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

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

VIRGINIA HISTORIC TAX CREDIT FUND 2001 LP;
VIRGINIA HISTORIC TAX CREDIT FUND 2001 LLC;
TAX MATTERS PARTNER, *et al.*,

Petitioners - Appellees,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent - Appellant.

ON APPEAL FROM THE DECISION OF
THE UNITED STATES TAX COURT

PAGE-PROOF BRIEF BY APPELLEES VIRGINIA HISTORIC TAX CREDIT FUND 2001 LP, *et al.*

DAVID D. AUGHTRY
HALE E. SHEPPARD
CHAMBERLAIN, HRDLICKA, WHITE, WILLIAMS & MARTIN
191 Peachtree Street, N.E. – 34th Floor
Atlanta, Georgia 30303-1747
(404) 659-1410 Telephone
(404) 659-1852 Facsimile

Virginia Historic Tax Credit Fund 2001 LP, et al., v.
Commissioner of Internal Revenue
4th Cir. No. 10-1333 (L)

DISCLOSURE OF CORPORATE AFFILIATIONS AND OTHER INTERESTS

Pursuant to Federal Rule of Appellate Procedure 26.1 and Local Rule 26.1, Petitioners-Appellees Virginia Historic Tax Credit Fund 2001 LP, *et al.*, make the following disclosure.

1.	Is party/amicus a publicly held corporation or other publicly held entity?	No.
2.	Does party/amicus have any parent corporations?	No.
3.	Is 10% or more of the stock of a party/amicus owned by a publicly held corporation or other publicly held entity?	No.
4.	Is there any other publicly held corporation or other publicly held entity that has a direct financial interest in the outcome of the litigation?	No.
5.	Is party a trade association?	No.
6.	Does this case arise out of a bankruptcy proceeding?	No.

TABLE OF CONTENTS

DISCLOSURE OF CORPORATE AFFILIATIONS

TABLE OF CONTENTS i

TABLE OF AUTHORITIES iv

STATEMENT OF JURISDICTION 2

STATEMENT OF ISSUES 3

STATEMENT OF THE CASE 5

STATEMENT OF FACTS 9

SUMMARY OF THE ARGUMENT 13

DISCUSSION 18

STANDARD OF REVIEW 18

A. THE TAX COURT'S FACT FINDINGS AS TO PARTNER STATUS, INTENT, AND CAPACITY SHOULD BE RESPECTED 19

B. THE TAX COURT PROPERLY FOUND THE EQUITY PARTNERS FULFILLED CRITICAL PARTNER ROLES IN THEIR SPECIAL-PURPOSE, STATE POLICY-BASED PARTNERSHIPS 21

1. The "Regulatory Realities" of the Virginia Historic Program Confirm that the Partners Intentionally Became Partners Based on Valid Business Purposes 22

2. These Partners Fulfilled Every Statutory Definition of "Partner" and "Partnership" in the Internal Revenue Code 25

3. The Tax Court and the Supreme Court Agree: the Partners' Intent in Joining the Funds Proves Their Role 28

4. At Least 20 Factors Prove that the Partners Were Partners.....31

5. No Part of the IRS Argument Withstands Scrutiny. 36

C. THE TAX COURT PROPERLY ANALYZED THE LARGELY REDUNDANT SECTION 707 IRS ARGUMENT 42

1. The Partners Acted in Their Capacity as Partners 43

2. The Same IRS Regulation Confirms Both the "Acting in Capacity as Partner" and the "Contribution" Exclusions 44

3. A Partnership Allocation of Tax Consequences Occurs By Operation of Law, Not By "Transfer".....46

4. These Non-transferrable Tax Attributes Arise By Operation of Law and Do Not Constitute "Property" 50

5. The Risks Preclude Recharacterizing the Partners' Interests as a "Disguised Sale" 54

CONCLUSION 60

REQUEST FOR ORAL ARGUMENT 61

ADDENDUM: SELECTED STATUTES AND Treasury REGULATIONS.....62

CERTIFICATE OF COMPLIANCE.....69

CERTIFICATE OF SERVICE

TABLE OF AUTHORITIES

CASES

ASA Investerings Partnership v. Commissioner, 201 F.3d 505, 513-14 (D.C. Cir. 2000) 24

BB&T Corp. v. United States, 523 F.3d 461, 464 (4th Cir. 2008) 24, 38

Bergford v. Commissioner, 12 F.3d 166, 169 (9th Cir. 1993) 27

Beth W. Corporation v. United States, 350 F. Supp. 1190, 1192-93 (S.D. Fla. 1972) 49

Black & Decker Corp. v. United States, 436 F.3d 431, 441 (4th Cir. 2006) 38

Braun v. Commissioner, 396 F.2d 264, 266-7 (2d Cir. 1968) 39

Commissioner v. Culbertson, 337 U.S. 733, 742-43 (1949) ..... *passim*

Commissioner v. Scottish Amer. Inv. Co., Ltd., 323 U.S. 119, 124 (1944) 18

Commissioner v. Tower, 327 U.S. 280, 286-87 (1946) 18, 29

Davis v. United States, 370 U.S. 65, 70-71 (1962) 49

Dawson v. J. G. Wentworth & Co., Inc., 946 F.Supp. 394, 396 (E.D. Pa. 1996) 26

Devonian Program v. Commissioner, T.C. Memo. 2010-153 ..... 28, 37

Evans v. Commissioner, 447 F.2d 547, 552 (7th Cir. 1971) 26

Faircloth v. Lundy Packing Company, 91 F.3d 648, 653 (4th Cir. 1996).....42

Flippo v. CSC Assocs. III, L.L.C., 547 S.E.2d 216, 226 (Va. 2001) 45

Frank Lyon Co. v. United States, 435 U.S. 561, 572-3 (1978) .....*passim*

Friedlander v. Commissioner, 216 F.2d 757, 758 (5th Cir. 1954) 39

Gilbert v. Commissioner, 248 F.2d 399, 406 (2d Cir. 1957).....29

Gillette Company v. RB Partners, 693 F.Supp. 1266, 1271 (D. Mass. 1988) 27

Hambuechen v. Commissioner, 43 T.C. 90, 99-100 (1964) 29

Harris v. Commissioner, 61 T.C. 770, 783, 786 (1974).....38

Hayes v. Irwin, 541 F.Supp. 397, 415 (N.D. Ga. 1982).....26

Helvering v. Taylor, 293 U.S. 507, 513 (1935) 20

Imperial Car Distributors, Inc. v. Commissioner, 427 F.2d 1334, 1336 (3d Cir. 1970).....45

In re Harrell, 73 F.3d 218, 220 (9th Cir. 1996).....52

In re I.D. Craig Service Corporation, 138 B.R. 490, 495 (Bankr. W.D. Pa. 1992) 52

Lewis and Taylor, Inc. v. Commissioner, 447 F.2d 1074, 1077 (9th Cir. 1971) 45

McCord v. Commissioner, 461 F.3d 614, 625, n. 22 (5th Cir. 2006) 20

McManus v. Commissioner, 583 F.2d 443, 447 (9th Cir. 1978) 25

Morgan v. Commissioner, 309 U.S. 78, 82 (1940) 44, 50

Randall v. Loftsgaarden, 478 U.S. 647, 657 (1986) 50

Reinberg v. Commissioner, 90 T.C. 116, 134 (1988).....25

Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 92 (4th Cir. 1985) 18

Roark v. Hicks, 362 S.E.2d 711, 714 (Va. 1987).....26

Sacks v. Commissioner, 69 F.3d 892, 992 (9th Cir. 1995).....23

Snyder v. Commissioner, 894 F.2d 1337 (Table) (6th Cir. 1990).....50

Stewart v. Commissioner, 714 F.2d 977, 987 (9th Cir. 1983).....39

Stout v. Commissioner, 273 F.3d 345, 350 (4th Cir. 1959).....20

Virginia Historic Tax Credit Fund 2001 LP, Virginia Historic Tax Credit Fund 2001, LLC, Tax Matters Partner, et al. v. Commissioner of Internal Revenue, T.C. Memo. 2009-295.....*passim*

Wheeler v. Commissioner, T.C. Memo. 1978-208.....27

Zmuda v. Commissioner, 731 F.2d 1417, 1421 (9th Cir. 1984) 38

STATUTES, RULES & REGULATIONS

VIRGINIA STATUTES

VA. CODE § 13.1-1002 44

VA. CODE § 50-73.1 44

VA. CODE § 50-73.26 32

VA. CODE § 58.1-339.2 .....*passim*

VA. CODE § 58.1-513(E) 50

UNITED STATES CODE

TITLE 16

National Historic Preservation Act of 1966 (16 U.S.C. § 470-1).....13, 22, 61

TITLE 26

Section 701 48

Section 702 48

Section 704 .....48, 59

Section 704(b).....41

Section 707 .....*passim*

Section 707(a)(2)(B) 1, 17

Section 761 .....15, 21, 25, 43

Section 761(a) 25, 27

Section 761(b).....25

Section 7701 .....21, 25

Section 7701(a).....25

TREASURY REGULATIONS

Treas. Reg. § 1.355-2(b)(2).....23

Treas. Reg. § 1.701-2(b) 24

Treas. Reg. § 1.704-1(b) 10

Treas. Reg. § 1.707-1(a).....44, 58

Treas. Reg. § 1.707-3(b) 54, 58

Treas. Reg. § 1.1001-1(h)(1).....48

Treas. Reg. § 301.7701-1 2

Treas. Reg. § 301.7701-3 2

REVENUE RULINGS

Rev. Rul. 54-84, 1954-1 C.B. 284.....27

Rev. Rul. 56-437, 1956-2 C.B. 507 49

Rev. Rul. 66-226, 1966-2 C.B. 239.....51

Rev. Rul. 76-83, 1976-1 C.B. 213.....49

Rev. Rul. 79-289, 1979-2 C.B. 145.....24

Rev. Rul. 79-300, 1979-2 C.B. 112.....22

Rev. Rul. 79-315, 1979-2 C.B. 27 51

Rev. Rul. 89-101, 1989-2 C.B. 67 .....24, 49

Rev. Rul. 91-36, 1991-2 C.B. 17 51

OTHER AUTHORITIES

59 Am. Jur. 2d, PARTNERSHIP § 47 26

Barksdale Hortenstine and Gregory Marich, *An Analysis of the Rules Governing Disguised Sales to Partnerships: Section 707(a)(2)(b)*, 830 PLI/TAX 969 (October-December, 2008) 56

Candace A. Ridgway, *Corporate Separations: Valid Business Purpose – Reducing State or Foreign Taxes*, BNA TAX MANAGEMENT PORTFOLIO, 776-3rd: VIII, C, 10 24

David Westfall, *et al.*, *Part V. Trust and Beneficiaries: Chapter 17. Noncharitable Trusts: Income Tax Aspects for Grantors, Beneficiaries, and Power Holders*, ESTATE PLANNING LAW & TAXATION, ¶ 17.09[1] n. 298 49

Harold R. Berk, *Tax Credit Transactions: Virginia State Historic Tax Credit Fund Case*, 13 J. PASSTHROUGH ENTITIES No. 3, at 41 (2010) 21

I.R.S. Coordinated Issue Paper, State and Local Location Tax Incentives, LMSB-04-0408-023, 2008 WL 2158109 (May 23, 2008).....51

Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 227 (98th Cong., 2d Sess.) (Comm. Print 1984).....59

MCKEE, NELSON, AND WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, Sec. 3.02[2] (4th ed. 2007).....26

R. Lipton, *et al.*, *A Tale of Two Cases: G-I Holdings and Virginia Historic Tax Credit Fund – Can They Both be Right?*, 112 J. TAX'N 154, 164 (2010).....30

S. ROWLEY, ROWLEY ON PARTNERSHIP § 6.5, at 77 (2d ed. 1960).....26

SHEPARD'S MCGRAW-HILL TAX DICTIONARY FOR BUSINESS (1994).....48

T.D. 8238, 1989-1 C.B. 92.....23

WEST'S TAX LAW DICTIONARY (1998).....48

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

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

VIRGINIA HISTORIC TAX CREDIT FUND 2001 LP;
VIRGINIA HISTORIC TAX CREDIT FUND 2001 LLC;
TAX MATTERS PARTNER, *et al.*,

Petitioners - Appellees,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent - Appellant.

PAGE-PROOF BRIEF BY APPELLEES VIRGINIA HISTORIC TAX CREDIT FUND 2001 LP, *et al.*

The Tax Court rendered its "solid and careful" opinion in these consolidated partnership cases on December 23, 2009 (T.C. Memo. 2009-295: Doc. 119 "Slip Op."). That opinion confirms that the equity partners in the Virginia Historic Tax Credit Fund 2001, L.P. and its two second tier partnerships ("Virginia Historic Funds") were true partners and that the Section[1] 707(a)(2)(B) "disguised sale" provisions do not apply to these facts. The Internal Revenue Service ("IRS") appeals that opinion. As recognized by the tax community, it should be affirmed.

[1] Unless indicated otherwise, all section references are to Title 26 of the United States Code (as amended through December 31, 2001).

STATEMENT OF JURISDICTION

While the Virginia Historic Funds[2] agree with the description of jurisdiction by the IRS, they disagree with two particular points in its "Introduction and Statement of Jurisdiction" that later bear on the burden of proof that impacts the IRS's appeal of the Tax Court's factual conclusions:

(i) The Final Partnership Administrative Adjustments convert 100 percent of the $7 million in partners' contributions into income taxable to the partnerships and their partners. (Slip Op. 2-3).

(ii) By stipulation, the IRS admitted that – even under its own credit-sale argument – the IRS overstated its alleged gain in two different ways. One, the IRS should have subtracted the "costs" the Virginia Historic Funds paid to the developer partnerships. (Stip. ¶¶ 191, 202, 214, 218, 225, 228). Coupled with the costs of the one-time-transfer contracts, the IRS stipulates that its $7 million gain should have been $1.5 million. (*Id.*). Two, the IRS then taxed the partnerships and their partners on the $7 million overstated gain twice – once in 2001 and once in 2002. (*Id.*; Stip. ¶ 8). The IRS acknowledges only the second form of overstatement. (IRS Br. 5 and 7, n. 5).

[2] All three entities are treated as partnerships for federal tax purposes, including Virginia Historic Tax Credit Fund 2001 SCP, LLC. Treas. Reg. §§ 301.7701-1 and -3. Hence, their members are collectively referred to herein as partners.

STATEMENT OF ISSUES

Set in the context of the Tax Court's factual findings and the applicable standards of review, the two issues answer themselves:

1. May the IRS disregard as "clearly erroneous" the role of the equity partners as partners where the trial court concludes from an ample record that (i) the partners intended to be partners, (ii) the partners joined their partnerships for the valid business purpose of supporting the Virginia Historic Program and sharing in non-federal-tax economic incentives Virginia provided for that support, (iii) they contributed capital to their partnerships in furtherance of those business purposes, (iv) their pooled capital contributions were critical to their partnerships' success, (v) their limited partnership interests created rights and responsibilities under State law, (vi) they shared a number of business risks that set them apart from mere purchasers, and (vii) their role as partners was compelled by the regulatory realities of the public-policy program?

2. Should the contributions to capital by the partners in 2001 and the partnership allocation of the Virginia incentives the following Spring be recharacterized as a Section 707 "disguised sale"?

Any one of five intermediate inquiries answers this issue:[3]

[3] In order to recharacterize the partners' contributions and their partnership allocations as "disguised sales" under the Section 707 rules, the IRS must prove that the answer to ALL FIVE QUESTIONS is "no."

a. Did any substantial evidence from the ample record support the Tax Court's finding that the equity partners contributed their capital and later received partnership allocations in their capacity as partners furthering the business purposes and success of their partnerships?

b. Did any substantial evidence from the ample record support the Tax Court's finding that the contractually defined capital contributions comported with their substance?

c. As a matter of law, did the allocation of the Virginia tax attributes constitute a sharing or division, as opposed to a "transfer"?

d. Did any substantial evidence from the ample record support the Tax Court finding that the Virginia incentives were non-refundable, non-inheritable, and non-transferable in the hands of the Virginia Historic Funds and their partners (and, thus, constitute State tax attributes, as opposed to "property" under Section 707)?

e. Given the Tax Court's finding (supported by the ample record and now corroborated by the IRS's admissions on brief) that the equity partners contributed their capital and received their ultimate allocation of Virginia credits at different times (*i.e.,* non-simultaneous), did any substantial evidence support the Court's extensive factual analysis and findings as to the entrepreneurial risks shared by the equity partners?

STATEMENT OF THE CASE

Rather than objectively describing the course of the Tax Court proceedings, the IRS presents the Stipulations in which the IRS admits the IRS errors in the FPAAs *under the IRS's own credit-sale theory* – as if the Virginia Historic Funds agreed with that theory. (IRS Br. 6-7). The Virginia Historic Funds never agreed with that theory. Moreover, the IRS resorts to an unfair and woefully incomplete description of the Tax Court opinion, which can be easily summarized.

The Tax Court concluded "after carefully considering the extensive evidence and testimony presented, that the investors were partners for Federal tax purposes." (Slip Op. 21-2). In reaching that conclusion, the Tax Court recognized that, under Supreme Court authority, "the existence of the requisite purpose is a question of fact that ultimately depends upon the parties' intent." (*Id.* at 23).

The Court determined that the partners intended to become partners based on an extensive factual analysis of six objective factors. In reaching that factual conclusion, the Court found that the partners pursued two purposes (what some partners referred to as the "feel good" motive of supporting of the Virginia Historic Program and, secondly, sharing in the resulting Virginia tax incentives). The Court then analyzed whether the partners pursued valid business purposes. On the financial side of that dual intent, the Court stated, "We find … that the parties intended to pool resources and share the results of investment." (*Id.* at 29).

The Court confirmed that all of the cases cited by the IRS dealt with ventures motivated solely by *Federal* taxes, "[t]he omission of the word 'Federal' from the anti-abuse regulation in the FPAA [that the IRS issued to the Virginia Funds] illustrates a critical distinction," discussed the IRS regulations and rulings recognizing State-tax minimization as a valid business purpose, and concluded:

> … that the investors had a business purpose for participating in a low-profitability venture because they expected a considerable net economic benefit from State tax savings and any federal tax consequences were incidental. (*Id*. at 34-5).

Under *Frank Lyon Co. v. United States*, 435 U.S. 561, 572-3 (1978), and other Supreme Court authority, the Court determined whether the substance comported with the form, as divorced from "mere formalisms, which exist solely to alter Federal tax liabilities." (*Id.* at 35-6). The Court began by rejecting the IRS attempt to change the issue *after* trial to whether the Virginia Historic Funds constituted partners of the upstream developer partnerships. The Court noted the authority requiring recognition of relationships compelled by "regulatory realities," the federal policy embedded in the National Historic Preservation Act of 1966, the purpose of the "Virginia Program's base-broadening allocation provision," and concluded:

> The investors became partners in the Virginia Historic Funds because they were required to join an entity to participate in the Virginia Program, which does not provide for freely transferrable credits. (Slip Op. 38).

The Court noted that the upstream developer partnerships were not equipped to deal directly with all these limited partners/members and that "the investors' partnership interests created rights and responsibilities between the parties under State law." (*Id.*). From these realities, the related considerations, and the record, the Court found that "this form was compelled by the realities of public policy programs, generally, and the Virginia Program, specifically." (*Id.*).

The Tax Court then analyzed and rejected the same arguments as to contribution amount, timing, and risk that the IRS repeatedly urges on appeal. The Court confirmed that the partners posted their contributions so their partnerships could meet the obligations required to fulfill their purposes, the timing comported with the partnerships fulfilling those purposes, and the partners shared a long list of risks arising from both the public-incentive and the traditional operational aspects of their partnerships – "shared risk [that] sets the investors apart from simple purchasers." (*Id.* at 42).

The Court, therefore, ultimately held that the partners constituted true partners because they intended to join together as partners, pooled their capital in an enterprise formed to invest in developer partnerships, did so for valid business purposes, and contributed to partnerships that allocated the Virginia credits through a consistent form and substance. (Slip Op. 42).

The Court then turned to the IRS alternative argument that the partners' contributions and their partnerships' allocations of the Virginia credits should be recharacterized as "disguised sales" under Section 707. In reciting the law, the Court pointed out the necessity of cross "transfers" of "money or property" that "when viewed together are properly characterized as a sale." (*Id.* at 43). The Court's partner analysis had already addressed the question of whether the contributions and allocations "are properly characterized as a sale." Consequently, the Court summarized three areas of its prior (largely factual) analysis that together confirmed, "[t]he substance of these transactions reflects valid contributions and allocations rather than sales." (*Id*. at 44).

In addition, the Court confirmed that the IRS regulations permit no "disguised sale" recharacterization where the alleged transfers are not simultaneous and the second transfer is subject to entrepreneurial risks. (*Id*., *citing* Treas. Reg. § 1.707-3(b)(1)). Because many of the credits did not arise and none were allocated until the Spring of 2002, the Court found that the 2001 contributions and 2002 allocations could not have occurred simultaneously. Consistent with the Court's lengthy factual analysis of the risks under the partner issue, the Court, therefore, held that no "disguised sale" occurred or converted any capital into income. (*Id*.).

The Tax Court rendered its Opinion on December 21, 2009, and entered a final Decision on December 23, 2009. The IRS timely appealed that Decision.

STATEMENT OF FACTS

In an exceptionally disciplined and orderly way, the Tax Court's extensive factual findings document the history of this extensive record. From their review of that record, the Virginia Historic Funds have confirmed that extensive evidence supports every sentence in those findings and every factual conclusion drawn from those findings. Therefore, the Virginia Historic Funds ask this Court to adopt the Tax Court's findings as complete and reliable.

The same cannot be said of the highly selective IRS Statement of Facts. In a case where the IRS seeks to reverse the Tax Court's factual conclusions, the IRS opening brief does not and cannot target any given fact as "clearly erroneous" – thereby imposing upon the Virginia Historic Funds the necessity of including sufficient excerpts in the joint appendix to cover every fact. Worse, the IRS merely reargues the isolated contract excerpts that the Tax Court properly balanced and set in the full context of the record. Further, several aspects require correction.

The IRS implies that the Virginia Historic Funds reaped some unseemly federal tax benefit. (IRS Br. 17, 38). The opposite is true. The parties stipulated in the Tax Court that, under the IRS's own theory, the limited partners as a whole *overpaid* their federal taxes and would be entitled to a substantial net federal tax refund. (Stip. ¶ 240). Similarly, the three individuals who own the general partner not only properly handled their federal tax obligations, they continue to devote

those funds to this worthwhile cause. Of the three owners of the general partner, Mr. Miller took a distribution of his share in 2002 (which he reported and on which he paid taxes) in order to fund other historic projects (Tr. 368); Mr. Brower took a distribution of his share in 2002 (which he reported and on which he paid taxes) to capitalize his State and Federal incentives business upon his imminent departure from Legg Mason (Tr. 234); and Mr. Gecker, after years of helping DHR on a *pro bono* basis long before starting the Virginia Historic Funds, left his share in the 2001 Funds and loaned them additional money to capitalize future projects (Tr. 368-9). The expense of this case has long since consumed Mr. Gecker's capital in the 2001 Funds. (Tr. 367). He and they are underwater.

The IRS's bald assertion that 99 percent of the losses passed through to these three men (IRS Br. 21) is horribly misleading in that the uncontroverted record confirms that their basis limitations indefinitely suspended these losses (Tr. 450-1), AND the general partner amended the petition to confirm that the limited partners were entitled to those losses under the Limited Partnership Agreement ¶ 13 and Treas. Reg. § 1.704-1(b). (Am. Pet. ¶ 11).

Most importantly, the IRS bottoms its appeal on the "undisputed fact" that the partners' "sole" purpose for joining the Virginia Historic Funds was the credits. (IRS Br. 39, 52). The record says otherwise on that and other essential facts:

1. The partners joined the Virginia Historic Funds for *two* (non-federal-tax) reasons: (i) helping Virginia fulfill its beneficial economic and community revitalization goals (*i.e.*, the "feel good" motivation), and (ii) sharing jointly in the pool of economic incentives provided by the Commonwealth, with the hope of reaping a net economic benefit (*i.e.*, the economic motivation). (Tr. 140-2, 165-6, 182, 311-2, 315-6, 395-6, 408, 634, 646).

2. Statutory and "regulatory realities" "compelled or encouraged" the partners to participate through a partnership because the Virginia statute and the Virginia Department of Historic Resources encourage use of a partnership or other pass-through entity. (Stip. ¶¶ 28, 33, 43; Ex. 12-P; Tr. 80, 82, 391).

3. As the partnership names conveyed, the partners pooled their capital in the 2001 "Virginia Historic Tax Credit Funds" for the special purpose of the partnerships obtaining a pool of Virginia credits from many sources. (Stip. ¶¶ 140-4, 148, 151, 154; Exs. 205–241-J, 519–527-P). The partners gave little thought to federal tax consequences and, overall, reported a net federal tax detriment. (Stip. ¶ 240; Tr. 155-6, 193-4, 316-20, 412-4, 458, 542, 668).

4. The Virginia Historic Funds then allocated prescribed shares of the Virginia credits among their respective partners upon issuance of Schedules K-1 on or about April 15, 2002. (Stip. ¶¶ 149, 152, 155; Tr. 140, 153, 167, 187-8, 194, 254, 314, 397, 408-9, 465-6, 640).

5. The partners acted solely in their capacity as (limited) partners, contributing capital in hopes of reaping a net economic benefit. (Stip. ¶ 126; Exs. 24-J, 61-J, 65-J, 500-P). The partners actually reaped a (non-federal-tax) net economic return of approximately 33 percent on their investment. (Stip. ¶¶ 99, 104, 118, 130; Exs. 42-J, 44-J, 46-J, 48-J, 50-J, 52-J, 62-J, 67-J).

6. The Virginia tax credits constitute tax attributes that were never refundable, inheritable, or transferable in the hands of the Virginia Historic Funds or their partners. (Stip. ¶¶ 31, 35, 41; Tr. 83-4, 112-8, 612-3, 617-8).

7. The partners contributed their capital to their respective partnerships pursuant to the promise to allocate Virginia historic rehabilitation credits to them in the future. (Stip. ¶¶ 99, 118, 130; Exs. 38–53-J, 62-J, 67–200-J, 501–518-P, 565-P). After the DHR certified the last of the credits the following Spring, the Virginia Historic Funds fulfilled their promise by allocating the credits on or about April 15, 2002. (Stip. ¶¶ 147-56).

8. The partners faced meaningful shared risks. (Exs. 37-J, 60-J, 543-P; Tr. 185-7, 230-3, 245, 252-3, 263-9, 338-9, 352, 361-2, 393-4, 441-2).

9. The limited partners in the Virginia Historic Funds were partners. (*See*, *e.g.*, Stip. ¶¶ 56, 60, 90, 99, 117, 118, 126, 130, 150, 153, 156; Exs. 38-J to 54-J, 62-J, 67-J to 200-J, 500-P to 518-P, 565-P; Tr. 140, 144-146, 188, 222-3, 237, 265-6, 408-9, 412, 472, 551, 553, 637, 651, 682).

SUMMARY OF THE ARGUMENT

These *Federal* tax cases focus upon *State* policy-based partnerships and the citizens who support them. Even the IRS "wholeheartedly agrees that the works that these Petitioners do are extremely beneficial to the community." (Tr. 36, 76-7, 125, 907). In short, these beneficial partnerships and their equity partners fulfilled *the* community-revitalization purposes embodied by the base-broadening partnership allocation provisions Virginia deliberately enacted in its historic preservation statute, VA. CODE § 58.1-339.2. Thirty years before Virginia enacted that statute, Congress enacted the National Historic Preservation Act of 1966 (16 U.S.C. § 470-1), establishing that "[i]t shall be the policy of the Federal Government … in partnership with the States … to … assist State and local governments to expand and accelerate the historic preservation programs and activities." These two statutes place this case squarely within the Supreme Court's "regulatory realities" mandate in *Frank Lyon*, 435 U.S. at 583-4:

> [W]e hold that where, as here, 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***. (Emphasis added).

The IRS itself recognizes that the "regulatory realities" of State incentives inject valid non-Federal-tax business purposes and economic substance into these Funds.

This case can thus be resolved in one sentence: The Tax Court found as a fact the partners intended to become partners based on an ample record, including:

* they intentionally pooled their capital,
* with the intent of sharing jointly in the diversified pool of (non-federal-tax) economic benefits from their special-purpose policy-based partnerships,
* pursuant to the partnership allocation provisions in VA. CODE § 58.1-339.2. (Stip. ¶¶ 140-4, 148-56; Tr. 139-53, 166-73, 185-90, 312-8, 636-42, 648-51, 671-5).

That resolves both the partner and disguised sale contentions, for the critical role the limited partners fulfilled falls within their capacity as partners – not buyers.

Following the *Frank Lyon* path, the Virginia Legislature and the dedicated people at the Virginia Department of Historic Resources wisely broadened the base of support for this public sector/private sector program in the most practical way. The VA. CODE § 58.1-339.2 partnership provision expands the base of support to Virginians who do not directly own historic structures, while the allocation "by mutual agreement" creates the ability of State credit partnerships to add capital to the capital generated by the federal partnerships. As confirmed by the stipulated VCU Study, the 10,769 new jobs, $444 million added wages, and $46 million added Virginia tax revenues prove the genius of that bifurcation incremental push.

None of that good work would be possible without the essential role played by the equity partners. A moment's reflection upon the 20 partner-factors confirms that those partners served as critical partners – in both the classic partnership statute (Section 761) sense and the policy-based special-purpose sense. As the Tax Court found, most of these exceptionally loyal partners share year after year in the laudable purposes of these partnerships (the "feel good" motive), and all of them hope to share the net economic benefit from their partnership collective activities. The partners pool their capital in their partnerships, the partnerships use that pool to support qualified historic projects, and, once the DHR certifies the last of the credits the following Spring, the partnerships allocate those credits among their partners in an economically rewarding way from the diversified pool of credits pursuant to the partnership allocation provisions in VA. CODE § 58.1-339.2.

In the words of Benjamin Franklin, these State incentives encourage citizens to "do well by doing good." Yet, the IRS twists those policy-based incentives in an effort to convert the partners into buyers and their capital contributions into income. Ironically, the IRS argues here, as it did at trial, its highly formalistic and selective set of isolated features *lifted from the contractual form*. That inconsistency heralds the reality that every orderly civilization creates and defines substance through public statutes and private contracts – just as the Virginia Legislature, the Virginia Historic Funds, and their partners define their substantive

rights as limited partners in these policy-based partnerships through the Virginia historic preservation statute, the Virginia limited partnership statute, the Virginia Historic Funds 2001 LP Limited Partnership Agreement, the Subscription Agreements, and the surrounding documents. The IRS turns a blind eye to the substance that distinguishes partners from buyers – the partners' limited liability, fiduciary protection, liquidation rights, and the legitimate state-tax-incentive business purposes the IRS recognizes in the regulations and rulings it never cites.

The Virginia Historic Funds track the standard structure for policy-based partnerships, as the witness from the National Historic Preservation Trust (created by Congress) confirmed. (Tr. 197-200). In order to broaden financial support for this important but otherwise economically unattractive activity, the Virginia Legislature supplies the economic benefit to partners who join such partnerships. And as the names of the "Virginia Historic Tax Credit Funds" conspicuously convey, sharing in that inducement represents their partners' economic reward for their support. Yet, the IRS focuses almost exclusively upon isolated non-policy-based rewards that motivate non-policy-based ventures. That misdirected focus misses the reality that these equity partners in these special-purpose partnerships profited by sharing in the overwhelming majority of the pooled economic benefits in proportion to the capital they contributed. The IRS simply ignores its own regulations and rulings that memorialize the validity of that business purpose.

Worse yet, William Machen, the *de facto* dean of this area upon whom the IRS itself relies, testified that the IRS Section 707 "disguised sale" contention in this one case jeopardizes *every* State and Federal inducement partnership: capital contributions necessarily occur within two years of the allocated incentives and, under the IRS theory, fall within the two-year "disguised sale" presumption. (Tr. 623-4). The IRS contention fails for a host of reasons.

The Tax Court explained how its earlier analysis as to partner status, intent, substance, and risks also disposes of the IRS Section 707(a)(2)(B) "disguised sale" argument. Without acknowledging that explanation or its constituent parts, the IRS calls the Tax Court's opinion "superficial analysis." Yet, the IRS assumes away every one of the four threshold obstacles that the statute and underlying regulations impose upon the IRS attempt to rewrite the enforceable Limited Partnership and Subscription Agreements. Section 707 bears no application where (i) the partners "act in their capacity as partners," (ii) the alleged consideration constitutes a "contribution" to capital, (iii) the partnership allocates tax attributes, rather than "transfers" them, OR (iv) the tax attributes constitute legal attributes, as opposed to "property." Remarkably, the IRS dismisses the fifth obstacle – the shared risks that distinguish partners from buyers – without addressing the Tax Court's detailed factual risk analysis. (Slip Op. 40-2). The IRS bears the burden of overcoming each of these five obstacles, yet can overcome none.

DISCUSSION

Standard of Review

As the IRS repeatedly represented to the Tax Court, this case turns on a question of fact – the determination of partner status. (IRS T. Ct. Br. 171-173, 192, 197, 198, 204 (*citing Commissioner v. Culbertson*, 337 U.S. 733, 742-43 (1949) and *Commissioner v. Tower*, 327 U.S. 280, 286-87 (1946)), and 225 (*citing* Treas. Reg. § 1.707-3(b)(1) ("based on all facts and circumstances"))). *See also, Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 92 (4th Cir. 1985). As the Supreme Court stated in *Tower*, 327 U.S. at 280 (and quoted in *Culbertson*):

> When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both. ***And their intention in this respect is a question of fact***, to be ***determined from testimony disclosed by their "agreement, considered as a whole, and by their conduct in execution of its provisions.***" (Internal citations omitted) (Emphasis added).

The Tax Court's factual findings must be respected when supported by *any* "substantial basis" and, hence, are not "clearly erroneous." *See Commissioner v. Scottish Amer. Inv. Co., Ltd.*, 323 U.S. 119, 124 (1944). For the same reason the IRS correctly represented to Judge Kroupa that she faced a question of fact, it is wrong in representing the opposite to this Court now.

A. THE TAX COURT'S FACT FINDINGS AS TO PARTNER STATUS, INTENT, AND CAPACITY SHOULD BE RESPECTED.

The Tax Court findings capture the unique nature of policy-based special-purpose partnerships like the Virginia Historic Funds. As their partnership names convey, they serve the laudable purpose of raising added capital for restoration of historic structures that would otherwise be destroyed. By doing so through the partnership structure required by VA. CODE § 58.1-339.2, their partners share in a diversified pool of economic inducements "allocated … as the partners mutually agree" – here in proportion to their capital contributions. Most importantly, they share in those inducements solely because they are partners – not buyers.

The Tax Court drew logical factual conclusions from extensive factual findings flowing from the ample record that corroborates virtually every finding with multiple sources. Because partner status, intent, and purpose turn on a question of fact and the IRS "disguised sale" argument requires proof that the partners were *not* acting in their capacity as partners and lacked any risk, the Tax Court's factual conclusions should dispose of the case and eliminate the chilling cloud that hangs over this wonderful program. Now that Judge Kroupa has drawn her conclusions as the finder of fact about the credibility of the witnesses called by both sides – especially as it relates to their fact-driven intent – the IRS seeks to reverse her factual conclusions by rearguing the same isolated excerpts that the IRS took out of context and unsuccessfully argued at trial.

Such factual findings and conclusions drawn by the judge who personally witnessed the testimony should be respected unless the appellant proves the specific factual statement is "clearly erroneous" – that is, unsupported by *any* substantial evidence. For good reason, the IRS opening brief never targets any fact finding or conclusion as clearly erroneous because to do so would invite the separate lines of record references that support that fact. And while the Tax Court found that the weight of the evidence proved the essential facts, let there be no doubt that the IRS bore the burden of proof based on what the Fifth Circuit described as "the disturbingly increased frequency" of the IRS asserting a "grossly exaggerated amount" for tactical advantage – here, twice asserting the now stipulated five-fold overstatement under the IRS's own theory. *McCord v. Commissioner,* 461 F.3d 614, 625, n. 22 (5th Cir. 2006). Especially where the IRS alleges omitted income, the burden shifts to the IRS when the taxpayer offers substantial evidence that the IRS claim is excessive or erroneous. *Helvering v. Taylor,* 293 U.S. 507, 513 (1935); *Stout v. Commissioner,* 273 F.3d 345, 350 (4th Cir. 1959). On the eve of trial, the IRS stipulated to that five-fold excess.

For the same reasons the IRS failed to prove its inherently factual partner intent, status, and capacity contentions by a preponderance of evidence at trial, the IRS cannot possibly prove that the trial court's findings as to partner status, intent, and capacity lack *any* substantial evidence.

B. THE TAX COURT PROPERLY FOUND THE EQUITY PARTNERS FULFILLED CRITICAL PARTNER ROLES IN THEIR SPECIAL-PURPOSE, STATE POLICY-BASED PARTNERSHIPS.

As the Tax Court correctly found "after carefully considering the extensive evidence and testimony presented," these partners were *bona fide* partners in the Virginia Historic Funds – both in substance and in form. (Slip Op. 21-22, 44).[4] The partners proved they were partners by their own words – partners who should be recognized under the policies that propelled Virginia to require them to join partnerships, under the definition of partners and partnerships Congress enacted (*i.e.*, Sections 761 and 7701), and under the Supreme Court's definition of partners and partnerships. In *Frank Lyon*, 435 U.S. at 583-4, the Supreme Court squarely confirms why the partners' roles as partners should be recognized:

> [T]here 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***. (Emphasis added).

These partners not only followed the Virginia statutory and contractual requirements for joining their partnerships, they did so in a way that fit the Internal Revenue Code's statutory definition of a "partner" that the IRS *never* cites.

---

[4] Harold R. Berk, *Tax Credit Transactions: Virginia State Historic Tax Credit Fund Case*, 13 J. PASSTHROUGH ENTITIES No. 3, at 41 (2010) ("The Tax Court decision is a ***solid and careful analysis*** of each of the issues") (Emphasis added).

1. <u>The "Regulatory Realities" of the Virginia Historic Program Confirm that the Partners Intentionally Became Partners Based on Valid Business Purposes</u>.

The Tax Court accurately recognized that the Virginia Historic Program embodied the "regulatory realities" endorsed in *Frank Lyon*, and found that "[t]he investors became partners in the Virginia Historic Fund because they were required to join an entity to participate in the Virginia Program." (Slip Op. 38). The Tax Court also found "the partnerships were successful in rehabilitating a diversified group of structures primarily because the principals made good business decisions and the investors provided a large pool of capital." (*Id.* at 29-30). These partners expanded the base of the Virginia Historic Program just as the Legislature intended in VA. CODE § 58.2-339.2 and Congress intended in 16 U.S.C. § 470-1.

State policy-based tax inducements constitute an important non-Federal-tax motive that injects financial meaning and substance into the relationships chosen by the parties. Such tax incentives provide one of the most effective instruments of governance in a free society. Even the IRS has long recognized the reality that, by design, tax incentives flowing from policy-based legislation provide the critical economic benefit to activities that conventional profit considerations could not justify. For example, the IRS ruled (well before Congress made the parallel statutory change) that low-income housing partnerships should not be subjected to the traditional profit-motive test. Rev. Rul. 79-300, 1979-2 C.B. 112.

In *Sacks v. Commissioner*, 69 F.3d 892, 992 (9th Cir. 1995), the United States Court of Appeals for the Ninth Circuit conveyed the same common sense in rejecting the same sort of argument the IRS urges here:

> A tax advantage such as Congress awarded for alternative energy investments is intended to induce investments which otherwise would not have been made … 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.

Moreover, pooling capital, supporting a State policy-based program, funding the restoration of a diversified set of historic projects, pooling the resulting incentives, and allocating distributive interests in that diversified pool among the partners all constitute a legitimate partnership purpose. By regulation, the law recognizes that "***a purpose of reducing non-Federal taxes***" constitutes a valid business purpose as long as the reduction of non-Federal taxes is greater than the reduction of Federal taxes. Treas. Reg. § 1.355-2(b)(2). In adopting this regulation, the Treasury Department punctuated the distinction the IRS blurs here:

> Commenters requested reconsideration of the "nontax" standard. ***The Internal Revenue Service has ruled that reduction of state and local capital taxes is a corporate business purpose.*** Rev. Rul. 76-187, 1976-1 C.B. 97. ***That rule will remain in effect***. However, Treasury and the Internal Revenue Service continue to believe that reduction of Federal taxes should not be regarded as a corporate business purpose. Accordingly, the final regulations replace the "nontax" standard with a "non Federal tax" standard. T.D. 8238, 1989-1 C.B. 92 (Emphasis added).

Simply put, "[t]he reduction of non-federal taxes, such as state and local or foreign taxes, is a valid business purpose" under the Internal Revenue Code. Candace A. Ridgway, *Corporate Separations: Valid Business Purpose – Reducing State or Foreign Taxes*, BNA TAX MANAGEMENT PORTFOLIO, 776-3rd: VIII, C, 10. *See also*, Rev. Rul. 89-101, 1989-2 C.B. 67; Rev. Rul. 79-289, 1979-2 C.B. 145.

The IRS still masks the State vs. Federal tax "critical distinction" – even after the Tax Court pointed out that all of the cases cited by the IRS deal with ventures motivated solely by *Federal* taxes and that the sleight of hand by the IRS in surgically extracting the word "federal" from the FPAA recitation of its regulation underscores that significance.[5] Remarkably, the IRS brief tendered to this Court relies heavily on *BB&T Corp. v. United States*, 523 F.3d 461, 464 (4th Cir. 2008), *ASA Investerings Partnership v. Commissioner*, 201 F.3d 505, 513-14 (D.C. Cir. 2000), and the like – without acknowledging that they, too, deal with ventures motivated *solely by Federal tax avoidance*. The IRS simply proceeds as if the Virginia incentives delivered through the legislatively designed base-broadening partnership requirement neither provide genuine substance nor fulfill valid business purposes for these partners and their partnerships.

[5] Consider the single word the IRS struck from the FPAA quotation of Treas. Reg. § 1.701-2(b): "… ***the partnership was formed with a principal purpose to reduce substantially the present value of the partners' aggregate [~~Federal~~] tax liability in a manner that is inconsistent with the intent of subchapter K.*** Accordingly, the partnership should be disregarded pursuant to Treas. Reg. § 1.701-2(b)." (Bracketed word stricken; italicized words lifted from Treas. Reg. § 1.701-2(b)).

2. These Partners Fulfilled Every Statutory Definition of "Partner" and "Partnership" in the Internal Revenue Code.

Federal tax law includes within the realm of partnership/partner relationships both those partnerships recognized under State common law and a broader range of other multiple-party relationships. *McManus v. Commissioner*, 583 F.2d 443, 447 (9th Cir. 1978), *aff'g*, 65 T.C. 197 (1975) ("Partnership for tax purposes is broader than common law partnership"); *Reinberg v. Commissioner*, 90 T.C. 116, 134 (1988) (same). The controlling statutes define partner and partnerships in all-encompassing terms – the controlling federal statutes the IRS *never* once cites.

a. Sections 761 and 7701 recognize these partners as partners.

Each of the partners joined together for the purpose of carrying on the business purposes for which they formed this community-revitalization partnership. Section 761(b) defines a "partner" as a "member of a partnership" and Section 761(a) then broadly defines "partnership" as:

> A ***syndicate, group, pool, joint venture, or other unincorporated organization*** through or by means of which ***ANY business, financial operation, or venture is carried on,*** and which is not, within the meaning of this title, a corporation or a trust or estate. [6] (Emphasis added).

The leading partnership treatise describes this all-encompassing definition as "equally clear that the intent of Congress as expressed in Sections 761(a) and 7701(a)(2) was that the partnership classification apply to *any* business, financial

[6] Section 7701(a) repeats these definitions of "partner" and "partnership."

operation, or venture that involves multiple participants." MCKEE, NELSON, AND WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, Sec. 3.02[2] (4th ed. 2007) (Emphasis in original). Partnerships require no writing and can arise by implication. *See, e.g., Evans v. Commissioner*, 447 F.2d 547, 552 (7th Cir. 1971) ("Partnerships, for tax purposes, have been implied from conduct of the parties, in the absence of any written agreement and even where parties deny any intent to form one"). *See also, Roark v. Hicks*, 362 S.E.2d 711, 714 (Va. 1987) ("A joint venture exists where two or more parties enter into a special combination for the purpose of a specific business undertaking, jointly seeking a profit, gain, or *other benefit*, without any actual partnership or corporate designation").

b. The law recognizes special-purpose relationships.

Courts and scholars alike recognize that even the common law subset of this broad Federal tax definition of "partnership" necessarily includes special-purpose partnerships like the Virginia Historic Funds. *See, e.g.*, S. ROWLEY, ROWLEY ON PARTNERSHIP § 6.5, at 77 (2d ed. 1960) (Citations omitted) ("[T]here may be a partnership merely for the consummation of a single transaction, adventure, or undertaking"); 59 Am. Jur. 2d, PARTNERSHIP § 47 ("Partnerships may be formed for almost any purpose not violative of declared public policy or express statutory inhibitions"); *Hayes v. Irwin*, 541 F.Supp. 397, 415 (N.D. Ga. 1982) ("A partnership may be created for a single venture or enterprise"); *Dawson v. J. G.*

Wentworth & Co., Inc., 946 F.Supp. 394, 396 (E.D. Pa. 1996) (Single-purpose partnership for purchasing claims); *Gillette Company v. RB Partners*, 693 F.Supp. 1266, 1271 (D. Mass. 1988) (Single-purpose partnership formed to buy Gillette stock). That comports with the broad Federal statutory concept of "***ANY*** business, financial operation, or venture." Section 761(a). Thus, two or more people may come together as partners for any legitimate special purpose.

The Courts and the IRS recognize that much more attenuated relationships than the Virginia Historic Funds constitute partnerships. *See, e.g., Bergford v. Commissioner*, 12 F.3d 166, 169 (9th Cir. 1993) (affirmed where "Tax Court found the economic benefits to the individual participants were not derivative of their co-ownership of computer equipment, but rather from their joint relationship toward a common goal"); *Wheeler v. Commissioner*, T.C. Memo. 1978-208 (partnership found where taxpayer retained authority to manage the day-to-day business affairs with no share of income or losses); Rev. Rul. 54-84, 1954-1 C.B. 284 (partnership despite properties in one partner's name and no sharing of losses). While loss sharing is not required, the Virginia Historic Fund 2001 Limited Partnership Agreement allocates losses, expenses, income, liquidation proceeds, etc., among the partners. (Ex. 23-J (2001 LP Agmt. ¶¶ 12-3, 18)).

The IRS simply substitutes a narrow definition for the broad partner/partnership definition that Congress enacted and that the IRS refuses to cite.

3. The Tax Court and the Supreme Court Agree: the Partners' Intent in Joining the Virginia Historic Funds Proves Their Role.

Because the IRS bottomed its argument on two Supreme Court partnership cases (and, as here, avoided the statutory definition), the Tax Court tested the IRS argument by carefully tracking the Supreme Court definition in the more recent of those two cases, *Culbertson*, 337 U.S. at 742-43:

> The question [of partner status] is … ***whether, considering all the facts*** – the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent – ***the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise*** … ***Triers of fact are constantly called upon to determine the intent with which a person acted.*** (Internal citations omitted) (Emphasis added).

The Tax Court held "[a]fter examining all of the objective facts in the record, we found that the investors intended to become partners in the Virginia Historic Funds to pool their capital in a diversified group of developer partnerships for the purpose of earning State tax credits." (Slip Op. 32). Just this past week, the Tax Court cited the *Virginia Historic* case ***in accepting the IRS' argument for partner recognition*** in *Devonian Program v. Commissioner*, T.C. Memo. 2010-153 (Tax Court agreed with the IRS that partner intent reflected by partnership agreement, subscription agreement, and Schedule K-1).

Startling as it may seem, the IRS brief cobbles together a reading of *Tower* and *Culbertson* here that excludes the ultimate inquiry – intent.[7] That permits the IRS to avoid the uncontroverted testimony by the three firms whose clients represent 100 percent of the limited partners and the eight partners who testified:

Witness	Testimony	Transcript
J. Stewart – Witt Mares	Explained to Virginia Fund LP partners that they were investing as partners	Tr. 540, 545-8
D. Gray – Legg Mason	Explained to all eight Virginia 2001 SCP LP partners that they were investing as partners	Tr. 526, 531
S. Biegler – Biegler & Associates	Explained to 70 of 93 Virginia Fund 2001 SCP LLC members that they were investing as member/partners	Tr. 454-5, 458-9, 461-2
J. Leibovic – Partner	Knew he invested as a partner	Tr. 182-5, 187-8
K. Smith – Partner	Knew he invested as a partner	Tr. 313-6, 318
C. Gray – Partner	Knew he invested as a partner	Tr. 636-8
J. Hager – Partner	Knew he invested as a partner	Tr. 140, 141, 142, 145
D. Stosch – Partner	Knew he invested as a partner	Tr. 166-88
E. Harrow – Partner	Knew he invested as a partner	Tr. 648-51
J. Felvey – Partner	Knew he invested as a partner	Tr. 673-5
J. Unnam – Partner	Knew he invested as a partner	Tr. 682

[7] On page 42, the IRS later miscites two other cases, *Gilbert* and *Hambuechen*, for the proposition that partner intent requires capital recovery dependent upon the success of the venture. Factually, the Virginia Historic Funds demonstrate that intent by their partners recovering capital and a 33 percent net return from the success of their special purpose. The two cases, however, look to success-based repayment in testing "loan," not "partnership," treatment.

The IRS never mentions, Kimber Smith who confirmed he was a partner *even though he would receive a refund if he disavowed that role*. (Tr. 318). The IRS never addresses the confirmation by John Hager (the Lieutenant Governor of Virginia in 2001) that he invested as a partner in order to support the goals of the Program (and reap the incentives). (Tr. 142). The IRS avoids at all cost the testimony by Steve Leibovic – the surgeon who became so enthused about the Virginia Program that he later developed his own historic projects. (Tr. 183).

Instead, the IRS points to that slice of their testimony where they, of course, acknowledge they joined the "Virginia Historic Tax Credit Funds" with the expectation of obtaining their share of the Virginia credits offered by the Virginia Legislature – as if that contradicts their status as partners.[8] (IRS Br. 39). The IRS simply misses the point: these deliberate State inducements constitute the valid business reasons for which the partners joined the partnership. The partners' interest in Virginia historic credits supports, not rebuts, their joining the Virginia Historic Funds. In the words of the former Chair of the ABA Tax Section, ***"The Tax Court clearly got it right in the Virginia Historic Tax Credit Fund."***[9]

---

[8] Interestingly, the IRS also asserts that the partners "understood that they would receive no *other financial* benefit as a result of their participation," (IRS Br. 39 (emphasis added)) thereby tacitly conceding both the financial benefit offered by the Virginia Legislature and the existence of the non-financial purpose – *i.e.*, the "feel good" motive in supporting Virginia's historic preservation.

[9] R. Lipton, *et al., A Tale of Two Cases: G-I Holdings and Virginia Historic Tax Credit Fund – Can They Both be Right?*, 112 J. TAX'N 154, 164 (2010).

4. <u>At Least 20 Factors Prove that the Partners Were Partners</u>.

One cannot long wonder why the Tax Court concluded the partners intended to be partners "[a]fter examining all the objective facts in the record." (Slip Op. 25-6, 32, 42). Consider the facts largely established by stipulations and IRS admissions:

(i) In comparison to the *Frank Lyon* structure "compelled or encouraged by ... regulatory realities," the general partner formed and the limited partners joined these partnerships pursuant to the ***partnership allocation provisions*** in the controlling Virginia historic rehabilitation ***statute***, VA. CODE § 58.1-339.2. (Slip Op. 25; R. Resp. P. RFA ¶¶ 20-5). Those partnership-allocation provisions constituted the ***only*** practical mechanism for those who wished to support the Virginia Historic Program but owned no historic structures. ***In short, the primary benefit derived by the limited partners DEPENDED ENTIRELY ON THEIR STATUS AS PARTNERS.***

(ii) Both parties agree that all three limited partnerships/LLCs were valid partnerships. (Slip Op. 21; IRS. Br. 23, 33; Stip. ¶¶ 48, 89, 107).

(iii) The partners joined their partnerships by executing separate Subscription Agreements that designated them as partners. (Slip Op. 15; R. Resp. P. RFA ¶ 93; Stip. ¶¶ 99, 118, 130).

(iv) Both under the partnership agreements and Virginia law, the partners obtained limited liability, liquidation, termination, management replacement, partnership record inspection, and other substantive rights ***purely because of their partner status***. *Compare* Slip Op. 24-26 *with* Exs. 1-J – 4-J, 23-J and VA. CODE § 50-73.26.

(v) As noted, the partners formed the 2001 Virginia Historic Funds for the special purpose conspicuously reflected by their names – to participate in the Virginia Historic Program and to share the resulting pooled Virginia historic tax credits among their partners. (Slip Op. 27, 39, 44; Tr. 387-88, 397, 408-410, 551, 560).

(vi) That policy-based State economic inducement renders a net economic benefit to the partners (a net return of approximately 33 percent). (Stip. ¶¶ 22-4 [Relationship between equity contributions and credit]).

(vii) Each partner contributed (by wire or check) a specified amount to the capital of his or her partnership. (Slip Op. 13; Stip. ¶¶ 104, 117, 126; R. Resp. P. RFA ¶¶ 87, 91).

(viii) The partnership books and records confirm that those capital contributions constitute capital the limited partners contributed, not sale proceeds. The consolidated General Ledger recognizes those contributions as "equity," and the U.S. Partnership Returns and

Schedules K-1 consistently record them as beginning "Capital Account" balances. (Stip. ¶¶ 104, 117, 126 ("equity"); Ex. 61-J, 65-J (Sch. K and K-1 "Beg. Cap. Acct.")).

(ix) The consolidated General Ledger, other partnership books and records, and the Stipulation confirm that the Virginia Historic Funds pooled the Virginia historic tax credits from many sources. (*See, e.g.*, Slip Op. 21-22; Stip. ¶¶ 55, 143; R. Resp. P. RFA ¶ 95-6).

(x) The partners shared in that partnership pool based on their agreed allocated shares, as provided by the partnership provisions in the Virginia historic rehabilitation statute, VA. CODE § 58.1-339.2. (Slip Op. 5-6; Stip. ¶¶151-2, 154-5).

(xi) The partnerships obtained the Virginia historic tax credits through the investment of substantial capital, not services. (Stip. ¶¶ 140, 143-4).

(xii) These capital-intensive partnerships allocated that policy-based State economic inducement among the partners by agreement roughly in proportion to their capital accounts. (Ex. 23-J, ¶ 18).

(xiii) The liquidation provisions in the Virginia Historic Fund 2001 LP Limited Partnership Agreement mandate that "[a]ny remaining assets shall be distributed to the Partners in accordance with the positive balances in their respective capital accounts." (Exs. 23-J, 37-J).

(xiv) The partnerships and their partners represented to State and Federal authorities that the partners were partners. As noted, each of the partnerships filed U.S. Partnership Returns (Forms 1065) for 2001, reporting both the net results from their activities and allocating those results among their separately named partners on separate Schedules K-1. (Slip Op. 17; Stip. ¶¶ 56, 90, 111; Exs. 26-J, 35-J, 58-J).

(xv) For purposes of reporting to the Commonwealth of Virginia, each of the partnerships provided each of their partners with a Schedule K-1 "Partners' Share of Income, Deductions, Credits, Etc." package that contained the partnerships' collection of rehabilitation credit certificates from the Virginia Department of Historic Resources and a designation of the partner's aliquot share of that pool. (Slip Op. 26; Stip. ¶¶ 90, 152, 155; Exs. 35-J, 36-J).

(xvi) Every partner filed his Virginia income tax return for 2001 under penalties of perjury attesting to his status as a partner entitled to his aliquot share of the partnership's pool of credits. (Tr. 189, 468).

(xvii) Similarly, every partner filed U.S. income tax returns for 2001 under penalties of perjury attesting to his or her status as a partner reporting the distributive share of partnership income, losses, deductions, etc. (Slip Op. 26; Tr. 189, 468, 550).

(xviii) *After the partnerships fulfilled their special purposes*, most (if not all) of the partners later sold their partnership interests incident to an Option Agreement that specified their partner status and their partner interests. (Slip Op. 16, 26; Stip. ¶¶ 118-19, 130-31, 162, 166).

(xix) Again for 2002, the partnerships' consolidated General Ledger, the partnerships' U.S. Partnership Returns, the Schedules K-1 distributed to the partners, and the partners' U.S. and Virginia returns all confirm their partner status. (Stip. ¶¶ 56, 60, 90; Exs. 27-J, 29-J, 36-J).

(xx) After the IRS mistakenly questioned the partner status in these cases, the Department of Taxation for the Commonwealth of Virginia took the extraordinary ***sua sponte*** step of issuing a ruling rejecting the IRS contention and recognizing the partners as partners in these policy-based partnerships under Virginia law. (R. Resp. P. RFA ¶¶ 118-9).

In balancing these 20 facts together with the record as a whole, the Tax Court properly reached the only logical factual conclusion – the partners in these policy-based, special-purpose partnerships were true partners.

5. No Part of the IRS Argument Withstands Scrutiny.

The IRS unfairly accuses the Tax Court of "conflating" the substance-over-form and economic substance doctrines, concedes economic substance, invokes the general substance-versus-form "incantation," creates straw arguments, and then presses a selective *factual* argument that focuses on isolated economic clauses. (IRS Br. 26-34). No part of that self-defeating argument withstands analysis.

One, even though the IRS briefs in the Tax Court used the concepts of economic substance and substance-over-form interchangeably (as do certain of the authorities cited by the IRS on appeal), the Tax Court applied those two doctrines in their appropriate contexts. Because the "regulatory realities" of VA. CODE § 58.1-339.2 represent the dominant feature of these policy-based partnership cases, the Tax Court, the IRS, and the Virginia Historic Funds all rely heavily upon the Supreme Court's "regulatory realities" test in *Frank Lyon* – the test phrased in terms of the "economic substance" that the IRS concedes on brief. Contrary to the IRS contention at page 33, the Tax Court properly confirms the economic substance injected by the economic inducements and continues on to evaluate the totality and substance of the partners' relationships. The IRS just does not like the Tax Court's factual conclusion as to that substance.

Two, the Tax Court focused upon the totality of the facts in determining the substance of the role the partners fulfilled – not the IRS's exceedingly narrow straw argument (IRS Br. 34-5). The Court did so by carefully applying the objective Supreme Court factors. The IRS dismisses most of the objective factors enumerated by the Supreme Court in *Culbertson* (*e.g.*, agreement, conduct of the parties in executing the agreement, statements by the parties, testimony by disinterested persons, etc.) and the same evidence the IRS successfully pressed in *Devonian* (partnership agreement, subscription agreement, and Schedule K-1). Those agreements create the substantive rights that both reflect the substance of their relationships as partners *and* refute the IRS assertion that they were mere buyers. Consider just five telltale distinctions between partners and buyers:

Virginia Historic Fund Limited Partner
Limited Partner vs. Simple Buyer

1. Limited Liability	1. No Limited Liability
2. Va. Code § 58.1-339.2 Partnership Allocation Of Credits	2. No Partnership Allocation And *No Credits Permitted*
3. Diversified Risks/Rewards From 16 Diversified Projects	3. No Diversified Risks/Rewards
4. Right To Fiduciary Duties	4. No Right To Fiduciary Duties
5. Continuing Relationship During Fulfillment Of Special-Purpose	5. No Continuing Relationship

Rather than address these differences, the IRS urges the self-defeating argument that credits convert partners into buyers who could not qualify for credits.

Three, the two doctrines sprout from the same "substance" tree. *See, e.g.*, *Zmuda v. Commissioner*, 731 F.2d 1417, 1421 (9th Cir. 1984). The Courts have long recognized that none of these intertwined doctrines bestow upon the IRS the unfettered license to recharacterize a given transaction or relationship into one that generates greater taxes. As the Court held in *Harris v. Commissioner*, 61 T.C. 770, 783, 786 (1974):

> But a mere incantation of 'substance versus form' and 'step transaction' does not transform a transaction with one set of tax consequences into a transaction with different tax consequences …. Furthermore, of critical significance is the obvious 'economic effect' of the allocation agreement.

Taxpayers retain the freedom to structure their affairs as they deem best, and the IRS should honor that structure - *unless* it is motivated *solely* by federal tax avoidance *and* carries *no* economic substance because *no* reasonable possibility of a profit exists. *Black & Decker Corp. v. United States*, 436 F.3d 431, 441 (4th Cir. 2006); *BB&T Corp. v. United States*, 523 F.3d 461, 471 (4th Cir. 2008). That high threshold for disregarding the structure chosen here by the Virginia Historic Funds and dictated by the "regulatory realities" of VA. CODE § 58.1-339.2 applies with equal force to the IRS incantation of substance-over-form:

> Typically, a "substance-over-form" case arises when a taxpayer chooses, as is his right, to structure a transaction so that it satisfies the formal requirements of a provision of the Internal Revenue Code in order to minimize his tax liability. The Commissioner, as is his duty, may seek to deny legal effect to the transaction, claiming that its ***SOLE PURPOSE*** was to "evade" taxation.

Stewart v. Commissioner, 714 F.2d 977, 987 (9th Cir. 1983) (Emphasis added). *Accord: Braun v. Commissioner*, 396 F.2d 264, 266-7 (2d Cir. 1968); *Friedlander v. Commissioner*, 216 F.2d 757, 758 (5th Cir. 1954).

Four, the IRS' highly selective factual argument exemplifies the wisdom of the "clearly erroneous" rule. The IRS simply reargues its isolated and rejected factual snippets in an attempt to reverse the intent-based factual conclusions drawn by the Tax Court in answering the questions of fact from its detailed review of the extensive record. Ample evidence supports those factual conclusions.

Without reciting the Tax Court's findings, nowhere does the IRS deal with the corroborated evidence as to the partners' non-tax intent of supporting the laudable purposes behind the Virginia Historic Program (*see, e.g.*, Tr. 141, 165-6, 315-6, 540) or the stipulations as to the success of those efforts in benefitting their State. (Stip. ¶¶ 13, 17). Nowhere does the IRS mention the extensive testimony by the partners and their advisors confirming that they knew they were joining the partnerships as partners, that they repeatedly swore under penalties of perjury in State and Federal filings that they were partners, or that they stayed in the partnerships until after the partnerships fulfilled their special purposes. (Tr. 316, 409-10, 551). Instead, the IRS relies upon demonstrably inaccurate statements such as, "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 …" (IRS Br. 39), and the still bolder statement, "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 subscription agreements to deliver the rehabilitation" (IRS Br. 52).

All three firms whose clients joined the partnerships, the majority of the partners who testified, and the contemporaneous descriptive materials confirm the dual purpose. Even Mr. Gray, one of the partners called by the IRS, testified that he understood the activity was charitable in nature – clearly a non-tax purpose. (Tr. 631-4). It is worth reflecting that the IRS, which bore the burden of proof, called only four partners to testify out of 282. As the Tax Court found, every partner who testified confirmed that he or she knew they were joining as a partner and the IRS could not identify a single partner out of the 282 who ever disavowed his or her partner status at any point during the eight years between 2001 and trial. (Slip Op. 28). Simply put, Judge Kroupa carefully listened to all the testimony, studied the factual record as a whole, and followed the facts to her conclusion.

Finally, the isolated facts that the IRS reargues on appeal can be divided into two buckets: one, the universally embraced but not very surprising evidence that the partners joined the "Virginia Historic Tax Credit Funds" with the expectation of sharing in the Virginia historic tax credits, and two, certain of the contract terms dealing with the non-policy-based aspects of the venture.

The second category consists of a narrow straw argument that seems to proceed on the assumption that partner status requires equal participation, even after the Tax Court pointed out that no such requirement exists. (Slip Op. 30). Justice Frankfurter's famous boat metaphor in *Culbertson* proves the point:

> [I]f they are in the same business boat, ***although they may have varying rewards and varying responsibilities***, they do not cease to be in it when the tax collector appears.

Culbertson, 377 U.S. at 754 (J. Frankfurter concurring) (Emphasis added).

By statute, Congress permits partnerships to "specially allocate" any item between the partners. 26 U.S.C. § 704(b). Of greatest importance here, the partners shared in the central partnership economic benefits in proportion to their capital accounts. (Stip. ¶¶ 13, 14, 15). Moreover, paragraphs 12, 13, and 18 of the Limited Partnership Agreement dictated that the division of profits, losses, and liquidation rights would be allocated based on the capital accounts that reflected the contributions by the partners. (Stip. ¶¶ 53, 100; Exs. 23-J, 54-J). The IRS simply confuses the capital accounts that the partnerships maintained with the one percent special allocations required to avoid the "phantom income" threat to the partners from "burned-out" partnerships. (Slip Op. 30; Tr. 203).

Similarly, the IRS repeatedly focuses upon the limited assurances in the offering materials without noting the Court's holding as to the exposed net economic benefit or the risk raised by the General Partner's limited liability.

C. THE TAX COURT PROPERLY ANALYZED THE LARGELY REDUNDANT SECTION 707 IRS ARGUMENT.

The partner argument by the IRS renders its Section 707 "disguised sale" argument redundant. Once the Tax Court ruled the partners were partners in substance and not buyers who bought credits with their capital contributions, logic will not tolerate the suggestion that they were nonetheless still buyers.

The IRS unfairly criticizes the Tax Court's Section 707 analysis – without noting that her fact-based extensive partner capacity, contribution, and risk analysis disposes of the question. Indeed, the IRS' "superficial analysis" runs from the controlling statute – by relying primarily on reports prepared by a congressional staff, in contravention of the Supreme Court prohibition against by-passing statutes in that way.[10] That device allows the IRS to skip over the three statutory threshold requirements: (i) the partner was "*not* acting within [his or her] capacity as a partner"; (ii) the partnership "transferred" – not allocated – something to the partner; and (iii) that something constituted "property" – not a tax attribute. This device also aids the IRS in ignoring the "contributions" exclusion embedded in its regulation. These four IRS assumptions jeopardize the entire world of State and Federal tax inducements by presuming the partners acted outside their capacity as partners when they contributed capital to their policy-based partnerships.

[10] *See, e.g., Faircloth v. Lundy Packing Company*, 91 F.3d 648, 653 (4th Cir. 1996) (*citing Caminetti v. United States*, 242 U.S. 470, 485 (1917)).

1. <u>The Partners Acted in Their Capacity as Partners</u>.

The IRS pursues its redundant Section 707 "disguised sale" argument that the partners acted as buyers, by glossing over the first premise: Section 707 only applies to instances where a "partner [is] *not* acting in the capacity as a partner" –

> (a) **PARTNER NOT ACTING IN THE CAPACITY AS A PARTNER**. -- (1) In General. – If a partner engages in a transaction with a partnership ***other than in his capacity as a member*** of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner. (Emphasis added).

The Tax Court's fact findings (compelled by the ample record) resolve this threshold dispute that the IRS avoids: as their principal partnership function, the equity partners contributed equity to these special-purpose, policy-based partnerships in their roles as partners. (Slip Op. 27). Indeed, the equity partners could only share their respective allocations of the Virginia historic tax credits under VA. CODE § 58.1-339.2 solely in their capacity as partners. Just as it avoids the controlling Federal partnership statute, the IRS avoids the controlling Virginia historic preservation statute, which provides only two methods for Virginians who do not directly own historic structures but who wish to participate in the Virginia Historic Program: join a partnership or an S Corporation. Hence, the Court's discussion as to why the partners constitute partners under Section 761 and the 20 partner factors dispose of the Section 707 allegation as well.

2. <u>The Same IRS Regulation Confirms Both the "Acting in Capacity as Partner" and the "Contribution" Exclusions</u>.

Treas. Reg. § 1.707-1(a) confirms two critical exclusions:

> **Partner not acting in capacity as partner.** ***A partner who engages in a transaction with a partnership other than in his capacity as a partner shall be treated as if he were not a member of the partnership*** with respect to such transaction. . . ***However, transfers of money or property by a partner to a partnership as contributions***, or transfers of money or property by a partnership to a partner as distributions, ***are not transactions included within the provisions of this section***. In all cases, the substance of the transaction will govern rather than its form. (Emphasis added).

Thus, the critical equity contributions by the equity partners separately resolve Section 707. Factually and legally, those contributions constitute contributions.

State law undeniably determines the existence and nature of property rights, while Federal law determines their tax consequences. *See, e.g., Morgan v. Commissioner*, 309 U.S. 78, 82 (1940). Virginia law defines a capital contribution with all the attendant rights, obligations, and capital risk that carries:

> "Contribution" means any cash, property, services rendered, or a promissory note or other binding obligation to contribute cash or property or to perform services, which a partner contributes to a limited partnership in his capacity as a partner.

VA. CODE § 50-73.1. *Accord:* VA. CODE § 13.1-1002 (contribution for LLC). These and related statutes imbue the equity partners' capital contributions with substantive voting, limited liability, fiduciary protection, and any number of enforceable rights that depart radically from the substance of simple sale proceeds.

Not surprisingly, Virginia law determines property rights based on the objective intent of contracting parties reflected in the contract terms they expressed at the time. According to the Virginia Supreme Court, the Court's duty is to:

> … construe the contract made between the parties, not to make a contract for them, and [t]he polestar for the construction of a contract is the intention of the contracting parties ***as expressed by them in the words they have used***. The facts and circumstances surrounding the parties when they made the contract, and the purposes for which it was made, may be taken into consideration as an aid to the interpretation of the words used, but not to put a construction on the words the parties have used which they do not properly bear ... ***It is the court's duty to declare what the instrument itself says it says***.

Flippo v. CSC Assocs. III, L.L.C., 547 S.E.2d 216, 226 (Va. 2001) (Internal citations omitted) (Emphasis added).

Federal tax law follows the same principle so important to this case:

> … the form of a contract is the considered and chosen method of expressing the substance of contractual agreements between parties and the dignity of contractual right cannot be judicially set aside simply because a tax benefit results either by design or accident. ***Form, absent exceptional circumstances, reflects substance.***

Lewis and Taylor, Inc. v. Commissioner, 447 F.2d 1074, 1077 (9th Cir. 1971), *quoting Edwards v. Commissioner*, 415 F.2d 578, 582 (10th Cir. 1969). *See also, Imperial Car Distributors, Inc. v. Commissioner*, 427 F.2d 1334, 1336 (3d Cir. 1970).

By public statute, private contracts, and ample evidence, the equity partners *contributed* their equity so that their partnerships could fulfill their special purpose.

3. A Partnership Allocation of Tax Consequences Occurs By Operation of Law, Not By "Transfer".

Without the benefit of authority or analysis, the IRS assumes away two particular Section 707 prerequisites more frequently than any others: that the partnership allocation of tax consequences among partners constitutes (i) a "transfer" (ii) of "property." While the IRS never discusses these two conditions precedent, it does quote at page 46-47 the subsection from which they arise:

> **(b)(2) Treatment of payments to partners for *property* or services.**--Under regulations prescribed by the Secretary--
>
> **(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. (Emphasis added).

The IRS assumes that the partnership not only could, but did sell/"transfer" the credits to its partners. (IRS Br. 51). Both the Director of the Virginia Department of Historic Resources and the Head of the Historic Tax Credit Program confirmed that neither the partnerships nor their partners could sell the credits even under the short-lived, One-Time-Transfer relief provision. (Tr. 83-4, 112-11).

No one in the Commonwealth of Virginia or elsewhere has ever assumed, as the IRS does here, that a partnership allocation of tax attributes constitutes a "transfer" for Section 707 purposes. The IRS couples that "transfer" assumption with his regulatory presumption of a disguised sale whenever the second "transfer" occurs within two years of the first. As the *de facto* dean of the State credit bar upon whom the IRS relies in its instructional materials, William Machen, warned at trial, the IRS' contribution/allocation Section 707 argument would cripple every State *and* Federal policy-based inducement partnership in the land: all those partnerships invariably allocate the tax inducement within two years of the original contribution. (*Compare* Tr. 623 *with* IRS Br. 29-39). Indeed, the same allegation (that contribution plus allocation within two years equals sale) would be true of the majority of non-inducement partnerships such as the allocation of accelerated depreciation to the owners of a real estate partnership, or a manufacturing business, or almost any partnership. The IRS stretches too far.

Yet nowhere does the IRS cite any statute, case, ruling, or other authority that ever once treated a partnership allocation – that is, a sharing or division – of tax consequences as a "transfer" for Section 707 or any other purpose.[11] The

[11] Consistent with the allocation by the Funds, "allocation" is defined as "the practice of segregating items with tax significance (e.g., *basis, amount realized, interest expense*) to transactions or to activities or property with which they can be fairly associated," SHEPARD'S MCGRAW-HILL TAX DICTIONARY FOR BUSINESS

partnership rules embedded in Sections 701, 702, and 704 constitute direct authority that a partnership allocation constitutes a division or sharing of joint tax consequences and not a "transfer." They reflect the aggregate theory of partnership taxation whereby the law recognizes the partnership as a group of partners among whom tax attributes are shared. *See* MCKEE, NELSON, AND WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, Sec. 1.02[3] (4th ed. 2007) ("The aggregate concept predominates in connection with the taxation of partnership income to the partners and the general nonrecognition provsions for contributions to and distributions from partnerships"). Only where the partners step out of their roles as partners does Section 707 invoke the entity theory and treat the *de facto* non-partners as dealing with the partnership entity as outsiders.

Even in the context of a taxable trust (*i.e.*, a separate entity) and even in the context of undeniable property, Treas. Reg. § 1.1001-1(h)(1) recognizes that an allocation/severance of trust assets constitutes a division and not a taxable transfer (provided the trust authorizes the division or allocation). Though adopted in 2007 and explicitly applicable to 2004 forward, this non-transfer treatment reflects "well over 100 private rulings permitting such divisions on a tax-free basis … [and] it is unlikely the Service would take a contrary position with respect to trust divisions

---

(1994), and "[a]pportion[ing] for a specific purpose or to a particular person or things. Set[ting] apart or earmark[ing]," WEST'S TAX LAW DICTIONARY (1998).

occurring prior to these dates if the conditions in the regulations [*i.e.*, authorization] are satisfied." David Westfall, *et al., Part V. Trust and Beneficiaries: Chapter 17. Noncharitable Trusts: Income Tax Aspects for Grantors, Beneficiaries, and Power Holders,* ESTATE PLANNING LAW & TAXATION, ¶ 17.09[1] n. 298. Similarly, the division or allocation of a joint tenancy in stock does not constitute a taxable transfer. *See* Rev. Rul. 56-437, 1956-2 C.B. 507.

Also, in both community and non-community property states, the division of joint property among divorcing spouses never resulted in a sale or exchange. *See, e.g., Davis v. United States*, 370 U.S. 65, 70-71 (1962) (where Supreme Court noted that a divorce settlement would have been a mere division of property, rather than a taxable event if the spouses were co-owners); *Beth W. Corporation v. United States*, 350 F. Supp. 1190, 1192-93 (S.D. Fla. 1972) (the property settlement constituted a nontaxable division of property by ex-spouse/co-owners of the joint property that in effect, merely partitioned the property); Rev. Rul. 81-292, 1981-2 C.B. 158 ("An approximately equal division of the total value of jointly owned property under a divorce settlement agreement in a noncommunity property state is a nontaxable division"); Rev. Rul. 76-83, 1976-1 C.B. 213 (same for community property). A host of other examples of non-transfers fill the Internal Revenue Code – examples like the partnership allocation of tax attributes that fall outside a Section 707 "transfer".

4. <u>These Non-transferrable Tax Attributes Arise By Operation of Law and Do Not Constitute "Property"</u>.

The Tax Court properly offered no declaratory *dicta* on the meaning of "property" because other Section 707 aspects render the property question academic. Without any authority or discussion, the IRS just assumes – for the first time in history – that these tax attributes constitute "property."

The Supreme Court described the posture of tax attributes in its ruling under the securities laws in *Randall v. Loftsgaarden*, 478 U.S. 647, 657 (1986):

> [T]ax benefits ... take the form of tax deductions or tax credits. These have no value in themselves; the economic benefit to the investor – the true "tax benefit" – arises because the investor may offset tax deductions *against* income received from other sources or use tax credits to reduce the taxes otherwise payable on account of such income.

Consistent with the *Morgan* doctrine that State law defines property rights, the Commonwealth of Virginia generally recognizes the non-property status of Virginia credits. *Cf.*, VA. CODE § 58.1-513(E) ("[T]he transfer of the [conservation] credit and its application against a tax liability shall not create gain or loss for the transferor or the transferee of such credit").

Federal tax authorities follow similar reasoning in concluding that tax attributes do not constitute receipt of property/income. *See Snyder v. Commissioner*, 894 F.2d 1337 (Table), 1990 WL 6953, at *4 (6th Cir. 1990) (the Sixth Circuit determined a tax attribute in the form of a pari-mutuel tax reduction

does not constitute income to the partnership). The IRS has also repeatedly ruled that tax attributes do not constitute income. *See, e.g.,* Rev. Rul. 91-36, 1991-2 C.B. 17 (where a taxpayer participates in an energy conservation program for which she receives a rate reduction or nonrefundable credit, "the amount of the rate reduction or nonrefundable credit is not includible in the [taxpayer's] gross income"); Rev. Rul. 79-315, 1979-2 C.B. 27 (IRS treated a tax rebate as a reduction of the outstanding liability, not income); Rev. Rul. 66-226, 1966-2 C.B. 239 ("If the amount of such gasoline tax credits or refunds for any taxable year exceeds the 'allowable deductions' attributable to the mineral property for the taxable year, such excess is not includible in 'gross income from the property'"). Applying these principles, the IRS recently admitted in the instructive, albeit non-precedential, IRS Coordinated Issue Paper that ***"tax benefits are not 'money or property'"*** I.R.S. Coordinated Issue Paper, State and Local Location Tax Incentives, LMSB-04-0408-023, 2008 WL 2158109 (May 23, 2008) (Internal citations omitted).

The factual nature of Virginia historic credits should eliminate all doubt – non-refundable, non-inheritable, non-transferable in the hands of these partnerships and their partners, and never before treated as property by State or local authorities. (Stip. ¶¶ 41, 118; Tr. 83-4, 112-19, 133, 612-8). A tax attribute does not constitute "property" in the hands of the partnership or its partners unless it carries dominant

property vestiges in their hands – such as inheritable, assignable, refundable, and transferrable in their hands. *Compare In re Harrell*, 73 F.3d 218, 220 (9th Cir. 1996)(revocable and unsellable season ticket holder's expectation of season ticket renewal could not be property) *with In re I.D. Craig Service Corporation*, 138 B.R. 490, 495 (Bankr. W.D. Pa. 1992) (transferable right to renew and automatic renewal upon payment of season tickets was property).

Several of the IRS non-precedential pronouncements point to refundability and transferability in the hands of the recipient as traits "like property." While those references lack cites to any authority, they do emphasize the reality that the Virginia historic tax credits were neither refundable nor transferable in the hands of the Virginia Historic Funds or their partners. The parties stipulated that these inducements are non-refundable. (Stip. ¶ 41) Similarly, neither the partnerships nor their partners could transfer these credits. Even the owner/developer "one-time" transfer provisions required approval by the Virginia DHR (Stip. ¶ 31), and the Virginia DHR never permitted a one-time transfer by a downstream partnership or partner. (Tr. 83-4, 115, 117-8). And obviously, the "one-time" transfers in the Credit Transfer Agreements barred any subsequent transfer. Consequently, these creations of law no more constitute "property" than do charitable contribution deductions, accelerated depreciation, low income housing credits, energy-saving inducements, or any other tax or non-tax statutory inducement.

The IRS completely avoids the critical "Tax Attribute v. Property" testimony by the Virginia Department of Historic Resources as to the factual nature of the Virginia historic rehabilitation credits. The parties stipulated that, by statute, the Virginia DHR manages this Program and that, again by statute, the Director must approve any one-time transfers during the short life of that aberrant provision. (Stip. ¶¶ 31, 34) Both the Director and her designated head of the Program during these years testified at length about the nature of these tax incentives, yet the IRS never mentions that essential, uncontroverted testimony in its disguised sales discussion. (Slip Op. 49-50). The Director of the Virginia DHR and the Head of this Program established that the Virginia historic credits:

a. Cannot be inherited,

b. Never treated as property for property tax purposes in Virginia,

c. Never treated as property by anyone to their knowledge (other than the IRS here), and

d. Not transferrable in the hands of a downstream partnership (like the Virginia Historic Funds) or its partners – even under the one-time transfer provisions (that require the Director's approval).

The IRS simply assumes "property" status on little more than its own *ipse dixit*.

5. The Risks Preclude Recharacterizing the Partners' Interests as a "Disguised Sale".

The IRS's regulations also confirm that shared risks bar application of Section 707 to non-simultaneous partnership/partner dealings. Treas. Reg. § 1.707-3(b). In two different ways, the IRS admits that these 2001 Virginia historic credits could not have been simultaneously exchanged with the 2001 contributions: one, the IRS stipulates that, even under its own position, no sale occurred in 2001 when almost all partners contributed their equity; and two, the Virginia DHR did not certify a large portion of the projects until 2002. (IRS Br. 6-7, 13, 15). To be sure, the Subscription Agreements contained the ***promise*** to allocate a stated amount from the pool of partnership credits, in order to satisfy the VA. CODE § 58.1-339.2 provision regarding allocating credits by written agreement. That promise to allocate credits could not constitute a simultaneous exchange of money and "property."

The Virginia historic tax credits only ripen in the developer partnerships effective as of December 31, many historic credits are not certified until the following Spring, the allocation does not occur until the partnerships distribute the Schedules K-1 to the partners (in the case of both the developer partnerships to the partnerships and from the partnerships to the individual partners), and the credits remain inchoate until the partners claim their shares on their returns in 2002.

a. The IRS Confuses the Simultaneous Promissory Allocation by Agreement Language Compelled or Encouraged by Va. Code § 58.1-339.2 With the Calendar-Impossibility of a Simultaneous Exchange.

The IRS repeatedly asserts its "simultaneous" transfer assertion that defies both of the IRS's own admissions (IRS Br. 16, 52-3) and misconstrues the VA. CODE § 58.1-339.2 "allocation by agreement" requirement as something other than a promissory contract. The calendar confirms the Court's fact-finding that the allocation of Virginia incentives could not possibly have occurred simultaneously because a significant portion of the credits were not certified and injected into the pool until *after* almost all the partners contributed their capital in December 2001.

Project	**Date of Cert.**	**Rec. Ref.**
Winthrop Development LLC	1/9/02	Stip. ¶ 140; Ex. 204-J
Richmond Dairy Associates LP	2/11/02	Stip. ¶ 140; Ex. 204-J
Randolph – Macon College	3/1/02	Stip. ¶ 140; Ex. 204-J
Hotel Norton Rehabilitation, LLC	3/15/02	Stip. ¶ 140; Ex. 204-J
The Hanson Company LLC	3/15/02	Stip. ¶ 140; Ex. 204-J
ICM Enterprises, LC	3/21/02	Stip. ¶ 140; Ex. 204-J

Further, the Court accurately confirmed as a factual matter that the Virginia Historic Funds could not and did not allocate the Virginia credits until they made those allocations upon filing the returns on April 15, 2002. (Slip Op. 39-40).

b. The IRS Admits Significant Risks but Mistakenly Dismisses Them as Non-Business Risks.

The greatest risk mistake the IRS makes arises from its assumption that the credit risks faced by the conspicuously named "Virginia Historic Tax Credit Funds" do not constitute a business risk to them and their partners. As noted, the IRS's own regulations and rulings establish that reduction of State tax (especially through inducement provisions) constitutes a legitimate business purpose.

Moreover, the risks preclude the "disguised sale" contention as a whole. As leading authorities note:

> The general rule of Section 1.707-3(b)(1) simply requires a showing that a subsequent transfer is dependent on the entrepreneurial risk of partnership operations. There is no requirement that such entrepreneurial risk be significant or meaningful, just that it be present.

Barksdale Hortenstine and Gregory Marich, *An Analysis of the Rules Governing Disguised Sales to Partnerships: Section 707(a)(2)(b)*, 830 PLI/TAX 969 (October-December, 2008). *As a factual matter amply supported by the record*, the Tax Court accurately found that these partnerships and their partners share significant ongoing risks here – ongoing risks that corroborate their continuing relationship and that would be borne solely by the buyer under a disguised or a declared sale. Among the risks tied to the public sector/private inducement nature of these special-purpose policy-based partnerships, both the partnerships and their partners faced the shared financial risk that:

* The developer could fail to complete the project in a qualified way;
* The developer could fail to complete the project on time – as actually occurred;
* The partnership could fail to acquire adequate credits; and
* Any credits granted could be retroactively revoked for a three-year period if the owner makes any disqualifying changes to the structure. (Slip Op. 40; Tr. 92-3, 268, 362; Ex. 17-P).

Again as an amply supported factual finding, the partners also faced continuing management risks mitigated only by prescribed terms for management removal for cause, *etc.* (*Id.*) Worse yet, the partnerships and their partners shared the continuing risk of defalcation by anyone up and down the line – a risk that the Virginia Historic Funds and their partners actually suffered when a developer took their money on the false representation that he held title to the underlying property. (*Id.* at 41; Tr. 230-2, 393). Also, the Virginia Historic Funds faced an actual defalcation risk when a would-be investor surreptitiously altered the terms of the Subscription Agreement. (Tr. 64).

The second greatest mistake the IRS makes as to risks arises from the assertion that the risk of a failure to perform on a contract represents no risk – a truly astounding proposition given the woes of most banks in the country. As further proof of the shared risks here, the General Partner assured some of the

partners that the General Partner would refund their capital to the extent the partnerships failed to obtain adequate Virginia credits. (Slip Op. 40; Tr. 233, 451). The General Partner is a limited liability company whose assurance is only as strong as its financial wherewithal, and the risk of a major defalcation destroys both the General Partner's ability to deliver and its ability to refund monies previously paid over to the culprit.

And let us not forget what this case proves above all else, the Virginia Historic Funds and their partners also faced greater (and suffered actual) litigation risks than they would in a simple sale.

c. By Its Own Terms, the Treas. Reg. § 1.707-3(b) Set of Factors Does Not Apply.

The IRS accuses the Tax Court of "superficial analysis" because its (extensive) partner analysis that the investors contributed capital as partners – not buyers – reduced any further commentary on the factors in Treas. Reg. § 1.707-3(b) to *obiter dicta*. That criticism is legally and factually wrong.

Most importantly, Treas. Reg. § 1.701-3(b), on its face, only applies to "transfers" (not partnership allocations) of "property" (not tax consequences). Indeed, Treas. Reg. § 1.707-3(b)(1), like Treas. Reg. § 1.707-1(a), explicitly excludes "contributions" of money by the partners. Hence, by their own terms, the factors cannot apply here.

The factors focus upon the typical disguised sale where the seller pretends he is a partner, contributes real estate, and, upon liquidation, receives cash. Consequently, the factors do not fit this situation where the partners contribute their capital, the partnership contributes that capital to developer partnerships, and the developers specially allocate favorable tax consequences to the Virginia Historic Funds, which, in turn, allocate those incentives to their partners. The allocation provisions of Section 704 govern that situation, not Section 707.

Even if one mistakenly assumes that a partnership allocation of tax attributes constituted a "transfer" of "property," the Congressional Report upon which the IRS relies most heavily deems risk to be the most important factor:

> [***t]he first and generally the most important factor is whether the payment is subject to an appreciable risk as to amount*** ... Thus, an allocation and distribution provided for a ... partner under the partnership agreement which subjects the partner to significant entrepreneurial risk as to both the amount and the fact of payment generally should be recognized as a distributive share and a partnership distribution … .

Joint Comm. on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 227 (98th Cong., 2d Sess.) (Comm. Print 1984).

Despite its inclusion of extensive legislative history in this argument, the IRS fails to acknowledge this single most important factor. Here, that risk and the face of the regulation itself render the lengthy argument over the ten factors, or even the IRS highly selective four factors, moot.

CONCLUSION

The thoughtful and carefully drawn Opinion by the Tax Court should be affirmed based on that Court's amply supported fact findings and the authorities discussed herein.

Respectfully submitted,

/s/ David D. Aughtry
DAVID D. AUGHTRY

/s/ Hale E. Sheppard
HALE E. SHEPPARD
Tax Court No. SH0819
CHAMBERLAIN, HRDLICKA,
WHITE, WILLIAMS & MARTIN
191 Peachtree Street, NE – 34th Floor
Atlanta, Georgia 30303-1747
(404)659-1410
(404)659-1852 Facsimile

COUNSEL FOR APPELLEES

341047.50

REQUEST FOR ORAL ARGUMENT

The Virginia Historic Funds respectfully submit that oral argument should be considered for five reasons: (i) the IRS position conflicts with both State and Federal historic preservation policies (*see, e.g.*, Va. Code § 58.1-339.2; 16 U.S.C. § 470-1); (ii) as established by the uncontroverted testimony from the leading authority in the country, the IRS Section 707 position jeopardizes *all* policy-based partnerships (Tr. 242-3); (iii) every State in the Fourth Circuit utilizes State tax credits and similar inducements as a legislative tool to implement policy (Stip ¶ 26; Ex. 16-P; Tr. 201); (iv) the Federal government uses Federal historic tax credits, low-income/affordable housing credits, energy credits, and similar inducements as a legislative tool to implement policy; and (v) most of the State and Federal inducements are implemented through policy-based partnerships – all of which could be adversely affected by the decision in this case.

ADDENDUM: SELECTED STATUTES AND TREASURY REGULATIONS

VIRGINIA CODE ANNOTATED

§ 58.1-339.2. HISTORIC REHABILITATION TAX CREDIT

A. Effective for taxable years beginning on and after January 1, 1997, any individual, trust or estate, or corporation incurring eligible expenses in the rehabilitation of a certified historic structure shall be entitled to a credit against the tax imposed by Articles 2 (§ 58.1-320 et seq.), 6 (§ 58.1-360 et seq.) and 10 (§ 58.1-400 et seq.) of Chapter 3; Chapter 12 (§ 58.1-1200 et seq.); Article 1 (§ 58.1-2500 et seq.) of Chapter 25; and Article 2 (§ 58.1-2620 et seq.) of Chapter 26 of this title, in accordance with the following schedule:

Year	% of Eligible Expenses
1997	10%
1998	15%
1999	20%
2000 and thereafter	25%

If the amount of such credit exceeds the taxpayer's tax liability for such taxable year, the amount that exceeds the tax liability may be carried over for credit against the taxes of such taxpayer in the next ten taxable years or until the full credit is used, whichever occurs first. Credits granted to a partnership or electing small business corporation (S corporation) shall be passed through to the partners or shareholders, respectively. 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, the form of which shall be prescribed by the Director of the Department of Historic Resources.

* * *

UNITED STATES CODE

TITLE 16

16 U.S.C. § 470-1. DECLARATION OF POLICY OF THE FEDERAL GOVERNMENT

It shall be the policy of the Federal Government, in cooperation with other nations and in partnership with the States, local governments, Indian tribes, and private organizations and individuals to--

(1) use measures, including financial and technical assistance, to foster conditions under which our modern society and our prehistoric and historic resources can exist in productive harmony and fulfill the social, economic, and other requirements of present and future generations;

(2) provide leadership in the preservation of the prehistoric and historic resources of the United States and of the international community of nations and in the administration of the national preservation program in partnership with States, Indian tribes, Native Hawaiians, and local governments;

(3) administer federally owned, administered, or controlled prehistoric and historic resources in a spirit of stewardship for the inspiration and benefit of present and future generations;

(4) contribute to the preservation of nonfederally owned prehistoric and historic resources and give maximum encouragement to organizations and individuals undertaking preservation by private means;

(5) encourage the public and private preservation and utilization of all usable elements of the Nation's historic built environment; and

(6) assist State and local governments, Indian tribes and Native Hawaiian organizations and the National Trust for Historic Preservation in the United States to expand and accelerate their historic preservation programs and activities.

TITLE 26 (INTERNAL REVENUE CODE OF 1986 As Amended)

§ 704. PARTNER'S DISTRIBUTIVE SHARE

(a) EFFECT OF PARTNERSHIP AGREEMENT.—A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement.

(b) DETERMINATION OF DISTRIBUTIVE SHARE**.**—A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if—

(1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or

(2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

* * *

§ 707. TRANSACTIONS BETWEEN PARTNER AND PARTNERSHIP

(a) PARTNER NOT ACTING IN CAPACITY AS PARTNER**.—**

(1) In general.—If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the TRANSACTION shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.

(2) Treatment of payments to partners for property or services.—Under REGULATIONS prescribed by the Secretary—

* * *

(B) Treatment of certain property transfers.—If—

* * *

(2) 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.

* * *

§ 761. TERMS DEFINED

(a) PARTNERSHIP.—For purposes of this subtitle, the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate. Under regulations the Secretary may, at the election of all the members of an unincorporated organization, exclude such organization from the application of all or part of this subchapter, if it is availed of—

(1) for investment purposes only and not for the active conduct of a business,

(2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or

(3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities,

if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.

(b) PARTNER.—For purposes of this subtitle, the term "partner" means a member of a partnership.

(c) PARTNERSHIP AGREEMENT**.**—For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.

* * *

§ 7701. DEFINITIONS

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

(1) Person.—The term "person" shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.

(2) Partnership and partner.—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

* * *

TREASURY REGULATIONS (26 C.F.R. §)

26 C.F.R. § 1.707-3. DISGUISED SALES OF PROPERTY TO PARTNERSHIP; GENERAL RULES.

* * *

b) TRANSFERS TREATED AS A SALE.—(1) In general. A transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership 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.

CERTIFICATE OF COMPLIANCE

I hereby certify that the foregoing brief complies with the type-volume limitation provided in FED. R. APP. P. 32(a)(7). The foregoing brief contains 13,833 words of Times New Roman (14 point) proportional type. The word processing software used to prepare this brief was Microsoft Word for Windows XP.

/s/ David D. Aughtry
David D. Aughtry

CERTIFICATE OF SERVICE

It is hereby certified that on this 26th day of July, 2010, this Brief By Appellees was electronically filed with the Clerk of Court using the CM/ECF system, which will send notice of such filing to the following attorney for the appellant, who is a registered CM/ECF user:

Ivan C. Dale, Esq.
U. S. Department of Justice – Tax Division
Post Office Box 502
Washington, D.C. 20044

/s/ David D. Aughtry
DAVID D. AUGHTRY
Attorney