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Tax Court Case Could Be Gateway to More Historic Rehabilitation Projects in States Offering Tax Credits, Says Practitioner

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The U.S. Tax Court recently issued its decision in Gateway Hotel Partners LLC v. Commissioner of Internal Revenue. The court determined that two of the transfers of Missouri historic preservation tax credits were partnership distributions but that a portion of the third credit transfer was a taxable sale.

In this interview, Philip Karter, attorney at Chamberlain Hrdlicka in Philadelphia, discusses the Gateway decision. As lead trial counsel for petitioner, Kimberly-Clark, Karter offers valuable insight on various aspects of the decision, including the imposition of a negligence penalty and the IRS's decision to allow one partner to escape taxation. In addition, he discusses some important tax planning issues for partners and partnerships that find themselves in similar situations.

In general, so long as developers of historic rehabilitation projects realize the importance of proper documentation and adherence to contractual arrangements, then the Gateway decision should provide comfort to developers that their tax reporting of such credit transactions is likely to be respected, says Karter.

Bloomberg BNA: What is the impact of the U.S. Tax Courts decision in *Gateway Hotel Partners LLC v. Commissioner of Internal Revenue*?

Karter: In recent years, taxpayers have not fared terribly well in the face of successful IRS challenges to the reported tax treatment claimed in historic rehabilitation tax credit cases. This has created a good deal of uncertainty about whether a transaction dependent upon attaining certain tax benefits will actually achieve those benefits. *Gateway Hotel Partners* did not deal with the eligibility of a partnership for the Section 47 federal rehabilitation credit, but it is an important case for parties interested in financing historic rehabilitation projects in terms of providing guidance and a greater level of comfort about the tax treatment accorded to the disposition of saleable state historic tax credits. The decision also provides considerable guidance on the circumstances under which a capital contribution from a partner to a partnership should be recharacterized as a taxable sale or exchange of property under I.R.C. 707(a)(2)(B) (i.e., a disguised sale).

Bloomberg BNA: What is the key takeaway from the decision?

Karter: For partners that enter into a historic rehabilitation transaction with an expectation that the allocation of income and loss will be respected for tax purposes, it is imperative that each step in the transaction be documented meticulously and that the substance of that transaction is consistent with its documented form. It is similarly

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important, to avoid recharacterization as a disguised sale of state historic tax credits, to ensure that the partnership agreement memorializes the entrepreneurial risk inherent in every partners capital contribution. In *Gateway*, this was achieved by providing in the partnership agreement that the partnership had the discretionary right to satisfy the preferred return due a contributing partner either with historic tax credits or other property out of available cash flow. Thus, both the amount and timing of any transfer of tax credits to a partner was determined to be uncertain enough to avoid disguised sale treatment. This, in turn, enabled the partnership to distribute the tax credits to a 1% partner on a tax-free basis and relieved the partner, to whom 99% of the gain was allocated, of any tax liability as a result of that distribution.

Bloomberg BNA: Does the decision have any larger implications beyond the specific Missouri historic preservation tax credits at issue?

Karter: Any court pronouncement on the nature of economic risk is important in predicting whether a nonrecognition partnership distribution claimed to occur between a partnership and a partner will be respected.

Bloomberg BNA: Do you think the decision will lead to more investment in historic building rehabilitation in Missouri, as well as other states offering similar credits?

Karter: Assuming historic rehabilitation developers appreciate the importance, from a tax standpoint, of carefully documenting the panoply of contractual arrangements required for their rehabilitation projects (from financing, to construction, to allocating benefits amongst the partners), and ensuring that the terms of those arrangements are adhered to in substance, then, yes, the case should provide comfort to developers that their tax reporting of such credit transactions is likely to be respected.

Bloomberg BNA: How does this case affect a partnerships decision to sell state tax credits in general?

Karter: What the decision tells us is how to ensure that your intended tax structuring of a historic tax credit transaction will be respected. In some instances, a sale by the partnership may be the preferred outcome whereas, in other instances, a distribution and sale by a partner may be the better alternative. The point is that both form and substance matter and it is better to understand that from the outset than when you are defending your tax treatment in court. Finally, with respect to bolstering a defense to a disguised sale argument, it is worth taking note of the disguised sale presumptions in Treasury Regulation 1.707-3(d), which provide that transfers occurring more than two years apart are robustly presumed not to constitute a disguised sale. Of course, not every rehabilitation project can plan around this presumption, but, if the timing of credit distributions makes the 2-year threshold a close call, it is far better to be on the right side of this presumption than the wrong side.

Bloomberg BNA: Are there other parties that will benefit from the decision?

Karter: The favorable result in *Gateway* should encourage developers of historic rehabilitation projects that a well-documented and executed transaction can produce significant tax benefits that will withstand the scrutiny of taxing authorities. Not only can they take comfort from this decision, but so can the various lenders, contractors and other third-parties who are likely to benefit from an uptick in the number of historic rehabilitation projects, perhaps encouraged by this result.

Bloomberg BNA: What do you think about the decision overall?

Karter: Particularly given the IRSs recent success in cases involving the disposition of historic rehabilitation credits, we are very pleased with the outcome and the financial impact of the decision overall, which came down in favor of the taxpayer and against the government with respect to just under 90% of the total proposed adjustments.

Our only disappointment about the decision was in the courts finding that one of the tax credit certificates issued for the wrong amount in the name of a partner (and treated as a tax-free return of capital) reflected the partnerships intention to sell the balance of credits earned (i.e., the difference between the face value of the credits and the erroneously discounted value) directly to the third-party tax credit buyer in a taxable transaction. Even there, had the partnership recognized the error and corrected it before the end of the taxable

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year instead of a few days into the new year, the court would have accepted the properly reissued certificates as controlling under the rescission doctrine, resulting in a 100% victory for the taxpayer.

Bloomberg BNA: Are there any downsides to the decision?

Karter: With respect to the small portion of the credits determined to have been sold by the partnership, the court imposed a 20% negligence penalty. Its decision was predicated on the premise that the partnership intended to sell a portion of the tax credits directly, rather than distribute them tax free to a partner, a conclusion we do not believe was consistent with the facts surrounding the erroneously issued tax credit certificate. Because the tax opinion letter the partnership obtained could not have anticipated the mistake made when the credits were issued, it provided no protection based on reasonable reliance. The dollar amount of the penalty was exceedingly small, but the courts determination that it should apply to the partnership income deemed unreported is a cautionary tale of what can happen when mistakes are made in documenting aspects of a transaction and thereafter are not quickly identified and rectified.

Bloomberg BNA: Do you have any other comments about the decision?

Karter: The enduring mystery about this case that only the government can answer is why it compromised its claim before trial against the other partner for a peppercorn, thereby putting itself in a whipsaw position. Under the terms of the partnership operating agreement, Gateways profits and losses were allocated one percent to the other partner and 99% to our client, Kimberly-Clark. Thus, a sale of the historic tax credits by the partnership would have allocated 99% of the gain from that sale to Kimberly-Clark. On the other hand, a distribution of the credits from Gateway to the other partner, and the subsequent sale by its parent of the credits to the third party would have resulted in a gain to the parent, which would have flowed through and been taxable to its shareholders. The courts decision upheld the latter treatment, meaning that the other partner should have been responsible for the tax. However, they were inexplicably let off the hook by the IRS, apparently in an ill-advised attempt to solicit their cooperation in a trial then limited only to the perceived deep-pocket partner. In the end, the loss to the government fisc was a product of the IRSs own peculiar decision-making in allowing a taxable gain to escape taxation.

One final item of interest is that, with better tax planning, there could have been a way for this transaction to have been structured so that a tax was avoided by both partners. Specifically, if the credits had been distributed to the 1% partner in liquidation of its partnership interest, the 1% partner would have been entitled to step up its cost basis in the historic credits to an amount equivalent to its outside basis, the amount of money it contributed to the partnership. If that plan had been effectuated, the subsequent sale of the credits would have produced no gain because the amount realized and the cost basis would have both been the same. However, the 1% partner was not liquidated at the time it received the distribution of tax credits. Accordingly, under the Internal Revenue Code partnership provisions, it was not entitled to take its outside basis in the tax credits; instead, the basis of the tax credits received by the 1% partner carried over the partnerships tax basis of zero and the subsequent sale produced taxable gain. That is the gain that escaped taxation because of the governments concession against the 1% partner. Of course, not every transaction is susceptible to such planning as a business matter, but that should be a decision based on deliberation rather than the unintended consequence of inadvertence.
