the investment tax credit, which discriminated against long-lived investment and was used as a tax shelter device. The incentive for investment provided by the credit instead will be provided by lower tax rates and accelerated depreciation.

STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., GENERAL EXPLANATION OF TAX REFORM ACT OF 1986, at 10 (Comm. Print 1987), http://www.jct.gov/jcs-10-87.pdf.

declining balance method, and adding a 7-year recovery class.[123] The Senate Finance Committee Report offers this explanation:

> The committee believes some further acceleration in the rate of recovery of depreciation deductions should be provided to compensate partly for the repeal of the investment tax credit. The committee is cognizant that other nations heavily subsidize business investments through tax and other policies, and the committee does not believe such policies can be completely ignored. Therefore, it was the committee's judgment that to maintain the international competitiveness of U.S. business changes were necessary to the accelerated cost recovery system which, in certain cases, provided greater incentives than those existing under present law. . . . Together with the large tax rate reductions, investment incentives will remain high and the nation's savings can be utilized more efficiently.[124]

In addition, the energy credit and the historic rehabilitation credit (as discussed above, both introduced in 1978) were extended (in both cases, subject to various adjustments) despite the repeal of the regular investment credit.[125] The Senate Report accompanying the 1986 Act explains the extension of the energy credit as follows:

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123. A 20-year class of personal property also was established.

124. S. REP. NO. 99-313, at 96 (1986).

125. The energy credit for solar energy property was set to 15 percent in 1986, 12 percent in 1987, and 10 percent in 1988, and was to terminate thereafter. The geothermal tax credit was extended at 15 percent in 1986 and 10 percent in 1987 and 1988 and set to terminate thereafter. The tax credit for biomass energy property was set at 15 percent in 1986 and 10 percent in 1987 and set to terminate thereafter. The credit for ocean thermal property was set at 15 percent through 1988 and was to terminate thereafter. Wind energy tax credits were allowed to expire at the end of 1985. *See* H.R. REP. NO. 99-426, at 218–22 (1986); S. REP. NO. 99-313, at 274–77 (1986); H.R. CONF. REP. NO. 99-841, vol. 2, at 128–29 (1986). The House bill extended the energy tax credits for solar and geothermal property. The committee stated that these alternative energy sources had "demonstrated responsiveness to the credit and warrant[ed] additional limited support." H.R. REP. No. 99-426, at 220 (1986). The House eliminated the energy credits for wind, ocean thermal, and biomass property, explaining that these sources

> have not demonstrated that the stimulation to demand from a tax credit is necessary. The absence of favorable technological developments in other renewable energy areas or the inability to find ways to reduce potentially high capital or operating costs have convinced the committee that the energy tax credits for most of the

> The committee believes that it is desirable to retain energy tax credits for renewable energy sources *in order to maintain an after-tax price differential between renewable and fossil fuel sources.* The recent steep decline in petroleum prices has eliminated the incentive to purchase or produce renewable fuel sources and the required equipment. Without the additional stimulus from the tax credit to purchase or produce renewable fuels, the experience gained in the production and use of such fuels and the technological competence developed in their production during the past decade will dissipate, and will not be available to call on if a fossil fuel shortage recurs.[126]

Further, the Senate Report describes the rationale for extension of the rehabilitation credit:

> The committee has concluded that the incentives granted to rehabilitations in 1981 remain justified. The committee believes that such incentives are needed because the social and aesthetic values of rehabilitating and preserving older structures are not necessarily taken into account in investors' profit projections. Additionally, *a tax incentive is needed because market forces might otherwise channel investments away from such projects because of the extra costs of undertaking rehabilitations of older or historic buildings.*[127]

In the case of the historic rehabilitation credit, it can be argued, the mission had changed since its first enactment in 1978. As noted in the discussion above, the rehabilitation credit originally represented an extension of the "initial policy objective of the investment credit."[128] It also had much broader sweep — available in the case of buildings *twenty* years or older. In 1981, the credit had been refined and re-focused on older buildings and certified historic structures. The 1986 Act, in turn, reduced the credit for

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> other renewable energy property are premature and have failed to stimulate a meaningful level of demand.

Id. In contrast, the Senate amendments extended the credits for wind, ocean thermal, and biomass energy property. *See* S. REP. NO. 99-313, at 275–77 (1986). The conference report followed the Senate amendments in the case of biomass and ocean thermal property and followed the House bill in the case of wind property. H.R. CONF. REP. NO. 99-841, vol. 2, at 128–29.

126. S. REP. NO. 99-313, at 275–76 (1986) (emphasis added).

127. S. REP. NO. 99-313, at 753 (1986) (emphasis added).

128. *See supra* note 61 and accompanying text.

rehabilitation of historic structures from 25 percent (applicable previously to historic structures) to 20 percent and otherwise restricted applicability of the credit solely to buildings placed in service before 1936, for which a 10 percent rehabilitation credit was fixed (previously fixed at 15 percent for 30-year old buildings and 20 percent for 40-year old buildings).

Thus, the regular investment credit was viewed as a "structural" component of the Code that violated the principle of neutrality and was in need of replacement. A combination of further acceleration of depreciation deductions and the dramatic reduction in tax rates effected by the 1986 Act was viewed as a superior incentive to investment lacking the prior bias in favor of short-lived assets. In contrast, Congress concurrently extended tax credits subsidizing programs advancing specific social and public policy goals and enacted the low-income housing credit ("LIHTC").[129]

D. The Low-Income Housing Tax Credit and Express Carve-out from a Pre-Tax Profit Requirement

1. In General

The Low-Income Housing Tax Credit ("LIHTC") was enacted as part of the 1986 Act. Generally, under section 42 the LIHTC is claimed over a period of 10 years in installments that have a present value equal to 70 percent of the "qualified basis" of new "qualified low-income buildings" and 30 percent of the "qualified basis" of used or federally subsidized buildings.[130] No reduction in the tax basis in the property is required to account for the provision of the tax credit, and depreciation deductions are allowed with respect to the property in accordance with the Modified Accelerated Cost Recovery System ("MACRS") introduced by the Tax Reform Act of 1986.[131]

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129. TRA 1986, *supra* note 58, § 252(a), 100 Stat. at 2189–205.

130. The LIHTC was made available for buildings placed in service after December 31, 1986. I.R.C. § 42(e). For buildings placed in service in 1987, the credit allowed for each year was set at 9 percent of the "qualified basis" (for new qualified low-income buildings) and 4 percent of the "qualified basis" (for used or federally subsidized buildings). The Housing and Economic Recovery Act of 2008 added a temporary minimum credit rate for non-federally subsidized new buildings: for buildings that are placed in service after July 30, 2008, and before December 31, 2013, the LIHC percentage cannot be below 9 percent of the "qualified basis," even if the present value calculation described in the text would yield a lower yearly percentage. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 3002(a), 122 Stat. 2654, 2879 [hereinafter HERA 2008].

131. A "qualified low-income building" is any building which is part of a qualified low-income housing project at all times during the 15–year compliance period. I.R.C. § 42(c)(2). The qualified basis is an amount equal to the "applicable

In broad outline, the LIHTC rules function today as they did when first enacted. Under the LIHTC program, the IRS allocates credits to State-run housing agencies that, in turn, award the credits to housing projects proposed by developers meeting the federal criteria for low-income housing and any additional strictures established by the applicable State. The developer acquires equity financing for the project from investors in return for tax benefits (centered on the LIHTC), which generally constitute the sole component of the investors' return.[132] Thus the recipients of the LIHTCs are neither the providers, nor the consumers and beneficiaries of the projects being subsidized, and typically — and permissibly so, for the reasons discussed below — have no real interest in the projects beyond the tax benefits.[133]

The 1986 Act included a number of provisions such as the passive activity loss rules making real estate investment less attractive, and in part the LIHTC can be seen as an antidote to encourage continued investment in real estate focused on the low-income community.[134] However, the new LIHTC regime was far more sweeping than this, both as to its design and

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fraction" of the "eligible basis" of a qualified low-income building. I.R.C. § 42(c)(1)(A). For new property, the "eligible basis" generally is its adjusted basis as of the close of the first taxable year of the credit period, without regard to sections 1016(a)(2) and (3) (i.e., no downward adjustment for depreciation taken). *See* I.R.C. § 42(d)(1), (d)(4)(D). The "applicable fraction" is the lesser of the "unit fraction" or the "floor space fraction." I.R.C. § 42(c)(1)(B). The "unit fraction" is a fraction (i) the numerator of which is the number of low-income units in the building; and (ii) the denominator of which is the number of residential rental units in such building. I.R.C. § 42(c)(1)(C). The "floor space fraction" is a fraction (i) the numerator of which is the total floor space of the low-income units in such building; and (ii) the denominator of which is the total floor space of the residential rental units in such building. I.R.C. § 42(c)(1)(D). A unit in a building qualifies as a "low-income unit" if it is rent-restricted and the individuals occupying such unit meet a income limitation. I.R.C. § 42(i)(3). The LIHTC rules described herein are substantially similar to the rules as enacted in 1986.

Under MACRS, the taxpayer may depreciate residential real property using the straight-line method over 27.5 years, using the mid-month convention. *See* I.R.C. § 168(b)(3)(B), (c), (d)(2).

132. *See* Mihir Desai, Dhammika Dharmapala & Monica Singhal, *Investable Tax Credits: The Case of the Low Income Housing Tax Credit* 3 (Harvard Kennedy School Faculty Research Working Paper Series, Working Paper No. RWP08-035, 2008) [the "Desai Study," hereinafter Desai et al., *Investable Tax Credit*].

133. In fact, the Desai Study found that "the real estate sector accounts for a negligible share of credits claimed." *Id.* at 29. The authors note that "this suggests that the separation of the provision of the service from the tax beneficiary allowed by investable tax credits has been important." *Id.*

134. *Id.* at 3.

intent. The Senate Report states that the low-income housing credit was meant to rectify the perceived defects in the existing tax preferences for low-income housing (e.g., tax-exempt bond financing and accelerated cost recovery deductions).[135] In particular, the prior incentives "operate[d] in an uncoordinated manner, result[ed] in subsidies unrelated to the number of low-income individuals served, and fail[ed] to guarantee that affordable housing [would] be provided to the most needy low-income individuals."[136] They were not effective in limiting incentives to "those persons truly in need of low-income housing," did not limit the rent that could be charged to low-income individuals, and did not link the degree of subsidy to the number of units servicing low-income persons.[137] The low-income housing credit was designed to address these defects by requiring that residential rental projects could only qualify for the low-income housing credit if, for a period of 15 years, a minimum of 20 percent of the housing units in the project were occupied by individuals with income of 50 percent or less of area median income, and the rent charged to tenants living in units for which the credit was allowable did not exceed a specified amount. As stated in the Senate Report: "In return for providing housing at reduced rents, owners of rental housing receive a tax credit designed to compensate them for the rent reduction."[138]

Property eligible for the LIHTC is subject to an at-risk limitation. The credit is nonrefundable and subject to the generally applicable cap on income tax liability that can be reduced by a general business credit (subject to carryover rules).[139] A provision of the passive activity loss rules treats the credit (but not losses) as arising from rental real estate activities in which the taxpayer actively participates.[140] Finally, as already noted, the basis of property for depreciation purposes is not reduced by the amount of low-income credits claimed.

2. *No Requirement of Pre-Tax Profit*

Alone among federal tax credits, the LIHTC has been granted an express reprieve from the requirement of a pre-tax profit. In a 1988 Private Letter Ruling,[141] the IRS determined that the section 183 not-for-profit

135. S. REP. NO. 99-313, at 758 (1986).
136. *Id.*
137. *Id.*
138. *Id.*
139. *See* I.R.C. § 42.
140. I.R.C. § 469(i)(6)(B)(1).
141. I.R.S. Priv. Ltr. Rul. 89-11-025 (Dec. 16, 1988).

rules[142] did not apply to disallow credits and deductions to a limited partnership, "Fund M," which was the sole limited partner in a partnership formed to acquire, build, and operate low-income housing projects. Under the facts of the ruling, the proposed limited partners of Fund M were to be Subchapter C corporations not subject to the passive activity loss rules of section 469. Fund M's capital contribution to each project partnership, to be paid over the first seven years of the applicable project, was to provide roughly one-third of the total requirements of each project, including the funding of an operating reserve required to secure financing to which all excess cash flow from operations was to be added; at the end of the first fifteen years the reserve was to be used to reduce the amount of outstanding debt. Due to the rent and occupancy restrictions imposed by section 42, the project partnerships were not anticipated to make any cash distributions from operations to Fund M during this first fifteen-year period, which was the anticipated duration of all of the project partnerships. Moreover, it was anticipated that the projects would fail to provide value appreciation such as to constitute a meaningful return on investment.[143] However, giving effect to section 42, the project partnership invested in by Fund M would enable it to earn returns competitive with returns generally realized by limited partner investors on their equity capital.

A ruling was requested on behalf of Fund M, two additional related funds, and the general and limited partners of the funds that "the 'not-for-profit' rules under section 183 of the Code would not limit credits and deductions otherwise available to the Funds and the Partners arising from the acquisition, construction, rehabilitation, and operation of low-income housing through the Project Partnerships." The IRS so ruled.

As a prefatory matter, the IRS noted that although section 183(a) refers to activities of individuals and S corporations, according to Revenue Ruling 77-320[144] it also applies to limit deductions at the partnership level and requires that partners' distributive shares reflect the adjustment in allowable deductions. The Private Letter Ruling then recounts the basic requirements for a project to qualify for the LIHTC, and particularly the limitations on rent charged to low-income individuals and the requirement that at least 20 percent of units in a given development for which the credit is being claimed be occupied by low-income individuals — the implication, of course, being that such restrictions presumably could prevent a low-income

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142. Section 183(a) provides, in general, that if an individual or an S-corporation engages in a not-for-profit activity, no deduction attributable to such activity shall be allowed.

143. If a project was sold for a price equal to taxes due on sale plus debt, Fund M effectively would receive no return of cash.

144. 1977-2 C.B. 78.

housing project from making a pre-tax profit. However, the ruling provides no more explicit rationale for its holding.[145]

Regulations section 1.42-4(a), promulgated in 1992, codifies this holding of the 1988 ruling. Thus, Regulations section 1.42-4(a) provides: "[s]ection 183 does not apply to disallow losses, deductions, or credits attributable to the ownership and operation of a building for which the section 42 low-income housing credit is allowable." The preamble to the Treasury Decision promulgating Regulations, section 1.42-4 states as follows:

> Although no explicit reference is contained in section 42 or its legislative history regarding its interaction with section 183, the legislative history of the low-income housing credit indicates that Congress contemplated that tax benefits such as the credit and depreciation would be available to taxpayers investing in low-income housing, even though such an investment would not otherwise provide a potential for economic return.
>
> Therefore, to reflect the congressional intent in enacting section 42, the regulatory authority under section 42(n) is being exercised to provide that section 183 will not be used to limit or disallow the credit.[146]

Thus, the generally applicable requirement of a potential for a pre-tax profit as a predicate for entitlement to the tax benefits flowing from a capital investment is "turned off." The investor "fronts" a rent subsidy on behalf of the federal government (curtailing or eliminating any pre-tax profit)

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145. In fact, somewhat oddly, the private letter ruling makes no mention of Revenue Ruling 79-300, 1979-2 C.B. 112, involving a predecessor to the LIHTC program, section 236 of the National Housing Act. Revenue Ruling 79-300 concludes that the construction and operation of an apartment project for low and moderate income housing under that legislation is not an activity to which section 183 applies:

> The . . . legislative history indicates that in limiting rental charges, Congress assumed deductions of tax losses would be allowed to encourage investment in projects providing decent housing for low or moderate income families under the Act. Consequently, application of section 183 of the Code to the present case would frustrate congressional intent in enacting the housing legislation. Therefore, section 183 will not be applied to disallow losses incurred in activities to provide low and moderate income housing under section 236 of the National Housing Act.

Id.

146. T.D. 8420, 1992-2 C.B. 13.

and is “reimbursed” by the Treasury via the LIHTC and associated tax benefits.

Still, the investor (typically, a partnership) otherwise must be the “owner” of the project under substantive federal income tax principles. Thus, Regulations section 1.42-4(b) provides as follows:

> [L]osses, deductions, or credits attributable to the ownership and operation of a qualified low-income building with respect to which the low-income housing credit under section 42 is allowable may be limited or disallowed under other provisions of the Code or principles of tax law. *See, e.g.*, sections 38(c), 163(d), 465, 469; *Knetsch v. United States*, 364 U.S. 361 (1960), 1961-1 C.B. 34 (“sham” or “economic substance” analysis); and *Frank Lyon Co. v. Commissioner*, 435 U.S. 561 (1978), 1978-1 C.B. 46 (“ownership” analysis).[147]

Accordingly, section 42 is not a repeat of the safe harbor leasing rules under which the “federal tax owner” of a project is determined by election. To the contrary, section 42 is constructed to provide a tax credit to *owners* of residential rental property that have agreed to reduced rents in return for the credit. The credit is conditioned on compliance with program requirements, with the penalty for noncompliance being recapture of prior credits. Generally, any change in ownership by a taxpayer of a building subject to the compliance period is also a recapture event. A new owner of the building during its 15-year compliance period is eligible to continue to receive the credit as if the new owner were the original owner.[148]

3. The LIHTC Program as Credit Monetization Technique

As previously discussed, *leasing* is a technique for monetizing tax benefits.[149] *Safe-harbor leasing* freed leasing from the strictures of the IRS

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147. Reg. § 1.42-4(b) (citations in original).

148. *See* I.R.C. § 42(j). The accelerated portion of credits claimed in previous years will be recaptured upon a transfer. I.R.C. § 42(j)(3). An exception is provided if it is reasonably expected the building will continue to be operated as a qualified low-income building for the remainder of the compliance period. I.R.C. § 42(j)(6).

149. In his statement in defense of the proposed adoption of the safe-harbor leasing rules, Senator Long offered this explanation:

> Leasing started when we passed the investment tax credit in 1962 under President Kennedy. This was such a strong tax advantage that companies could hardly afford not to take advantage of it. Those who were not paying enough taxes to take advantage of the

"true lease" guidelines for a short-time and in so doing created a purely form-driven — and therefore arguably more efficient — tax benefit transfer mechanism. The stated goal was to better facilitate the transfer of tax benefits from parties with a tax base to those lacking a sufficient tax base (start-up companies and loss corporations). As already noted, the safe harbor leasing rules therefore are best viewed simply as a mechanism for delivering a subsidy. However, from any distance, this was a rather opaque point, and moreover, the apparent beneficiaries of the provision that emerged, as a matter of public perception, were "indefensible."

The LIHTC program, by contrast, has had a clear public policy goal and is unmistakably a federal subsidy administered through the Code. The intended beneficiaries of the program are clear and clearly defensible. The credit itself singly is the mechanism for delivering the subsidy, and LIHTC transactions, simply put, are tax credit monetization transactions. As one paper analyzing the LIHTC program puts it, "the government allocates tax credits to developers of low-income housing who then sell the credits, often via intermediaries, to investors in exchange for equity financing."[150] The authors — who refer to low-income housing tax credits as "investable credits"[151] — further note as follows:

> Unbundling the tax benefits is required to ensure a level playing field among different providers of the desired service. The absence of investability would shift production away from potentially efficient nonprofit developers and for-profit developers with little or no tax liability. In short, the investable nature of the credits undoes the bias toward providers with taxable income.[152]

Otherwise, nonprofit developers, for example, either would require a direct subsidy in order to participate on an equal footing with for-profit developers, or a *refundable* as opposed to non-refundable tax credit.

> tax credit found it advantageous to arrange for someone else to buy the equipment and lease it to them so that they could have the advantage of the investment tax credit.

Statement of Senator Long, *supra* note 104, at 30,915.

150. Desai, et al., *Investable Tax Credits*, *supra* note 132, at 1.

151. This apparently is to connote that an investor may invest *for* the credit and secure its desired return without regard to the economic performance of the underlying assets. A "non-investable tax credit" would be a credit that is "valuable only to for-profit producers with sufficient tax liability." *Id*. at 15. In the context of low-income housing, such a credit "would be exposed to the specific tax positions of the provider of low-income housing alone." *Id*. at 15–16.

152. *Id*. at 2.

Advantages of an *investable* tax credit over a direct government subsidy that are noted include the institutional capacities of tax administrators, an established mechanism for enforcing program requirements,[153] and a lessened risk of "regulatory capture" by special interest groups: tax expenditures are decided by the House Ways and Means and Senate Finance Committees as opposed to industry-focused committees and agencies arguably more easily swayed to support subsidies that are "inefficiently large."[154] Further, the "investable nature" of the credit neutralizes the "production bias" otherwise inherent in a tax-based subsidy.[155] As the authors note:

> Comparable devices to achieve this neutrality — either refundable tax credits or an untrammeled leasing market — have proven politically unpopular and operationally complicated. As such, investable tax credits provide the same virtues as these devices but in a more politically tenable manner. Investable tax credits may also improve *ex post* compliance by providing a punishment mechanism for projects that fail to comply and by encouraging delegated monitoring by investors. Extending investable tax credits to other domains promises to provide these benefits in other settings characterized by these concerns.[156]

On the other hand, the LIHTC program is not necessarily a particularly efficient method for delivering the intended subsidy. Insofar as investors factor a "risk premium" into the "price" paid for credits to account for the risk that a project falls into noncompliance, with attendant risk of forfeiture of credits, a lower subsidy is delivered by the program.[157] A period

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153. This includes the ability to enforce program requirements after completion of the project based on the structure of the credit and the credit recapture rules. Neither a direct subsidy nor a refundable credit would accomplish this goal as effectively while at the same time providing the developer front-end financing. The investors in the project in effect become "delegated monitors." *See id*. at 18.

154. Desai et al., *Investable Tax Credits*, *supra* note 132, at 10. A further advantage relates to the requirement under the Community Reinvestment Act ("CRA") that banks provide credit in their local communities. One metric on which banks are judged is investments in low-income communities. Investments eligible for the LIHTC can double-count towards CRA requirements, thus "open[ing] up the possibility that entities may be willing to bid the price of tax credits above their actuarially fair value as they can jointly realize tax advantages and fulfill CRA obligations." *Id*. at 17.

155. *Id*. at 31.

156. *Id*.

157. *Id*. at 25.

of reduced demand due to a general downturn in the economy (i.e., fewer investors with the requisite tax base) similarly will negatively impact prices. Finally, syndication and other transaction costs historically have diverted a substantial portion (up to roughly 30 percent) of the funds invested in low-income housing projects away from the projects themselves.[158]

4. *Section 1602 Grant Program*

Section 1602 of ARRA established, for 2009 only, a grant program under which states could elect to receive cash grants from the federal government in lieu of an allocation of LIHTCs.[159] Under the section 1602 grant program, a grant was made from the federal government to designated state housing credit agencies. The state agencies then made cash subawards to projects qualifying for the credit under section 42. The states were responsible for developing procedures for making the subawards and for assuring compliance with the section 42 rules. The taxpayer's basis in a qualified low-income building was not reduced by the amount of any grant subaward.[160] Moreover, "[b]ased on the legislative history of the Act," subawards made pursuant to section 1602 were excluded from the gross income of recipients and were exempt from taxation.[161]

ARRA also established Tax Credit Assistance Program ("TCAP") Grants administered by state agencies under which grants were available

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158. According to the Desai Study, "syndication costs may consume 10-27% of equity invested in low-income housing credit projects" (citing a 1997 GAO study). Desai et al., *Investable Tax Credits*, *supra* note 132, at 26. A second study cited by Desai Study (Cummings and DiPasquale (1997)) found that "the average ratio of net equity to gross equity . . . is 0.71." *Id*.

159. ARRA 2009, *supra* note 28, § 1602, 123 Stat. at 362–64. In addition, section 3022 of the Housing and Economic Recovery Act of 2008 provided that the low-income housing tax credit and rehabilitation credit could offset alternative minimum tax liability. HERA 2008, *supra* note 130, § 3022, 122 Stat. at 2893–94. Fannie Mae, one of the largest consumers of low-income housing credits, had previously announced that it might be subject to the alternative minimum tax, which may have depressed the demand for LIHTCs and contributed to the overall decline in credit prices in 2007 and 2008. Desai, et al., *Investable Tax Credits*, *supra* note 132, at 30. Fannie Mae had invested $620.5 million in tax credits in the first six months of 2007, but only $10 million in the first six months of 2008. Donna Kimura, *Syndicators Foresee Muted Second Half*, APARTMENT FIN. TODAY (October 2008), http://www.housingfinance.com/aft/articles/2008/oct/1008-capital-tax-credit.htm.

160. *See* I.R.C. § 42(i)(9)(B) (added by ARRA 2009, *supra* note 28, § 1401, 123 Stat. at 352).

161. Notice 2010-18, 2010-14 I.R.B. 525.

until September 2011.[162] In contrast to the section 1602 grants, the TCAP grants were includible in gross income.[163]

E. The New Markets Tax Credit

Like the LIHTC, the New Markets Tax Credit ("NMTC"), enacted pursuant to the Community Renewal Tax Relief Act of 2000 and codified as section 45D,[164] ostensibly is geared to benefit the low-income community. Its purpose is to secure "qualified equity investments" for "target populations" within the "low-income community" via the provision of a tax credit.[165] The provision is structured to provide a tax credit in an amount equal to 39 percent of a taxpayer's equity investment over a seven-year period in return for investment in low-income communities.[166] The amount of available NMTCs is a function of the authority granted to the Treasury Department. The initial grant of authority for investments during the 2001 to 2007 period was $15 billion ($5.85 billion in credits). Since then, the Treasury has reserved additional grants of authority of $5 billion of investment for each of 2008 and 2009 and $3.5 billion of investment for each of 2010 and 2011. Pursuant to a delegation of authority, the tax credits are distributed by the Community Development Fund Initiative ("CDFI") to qualified investor groups in rounds.

Under section 45D, an investor must make a "qualified equity investment" ("QEI")[167] in cash into a "qualified community development

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162. ARRA 2009, *supra* note 28, tit. XII, 123 Stat. at 203–26.

163. *See, e.g*., I.R.S. Chief Couns. Adv. 2011-06-008 (Feb. 11, 2011).

164. *See* Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, § 121, 114 Stat. 2763A-587, 2763A-605 to 2763A-610 (incorporating by reference H.R. 5662, 106th Cong. (2000)).

165. *See* I.R.C. § 45D(b), (e).

166. The credit is five percent in each of the first three years and six percent for the remaining credit allowance dates. I.R.C. § 45D(a)(2).

167. For an investment to constitute a QEI, substantially all of the cash must be used by the CDE to make "qualified low-income community investments." I.R.C. § 45D(b)(1)(B). The term "equity investment" encompasses any stock other than non-qualified preferred stock (as defined in section 351(g)) and any capital interest in a partnership. I.R.C. § 45D(b)(6). A "qualified low-income community investment" is

> (A) any capital or equity investment in, or loan to, any qualified active low-income business, (B) the purchase from another qualified community development entity of any loan made by such entity which itself is a qualified low-income community investment, (C) [the provision of] financial counseling and other services specified in regulations prescribed by the Secretary to businesses located in, and residents of, low-income communities,

entity" ("CDE")[168] — typically taking the form of a partnership interest. The CDE, in turn, must invest the QEI in a low-income community project either directly or through approved entities. A CDE may make an investment in, or make a loan to, a business engaged in the rental to others of real property located in a low-income community so long as the property is not residential rental property, and there must be substantial improvements located on the property.[169] The CDE allocates the credits to the investors. The basis in the property is reduced by the amount of the credit,[170] and the credit is subject to recapture if a "recapture event" with respect to an equity investment in a CDE occurs during the seven-year credit period (the entity ceases to be a CDE, the proceeds of investment are not used as required, or the investment is redeemed by the entity).[171] The full amount of previously claimed credits is recaptured and a non-deductible interest charge is imposed on the amount of the recaptured credits.[172]

At the time of its enactment, the NMTC "received little fan-fare or public attention beyond those already in the know."[173] H.R. 5662 was introduced, voted on, and passed all on the same day (December 14, 2000) and signed into law a week later on December 21, 2000, "tucked away into obscurity within the massive appropriations act."[174] The legislative history

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> and (D) any equity investment in, or loan to, any qualified community development entity.

I.R.C. § 45D(d)(1).

168. For an entity to qualify as a CDE it must be a domestic corporation (including a non-profit corporation) or partnership (1) whose primary mission is serving, or providing capital, for low-income communities or persons; (2) that provides low-income resident representation on its governing body; and (3) that is formally certified by the Director of the CDFI as a CDE. I.R.C. § 45D(c)(1).

169. Reg. § 1.45D-1(d)(5)(ii). However, the business cannot consist primarily of the development or holding of intangibles for sale or license, nor can it consist of the operation of any golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, or other gambling facility. Reg. § 1.45D-1(d)(5)(iii). Finally, the business's principal activity cannot be farming. Reg. § 1.45D-1(d)(5)(iii).

170. I.R.C. § 45D(h).

171. I.R.C. § 45D(g).

172. I.R.C. § 45D(g)(2).

173. Roger M. Groves, *The De-Gentrification of New Markets Tax Credits*, 8 FLA. TAX REV. 213, 217 n.15 (2007) [hereinafter Groves, *New Markets Tax Credits*].

174. *Id.* The appropriations act was Title I of the Consolidated Appropriations Act of 2001. Pub. L. No. 106-554, tit. I, 114 Stat. 2763, 2763A-3 to 2763A-12 (2000).

offers little in the way of explanation of the reasoning behind the new regime beyond the purposes stated in the legislative language itself.[175]

One commentator has observed that the features of the NMTC legislation evidence that "Congress intended each party to the transaction as purposely designed as a mere conduit to the delivery of equity capital to existing low-income community residents, not new entrants without the economic need."[176] However, in practice, the NMTC rules apparently have allowed, and effectively encouraged, investment *in* low-income communities that is not always in practice *for the benefit* of the residents of these communities. Thus, projects receiving approximately $2 billion in tax credit subsidies have included a performing arts center for opera, symphony, and ballet, a 617-room convention center and hotel, museums, upscale commercial office space, and tourist centers.[177]

Developments since do not seem to have materially altered the functioning of the credit.[178]

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175. In the February 1999 "Green Book" outlining the President's revenue proposals for the following fiscal year, the Treasury had described a proposal for a "New Markets Tax Credit." DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S REVENUE PROPOSALS 33–36 (1999), http://www.treasury.gov/resource-center/tax-policy/documents/general-explanations-fy2000.pdf. The Green Book noted that under current law, "there are limited tax incentives for investing and making loans to businesses in low-income communities" and that "[b]usinesses in our nation's inner cities and isolated rural communities often lack access to equity capital to grow and succeed." *Id*. at 33. Therefore, "[t]o help attract new capital to these businesses," it proposed "a new tax credit for equity investments in these businesses." *Id*.

176. Groves, *New Markets Tax Credits*, *supra* note 173, at 221.

177. *Id*. at 225–26 (the author includes a complete table of projects he refers to as "Problematic Purposed Projects"). By the same token, the NMTC program also has brought support to community healthcare facilities, child care centers, senior centers and affordable housing for local residents. *Id*. at 234.

178. Section 221 of the American Jobs Creation Act of 2004, expanded the definition of "low-income community." American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 221, 118 Stat. 1418, 1431 [hereinafter AJCA 2004). The AJCA 2004 added section 45D(e)(2), directing the Treasury to prescribe regulations under which certain "targeted populations" were to be considered "low-income communities." *Id*. at § 221(a). In 2006, the IRS issued a (now obsolete) Notice offering guidance on section 45D(e)(2) until final regulations are adopted. *See* Notice 2006-60, 2006-2 C.B. 82. Proposed regulations adopting the Notice 2006-60 rules without significant changes were promulgated in 2008 and have since been finalized. *See* Reg. § 1.45D-1 (as amended by T.D. 9560, 2012-4 C.B. 299); Prop. Regs. § 1.45D-1, 73 Fed. Reg. 54,990 (2008).

The AJCA 2004 also added new section 45D(e)(4), treating population census tracts with a population of less than 2,000 as "low-income communities" if the tract is within an empowerment zone under section 1391, and is contiguous to one or more other low-income communities. AJCA 2004, *supra* § 221(b), 118 Stat.

In a March 2011 report, the Government Accountability Office ("GAO") suggested converting the NMTC into a grant program in order to "increase program efficiency and reduce the overall cost of the program."[179] It reasoned as follows:

> [R]eplacing the tax credit with a grant likely would increase the equity that could be placed in low-income businesses and make the federal subsidy more cost-effective. When CDE sells credits to investors to raise additional funds, the price investors pay for the credits reflects market conditions and the investors' attitudes toward risk. According to CDE representatives GAO interviewed in 2009, when the demand for NMTCs was highest, before the housing market collapse and 2008 credit crisis, the tax credits sold for $0.75 to $0.80 per dollar. Therefore, the federal subsidy intended to assist low-income businesses was reduced by 20 percent to 25 percent before any funds were made available to CDE. Representatives from CDE [whom] GAO interviewed also noted that *with low demand for the tax credits, as was the case when GAO conducted its work during 2009, the credits generally sold for about $0.65 to $0.70 and have sold for as*

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at 1431. Finally, the AJCA 2004 added section 45D(e)(5), modifying the income requirement for census tracts within high migration rural counties. *Id*. at § 223(c).

In 2006, section 102 of the Tax Relief and Health Care Act, added new section 45D(i)(6), directing the Treasury to adopt regulations to "ensure that non-metropolitan counties receive a proportional allocation of qualified equity investments." Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432 § 102, 120 Stat. 2922, 2934. The Treasury also issued proposed regulations in 2008 providing that there will be no recapture of the new markets tax credit upon a section 708(b)(1)(B) termination of a partnership CDE and clarified when a cash distribution by a partnership CDE to its partners would be treated as a redemption triggering a recapture event. Prop. Reg. § 1.45D-1, 73 Fed. Reg. 46,572 (2008). Most recently, in 2011, the Treasury issued proposed regulations that would expand the allowable options for the reinvestment of CDE proceeds. Prop. Reg. § 1.45D-1, 76 Fed. Reg. 32,882 (2011). The proposed changes are described by the Opportunity Finance Network (a network of Community Development Financial Institutions in Philadelphia) as "very limited and unlikely to have a significant impact." Liz White, Tax Credits: Comments Offer Insights on Issues, Problems with IRS Changes to New Markets Tax Credit, 187 Daily Tax Rep. BNA G-5 (2011). *See also* Liz White, Tax Credits: Time Limit, Risk Prevent Non-Real Estate Investments in New Markets Credit Program, 190 Daily Tax Rep. BNA G-1 (2011).

179. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-318SP, OPPORTUNITIES TO REDUCE POTENTIAL DUPLICATION IN GOVERNMENT PROGRAMS, SAVE TAX DOLLARS, AND ENHANCE REVENUE 276 (2011) [hereinafter GAO [hereinafter GAO NMTC REPORT http://www.gao.gov/assets/320/315920.pdf.

> *little as $0.50 or less.* After accounting for CDE and other third-party fees, such as asset management and legal fees, about 50 percent to 65 percent of the federal subsidy generally reaches low-income businesses.
>
> In a grant program, these up-front reductions in the federal subsidy could be largely avoided. If the grant program is well designed and at least as effective as the credit in attracting private investment, it could save a significant portion of the estimated $3.8 billion five-year revenue cost of the current program.[180]

The GAO Report has garnered some disagreement, with one commentator arguing that in analyzing a "a theoretically-equivalent cash grant program to the NMTC program," the NMTC is up to 15 percent more efficient.[181]

Interestingly, in January 21, 2010, comments to a draft of the GAO NMTC Report, the Treasury Department took umbrage at the GAO's recommendation that the NMTC program be replaced with a program of grants to CDEs.[182] First, it observes, the NMTC is "likely *more* cost-effective than a grant, since investors in NMTCs are required to pay taxes on the value of their NMTC investments" whereas many of the CDEs to which grants would be made are non-profits.[183] Second, it argues that "[s]witching from a tax credit to grant [would] require significant programmatic changes on the part of the Treasury Department," noting, among other things, that "compliance elements normally undertaken by the IRS as part of tax audits would be shifted to the CDFI Fund."[184] Third, the Treasury submission

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180. *Id*. at 276–77 (emphasis added).

181. Michael J. Novogradac, *Tax Credits are More Efficient than Cash Grants*, NOVOGRADAC J. OF TAX CREDITS, Nov. 2011, at 1, http://www.novoco.com/journal/2011/11/novogrodac_jtc_2011-11-ww-pg4.pdf.

182. Letter from the Dep't of the Treasury Cmty. Dev. Fin. Inst. Fund to Michael Brostak, Dir. for Tax Issues, U.S. Gov't Accountability Office (Jan. 21, 2010), *in* GOV'T ACCOUNTABILITY OFFICE, GAO-10-334, NEW MARKETS TAX CREDIT 55-58 (2010) [hereinafter Dep't of the Treasury Letter].

183. *Id*. at 56.

184. *Id*. The Treasury Department comments state as follows:

> In fact, such a change would alter all aspects of program implementation, including the following: (i) IRS regulations would have to be amended and new CDFI Fund regulations governing the administration of grants would need to be drafted; (ii) the CDFI Fund's application materials and selection processes would have to be altered to provide for a more substantive review of the awardee's financial capacity to administer the grant; (iii) the CDFI Fund would have to create a disbursement tracking system to award and monitor the funds, in a manner that satisfies Federal grant-making requirements; [and] (iv) award agreements would

argues, conversion to a grant program would eliminate the "extra layer of investor due diligence" embedded in a tax credit program and "could lead to higher incidences of non-compliance."[185] Finally, the Treasury observes that a low-income business receiving a direct grant (in lieu of a tax credit to the tax equity investor) may be unable to attract the same amount of debt capital to its project, and on the same terms and conditions, particularly since the debt investor and equity investor in many NMTC deals are often the same person.[186]

F. Legislative Developments with Respect to Energy Credits Since 1986

1. Extension of the Energy Credit

The Omnibus Budget Reconciliation Act of 1990 eliminated expired and obsolete investment tax credit provisions and enacted new sections 46 through 50.[187] The new "investment credit" was the sum of the new section 48(a) energy credit, section 48(b) reforestation credit,[188] and new section 47 rehabilitation credit. The new energy credit, as re-codified in section 48(a), was a 10 percent credit, and was only available for solar and geothermal property. As originally enacted in 1990, the energy credit was set to expire on December 31, 1991.[189] It was later extended to June 30, 1992,[190] and made permanent in 1992 pursuant to the Energy Policy Act of 1992.[191] The Committee Report stated that it believed that

> it is important to provide tax-based support for the development of alternative energy sources. Moreover, the committee believes that making the credits for investment in solar and geothermal property permanent will provide potential investors in long-term projects an additional degree

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> have to be modified and all awardees would have to agree to the terms and conditions governing uses of Federal grant dollars, which entails a host of new burdens for awardees.

Id.

185. *Id*.

186. Dep't of Treasury Letter, *supra* note 182, at 56–57.

187. RRA 1990, *supra* note 56, tit. XI, 104 Stat. at 1388–400.

188. The reforestation credit was repealed in 2004 by section 322(d)(2) of the American Jobs Creation Act of 2004; AJCA 2004, *supra* note 178, § 322(d)(2), 118 Stat. at 1475.

189. I.R.C. § 48(a)(2)(B).

190. Tax Extension Act of 1991, Pub. L. No. 102-227, § 106, 105 Stat. 1686, 1687.

191. Energy Policy Act of 1992, Pub. L. No. 102-486, § 1916, 106 Stat. 2776, 3024 [hereinafter EPA 1992].

of certainty as to the availability of the credits that may have been lacking in the past.[192]

2. *The Production Tax Credit*

a. *In General*

The Energy Policy Act of 1992 also added section 45,[193] which provides a per-kilowatt hour credit (a "production tax credit") on the sale of electricity produced from qualified renewable energy resources during the ten year period following the date when the facility producing the energy is first placed in service.[194] The amount of the credit is not includible in the taxpayer's gross income.[195] At the time of passage, the House Report stated that "[t]he credit is intended to enhance the development of technology to utilize the specified renewable energy sources and to promote competition between renewable energy sources and conventional energy sources."[196] Under section 45(b), the credit is phased out as the market price of electricity exceeds certain threshold levels and is subject to reduction if the project was financed with government grants, tax-exempt bonds, other federal tax credits, or government-subsidized financing programs.

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192. H.R. REP. NO. 102-474, pt. 6, at 47 (1992).

193. EPA 1992, *supra* note 191, § 1914(a), 106 Stat. at 3020–23. As originally enacted, this legislation provided a 1.5 cent credit for each kilowatt hour of energy produced from wind and closed-loop biomass. Currently it provides a 2.2 cent per kilowatt hour credit on the sale of electricity produced from wind, closed-loop biomass, geothermal energy and a solar energy, and 1.1 cent per kilowatt hour on the sale of electricity produced in open-loop biomass facilities, small irrigation power facilities, landfill gas facilities, trash combustion facilities, qualified hydropower facilities, and marine and hydrokinetic energy facilities. I.R.C. § 45(b)(2), (b)(4). According to a Joint Committee Study, as of the time of its writing "[i]n practice, investors have only found it profitable to invest in wind facilities [as among the eligible types of facilities]." STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX CREDITS FOR ELECTRICITY PRODUCTION FROM RENEWABLE SOURCES 14 (Comm. Print 2005) [hereinafter JTC, TAX CREDITS FOR ELECTRICITY PRODUCTION], http://www.jct.gov/publications.html?func=showdown&id=1579.

194. Under section 45(b)(4), a five-year credit period applies in the case of electricity produced and sold from certain facilities.

195. While this seems to be well accepted, the basis for this conclusion is elusive. *Cf.* JCT, TAX CREDITS FOR ELECTRICITY PRODUCTION, *supra* note 193, at 8 n.5 ("Under general income tax principles, such a subsidy [i.e., the production tax credit] paid to the taxpayer would be includable in taxable income as part of revenue.").

196. H.R. REP. NO. 102-474, pt. 6, at 42 (1992).

b. Role as Subsidy

Unlike the LIHTC and NMTC, which are meant to deploy taxpayer-investors effectively to deliver a subsidy to a separate intended beneficiary presumptively unable to use the tax credit (low-income persons), the production tax credit has as its primary target for a subsidy the producer of electricity.

> For a taxpayer with a positive tax liability, the electricity production credit is equivalent to a subsidy that pays the taxpayer for each kilowatt-hour of electricity produced in addition to the price at which the producer sells the electricity. That is, a tax credit that reduced a taxpayer's tax liability and therefore increases the taxpayer's bottom line produces a benefit to the taxpayer similar to a direct subsidy that is paid to the taxpayer to improve the taxpayer's top line.
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> . . .
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> An alternative way to assess the value of the credit to the taxpayer should be to think of the credit as part of the taxpayer's stream of receipts across the life of the taxpayer's investment in the renewable energy project. In this view, the value of the credit to the taxpayer is equal to the value of the payment the taxpayer would have to receive annually per kilowatt-hour of electricity produced over the life of the project to produce a revenue stream that is equal in present value to the revenue produced by the credit over the life of the project (recognizing that generally the credit only produces revenue for the first ten years of the project and nothing thereafter).[197]

Still another passage is worthy of quoting:

> The electricity production tax credit is economically equivalent to an open-ended subsidy, available to any taxpayer with no requirement to make an application to a government agency for the subsidy. If a taxpayer believes that the sum of electricity prices plus the credit creates a profitable rate of return, the taxpayer will invest in a qualifying facility. In theory, investors should invest in qualifying facilities up to the point where the return from

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197. JCT, TAX CREDITS FOR ELECTRICITY PRODUCTION, *supra* note 193, at 8–9.

> additional investment in qualifying facilities is no greater than the return on alternative investments.[198]

Thus, the credit under section 45(a)(2)(B) generally is a function of the quantity of electricity produced at a "facility owned by the taxpayer" in turn "sold by the taxpayer."[199]

The Joint Committee Report from which the passage above is excerpted goes on to note the inherent inefficiencies in the tax credit mechanism, since some projects, based on the effect of geographical location on costs, energy resources (such as wind), and similar considerations, "would be profitable investments in the absence of any subsidy."[200]

c. Revenue Procedure 2007-65

Recognizing that project developers often lack the tax base to avail themselves of tax incentives such as the production tax credit, in Revenue Procedure 2007-65,[201] the IRS established a safe harbor for "wind farm" partnerships between project developers and participating investors. If a transaction conforms with the requirements of the safe harbor, the IRS will respect the allocation of the section 45 production tax credits under section

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198. *Id*. at 16–17 (internal footnote omitted).

199. I.R.C. § 45(a)(2)(B), (d). In the case of biomass facilities, to the contrary, if the owner of the facility is not the producer of electricity the credit goes to the "lessee or operator" of the facility. *See* I.R.C. § 45(d)(2)(C), (d)(3)(C). Under section 45(e)(3), if a facility has multiple owners the credit is to be allocated in accordance with their relative interests in gross sales from the facility.

200. JCT, TAX CREDITS FOR ELECTRICITY PRODUCTION, *surpa* note 193, at 17. *See also* H.R. REP. NO. 102-474, pt. 6, at 42 (1992):

> The committee believes that the development and utilization of certain renewable energy sources should be encouraged through the tax laws. A production-type credit is believed to target exactly the activity that the committee seeks to subsidize (the production of electricity using specified renewable energy sources). The credit is intended to enhance the development of technology to utilize the specified renewable energy sources and to promote competition between renewable energy sources and conventional energy sources. The committee believes that if the national average price of electricity is sufficiently high, the need for a tax subsidy is reduced. Accordingly, the tax credit will be phased out in the event that the price of electricity generated from these sources is sufficiently high.

201. 2007-2 C.B. 967.

704(b).[202] The term "investors" is defined as "partners in the Project Company whose investment return is reasonably anticipated to be derived from *both* § 45 credits and participation in operating cash flow."[203]

Revenue Procedure 2007-65 is not intended to provide substantive rules and its provisions are not to be used as audit guidelines. Rather, it is intended to provide guidance to taxpayers establishing or participating in wind energy partnerships in lieu of the issuance of private letter rulings. Among its requirements are these: (i) the developer must have a minimum one percent interest in each material partnership item at all times; (ii) the investor must have a minimum interest in partnership income and gain at all times equal to at least five percent of the investor's largest percentage interest in partnership income and gain; (iii) the investor must make a minimum unconditional investment in the partnership equal to at least 20 percent of the sum of the fixed capital contributions; and (iv) at least 75 percent of the sum of the fixed capital contributions plus reasonably anticipated contingent capital contributions to be contributed by an investor with respect to an interest in the partnership must be fixed and determinable.[204]

Purchase and sale rights are subject to specific constraints:

(1) Neither the developer nor the investor (or any related party) may have a contractual right to purchase the wind farm, any property included in the wind farm, or an interest in the partnership unless the purchase price is either a price that is not less than the fair market value of the property determined at the time of exercise or, if the purchase price is determined prior to exercise, a price that the parties reasonably believe, based on all facts and circumstances at the time the price is determined, will not be less than the fair market value of the property at the time the right may be exercised. Further, the developer may not have a contractual right to purchase the property earlier than five years after the qualified facility is first placed in service;

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202. *But see* Reg. § 1.704-1(b)(1)(iii) ("[A]n allocation of loss or deduction to a partner that is respected under section 704(b) and this paragraph may not be deductible by such partner if the partner lacks the requisite motive for economic gain (*see, e.g.*, Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966. . . .").

203. Rev. Proc 2007-65, 2007-2 C.B. 967 (emphasis added).

204. *Cf.* I.R.S. Priv. Ltr. Rul. 2008-05-007 (Feb. 1, 2008); I.R.S. Priv. Ltr. Rul. 2007-26-007 (June 29, 2007); I.R.S. Priv. Ltr. Rul. 2007-14-013 (Apr. 6, 2007); I.R.S. Priv. Ltr. Rul. 2006-17-010 (Apr. 28, 2006); I.R.S. Priv. Ltr. Rul. 2006-17-009 (Apr. 28, 2006); I.R.S. Priv. Ltr. Rul. 2005-27-006 (July 8, 2005); I.R.S. Priv. Ltr. Rul. 2004-07-001 (Feb. 13, 2004); I.R.S. Priv. Ltr. Rul. 2004-39-026 (Sept. 24, 2004); I.R.S. Priv. Ltr. Rul. 2003-07-076 (Feb. 14, 2003); I.R.S. Priv. Ltr. Rul. 2003-09-024 (Feb. 28, 2003). These rulings allow up to 50 percent of the consideration paid by the tax equity investor in a section 29 or 45K transaction to be in the form of contingent payments.

(2) The partnership cannot have a contractual right to cause any party to purchase the wind farm or any property included in the wind farm, excluding electricity; and

(3) The investor may not have a contractual right to cause any party to purchase its partnership interest in the partnership.

Among other requirements, no person may guarantee or otherwise insure the Investor the right to any allocation of the production tax credit; the partnership must bear the risk that the available wind resource is not as great as anticipated or projected;[205] and the production tax credit must be allocated in accordance with Regulations section 1.704-1(b)(4)(ii).

Needless to say, the point behind these requirements is to ensure that the parties claiming the production tax credit are the parties having the predominant substantive investment and benefits and burdens of ownership of the project whose development the tax credit was meant to foster. To place a down payment on the ultimate thesis of this Article, one could observe that the role of the tax equity financiers presumably would cost the developer less dearly if these requirements of substance were waived and the tax equity investors were permitted to simply front the federal subsidy for a fee.

d. Optional Election for Energy Credit

As part of the ARRA, discussed in more detail below, Congress added section 48(a)(5), which allows taxpayers owning "qualified property" placed in service after 2008 and before 2014 (before 2013 in the case of wind facilities) to irrevocably elect the 30 percent energy credit (see discussion below) in lieu of the production tax credit.[206] "Qualified property" is defined as tangible property that is used as an integral part of a section 45 qualified investment credit facility (not including a building or its structural components) for which depreciation (or amortization in lieu of depreciation) is allowed.[207] The effect of this election is to cause such property to be treated as "energy property" for purposes of section 48, even if it otherwise would not qualify as such. As the Joint Committee on Taxation explained, "[t]he Congress believes that current economic circumstances are constraining investments in facilities that ordinarily would utilize the

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205. A guarantee regarding wind resource availability may be provided by a third party not related to the developer or other parties associated with the transaction if the project company or an investor directly pays the cost of a premium for such guarantee.

206. ARRA 2009, *supra* note 28, § 1603, 123 Stat. at 364–66; I.R.C. § 48(c)(5).

207. I.R.C. § 48(a)(5)(D).

production tax credit, and wishes to give maximum flexibility to taxpayers to choose the tax incentive that will deliver the greatest benefit to them."[208]

3. 2005 Enhancements to the Energy Credit

In 2005, the amount of the energy credit was increased from 10 percent to 30 percent for solar energy property without apparent fanfare or explanation.[209] In 2008, small wind energy property was also made eligible for the 30 percent credit.[210]

4. Response to the Economic Downturn: The ARRA Grant Program[211]

The economic downturn that became pronounced following the Lehman Brothers bankruptcy filing threw many companies that historically were participants in tax credit transactions (including the major banks and (surviving) investment banks) into loss positions, with the consequence that tax credit transactions lost their attraction. Continued stimulus of targeted areas of investment such as renewable energy no longer could be delivered via tax credit subsidies. Thus, in February 2009, President Obama signed ARRA into law.[212] Section 1603(a) of ARRA reads as follows:

> Upon application, the Secretary of the Treasury shall, subject to the requirements of this section, provide a

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208. STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 111TH CONGRESS 105 (Comm. Print 2011) [hereinafter "JCT, GENERAL EXPLANATION"].

209. Energy Policy Act of 2005, Pub. L. No. 109-58, § 1337, 119 Stat. 594, 1038. In addition, fuel cell property and qualified microturbine property were made eligible for the energy credit.

210. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 104, 122 Stat. 3765, 3770–71.

211. While the focus of this Article is credits and grants, of course, there have been significant liberalizations of the depreciation regime as well in the wake of the economic crisis — e.g., 50 percent bonus depreciation for property placed in service after December 31, 2007 and before January 1, 2013 and 100 percent bonus depreciation for property placed in service between September 8, 2010 and December 31, 2011. *See* I.R.C. § 168(k)(1), (5).

212. *See* AARA 2009, *supra* note 28, 123 Stat. at 115; *The Recovery Act*, RECOVERY.GOV, http://www.recovery.gov/About/Pages/The_Act.aspx (lasted visited Mar. 23, 2012). The 2010 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act, extended the grant program under section 1603(a) of ARRA until the end of 2011. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 707(a)(1), 124 Stat. 3296, 3312 [hereinafter TRA 2010).

> grant to each person who places in service specified energy property to reimburse such person for a portion of the expense of such property as provided in subsection (b).[213]

Under the grant program, qualified applicants receive a cash grant in an amount equal to 30 percent of renewable project costs in lieu of the energy tax credit and the production tax credit. Eligible projects include solar power projects, municipal waste projects, combined heat and power projects, wind power projects, hydropower projects, system property power projects, biomass power projects, marine and hydrokinetic power projects, geothermal power projects, fuel cell power projects, gas landfill power projects, and microturbine power projects.

Recipients of the grant are not required to include the grants in income, but are required to reduce their tax basis in the predicate projects by an amount equal to 50 percent of the grant. This, of course, reduces future depreciation deductions and has the effect of increasing income over the recovery period for the project. Of course, fundamentally, the requirement of only a 50 percent reduction in basis delivers a further subsidy (albeit a tax based subsidy).

Highlights of the grant program (as modified by the Tax Relief Act of 2010) are as follows:[214]

> (1) Grants are only available for property placed in service during 2009, 2010 or 2011 or for property placed in service after 2011 if construction began on the property in 2009, 2010 or 2011.
> (2) Grant applications for all property are due by October 1, 2012.
> (3) Ownership requirements:
>   (a) Projects cannot be owned by government entities or tax-exempt organizations or foreign persons or entities.

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213. ARRA 2009, *supra* note 28, § 1603(a), 123 Stat. at 364.

214. General guidance regarding the grant program is available on the Treasury department's webpage. *Recovery Act*, U.S. DEP'T OF THE TREASURY, http://www.treasury.gov/initiatives/recovery/Pages/1603.aspx (last updated Jan. 18, 2011) (including program guidance). *See* U.S. TREASURY DEP'T OF THE FISCAL ASSISTANT SEC'Y, PAYMENTS FOR SPECIFIED ENERGY PROPERTY IN LIEU OF TAX CREDITS UNDER THE AMERICAN RECOVERY AND REINVESTMENT ACT of 2009, at 2 (rev. 2011) [hereinafter TREASURY DEP'T, PROGRAM GUIDANCE], http://www.treasury.gov/initiatives/recovery/Documents/B%20Guidance%203-29-11%20revised%20(2)%20clean.pdf, for the most recent version of the program guidance for the section 1603 grant.

(b) Projects also cannot be owned by any partnership or other pass-through which has disqualified partners (e.g., tax-exempt owners).
(c) Disqualified persons, however, can own interests in projects if they do so through taxable subchapter C corporations.

(4) Additional rules and tests apply in determining whether construction has begun for grant purposes.
(5) The grant is subject to recapture under "rules similar to the rules of section 50."

It is clear that, in enacting the grant program, Congress intended to hone to the principles in place governing the production tax credit and energy credit. The Conference Report states that "[t]he grant may be paid to whichever party would have been entitled to a credit under section 48 or section 45, as the case may be."[215] Elsewhere the Conference Report states "[i]t is intended that the grant provision mimic the operation of the credit under section 48. For example, the amount of the grant is not includable in gross income."[216] Nonetheless, while as an example only a "taxpayer" can claim a credit under section 45 and the production tax credit, in turn, is computed based on the amount of electricity sold by "the taxpayer," at least one commentator has suggested it is less than clear whether an applicant for a cash grant under ARRA section 1603 necessarily has to be "the taxpayer."[217] In fact the commentator makes a suggestion, which is somewhat intriguing in relation to the thesis of this Article, that a person placing property in service and holding legal title to the property arguably may be eligible for a section 1603 grant even where "a second person has a bundle of economic rights and obligations with respect to the property that cause that second person to be treated as the owner of the property for federal income tax purposes."[218]

In any event, as discussed in Part III below, as a practical matter, it does not seem industry participants and their advisors are taking such a

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215. H.R. REP. NO. 111-16, at 621 (2009); *see* JCT, GENERAL EXPLANATION, *supra* note 208, at 110.

216. JCT, GENERAL EXPLANATION, *supra* note 208, at 110.

217. Neil D. Kimmelfield, *Grants in Lieu of Tax Credits Under the Recovery Act — A Square Peg in a Round Hole*, 112 J. OF TAX'N 21, 28 (2010) [hereinafter Kimmelfield, *Grants in Lieu of Tax Credits*].

218. *Id*. The author asks whether "if Treasury chooses to issue a grant to an applicant with respect to an eligible property without first asking whether a person other than the applicant has the benefits and burdens of ownership of the property, is it appropriate for a court to pursue that inquiry if Treasury later seeks return of the grant proceeds?" *Id*.

formalistic view in connection with grant applications. Without more, then, the recipient of the grant generally would be the party that will be claiming MACRS deductions with respect to the qualifying property. Exceptions to this would include the lease context where the lessor cedes the grant to the lessee. (Section III of the program guidance provides that an applicant eligible for the grant "must be the owner or lessee of the property and must have originally placed the property in service."[219]) Also, in the partnership context, there likely will be a fair amount of flexibility as to how the grant is distributed among the partners.[220]

It also should be possible, using the partnership form, for a developer to construct qualified property, place it in service, and thereafter locate investors to purchase interests in the partnership. The partnership, as original user of the project, should be able to apply for the grant. It has been suggested it may even be reasonable to request a grant using basis as adjusted under section 743(b) if a section 754 election is in place.[221]

The application process is very involved and requires extensive documentation as to the eligibility of the project, placement in service of the project and documentation of the cost of the property[222] — sufficiently so that many developers (quite apart from considerations of tax base) cannot "go it alone" without the involvement of "tax equity investors" because they need the investors' funds to support the development and construction of the project pending receipt of the grant. Rather, the developer leverages the eventual grant money to gain required funding earlier in the process. For their part, the investors sometimes look to the grant for a substantial part of their return. However, the allocation of the grant between the developer and

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219. TREASURY DEP'T, PROGRAM GUIDANCE, *supra* note 215. Section IV.G of the Program Guidance requires that "[t]he original use of the property must begin with the applicant." *Id*.

220. Kimmelfield, *Grants in Lieu of Tax Credits*, *supra* note 217, at 42 ("a grant received by a partnership increases the capital of the partnership, and a special allocation of the grant can have an economic effect on the partners by affecting their right to current or future distributions. Accordingly, it should be permissible for a partnership to specially allocate among its partners the 50% portion of a grant that is reflected in a permanent increase in the basis of the partnership's property, and the partners should be entitled to take that allocation into account in adjusting the bases of their partnership interests under Section 705(a)(1)(B)").

221. *Id*. at 34.

222. For a project with a cost basis in excess of $500,000, the applicant must provide the certification of an independent accounting firm as to the accuracy of all claimed costs. Requests for grants under $1 million require the accountant to make judgments as to the eligibility of the subject property. See Kimmelfield, *Grants in Lieu of Tax Credits*, *supra* note 217, at 36–37, for a complete discussion of the intricacies of the attestation requirement.

the investors is a matter of negotiation and the structuring of the overall economics of the project, and can vary widely from one project to the next. Anecdotal evidence suggests that the grant process has departed from its tax "roots" somewhat substantially and generally in ways favorable to the applicants. Examples include leases of facilities by grant recipients to municipalities (in the tax credit context, this would be disqualifying) and failure to apply the section 50 recapture rules as they would apply in the credit context. The rules governing projects covered by the grant program effectively are being made "on the fly," in discussions with representatives of the Treasury Department, via e-mail correspondence and by word-of-mouth.

At the conclusion of this process, upon receipt of a complete and final grant application, the Treasury Department may (1) notify the applicant that the application is approved (in which case payment of the grant is due within five days of the notice);[223] (2) require additional information (in which case the applicant has 21 days to respond); or (3) reject the application and provide the applicant its reasons.[224] If the Treasury Department rejects an application, the determination is final and "no administrative appeal is available."[225] Sole recourse would appear to be a lawsuit. If the Treasury Department makes a section 1603 payment and subsequently determines the payment was in error, unless the recipient of the grant returns the funds voluntarily, similarly the Treasury Department's sole recourse would appear to be a lawsuit. Obviously, this is a far cry from the procedural implications of a subsidy delivered via tax credit, complete with self-reporting, audit, administrative appeal, and established forums for judicial review.[226]

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223. Section 5 of the terms and conditions segment of the Program Guidance requires grant recipients to make annual reports to Treasury regarding the performance of the property for five years after it is placed in service. Section 6 requires a certification that no recapture event (e.g., the property is disposed of or ceases to be specified energy property) has occurred. TREASURY DEP'T, PROGRAM GUIDANCE, *supra* note 214.

224. *See id.* at 4.

225. Kimmelfield, *Grants in Lieu of Tax Credits*, *supra* note 217, at 35.

226. *See id*. at 34–35 (providing a more extensive discussion of these points). In a recent Generic Legal Advice Memorandum, AM 2011-004, dated September 27, 2011, the Office of Chief Counsel (Passthroughs and Special Industries) addresses the income tax consequences of an overpayment of Section 1603 grants (includable in income) and repayments of overpayments (deductible). While this implies that the Treasury is intending to audit awards of grants (and, in fact, the author understands a number of audits are underway), the procedures for this are unclear. *See also supra* note 153 and accompanying text (structure of LIHTC facilitates enforcement of program requirements).

Loss of the section 1603 grant mechanism in 2012 (absent extension) will leave taxpayers with the production tax credit and energy tax credit regimes discussed above (subject to scheduled expirations).

III. FEDERAL TAX CREDIT MONETIZATION STRUCTURES IN PRACTICE

A. Renewable Energy Projects

1. In General

Typically, project developers are not in a position to make use of tax benefits such as depreciation deductions and tax credits to any significant degree. Therefore, of necessity, developers routinely partner with "tax equity investors" through various mechanisms. Two structures are commonly used to finance renewable energy projects by allocating tax benefits to tax equity investors in exchange for their investments. These structures are the partnership flip structure and the lease structure, both discussed further below. A safe harbor for the partnership flip structure that actually borrows heavily from a combination of the IRS's "true lease" guidance and rulings practice under section 29[227] was established in the context of wind energy projects in Revenue Procedure 2007-65, discussed above. In practice, taxpayers routinely rely on the Revenue Procedure outside the context of wind projects as well. These same structures are being deployed in the cash grant context both as a vehicle to bridge finance the grant and to make appropriate use of depreciation deductions via the involvement of the tax equity investor.

2. Illustration of Partnership Flip Structure

A typical renewable energy partnership structure based on Rev. Proc. 2007-65 can be illustrated as follows.

E, a tax equity investor, contributes $100 in cash to Partnership in exchange for a 99 percent interest in all items of income, gain, loss, deduction (including MACRS depreciation), and credits/grants. S, a strategic partner, contributes $90 in assets to Partnership in exchange for a one percent interest in all partnership items of income, gain, loss, deduction (including MACRS depreciation), and credits/grants. Partnership will obtain a credit/grant of 30 percent of the project costs. It may also be eligible for state incentives. In the grant scenario, there is considerable flexibility as to the

227. *See supra* note 204 and accompanying text.

allocation of the grant among the partners.[228] This will similarly be true as to any state cash incentives.

Under the terms of the agreement, 99 percent of the credit/grant is allocated to E; once E achieves a specified internal rate of return taking into account the credit/grant and other tax-related benefits to E from participation in the project, the interest of E in the partnership "flips" such that E thereafter has a 5 percent interest, and S has a 95 percent interest in all Partnership items of income, gain, loss, deduction (including MACRS depreciation), and credits (including credit/grant).

The end result is that E realizes the lion's share of its return as an equity investor over the first five years (the recapture period) on the strength of the credit/grant. Thereafter E maintains a 5 percent interest in the project.

3. Lease Structure

The parties can employ either a sale-leaseback structure or a "straight" lease transaction whereunder in either case the tax equity investor acquires the project and leases it to the developer under a lease satisfying the conditions for a true lease and claims all tax credits and depreciation deductions associated with the project. Alternatively, the tax equity investor can cede the credit/grant to the lessee (retaining the MACRS deductions). Under yet another structure, the developer can play the role of lessor under the lease and cede the credit/grant to the tax equity investor, as lessee. In this case, the tax equity takes up the entrepreneurial roles of operator/lessee, albeit it may contract for operations and maintenance and similar services with the developer/lessor.

The lease monetization structure can be illustrated as follows.

Tax Equity contributes $100 to Tax Equity LLC. Tax Equity LLC purchases the energy project from Project LLC for $100. Strategic Investor contributes $80 to Project LLC in exchange for 100 percent of the interests in Project LLC. Tax Equity LLC leases the energy project to Project LLC for an up-front prepaid lease payment of $80 funded by Strategic Investor's contribution or periodic lease payments equal to $80 on a present value basis. The parties agree that under applicable law Tax Equity LLC is the tax owner of the energy project entitled to the MACRS depreciation deductions related to the energy project. The $30 energy credit or grant and any state cash incentives may be claimed by Tax Equity LLC or Project LLC, as the parties agree. The foregoing is subject to the proviso that the lease qualifies as a "true" lease for federal tax purposes.

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228. *See supra* note 220 and accompanying text. By contrast, as noted above, allocation of the energy credit must be in accordance with the requirements of section 704(b). *See supra* notes 8–12, and accompanying text.

4. Reliance on Targeted Return

A pre-tax internal rate of return ("IRR") to the tax-equity investor in the range of two to three percent commonly has been deemed sufficient to establish the validity of such transactions for federal tax purposes, counting tax credits and grants allocable to the investor as cash for this purpose. Practices in light of the enactment of section 7701(o) (see Part IV below) are still developing.[229]

B. Other Tax Credit Transactions in Practice

As in the case of renewable energy transactions, NMTC transactions reportedly are structured to provide investors with a targeted IRR earned over the section 45D seven-year credit period through a combination of the credits and (generally) a cash-on-cash return. Anecdotal evidence suggests that historic rehabilitation tax credit transactions generally call for an annual cash distribution (3-percent cash-on-cash apparently is common) and include a schedule showing an anticipated return of investment over the life of the project. In LIHTC deals, indications are that the developer/general partner generally retains 80 to 90 percent of the cash flow.

A detailed explanation of the techniques for structuring these transactions — from the use of leverage[230] to lease pass-through structures — is beyond the scope of this Article. Among the issues tax planners often need to address are debt-equity and related issues presented by the use of guarantees and other risk mitigation devices.

C. The Sacks *Case*

Sacks v. Commissioner[231] is notable for its determination that a transaction projected to lose money on a pre-tax basis and lacking a pre-tax profit motive, and dependent on tax credits for its profitability, is not necessarily on that account a sham requiring a disallowance of the tax benefits claimed by the taxpayer.

In *Sacks*, the taxpayer was among an investor group that purchased solar water heating equipment for leaseback to the seller, BFS Solar Incorporated ("BFS"). BFS's business plan was to lease the units to homeowners. Rent payable to the taxpayer under the head lease consisted of

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229. *See infra* notes 280–81 and accompanying text. *See also* N.Y. STATE BAR ASS'N TAX SECTION REPORT ON CODIFICATION OF THE ECONOMIC SUBSTANCE DOCTRINE, 24 n.61 (2011) [hereinafter NYSBA REPORT], http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1228-Ltr.pdf.

230. *See, e.g.*, Rev. Rul. 2003-20, 2003-1 C.B. 465 (use of leverage in NMTC transactions).

231. 69 F.3d 982 (9th Cir. 1995), *rev'g* 64 T.C.M. (CCH) 1003 (1992).

a base rent for a fixed term of 53 months plus a percentage of the homeowners' lease payments to have the units on their roofs (50 percent of the portion of sublease rents in excess of BFS's base rent payable to the taxpayer). The taxpayer made a 50 percent down payment for the equipment in cash and executed an interest-bearing negotiable recourse note in favor of BFS for the balance of the purchase price.[232] All of the units in question were installed in homes and leased to homeowners. The taxpayer claimed depreciation deductions, the regular investment credit and the energy credit for the units for the 1983, 1984 and 1985 tax years. It was questionable whether the investment would produce a profit without taking into account these tax benefits. The IRS disallowed the tax benefits on the basis that the taxpayer's investment was a sham transaction, and the Tax Court sustained that determination, finding that the taxpayer had purchased a "package of tax benefits."[233] The Ninth Circuit reversed.

The Ninth Circuit's holding in *Sacks* is sometimes cited for the notion that "subsidy-like" targeted tax credits should be treated like cash and included as part of the taxpayer's pre-tax profit. However, what the court actually articulated as the basis for its holding is something different: "Where a transaction has economic substance, it does not *become* a sham merely because it is likely to be unprofitable on a pre-tax basis."[234] Among the factors the court cites for concluding the transaction had "genuine economic effects" and was not a sham were (1) the taxpayer's recourse obligation to pay the promissory note, (2) the fact that the taxpayer paid fair market value for the units, (3) the fact that the business of installation of solar water heaters was genuine and (4) the fact that the business consequences of a rise or fall in energy prices and solar energy devices were genuinely shifted to the taxpayer.[235] The court noted that "the tax benefits would have existed for someone, either BFS Solar or Mr. Sacks, so the transaction shifted them but did not create them from thin air."[236]

The court placed heavy reliance on the recourse nature of the taxpayer's obligations, holding the Tax Court's finding that the taxpayer "was not at risk" to be clearly erroneous.[237] At another juncture, the court

232. The taxpayer also granted BFS a security interest in the equipment and assigned BFS the rents payable under the head lease (i.e., the rent payable by BFS) to secure payment of the notes.

233. Sacks v. Commissioner, 64 T.C.M. (CCH) 1003, 1022 (1992).

234. *Sacks*, 69 F.3d at 991 (emphasis added). The court described economic substance and business purpose as "simply more precise factors to consider" in determining whether a transaction has non-tax economic effects, noting it had "repeatedly and carefully noted that this formulation cannot be used as a 'rigid two-step analysis.'" *Id.* at 988.

235. *Id.*

236. *Id.*

237. *Id.* at 989.

notes that the taxpayer "participates more fully in the attributes of ownership than the taxpayer in *Frank Lyon*":[238]

> Mr. Sacks, unlike Mr. Lyon's company, owns the potential for upside gain on the water heaters. In *Frank Lyon*, the bank had the contractual right to buy out the investor for what the investor had in the deal plus a 6% return on the down payment. 435 U.S. at 567, 98 S. Ct. at 1294. If the value of the building went up, the bank could exercise its option and reap all of that gain. In contrast, Mr. Sacks owns the solar water heaters, whether they turn out to be duds or bonanzas. If energy prices rise faster than the price of solar water heaters fall, Mr. Sacks stands to make more money. After 53 months, when the units are still well within Amcor's warranty period and their useful life by any measure, Mr. Sacks owns them free and clear and can negotiate whatever deal the market will bear. If energy prices were to fall substantially, Mr. Sacks would be stuck with writing checks to cover his notes, and doing something with all the economically useless hardware.[239]

The Ninth Circuit expressed skepticism as to a number of the Tax Court's factual findings, including its determination that a pre-tax profit was unlikely and subsidiary findings of fact as to useful life, salvage value, future energy costs and related matters. However, the court concluded it need not reach a conclusion regarding whether these findings of fact were clearly erroneous, as "[i]n this particular sale-leaseback transaction . . . even if these findings of fact were correct, we would still reject the sham determination."[240] The court continued:

> Mr. Sacks' investment did not become a sham just because its profitability was based on after-tax instead of pre-tax projections. It is undisputed that he stood to make money on an after-tax basis. "The fact that favorable tax consequences were taken into account . . . is no reason for disallowing those consequences." *Frank Lyon*, 435 U.S. at 580. Where a transaction has economic substance, it does not become a sham merely because it is likely to be unprofitable on a pre-tax basis. If in a sale-leaseback, the purchaser retains

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238. *Id. Sacks*, 69 F.3d at 991 (referring to Frank Lyon Co. v. United States, 435 U.S. 561 (1978)).

239. *Id.*

240. *Id.*

> significant risks and benefits of ownership and is "the one whose capital was committed" based on cash or negotiable full recourse promissory notes, then the possible imprudence of his investment does not disqualify him from taking the depreciation deductions and tax credits. *Id*. at 572, 581, 1298, 98 S. Ct. at 1302. This is true even though the investor paid more "because [the investor] anticipated the benefit of the depreciation deductions." *Id*. at 5801, 98 S. Ct. at 1302.[241]

Finally, as to the absence of pre-tax profitability the court observed:

> If the government treats tax-advantaged transactions as shams unless they make economic sense on a pre-tax basis, then it takes away with the executive hand what it gives with the legislative. A tax advantage such as Congress awarded for alternative energy investments is intended to induce investments which otherwise would not have been made. Congress sought, in the 1977 energy package, of which the solar tax credits were a part, to increase the use of solar energy in U.S. homes and businesses. H.R. Rep. No. 95-543, 95th Cong. 1st Sess., 1978 U.S.C.C.A.N. 7673, 7678 (stating that among the goals of the National Energy Act is that there be solar energy in more than 2-1/2 million homes by 1985).
>
> If the Commissioner were permitted to deny tax benefits when the investments would not have been made but for the tax advantages, then only those investments would be made which would have been made without the Congressional decision to favor them. The tax credits were intended to generate investments in alternative energy technologies that would not otherwise be made because of their low profitability. See H.R. Rep. No. 496 at 8304. Yet the Commissioner in this case at bar proposes to use the reason Congress created the tax benefits as a ground for denying them. That violates the principle that statutes ought to be construed in light of their purpose. *Cabell v. Markham*, 148 F.2d 737 (2d Cir. 1945) (L. Hand, J.).[242]

Thus, tax credits were not in the eyes of the court a *substitute* for a pre-tax profit. To the contrary, a transaction *otherwise* having economic

241. *Id*.
242. *Id*. at 992.

substance does not become a sham because it is predicated on an *after-tax* profit, at least where the tax benefits in question are perceived by Congress as necessary to entice taxpayers to make the investment in question for the very reason of its lack of profitability or low profitability.

D. The Historic Boardwalk Case

In *Historic Boardwalk Hall, LLC v. Commissioner*,[243] the Tax Court extends and, in extending, arguably alters the principle established in *Sacks*, by taking tax credits into account to *establish* economic substance.

In *Historic Boardwalk*, as touched on briefly in the introductory section of the paper, a tax equity investor (Pitney Bowes) and a state instrumentality (New Jersey Sports and Exposition Authority or "NJSEA") formed Historic Boardwalk Hall, LLC ("HBHall") to own a convention center qualifying as a certified historic structure and eligible for 20 percent rehabilitation tax credits.

In return for a cash contribution of approximately $18.2 million (to be made in stages), Pitney Bowes was to receive 99.9 percent of all partnership items, a 3-percent preferred return on its investment, and a guarantee of the tax benefits, including depreciation deductions and historic rehabilitation tax credits. NJSEA would receive 0.1 percent of all partnership items. NJSEA had an option to repurchase Pitney Bowes' interests at any time upon giving notice that it intended to sell, dispose of, or refinance the convention center, among other things. Upon exercise, NJSEA would have to pay Pitney Bowes the present value of its remaining projected tax benefits and cash flow. NJSEA also had a call option over Pitney Bowes' interests exercisable for 12 months beginning 60 months after the convention center was placed in service. Pitney Bowes had a put option with respect to its interest exercisable if NJSEA did not exercise the call option.[244] The put option could be exercised during a 12 month period beginning 84 months after the convention center was placed in service. Both the put and call options were exercisable at a price equal to the greater of: (1) 99.9 percent of the fair market value of 100 percent of the membership interests in HBHall, or (2) any accrued and unpaid preferred return payable to Pitney Bowes. NJSEA was required to purchase a guaranteed investment contract ("GIC") to backstop its payment obligations in the event it were to reacquire Pitney

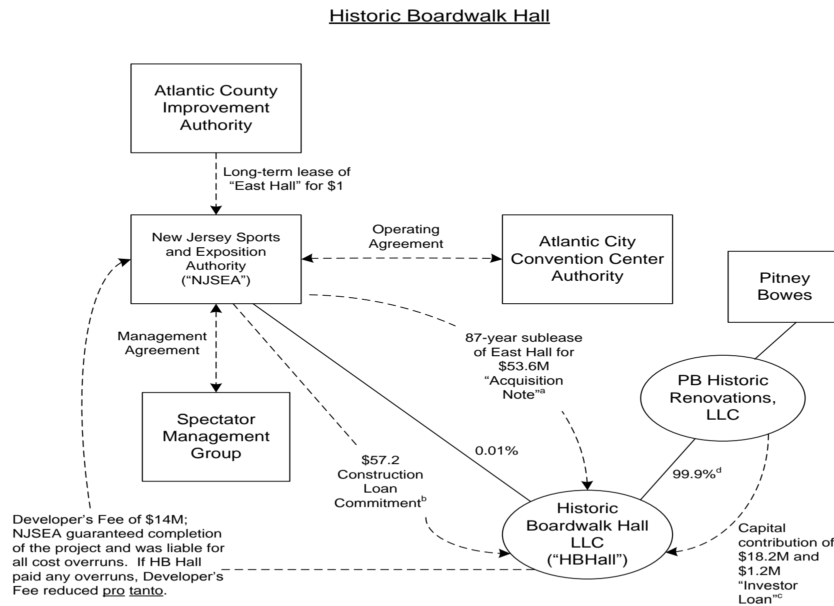
243. 136 T.C. 1 (2011).

244. Pitney Bowes also had an additional put option on its interest in the partnership exercisable only until January 15, 2001 at a put price equal to (1) capital contributions plus 15 percent interest, plus (2) fees and expenses, plus (3) $100,000, except that the $100,000 amount was only payable if rehabilitation tax credits for 2000 were less than $650,000 or phase 3 of the rehabilitation was not in service as of December 31, 2000.

Bowes' interest in HBHall.[245] NJSEA also placed money in escrow to secure its payment obligations under the put and call options. (At the time of the trial, none of these options had been exercised.)

In addition, Pitney Bowes and HBHall executed a "Tax Benefits Guaranty Agreement" by which the projected tax benefits allocable to Pitney Bowes were guaranteed. NJSEA was to fund any payments made under the guaranty.[246]

Additional details regarding the transaction are captured in the following schematic:



a Equated to all amounts expended to date by NJSEA. Interest rate set at 6.09% per annum. Fixed annual amounts were payable by HBHall to the extent it had sufficient cash flow to make the payments.

b Interest rate set at 0.1% per annum.

c Interest rate started at 7.1% per annum and increased to 8.22% in 2009

d Interest in profits, losses, credits and distributions

The IRS argued that the partners lacked any business motivation other than transferring tax credits from NJSEA to Pitney Bowes, that the rehabilitation credits must be ignored in evaluating the economic substance of the transaction, and that, accordingly, HBHall was a sham. In part, the

245. Funds contributed by Pitney Bowes were used to pay down a portion of NJSEA's acquisition loan to HBHall; NJSEA used the funds so received to purchase the GIC.

246. *Historic Boardwalk*, 136 T.C. at 15.

government rested its argument on the existence of counterbalancing economic compulsions embedded in the put and call options it argued were structured to assure that, whether the venture was profitable or unprofitable, Pitney Bowes' interest would be retired after the expiration of the credit recapture period. The IRS further contended that the parties knew that HBHall would not earn a profit, that the 3-percent return in any event was sub-optimal, and that the investment (apart from tax benefits) produced a negative cash flow for Pitney Bowes on a present value basis. The IRS also cited the various contractual provisions — the tax benefits guaranty agreement, the operating deficit guaranty, the completion guaranty — and the fact that all the partnership debt was nonrecourse to Pitney Bowes to show that "the parties' economic positions were all fixed and unaffected by the return from Historic Boardwalk Hall in any circumstance."[247]

The taxpayer argued that (1) as a matter of Congressional intent, the economic substance doctrine is inapplicable (because the historic rehabilitation tax credit is in the nature of a subsidy to encourage investment in unprofitable projects); (2) alternatively, the tax credits can be taken into account in determining whether the transaction has economic substance and provided the taxpayer a net economic benefit; (3) the taxpayer had a "chance of earning a profit" even without taking the credit into account; and (4) in any event, the 3-percent preferred return gives the transaction economic significance.

The Tax Court held that HBHall was not a sham and did not lack economic substance, finding that the 3-percent preferred return and the expected tax benefits should be viewed together, and viewed as a whole, the transactions had economic substance.[248] Further, the court noted, "Pitney Bowes, NJSEA, and Historic Boardwalk Hall had a legitimate business purpose — to allow Pitney Bowes to invest in the East Hall's rehabilitation."[249] The court took express note that "[m]ost of Pitney Bowes' capital contributions were used to pay a development fee to NJSEA"[250] but cast this in a favorable light, "Pitney Bowes' investment provided NJSEA with more money than it otherwise would have had."[251] As if meeting an unspoken objection to this line of reasoning, the court noted "[r]espondent does not allege that a circular flow of funds resulted in Pitney Bowes receiving its 3-percent preferred return on its capital contributions."[252]

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247. *Id*. at 21.

248. The court did not take up the argument that the economic substance doctrine is inapplicable.

249. *Historic Boardwalk*, 136 T.C. at 24.

250. *Id*.

251. *Id*.

252. *Id*. The court does not seem to consider the fact that part of the contribution effectively was used to purchase the GIC.

The court offered additional factors in support of its holding: Pitney Bowes "faced the risk that the rehabilitation would not be completed," and faced potential liability for environmental hazards if the insurance coverage was inadequate and NJSEA was financially unable to cover its indemnification of Pitney Bowes for such risk.[253] As to the implications of "side agreements and guaranties," the court stated "they were necessary to attract an equity investor,"[254] and rather than showing a lack of economic substance "show that the East Hall and Historic Boardwalk Hall did in fact affect the parties' economic positions — the agreements were meant to prevent the transaction from having a larger impact than the parties had bargained for."[255]

The court stated (without citation to the legislative history) that the legislative purpose of section 47 is "to encourage taxpayers to participate in what would otherwise be an unprofitable activity," noted that the East Hall had operated at a deficit, observed that "[t]he purpose of the credit is directed at just this problem," and concluded that without the credit no private investor would have invested and NJSEA "would not have had access to the nearly $14 million paid to it as a development fee . . . ."[256] With reference to its prior decision in *Friendship Dairies*, the court noted it had "disregarded a sale-leaseback transaction which had no chance of profitability" and determined "[t]his case is distinguishable on its facts."[257] In conclusion, on this prong of the government's attack, the court concluded as follows:

> The rehabilitation of the East Hall was a success. Historic Boardwalk Hall has been operating and continues to operate day to day, with the East Hall being used as a convention facility. In conclusion, Historic Boardwalk Hall had objective economic substance.[258]

The court's discussion of the *Sacks* case was at the start of the opinion, and the foregoing essentially was the court's exegesis of its extension of the reasoning of the Ninth Circuit in that case.

In response to the IRS's argument that the "development fee" was a disguised purchase price for the tax credits,[259] the court noted that a

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253. *Id*. at 25. Pitney Bowes invested through a special purpose entity. In addition, it was a named insured on the insurance policy.

254. *Historic Boardwalk*, 136 T.C. at 25. Compare this to the requirements of Rev. Proc 2007-65. *See supra* note 204–05 and accompanying text.

255. *Historic Boardwalk*, 136 T.C. at 26.

256. *Id*.

257. *Id*. at 27. For *Friendship Daires*, *see supra* text at notes 116–120.

258. *Id*.

259. The government, in its brief, made much of the fact that the Confidential Offering Memorandum issued by NJSEA repeatedly characterized the

development fee is a qualified rehabilitation expense under section 1.48-12(c)(2), and further that "[r]espondent does not argue that any portion of the rehabilitation credits claimed is inappropriate or attempt to disallow any of Historic Boardwalk Hall's claimed credits on the ground that the development fee was not a qualified expense."[260]

Having so disposed of the sham argument, the court rejected the government's next argument that Pitney Bowes was not a partner in the HBHall partnership finding it "clear" in combination with its holding that HBHall had economic substance that Pitney Bowes was a partner in the partnership. As to the IRS's argument that Pitney Bowes' interest was more akin to debt than equity, the court noted that even were it to "ignore the tax credits," Pitney Bowes' interest is not more like debt than equity "because Pitney Bowes is not guaranteed to receive a 3-percent return every year."[261] In fact, without reference to the GIC, the court stated that "Pitney Bowes might not receive its preferred return until NJSEA purchased [its] membership interest, if at all."[262]

The IRS's third argument was that HBHall never acquired tax ownership of the East Hall in light of all of the burdens of operation and rehabilitation retained by NJSEA (including the risk it was not guaranteed to receive payments on its acquisition loan each year) and NJSEA's call option. The court recognized factors pointing in both directions, but concluded that NJSEA transferred the benefits and burdens of ownership of the East Hall to HBHall. On the question of NJSEA's purchase option, the court noted with reference to the tax credit recapture rules that "the statute demonstrates an anticipation of repurchase and creates a disincentive. Congress established a means to police early dispositions and created a deterrent to a premature buyout. For these reasons, NJSEA's purchase option was not contrary to the purpose of the rehabilitation tax credit."[263]

Finally, the court rejected the IRS's arguments under the Regulations section 1.701-2 anti-abuse rules.[264] It did so largely in reliance on Example 6

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transaction as a "sale" of the tax credits. *See* Opening Brief for Respondent at 85, Historic Boardwalk Hall, LLC v. Commissioner, 136 T.C. 1 (2011) (No. 11273-07).

260. *Historic Boardwalk*, 136 T.C. at 25. The IRS, of course, had disallowed the claimed tax credits in their entirety on the basis that the transaction constituted an impermissible attempt to purchase the tax credits.

261. *Id*. at 30.

262. *Id*. Of course, if true, this cuts both ways.

263. *Id*. at 33. Interestingly, the original rationale for a recapture rule was to prevent taxpayers from "churning" — selling after the credit is generated and using the proceeds to make an additional investment qualifying for a tax credit. The focus was not on "repurchases" by other parties to the transaction. *See supra* note 39 and accompanying text.

264. *Historic Boardwalk*, 136 T.C. at 34–37. Regulations section 1.701-2(b) gives the Commissioner the authority to recast transactions for federal income tax

of Regulations section 1.701-2(d), dealing with an allocation of low-income housing tax credits (rejecting the IRS's attempt to distinguish the example either factually or based on the fact that section 42 does not require a pre-tax profit motive) and Congressional intent:

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purposes 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 income tax liability in a manner that is inconsistent with Subchapter K. Regulations section 1.701-2(a) provides that the following requirements are implicit in the intent of Subchapter K (paraphrasing): (1) the partnership must be bona fide and each partnership transaction or series of related transactions must be entered into for a substantial business purpose; (2) the form of each partnership transaction must be respected under substance over form principles; and (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.

Regulations section 1.701-2(a)(3) notes certain provisions of Subchapter K adopted for reasons of administrative convenience or to promote certain policy objectives ("Special Provisions") the application of which may produce results inconsistent with the clear reflection of income requirement, and provides that if a transaction satisfies requirements (1) and (2), the clear reflection of income requirement will be treated as satisfied to the extent that the application of such a Special Provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by the Special Provision (citing, among others, Example 6 of Regulations section 1.701-2(d) (as an illustration of the application of the "value equals basis rule" of Regulations section 1.704-1(b)(2)(iii)(c)).

The regulations provision states that the determination of whether a transaction involving a partnership ought to be recast is made with consideration given to the statutory provision giving rise to the tax benefits and all pertinent facts and circumstances. Regulations section 1.701-2(c) provides a nonexclusive list of factors to be considered, including whether: (1) the present value of the partners' aggregate Federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly; (2) one or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities, or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital; (3) partnership items are allocated in compliance with the literal language of Regulations sections 1.704-1 and 1.704-2, but with results that are inconsistent with the purpose of section 704(b) and those regulations; or (4) the benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party).

> Although Pitney Bowes' aggregate tax liability was reduced as a result of this transaction, Congress intended to use the rehabilitation tax credit to draw private investments into public rehabilitation.
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> Further the regulations clearly contemplate a situation in which a partnership is used to transfer valuable tax attributes from an entity that cannot use them . . . to individuals who can.[265]

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265. *Historic Boardwalk*, 136 T.C. at 37. Regulations section 1.701-2(d), Example 6, describes A and B, high-bracket taxpayers, and X, a corporation with net operating loss carryforwards, who form a general partnership to own and operate a building that qualifies for the LIHTC. The project is financed with both cash contributions from the partners and nonrecourse indebtedness. The partnership agreement specially allocates income and deductions, including depreciation deductions attributable to the building, to A and B equally in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the building. The LIHTC credits are allocated to A and B in accordance with the allocation of depreciation deductions. The nonrecourse indebtedness is validly allocated to the partners under the rules of section 1.752-3, thereby increasing the basis of the partners' respective partnership interests. The basis increase created by the nonrecourse indebtedness enables A and B to deduct their distributive share of losses from the partnership against their nonpartnership income and to apply the credits against their tax liability:

> At a time when the depreciation deductions attributable to the building are not treated as nonrecourse deductions under section 1.704-2(c) (because there is no net increase in partnership minimum gain during the year), the special allocation of depreciation deductions to A and B has substantial economic effect because of the value-equals-basis safe harbor contained in section 1.704-1(b)(2)(iii)(c) and the fact that A and B would bear the economic burden of any decline in the value of the building (to the extent of the partnership's investment in the building), notwithstanding that A and B believe it is unlikely that the building will decline in value (and, accordingly, they anticipate significant timing benefits through the special allocation). Moreover, in later years, when the depreciation deductions attributable to the building are treated as nonrecourse deductions under section 1.704-2(c), the special allocation of depreciation deductions to A and B is considered to be consistent with the partners' interests in the partnership under section 1.704-2(e).

Reg. § 1.701-2(d) Ex. 6(ii).

The example further states that "Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax . . . . Thus, even though the partners' aggregate federal tax liability may be substantially less than had the partners owned the partnership's assets directly (due to X's inability to use its allocable share of the

The court did not reach (and the IRS did not brief) what a technical analysis under Subchapter K could reveal based on its findings — i.e., assuming that the partnership is *not* a sham, Pitney Bowes *is* a bona fide partner, HBHall *is* the tax owner of East Hall and the anti-abuse rules do *not* apply. Based on the parties' briefs, it would appear that Pitney Bowes had no deficit restoration obligation. While Pitney Bowes nominally held 99.9 percent of the equity on account of its $18.2 million capital contribution (implying an equity contribution by NJSEA of approximately $19,000), NJSEA, a 0.1 percent partner, had loaned HBHall approximately $100 million. Was this debt or equity? The tax advisers to Pitney Bowes were concerned about this, as noted in the IRS's opening brief,[266] yet the IRS did not in fact brief the issue. If debt, was it recourse or nonrecourse? Was it "partner nonrecourse debt"? If so, would depreciation deductions essentially all nonetheless be allocable to Pitney Bowes? (Presumably not and in any event section 704(d) would limit Pitney Bowes's deductions.) What was the section 704(b) analysis that justified allocating 99.9 percent of the tax credits to Pitney Bowes? Does it matter (if factually correct) that the project was more or less assured of losing money and there was no realistically foreseeable net cash flow? What impact should the use of contributed capital to buy a GIC have on the analysis? NJSEA's purported call option? Pitney Bowes' put option? The Tax Benefit Guaranty?

Should part of the funds supplied by Pitney Bowes have been allocated to the cost of the GIC (i.e., as acquired on Pitney Bowes's behalf)? To payment for the Tax Benefit Guaranty? If so, how much? Was some or all of the development fee a guaranty fee? If not, why did NJSEA agree to the guarantees? If so, then at a minimum was some portion of the developer's fee ineligible for the rehabilitation tax credit? How does one account for the Completion and Operating Deficit Guarantees?

So, there is a whole host of unexamined or underexamined issues. However, we can observe that an historic rehabilitation project was completed and the section 47 credit operated to defray the costs. The question to be considered by the Third Circuit on appeal ultimately is whether the Tax Court was right to conclude on the facts before it that the parties' transaction, to borrow from *Gregory v. Helvering*, accomplished "the thing which the statute intended."[267]

While *Sacks* articulates the principle that a transaction otherwise having economic substance does not *become* a sham because it is predicated on an after-tax profit, at least where the tax benefits effectively function as a

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partnership's losses and credits) . . . the transaction is not inconsistent with the intent of subchapter K." *Id*. at (iii).

266. Opening Brief for Respondent at 31, Historic Boardwalk Hall, LLC v. Commissioner, 136 T.C. 1 (2011) (No. 11273-07).

267. Gregory v. Helvering, 293 U.S. 465, 469 (1935).

targeted, Congressionally mandated subsidy, the question is whether a corollary rule can also be articulated: viz., a transaction otherwise *lacking* economic substance is not imbued with economic substance because it generates a profit after accounting for associated tax benefits, even where the tax benefits effectively function as a targeted, Congressionally mandated, subsidy.

Such a transaction would seem to be the kind of "paper transaction" eschewed by the court in *Friendship Dairies*.[268] However, the credit at issue in that case was the regular investment credit, and the court specifically concluded that "at no point do the Committee reports indicate that the credit was intended to transform unprofitable transactions into profitable ones."[269] In *Historic Boardwalk*, the credit at issue, in contrast, was one that the Tax Court expressly determined was enacted to encourage participation in otherwise unprofitable activities. Against that backdrop, the Tax Court found the requisite economic substance existed, viewing non-tax economics and the tax credits *together* and taking into account the risks and realities of the investment as it found them to be (and notwithstanding the significant extent to which Pitney Bowes was insulated from the risk of loss). Whether the corollary rule above is a fair extrapolation from existing case law is unclear. What is clear is that, under the case law, the absence of a pre-tax profit and profit objective in tax credit subsidy cases is not dispositive of the outcome.

IV. ENACTMENT OF SECTION 7701(O)

> A lot of these [tax credit] deals are not economically feasible without the tax benefits, so maybe they should not be respected, but the policy is to promote investment. We're hoping for legislative history and economic substance guidance.[270]

A. Basic Summary of the Provision

Section 1409 of the Health Care and Education Reconciliation Act of 2010 (the "2010 Act")[271] added new section 7701(o) to the Code, effective with respect to transactions entered into on or after March 31, 2010. Section 7701(o)(1) (entitled "Clarification of Economic Substance Doctrine")

268. *See supra* notes 116–20 and accompanying text.

269. Friendship Dairies, Inc. v. Commissioner, 90 T.C. 1054, 1065-66 (1988).

270. Statement of Christopher Kelley, Special Counsel, Internal Revenue Service Office of Assoc. Chief Counsel (Passthroughs and Special Indus.), *in* Lee A. Sheppard, *News Analysis: Partnership Administrative Update*, 127 TAX NOTES 962, 963 (May 31, 2010).

271. HCERA 2010, *supra* note 26, § 1409, 124 Stat. at 1067–70.

provides that, in the case of any transaction "to which the economic substance doctrine is relevant," the transaction shall be treated as having economic substance only if (i) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position; and (ii) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into the transaction. Section 7701(o)(5)(A) provides that the term "economic substance doctrine" means "the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose."

Section 7701(o)(5)(C) states that the determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if section 7701(o) had never been enacted.

Section 7701(o)(2)(A) provides that a transaction's potential for profit shall be taking into account in determining whether the transaction satisfies the requirements of section 7701(o)(1) only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits.[272]

For transactions entered into on or after March 31, 2010, to which the economic substance doctrine is relevant, section 7701(o)(1) mandates the use of a conjunctive two-prong test to determine whether a transaction shall be treated as having economic substance. The first prong, found in section 7701(o)(1)(A), requires that the transaction change in a meaningful way

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272. The 2010 Act also added section 6662(b)(6), which provides that the accuracy-related penalty imposed under section 6662(a) applies to any underpayment attributable to any disallowance of a claimed tax benefit because of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet any similar rule of law (collectively a section 6662(b)(6) transaction). *Id*. at § 1409(b)(2). In addition, the 2010 Act added section 6662(i), which increases the accuracy-related penalty from 20 percent to 40 percent for any portion of an underpayment attributable to one or more section 6662(b)(6) transactions with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return or in a statement attached to the return. Furthermore, new section 6662(i)(3) provides that certain amended returns or any supplement to a return shall not be taken into consideration for purposes of section 6662(i). *Id*. at § 1409(b)(2).

Finally, the 2010 Act amended section 6664(c) so that the reasonable cause exception for underpayments found in section 6664(c)(1) shall not apply to any portion of any underpayment attributable to a section 6662(b)(6) transaction; similarly amended section 6664(d) so that the reasonable cause exception found in section 6664(d)(1) shall not apply to any reportable transaction understatement (within the meaning of section 6662A(b)) attributable to a section 6662(b)(6) transaction; and amended section 6676 so that any excessive amount (within the meaning of section 6676(b)) attributable to any section 6662(b)(6) transaction shall not be treated as having a reasonable basis. *Id*. at § 1409(c), (d).

(apart from Federal income tax effects) the taxpayer's economic position. The second prong, found in section 7701(o)(1)(B), requires that the taxpayer have a substantial purpose (apart from Federal income tax effects) for entering into the transaction.

In Notice 2010-62,[273] providing interim guidance regarding the codification of the economic substance doctrine, the IRS states that it will continue to rely on relevant case law under the common-law economic substance doctrine in applying the two-prong conjunctive test in section 7701(o)(1):

> Accordingly, in determining whether a transaction sufficiently affects the taxpayer's economic position to satisfy the requirements of section 7701(o)(1)(A), the IRS will apply cases under the common-law economic substance doctrine (as identified in section 7701(o)(5)(A)) pertaining to whether the tax benefits of a transaction are not allowable because the transaction does not satisfy the economic substance prong of the economic substance doctrine. Similarly, in determining whether a transaction has a sufficient nontax purpose to satisfy the requirements of section 7701(o)(1)(B), the IRS will apply cases under the common-law economic substance doctrine pertaining to whether the tax benefits of a transaction are not allowable because the transaction lacks a business purpose.[274]

As to the determination of whether a transaction falls within the operation of section 7701(o) (i.e., is a transaction to which the economic substance doctrine is "relevant"), the Notice provides that the IRS

> will continue to analyze when the economic substance doctrine will apply in the same fashion as it did prior to the enactment of section 7701(o). If authorities, prior to the enactment of section 7701(o), provided that the economic substance doctrine was not relevant to whether certain tax benefits are allowable, the IRS will continue to take the position that the economic substance doctrine is not relevant to whether those tax benefits are allowable.[275]

The Notice states that "[t]he Treasury Department and the IRS do not intend to issue general administrative guidance regarding the types of transactions

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273. Notice 2010-62, 2010-40 I.R.B. 411.
274. *Id.*
275. *Id.*

to which the economic substance doctrine either applies or does not apply."[276]

B. Relevant Legislative History

There is no official legislative history accompanying the enactment of section 7701(o). The principal document practitioners are consulting for assistance in understanding the provision, therefore, is the Joint Committee explanation of the provision.[277] The JCT Technical Explanation acknowledges the existence of overlapping common-law doctrines that courts can apply to deny the tax benefits of a tax-motivated transaction notwithstanding that the transaction may conform to the literal technical requirements of a tax provision — among them, the "economic substance" doctrine, but also "closely related doctrines" such as the "sham transaction doctrine," "business purpose doctrine," and "substance over form doctrine." The JCT Technical Explanation notes the conflicting views expressed in judicial decisions as to the role of business purpose in the economic substance evaluation and variations in the formulation of what constitutes a sufficient non-tax economic benefit to justify claimed tax benefits. Section 7701(o), it explains, "provides a uniform definition of economic substance, but does not alter the flexibility of the courts in other respects."[278]

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276. *Id.*

277. STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," AS AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT," 142 (Comm. Print 2010) [hereinafter "JCT, TECHNICAL EXPLANATION"]. Arguably, the House Budget Committee's report, H.R. REP. NO. 111-443 (2010), constitutes official legislative history. However, this is questionable as it is based on an explanation of the codification proposal prepared by the House Ways & Means Committee, and is dated October 14, 2009, for H.R. 3200, 109th Cong. (2005), a bill containing differences from the final legislation. See NYSBA REPORT, *supra* note 229, at 13 n.33, for a more comprehensive discussion. As also discussed in the NYSBA Report, while reports prepared by the Joint Committee staff do not rise to the level of legislative history, given the timing of the release of the JCT Technical Explanation (four days before either house of Congress voted on the final legislation) and the absence of any other Congressional guidance on the law, as enacted, the JCT Technical Explanation should carry greater weight in this case than in the case of JCT reports generally. *Id.*

278. JCT, TECHNICAL EXPLANATION, *supra* note 277, at 152. In a similar vein, elsewhere the JCT Technical Explanation states that "[t]he provision is not intended to alter or supplant any other rule of law, including any common-law doctrine or provision of the Code or regulations or other guidance thereunder; and it is intended the provision be construed as being additive to any such other rule of law." *Id.* at 155.

On the threshold question of whether the economic substance doctrine is "relevant" to a transaction, the JCT Technical Explanation states that "[t]he determination . . . is made in the same manner as if [section 7701(o)] had never been enacted. Thus, the provision does not change present law standards in determining when to utilize an economic substance analysis."[279]

Pinned to this statement is footnote 344 — a footnote that has garnered a fair amount of attention for its relevance to tax credit transactions:

> If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed. See, e.g., Treas. Reg. sec 1.269-2, stating that characteristic of circumstances in which an amount otherwise constituting a deduction, credit, or other allowance is not available are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit or other allowance was designed by the Congress to effectuate. Thus, for example, it is not intended that a tax credit (e.g., section 42 (low-income housing credit), section 45 (production tax credit), section 45D (new markets tax credit), section 47 (rehabilitation credit), section 48 (energy credit), etc.) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.[280]

The meaning of footnote 344, of course, is less than clear. After all, in both *Sacks* and *Historic Boardwalk*, when presented with transactions involving tax credits of the type enumerated, the courts *utilized* an economic substance analysis, albeit a different *version* of the economic substance analysis than that required by the new "uniform" definition. Yet, the implication of footnote 344 would seem to be that the economic substance doctrine is not *relevant* in such cases. Rather the test is whether the transaction triggering the tax credit is one in which "in form and substance" the taxpayer made "the type of investment" or undertook "the type of activity" that the credit was intended to "encourage."

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279. *Id.*
280. *Id.*

Is this to say that tax credit transactions fall under "closely related" doctrines such as "sham transaction" and "substance over form?" Clearly, the requirement that tax credit transactions conform "in form *and substance*" to the relevant legislative mandate confirms that the taxpayer claiming the credit must meet a substantive test — perhaps just not the test laid out in section 7701(o)(1).[281]

Literally speaking, section 7701(o), where applicable, does not impose a pre-tax profit/profit motive test. Rather, it requires that the transaction "changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position"[282] and that the taxpayer has a substantial non-tax purpose for entering into the transaction. The taxpayer in *Sacks* ostensibly could meet this test. However, if pre-tax profit potential is offered as the predicate for satisfying the economic substance test, the heightened standards of section 7701(o)(2) (present value of reasonably expected pre-tax profit substantial in relation to present value of expected net tax benefits) must be satisfied. As commentators have noted, it is not clear that many tax credit transactions would satisfy this test, and certainly not if the conclusion is that tax credits cannot be treated as "cash" for purposes of the pre-tax profit test.[283] If a tax credit transaction does not pass muster on

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281. *See* NYSBA REPORT, *supra* note 229, at 25 (recommending that for non-abusive leasing and tax equity transactions nonetheless not clearly intended by Congress, IRS and Treasury issue specific guidance "such as an update to the leasing, wind energy and similar guidelines or other means, that would instruct taxpayers as to the proper method for conducting those transactions such that they were sufficiently economic to be viewed as 'appropriate' and not in violation of Section 7701(o)."). *See also id*. at 76–77 (proposing safe harbors "for when transactions of this nature are deemed to satisfy Section 7701(o) by specifying minimum amounts of genuine 'at risk' investment and profit without regard to tax benefits (*e.g*., a minimum, pre-tax IRR))."

282. JCT, TECHNICAL EXPLANATION, *supra* note 277, at 155.

283. *See supra* Part III. A. 4., III. B. *See also* Hershel Wein, Tax Credit Investments and the Ossification of the Economic Substance Doctrine 24 (Oct. 24, 2011) [hereinafter Wein, Tax Credit Investments] (unpublished article) (on file with the (other) Tax Club) ("as the new provision states that only pre-tax amounts are to be utilized in determining the existence of pre-tax profit in a transaction, a strong argument can be made that the Credits as Cash approach no longer has any legal basis and the court in Historic Boardwalk Hall would have been hard pressed to adopt its analysis if section 7701(o) has been applicable"). *Cf.* Toby Cozart, *Does Section 7701(o)'s Pre-Tax Profit Test Permit Tax Equity Financings? Part One: Present Valuation*, 52 TAX MGM'T MEMORANDUM 267, 270 (2011) (referring to "advice frequently rendered by responsible tax advisers, under prior law, with respect to tax-incentive- based financings" that require transactions to show "a 2-3% pre-tax IRR, taking income tax credits (or Treasury cash grants) into account as the equivalent of cash" and noting that "[s]ome law firms representing tax equity investors have reportedly adopted this advice for purposes of opining on these

that basis, then does it simply fail? Footnote 344 suggests further inquiry — or perhaps a *different* inquiry — is needed, but it would seem the transaction may yet fail if, for example, the investors are too insulated from the risks and realities of the venture (i.e., such that allowance of the tax benefits would be perceived as resulting in a distortion of tax liabilities). While the requirement of a meaningful equity stake at the risk of the venture is nothing new, the question is how this fits in an age of 30 percent tax credits and grants.

The JCT Technical Explanation sheds no additional light. As regards leasing transactions in general, it states that "like all other types of transactions, [they] will continue to be analyzed in light of all the facts and circumstances."[284]

C. IRS Field Directive on the Codified Economic Substance Doctrine

On September 14, 2010, the IRS Large Business and International Division ("LB&I") issued a procedural directive to the field requiring approval at the level of Director of Field Operations ("DFO") of any proposal to impose the new strict liability penalty under section 7701(o) pursuant to section 6662(b)(6).[285] On July 15, 2011, LB&I issued a further directive (the "Directive") providing guidance on when it is appropriate to seek DFO approval to raise the economic substance doctrine on audit.[286] It also sets forth a series of inquiries the examiner must develop and analyze in order to seek approval for ultimate application of the doctrine in the examination. The first step of a four-step process the examiner is to undergo is an evaluation of whether the circumstances in the case are such that application of the economic substance doctrine likely is not appropriate. The

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transactions subsequent to § 7701(o)'s effectiveness, when they otherwise conclude that the transaction is not abusive."). Cozart further notes that, even taking tax credits (and grants) into account as the equivalent of cash, use of the "Net Present Value Approach" recommended by the New York State Bar Association Tax Section Executive Committee for determining pre-tax profit that relies on the taxpayer's cost of funds as the discount rate "could invalidate a great many tax equity financings in the marketplace if the ESD were deemed relevant." *Id*. at 274. "More fundamentally," he states, "[it] would generally deprive developers and sponsors of the relevant property, who wish to retain a subordinate economic interest in it, of an economic justification for entering into the transaction." *Id*.

284. JCT TECHNICAL EXPLANATION, *supra* note 277, at 153.

285. Heather C. Maloy, Comm'r, IRS Large and Mid-Size Bus. Div., Directive for Industry Directors, LMSB-20-0910-024 (Sept. 14, 2010). *See supra* note 272 and accompanying text.

286. Heather C. Maloy, Comm.'r, IRS. Large Bus. & Int'l Div., LB&I Directive for Industry Directors, LB&I-4-0711-015 (July 5, 2011) [hereinafter the Maloy, LB&I Directive].

Directive notes that among such cases is a "transaction that generates targeted tax incentives [and] is, in form and substance, consistent with Congressional intent in providing the incentives."[287] On the other hand, application of the doctrine may be appropriate where a transaction is "highly structured" or a taxpayer's "potential for gain or loss is artificially limited."[288]

If the examiner concludes that application of the doctrine may be appropriate under circumstances where the transaction involves tax credits "that are designed by Congress to encourage certain transactions that would not be undertaken but for the credits" then the examiner is required to obtain specific approval of his or her manager in consultation with local counsel before proceeding with application of the doctrine.[289] Further, in all cases, an examiner is not to apply the economic substance doctrine if "another judicial doctrine (e.g., substance over form or step transaction) more appropriately address[es] the noncompliance that is being examined."[290] This likewise is the case if recharacterizing the transaction (e.g., recharacterizing debt as equity) is a more appropriate line of attack.

Finally, the Directive provides as follows.

> [U]ntil further guidance is issued, the penalties provided in sections 6662(b)(6) and (i) and 6676 are limited to the application of the economic substance doctrine and may not be imposed due to the application of any other 'similar rule of law' or judicial doctrine (e.g., step transaction doctrine, substance over form or sham transaction)."[291]

V. THE CASE FOR A NEW FEDERAL TAX BENEFIT TRANSFER REGIME

The enactment of section 7701(o) has both highlighted and heightened the uncertainties as to the tax treatment of transactions involving targeted tax incentives. At the same time, in recognition of this, corollary to the enactment of section 7701(o) has been the pronouncement in the JCT Technical Explanation that "[i]f the realization of the tax benefits of a

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287. *Id*. Others include transactions that have a significant risk of loss.

288. *Id*.

289. *Id*.

290. *Id*.

291. Maloy, LB&I Directive, *supra note* 286. *See* Wein, Tax Credit Investments, *supra* note 283, at 29–30 (considering the elasticity of the "sham transaction doctrine" in the case law). *Cf*. Reg. 1.42-4(b); s*upra* notes 141–48 and accompanying text (despite non-applicability of a pre-tax profit requirement in the context of LIHTC, a LIHTC nonetheless may be disallowed on other grounds, including "sham or economic substance analysis").

transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed."[292] We have the further statement in the JCT Technical Explanation that "it is not intended that a tax credit . . . be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was designed to encourage."[293] This is mirrored by the Directive, which notes that among the transactions to which application of the economic substance doctrine likely is inappropriate is a "transaction that generates targeted tax incentives [that is], in form and substance, consistent with Congressional intent in providing the incentives."[294]

Since the determination of whether the economic substance doctrine is "relevant" is meant to be made as though section 7701(o) never was enacted, such statements imply a conclusion that under the case law the economic substance doctrine has not been deemed relevant to tax credit transactions. As discussed above, that really is not a supportable stance. Be that as it may, a fairly specific test has now been enunciated. Thus, if a taxpayer makes an investment or engages in a transaction meant to generate targeted tax incentives and it is determined that the transaction in fact, in form and substance, conforms with congressional intent in providing the incentive (the "congressional intent test"), presumably that is the end of the inquiry. Some commentators lament that this is an ambiguous test, and that is a fair comment, but a test nonetheless it is.

Presumably, under this test, if a transaction conforms with congressional intent in form but *not* in substance, the transaction fails and the hoped-for tax benefit will be disallowed. The Directive could be read as implying, to the contrary, that in such a case one instead then proceeds to an analysis under section 7701(o). However, that may be a false inference. As noted above, the Directive states that an examiner is not to apply the economic substance doctrine if another judicial doctrine, such as substance over form, "more appropriately addresses the noncompliance that is being examined."[295]

The central challenge for tax credit transactions under the congressional intent test is to determine what constitutes a transaction *in form and substance* that is the "type of investment" or "type of activity" that the credit was designed to encourage. In the LIHTC context, we know the transaction need not generate a pre-tax profit. It seems reasonable to extrapolate that this is true as to the full array of tax credits available today. After all, the initial judgment on this question currently reflected in

292. JCT TECHNICAL EXPLANATION, *supra* note 277, at 152 n.344.
293. *Id.*
294. Maloy, LB&I Directive, *supra* note 286.
295. *Id.*

Regulations section 1.42-4 was reflected in a revenue ruling,[296] and courts can entertain the same points of policy and legislative intent as can the Treasury in the context of a revenue ruling as evidenced by the Ninth Circuit's decision in *Sacks*.[297]

Does the transaction generating the tax credit in question not only "need not generate" but in fact "need *not to* generate" a pre-tax profit? There seemingly is some logic to support that notion, since the operative intent is to benefit and thereby incentivize transactions and investments that would be unprofitable but for the tax incentives. However, that implies a level of transaction-specific factual scrutiny that is both administratively impractical and decidedly outside the contemplation of the legislators. To the contrary, as explained in a recent Joint Committee print,[298] tax credits and other subsidies apply to "infra-marginal activity" — activity that would have occurred without the provision of the incentive. The result is that "for such activity the government incurs an expense in subsidizing it in order to induce others at the margin to engage in the tax-favored activity."[299] This marks an "inherent inefficiency" in the tax credit mechanism since some projects "would be profitable investments in the absence of any subsidy."[300]

The more pertinent threshold questions would appear to be (1) whether the tax credit in question is, indeed, in the nature of a subsidy and (2) if so, who the intended beneficiaries are. In the simple case there are no difficulties discerning this. For example, a taxpayer engages directly in activities eligible for the production credit, taking all risks inherent in the targeted business and entitled to all rewards. This is a clear case of a "transaction pursuant to which, in form and substance," the taxpayer engaged in a "type of activity that the credit was intended to encourage." If, however, the producer lacks a sufficient tax base to use the production tax credit and associated depreciation deductions, some form of tax credit monetization structure will need to be deployed to deliver the benefit of the subsidy to the producer. As discussed above, the typical vehicles for this are lease structures and partnership "flip" transactions. The "true lease" guidelines set forth in Rev. Proc. 2001-28 and the Rev. Proc. 2007-65 safe harbor for partnership flip structures involving wind projects provide benchmarks (albeit pre-section 7701(o) benchmarks) for evaluating whether an investor is participating and invested sufficiently in a project to be justified in claiming a tax credit and other tax benefits associated with investment in a project. However, insofar as tax credit transactions are structured to insulate the

296. *See supra* note 145 and accompanying text.

297. *See supra* note 231 and accompanying text.

298. *See* JCT, ENERGY-RELATED TAX EXPENDITURES, *supra* note 62, at 24.

299. *Id*.

300. *See* JCT, TAX CREDITS FOR ELECTRICITY PRODUCTION, *supra* note 193, at 17.

investor from economic risk and depend on a combination of tax credits and cash flow to demonstrate "pre-tax profit," satisfaction of the Congressional intent test is by no means assured.[301]

In the LIHTC context, as discussed in Part II.D.2. above, the IRS and the Treasury Department concluded that "Congress contemplated that tax benefits such as the credit and depreciation would be available to taxpayers investing in low-income housing, even though such an investment would not otherwise provide a potential for economic return." At the same time, section 1.42-4(b) preserves the idea that "losses, deductions, or credits attributable to the ownership and operation of a qualified low-income building . . . may be limited or disallowed under other provisions of the Code or principles of tax law," including "sham" or "economic substance" analysis and "ownership analysis."[302] The quid pro quo for committing to an investment generating below-market rents and a pre-tax loss is the LIHTC and associated benefits but the taxpayer claiming LIHTCs has to have sufficient hallmarks of *ownership* to sustain its position. The transaction cannot be a sham. If another person has a superior claim to ownership of the project (for example, such person holds a dollar purchase option), it will not suffice to lay claim to the LIHTCs that the "investor" holds legal title to the property.

It would seem conformity in "form *and substance*" with Congressional intent means at least passing muster under the type of sham/economic substance/ownership analysis that is referenced by Regulations section 1.42-4(b). However, historically, outside the LIHTC context, it appears that most advisers have concluded that an investor's tax position is better secured if it in fact can show a pre-tax profit in connection with the investment. Thus, whereas the developer, lacking a tax base, would like to retain all of the cash flow from the project and allocate the investors solely tax benefits for their return, this will meet with the objection that the investors must show a pre-tax profit. The tax credits may even be counted as cash in calculating "pre-tax" profit, but without some allocation of cash flow as well, the investors may be unable to demonstrate a pre-tax profit.[303]

One commentator has observed that "[t]he adoption of [such] a Credits as Cash approach . . . puts a brake on the use of structures which are

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301. *See* Kevin Juran & Michael Bauer, Tax-Based Leasing, Tax Credits and Economic Substance, 76 Daily Tax Rep. (BNA) J-4 (2010) ("When does the absence of both a true economic profit and a meaningful equity stake at risk mean that in form and substance the transaction is not one which the credit was intended to encourage?").

302. Reg. § 1.42-4(b) (citing Frank Lyon Co. v. United States, 435 U.S. 561 (1978)).

303. *See generally supra* note 281–82 and accompanying text. *See also* Wein, Tax Credit Investments, *supra* note 283, at 18 ("under the Credits as Cash approach . . . some of the pre-tax cash flow will have to be allocated to the investor to satisfy the ESD.").

essentially pure sales of tax benefits to investors, at least in those instances when the credits alone are insufficient to generate a 'profit.'"[304]

However, this leads, more or less directly, to the question of what would be so bad about that. In fact, the notion that the tax law requires that the investor extract *more* in the way of non-tax economic benefits from the sponsor/developer that is the "natural" beneficiary of the subsidy in order for the subsidy to operate appears to be a *perversion* of applicable *non-tax* policy goals. The goal of the system should be the efficient delivery of the government subsidy to the intended beneficiary. Uncertainty as to the ability of investors to successfully claim the targeted tax incentives, attendant complexities in the structuring of transactions' and high transaction costs run counter to this goal. If, in order to claim the targeted tax benefits, the investor must demonstrate a meaningful equity stake in the venture subject to the risks of the venture, it will require a higher return commensurate with the risks it has assumed, which return will reduce the subsidy delivered via its investment. Indeed, a requirement, on whatever predicate, that the investor show an expectation of profit from cash flow and residual value over and above the economic return provided by the tax benefits or grant erodes the subsidy effect.

The foregoing observations notwithstanding, consistent with generally accepted *tax* policy principles, under the current state of the law a *substance* test applies. This appears to be a function of a normative view of the tax benefits in question — i.e., seeing the tax credits and accelerated depreciation deductions as structural components of the income tax incident to the computation of the "normal tax" of the taxpayer. The early history of the investment credit (discussed in Part II.A. above) comports with this understanding and provided ballast for the Tax Court's holding in *Friendship Dairies* that a transaction tantamount to a sale of the investment credit "would be a distortion of congressional intent"[305] that must not stand.

It can be argued that the historic rehabilitation tax credit, as originally enacted, similarly was designed as a structural component of the income tax, rather than a subsidy. It marked an extension of the "initial policy objective of the investment credit"[306] to apply to longer-lived structures (properties a mere *twenty* years old or older) as well as equipment. Like the investment credit, the focus of the historic rehabilitation tax credit was on broad policy goals such as modernization and stimulation of

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304. *See id.* at 18. Elsewhere, this same author observes that "[a] requirement that the tax capital investor earn a 'significant' pre-tax return (as compared to the tax benefits) would result in the end user of the property making excessive payments to lease the property, and generating more after-tax profit than the tax capital investor market would otherwise require." *Id.* at 28.

305. Friendship Dairies, Inc. v. Commissioner, 90 T.C. 1054, 1067 (1988).

306. H.R. REP NO. 95-1445, at 86 (1978).

investment within a broad class of property generally.[307] In 1981, the historic rehabilitation tax credit was re-focused on older buildings and certified historic structures and further restricted (but preserved) under the 1986 Act. In preserving the credit in 1986, the Senate Report explained that a "tax incentive is needed" because "the social and aesthetic values of rehabilitating and preserving older structures are not necessarily taken into account in investors' profit projections."[308] This is "economist-speak" for a subsidy (values such as those referenced are "positive externalities" that justify a subsidy).[309]

The energy credit, as first enacted, included both a carrot (credit for alternative energy investments) and a stick (denial of credit and accelerated depreciation for new fossil fuel boilers and combustors). As previously noted, the credit for investment in wind and solar projects originally was *refundable*, clearly signaling that the credit was intended from the outset as a targeted subsidy in those cases.

Finally, as discussed above, while the 1986 Act had as its primary goal greater neutrality in the tax system, it also turned to the use of tax credits qua subsidies to achieve targeted objectives – in extending the historic rehabilitation and energy tax credits, but most particularly with enactment of the LIHTC.[310]

Thus, the case can be made that a normative view of these tax credits is misplaced. Indeed, with the enactment in 1981 of the safe harbor leasing rules, for a short time the case was successfully made that even the basic investment credit and accelerated depreciation deductions should be viewed as subsidies and therefore "non-structural."[311] This, in part, was a function of the sheer magnitude of the tax benefits, establishing as they did a *negative* effective tax rate on income from qualifying equipment. Congress thus concluded the tax benefits should be transferable and that "unfettered" leasing rules would serve as the delivery mechanism both to effect transfers

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307. *See supra* notes 56–61 and accompanying text.

308. *See* S. REP. NO. 99-313, at 753 (1986).

309. *See* JCT, ENERGY-RELATED TAX EXPENDITURES, *supra* note 62, at 21–22.

310. The LIHTC is perhaps the clearest case of a quid pro quo: the investor "fronts" a subsidy (by accepting below market rents) and is reimbursed via the LIHTC and accelerated depreciation deductions.

311. Analytically, only the *accelerated* portion of depreciation deductions should have been viewed as in the nature of a subsidy and therefore transferable. That is, the user should be allowed depreciation deductions matching economic depreciation of the assets; the "buyer" should be allowed to claim the accelerated deductions "and recapture them as the asset depreciates economically and a deduction is allowed to the user." Koffey, *Safe Harbor Leasing*, *supra* note 88, at 2–5.

of the benefits and to secure a substantial portion of the subsidy for the transferor (lessee/user).

In the current timeframe, significant tax incentives have been enacted to encourage investment in renewable energy projects in particular. The energy credit demonstrably functioned as a subsidy even before the enactment as part of ARRA of the cash grant program. As noted above, a grant-in-lieu-of program also was adopted for a time for LIHTC projects and the GAO has recommended converting the NMTC into a grant program.

All of this points to the conclusion that the modern array of business tax credits discussed in this Article — the historic rehabilitation tax credit, production tax credit, energy credit, LIHTC, and NMTC — are not best seen as structural components of the income tax, but rather as "government subsidies that are located in the Internal Revenue Code merely as a matter of convenience."[312]

So understood, the focus should be on determining the most efficient means of delivering these subsidies to the intended beneficiaries. In certain cases, the intended beneficiary may have a sufficient tax base to claim the tax incentives itself on a current basis but in many, and perhaps most, cases this will not be so and some mechanism for monetizing the tax incentives will be needed. This Article posits that a new "tax benefit transfer" regime would serve this objective far better than a continued muddle over what satisfies the congressional intent test.

The latter is likely to include a requirement that the investor earn some demonstrable pre-tax profit or have a meaningful at risk equity stake or both. If, however, the investor is meant to function as the delivery mechanism by which the true intended beneficiary of the program receives a subsidy (for which the investor is compensated via the tax benefits), these requirements would appear to be impediments: the investor will charge a premium for taking risks (these can be mitigated by "side agreements and guarantees" but these in turn may imperil the tax analysis); the complications added to the transaction will increase transaction costs (which invariably come "off the top"); and the requirement of a pre-tax profit for the investor of necessity comes at the expense of other participants in the project.

The question of how best to design such a new tax benefit transfer regime, of course, is a complicated one. Further, it presumes that a continuation of the subsidies in question is desirable. Obviously, if Congress were to adopt a proposal such as that made in the Simpson-Bowles Report — viz., to eliminate nearly all tax expenditures — that would render this discussion moot.[313] Of course, a decision to convert the current tax credits to direct subsidies similarly would eliminate consideration of re-designing tax credit subsidies.

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312. *See supra* note 98 and accompanying text.

313. *See* NAT'L COMM'N, MOMENT OF TRUTH, *supra* note 121.

In Part VI, below this Article briefly explains the experiences of some of the states in regard to monetization of tax credits. Part VII examines the associated federal income tax implications. Finally, Part VIII offers some concluding thoughts that hopefully pull together all of the threads of discussion in this Article.

VI. OVERVIEW OF SELECT STATE BUSINESS TAX CREDITS AND OFFICIALLY SANCTIONED MONETIZATION STRUCTURES

As noted in the Introduction, there is a significant degree of variability in the handling of tax credits by the states. Some states have initiated refundable tax credits and others transferable tax credits and still others non-transferable tax credits, sometimes with lenient partnership allocation rules that facilitate "transfers" and sometimes not.[314]

A. Refundable State Tax Credits

In 2000, Maryland enacted the "Clean Energy Production Tax Credit,"[315] offering a state income tax credit of 0.85 cents per kWh for electricity generated from qualified renewable sources. In early 2010, the Maryland Energy Administration issued a report recommending that the production tax credit be made either refundable or transferable, "to enable those with insufficient or no tax liability to utilize the incentive."[316] It noted that "[t]o date, the tax credit program has been underutilized; approximately $5.1 million of the authorized $25 million in tax credits have been allocated."[317] The report drew on the experiences of other states that had enacted comparable programs. For example, Iowa's transferable production tax credit programs had resulted in "Iowa's total installed wind capacity of 3,053 MW (as of June 2009) rank[ing] second among all states."[318] Oklahoma's freely-transferable "Zero-Emissions Facilities Production Tax Credit" had caused "growth in renewable energy generation in Oklahoma [to be] fifth fastest among all states."[319] In June 2010, the Maryland state legislature passed legislation allowing corporations and individuals to claim

314. *See supra* notes 18–22 and accompanying text.

315. MD. CODE ANN., TAX-GEN. § 10-720 (2000).

316. MD. ENERGY ADMIN., MARYLAND ENERGY OUTLOOK 70 (2010), http://www.energy.state.md.us/documents/MEOFINALREPORTJAN2010.pdf.

317. *Id*. at 73.

318. *Id*. at 71.

319. *Id*. at 72.

a refund in the amount of any excess credit.[320] In doing so, it joined a number of other states that have adopted refundable tax credits.[321]

B. Transferable State Tax Credits

In June 2005, Iowa enacted production tax credits for producers of wind energy ("Section 476B Credit")[322] and other producers of renewable energy ("Section 476C Credit").[323] The owner of an eligible facility is allowed a credit for each kilowatt hour of energy produced (1.5¢/kWh for the Section 476C Credit; 1.0¢/kWh for the Section 476B Credit) during the 10 year period beginning on the date the facility was placed in service. In 2008, the Section 476B Credit was changed from being transferable only one time to being freely transferable.[324] The Section 476C Credit may also be transferred, but only one time.[325] Any consideration received by the transferor of the tax credit certificates will not be included in the transferor's gross income. Likewise, any consideration paid for the tax credit certificate will not be deducted from the transferee's income. The Iowa Department of Revenue will issue a replacement tax credit certificate to the transferee.[326] The statutes direct the Iowa Department of Revenue to "develop a system for the registration of the wind energy production tax credit certificates issued or transferred under this chapter and a system that permits verification that any tax credit claimed on a tax return is valid and that transfers of the tax credit certificates are made in accordance with the requirements of this chapter."[327]

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320. MD. CODE ANN., TAX-GEN. § 10-720(d), *amended by* Maryland Clean Energy Incentive Act of 2010, 2010 H.B. 464, effective July 1, 2010.

321. *See supra* note 18 and accompanying text.

322. IOWA CODE ANN. § 476B (West 2011).

323. IOWA CODE ANN. § 476C (West 2011).

324. IOWA CODE ANN. § 476B.7, *amended by* 2008 S.B. 2405, effective Jan. 1, 2008.

325. IOWA CODE ANN. § 476C.6 (West 2011) (For these purposes, "a decision between a producer and purchaser of renewable energy regarding who claims the tax credit issued pursuant to this chapter shall not be considered a transfer . . . .").

326. *See, e.g.*, IOWA CODE ANN. § 476B.7 (West 2011) ("Within thirty days of transfer, the transferee must submit the transferred tax credit certificate to the department . . . . Within thirty days of receiving the transferred tax credit certificate and the transferee's statement, the department shall issue one or more replacement tax credit certificates to the transferee . . . . A tax credit shall not be claimed by a transferee under this chapter until a replacement tax credit certificate identifying the transferee as the proper holder has been issued. A replacement tax credit certificate may reflect a different type of tax than the type of tax noted on the original tax credit certificate.").

327. IOWA CODE ANN. § 476B. 9 (West 2011).

In late 2009, Iowa Governor Chet Culver designated a seven-member "Tax Credit Review Panel" to review Iowa's existing tax credit programs.[328] Among the panel's findings were that "[t]ransferability allows entities that are the direct beneficiaries of the tax credit program with low or zero tax liability to still benefit from a tax credit, and it also allows those entities to immediately receive cash from an award, not waiting until they file their tax return."[329] However, it also found as follows:

> Transferability of tax credits complicates the projection of revenues and the tracking of credits, creates uncertainty about when credits will be claimed because the purchasing entity may utilize a different fiscal year than the entity awarded the credit, and siphons resources from awarded entities through brokerage fees. In essence, the individual or entity that benefits from the tax credit is not the entity that is the objective of the tax credit program or is undertaking the original intent of the public policy for the tax credit program. Once tax credits are transferred, it creates limited recourse for the state to recover funds claimed in instances where the business awarded the original credit does not fulfill the contracted obligations or if the credit was awarded in error. Additionally, transferability has also resulted in abuses in some tax credit programs.[330]

The report ended by recommending the elimination of the transferability provisions for both the Section 476B and Section 476C Credits.[331] These recommendations seem not to have been adopted by the legislature.

Other examples of transferable state tax credits are noted in Part I.[332]

C. Flexible Partnership Allocation Schemes

New Mexico's Renewable Energy Production Tax Credit offers a tax credit of $0.01/kWh for companies that generate electricity from wind and biomass and a $0.027/kWh credit for companies that generate electricity

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328. Letter from Richard Oshlo, Interim Dir., Iowa Dep't of Mgmt., to Chester J. Culver, Iowa Governor (Jan. 8, 2010), http://www.desmoinesregister.com.

329. STATE OF IOWA TAX CREDIT REVIEW PANEL, STATE OF IOWA TAX CREDIT REVIEW REPORT 4 (2010), http://www.com.state.ia.us/tax_credit_review/files/TaxCreditStudyReviewReportFinal_ReportFINAL1_8_2010.pdf.

330. *Id.*

331. *Id.* at 10.

332. *See supra* note 19.

from solar energy.[333] To qualify for the credit, the taxpayer must either hold title to a "qualified energy generator"[334] or lease from a county or municipality, under authority of an industrial revenue bond, the property on which the generator operates. A taxpayer may be allocated all or a portion of the right to claim the credit without regard to its proportional ownership interest, so long as (1) the taxpayer owns an interest in a business entity that is taxed for federal income tax purposes as a partnership, (2) the partnership (or a lower-tier partnership) would qualify for credit; and (3) the taxpayer and all other taxpayers allocated a right to claim the credit collectively own at least a 5 percent interest in the qualified energy generator.[335] The partnership must provide notice of the allocation to the New Mexico Energy, Minerals, and Natural Resources Department ("EMNRD") and the EMNRD must approve the allocation in writing.[336] The taxpayer must request a certification of eligibility for the credit from the EMNRD. To claim the credit, the taxpayer must attach to their income tax return (1) the certificate of eligibility; (2) the allocation notice approved by the EMNRD; (3) documentation of the amount of electricity produced by the renewable energy facility for the tax year; and (4) Renewable Energy Production Tax Credit Claim Form RPD-41227.

Another case in point is Virginia's State Historic Rehabilitation Tax Credit,[337] which provides that credits granted to a partnership may be allocated among all partners, either in proportion to their ownership interest in the partnership, or as the partners mutually agree.[338] The Virginia Department of Historic Resources must certify the amount of rehabilitation expenses eligible for the credit, and the certification letter will make reference to the partnership agreement or other partnership document that allocates the credits to the partners.[339] The FAQs for the rehabilitation credit

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333. N.M. STAT. ANN. § 7-2A-19 (West 2011). The credits are available for 10 years. The credit amount for solar varies in each of the ten years from $.015/kWh to $.04/kWh, but comes out to an average of $.027/kWh over a ten-year period.

334. A "qualified energy generator" means "a facility with at least one megawatt generating capacity located in New Mexico that produces electricity using a qualified energy resource and that sells that electricity to an unrelated person." N.M. STAT. ANN. § 7-2A-19(F)(2) (West 2011).

335. N.M. STAT. ANN. § 7-2A-19(H) (West 2011).

336. N.M. STAT. ANN. § 7-2A-19 (H) (West 2011). *See also* NEW MEXICO TAXATION AND REVENUE DEP'T, CLAIMING TAX CREDITS FOR CRS TAXES AND BUSINESS-RELATED INCOME 10 (rev. 2010), http://www.tax.newmexico.gov/SiteCollectionDocuments/Publications/FYI-Publications/FYI-106_CLAIMING%20TAX%20CREDITS%20FOR%20CRS%20TAXES%20AND%20BUSINESS%20RELATED%20INCOME%20-%20June%202009.pdf.

337. VA. CODE ANN. § 58.1-339.2 (West 2011).

338. VA. CODE ANN. § 58.1-339.2.A (West 2011).

339. 17 VA. ADMIN. CODE § 10-30-140(B) (2006).

state that while the tax credits may not "technically" be sold, they "may be syndicated through the use of limited partnerships" which is a "common tool for bringing investors into a rehabilitation project."[340]

D. Traditional Partnership Allocation Schemes

New Mexico's Qualified Business Facility Rehabilitation Credit may be claimed by individual partners in a partnership, but only in an amount equal to the partner's pro rata share of the credit.[341] An individual claiming the credit derived from a partnership must provide a schedule listing the names, addresses and social security numbers or federal employer identification numbers of all partners in the partnership, the pro rata share of the credit of each partner, and the federal employer identification number and New Mexico Combined Reporting System identification number, if any, of the partnership.[342]

E. Hybrid Schemes

Arizona's Solar and Wind Energy Tax Credit,[343] established in 2006,[344] provides a personal and corporate tax credit equal to 10 percent of the installed cost of a "solar energy device."[345] The tax credit is non-refundable[346] and may be carried forward for up to five years.[347] Where the credit is claimed by partners in a partnership, each partner may only claim a pro rata share of the credit "based on the ownership interest or financial

340. VA. DEP'T OF HISTORIC RES., *Rehabilitation Tax Credits: Frequently Asked Questions*, VIRGINIA.GOV, http://www.dhr.virginia.gov/tax_credits/tax_credit_faq.htm (last visited Dec. 8, 2011).

341. N.M. STAT. ANN. § 7-2-18.4(E) (West 2011) ("A taxpayer who otherwise qualifies and claims a credit on a restoration, rehabilitation or renovation project on a building owned by a partnership or other business association of which the taxpayer is a member may claim a credit only in proportion to his interest in the partnership or association.").

342. N.M. CODE R. § 3.3.13.11(I)(2) (LexisNexis 2011).

343. ARIZ. REV. STAT. ANN. § 43-1085 (West 2011); ARIZ. REV. STAT. ANN. § 43-1164 (West 2011); ARIZ. REV. STAT. ANN. § 41-1510.01 (West 2011).

344. H.R. 2429, 47th Leg., 2nd Sess. (Ariz. 2006).

345. The program guidelines for the solar energy tax credit program state that "wind generator systems" are also included in the definition of solar energy devices. ARIZ. COMMERCE AUTH., COMMERCIAL/INDUSTRIAL SOLAR ENERGY TAX CREDIT PROGRAM: PROGRAM GUIDELINES 2 (2011), http:/www.azcommerce.com/assets/pdfs/incentives/Commercial-Industry-solar-program/Solar-Guidelines.pdf.

346. *Id*. at 3.

347. ARIZ. REV. STAT. ANN. § 43-1085(E) (West 2011); ARIZ. REV. STAT. ANN. § 43-1164(E) (West 2011).

investment in the system."[348] In 2007, however, the credit was revised retroactively to allow taxpayers who qualify for the credit to transfer the credit to third-party organizations "that financed, installed, or manufactured" the solar energy devices.[349] The party that installs the solar energy device must apply to the Arizona Commerce Authority for a credit certificate in order to claim the credit. Upon completion of the project, it is required to submit a completion report, stating the name, address, and telephone number of the third-party financier if it is electing to pass through the credit to a third party. The Arizona Commerce Authority will only certify requests to pass on the entire credit allocation for a specific solar energy device, and will not approve requests to pass on only a portion of a credit.

In contrast, Arizona's Renewable Energy Industry Credit, which provides a 10 percent credit to a taxpayer who either locates or expands a renewable energy manufacturing facility or renewable energy business headquarters in Arizona, and is subject to the same partnership allocation rules as the Solar and Wind Energy Tax Credit, is not specifically transferable to a third-party, but instead is refundable.[350]

VII. FEDERAL TAX TREATMENT OF STATE TAX CREDIT GRANTS, TRANSFERS AND ALLOCATIONS

A chronological survey (not intended to be exhaustive) of the hodge-podge of rulings (Revenue Rulings, Private Letter Rulings ("PLRs") and Chief Counsel Advice ("CCA")), cases, and other guidance addressing the federal tax treatment of state tax credit grants, transfers' and allocations is set forth below. They are interesting, not only for their specific holdings, but also on occasion for their description of a state's tax credit regimes.

A. Survey of the Guidance

Revenue Ruling 79-315[351] *— Treatment of Recipient*. Holding 3 of Revenue Ruling 79-315 provides that if all or a portion of a state tax rebate (the ruling addresses a program of tax rebates enacted by the Iowa legislature) is credited against tax due for a taxable year, the amount credited is treated as a reduction of the outstanding liability and is neither includible in income nor allowable as a section 164 deduction.

348. ARIZ. REV. STAT. ANN. § 43-1085(F) (2011) (West); ARIZ. REV. STAT. ANN. § 43-1164(F) (West 2011).

349. H.R. 2491, 48th Leg., 1st Sess., § 2 (Ariz. 2007).

350. ARIZ. REV. STAT. ANN. § 43-1085.01 (West 2011); ARIZ. REV. STAT. ANN. § 43-1164.01 (West 2011); ARIZ. REV. STAT. ANN. § 41-1511 (West 2011).

351. Rev. Rul. 79-315 1979-2 C.B. 27.

PLR 8742010[352] — *Treatment of Purchaser*. Pursuant to an applicable state law program, T purchased tax credits (allowable over a five year period) from Y by paying Y an amount equal to the present value of the tax credits. Under the facts presented in the ruling, T's participation in the program was required by state law in the conduct of T's business. The ruling concludes that T should be permitted a deduction under section 162 for amounts paid to Y to acquire Y's state tax credits in the years and in the proportions the credits to which the amounts paid relate are applied as an offset to state taxes. To the extent the credits are applied as an offset to state taxes in future years, T should recognize such tax-offsets as a reduction in the deduction for state excise taxes in the years the credits are applied as an offset to state taxes.

Snyder v. Commissioner[353] — *Treatment of Recipient*. The State of Ohio provided a reduction in taxes (formulated as a percent of wagers) for holders of horse-racing permits who made certified capital improvements to their facilities. The tax reduction was structured to apply for six years or until equaling 70 percent of the cost of the improvements. The Tax Court had held that certification of improvements satisfied the all events test such that the taxpayer should have included the amount of the tax reduction in income in full in the year of certification of the capital costs. However, before the case reached the Sixth Circuit, the IRS acknowledged that its prior position regarding the tax reductions was erroneous, and agreed with the taxpayer that the proper treatment of the tax reduction was simply "to reduce the deductions available to [the partnership] for its pari-mutuel tax obligations, which reduced deductions accrue as those become due."[354] The Sixth Circuit agreed with this analysis. The court noted that this case "does not involve any right on the part of [the taxpayer] to receive an amount of money from the State of Ohio; it simply involves a right to start paying the state less in taxes than would have to be paid in the absence of the right."[355] The court held there was no "income" from the State of Ohio for the partnership to accrue.[356]

CCA 200126005[357] — *Treatment of Purchaser*. CCA 200126005 addresses the tax treatment of a purchaser of Colorado state tax credits granted for donations of conservation easements. The CCA concludes that the purchaser's application of the purchased credit in satisfaction of its tax liability is "analogous to a taxpayer being permitted to pay its state tax liability by transferring property to the state" and such payment is deductible

352. I.R.S. Priv. Ltr. Rul. 87-42-010 (July 10, 1987).
353. No. 89-1276, 1990 WL 6953 (6th Cir. Feb. 1, 1990).
354. *Id*. at *4.
355. *Id*.
356. *Id*.
357. I.R.S. Chief Couns. Adv. 2001-26-005 (June 29, 2001).

under section 164. The credit was refundable in certain circumstances (but only in the hands of the original recipient) and transferable.

A companion CCA addressing promised guidance for the original recipient of the Colorado conservation easement credit concludes the issues are best addressed in published guidance and declines to express a view. [358] The CCA does, however, outline a number of issues peculiar to the interplay of the credit with the grant of the easement and the charitable contribution deduction.

CCA 200211042[359] *— Treatment of Recipient/Seller*. The credit in question in CCA 200211042 was a Missouri income tax credit based on environmental remediation expenditures. It could be claimed for the year in which the costs were incurred or over twenty years. If the expenditures were made by an S corporation or partnership, the Missouri law specified the credit was to be claimed by the members of the entity based on proportional share ownership. The credit also was transferable; in the case of a transfer the state would reissue the credit in the name of the transferee. The ruling recites that brokers facilitated sales of the credits at between eighty and ninety cents on the dollar.

The CCA addresses two questions: the federal tax consequences of receipt of the state tax credit and the federal tax treatment of a sale of the tax credit. It concludes that receipt of the credit is not includible in income; if the recipient uses the credit to reduce its state taxes this simply reduces the recipient's federal tax deduction for state taxes pro tanto:

> Generally, a state tax credit, to the extent that it can only be applied against the 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. The amount of the credit is not included in the taxpayer's federal gross income, or otherwise treated as a payment from the state, and is not deductible as a payment of state tax under § 162 or § 164. Cf. Rev. Rul. 79-315, 1979-2 C.B. 27, Holding (3) (Iowa income tax rebate). Similarly, an accrual-basis taxpayer is not required to take the value of such future tax credits into income; the credits will simply reduce the taxpayer's otherwise-deductible tax liabilities as, and if, they accrue. *See Snyder v. United States*, 894 F.2d 1337 (6th Cir. 1990).[360]

358. I.R.S. Chief Couns. Adv. 2002-38-041 (Sept. 20, 2002).

359. I.R.S. Chief Couns. Adv. 2002-11-042 (Mar. 15, 2002).

360. The ruling explains that refundable credits similarly do not generate income except to the extent of the actual refund. The portion of the credit that

The ruling notes that transferability is a hallmark of "property" and that this feature of the credit suggests the issuance of the credit should be includible in income. However, the ruling concludes that the right of transferability, without more, should not require that outcome: "the remediation tax credit retains its character as a reduction or potential reduction in state tax liability, unless and until it is actually sold to a third party."[361]

Having so concluded as to the tax consequences of receipt of the tax credit, the ruling notes the recipient thus has no tax cost basis in the credit and therefore upon a sale of the credit will be required to include the gross proceeds of sale in income. The ruling further determines that the income should be reported as ordinary income. After first acknowledging that under section 1221 the term "capital assets" includes "all classes of property not specifically excluded by section 1221,"[362] and further that none of the listed exceptions in section 1221 appears to apply to the state tax credit, the ruling states that nonetheless the tax credit is not a capital asset:

> [D]espite § 1221's apparent broad definition of capital asset, the Supreme Court has stated "it is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset"; rather, "the term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year." *Commissioner v. Gillette Motor Transport, Inc*., 364 U.S. 130. 134 (1960) . . . . Accordingly, the Court has held that certain interests that are concededly "property" in the ordinary sense are not capital assets. *Id*.; *Hort v. Commissioner*, 313 U.S. 28 (1941) (unexpired lease); *Commissioner v. P.G. Lake, Inc*., 356 U.S. 260 (1958) (oil payment rights).
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> A taxpayer who sells a remediation tax credit has parted with all rights in the credit. However, as discussed above in connection with its original issuance, the credit, even though it is transferable, primarily represents the right to a reduction

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operates to zero out the state tax is not includible in income, but rather simply reduces the allocable federal tax deduction for state taxes.

361. I.R.S. Chief Couns Adv. 2002-11-042 (Mar. 15, 2002).

362. *Id*.

> or potential reduction in the holder's tax liability. It is not incident to, and does not create an estate in, property that is itself a capital asset. While it does not represent compensation for specific services, it was issued as an incentive for the recipient to engage in remediation activities. Moreover, in that sense it has already been "earned". . . . Although the credit is not a right to a stream of ordinary income, it is a right to reductions in tax payments normally deductible from ordinary income. As a transferable asset, the credit has a certain market value that may fluctuate over time; however, as a credit against a state tax liability, it does not appreciate or depreciate and can be used at any time for its stated amount by any holder with a tax liability. Finally, the original issuance of the credit was not treated for federal tax purposes as a transfer of property includable in the recipient's income; the recipient has no "tax cost" or other basis in the credit, no investment, and no risk of loss. Balancing these factors, we conclude that the remediation tax credit is not property for purposes of § 1221.[363]

CCA 200445046[364] *— Treatment of Purchaser*. CCA 200445046 addresses whether the purchasers of Massachusetts historic rehabilitation tax credits and low-income housing tax credits have made a "payment" for purposes of section 164(a) when they file their state tax returns and use the purchased credits to reduce their state tax liability. The CCA concludes in the affirmative, but clarifies that the payment made by the purchaser to the transferor of the credit is not a payment of tax or a payment in lieu of a tax for purposes of section 164. Rather, having purchased the credit for value, the credit is "property" in the purchaser's hands; therefore, the use of the credit by the purchaser to reduce its state taxes is akin to the transfer of property to the state in satisfaction of the transferee's liability — a payment of tax for purposes of section 164.

The CCA involved two Massachusetts tax credits — an historic rehabilitation tax credit and LIHTC. A Massachusetts taxpayer eligible for the applicable credit is entitled to transfer it (on prior notice to the Massachusetts Department of Revenue) pursuant to a transfer contract with

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363. *Id*.

364. I.R.S. Chief Couns. Adv. 2004-45-046 (Nov. 5, 2004). *See also* I.R.S. Priv. Ltr. Rul. 2003-48-002 (Nov. 28, 2003).

the transferee "without the requirement of transferring any ownership interest in the project or any interest in the entity which owns the project."[365]

CCA 200704028[366] *— Treatment of Recipient/Seller and Purchaser of Nominally Nontransferable Credits*. CCA 200704028 is the pre-cursor to the *Virginia Historic Tax Credit* litigation. The facts of the case, of course, are more elaborately set forth in the Tax Court and Fourth Circuit decisions. Simplifying somewhat, the CCA describes individual investors investing cash in a partnership and receiving, in the aggregate, a 1 percent partnership interest and an allocation of 100 percent of certain state rehabilitation tax credits. The investors were described as "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."[367] The investors granted options to the partnership to repurchase their interests for fair value for a period of one year. However, most of the investors sold their interests after only a matter of months to one of the key promoters for a small fraction of their investments. Consequently, the investors claimed large capital losses on their federal income tax returns. The investors were told that they would not receive any material economic interest in the partnership, and the marketing materials stated that the investors' returns would be dependent entirely upon the allocation of the state tax credits and the tax loss on the sale.

The CCA concludes that the investors are not partners in a partnership for federal income tax purposes and accordingly the transaction should be "recast under the principles of the Substance-over-Form doctrine" as "direct sales and purchases of the credits."[368] The partnership generating the credits thus must report gains from the sale of the credits allocable to the

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365. I.R.S. Chief Couns. Adv. 2004-45-046 (Nov. 5, 2004) (quoting from 830 MASS. CODE REGS. 63.38R.1(7)(a) (LexisNexis 2011), governing transfers of the Massachusetts historic rehabilitation tax credit.) The wording of 760 MASS. CODE REGS. 54.07(1) (LexisNexis 2011), governing transfer of the LIHTC is nearly identical. The former permits transfers by "any taxpayer allowed to take the historic rehabilitation credit . . . to any individual or entity." The latter permits transfers by "any taxpayer with an ownership interest in a qualified Massachusetts project with respect to which there has been allocated Massachusetts low-income housing tax credit and any taxpayer to whom the right to claim Massachusetts low-income housing tax credit has been allotted or transferred . . . to any other Massachusetts taxpayer eligible to claim a federal low-income housing tax credit with respect to the original or a different qualified Massachusetts project." The historic rehabilitation tax credit may be transferred in whole or in part, whereas in the case of the LIHTC the transferor is required to transfer the entire credit attributable to periods after the transfer date.

366. I.R.S. Chief Couns. Adv. 2007-04-028 (Jan. 26, 2007). *See also* I.R.S. Chief Couns. Adv. 2007-04-030 (Jan. 26, 2007).

367. I.R.S. Chief Couns. Adv. 2007-04-028 (Jan. 26, 2007).

368. *Id.*

developers, promoters, and other partners in the partnership. When the investors use the credits to reduce their state tax liability they will engage both in a taxable disposition of the credits under section 1001 and a payment of state taxes deductible under section 164. The losses claimed by them on the sales of putative partnership interests will be disallowed.

The CCA further concludes the transaction should be "recharacterized as a disguised sale of property under § 707(a)(2)(B)" and "recast under the partnership anti-abuse rule":[369]

> 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 [partnership] 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, [partnership] 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.[370]

The IRS Office of Chief Counsel concurrently released AM 2007-002, addressed to the Deputy Division Counsel for the Small Business/Self-Employed Division, responding to a request for advice on "a partnership structure . . . that is being used to market transferable and nontransferable state income tax credits . . . to generate federal income tax losses."[371] The facts and legal analysis largely track the CCA, with the exception of the omission of a discussion of section 707.

2008 Coordinated Issue Paper[372] *— Treatment of Recipient*. In 2008, the IRS National Office issued a position paper relating to state and local

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369. The CCA also concludes that whether an investor in a partnership is a partner constitutes a "partnership item" under the TEFRA partnership procedures.

370. I.R.S. Chief Couns. Adv. 2007-04-028 (Jan. 26, 2007).

371. I.R.S. Adv. Mem. 2007-002 (Jan. 26, 2007).

372. I.R.S., Coordinated Issue Paper All Industries-State and Local Location Tax Incentives, LMSB-04-0408-023 (May 23, 1008). *See also*, I.R.S., Coordinated Issue Paper All Industries-Exclusion of Income: NonCorporate Entities and Contributions to Capital, LMSB04-1008-051 (Nov. 18, 2008). In this coordinated issue paper, the IRS states that "neither section 118 nor any common

location tax incentives (rate reductions, abatements, property tax reductions, and other incentives, as well as tax credits) in reaction to the practice of certain corporate taxpayers of treating the incentive as income excludable under section 118 (albeit triggering a basis reduction under section 362(c)) while claiming a federal tax deduction for the full, unabated tax applicable in the absence of the incentive.

The position paper concludes that (1) a state or local location or similar tax incentive is not income under section 61; (2) even if it is, it would generally not be excludible from income as a non-shareholder contribution to capital under section 118(a); and (3) a location tax incentive is not deductible as tax paid or accrued in the taxable year under section 164 (to the contrary, the tax incentive simply reduces the taxpayer's state and local tax obligations). The position paper relies on Revenue Ruling 79-315 and *Snyder*, both discussed above, among other authorities. The position paper expressly does not address "the correct federal tax treatment of state or local refundable credits, transferable credits (including nominally nontransferable credits that are treated for federal tax purposes as transferable, under the Virginia Historic Tax Credit CCA discussed above) or tax benefits provided in return for specific consideration, such as services, property or the use of property."[373]

LAFA 20085201F[374] *— Treatment of Recipient*. A 2008 memorandum issued by Associate Area Counsel in Detroit addresses Michigan Economic Growth Authority ("MEGA") credits. Eligibility for the credits was tied to the creation of "qualified new jobs." The credits were non-transferable but were refundable. The memorandum concludes that "refundability, by itself, does not cause the entire credit to be treated as a payment from the state."[375] Rather the credit is includable in gross income to the extent it exceeds the taxpayer's tax liability and is made available to the taxpayer as a cash payment, and otherwise is a reduction in the amount of state tax expense (and in the amount allowable as a deduction under section 164). The memorandum further concludes that credit refunds includible in income do not qualify as a non-shareholder contribution to capital under section 118, among other reasons because the intent of the state in granting the credit is to subsidize operating expenses, not capital formation.

CCA 201147024[376] *— Treatment of Recipient/Seller and Purchaser*. CCA 201147024 addresses questions arising with respect to the receipt and

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law contribution to capital doctrine permits the exclusion from gross income of amounts paid to non-corporate entities by a non-owner."

373. I.R.S., Coordinated Issue Paper All Industries-State and Local Location Tax Incentives, LM5B-04-0408-023, (May 23, 2008).

374. I.R.S., Legal Adv. Issued by Field Attorneys, 2008-52-01F (Nov. 26, 2008).

375. *Id.*

376. I.R.S. Chief Couns. Adv. 2011-47-024 (Nov. 25, 2011).

transfer of various non-refundable, transferable Massachusetts tax credits, including (among others) the Massachusetts Historic Rehabilitation Tax Credit and LIHTC.[377] Consistent with earlier rulings, including CCA 200211042, it concludes that the taxpayer receiving the tax credit should not be viewed as having received property in a realization event resulting in a section 61 income inclusion, notwithstanding a right to transfer the credit. Further, it concludes that a transfer of the credit to another taxpayer for return consideration is a sale, that the original recipient of the credit has no tax cost basis in the credit and that therefore the gross proceeds of the sale are includible in income as gain on the sale. The CCA departs from prior guidance such as CCA 200211042, in light of the decision in *Tempel* (discussed below), and concludes that a taxpayer qualifying for one of the nonrefundable tax credits addressed in the CCA generally would realize capital gain on the sale of the credit.[378]

Finally, the CCA concludes vis-à-vis the purchaser of the tax credit that, for federal tax purposes, the use of the tax credit to satisfy the purchaser's state tax liability is a transfer of property to the state in satisfaction of the liability, not a reduction in the liability. As a result, in the year or years the purchaser applies the tax credit to satisfy its state tax liability, the purchaser will realize gain or loss under section 1001 equal to the difference between the basis of the tax credit and the amount of liability satisfied by the application of the tax credit.[379] In addition, the purchaser will be treated as having made a payment of state tax for purposes of section 164(a).

B. The Tempel *Case*

Tempel v. Commissioner[380] addresses the federal income tax consequences of sales of Colorado conservation easement income tax credits.[381] The taxpayers (husband and wife) had donated a qualified conservation easement to charity and received the credits as a result of their donation. They sold some of the credits and retained the balance, allocating

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377. *Cf.* I.R.S. Chief Couns. Adv. 2004-45-046 (addressing the federal income tax treatment of the *purchase* of such credits). *See also supra* notes 364–65 and accompanying text.

378. The CCA states that: "[w]e do not agree with the reasoning in *Tempel* that the multi-factor analysis in cases like *Foy* and *Gladden* applies only when there are contract rights at issue. . . . However, we accept the conclusion of the Tax Court in *Tempel* and *McNeil*, which the court could have reached under the established multi-factor test, that a nonrefundable state tax credit that does not fall within the statutory exclusions in § 1221(a) is a capital asset for purposes of § 1221."

379. *See also* I.R.S. Priv. Ltr. Rul. 2009-51-024 (Dec. 18, 2009).

380. 136 T.C. 341 (2011).

381. *See supra* notes 357–58 and accompanying text.

the professional expenses they incurred in connection with donation of the property, pro rata, as "basis" in the credits. The donation to charity and sale of credits both occurred in December 2004. The taxpayers originally reported their gains as short-term capital gains. On audit, the IRS disallowed the basis claim and characterized the gains as ordinary rather than capital. On cross-motions for summary judgment before the court, the taxpayers claimed that their gains should have been reported as long-term capital gains.

The tax credits in question were refundable under certain circumstances not factually present in the case. The credits also were transferable; transferees were permitted to use the credits only to offset their tax liability and were ineligible for a refund in all cases. The parties stipulated that the conservation easement contribution was neither a sale or exchange of the easement nor a *quid pro quo* transaction.

The court agreed with the taxpayers that the tax credits at issue were capital assets and agreed with the IRS that the taxpayers had neither basis, nor a long-term holding period in the tax credits.

On the central issue of the character of the gain, the court addressed much of the same authorities addressed in CCA 200211042 discussed above and, specifically, articulated the proposition that the term "capital asset" is "not without limits beyond those imposed by statute" (i.e., the eight categories of property specifically excluded from the definition of "capital assets" set forth in section 1221).[382] However, after a brief review of the case law, the court concluded that "the substitute for ordinary income doctrine is the only recognized judicial limit to the broad terms of section 1221."[383]

The court, in turn, concluded that the Colorado tax credits do not come within the substitute for ordinary income doctrine on the grounds that: (1) a government-granted tax credit is not a contract right; (2) the tax credits are not a substitute for a tax refund that would have been ordinary income because the facts do not establish a refund would have been forthcoming; (3) a reduction in state tax liability (the default outcome in the absence of a sale of the credits) is not an accession to wealth; and (4) the taxpayer "never possessed a right to income" on account of the credits and "did not sell a right either to earned income or to earn income."[384]

The court's decision is compatible with the IRS's position discussed above that "the right of transferability, without more" is insufficient to require the receipt of a tax credit to be included in income.[385] However, this

382. *Tempel*, 136 T.C. at 346.

383. *Id*.

384. *Id*. at 348–52.

385. *See, e.g.*, I.R.S. Chief Couns. Adv. 2002-11-042 ("[T]he remediation tax credit retains its character as a reduction or potential reduction in state tax liability, unless and until it is actually sold to a third party.") *See also supra* notes 359–63 and accompanying text.

position really is discernible only from guidance from the Office of Chief Counsel to the Field, whereas the Tax Court cites *Browning v. Commissioner*[386] and Revenue Ruling 79-315 as the authority for its decision. Revenue Ruling 79-315, as briefly summarized above, addresses the issuance of a nontransferable tax rebate (in the form of a tax credit or, in the absence of a tax liability, cash refund); to the extent credited against tax due it is treated simply as a reduction in the liability and is neither includible in income nor allowable as a section 164 deduction. The *Browning* case involved a bargain sale of property to a charity and held that the tax benefits generated by the transaction are not includible in the taxpayer's amount realized for purposes of computing the charitable contribution deduction.[387] Neither authority is on point.

If, to the contrary, an income inclusion is deemed triggered by issuance of a transferable tax credit to a taxpayer, the taxpayer would have a tax cost basis in the credit, so that a subsequent sale of the credit at a discount from face either produces no gain or loss (if the credit was valued based upon its realizable value on sale) or results in a loss (if the credit was included in income at its face value) presumably to be characterized as ordinary, and a net ordinary income inclusion in the amount of the cash received on sale. The taxpayer that instead simply uses the tax credit would be entitled to an offsetting section 164 deduction in light of the income inclusion (at face) and thus no net deduction, and increased ordinary income for federal income tax purposes in the amount of the state tax credit (same arithmetic result as exclusion of the credit from income and denial of a section 164 deduction). Such an approach in *Tempel* would have produced a more sensible outcome.[388] Deployment of the underlying principle also might have implications in cases like *Virginia Historic Tax Credit* as will be discussed in Part VII.D.

386. 109 T.C. 303, 324–25 (1997).

387. The government argued that "the value of tax deferral received from the installment sale of the easement to the county, the tax-free nature of the interest on the county's debt, and the value of the charitable contribution deduction all must be subtracted from the fair market value of the easement in determining the amount of any gift to the county." *Id*. at 324.

388. *Accord* Robert Feldgarden, Letter to the Editor, *Tempel: Allowing Capital Gain on Unappreciated Property*, 131 TAX NOTES 329 (Apr. 18, 2011) (suggesting the taxpayer in *Tempel* should have been required to include the fair market value of the state tax credits in gross income (based on the sales price of the credits sold of approximately 85 cents on the dollar) upon issuance). *See also infra* note 415 and accompanying text.

C. The Virginia Historic Tax Credit *Case*

In *Virginia Historic Tax Credit*,[389] the Court of Appeals for the Fourth Circuit ruled that a partnership's purported allocations of Virginia state historic rehabilitation tax credits to certain of its partners for the 2001 and 2002 tax years amounted to "sales" of the tax credits for federal tax purposes, pursuant to section 707. It did so "[a]ssuming, without deciding, that a 'bona fide' partnership existed."[390] The Tax Court had determined, to the contrary, that the state tax credit investors (the "investors") were in fact partners in a bona fide partnership for federal tax purposes and that the transactions between these investors and the partnership were not disguised sales under section 707; rather the Tax Court held that "the substance of the transactions matched their form."[391]

Under the Virginia legislation, any person rehabilitating a historic property that obtained state approval and certification of the project by the Virginia Department of Historic Resources was entitled to receive tax credits for up to 25 percent of eligible renovation costs.[392] The tax credits generally were not transferable but the Virginia legislation authorized a partnership in receipt of the state tax credits to divide them among the partners "as the partners . . . mutually agree."[393] An exception to the rule against transfer of the credits was made in 1999 to allow for a one-time transfer (by sale or otherwise) of credits for projects that had received certification prior to the finalization of the rules, to protect projects that had been structured on the assumption the credits would be transferable.

The structure involved in *Virginia Historic Tax Credit* was as follows:

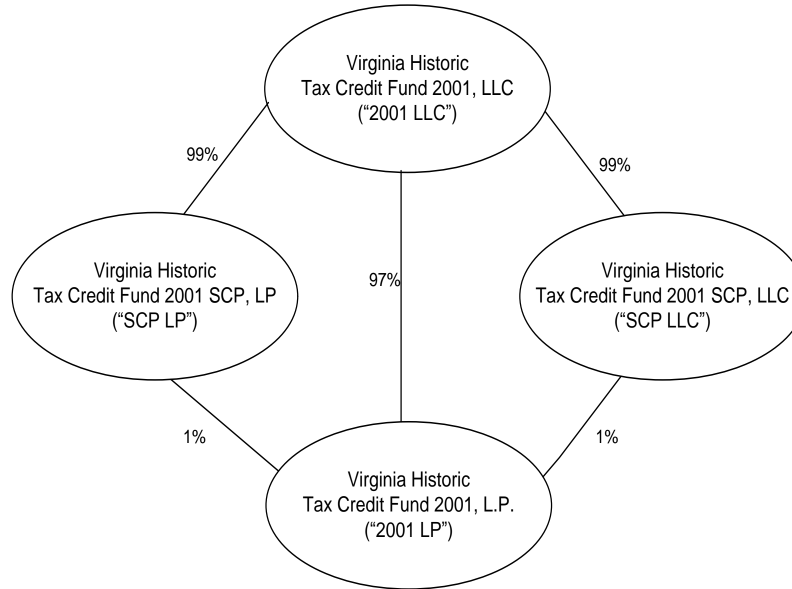
389. Virginia Historic Tax Credit Fund 2001 v. Commissioner, 639 F.3d 129 (4th Cir. 2011), *rev'g* 98 T.C.M. (CCH) 630 (2009).

390. 639 F.3d at 137.

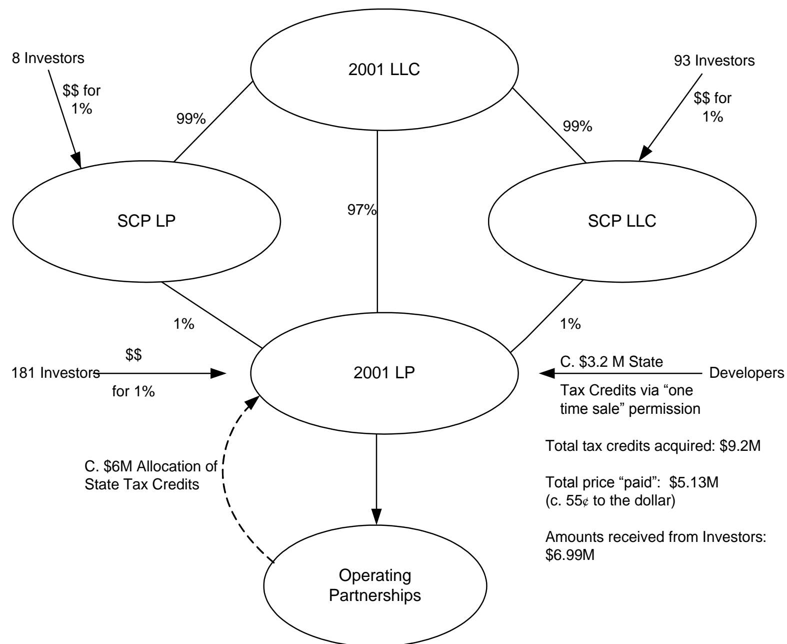
391. Virginia Historic Tax Credit Fund 2001 v. Commissioner, 98 T.C.M. (CCH) 630, 635 (2009).

392. VA. CODE ANN. § 58.1-339.2 (West 2011).

393. VA. CODE ANN. § 58.1-339.2(A) (West 2011).



One percent interests in each of SCP LP, SCP LLC and 2001 LP (the "Funds") were reserved for investors.



Each investor was promised a specific amount of the credits and a limited partnership interest in exchange for a capital contribution. Each investor "paid" between 74¢ and 80¢ for each dollar of tax credit and was allowed a refund (net of expenses) of its investment if the credits could not be obtained. The total amount raised from investors in this way was approximately $6.99 million. As a practical matter, the investors in each of the three funds depicted above received in return (apart from the tax credits) an *aggregate* one percent interest in the respective Funds and were advised they would "receive no material amounts of partnership income or loss."[394]

Each investor granted its Fund an option permitting the general partner to purchase the investor's interest for fair market value during 2002. In April 2002, the Funds distributed Schedules K-1 to the investors designating to each investor his promised amount of the tax credits. In May 2002, the promoter-partners of the Funds bought out all the investors, paying them each .001 times their contribution for a total buyout cost of approximately $7,000.

The buy-out had two notable apparent effects: (1) ostensibly for 2002 it triggered a tax loss of approximately $7 million for the investors upon sale of their interests in the Funds (notwithstanding their enjoyment of $9.2 million in state tax credits against an investment of $7 million); and (2) it generated a "windfall" for the continuing partners — we will return to the question of taxability — of approximately $1.53 million ($6.99 million received from the investors less the $5.15 million paid to developers or contributed to Operating Partnerships less syndication costs and other expenses of $330,986).

For tax purposes, the Funds reported the money paid to the Operating Partnerships and others in exchange for tax credits under the grandfather provision for sales of credits as deductible expenses (query on what theory), while reporting the $6.99 million received from the investors as non-taxable capital contributions, so that the Funds' tax returns showed a loss of $3.28 million in total for 2001 and 2002. Moreover, the Funds did not have section 754 elections in place, so (under then applicable law) there was no step down in the inside basis of partnership property associated with the acquisition by the promoter-partners of the investors' interests at negligible values.

The IRS took the position that the investors were not actual partners and that the putative capital contributions therefore were proceeds of sales of state tax credits to the investors. In the alternative, the IRS argued that the

394. *Virginia Historic Tax Credit*, 639 F.3d at 134.

transaction between the investors and the Funds were "disguised sales" under section 707. Either argument would suffice for the IRS to prevail.[395]

The Tax Court held for the taxpayers. It did so on the following grounds: (1) the intent to form a partnership as tested under objective factors;[396] (2) the existence of a valid business purpose to achieve state tax savings (the parties apparently having stipulated that "any Federal tax consequences were incidental");[397] and (3) conformity between the form and substance of the transaction.

> The Virginia Program's base-broadening allocation provision encourages capital contributions to cover the credit gap between cost and available financing. This allocation provision allows state investors to contribute capital to historic rehabilitation projects without interfering with the allocation of Federal tax credits. . . . [T]his form was compelled by realities of public policy programs, generally, and the Virginia Program, specifically.
>
> Respondent ignores these realities and argues that the amounts of the contributions, the timing of the transactions, and the investors' lack of risk suggest that the transactions were in substance sales. Respondent argues that the entire amount of an investor's contribution went to the purchase of his or her allocated state tax credits. We find instead that the contributions were pooled to facilitate investment in the developer partnerships, to purchase additional credits under the one-time transfer provision to meet the needs of the partnerships, to cover the expenses of the partnerships, to insure against the risks of the partnerships, and to provide capital for successor entities in which many of the investors participated year after year and for other rehabilitation projects. These pooled capital contributions were critical to the success of both the Virginia Historic Funds and the developer partnerships.[398]

The court noted that "[t]he parties have stipulated that the investors remained in the partnerships until after the partnerships had fulfilled their

395. Note that the government did not argue a third possible avenue of attack — namely, that there was a taxable *capital shift* occasioned by the investors $7 million investment in return for an aggregate one percent interest.

396. *Virginia Historic Tax Credit*, 98 T.C.M. (CCH) at 639 (relying on such authorities as *Commissioner v. Culbertson*, 337 U.S. 733 (1949) and *Luna v. Commissioner*, 42 T.C. 1067 (1964)).

397. *Id.*

398. *Id.* at 639–40.

purpose."[399] It noted the investors bore certain risks, including non-completion of the projects[400] and a potential lack of resources to honor their rights to refunds if the anticipated credits are not obtained,[401] and further noted that the investors shared their risks, pro rata to their interests, across the projects generating the credits.

Finally, the court rejected the IRS's disguised sale argument noting that "the substance of these transactions reflect valid contributions and allocations rather than sales."[402] Section 707(a)(2)(B) allows the IRS to treat a transaction that occurs between a partner and his partnership as though it occurred "between the partnership and one who is not a partner" if the partner transfers money to the partnership in exchange for "a related direct or indirect transfer of money or other property by the partnership to such partner," such that the transaction is "properly characterized as a sale or exchange." Transactions are "presumed sales" when they occur within two years of one another, yet the Tax Court found that the transactions in question were not disguised sales because the transactions were "not simultaneous"[403] and the investors faced "entrepreneurial risks" in the partnership.

> [T]here is no disguised sale when the transactions are not simultaneous and the subsequent transfer is subject to the entrepreneurial risks of the partnership's operations. . . . The investors were promised certain amounts of credits in the subscription agreements, but there was no guarantee that the partnerships would pool sufficient credits. This risk, as well as the other risks addressed in our discussion of business purpose, represent the risks of the enterprise. Accordingly, we conclude that the transactions are not disguised sales. We further hold that the partnerships did not have $7 million

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399. *Id*. at 640.

400. According to the Fourth Circuit decision discussed below, the respective partnership agreements provided that the Funds would only invest in completed projects "thereby eliminating a significant area of risk." Virginia Historic Tax Credit Fund 2001 v. Commissioner, 639 F.3d 129, 134 (4th Cir. 2011), *rev'g* 98 T.C.M. (CCH) 630 (2009).

401. The Fourth Circuit further notes that the right to a refund was supported by guarantees in certain cases. *Id*. at 145.

402. *Virginia Historic Tax Credit*, 98 T.C.M. (CCH) at 641.

403. The Fourth Circuit opinion notes that the subscription agreements executed by the state tax credit investors stated that the amount each paid was "in exchange for the allocation of a corresponding number of tax credits '*simultaneously* with Investor's admission.'" *Virginia Historic Tax Credit*, 639 F.3d at 135 (emphasis in original).

> in unreported income from these transactions in either of the years at issue.[404]

The government appealed the Tax Court's decision to the Fourth Circuit reiterating the arguments it had presented at the trial level. The Fourth Circuit reversed the Tax Court, finding that the transactions at issue were "sales" under section 707. As already noted, it assumed, without deciding, that a bona fide partnership existed.

The court first conducted a thorough review of the disguised sale rules, including the detailed factors for determining the presence of a sale or exchange set forth in Regulations sections 1.707-3 and 1.707-6. Citing *Otey v. Commissioner*,[405] the court noted that section 707 "prevents use of the partnership provisions to render nontaxable what would in substance have been a taxable exchange if it had not been 'run through' the partnership."[406] It noted that under Regulations section 1.707-6 the determination of whether a transfer by a partnership of property to a partner and one or more transfers of money or other consideration by that partner to the partnership are to be treated as a sale of the property to the partners is to be tested with reference to the rules of Regulations section 1.707-3, including the presumption that all transfers "made within two years" of each other are sales unless the facts and circumstances "clearly establish" otherwise.[407]

It then took up the argument advanced by the Funds that section 707 could not apply because the transactions did not involve an exchange of money for "property" — i.e., because the state tax credits are not property. As discussed above, it is well-established that transferable credits can be brought and sold as items of property with the attendant consequences. However, the Virginia historic state tax credits were non-transferable and non-heritable under applicable state law and this formed the basis for the taxpayer's argument.

The court examined whether the rights associated with the Virginia tax credits embodied essential property rights, such as the right to use and exclude others from use, whether the rights were "valuable" and whether they are transferable (noted as a relevant but "not essential" factor), and concluded the transfer of tax credits at issue was a transfer of "property." It dismissed the Virginia law prohibition on transfer as a "nominal prohibition" only:

> As the facts here illustrate, it is a relatively simple matter in Virginia to effectuate a third-party transfer by forming a

404. *Virginia Historic Tax Credit*, 98 T.C.M. (CCH) at 641.
405. 70 T.C. 312, 317 (1978).
406. *Virginia Historic Tax Credit*, 639 F.3d at 138.
407. *Id*. at 139.

> partnership with an interested buyer who is then "allocated" the credits in exchange for a contribution to the partnership. To hold that these tax credits, which the Funds undeniably gave to investors in exchange for money, are not property simply because they could not be directly bought and sold would elevate form over substance in precisely the manner we are advised to guard against.[408]

The court next turned to the question of whether these transfers should be properly recharacterized as "sales" under section 707 and the factors enumerated in Regulations section 1.707-3. In determining that they should be, the court took a number of factors into account — from the essential certainty as to timing and amount of the credits to be received, to the legally enforceable rights of the investors created under the agreements, to the right to refunds, to the size of the investments in relation to the investors' "general and continuing interest[s] in partnership profits,"[409] to the transitory nature of the investors' status as partners.

As to the Tax Court's reliance on "entrepreneurial risk" as a basis for setting aside the IRS's disguised sale argument, the Fourth Circuit offered that "upon closer examination" the risks are "speculative and circumscribed."[410] To the contrary, the court concluded, the "investors were promised what was, in essence, a fixed rate of return on investment rather than any share in partnership profits tied to their partnership interests."[411]

In a final footnote, the court acknowledged the transactions were undertaken "with the partial goal of aiding Virginia's historic rehabilitation efforts" and takes the occasion to observe that the Virginia program "is not under attack here."[412] To the contrary, "[t]he Funds remain free to continue their partnership arrangement with investors under Virginia law, and investors remain free to utilize the historic rehabilitation tax credits they receive through this arrangement in their state tax filings."[413]

As can be seen from the survey of authorities above, transferable state tax credits effectively are deemed to "become property upon transfer" (albeit — with the exception of the *Virginia Historic Tax Credit* CCA itself — none of the authorities examined above took up the question in the context of section 707). Therefore, if as the Fourth Circuit found the

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408. *Id*. at 141–42.
409. *Id*. at 144.
410. *Id*. at 145.
411. *Virginia Historic Tax Credit*, 639 F.3d at 145.
412. *Id*. at 146 n.20.
413. *Id*.

allocation scheme in *Virginia Historic Tax Credit* was tantamount to a sale of the credits, the "property" characterization fits rather easily.[414]

Note the implications to the purchasers of the credits of the court's decision (albeit the direct holding of the case addresses the tax treatment of the "sellers" of the credits): presumably, consistent with the guidance reviewed above, the investors had a $7 million tax cost basis in the credits, were entitled to a $9.2 million deduction for state taxes deemed paid with the credits (subject to the alternative minimum tax rules), and recognized $2.2 million of gain from use of the credits to satisfy the tax. In contrast, if the transaction had been respected, the investors would have had $9.2 million of additional ordinary income for federal tax purposes (because the deduction for state taxes would have been reduced by that amount) and a $7 million capital loss on disposition of their interests. The decision is likely to help bring parity to the federal tax treatment of various state tax incentive schemes.

D. Proposal for a Unifying Rule

Virginia Historic Tax Credit reflects a determination *sub silentio* that the receipt of (effectively) transferable state tax credits is not a realization event — this notwithstanding the Fourth Circuit's holding that the state tax credits constitute "property" for purposes of section 707. This is consistent with the authorities reviewed above, including *Tempel*. If, to the contrary, *receipt* of transferable state tax credits were a realization event, then 99 percent of the income arising from the Funds' newly issued credits would have been allocable to the continuing partners of the Funds, as would have any gain or loss on the subsequent sale of the credits. Pro rata *use* of the credits (i.e., if used rather than sold) would have resulted in offsetting section 164 deductions. As to the credits that were *purchased* by the Funds, under the authorities discussed above *use* of the purchased credits to satisfy state

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414. Assume partners in a partnership contribute funds for development of a project and incident to the development of the project tax credits are allocable pro rata among the partners based on their relative capital accounts. In such a case, while the credits may have been part of a collective quid pro quo between the partners and the partnership, no one would argue a "sale" or other taxable event had occurred because there was no quid pro quo between partners or between certain partners and the partnership (and hence between partners). That is, enjoyment of the tax credits in such case would be proportionate to each partners' investment.

It is the existence of the prohibited quid pro quo (allocating tax credits as the partners mutually agree and adjusting other economics to accommodate for it in a manner such that the partners allocated the credits have no other meaningful interest in the partnership) that belies the argument that the credits were non-transferable. Thus, as the Fourth Circuit effectively held, the argument that the credits cannot be "property" because they are non-transferable is both circular and begs the question.

tax obligations would trigger gain realization under section 1001 insofar as the credits were purchased at a discount from face. The holding of the Fourth Circuit, of course, is that the purchased credits in that case effectively were *resold* to the investors, triggering gain on that account to the Funds. The investors, therefore, were to be the ones to recognize gain on *use* of the credits at a discount.

In the discussion of *Tempel* above, this Article posits that a more sensible approach to resolving the taxation of the receipt and subsequent sale of tax credits in that case would have been, in fact, to treat the original receipt of the tax credit as a taxable event. If the recipient *uses* the credit the *face* amount of the credit would be required to be included in income subject to an offsetting section 164 deduction. If (as in *Tempel*) the recipient *sells* the credit — the question of valuation thereby resolved — the tax credit would be included in income at fair value and the recipient would realize no gain or loss on the sale (if instead the recipient had included the tax credit in income at face value, it would realize a loss (presumably an ordinary loss) on sale).

One could further refine this alternative theorization of the tax consequences of receipt and use or sale of state tax credits by requiring inclusion in income of the face amount of the state tax credits only if and at such time as the credits are used (also triggering an offsetting section 164 deduction) and inclusion in income at fair value if and at such time as sold.[415] Further, the rule could be limited to those instances involving transferable state tax credits — both those that are transferable pursuant to the express provisions of the enabling legislation and those that are nominally non-transferable (such as the Virginia historic tax credits), but effectively transferable via a "flexible" allocation scheme or otherwise.

It is submitted that such an approach would result in there being a set of uniform and internally consistent answers as to the federal tax treatment of state tax credit grants, transfers and allocations. CCA 200211042, discussed above, addressed the question of whether receipt of a transferable state tax credit should be includable in income. While acknowledging that transferability is a hallmark of "property," it nonetheless concludes that the right of transferability, without more, should not require that outcome. To the contrary, the state tax credit "retains its character as a reduction or potential reduction in state tax liability" — effectively, the absence of a tax as opposed to an accretion to wealth — "unless and until it is actually sold to a third

415. *Accord* Robert Feldgarden, *The Federal Tax Treatment of State Tax Credits*, 127 TAX NOTES 560, 563 (May 3, 2010), (citing Warren Jones Co. v. Commissioner, 524 F.2d 788 (9th Cir. 1975), *rev'g* 60 T.C. 663 (1973)). Feldgarden notes that transferability "provides some basis for treating . . . earning of the credit as a taxable event. . . . When the credit is claimed or sold . . . the [recipient] should be required to include its value in gross income for that year unless it is a corporation and the requirements of section 118 are satisfied . . . ."

party."[416] It is submitted that unless it offends bedrock principles as to the definition of "income," the alternative conclusion (receipt of transferable state tax credits is an income event) leads to clearer and more consistent outcomes.

VIII. CONCLUSION

There has been a convergence of events affecting tax-based subsidies. The Simpson Bowles Report recommends their elimination. While efforts are afoot among some to persuade Congress to extend the cash grant program in effect for certain renewable energy projects through the end of 2011, as of the writing of this Article this quintessential program for the monetization of tax credits is due to expire — more a victim of its "success" than failure.[417] Certain tax credits are up for extension or will be soon.[418] Section 7701(o) has introduced an extra measure of uncertainty as regards acceptable structures for tax credit transactions. The government's appeal of the Tax Court's decision in *Historic Boardwalk* to the Third Circuit is being closely watched; industry observers have expressed concern that an adverse decision could seriously undermine the market for tax credit transactions.[419]

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416. I.R.S. Chief Couns. Adv. 2002-11-042 (Mar. 15, 2002).

417. *See* Shamik Trivedi, *Future Uncertain for Energy Tax Incentive Extension*, 2011 TNT 236–3 (Dec. 8, 2011) (quoting a commentator for the proposition that programs like the section 1603 program may be "victim[s] of their own success" which given their cost may not be extended). The article notes that as of November 11, 2011, $9.78 billion in Section 1603 grants had been made to 4,254 recipients. *See also* Eric Lipton & Clifford Kraus, *A Gold Rush of Subsidies in Clean Energy Search*, N.Y. TIMES, Nov. 9, 2011 (noting that when the Obama administration and Congress expanded the clean energy incentives in 2009 "a gold-rush mentality took over" as "[f]rom 2007 to 2010, federal subsidies [for renewable energy projects] jumped to $14.7 billion from $5.1 billion.").

418. *See* Liz White, Lawmakers Question Keeping, Expanding Temporary Tax Credits for Renewable Energy, 241 Daily Tax Rep. (BNA) G-3 (2011) (with numerous energy tax credit provisions expiring at the end of the year, and another five expiring at the end of 2012, including the wind industry's 2.2-cent-per-kilowatt-hour production tax credit, members of a Senate panel "expressed concerns . . . over keeping renewable energy industries on government subsidies for extended periods of time through tax credits rather than allowing the marketplace to run its course").

419. *See* John Leith-Tetrault, *History and the Hill: The IRS' Appeal of Boardwalk Hall v. Commissioner Raises Concerns in the HTC Industry*, NOVOGRADAC J. OF TAX CREDITS, Dec. 2011, at 4 (noting potential "far-reaching impact" and high stakes "not just for the federal HTC, but all similar credit transactions including the low-income housing tax credit, new markets tax credit and renewable energy tax credits."). The author comments:

> [U]nlike the facts in *Virginia Tax Credit Fund* . . . Boardwalk involves a conservatively structured operating partnership. . . .

The government's victory in the Fourth Circuit in the case of *Virginia Historic Tax Credit* has heightened concern as to the taxpayer's chances in the *Historic Boardwalk* appeal. In its brief filed with the Third Circuit on October 27, 2011, as to be expected, the government exploits its victory in the Fourth Circuit.

The common element in the two cases as framed by the government is that the taxpayer's position fails on "substance-over-form" grounds. In both cases, the government argues the transaction in question was tantamount to a *sale* of the tax credits, leading to an invalidation of the allocation of the tax credits in the *Historic Boardwalk* case (involving, as it does, an allocation of federal credits) and sale treatment for the allocation of the tax credits in the *Virginia Historic Tax Credit* case (involving an allocation of state tax credits). Interestingly, in its attempt to assuage concerns as to the reach of section 7701(o) in the context of tax-credit transactions, the JCT Technical Explanation and the IRS Directive have articulated the congressional intent test, which requires that a tax credit transaction measure up to congressional intent "in form and substance."

A possible implication of a government victory before the Third Circuit in *Historic Boardwalk* is that for deals to pass muster they must have more substance than was demonstrated in that case — the tax credit investor must demonstrate greater benefits and burdens of ownership. Without doubt, the principle that the tax benefits of ownership of an asset are to be afforded the substantive owner (subject to the ability to cede the investment credit to a lessee) is well-established as a matter of *tax* policy. However, Part V makes the case that the *ultimate* policy goals of the current array of federal tax credits discussed in this Article would be better served by adoption of a tax benefit transfer regime such as the short-lived safe-harbor leasing rules enacted under ERTA.

Upon the expiration of the cash grant program and a return to the *status quo ante* for renewable energy projects, given current economic conditions, the tax base problem that led to the enactment of the grant program in the first place is likely to persist. Constraining the monetization of tax credits through the continued imposition of substantive requirements — and, after the Third Circuit renders judgment in *Historic Boardwalk* potentially "enhanced" substantive requirements — will only hinder the

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> The pending appeals court decision may well answer the question that the IRS continues to pose in a number of circumstances: whether traditional historic tax credit (HTC) structures that rely on managing member guaranties, fixed priority returns and standard put and call exit strategies to attract limited partner capital can meet the requirements for characterization as a federal tax partnership.

Id.

delivery of tax-based subsidies to their intended beneficiaries.[420] If, to the contrary, the goal is "investable credits" (a phrase coined for LIHTCs),[421] that is where the focus should be placed.

As was true in 1981, adoption of a tax benefit transfer regime, of course, would require legislative action. The survey of initiatives undertaken by some of the states is a potential source of instruction in connection with the design of a federal system of "investable" credits.

Part VII examined the emerging *federal* tax treatment of the issuance, transfer and allocation of state tax credits and suggests that in both *Tempel* and *Virginia Historic Tax Credit* the courts missed the opportunity to characterize the *issuance* of transferable state tax credits as an income inclusion event for federal income tax purposes. Part VII. D. offers a "unifying rule" that proceeds from that idea. The underlying thought might even warrant consideration in the design of a federal tax benefit transfer regime.

A system of refundable credits has some of the elements of a cash grant program. Like the cash grant approach, it addresses the core issue of absence of a tax base head-on. It presumably would require a Congressional appropriation. It likely would fit within existing enforcement mechanisms more easily than the section 1603 cash grants. In theory, it would eliminate the need for other forms of tax credit monetization. However, in practice, the use of refundable credits may not attract the wider base of financial support for certain projects that an "investable" credit would.[422]

A study by Desai, Dharmapala, and Singhal found that the LIHTC was successful in attracting largely non-real estate investors to invest in low-income housing projects.[423] This correlates to the fact that LIHTC investors are investing for the credit; fundamentally, these investors are not making an economic bet on real estate. The tax benefits of the investment are "unbundled" which, in turn, "undoes the bias toward providers with taxable income" otherwise inherent in tax-based subsidies.[424] The Desai, Dharmapala, and Singhal study notes "comparable devices" to neutralize this bias: refundable credits and "an untrammeled leasing market" (presumably a reference to the safe-harbor leasing rules).[425]

As noted in the preceding discussion, the adoption of the safe-harbor leasing rules under ERTA was preceded by a period of analysis and evaluation of a number of alternative options, including not only a

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420. One can question the need for and basic value of these subsidies, but that is a subject for a different Article.

421. *See supra* note 151 and accompanying text.

422. *See, e.g.*, *supra* note 150–58 and accompanying text.

423. Desia et al., *Investable Tax Credits*, *supra* note 132.

424. *See supra* note 152 and accompanying text.

425. *See supra* note 156 and accompanying text.

refundable investment tax credit but also a "pure sale of the benefits."[426] The choice of a "safe harbor guarantee of lease treatment" seemed to reflect both a concern, on the one hand, to come up with a regime that addressed the ACRS benefit as well as the investment tax credit and a desire, on the other hand, to require the (nominal) lessor to "pick up an income stream from the transaction in the form of rent payments."[427] The resulting construct was not uncomplicated.

There are numerous examples of transferable state tax credits, involving varying types and degrees of protection against the risk of "fraud and abuse." Among other things, a well-designed system presumably would seek to ensure that as between the transferor and transferee (or as among the partners and the partnership, in the case of a "flexible" allocation scheme) one can discover the requisite "bundle of sticks" of ownership. That is, a third party should not have a superior claim to substantive ownership.[428]

Which among these various options or others warrants consideration, if any, depends on one's frame of reference. If the judgment is that all tax expenditures should go, the question is moot. However, if the judgment is that some tax expenditures should *stay*, given the budgetary crisis facing the United States, as a starting point the articulation of the underlying goals and intended beneficiaries of current tax-based subsidies should be sharpened and our existing "delivery mechanisms" closely examined and possibly overhauled.

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426. *See supra* note 105 and accompanying text.

427. *See supra* note 105 and accompanying text. On the question of MACRS depreciation deductions for subsidized projects, it seems that a program of transferable tax credits, without more, would not do anything to "relocate" the deductions. Depreciation deductions, of course, have a "structural" aspect insofar as allowable depreciation deductions match economic depreciation. *Accelerated* depreciation deductions, on the other hand, include a "subsidy" component. In theory, a "purchaser" could be allowed to claim accelerated deductions provided the purchaser recaptures them as the owner of the asset claims depreciation over the economic useful life of the asset. However, there does not appear to be any precedent for such an approach; moreover, this might be viewed as taking the subsidy argument too far.

428. *See supra* note 94 and accompanying text.