

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

IN THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

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

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant

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

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PAGE-PROOF OPENING BRIEF FOR THE APPELLANT

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INTRODUCTION AND STATEMENT OF JURISDICTION

Although partnerships are pass-through entities that do not themselves pay federal income tax, the Internal Revenue Code (26

U.S.C.) (“I.R.C.”) requires them to file annual information returns reporting various items of income, deduction, and credit. I.R.C. § 6031. Individual partners then report their distributive shares of these items on their respective income tax returns. I.R.C. §§ 701-704. To provide for consistent treatment of partnership-wide tax issues among these individual partners, the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”), Pub. L. No. 97-248, 96 Stat. 324 (codified in pertinent part at I.R.C. §§ 6221-6233), allows disputes over such issues – called “partnership items” – to be resolved in a unified, partnership-level proceeding.

On October 11 and 12, 2007, and pursuant to TEFRA procedures, the Commissioner of Internal Revenue issued Notices of Final Partnership Administrative Adjustment (“FPAAs”) (Exs. 6-11, Stip ¶ 8),¹ making adjustments to partnership items with respect to the 2001 and 2002 returns of Virginia Historic Tax Credit Fund 2001 LP

¹ Unless otherwise specified, “Doc.” references are to the docket sheet entries in Tax Ct. No. 716-08, as numbered by the Clerk of the United States Tax Court. “Tr.” references are to the transcript of trial. (Docs. 90-91, 93-94, 96-97.) “Ex.” references are to the exhibits admitted at trial. “Stip.” references are to the parties’ stipulation of facts. (Doc. 76.)

(“2001 LP”) and two affiliated partnerships (the “lower-tier partnerships”), Virginia Historic Tax Credit Fund 2001 SCP, LLC (“2001 SCP LLC”) and Virginia Historic Tax Credit Fund 2001 SCP, LP (“2001 SCP LP”).² The FPAAs explained that certain payments that individuals made to the Funds in 2001 and 2002 to acquire Virginia tax credits were properly characterized for federal tax purposes as the proceeds from sales of credits, rather than capital contributions by a partner to a partnership. (Exs. 6-11.)

The FPAAs were issued to Virginia Historic Tax Credit Fund 2001, LLC (“2001 LLC”), which is the Funds’ general partner and Tax Matters Partner (“TMP”) (Stip. ¶¶ 3-4) authorized by law to act on behalf of the other partners in certain respects, *see, e.g.*, I.R.C. §§ 6224(c)(3), 6226(a), 6229(b)(1)(B). On January 9 and 10, 2008, within the 90-day period contemplated by I.R.C. § 6226(a),³ the 2001

² We sometimes collectively refer to 2001 LP and the lower-tier partnerships as the “Funds”.

³ Although the TMP’s petition with respect to the SCP LP was received by the Tax Court and stamped as “filed” on January 10, 2008, which is the 91st day after the FPAAs relating to the SCP LP were mailed, the petition was mailed to the Tax Court via a designated delivery service within the 90-day period of I.R.C. § 6226(a), and is thus
(continued...)

LLC filed petitions in the United States Tax Court to challenge the adjustments in the FPAAs. (Doc. 1; No. 870-08 Doc. 1; No. 871-08 Doc.

1.) Accordingly, the Tax Court had jurisdiction pursuant to I.R.C.

§ 6226(a).⁴

The cases commenced by the petitions were consolidated for trial, briefing, and opinion. (Doc. 27.) On December 23, 2009, the Tax Court

³(...continued)
timely under I.R.C. § 7502.

⁴ The Tax Court (Doc. 120) dismissed for lack of jurisdiction a portion of the petitions with respect to the lower-tier partnerships. Specifically, the parties agreed that, if the investors' payments in issue were treated as sales, then any income attributable to such sales was earned by the upper-tier partnership, 2001 LP. (Doc. 78 ¶¶ 5,6; Doc. 120 at 6.) As such, the Tax Court found that this income was a "partnership item" of the 2001 LP, to be determined at that level, and not in the lower-tier proceedings. I.R.C. § 6221; *see, e.g., Kaplan v. United States*, 133 F.3d 469, 473 (7th Cir. 1998). Accordingly, the court dismissed "so much of these cases as adjusts the [lower] tier partnerships' income from the sale of State tax credits." (Doc. 120 at 6.) The Commissioner does not challenge in this appeal the Tax Court's partial dismissal of the lower-tier proceedings for lack of jurisdiction.

The court retained jurisdiction over the petitions with respect lower-tier partnerships insofar as they involved the determination that the so-called investors in the lower-tier partnerships were not partners for federal tax purposes. (Doc. 120 at 5.) The court found, and we agree, that this determination is a "partnership item" of the lower-tier partnerships. *Cf. Keener v. United States*, 551 F.3d 1358, 1365 (Fed. Cir. 2009) (characterization of a partnership's transaction as a "sham" is a partnership item).

entered decisions in each of the consolidated cases, ordering that the adjustments for 2001 were barred by the applicable statute of limitations, and rejecting the recharacterization of payments to the Funds and the associated adjustments for 2002. (Doc. 121; No. 870-08 Doc. 114; No. 871-08 Doc. 114.) The Tax Court's decisions finally disposed of all issues as to all parties. The Commissioner filed notices of appeal in each of the consolidated cases on March 15, 2010. (Doc. 122; No. 870-08 Doc. 115; No. 871-08 Doc. 115.) The notices of appeal were timely filed within 90 days of the entry of the Tax Court's decisions. *See* I.R.C. § 7483. This Court has jurisdiction under I.R.C. § 7482(a).

STATEMENT OF THE ISSUES

1. Whether the so-called investors were, in substance, merely purchasers of Virginia tax credits sold by the Funds, rather than limited partners in the Funds, such that the Funds' net proceeds from the investors' purported capital contributions were taxable income to the Funds in 2002.

2. Whether, in the event the purported limited partners are determined to be *bona fide* partners for federal tax purposes, the

transactions between such “partners” and their partnerships constituted sales of property within the meaning of I.R.C. § 707 and the regulations thereunder, with the result that the payments made by such “partners” constituted taxable sales proceeds.

STATEMENT OF THE CASE

2001 LLC, the TMP of the Funds, filed petitions in the Tax Court to challenge the Commissioner’s adjustments, set forth in the FPAAs, resulting from the recharacterization of the Funds’ transactions with its so-called investors as sales of Virginia tax credits. (Doc. 1; No. 870-08 Doc. 1; No. 871-08 Doc. 1.) The cases were consolidated for trial. (Doc. 27.)

Prior to trial, the parties stipulated that any taxable gain from treating the transactions as sales of state tax credits was earned by the 2001 LP, and not the lower-tier partnerships. (Doc. 78 ¶ 5.) Finding that the income adjustment was not a “partnership item” of the lower-tier partnerships, the Tax Court dismissed “so much of these cases as adjusts the tier partnerships’ income from the sale of State tax credits.” (Doc. 120 at 6.) In addition, the parties stipulated that any such

taxable gain earned by 2001 LP was realized in 2002, not 2001.⁵

(Doc. 78 ¶ 5.)

A four-day trial was held, and on December 21, 2009, the Tax Court issued an opinion holding that the Funds' so-called investors were partners for federal tax purposes, rather than merely purchasers of Virginia tax credits, and further that the transactions between the investors and the Funds are not to be treated as sales under I.R.C. § 707. (Doc. 119 at 2.) The Tax Court entered decisions on December 23, 2009, denying the proposed adjustments contained in the FPAAs. (Doc. 121; No. 870-08 Doc. 114; No. 871-08 Doc. 114.) The Commissioner now appeals. (Doc. 122; No. 870-08 Doc. 115; No. 871-08 Doc. 115.)

⁵ To prevent a possible whipsaw, the Commissioner had taken inconsistent, alternative positions in the FPAAs, including the same income from the sale of tax credits on both of the 2001 and 2002 returns, as adjusted. (Exs. 6-11.) The concern over whipsaw was alleviated by the parties' stipulation attributing the income, if the Commissioner prevailed, to 2002. (Doc. 78 ¶ 5.) Even though the 2001 adjustments were conceded by the Commissioner in the parties' stipulation, the Tax Court held, in any event, that the 2001 adjustments were barred by the applicable statute of limitations. (Doc. 119 at 45-47.)

STATEMENT OF FACTS

1. The Virginia Historic Rehabilitation Tax Credit Program

The rehabilitation of historic buildings is generally more expensive than tearing the buildings down and constructing new ones in their stead. (Tr. 81, 204.) To encourage developers to preserve and improve historic buildings, rather than demolish them, many states offer income tax credits for expenses incurred in rehabilitating certified historic structures. *See, e.g.*, N.C. Gen. Stat. § 105-129.36 (2010); W. Va. Code § 11-21-8g (2010). The Commonwealth of Virginia offers such an incentive by way of its Historic Rehabilitation Tax Credit Program, Va. Code Ann. § 58.1-339.2, created in 1996 and administered ever since by the Virginia Department of Historic Resources (“DHR”). (Stip. ¶¶ 10-12.)

During the years in issue here, Virginia’s Historic Rehabilitation Program awarded credits totaling 25 percent of eligible rehabilitation expenses which, in turn, provided a dollar-for-dollar reduction in the credit holders’ Virginia income tax liability. (Stip ¶¶ 27, 37.) If the credits exceeded the amount of a taxpayer’s Virginia income tax liability for any given year, the credits could be carried to the next year,

for up to 10 years. (Stip. ¶ 42.) Most developers are able to use these credits to offset their own Virginia income taxes. (Stip ¶ 20.) But after the program was enacted in 1996, and before the publication of proposed regulations in 2002, many developers began rehabilitation projects in Virginia with the understanding that the credits they earned would be freely transferrable to others. (Tr. 112-13.) Although some states do permit direct transfers or sales of historic rehabilitation credits, *see* W. Va. Code § 11-21-8h(a), the Virginia statute lacks the specific language necessary to allow the direct sale of tax credits. (Tr. 113.) To provide relief to those developers who had begun projects with the understanding that the credits they earned would be transferrable, the Virginia legislature, in 1999, authorized the DHR to permit developers to elect to make a one-time transfer of credits earned with respect to projects completed before publication of the final regulations. (Stip ¶ 31; Tr. 83.)

Daniel Gecker (one of the petitioner's original three owners) drafted, for DHR committee review and approval, the Historic Rehabilitation Program regulations. (Tr. 373-74.) The regulations establish a three-part process for obtaining DHR certification of historic

rehabilitation projects. Part 1 is used to obtain DHR certification of the historic significance of a particular property. *See* 17 Va. Admin. Code § 10-30-30 (2010). After a Part 1 certification is obtained, the applicant may seek Part 2 certification of the specific plan of rehabilitation. 17 Va. Admin. Code § 10-30-50. Once the project is completed, in Part 3, the DHR reviews evidence of the completed work to ensure that it complies with the certified rehabilitation plan. (*Id.*) The DHR determines the amount of eligible rehabilitation expenses and issues a Certificate of Rehabilitation, which enables the recipient of the certificate to claim the associated tax credit. (Stip. ¶ 39.) The credits are reported in the year in which the project is completed or when the last expenditure is made. (Stip. ¶ 40.) The regulations reserve to DHR the right to inspect a project, within three years of completion, to ensure that it was completed as represented, and to revoke certification if it was not. 17 Va. Admin. Code § 10-30-50. But, according to the DHR employee who oversaw the rehabilitation tax credit program from its inception until 2006, the DHR never revoked a certification once it was issued. (Tr. 101; *see also* Tr. 366.)

As discussed, the developer who earns the credit generally is not permitted (except under the one-time transfer provision) to sell or otherwise directly transfer the credit to another person. But the statute and its implementing regulations do provide that, if the credits are granted to a partnership, they may be allocated among all partners “either in proportion to their ownership interest . . . or as the partners mutually agree as provided in an executed document, the form of which shall be prescribed by the [DHR] Director.” Va. Code Ann. § 58.1-339.2. Transfers of tax credits ostensibly made under this allocation provision are at the root of these consolidated cases.

2. The Funds’ formation and acquisition of Virginia rehabilitation tax credits

By virtue of his role in drafting the Historic Rehabilitation Program regulations and advising DHR of the legal requirements of the program (Tr. 93-94), Gecker was singularly situated to know when and how to obtain the tax credits (Tr. 363). Beginning in 1999, Gecker, Robert W. “Robin” Miller, a real estate developer, and George Brower, a senior vice-president of a division of the Legg Mason investment firm, began acquiring historic rehabilitation tax credits, with an eye toward

not only recouping the costs of acquisition, but profiting therefrom, by later allocating the credits to so-called investors. (Tr. 220-21, 368, 384, 394, 488.) Banks were willing to finance this venture because Gecker, Miller, and Brower dealt only with projects that were far along in the certification process (in fact, completed in most cases). (Tr. 267, 383.)

To this end, Gecker, Miller, and Brower formed four entities, effective April 6, 2001. (Exs. 1-4.) First, Gecker, and BKM LLC (Miller's wholly-owned company) became 35% owners of 2001 LLC, while Brower owned the remaining 30%. (Stip. ¶ 62.) The schedules to 2001 LLC's partnership returns do not indicate that Gecker, BKM or Brower contributed any capital to obtain these ownership interests. (Ex. 28-J.) 2001 LLC, in turn, became general partner and 97% owner of 2001 LP (Stip. ¶ 3; Ex. 26-J at 554.), and general partner and 99% owner of the lower-tier partnerships (Stip. ¶ 3; Ex. 29-J; Ex. 35-J at 23). 2001 LLC did not contribute any capital in exchange for these ownership interests in the Funds. (Ex. 26-J at 554; Ex. 29-J; Ex. 35-J at 23.) The lower-tier partnerships were each 1% partners in the 2001 LP. (Ex. 26-J at 557, 560.) The remaining 1% interests in the Funds

would later be purportedly sold to individuals seeking to reduce their Virginia income tax liability (see pp. 15-19, *infra*).

The Funds acquired approximately \$9.2 million in historic rehabilitation tax credits for 2001. (Stip. ¶ 140.) At least \$3.3 million of these, or 36%, were purchased outright from developers under the DHR's one-time transfer provision, at a price of 55 cents per \$1 of tax credit. (Stip. ¶ 144; Exs. 235-J-239-J.) The credit transfer agreements provided that the purchase would only occur if the developer already had a DHR Certificate of Rehabilitation in hand. (Exs. 235-J-239-J.) All but one of these certificates were in hand by mid-December 2001; only the certificate relating to the Old College Chapel at Randolph-Macon College (under which \$316,755 in credits were transferred to the Funds) was issued later, on March 1, 2002. (Stip. ¶ 140.) But because the work on the Old College Chapel (and, indeed, all of the rehabilitation giving rise to for the credits in this case) was completed by the end of 2001, the 2002 certificate still entitled the Funds to 2001 tax credits. (Ex. 204-J at 15.)

In addition to acquiring the credits by direct purchase, the Funds acquired 2001 historic rehabilitation tax credits by participation in

partnerships with developers. (Stip. ¶ 140.) To that end, the Funds entered into agreements providing that the Funds would acquire a 0.01% ownership interest in the developer partnerships in exchange for a payment equaling 55 cents per \$1 of historic rehabilitation tax credits generated by the partnerships and allocated to the Funds. (Exs. 216-J, 219-J, 222-J, 227-J, 525-P, 526-P.) The Funds' payments to the partnerships were frequently contingent upon receipt by the Funds of the Certificate of Rehabilitation (Ex. 222-J at 17) and often involved a third-party guaranty to protect against the developer's default (Exs. 218-J, 221-J, 229-J). The agreements provided that the Funds' payments would be reimbursed, with interest, to the extent the partnerships were unable to deliver the credits or the credits were later recaptured or reduced by the Commonwealth. (Exs. 216-J, 219-J, 222-J, 227-J, 525-P, 526-P.)

The DHR issued Certificates of Rehabilitation entitling the Funds to credits under these partnership or credit transfer agreements throughout 2001 and in the early part of 2002. As of November 6, 2001, DHR had issued certificates with respect to \$3.25 million of the Funds' credits. (Stip. ¶ 140.) By December 19, 2001, the DHR had authorized

\$4.69 million of such credits, and by February 11, 2002, the DHR had authorized \$7.58 million of the credits. (*Id.*)

3. The Funds' resale of Virginia rehabilitation tax credits to individual investors

In November and December, 2001, Gecker, Miller, and Brower began soliciting the contributions of individuals (sometimes referred to herein as “investors”) who were interested in acquiring Virginia rehabilitation tax credits to reduce their Virginia income tax liability. (Tr. 395, 445.) Potential investors were given a package of offering materials including an offering memorandum, subscription agreement, and option agreement. (Stip. ¶¶ 98, 116, 122.)

The materials explained that the investors' contributions would be determined on a per-credit basis – that is, depending on the investor, for every 74 to 80 cents contributed, the investor would be allocated \$1.00 of Virginia income tax credits.⁶ (Exs. 37-J, 60-J, 565-P at 7, 11.)

⁶ Although the offering materials given to investors did not always correctly identify the fund in which they were participating (*see* Tr. 387-88), investors in the 2001 LP paid 74 cents per \$1.00 of credits they received (Ex. 60-J at 11; Stip. ¶ 156), investors in the 2001 SCP LP paid 80 cents per \$1.00 of credits they received (Ex. 565-P at 11; Stip. ¶ 150), and investors in the 2001 SPC LLC paid somewhere between 74 and 80 cents per \$1.00 of credits (Stip. ¶ 153).

The signed subscription agreements provided that the investor would be allocated such credits “simultaneously with the Investor’s admission” to the Funds. (Ex. 56-J.)

In addition, under the partnership agreements signed by some of the investors, the Funds agreed to deposit the investor payments into an interest-bearing account until contributed by the Funds to a developer partnership. (Ex. 54-J at 4, Ex. 565-P Ex. A at 4.) The Funds were not to contribute money to a developer partnership until and unless the developer had received Part III certification from DHR. (Ex. 54-J at 3-4, Ex. 565-P Ex. A at 3-4.) Further, the Funds agreed to refund investor payments, with interest, to the extent they were unable to deliver the required amount of credits.⁷ (Exs. 37-J, 60-J, 565-P at 7.)

As a condition of admission to the partnership, each investor was required to execute an agreement granting 2001 LLC an option to buy out his or her partnership interest in 2002. (Ex. 54-J at 4; Ex. 62-J; Ex. 565-P Ex. A at 12.) The option agreement granted irrevocable power of

⁷ Although the offering materials state that the amount refunded in such circumstances would be the contribution, plus interest, “net of expenses” (Exs. 37-J, 60-J, 565-P at 7), they elsewhere state that all operating expenses would be paid by the developers and/or the general partner (2001 LLC), not the investors (Exs. 37-J, 60-J, 565-P at 10).

attorney to Gecker to execute, on the investor's behalf, any and all documents required to transfer the interest to 2001 LLC upon the exercise of the option. (Ex. 62-J.)

The offering materials provided to investors advised them that they would not be receiving any income from partnership operations or gain on their investment (Exs. 37-J, 60-J, 565-P at 7) (emphasis omitted):

The Investors will not receive any material distributions of cash flow or net proceeds from a sale of the projects or Operating Partnerships and will not be allocated material amounts of federal income tax credits or partnership items of income, gain, loss, or deduction. Accordingly, any return on investment or of an investment in the Partnership is dependent entirely upon the Investor's allocations of the Virginia Historic Credits and any capital loss for federal income tax purposes generated upon the sale of the investment in the Partnership.

The only economic benefits the investors expected to receive in exchange for their contributions were the Virginia income tax credits (and, to a lesser extent, a reduction in federal taxes). (Tr. 159-60, 170, 315, 458, 540.) As one investor put it (Tr. 159-60):

I bought the partnership interest to get the tax credits on my Virginia state income tax return, which I got, and that was the value to me of my investment, and that's the end of it.

The first investor payment to the Funds was dated November 26, 2001. (Stip. ¶ 104.) One of the lower-tier partnerships, 2001 SCP LP, found 8 investors, who made contributions ranging from \$16,000 to \$1.1 million in November and December, 2001 and in January, 2002. (*Id.*) 2001 LP deposited contributions from 181 investors, ranging in amount from \$1,850 to \$529,840, in December, 2001 and in January, February and March, 2002. (Stip. ¶ 126.) The other lower-tier partnership, 2001 SCP LLC, had 93 investors, who made contributions, ranging from \$3,700 to \$116,696, between December, 2001 and April, 2002. (Stip. ¶ 117.)

The ownership interest assigned to the investors on account of their contribution was nominal. In each of the Funds, the investors' *collective* ownership interest was only 1 percent.⁸ (Exs. 26-

⁸ The subscription agreements (Exs. 68-J-200-J) generally provided that each investor would receive a 0.01% partnership interest, regardless of the amount of their contribution. But some of the agreements provided that each investor would receive a 1% interest. (Exs. 148-J-165-J.) Given that there were 282 investors in the Funds and that the Funds were effectively 99% owned by 2001 LLC, the ownership percentages in the subscription agreements do not add up. Perhaps as a result, the Funds did not report the investors' ownership interests in their Schedules K-1 consistently with the subscription agreements. (Exs. 26-J, 35-J, 58-J.) Regardless, because Virginia law

(continued...)

J, 35-J, 58-J.) In Virginia 2001 LP, for example, the average investor's ownership interest was $1/181 \times 1$ percent. (Ex. 26-J.)

On or about May 20, 2002, the investors were sent a letter stating that "SCP LLC" was exercising its right to buy their interest in the Funds. (Stip. ¶ 159.) The letter enclosed a check, dated May 13-15, 2002, for the buyback price, which was determined by Gecker to be .001 times the amount of the investor's contribution. (Stip. ¶¶ 161, 164, 168; Tr. 441.) The total amount of contributions was \$6,995,332 (Stip. ¶¶ 104, 117, 126); therefore, the *total* cost of buying out all of the investors' interests was \$6,995 (Stip. ¶¶ 161, 164, 168). For example, investor Hal D. Borque, who had purportedly acquired a 0.009% interest in SCP LLC (Ex. 243) with a \$14,060 check, dated March 27, 2002 and deposited April 3, 2002 (Stip. ¶ 117), had that same interest bought back by Gecker six weeks later for a payment of \$14.06 (Stip.

⁸(...continued)

does not require allocation of historic rehabilitation tax credits in accordance with ownership interest, Va. Code Ann. § 58.1-339.2, and because the investors were only out to obtain the credits, not to share in the rents, sales proceeds, or other profits of a real estate venture (Tr. 159-60, 170, 315, 458, 540), the size of the putative ownership interest assigned to the investors was not critical to the Funds' operation.

¶ 168). Every other investor was bought out in substantially the same manner. (Stip. ¶¶ 161, 164, 168.)

4. The Funds' tax reporting of the transactions and the IRS's audit of their returns

The Funds timely filed their 2001 federal partnership returns (Forms 1065) and accompanying Schedules K-1 with respect to each of the investors on April 15, 2002. (Stip. ¶ 6; Exs. 26-J, 35-J, 58-J.) Each of the investors received a copy of their respective Schedule K-1, accompanied by DHR Certificates of Rehabilitation regarding most (if not all) of the projects through which the funds acquired credits. (Stip. ¶¶ 149, 152, 155; Exs. 242-J, 243-J.) The Schedules K-1 advised the investors of the amount of the 2001 Virginia historic rehabilitation tax credits to which they were entitled and how to claim them on their 2001 Virginia income tax returns. (Exs. 242-J, 243-J.)

2001 LP deducted on its 2001 and 2002 returns a total of \$3,142,188 in "tax credit acquisition fees." (Stip. ¶ 229; Exs. 26-J at 1, 9, 27-J at 1,5.) However, neither 2001 LP nor the lower-tier partnerships included the amounts paid by the investors to acquire tax credits (\$6,995,332) in their gross receipts. (Exs. 26-J, 27-J.) Instead,

the 2001 LP identified the investor payments as non-taxable contributions to capital. (Exs. 26-J at 4.) Because they reported virtually no income, but deducted the tax credit acquisition costs and other expenses, the Funds' returns stated that they sustained more than \$3.28 million in losses for 2001 and 2002. (Exs. 26-J at 1, 27-J at 1.) Approximately 99% of these reported losses passed through to the ultimate owners of the Funds, Gecker, Brower and Miller's wholly-owned company, BKM LLC. (Exs. 28-J, 29-J.)

Upon audit of the Funds' tax returns, the IRS determined that the investors' contributions to the Funds constituted proceeds from the sale of Virginia historic rehabilitation tax credits and, as such, were includable in the Funds' gross income. (Exs. 6-11, Stip. ¶ 8.) The IRS' inclusion of the contributions in the Funds' gross income resulted from three alternative determinations. First, the IRS determined that, in substance, the investors were not partners of the Funds for federal tax purposes, but instead were merely purchasers of tax credits sold by the Funds. (Exs. 6-11 at p. 10.) In the alternative, the IRS determined that, even if the investors were regarded as *bona fide* partners for federal tax purposes, the transactions in issue between the partners

and the Funds constituted disguised sales of property to the partners under I.R.C. § 707. (Exs. 6-11 at p. 11.) Finally, the IRS disregarded the partnership entirely under the anti-abuse regulation, Treas. Reg. (26 C.F.R.) § 1.701-2, finding that it was formed principally to reduce the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. (Exs. 6-11 at p. 11.)

As a result of these determinations, the IRS issued FPAAs for each of the Funds, which included investor payments in the gross income of the Fund that reported the investor as a partner. (Exs. 6-11, Stip ¶ 8.) In addition, the IRS determined that a 20% accuracy-related penalty under I.R.C. § 6662 was applicable. (Exs. 6-11 at 11.) To guard against a possible "whipsaw," the IRS included the same income from the sale of tax credits on both of the 2001 and 2002 returns. (Exs. 6-11.) In addition, the IRS did not include on the adjusted return any deduction for the Funds' costs in acquiring the credits beyond what the 2001 LP had already reported as "tax credit acquisition fees." (Exs. 6-J, 26-J at 1, 9, 27-J at 1,5.)

5. The Tax Court proceedings

The 2001 LLC filed petitions in Tax Court to challenge the adjustments in the FPAAs. (Doc. 1; No. 870-08 Doc. 1; No. 871-08 Doc. 1.) The cases were consolidated for trial. (Doc. 27.)

Prior to trial, the parties agreed to various matters. The Commissioner dropped his anti-abuse theory, conceding that the partnerships themselves would not be disregarded for tax purposes. (See Doc. 119 at 3.) In addition, the parties stipulated that any gain from treating the transactions as sales of credits was earned by the 2001 LP, and not the lower-tier partnerships, and was realized in 2002, not 2001. (Doc. 78 ¶ 5.) The parties stipulated that, if the Government prevailed, the expenses incurred by 2001 LP for acquiring the tax credits were \$ 5.46 million (not the \$ 3.14 originally reported as “tax credit acquisition fees”) and the net partnership gain was \$ 1.53 million.⁹ (*Id.*)

The remaining issues were held over for trial, including (1) whether the investors were, in substance, purchasers of tax credits

⁹ For simplicity, the actual figures are rounded off to the nearest \$ 10,000 in this statement of facts.

or *bona fide* partners in the Funds, (2) whether, even if the investors were *bona fide* partners, their transactions with the funds should be treated as sales under I.R.C. § 707, and (3) whether the imposition of the accuracy-related penalty was appropriate. (Doc. 119 at 3.) A four-day trial on these issues was held.

In a 47-page opinion, the Tax Court (Judge Kroupa) ruled for the petitioner and against the Government on all issues. (Doc. 119.) The opinion begins with a lengthy discussion of the legislative intent underlying the Virginia Historic Rehabilitation Program and of the critical role that the rehabilitation tax credits play in facilitating the objectives of the program. (Doc. 119 at 4-10.) The court then proceeded to reject both of the Commissioner's arguments in support of his determination that the investors' purported capital contributions were, in reality, the proceeds from the Funds' sales of tax credits. With respect to the Commissioner's argument that, in substance, the investors were merely purchasers of tax credits, not *bona fide* partners, the court gave controlling weight to their formal trappings of partnership status, *e.g.*, the investors executed various documents in which they were characterized as partners and their payments were

characterized in the documents as capital contributions. (Doc. 119 at 24-25.) The court pointed to provisions in the partnership agreement in which investors were to receive an interest in the partnerships' profits and have liquidation rights, without discussing the fact that any meaningful distribution was impossible during the few weeks or months that the investors held their microscopic ownership interests. (Doc. 119 at 24.) The court was not persuaded by the vast discrepancy between the amount an investor's "capital contribution" and the size of his purported partnership interest, nor by the fact that there was a direct correlation between the amount of his "capital contribution" and the amount of tax credits due him under his subscription agreement.

Instead, the court relied upon its finding that the form of the transactions was "compelled by the realities of public policy programs, generally, and the Virginia program, specifically," and was not "undertaken for purposes of Federal tax avoidance." (Doc. 119 at 37.) As to the requirement that partners be engaged in a joint enterprise for profit, the court stated that, although the investors made their contributions between November 28, 2001 and April 14, 2002 (Stip. ¶¶ 104, 117, 126), for use by the Funds only after completion of

rehabilitation projects (Ex. 54-J at 3-4, Ex. 565-P Ex. A at 3-4), the investors had nonetheless “pooled” their money to “meet the needs . . . and cover the expenses of the [developer] partnerships” as well as “to provide capital for successor entities” and for unspecified “other rehabilitation projects” (Doc. 119 at 39). As to the risks of the enterprise, the court determined that, even though investor contributions “would be refunded if . . . the anticipated credits could not be had or revoked,” the investors had “risked their net economic benefit,” and perhaps the contributions themselves if the credits were revoked after the Funds became insolvent. (Doc. 119 at 40-41.) The court rejected the Government’s substance-over-form argument, “conclud[ing] that the form of the investors’ contributions . . . and the resulting allocations of credits reflect their substance.” (*Id.* at 42.)

The court gave short shrift to the Commissioner’s alternative argument that, regardless of whether the investors were limited partners, their transactions with the Funds were a disguised sale of property under I.R.C. § 707 and the regulations promulgated thereunder. (Doc. 119 at 43-45.) Although noting that the investor payments and associated allocation of credits are “presumed sales when

they occur within two years of one another,” the court stated that the transactions could not be treated as disguised sales under Treas. Reg. § 1.707-3(b)(1) if the investor payments were “subject to the entrepreneurial risks of the partnership’s operations.” (Doc. 119 at 44-45.) The court held that the investor’s funds were at risk because “there was no guarantee that the partnerships would pool sufficient credits.”¹⁰ (Doc. 119 at 45.)

On this basis, the Tax Court entered decisions denying the proposed adjustments contained in the FPAAs. (Doc. 121; No. 870-08 Doc. 114; No. 871-08 Doc. 114.) These appeals followed. (Doc. 122; No. 870-08 Doc. 115; No. 871-08 Doc. 115.)

SUMMARY OF THE ARGUMENT

1. It is a fundamental principle of federal tax law that the tax treatment of a transaction is governed by its substance and not its form. The Tax Court purported to apply this principle in determining that so-called investors were *bona fide* limited partners of the Funds in this case, and not merely purchasers of the Virginia tax credits sold by

¹⁰ The Tax Court declined to address “whether the State tax credits are property for purposes of [I.R.C. §] 707.” (Doc. 119 at 43 n.14.)

the Funds. In reality, however, the Tax Court paid only lip service to the substance-over-form doctrine in rejecting the Commissioner's argument that the purported capital contributions made by the investors to the Funds were, in substance, nothing more than the purchase price of the credits sold by the Funds and, as such, includible in the Funds' gross income.

In making its determination that the investors were *bona fide* limited partners, the Tax Court relied on the formal trappings of their partner status and ignored the undisputed evidence that demonstrated that there was no substance to that status. In particular, the Tax Court paid no attention to the undisputed fact that the investors, as they were expressly advised in the offering memoranda, had no possibility of realizing any economic benefit from the Funds other than being able to acquire state tax credits at a discount from their face value. In a similar vein, the Tax Court ignored the undisputed evidence that (1) each investor's purported interest in the Funds' profits was so minuscule as to be utterly meaningless, (2) each investor was required to give the Funds an option to buy out his interest for a nominal payment, (3) the amount of the investor's interest did not

correlate with the size of his capital contribution, but there was a direct, dollar-for-dollar correlation between the amount of the purported capital contribution and the amount of the credits allocated to each investor, and that (4) the purported capital contributions were to be refunded to the investors to the extent the Funds were unable to deliver the amount of credits due to each investor under his agreement with the Funds.

The above-described evidence, ignored by the Tax Court, plainly demonstrates that, in substance, the amounts paid by the investors to the Funds were nothing more than the purchase price of the tax credits sold to them by the Funds, and were not non-taxable contributions to capital.

2. Whether or not the investors were *bona fide* limited partners for federal tax purposes, the Tax Court still committed reversible error in rejecting the Commissioner's alternative argument that the transactions between the investors and the partnerships constituted disguised sales of property under I.R.C. § 707 and the regulations issued thereunder. Section 707 provides that where there is a direct or indirect transfer of property by a partnership to a partner,

and a related transfer of money by the partner to the partnership, and where the two transactions, when viewed together, are properly characterized as a sale of property, such transfers are to be treated as a transaction between a partnership and a partner acting other than in his capacity as a member of the partnership. In other words, when the requirements of the statute are met, the transaction between the partnership and the partner is treated as a sale of property by the partnership to the partner (or vice versa).

The undisputed evidence in the record establishes that all the requirements set forth in Section 707 for treating a transfer between a partnership and one or more of its partners as a sale of property are satisfied in this case. Accordingly, even if the investors are deemed to be limited partners of the Funds for federal tax purposes, Section 707 requires that the payments made by the investors to the Funds be treated as taxable sales proceeds, and not as non-taxable contributions to capital.

The decision of the Tax Court should be reversed.

ARGUMENT

I

THE TAX COURT ERRED IN DETERMINING THAT THE INVESTORS WERE *BONA FIDE* PARTNERS IN THE FUNDS RATHER THAN PURCHASERS OF VIRGINIA TAX CREDITS

Standard of review

The general characterization of a transaction for tax purposes is a question of law subject to *de novo* review. The particular facts from which the characterization is to be made are reviewed for clear error. *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n.16 (1978), citing *American Realty Trust v. United States*, 498 F.2d 1194, 1198 (4th Cir. 1974).

A. It is a fundamental principle of federal tax law that the taxation of a transaction is governed by its substance and not its form. See *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Comm'r v. Court Holding Co.*, 324 U.S. 331 (1945); *Rogers v. United States*, 281 F.3d 1108 (10th Cir. 2002). Indeed, it has long been recognized that “[t]he principle of looking through form to substance . . . is the

cornerstone of sound taxation.” *Weinert’s Estate v. Commissioner*, 294 F.2d 750, 755 (5th Cir. 1961). In applying the doctrine of substance over form, the courts look to the objective economic realities of a transaction rather than to the particular form the parties employed. *Frank Lyon Co.*, 435 U.S. at 572-73; *McDonald’s Restaurants of Illinois, Inc. v. Commissioner*, 688 F.2d 520, 523-525 (7th Cir. 1982) (holding that a purported merger was, in “substance,” a cash sale).

The doctrine that substance, rather than form, controls for federal tax purposes is well-established in this Court. *W.Va.N.R.R. Co. v. Commissioner*, 282 F.2d 63, 65 (4th Cir. 1960) (“It is well settled in matters of taxation that substance rather than form prevails and that the taxability of a transaction is determined by its true nature rather than by the name which the parties may use in describing it”). Most recently, in *BB&T Corp. v. United States*, 523 F.3d 461 (4th Cir. 2008), the Court held that, although in form the taxpayer had leased certain property from a third party which it then sub-leased back to that party, in substance the transaction was nothing but a financing arrangement and, consequently, the taxpayer never acquired a leasehold interest in the subject property.

Initially, we note that, in discussing the substance-over-form doctrine, the Tax Court appears to conflate it (Doc. 119 at 32) with the “economic substance” test, used to weed out transactions having no legitimate nontax business purpose (such as abusive tax shelters). It is undisputed in this case that Gecker, Miller, and Brower intended to join together as *bona fide* partners to profit from tax credit transactions with the investors and that, consequently, the transfers of tax credits by the Funds to the investors had economic substance. The critical question remains, however, as to the substance of the transactions. That is, were the investors *bona fide* limited partners who made non-taxable capital contributions to the Funds, as they purported to be, or were they, in substance, merely purchasers of the tax credits sold by the Funds such that their payments to the Funds constituted taxable proceeds from the sale of the credits.

In this regard, the substance-over-form doctrine is independent of the “economic substance test,” having been established as a fundamental principle since the onset of the income tax, *see United States v. Phellis*, 257 U.S. 157, 166 (1921) (exchange of stock for stock in successor corporation was taxable event; in applying tax laws, “[w]e

recognize the importance of regarding matters of substance and disregarding forms.”) It is well-established, then, that courts may recharacterize transactions according to their substance without determining that the transaction lacks economic substance. *E.g.*, *TIFD III-E, Inc. v. United States* (“*Castle Harbour*”), 459 F.3d 220, 231 (2d Cir. 2006) (holding that “even when [a taxpayer’s] interest has economic substance,” the Commissioner may “reject[] a taxpayer’s characterization” of that interest under substance-over-form doctrine); *Rogers*, 281 F.3d at 1114-1118 (explaining the difference between the economic-substance and substance-over-form doctrines).

B. In the instant case, the Tax Court, in rejecting the Commissioner’s argument that the so-called investors were partners in name only and in substance were simply purchasers of tax credits sold to them by the Funds, paid only lip service to the substance-over-form doctrine. (Doc. 119 at 37-43.) Thus, although the court determined that the investors were partners in substance, as well as form, in reaching that conclusion the court relied on the formal indicia of their partner status and ignored the overwhelming evidence that there was no substance to that status. Among the factors relied on by the Tax

Court were that the various documents executed by the investors described the investors as partners (Doc. 119 at 24), that the partnership agreement for each investor recited that the investor would have an interest in profits, losses, and net cash receipts of the Funds in proportion to his ownership interest (*id.*), and that each partnership agreement also provided that assets remaining after satisfying the Funds' liabilities shall be distributed to the partners in accordance with the positive balances in their respective capital accounts upon dissolution (*id.* at 24-25). The court added that the investors contributed capital to the Funds upon execution of the partnership documents (*id.* at 29) and received Schedules K-1 from their respective Funds allocating their shares of the rehabilitation tax credits (*id.* at 26). The court also stated that the investors filed Federal tax returns for 2002 that were consistent with their claimed status as limited partners. (*Id.*)

The factors cited by the Tax Court establish no more than that the formal trappings of partner status was observed by the parties in

this case. This is contrary to the admonition of the Supreme Court in this regard (*Frank Lyon Co.*, 435 U.S. at 572-73.):

The Court has never regarded the simple expedient of drawing up papers as controlling for tax purposes when the objective economic realities are to the contrary. In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding.

Obviously, if the partnership documents did not describe the investors as partners, the Funds would not have claimed that the amounts received from the investors were capital contributions and not proceeds from the sales of tax credits. Similarly, that the purported partners received Schedules K-1 and filed federal tax returns that were consistent with their claimed status as partners is not evidence that there was any substance to that status. The court's statement that the investors made "capital contributions" obviously begs the ultimate question in this case, and its observation that the investors had an interest in their Funds' profits, losses and net cash receipts (and also had valuable liquidation rights) ignores the undisputed evidence that their purported ownership interests (and liquidation rights) were meaningless and illusory.

To be sure, the Supreme Court has said that “where . . . there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.” *Frank Lyon Co.*, 435 U.S. at 583-84. But immediately after that statement, the Court went on to state that (*id.*):

Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes. What those attributes are in any particular case will necessarily depend upon its facts.

Thus, the Court made it clear that substance – “significant and genuine attributes” corresponding to the transaction’s form – is of overriding importance. To establish in the instant case that the investors are partners for tax purposes, the investors and the general partner must have “join[ed] together . . . for the purpose of carrying on a . . . business” and there must be a “community of interest in the profits and losses.” *Commissioner v. Tower*, 327 U.S. 280, 286 (1946); *see also Commissioner v. Culbertson*, 337 U.S. 733, 738-42 (1949). The

Court must consider the actual circumstances in making this determination; the names by which the parties refer to the entity and one another is not determinative. *Twenty-Mile Joint Venture PND, Ltd. v. Commissioner*, 200 F.3d 1268, 1277 (10th Cir. 1999); *Estate of Kahn v. Commissioner*, 499 F.2d 1186, 1189 (2d Cir. 1974); *S&M Plumbing Co., Inc. v. Commissioner*, 55 T.C. 702, 706-09 (1971).

Here, the Tax Court ignored the evidence that this transaction was marketed to the investors as a means to reduce their Virginia income tax liability by acquiring rehabilitation tax credits at a discounted price.¹¹ The confidential offering memorandum provided to the potential investors advised them that they would not receive any material distributions of cash from the partnerships, nor would they be allocated material amounts of partnership items of income, gain, loss or deduction. (Exs. 37-J, 60-J, 565-P at 7.) The memorandum went on to state that “[a]ccordingly, any return on investment or of an investment in the Partnership is dependent *entirely* upon the Investor’s allocations of the Virginia Historic Credits and any capital loss for federal income

¹¹ The offering memoranda suggested one and only one other benefit to investors: the allocation of capital losses for federal tax purposes. (Exs. 37-J, 60-J, 565-P at 7.)

tax purposes generated upon the sale of the investment in the Partnership.” (Exs. 37-J, 60-J, 565-P at 11 (emphasis added).) The Tax Court also ignored the uncontested testimony of the investors called as witnesses by the Commissioner that they participated in this venture solely to acquire the state tax credits and a possible federal capital loss upon the disposition of their “interest” and that they understood that they would receive no other financial benefit as a result of their participation. (Tr. 159-60, 170, 315, 458, 540.) The court also paid no attention to the fact that, *collectively*, all 282 purported limited partners had only a 1-percent ownership interest in the partnerships and that, consequently, each investor’s purported interest in the profits of the enterprise was so small as to be utterly meaningless. (Exs. 26-J, 35-J, 58-J.)

In reciting that each investor made a “capital contribution” to his respective partnership, the court paid no attention to the vast discrepancy between the amount of the investor’s purported contribution and the size of the investor’s ownership interest. The amount of each investor’s capital contribution was determined exclusively by the amount of tax credits each investor sought to acquire

and the purchase price of the credits. (Exs. 37-J, 60-J, 565-P at 11; Stip. ¶¶ 150, 153, 156.) Thus, under the standard price of \$.74 for \$1 of tax credit, the investor who made a “capital contribution” of \$1 million would be allocated approximately \$1,350,000 of tax credits, whereas the investor who “contributed” \$10,000 would receive an allocation of only approximately \$13,500 credits. Notwithstanding the huge disparity between each investor’s “capital contribution” in the above example, each investor subscribed essentially to the same negligible “ownership interest” in the partnership, *i.e.*, an interest that was generally 1/100 of 1 percent, or less. (Exs. 68-J-200-J; *see supra* note 8.)

Moreover, the buy-out, option agreement each investor was required to execute rendered wholly illusory the investor’s purported ownership interest in his partnership, as well as his liquidation rights upon dissolution of the partnership. In the case of every investor, the buy-out option was exercised within months, if not weeks, of the time the investor had made his initial “contribution,” and the purchase price for the buyout was unilaterally determined by Gecker to be 1/10 of 1 percent of the amount of such “contribution.” (Stip. ¶¶ 161, 164, 168; Tr. 441.) There is no evidence in the record that any investor

complained (or had any right to complain) that his purported interest was worth more than the pittance determined by Gecker, nor was any evidence introduced that the collective fair market value of the investors' interests exceeded the amounts determined by Gecker.

The fact that the investors had no "significant and genuine" expectation of sharing in the Funds' gains, *Frank Lyon Co.*, 435 U.S. at 583-84, is in stark contrast to the expectation of the general partner, 2001 LLC, and its principals, Gecker, Brower, and Miller, who stood to earn well over \$1 million from the Funds by means of selling the credits to the investors at a substantial mark-up.¹² (Tr. 368, Tr. 488.)

Conversely, the investors were not exposed to the risk of loss in the event the partnerships were unsuccessful since they received a written promise from the Funds (Exs. 37-J, 60-J, 565-P at 7) that their purported capital contributions would be refunded to the extent the Funds were unable to deliver the tax credits due the investors under the subscription agreements. Under these circumstances, there was clearly no "community of interest in the profits and losses," *Tower*, 327

¹² In 2002, for example, \$444,043 was distributed to Brower and \$308,047 to BKM, representing a little over half of the three owners' anticipated net income from the Funds. (Tr. 368; Ex. 29-J.)

U.S. at 286, as between the investors and the principals. Rather, the substance of the transaction was that of any advance purchase: the buyer's benefit-of-the-bargain was fixed, subject only to the contractual risk that the seller would not honor the terms of the contract, while the seller's benefit varied with the costs of the enterprise. These undisputed facts, then, clearly establish that the investors' purported capital contributions were nothing more than the sales price for the tax credits purchased from the partnerships.

C. The intent to become a partner may also be inferred from the circumstances, including the contribution of money to the entity with the intent that it be repaid only if the venture succeeds. *See Gilbert v. Commissioner*, 248 F.2d 399, 406 (2d Cir. 1957); *Hambuechen v. Commissioner*, 43 T.C. 90, 99-100 (1964). The fact that a partner is protected from the risks of the venture, however, suggests that the partner's participation is formal rather than substantive. *Cf. ASA Investings Partnership v. Commissioner*, 201 F.3d 505, 513-514 (D.C. Cir. 2000) (noting that partner whose risks are all insured at the expense of another partner "hardly fits within the traditional notion of a partnership"); *Saba Partnership v. Commissioner*, 273 F.3d 1135,

1141 (D.C. Cir. 2001) (observing that a valid partnership is not formed where, among other things, one partner receives a guaranteed, specific return).

The Tax Court in this case failed to give weight to the highly probative fact that each investor's partnership agreed to refund his "capital contribution" to the extent the partnership was unable to secure sufficient tax credits to allocate the entire amount of credits due the investor under his subscription agreement. The court acknowledged (Doc. 119 at 40) that the investors' "capital contributions" were refundable to the extent the partnerships could not deliver all the tax credits due the investors, but gave no weight to the refund provision because there was some, slight risk that the partnerships might lack the means to honor their obligation in this regard. It is, however, the fact that the capital contributions were refundable if the tax credits were not delivered that is significant. That there was a slight risk that the partnerships might default on their obligation has no relevance to the question presented in this case. In this regard, any time a purchaser makes an advance payment to a seller for an item to be delivered in the future he runs the risk that he

will not receive the refund he would be entitled to in the event the seller were to fail to deliver the purchased item.

In short, the undisputed evidence establishing that the investors, as they were expressly informed, had no possibility of realizing any meaningful economic benefit from the partnerships, other than acquiring the tax credits at a discount, that the investors acquired only nominal interests, that their purported capital contributions were refundable in the event they did not receive the credits, and that the investors were required to agree to a buyout of their interests in return for a token payment (which served to wholly negate their negligible ownership interest and their liquidation rights), confirms the obvious conclusion, lost on the Tax Court, that, in substance, the investors were not *bona fide* partners, but, instead, were nothing more than purchasers of the tax credits sold by the partnerships. It necessarily follows from this conclusion that the amounts transmitted by the investors to the partnerships constituted sales proceeds includable in the partnerships' gross income, and not capital contributions.

II

REGARDLESS OF WHETHER THE INVESTORS WERE *BONA FIDE* PARTNERS FOR FEDERAL TAX PURPOSES, THEIR TRANSACTIONS WITH THE FUNDS SHOULD NOT BE TREATED AS SALES UNDER I.R.C. § 707

A. Applicable law regarding so-called “disguised sales”

Even if it were determined that the investors were *bona fide* limited partners for federal tax purposes, the transactions between the investors and the Funds are nonetheless governed by I.R.C. § 707. I.R.C. § 707(a)(1) provides the general rule that if a partner engages in a transaction with a partnership, other than in his capacity as a member of such partnership, the transaction (subject to certain specified exceptions) shall be treated as occurring between the partnership and one who is not a partner. In 1984, Congress sharpened the focus of § 707 with two new rules governing transactions between a partner and his partnership. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 73(a). In providing these new rules, Congress was aware that to be considered partners for tax purposes, persons must, *inter alia*, pool their assets and labor for the joint production of profit. And to the extent that a partners’ profit from a transaction is assured,

“there is not the requisite joint profit motive, and the partner is acting as a third party.” Staff of Joint Comm. on Tax’n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 226. Congress was concerned that “taxpayers have deferred or avoided tax on sales of property . . . by characterizing sales as contributions of property (including money) followed (or preceded) by a related distribution of partnership property (including money)” and the cases had permitted tax-free treatment “in cases which were economically indistinguishable from sales of property.” H.R. Rep. No. 98-861, at 860 (1984) (Conf. Rep.).

As a result, one of the new rules, codified as I.R.C. § 707(a)(2)(B), provides as follows:

**(B) TREATMENT OF CERTAIN
PROPERTY TRANSFERS. — If —**

(i) there is a direct or indirect transfer of money or other property by a partner to a partnership,

(ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and

(iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property,

Such transfers shall be treated either as a transaction described in paragraph (1) or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

According to the Joint Committee Report, this rule was “intended to prevent the parties from characterizing a sale or exchange of property as a contribution to the partnership followed by a distribution from the partnership and thereby to defer or avoid tax on the transaction.” Staff of Joint Comm. on Tax’n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 231.

The Act authorized the Treasury Department to prescribe any regulations that were necessary or appropriate to further this intent.

Id.

In this regard, Treasury promulgated Treas. Reg. (26 C.F.R.) § 1.707-3(c) to describe so-called “disguised sales” of property from a partner to a partnership. Treas. Reg. § 1.707-6(a), in turn, states that for potential sales in the other direction – that is, disguised sales from

the partnership to the partner – rules similar to those provided in Treas. Reg. §1.707-3 apply. Under these rules, if within a two-year period a partnership transfers property to a partner and a partner transfers money or other consideration to the partnership (in any order), the transfers are presumed to be a sale of property to the partner “unless the facts and circumstances clearly establish that the transfers do not constitute a sale.” Treas. Reg. § 1.707-3(c)(1).

The two-year presumption of Treas. Reg. § 1.707-3(c)(1) is consistent with the Joint Committee’s admonition that “the closeness in time of the distribution to the partner and the purported contribution” is a significant factor indicating a transaction that should be treated, for tax purposes, as a sale. Staff of Joint Comm. on Tax’n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 232. Other factors that Congress expected to be evaluated when deciding whether a transaction is to be treated as a third-party transaction under § 707 include:

- Whether the payment is subject to an appreciable risk as to amount. “[C]ontinuing arrangements in which purported allocations and distributions . . . are fixed in amount or reasonably determinable” should be considered suspect. Staff of Joint Comm. on Tax’n, 98th Cong., 2d Sess., General

Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 227-28;

- Whether the partner status of the recipient is transitory. “Transitory partner status (which limits the duration of a joint undertaking for profit) suggests that a payment is a fee or in return for property.” *Id.* at 228;
- Whether “the value of the recipient’s interest in general and continuing partnership profits is small in relation to the allocation in question,” particularly where the allocation is for a limited period of time. *Id.*

In addition, where it appears that a partner became a partner primarily to obtain tax benefits for himself or the partnership, it is strongly suggestive of a disguised sale. *Id.* That said, “the existence of significant non-tax motivations for becoming a partner is of no particular relevance in establishing that a transaction is not a disguised sale.” *Id.* at 232.

B. The petitioner failed to clearly establish that the investor contributions and contemporaneous allocation of state tax credits did not constitute sales under Section 707.

1. In this case, it is undisputed that each of the investors transferred money to the Funds and was allocated Virginia historic rehabilitation tax credits within two years of that transfer. As such, the exchanges between the investors and the Funds are presumed to be

sales of credits under Treas. Reg. § 1.707-3(c)(1). The Tax Court was thus required to treat them as such “unless the facts and circumstances *clearly establish* that the transfers do not constitute a sale.” *Id.*

(emphasis added). Under the “clearly establish” standard, a mere preponderance of the evidence (the standard of persuasion that would apply otherwise) will not suffice. 4 Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 89.1.4, at 89-13 n. 54 (3d ed. 1999).

Treas. Reg. § 1.703-3(b)(1) provides that transfers of property and money between a partnership and a partner constitute a sale of property only if, based on all the facts and circumstances,

(i) The transfer of money or other consideration would not have been made but for the transfer of property; and

(ii) In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

To this end, Treas. Reg. § 1.707-3(b)(2) sets forth a non-exclusive list of ten facts and circumstances that indicate that a transfer of property from a partner to a partnership is a disguised sale of such property.

The Tax Court failed to discuss or even mention a single one of these

factors, even though nearly all of the factors directly support the conclusion that the investor transactions with the funds were to be treated as disguised sales under § 707.

Of greatest relevance to this case, the following factors identified in Treas. Reg. § 1.707-3(b)(2) (as applied to the instant case by § 1.707-6(a)) strongly support the conclusion that the investor transactions were to be treated as disguised sales:

- That the timing and amount of the allocation of credits were determinable with reasonable certainty at the time the investors made their contributions (§ 1.707-3(b)(2)(i));
- That the investors had a legally enforceable right to the subsequent transfer of credits (§ 1.707-3(b)(2)(ii));
- That the investors' right to receive the credits was secured by a money-back guarantee (§ 1.707-3(b)(2)(iii)); and
- That the investors' transfers of money to the Funds were disproportionately large in relationship to the investors' general and continuing interest in partnership profits (§ 1.707-3(b)(2)(ix)).

On the other hand, none of the factors identified in Treas Reg. § 1.707-3(b)(2) supports the conclusion of the Tax Court, much less "clearly establish" that the investor transactions do not constitute a sale.

2. As a result, the Tax Court erred in analyzing Treas. Reg. § 1.703-3(b)(1), without considering the facts and circumstances that Treas Reg. § 1.707-3(b)(2) states should be considered in that analysis. But even the Tax Court's superficial analysis of Treas. Reg. § 1.703-3(b)(1) is off the mark.

The Tax Court found that, because the investors contributed capital at various times, but the tax credits were not allocated to the investors until the Funds attached the tax credit certificates to their respective Schedules K-1, the transfers were not simultaneous. (Doc. 119 at 44-45.) To the contrary, the undisputed evidence in this case establishes that the sole reason the investors made their purported capital contributions was in exchange for the promise in the subscription agreement to deliver the rehabilitation tax credits. (Exs. 37-J, 60-J, 565-P at 7; Tr. 159-60, 170, 315, 458, 540.) Indeed, the subscription agreements for each of the investors expressly provides that the partnership agrees to allocate the investor's share of the tax credits *simultaneously* with his admission to the partnership. (Exs. 68-J-200-J.) The subscription agreements further provide that all documents necessary to effect the investor's admission to the

partnership and the allocation of the tax credits due him will be executed *simultaneously* with the partnership's receipt of the investor's cash contributions. (*Id.*) Accordingly, the requirement of Treas. Reg. § 1.707-3(b)(1)(i) clearly is satisfied in this case. The Tax Court simply ignored the subscription agreements in making its finding that the investors' payments of their "capital contributions" were not simultaneous with the transfer of the credits to the investors.¹³

As for its conclusion that investor contributions were subject to the risks of the enterprise, the Tax Court identified several factors it thought were "entrepreneurial risks" (Doc. 119 at 40-42, 45) – namely, the risk that the Funds would not secure the credits, whether due to mismanagement, fraud, construction or zoning issues, or DHR oversight, or that the DHR would revoke the credits. But these factors are belied by several, undisputed facts, ignored by the Tax Court.

First, the Tax Court ignored the certificates of rehabilitation themselves (Ex. 204-J), which establish that the projects were

¹³ Contrary to the Tax Court's conclusion (Doc. 119 at 44), the Schedules K-1 issued to each investor are not themselves a transfer of the right to claim the tax credits but, instead, the mere reporting of the allocation of credits that had already occurred.

completed *before* the investors made contributions.¹⁴ Second, the Tax Court ignored the subscription agreements, which state that the investor agreed to purchase his limited partnership interest by a date certain, *provided* that the partnership has received a Certificate of Rehabilitation from the Virginia Department of Historic Resources. Thus, the subscription agreements required the Funds to have on hand the appropriate amount of tax credits at the time each investor made his “contribution” and was admitted to his partnership. Finally, the Tax Court improperly dismissed the critical fact that the partnership agreements and the offering memoranda guarantee the refund of the investor’s “contribution” to the extent the Funds were unable for any reason to provide him with the allocation of tax credits due him under his subscription agreement. That the Funds theoretically might not honor this refund provision is of no moment: every advance purchase

¹⁴ Only four of the projects – Sweet Briar, Watkins-Cotrell, Hotel Norton, and Hanson Company – had completion dates after November 26, 2001, the date of the first investor contribution. (Stip. ¶ 104; Ex. 204-J.) The final project was completed December 24, 2001. (Ex. 204-J.) The majority of investor checks were signed after December 24, 2001. Accordingly, to the extent the developers received investor money, via the Funds, they did so only after any construction risks had passed.

runs the risk that the seller might default on their obligations to deliver the purchased property or refund the purchase price if they cannot. This *caveat emptor* aspect to the transaction does not constitute an *entrepreneurial* risk of an investor. Thus, the undisputed evidence flatly contradicts the Tax Court's determination that the investor transfers were placed at the risk of the Funds' operations and makes clear that the amounts paid by the investors should be treated, for tax purposes, as the purchase price for the credits being sold by the Funds.

CONCLUSION

For the reasons stated above, this Court should reverse the decision of the Tax Court.

STATEMENT REGARDING ORAL ARGUMENT

Counsel for the United States believe that oral argument would be helpful in this case to aid the Court's understanding of the issues presented.

Respectfully submitted,

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It is hereby certified that on this 21st day of June, 2010, this page-proof brief was electronically filed with the Clerk of the Court using the CM/ECF system, which will send notice of such filing to the following attorneys for the appellees, who are registered CM/ECF users:

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