TAX CREDIT GUIDANCE RAISES OLD QUESTIONS

On February 19, 2020, the IRS issued [Rev. Proc. 2020-12](https://www.irs.gov/newsroom/irs-provides-answers-and-a-safe-harbor-on-carbon-capture-credits) which provides a safe harbor that an investor in a section 45Q (carbon oxide sequestration) partnership must meet in order to be treated as a bona fide partner in the partnership. This is necessary so that the investor can be allocated the credits as a partner and not be treated as a mere purchaser of the credits.

In addition to setting forth the safe harbor criteria which mirror, to a significant degree, the criteria set forth in the rehabilitation credit safe harbor revenue procedure described below, the IRS had this to say about being a bona fide partner:

A partnership exists when two or more “parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.” Commissioner v. Culbertson, 337 U.S. 733, 742 (1949). In making this determination, courts “look not so much at the labels used by the partnership but at true facts and circumstances” to determine whether a partner has a “meaningful stake in the success or failure” of the enterprise. TIFD III-E, Inc. v. United States, 459 F.3d 220, 231 and 241 (2d Cir. 2006). A purported partner in a partnership may in substance be more properly viewed as a lender to the partnership or purchaser of partnership assets if the purported partner lacks “any meaningful downside risk or any meaningful upside potential in” the partnership. Historic Boardwalk Hall, LLC v. Commissioner, 694 F.3d 425, 455 (3d Cir. 2012)

The criteria for the safe harbor mirror those set forth in [Rev. Proc. 2014-12](https://www.irs.gov/pub/irs-drop/rp-14-12.pdf). This latter revenue procedure dealt with the safe harbor for the rehabilitation tax credit under section 47. In addition to setting forth its safe harbor criteria, the IRS stated here that:

In Historic Boardwalk Hall, LLC. v. Commissioner, 694 F.3d 425 (3d Cir. 2012), cert. denied, U.S., No. 12-901, May 28, 2013, the Third Circuit considered whether an investor’s interest in the success or failure of a partnership that incurred qualifying rehabilitation expenditures was sufficiently meaningful for the investor to qualify as a partner in that partnership. The agreements governing the Historic Boardwalk Hall transaction ensured that the investor would receive the § 47 rehabilitation credits (or their cash equivalent) and a preferred return, with only a remote opportunity for additional sharing in profit. Both the § 47 rehabilitation credits and the preferred return were guaranteed as part of the transaction. The preferred return guarantee was funded. The Third Circuit determined that the investor’s return from the partnership was effectively fixed, and that the investor also had no meaningful downside risk because its investment was guaranteed. The Third Circuit agreed with the Commissioner’s reallocation of all of the partnership’s claimed losses and tax credits from the investor to the principal, holding that “because [the investor] lacked a meaningful stake in either the success or failure of [the partnership], it was not a bona fide partner.”

Thus, this revenue procedure answered the lingering question that had hung over the rehabilitation tax credit industry since [Historic Boardwalk Hall](https://scholar.google.com/scholar_case?case=10309944708351038004&q=historic+boardwalk+hall+llc+v+commissioner&hl=en&as_sdt=4,76,90,100,108,123,139,153,163,298,299,300,361,362,363) had been decided by the Third Circuit; that is, whether an investor would be treated as a bona fide partner in the partnership. As a result of the case, the revenue procedure set forth minimum sharing percentages in the partnership by the investor, a minimum unconditional investment, protections against the reduction of the investor’s interest in and investment in the partnership, guarantees that were permitted and those that were not, loans, purchase and sale rights, and similar matters. If those requirements were met, the allocation of the credit would be respected if the allocations followed the item upon which the credit was based (receipts or expenditures, as the case may be).

The Third Circuit, it should be noted, reversed the [Tax Court](https://scholar.google.com/scholar_case?case=569590072295252681&q=historic+boardwalk+hall+llc+v+commissioner&hl=en&as_sdt=4,192) on this issue. The Tax Court had essentially applied the same law but came to the opposite conclusion on the facts.

The Third Circuit did not address the issue presented in [Sacks](https://scholar.google.com/scholar_case?case=5415711364570772047&q=69+F.+3d+982&hl=en&as_sdt=4,72,73,78,79,80,86,88,93,114,129,134,135,141,142,143,149,151,156,258,259,260,261,310,311,321,322,323,324,373,374,383) as to whether the tax credit at issue could or should be taken into account in testing the transaction for economic substance. The Third Circuit stated:

At oral argument, the IRS conceded that this case “lends itself more cleanly to the bona fide partner theory,” under which we look to the substance of the putative partner‟s interest over its form....Accordingly, we focus our analysis on whether PB is as a bona fide partner in HBH, and in doing so, we assume, without deciding, that this transaction had economic substance. Specifically, we do not opine on the parties‟ dispute as to whether, under Sacks v. Commissioner, 69 F.3d 982 (9th Cir. 1995), we can consider the HRTCs in evaluating whether a transaction has economic substance.

In [Sacks](https://scholar.google.com/scholar_case?case=5415711364570772047&q=69+F.+3d+982&hl=en&as_sdt=4,72,73,78,79,80,86,88,93,114,129,134,135,141,142,143,149,151,156,258,259,260,261,310,311,321,322,323,324,373,374,383), the IRS asserted that the transaction at issue, relating to entitlement to the investment tax credit in a sale-leaseback where no partnership was at issue, was a sham. The key language of the Ninth Circuit which, once again, had reversed the Tax Court on this issue, was as follows:

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....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....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.

The precursor to both of the safe harbor revenue procedures described above was [Rev. Proc. 2007-65](https://www.irs.gov/pub/irs-drop/rp-07-65.pdf). This revenue procedure provided a safe harbor for investors in section 45 partnerships (renewable energy tax credits for wind farms). The same general criteria dealing with the investor’s minimum investment and sharing percentages and protections and prohibitions relating to dilution of that investment served as the fundamental part of the safe harbor.

Ever since the advent of the so-called check-the-box regulations in 1996, the focus of the classification issue for entities that are not per se corporations or other special types of entities was and is whether the investor is either an “owner” or “member” of the organization at issue. Neither of these terms is defined. Logically, as has been pointed out in the tax literature, if an organization can decide whether it will be treated as either an association or partnership for tax purposes and if, as is the case, an organization must first be a tax entity with one or more “owners” or “members”, the determination of whether an investor is such an owner or member must be made before the entity chooses (or defaults into) its tax classification. After all, it would be difficult to apply the [Culbertson](https://scholar.google.com/scholar_case?case=223506232177772828&q=culbertson&hl=en&as_sdt=4,60,72,73,78,79,80,86,88,93,114,129,134,135,141,142,143,149,151,156,258,259,260,261,310,311,321,322,323,324,373,374,383) test to determine whether an investor is a partner in a partnership, which is frequently done, and then determine that the entity decides to be classified as an association. Conversely, one could attempt to apply the [Moline](https://scholar.google.com/scholar_case?case=3982893174008604376&q=moline+properties+inc+v+commissioner&hl=en&as_sdt=4,60,72,73,78,79,80,86,88,93,114,129,134,135,141,142,143,149,151,156,258,259,260,261,310,311,321,322,323,324,373,374,383) test as to respect of the corporate entity and then find that an unincorporated organization determines to be classified as a tax partnership. Nevertheless, despite the logic of this position, it is not the law today as applied both by the IRS and by the courts. Reform of this area of law is clearly warranted.

In addition, it seems somewhat redundant that the IRS issue a separate revenue procedure for separate tax credits that are the flavor of the month. It would seem much more logical to issue an omnibus revenue procedure dealing with all tax credits.