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Who Is a Partner Under the Inflation Reduction Act of 2022?

To the Editor:

Section 6418, as added by the Inflation Reduction Act of 2022 (P.L. 117-169), states that if the election under that section is made, payments of cash on a sale of the credits specified in that section are not includable in gross income of the transferor-seller and are not deductible by the transferee-buyer. That section also treats the payments as tax-exempt income under section 705(a)(1)(B) if the partnership is the seller of the credits, and the tax-exempt income is allocated in the same manner as the credit would be allocated (based on the allocation of the receipts or expenses forming the basis for the credit under reg. section 1.704-1(b)(4)). The same property held by the partnership cannot be again claimed as a credit by the partners in their personal capacity.[1]

The statute implies, but does not specifically state, that the sales price must be fixed and payable in full upfront, but it does expressly say that it is payable "in cash." That technically omits a deferred payment obligation, the assumption or taking subject to debt that travels with the credit sold or payment of the price in publicly traded property that is the equivalent of cash. A contingent sales price also seems to be disallowed.[2] The credits that come within this sale-of-credit rule are those under sections 30C, 45(a), 45A, 45U, 45V, 45Z, 48, 48C, and 48D. The historic rehabilitation tax credit under section 47 is not part of this regime.

If the section 6418 election is not made, the regular rules of the IRC apply. This would mean a sale of credits would be a taxable sale (assuming that it's property that can be sold, which the disguised sale case law has held to be the case), regardless of whether the sale was originally treated as a sale by the taxpayer or later treated by the IRS as a disguised sale by the partnership to the partners under reg. section 1.707-3, -5, and -6.

What happens if a typical flip energy partnership is still formed under the new law but the allocations under the pertinent revenue procedures[3] providing for section 704(b) safe harbors are not followed? Are the investors no longer partners because they are, as a matter of tax law, only buying credits from the putative partnership? A partnership could still be used as a monetization vehicle as it was pre-section 6418, but, in the section 6418 case, not for the purpose of monetizing the credit (which is sold), but for the purpose of monetizing the depreciation from the property producing or otherwise responsible for the credit that remains with the developer post-section 6418. How the economics of this play out remains to be seen.

It would seem that there would be no tax partnership at all in the case of just a credit sale under the new law — that is, only the developer selling the credits. This is because the payment for the credit would likely not be recognized in the federal partnership tax system because it is not includable in the gross income of the seller and does not create tax deductions for the buyer. What then remains in substance is only an over-the-top sale by the developer to the investors who are not partners with the developer because they would lack a proprietary interest in the partnership entity. To have a partnership for federal tax purposes, there would need to be new money coming into the partnership from either the buyers of the credits or someone else (related or unrelated).

Relating to this issue of the treatment of the seller of tax credits is the treatment of the investors who in form (under new section 6418) or in substance (under the disguised sale rules) purchase the credits. It is not uncommon in those arrangements for the investment on a pretax basis

[1] *See, generally*, Lee A. Sheppard, "Green Safe Harbor Leasing," *Tax Notes Federal*, Aug. 22, 2022, p. 1179.

[2] *Id.*

[3] For the prior credit section 704(b) safe harbor revenue procedures, see Rev. Proc. 2007-65, 2007-50 IRB 967; Rev. Proc. 2014-12, 2014-3 IRB 415; and Rev. Proc. 2020-12, 2020-11 IRB 511.

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to show a loss but then show a profit as measured after taking the tax credit into account. In a recent case, *Cross Refined Coal*,[4] the court held, consistent with the 1995 Ninth Circuit opinion in *Sacks*,[5] that a tax incentive (a credit in both cases) can properly be taken into account in computing profits in testing for partnership and partner status. But see *Historic Boardwalk Hall*,[6] to the contrary. In this regard, a Joint Committee on Taxation report[7] states that the codified economic substance doctrine under section 7701(o) is not intended to disallow tax benefits that Congress encouraged (expressly granted an incentive) to be used, i.e., tax credits. The cited case law treats the formation of a partnership and the allocation of credits to the investor-partners as a taxable sale if the upside and downside of the investment is not, in the court's view, meaningful, but as a bona fide contribution and allocation if the court does not so find.[8]

Section 6418 is stated to be effective for tax years beginning after December 31, 2022. If a partnership is the credit seller, will it matter if the partnership has a fiscal year? Likely not. If a partnership was already formed and funded on the effective date, can an election be retroactively effective? Not very likely.

On the "who is a partner" issue, it is regrettable that the IRS has not provided definitive guidance in the form of a safe harbor or similar-type guidance. The *Cross Refined Coal* case held, on the facts, that there existed a material risk of failing to receive a return on investment, but the *Historic Boardwalk Hall* case held, on the facts there, that there was neither a meaningful downside risk (because the court held that the taxpayer in question was certain to recoup its contributions) nor any meaningful upside potential.

In the end, what kind of guidance does this conflict among the cases provide?

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[4] *Cross Refined Coal LLC v. Commissioner*, No. 20-1015 (D.C. Cir. 2022).

[5] *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995).

[6] *Historic Boardwalk Hall LLC v. Commissioner*, 694 F.3d 425 (3d Cir. 2012).

[7] JCT, "General Explanation of Tax Legislation Enacted in the 111th Congress," JCS-2-11, n.996, 1034, pp. 370, 378 (Mar. 2011).

[8] See *Route 231 v. Commissioner*, 810 F.3d 247 (4th Cir. 2016) (Virginia tax credits were "property," and a disguised sale by the partnership to the investors based on the 10 listed factors under reg. section 1.707-3 occurred), *aff'g* T.C. Memo. 2014-30 (same); *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011) (reversed Tax Court and held that a disguised sale of property — the tax credits — had occurred), *rev'g*, T.C. Memo. 2009-295 (that was held not a sale based on its reading of the facts); *SWF Real Estate LLC v. Commissioner*, T.C. Memo. 2015-63 (same as the Fourth Circuit cases, *Virginia Historic*, *Route 231*), which treats the formation of a partnership and the allocation of credits to the investor-partners as a taxable sale by the partnership to the investors under reg. section 1.707-6 if there is minimal upside and downside to the investors on the investment.

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