Fourth Circuit Affirms Tax Court Decision Holding Partnership Allocation of State Tax Credits Was a Taxable Disguised Sale.

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In its recently issued opinion in the case of *Route 231, LLC v. Commissioner*, No. 14-1983, 2016 WL 97598 (4th Cir. 2016), the U.S. Court of Appeals for the Fourth Circuit (the "Court") affirmed the U.S. Tax Court's decision finding that a transfer of state tax credits to a 1% member who had contributed $3.8 million to the company was a disguised sale requiring the taxpayer to recognize income from the transfer.

Factual Background

Two individual Virginia resident taxpayers formed Route 231, LLC, a Virginia limited liability company that is taxed as a partnership ("Route 231"), in May 2005. Route 231 purchased Castle Hill, a 1,203 acre tract near Albemarle County, Virginia including an 18th century manor home, and Walnut Mountain, a 345 acre tract in the same vicinity. The loan utilized to purchase these properties was personally guaranteed by the individual members. The members intended to donate conservation easements on these parcels to obtain Virginia Land Preservation Tax Credits (the "credits").

Route 231 obtained an appraisal of both properties on December 9, 2005 valuing a conservation easement on Castle Hill at $8,849,240; a conservation easement on Walnut Mountain at $5,225,249; and a fee interest in Walnut Mountain subject to the Walnut Mountain easement at $2,072,880. Effective December 30, 2005, Route 231 made the following charitable donations: (1) a deed of gift of the Castle Hill easement to the Nature Conservancy; (2) a deed of gift of the Walnut Mountain easement to the Albemarle County Public Recreational Facilities Authority; and (3) a deed of gift of the Walnut Mountain fee interest to the Nature Conservancy (collectively, the "donations").

Virginia Conservation, a Virginia limited liability limited partnership ("Virginia Conservation"), agreed to make a capital contribution to Route 231 based on the number of credits Route 231 agreed to allocate to it. On December 27, 2005, the two individual Route 231 members and Virginia Conservation executed an amended operating agreement in which Virginia Conservation was admitted as a member. Virginia Conservation was deemed to have made a $500 capital contribution and an additional capital contribution of $0.53 for each $1.00 of credits allocated to it. Under the amended operating agreement, the allocation of items of Route 231 partnership profits and losses would be 49.5% to each individual and 1% to Virginia Conservation. In addition, the amended operating agreement provided that, in the event the credits were disallowed by the Virginia Department of Taxation ("VDT") or Internal Revenue Service ("IRS"), Route 231 and the individual members would indemnify Virginia Conservation for its capital contribution.

Route 231 and Virginia Conservation entered into three escrow agreements for the required capital contributions of Virginia Conservation based on the anticipated credits applicable to each of the donations. The funds in each escrow account would be released to Route 231 when the escrow agent received the VDT-issued Credit Transaction Number, a recorded deed of gift and a title insurance policy. When Virginia Conservation finally received proof of the credits allocable to it, the credits were $84,000 short and were replaced by credits transferred from one of the individual members. In total, the credits were allocated $215,983 to one individual member and $7,200,000 to Virginia Conservation.

Route 231 received letters from VDT listing the credit transaction number for each of the three donations on March 27, 2006. The credits had an effective year of 2005 and expiration tax year of 2010. On its federal income tax return for the 2005 tax year, Route 231 reported an accrual method of accounting, charitable donations of $14,831,967, and cash capital contributions of $8,416,000. The state income tax return for Route 231 from 2005 included $7,415,893 of Land Preservation Tax Credits.

The IRS issued Route 231 a final partnership administrative adjustment for a failure to report incurred ordinary income of $3,816,000 from the sale of the credits on March 17, 2010.

Circuit Court Ruling

The issue before the Court was whether the capital contribution of cash by Virginia Conservation and subsequent allocation of credits to it by Route 231 constituted a disguised sale under IRC Section 707. Generally, a partner may contribute capital to a partnership tax free and receive a tax-free return of previously taxed profits, except to the extent that the distribution exceeds the partner's adjusted basis. IRC Sec. 721, 731. However, a disguised sale occurs (1) when a partner transfers money or property to a partnership, (2) there is a related transfer of money or other property by the partnership to the partner, and (3) when viewed together, the transfers are properly characterized as a sale or exchange of property. IRC Sec. 707(a)(2)(B). Transfers made between a partner and a partnership within a two-year period are presumed to be a disguised sale unless the facts and circumstances indicate otherwise. Treas. Reg. Sec. 1.707-3(c)(1).

Defining Disguised Sale

In evaluating whether or not a transfer constitutes a disguised sale, all the facts and circumstances must indicate that the transfer by the partnership would not have been made "but for" the transfer by the partner, and, in cases in which the transfers are not simultaneous, the subsequent transfer is not dependent on the entrepreneurial risks. Treas. Reg. Sec. 1.707-3(b)(1). The Court found that, out of a list of ten non-exhaustive facts and circumstances that would tend to prove the existence of a disguised sale, six of the facts and circumstances were relevant to the determination of this case. These facts and circumstances are: (1) timing and amount of the subsequent transfer are determinable with reasonable certainty at the time of the earlier transfer; (2) the transferor has a legally enforceable right to the subsequent transfer; (3) the partner's right to receive the transfer is secured; (4) the partnership has been loaned the money or other consideration to make the transfer; (5) the transfer by the partnership is disproportionately large compared to the partner's profits interest; and (6) the partner has no obligation to return or repay the consideration to the partnership. Treas. Reg. Sec. 1.707-3(b)(2).

Virginia Historic Tax Credit Fund

The Court reasoned that its prior case, *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011), was highly instructive in the case of Route 231. In *Virginia Historic*, the Court held that there was a disguised sale of tax credits where the partnership at issue had solicited capital contributions from investors in exchange for (in most cases) .01% interests in the partnership and an allocation of state tax credits. Following the allocation, the partnership exercised its option to buy out the investors interests at 1/1,000th of each investor's capital contribution. In the present case, the Court found sufficient factual similarities between the entities and the transactions such that the disguised sale analysis of *Virginia Historic* would govern.

Transfer of Property
The first issue before the Court was whether Route 231 transferred “property” related to the prior cash contribution in order for the transaction to be subject potentially to the disguised sale rules of IRC Section 707. The taxpayer asserted that the credits were not property, but rather a potential reduction of taxes. Using the analysis of *Virginia Historic*, the Court agreed with the Tax Court’s determination that the credits were valuable and consisted of essential property rights and were therefore property for purposes of Sec. 707.

Disguised Sale
The Court found that Route 231 would not have transferred the credits to Virginia Conservation, but for Virginia Conservation’s prior cash transfer and that Virginia Conservation’s right to receive the tax credits did not depend on the entrepreneurial risks of the company. The Court’s conclusion was supported by the facts and circumstances, including, (1) the amount of credits to be received and the date by which they would be earned were set when Virginia Conservation transferred its funds; (2) Virginia Conservation had a breach of contract claim to assert its rights to the credits; (3) Virginia Conservation’s right to be indemnified by Route 231 in the event it did not receive all the tax credits for which it had provided money; (4) the individual member agreed to reduce the amount of tax credits he would receive in order for Route 231 to complete the promised transfer of credits to Virginia Conservation; (5) Virginia Conservation held a 1% interest in the company profits and losses and distribution of net cash flow, but received 97% of the credits; and (6) Virginia Conservation had no obligation to return the credits to Route 231. Accordingly, the Court held that the Tax Court did not error in finding that Virginia Conservation and Route 231 engaged in a disguised sale.

Timing
The Court rejected the taxpayer’s assertion that any potential disguised sale could not have occurred in 2005. The taxpayer asserted that the disguised sale could not have taken place in 2005 because the credits were not registered until 2006. First, the Court noted that, under Virginia law in effect during 2005, a taxpayer earned and held a credit when the taxpayer satisfied the statutory requirements. Filing with the VDT was not necessary at the time. The parties did not dispute that Route 231 met the relevant statutory requirements in 2005. In addition, Route 231 transferred the credits to two of its members on December 30, 2005, and it would be impossible to transfer something that the transferor did not possess. In the alternative, the Court noted that Route 231 was an accrual taxpayer that met the “all events” test, and, as such, the disguised sale proceeds should be income for 2005.

Conclusion
Unlike the tax credit investor partners in *Virginia Historic*, Virginia Conservation remained a member in Route 231 up through the litigation of the case. This fact did not change the Court’s analysis. The Court focused on the certainty of the amount and timing of Virginia Conservation’s received credits, the promise by Route 231 and the individual members of indemnification in the event of credit disallowance and the actual transfer of credits by an individual member to make up for Virginia Conservation’s deficiency. This case shows that, even when there is a legitimate and ongoing partnership, the IRS and the courts will look to the specific contributions and distributions, and entrepreneurial risks (or lack thereof) relevant to those transactions, to determine whether there has been a disguised sale of property, including tax credits. Taxpayers should continue to exercise caution in their planning and consult their tax advisors as they conduct these tax credit transactions.

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