MISSOURI TAX CREDIT REVIEW COMMISSION

Memorandum

Co-Chairs:

Senator Chuck Gross *
Steven J. Stogel

Council Members:

Sen. Matt Bartle
Sen. Jolie Justus
Sen. Robin Wright-Jones
Rep. Tim Flook
Rep. Sam Komo
Zack Boyers
Mark Gardner
Luana Gifford
Bill Hall
Dee Joyner
David Kendrick
Alan Marble
Troy Nash
Melissa Randol
Tom Reeves
Penney Rector
Russ Still
Craig Van Matre
Ray Wagner
Todd Weaver
Shannon Weber
Mike Wood
David Zimmermann

*Not now serving

TO: **Senator Chuck Gross**

FROM: **Tax Law Committee:**
Steven Stogel, Chair
Penny Rector
Russ Still
Ray Wagner

CC: **Chris Pieper**

DATE: **October 28, 2010**

RE: **Tax Law Committee Report**

This Report of the Tax Law Committee of the Missouri Tax Credit Review Commission ("TCRC") focuses on the Federal tax incidences of almost all Missouri tax credits.

Several examples of this not so hidden cost are as follows:

For the Social Credits, there is, for non-AMT federal taxpayers, an increase in their federal tax liability as the Social Credits used reduce state tax liability. This reduction lowers the deduction on the Federal tax return for state taxes "paid". This embedded cost can be as much as 35% of the credit applied. The same result occurs for the MO Low Income Housing Tax Credits, as the credits stream in over ten years.

For Historic Tax Credit, Brownfield Credits and all other certificated and transferable credits, there is among some conflicting IRS guidance, some consensus that these certificates have zero basis and when received and sold by a partnership or other entity earning the credit creates ordinary income.

To mitigate this "federal tax cost" a variety of plans and programs have been deployed, involving expensive and time consuming complexities. Accordingly, as part of the Mission of the TCRC, this Committee is proposing a three prong direct approach to achieve a clear and effective clarification of all federal tax issues on all Missouri credits, all booked on a projected FY 2001 redemption amount of $552,000,000.

Plan 1: The Change of Federal Law Plan

Attached, as Exhibit 1, is a memorandum that details two alternate desired Federal law changes to eliminate the impact of all Federal taxes on State tax credit programs not only in Missouri, but in all States.

For Missouri, this legislative change, if enacted, would easily allow the reduction in awarded credits of up to $120 M +, without then affecting any user, program or project.

The Committee recommends the State follow on with the Congressional delegation to enact new legislation that prevents the federal government from taxation state credits or incentives whether for social programs, economic development or qualifying real estate projects.

Plan 2: The IRS Ruling Plan

Attached, as Exhibit 2, is a memorandum that details an ambiguity in existing interpretative Federal tax law on whether tax credits are capital assets or not.

For Missouri, the IRS Ruling , if requested and granted, as an alternate to Plan 1, would easily allow the reduction in awarded credits of up to $ 80 M +, without then effecting any user, program or project.

The Committee recommends the State immediately proceed to request an expedited Private Ruling request from the Internal Revenue Service on this issue.

Plan 3: The Change of State Law Plan

Attached, as Exhibits 3-A and 3-B, are distinct memorandums that details two State legislative changes that would affect significant savings in the Missouri Historic Tax Credit and the Missouri Low Income Housing Tax Credit, respectively.

For Missouri, if Plans 1 and 2 are not implemented, this fall back position should easily allow a reduction in awarded credits of up to $40 M, at current redemption levels, without effecting any user, program or project.

The Committee recommends the State prepare legislation for enactment in the 2011 Session, if Plan 1 or 2 does not "happen".

Summary

1. To the extent tax credit redemptions drop by 40% to $350,000,000±, the savings under the respective plans will reduce by the same percentages.

2. The Tax Law Committee would like to thank the following professional firms who contributed hours of professional services and counsel in preparation of these Exhibits: (i) Husch Eppenberger, (ii) Bryan Cave, (iii) Rosenblum, Goldenhersh, Silverstein and Zafft, and (iv) Novogradac and Company.

Exhibit 1

TO: Tax Law Committee
Missouri Tax Credit Review Commission

FROM: Steven Stogel
Chair, Tax Law Committee

DATE: October 12, 2010

SUBJECT: Federal Tax Law Changes

The eight states that border Missouri (Illinois, Kentucky, Tennessee, Arkansas, Oklahoma, Kansas, Nebraska and Iowa) all have distinct tax credit programs, totaling, for instance, 153 programs just for economic development. **These local programs all bear the burden of adding a Federal income tax to fiscal investment and use of tax credits.**

The Tax Law Committee of the Missouri Tax Credit Review Commission should recommend that the Federal Government eliminate this Federal income tax "cost" as part of a better national policy that allows each State to dedicate scarce resources in these difficult economic times to promote its own economy as local needs dictate, and to shift part of the budgetary responsibility to stimulate the economy from the Federal Government to the States.

Stated simply, state tax credits now carry up to a 35% Federal tax cost, depending on the format of the state credits and the tax bracket of the donor or investor. In these economic times, that cost can no longer be borne as an embedded cost. So, in order to preserve and maximize these valuable and critical resources for local stimulus programs, and given the declining available "stimulus" help from Washington, it is critical to have the States create capital investment incentives and job creation programs at the most efficient cost, specifically without an embedded Federal tax cost.

Accordingly, the Tax Law Committee should make two distinct recommendations to eliminate this "tax cost":

Recommendation #1: Amend Section 164(a) of the Internal Revenue Code ("Code") to provide for a Federal tax deduction for the use of state tax credits

Current Section 164(a) provides for a Federal income tax deduction for certain state and local taxes that are "paid or accrued" during the taxable year. However, under current law, a state tax credit is treated for Federal income tax purposes as a reduction in the taxpayer's state tax liability and not as a payment of that liability. Accordingly, the state tax credit reduces the amount that the taxpayer would otherwise be entitled to deduct under Section 164.

The Tax Law Committee should recommend amending Section 164(a) to provide that state taxes are "paid or accrued" for purposes of Section 164(a) to the extent the taxpayer transfers cash, property or state tax credits to satisfy its state tax liability. The Federal tax effect of such an amendment would be to increase the deduction for state and local taxes paid because a state tax credit would be viewed as a payment, rather than a reduction, of state tax liability. It is noted that this change would affect only taxpayers not in AMT, as State income taxes are not deductible in the AMT calculus. This change would allow Missouri to either (i) increase the required contribution tax credit match to $3 of donation per $1 of tax credit, or (ii) maintain a $2 donation for 65¢ of tax credits.

Recommendation #2: Add New Section 139D to the Code to provide that amounts realized from the sale of state tax credits are excluded from gross income

State tax credits are often certificated and also are transferable, so a taxpayer may choose to transfer the credit to a third party for cash rather than using the credit to reduce its own state tax liability. The sale of a state tax credit, under current law, results in the realization of Federal taxable gain by the transferor equal to the amount realized upon the sale. The Federal tax on the sale proceeds reduces the effective value of these investment credits.

If a new provision were added as Section 139D to the Code, it could provide that the proceeds from the sale of state tax credits are excluded from the gross income of the transferor. This change would allow Missouri to reduce the investment credit awarded to a business, real estate project or job training program by up to 35¢ and still maintain the full force and effect of this State economic incentive.

Absent the adoption of these recommendations, or similarly effective Federal legislation, it is clear that Missouri faces a substantial redefinition and reduction of these programs, given Missouri's declining General Revenues. Missouri is like virtually all States in this regard at this time.

I note that these two Recommendations will need to go through the regular Congressional processes, including "scoring", but the impact to the Federal budget is minor when compared to the positive impact of allowing each State to utilize its own resources for job creation and increased capital investment, all of which are of incalculable value.

The Tax Law Committee should recommend seeking guidance on how to raise this to a National issue, so the requisite legislation might be enacted yet this year, so the economic power of these tax credits can be continued, and perhaps, increased, thereby benefiting both Missouri and other states, and the national economy.

Exhibit 2

ROSENBLUM, GOLDENHERSH, SILVERSTEIN & ZAFFT, P.C.

ATTORNEYS AT LAW

MERLE L. SILVERSTEIN
GENE M. ZAFFT
CARL C. LANG
RICHARD S. BENDER†
MICHAEL A. MARKENSON
ROGER M. HERMAN
THOMAS A. DUDA
DAVID T. WOODS
DAVID S. LANG††
SEAN P. CLANCY†
JALAINE M. WHEELER
JENNIFER A. MERLO◇

VINCENT R. KREKELER
DAVID G. BENDER†
CHRISTOPHER D. CASTELLANOS
JILL A. SILVERSTEIN
THERESA A. PHELPS†
BRIAN J. BECK

OF COUNSEL
DAVID P. OETTING
BRADLEY J. BRITZMANN◇◇
JOHN J. GAZZOLI, JR.†

STANLEY M. ROSENBLUM
1922-2001

ROBERT S. GOLDENHERSH
1922-2008

PRIMERUS MEMBER

7733 Forsyth Boulevard
Fourth Floor
St. Louis, Missouri 63105-1812
Telephone 314-726-6868
Facsimile 314-726-6786
Website www.rgsz.com

† Also Licensed in Illinois
†† Also Licensed in Florida
◇ Also Licensed in North Carolina
◇◇ Also Licensed in Idaho Washington & Utah

ATTORNEY-CLIENT MEMORANDUM

TO: Steven Stogel

FROM: Rosenblum, Goldenhersh, Silverstein & Zafft, P.C. & Bryan Cave, LLP

DATE: October 28, 2010

RE: Missouri State Tax Credit Review Commission – Seeking New IRS Guidance and Amending I.R.C. §1221 to Make Transferrable State Tax Credits Capital Gain Property

---

Problem: The IRS has issued a chief counsel advice memorandum that the sale of Missouri transferrable tax credits are not the sale of a capital assets[1] and such sales generate ordinary income ("2002 Memorandum").[2] The IRS position is inconsistent with an earlier private letter ruling concluding that the sale of mitigation credits, not held for resale to its customers in the ordinary course, generates capital gain income versus ordinary income ("1996 PLR").[3] This memorandum reviews the flaws of the 2002 Memorandum and the arguments in support that the 1996 PLR approach is the better approach for Missouri transferrable credits.

Impact of IRS Position in 2002 Memorandum. For example, Project Partnership is allocated $1,000,000 of Missouri Historic tax credits ("MO HTC"). Project Partnership sells the MO HTC to Buyer for $.90/credit. The sale generates a $900,000 gain.[4] Under the IRS position, a taxpayer subject to ordinary rates[5] pays a tax of $369,000, netting $531,000. In contrast, if the Project Partnership held the tax credits for an entire year and sold the MO HTC as capital assets, subject to special long-term capital gains rates,[6] the total taxes would be $189,000, netting $711,000. The difference between long term capital gains rates and ordinary rates causes $180,000 of additional federal taxes to result and less equity for the project to receive the benefits of the MO HTC.[7]

---

1 "Capital assets" are defined under I.R.C. §1221. Certain business assets used in a trade or business may be treated as capital assets when sold at a net gain under I.R.C. §1231.

2 See C.C.A. 200211042. (transferrable Missouri Credits are not property for purposes of I.R.C. §1221, and the sale of a right to reduce state tax liability generates ordinary income).

3 See PLR 9612009, Rev. Rul. 92-91, and Rev. Proc. 92-91.

4 Under I.R.C. §1001, the taxpayer realizes gain to the extent the amount realized exceeds the adjusted basis in the property sold ($900,000 – 0 = $900,000). Section 1012 provides generally that the basis of property shall be the cost of the property. Section 1.1012-1(a) defines cost to be the amount paid for the property in cash or other property. Since nothing was paid for the credits to the credit recipient, the taxpayer has a tax basis of $0 per C.C.A. 200211042. The transaction must be a "sale or exchange" under I.R.C. §1222 to receive special capital gains tax rates.

5 $900,000 of ordinary income less 6% Missouri income tax and 35% federal income tax at the highest marginal individual rate.

6 I.R.C. §1(h). Long term capital gains rates are currently 15%.

7 $900,000 x 20% (41%-21%) = $180,000.

Definition of Capital Assets: Section 1221 defines the term "capital asset" as property held by the taxpayer, regardless of the taxpayer's trade or business, unless the property meets one of eight listed exceptions.[8] If read literally, the definition of capital asset would encompass income which Congress did not intend to give the benefit of the lower capital gains tax rate. Consequently, the courts have narrowly interpreted the definition of capital assets.[9] Rather, "the term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year."[10] Accordingly, the U.S. Supreme Court has held that certain interests that are concededly "property" in the ordinary sense are nonetheless not capital assets.[11]

Chief Counsel Memorandum 200211042 In Chief Counsel Memorandum, the Missouri Department of Economic Development asked the Service to rule in part on whether the subsequent sale of Missouri Brownfield Remediation Credit, a transferrable tax credit, was property for purposes of Sections 1221. In its analysis, it noted the courts have considered a variety of factors, including how the rights originated or were acquired; whether the rights can appreciate in value over a period of years as the result of market forces; whether significant investment risks are associated with the transferred rights and included in the transfer. Other factors included: whether the rights were treated as property for federal tax purposes when acquired; whether the rights are incident to, or create an estate in, specific real or personal property that is itself a capital asset; whether the rights represent income already earned or about to be earned; whether a market and a market price exists for the rights; whether the transfer merely substituted the source from which the taxpayer otherwise would have received ordinary income; whether the rights primarily represented compensation for past or future personal services; whether the taxpayer parted with the totality of its rights, or "carved out" a portion in some fashion; and whether it is possible to assign a specific basis to the transferred rights. No single factor or group of factors is dispositive. The ruling concludes that the credits are not property for purposes of Section 1221, rather *they primarily represent the right to a reduction or potential reduction in the holder's tax liability.* While it does not represent compensation for specific services, the Service ruled it "was issued as an incentive for the recipient to engage in remediation activities." Furthermore, "*unlike a right the value of which depends on further exploitation by the holder, the only substantial contingency preventing realization of the value of the remediation tax credit is that the holder (or a potential transferee) incurs a tax liability against which it can be applied.*" According to the CCA, although the credit was not a right to a stream of ordinary income, it "was a right to reductions in tax payments normally deductible from ordinary income." As a transferable asset, the credit has a certain market value that may fluctuate over time depending on the time value of money, the number of taxpayers with Missouri source income and the concentration of that income in a particular number of taxpayers. ; however, as a credit against a state tax liability, it does not materially appreciate or depreciate and can be used at any time for its stated amount by any holder with a tax liability. Finally, the original issuance of the credit was not treated for federal tax purposes as a transfer of property includable in the recipient's income; the recipient has no "tax cost" or other basis in the credit, no investment, and no risk of loss. Balancing these factors, the ruling concludes that the remediation tax credit is not property for purposes of § 1221. Accordingly, the sale of the remediation tax credit by the original recipient resulted in ordinary gain.

Private Letter Ruling 199612009. In PLR 9612009, a public utility asked the Service to rule on the tax consequences from certain transactions related to a state environmental mitigation tax credit program. The state statute provided that the adverse impact of activities affecting wetlands may be offset by the creation and maintenance of mitigation areas or

---

[8] I.R.C. §1221 exceptions include, (i) inventory, (ii) personal property and real property used in a trade or business, (iii) certain copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, (iv) accounts or notes receivable acquired in the ordinary course of trade or business, (v) US Government publications, (vi) any commodities derivative financial instrument held by a commodities derivatives dealer (subject to certain exceptions), (vii) certain hedging instruments, and (viii) supplies used in a trade or business.

[9] See, e.g., Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 52, 53-54 (1955); Commissioner v. P. G. Lake, 356 U.S. 260, 265 (1958); limited by Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988).

[10] Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130, 134 (1960) (citing Burnet v. Harmel, 287 U.S. 103, 106 (1932)).

[11] Hort v. Commissioner, 313 U.S. 28, 61 S. Ct. 757, 85 L. Ed. 1168, 1941-1 C.B. 319 (1941) (unexpired lease); Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 78 S. Ct. 691, 2 L. Ed. 2d 743, 1958-1 C.B. 516 (1958) (oil payment rights).

mitigation banks. The mitigation banking concept allowed for the "banker" (creator of the bank) to receive "credits" by restoring wetlands. As part of the ruling, the Company asked to Service to rule on the tax consequences of the sale of any excess credits.[12] Assuming the Company continued to not be holding mitigation credits primarily for sale to customers in the ordinary course of its trade or business, it recognized capital gain or loss on the sale or exchange of a mitigation credit (to the extent of the difference between the amount realized and Company's adjusted basis in that mitigation credit).

IRS Clarification Needed or Proposed Amendments to Code.

We disagree with the Service's assertion in the 2002 Memorandum that there was no investment in the credits or risk of loss[13] and believe the 1996 PLR is the better answer. Many transferrable credits require specific capital investment to earn credits from the State, and costs are incurred by the taxpayer to apply and obtain credits. The Missouri Low-Income Housing Credit, [14] in particular, is awarded over a ten-year stream to subsidize capital investment and realizes value over a "substantial period of time."[15] We also do not believe that purchased streams of future deductions, the converse of a sale of prior earned income, should be taxed in a similar manner.[16] We recommend that the State encourage the IRS to issue a revenue ruling similar to the 1996 Ruling [17] or request another private letter ruling or similar guidance to reconsider these issues. The federal legislative alternative would be to have Congress amend Section 1221 so that all transferrable state tax credits, which are for designated as part of State general welfare programs and serving other similar purposes, are included in the definition of "capital assets."

---

12 The Service referred to Q&A-4 of Rev. Proc. 92-91 and noted that, generally, a utility will recover its basis on the sale or exchange of an emission allowance. Furthermore, the utility realized capital gain or loss on the sale or exchange of an emission allowance to the extent of the difference between the amount realized and the utility's adjusted basis in that allowance. In its analysis, the Service stated that Q&A-4 of Rev. Proc. 92-91 was applicable to mitigation credits.

13 A logical argument can be made that some costs should be allocable to the credits. To state that there can be no possibility of a risk of loss in the 2002 Memorandum ignores the reality of the times that State budgets are under tremendous fiscal pressure, and issued credits may not necessarily be redeemed.

14 Missouri Revised Statutes §135.350-135.363

15 See Commissioner v. Gillette Motor Transport, Inc and discussion at footnote 10 regarding the nature of a capital asset.

16 Compare Hort v. Commissioner, 313 U.S. 28 (1941) (Payment to lessor of lump sum right to future payments was ordinary income) with Commissioner v. Golonsky, 200 F.2d 72 (3d Cir. 1952) (Payment to lessee to terminate right to leasehold was capital gain). We believe gain from the future deductions of state taxes is closer to Golonsky, where the lessee was paid to terminate a leasehold containing a right to future rent deductions.

17 An IRS revenue ruling is generally deemed more authoritative source than a private letter ruling or chief counsel advice memorandum.

Exhibit 3-A

Memorandum

Bryan Cave LLP
One Metropolitan Square
211 North Broadway
Suite 3600
St. Louis, MO 63102-2750
Tel (314) 259-2000
Fax (314) 259-2020
www.bryancave.com

Date:	October 28, 2010
To:	Steven Stogel Sen. Chuck Gross
From:	Daniel C. White, Bryan Cave LLP Sean Clancy, Rosenblum, Goldenhersh, Silverstein & Zafft, P.C. Carl Lang, Rosenblum, Goldenhersh, Silverstein & Zafft, P.C.
Re:	Missouri State Tax Credit Review Commission: Recommendation to Improve Tax Efficiencies of Missouri Historic Tax Credit (Mo. Rev. Stat. §§ 253.545 -253)

This memorandum outlines certain federal income tax issues creating inefficiency in the Missouri Historic Tax Credit ("MO HTC"), which is available to directly support rehabilitating historic structures, and proposes certain changes to Missouri law to eliminate these inefficiencies. Projects qualifying for the MO HTC require subsidy due to the excess of the costs to rehabilitate and preserve a historic structure over the value of the project upon completion. In the experience of some developers, historic structures are typically sold at 50-60% of their initial rehabilitation cost several years following the rehabilitation. Under present law, a development project that qualifies for MO HTC generates a transferable Missouri tax credit to help subsidize the total costs. While neither the receipt of the credit by the project nor the use of the credit by a project partner generates taxable income, the IRS has ruled that when the project sells the credit, it recognizes ordinary income equal to the selling price.[1]

For a typical taxpayer, $1 million of MO HTC saleable for $900,000 would net only $530,000 to a project.[2] If the seller of the credit is not presently subject to tax (e.g., a corporation with net operating losses), in general, no tax would be due on sale and all $900,000 would be available to the

---

1 See C.C.A. 200211042 (transferrable Missouri Credits are not property, and the sale of a right to reduce state tax liability generates ordinary income).

2 $900,000 of ordinary income less 6% Missouri income tax and 35% federal income tax at the highest marginal corporate or individual rate.

project, less any profit earned by the seller.[3] It is our understanding, in the current environment, that such seller's profit can total 10% of the selling price of the credit. In that case, the $1 million MO HTC would net $810,000 to the project. If substantially all of this profit could be eliminated, an additional $90,000 of incentive is directly available to rehabilitate historic structures.

I. New Legislative Provisions for Missouri Historic Tax Credit

The proposed change to Missouri law would create a supplemental structure to MO HTC. Under the proposal, the project would apply for MO HTC in the same manner provided under current law. The project would negotiate with either a State Agency or the City where the project is located ("Political Subdivision") to set up the following three-party arrangement ("State Agency Approach"):[4]

1. During the application process, Developer and Missouri Department of Economic Development (MO DED), agree that all MO HTC are to be assigned to a Political Subdivision ("Credit Recipient") upon completing the project rehabilitation.
2. If the project properly rehabilitates an appropriate historic structure, the Credit Recipient receives the transferable MO HTC.
3. Credit Recipient sells MO HTC for cash, free of all federal income tax consequences, to syndicators and other taxpayers.[5]
4. Pursuant to the negotiated arrangement, Credit Recipient grants all or a portion of these sales proceeds to a corporate general partner (controlled by Developer), who has elected to be taxed as a Subchapter S corporation,[6] in a transaction that qualifies as a non-taxable non-owner contribution to capital.[7] *See Exhibit #1 for a detailed tax analysis of the non-taxable non-owner contribution to capital issues.*
5. The corporate general partner makes a capital contribution to the project partnership with the grant proceeds on a tax-free basis.[8]
6. The corporate general partner has no basis in its partnership interest in the project partnership.[9]

II. Amendments to Existing Missouri Law

In addition to the changes in Missouri Revised Statutes section 253.545 et seq. to effect the structure illustrated above, Missouri Revised Statutes section 253.557.1 must be amended to permit

---

3 The seller may owe alternative minimum tax from the transaction. These structures may be subject to challenge as lacking economic substance or otherwise. In a recent case, the Tax Court held that one such arrangement was valid. See Virginia Historic Tax Credit Fund 2001, L.P. v. Commissioner, T.C. Memo 2009-295.

4 A tax analysis follows to show how this structure is supported by existing federal tax law. A private ruling is recommended with the IRS to confirm this analysis.

5 I.R.C. §115. As a political subdivision of the State of Missouri, no federal income tax would be generated by the sale under the Tenth Amendment to the US Constitution also.

6 I.R.C. §1361. The S corporation general partner will incur only one level of tax upon its liquidation.

7 See Edwards v. Cuba Railroad Co., 268 U.S. 628 (1925). Internal Revenue Code §118(a). See Exhibit #1

8 I.R.C. §721.

9 I.R.C. §362(e).

non-profit entities as transferors, sellers, or assignors of MO HTC, and Missouri Revised Statutes section 355.131 should be amended to state that a general not-for-profit corporation may conduct any activities that lessen the burdens of government or promote social welfare, including those activities described in this new law.[10]

III. Illustration of Proposed Legislation

The following example provides a basic illustration of the life cycle of a project under the proposed legislation.

A. Capitalization

Developer forms a Subchapter S corporation ("GP Corporation"), and GP Corporation purchases for $1,000,000 a building ("Project"), which has been nominated on the National Register of Historic Places. GP Corporation financed $900,000 of the acquisition with thirty year amortizable loan ("Acquisition Loan") and contributed $100,000 toward the down payment of the purchase price. GP Corporation plans to turn the Project into rental apartments. GP Corporation, along with a Federal Investor, form a limited liability company ("Project Partnership") for the purpose of owning and rehabilitating the Project. GP Corporation contributes the Project subject to the Acquisition Loan to the Project Partnership in exchange for a 1% managing member interest. The Federal Investor owns the remaining 99% limited member interest in Project Partnership in exchange for an investment of $649,440.[11]

Rehabilitation of the Project results in $4,000,000 of qualified rehabilitation expenditures (QRE(s)) for federal historic tax credit and MO HTC purposes. The Project Partnership negotiates with the City of St. Louis to serve as the Credit Recipient. The Credit Recipient agrees to accept the proposal and sells the MO HTC.[12] The proceeds from the sale of the MO HTC are granted to the GP Corporation pursuant to a negotiated Grant Agreement between the DED, City of St. Louis, GP Corporation and Project Partnership.[13] The Grant Agreement specifies the conditions of the grant, including the requirement that all grant proceeds be designated as a permanent part of the capital structure of GP Corporation for investment in the Project Partnership and its use to repay the Acquisition Loan. The Project Partnership obtains a construction loan for $4,000,000 to complete the QRE(s).

B. Receipt of New MO HTC

MO DED issues the MO HTC certificate to the City of St. Louis for $1,000,000.[14] The City of St. Louis sells the MO HTC credit to buyer for $.90/credit for a total of $900,000. Pursuant to the Grant Agreement, the City of St. Louis makes a $900,000 grant to the GP Corporation. The GP

---

10 Political subdivisions will have the option then of using a non-profit corporation to accomplish state objectives.

11 This investment is priced at $0.82 per dollar of federal historic credit projected to be earned by the Project Partnership multiplied by 99%.

12 The City would be exempt from taxation on the income from the sale of the MO HTC under I.R.C. §115(1).

13 In reality, some portion less than all of the credit proceeds would likely be granted. This illustration uses a 100% grant for simplicity only.

14 Equal to 25% credit on $4,000,000 of QRE(s).

Corporation contributes 100% of the $900,000 grant to the Project Partnership. The GP Corporation's basis in the Project Partnership is not increased by the $900,000 grant contributed pursuant to Section 362(c) of the Code.

The Project Partnership applies the $900,000 contribution from the GP Corporation toward the repayment of the Acquisition Loan.[15] The Federal Investor contribution is used to reduce the construction loan, which is then converted into a permanent loan of $3,350,560, which is amortizable over fifteen years and qualified non-recourse financing.[16]

The inside basis of the Project assets after the rehabilitation is $4,200,000.[17] The Project Partnership allocated $200,000 to land and $4,000,000 to depreciable basis. The total outside basis of the Project Partnership interests held by both the Corporation GP and the Federal Investor is $3,272,727, which is the sum of the total capital contributions made less the grant from MO HTC proceeds and the permanent loan. The difference between outside basis and inside basis is $900,000, attributable solely to the grant.

C. Disposition of Project

1. Sale at $3 million

Five years after placing the Project in service the Project Partnership sells the Project.[18] The Project has earned net operating income before depreciation on an annual basis of $125,000 per year ($625,000 over the five year period), which was used to repay principal on the Permanent Loan. At the time of sale, the principal balance on the loan is $2,725,560. Depreciation on an annual basis was approximately $145,455 per year ($727,275 over the five year period).

The Project Partnership sells the Project for $3,000,000, an amount equal to 60% of its total original cost. The Project Partnership recognizes a loss equal to $272,727. The Project Partnership pays off the balance of the construction loan of $2,725,560 and distributes the balance of $274,440 to the Members. Due to adjustments under federal partnership tax rules, the partners will realize a $75,000 gain upon liquidation of their partnership interests.[19] The net gain to the partners after the sale of the Project and the Project Partnership's liquidation is a net loss of $197,725 ($272,727 – 75,000 = $197,727).

This sale scenario illustrates that at this particular sales price, the loss basis from the grant proceeds does result in gain recognized in a sale scenario. In this case, any gain is less than the loss recognized from the sale of the Project. ***At the right selling price after the federal historic tax credit recapture***

---

15 Grant proceeds are applied to non-eligible expenditures to avoid a portion of the federal historic credits being reduced. To the extent a grant is used for qualified rehabilitation expenditures, federal historic credits are generally limited.

16 I.R.C. §465.

17 Equal to $1,000,000 acquisition costs plus $4,000,000 QRE less $800,000 for federal credit basis reduction. See I.R.C. §50(c) (requires basis reduction equal to the federal historic credit claimed).

18 I.R.C. §50(a) (provides a recapture period of five years).

19 I.R.C. §752. Distributions in excess of outside basis of a partnership interest are taxable.

period expires, it is possible that the grant funds excluded under Section 118 will reduce the net capital loss on the project but not ultimately result in net capital gains.

2. Sale at $4 million

The facts are the same as above only the selling price is $4,000,000. In that case, the members recognize $727,273 of gain from the sale of the Project.[20] This additional gain increases the member's basis in their partnership interests by a like amount. Upon the distribution of $1,274,440 to the partners, the same additional outside gain is recognized.

---

20 The net effect of the sale at $4,000,000 (versus $3,000,000) is an additional $1,000,000 of inside partnership gain from the sale of the Project.

EXHIBIT 1
Tax Analysis of Proposed MO HTC Project Contribution Under Section 118 As a Non-Shareholder Capital Contribution

General Rule

In the case of a corporation, capital contributions are not includable in gross income.[21] This exclusion applies equally to capital contributions made by non-shareholders.[22] Amounts that constitute certain "contributions in aid of construction," however, are excluded from the definition of capital contributions and must be included in gross income.[23] In determining whether a transfer of MO HTC proceeds to a corporate recipient are excludable from gross income as a non-shareholder contribution to capital, the taxpayer must show that (i) the payment is not a Contribution In Aid of Construction or other contribution "as a customer or potential customer" and (ii) the payment otherwise falls within the definition of "contribution to capital" for purposes of Section 118(a). Courts and the Service consistently adhere to this two-step analytical framework.[24]

A. Contributions In Aid of Construction or Other Contribution as a Customer or Potential Customer

The 1986 legislative history of Section 118(b) provides that Congress subjected Contributions In Aid of Construction to current taxation because they were viewed as a form of prepayment for future services that the taxpayer would eventually provide to its customers.[25] The legislative history underlying the 1954 enactment of Section 118(a) similarly focuses on payments providing intangible benefits other than as a "payment for future services."[26] Neither the Code, nor the Regulations, define a Contribution In Aid of Construction payment for the benefit of "a customer or potential customer." Instead, the 1986 legislative history notes that a taxpayer is considered to have received property to encourage the provision of services for the payor's benefit if the transfer (i) is a prerequisite to the provision of services, (ii) results in the provision of services earlier than would be the case had the property not been received, or (iii) otherwise causes the transferor to be favored in any way. On the other hand, where it is clearly shown that the benefit of the public as a whole was the primary motivating factor in the transfer, the payment is not treated as a Contributions In Aid of Construction "as a customer or potential customer."[27] Transfers of MO HTC proceeds to a corporate general partner of a qualifying project partnership promote the general public welfare and do not to benefit the State as a customer or potential customer for a specific project or purpose.

---

21 I.R.C. §118(a).

22 Treas. Reg. §1.118-1.

23 I.R.C. §118(b).

24 See *James L. Atkinson, "IRS Increase Scrutiny of Section 118 Abuse," Tax Executive (Fall 2008).*

25 H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 644 (1985), 1986-3 (vol. 2) C.B. 644-45 ("House Report").

26 S. Rep. No. 83-1622, 83d Cong., 2d Sess. 18-19 (1954), H.R. Rep. No. 83-1337, 83d Cong., 2d Sess. 17 (1954).

27 House Report at 644. For example, payments to bury utility lines as part of a city beautification program were held not to contribution in aid of construction. See PLR 200248014 (August 22, 2002). Compare PLR 200542001 (July 6, 2005) (payment was a contribution in aid of construction as it enabled developer to get permit and service customers).

B. Contribution to Capital of a Corporation

Once the taxpayer has shown that a receipt is not a Contribution In Aid of Construction, exclusion from gross income requires that the receipt also meet the definition of "contribution to the capital of a corporation" for purposes of Section 118(a). While this standard is not defined by statute or regulation, courts and the IRS have developed a largely factual analysis.

1. Case Law and IRS Position

The standard now used in applying Section 118(a), first appears in the Supreme Court's 1973 decision in United States v. Chicago, Burlington, & Quincy Railroad Co.[28] There, the Court was asked to address whether a railroad had received an accession to wealth when it received from the government certain devices and improvements intended to improve railroad safety and to better protect the public. For example, the railroad received without charge highway crossings, bridges, signs, and crossing signals. In analyzing whether the receipt represented a non-taxable contribution to capital, the Court noted that non-taxable capital contributions typically share five characteristics. These factors have come to be known as the "Chicago, Burlington, & Quincy Railroad Co. Test" and are the principal standard for determining whether a payment is excludible from gross income under Section 118(a). Under this test: (a) the payment must become a permanent part of the transferee's working capital structure; (b) the payments must not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee; (c) the payment is "bargained for"; (d) the asset transferred foreseeably must result in a benefit to the transferee in an amount commensurate with its value; and (e) the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect. The Chicago, Burlington, & Quincy Railroad Co. Test is frequently analyzed as five discrete considerations, each of which must be satisfied in order for a receipt to qualify for exclusion from income under Section 118(a).[29] In reality, the factors often appear to be little more than result-driven support for whatever conclusion the decision maker has already reached designed to uncover the payor's subjective intent in making the payment than it is any of the individual factors.[30] The

---

28 412 U.S. 401 (1973). See also, Atkinson at footnote 25. The roots of the capital contribution doctrine generally are traced to the United States Supreme Court's 1925 decision in Edwards v. Cuba Railroad Co., 268 U.S. 628 (1925). In analyzing this issue, the Supreme Court largely focused on the nature of the payment. In Cuba Railroad, the Court employed an objective functional-use test focusing on the manner in which the cash and property was used. Subsequently, the Court shifted to a more subjective analysis, focusing instead on the donor's motivation in making the payment. The Supreme Court found in Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950), that payments by local civic organizations to induce a manufacturer to retain or expand its presence in the community were intended to benefit the community at large, rather than providing a direct and measurable benefit to the specific payors.

29 See, e.g. Deason v. Commissioner, 590 F.2d 1377 (5th Cir. 1979) (holding a receipt as taxable when one of the five factors was not satisfied).

30 See Atkinson, at footnote 25. For example, the first and second factors arguably both probe the distinction between an addition to the corporation's capital and a more transitory payment constituting ordinary income. Similarly, the fourth and fifth factors seem to test whether the payment has the sort of long-term utility to the recipient's trade or business that would be expected of an addition to capital as opposed to payment of a current operating expense. Even the courts frequently are unsure how to apply the Chicago, Burlington, & Quincy Railroad Co. Test, particularly in the context of government grants. In Coastal Utilities, the court

intent appears to be whether the payment was added to the recipient's capital rather than to surplus, suggesting that the funds were to be used for some form of long-term improvement in the company's capital structure rather than to pay current operating costs.[31] In analyzing the Chicago, Burlington, & Quincy Railroad Co. Test, the IRS Large and Mid-Size Business division ("LMSB") has designated "Section 118 abuse" a Tier I issue in LSMB Industry Directive #4.[32] LSMB Industry Directive #4 seeks to curb a corporate tax strategy that has been marketed for the federal tax treatment of state and local tax incentives.[33]

2. Application of State Agency Approach for Missouri Historic Grants

Our facts are distinguishable from those facts described in LSMB Industry Directive #4 because we are dealing with cash transfers from the state and not using Section 118 to exclude state tax credits or taking income tax deductions for amounts already satisfied with state tax credits. A corporate general partner should be able to exclude the cash proceeds that it uses to finance acquisition of or capital improvements in a project partnership owning the historic structure under Section 118. First, there is a bargain element to the three-party arrangement from the outset and having multiple Political Subdivisions participating in the process could lend more than one option to Developer. Second, the MO HTC program is a general welfare program designed to preserve historic communities generally and facilitate capital improvements. To ensure Section 118 treatment though, the new statute needs to limit grant funds so they are not construed by the IRS as unrestricted in use or serve as an income replacement. The State could require contractual agreements with each of grant recipients, with representations and warranties as to how historic grant funds must be earmarked for reimbursement for capital costs. Another possibility might be to authorize the creation of a special type of statutory corporation to serve as a corporate general partner, which could receive grants for a project partnership. The legislature could build in

---

largely admitted that it did not know how to apply the Chicago, Burlington, & Quincy Railroad Co. Test generally and the "bargained for" factor in particular and, as such, simply reached what it felt was the correct answer under Section 118(a), treating the Chicago, Burlington, & Quincy Railroad Co. Test more as suggested considerations rather than as a hard-and-fast rule.[30]

31 See Atkinson, at footnote 25. Recently, the Service has seemingly placed heightened importance on this factor, even suggesting that, unless the use of the receipt was expressly limited to some form of capital investment or improvement, it is ineligible for exclusion under Section 118(a). The Service has suggested that if a receipt's use is unlimited, such that it could be used to pay current operating expenses, dividends, or any other permissible corporate purpose, the company fails this component of the Chicago, Burlington, & Quincy Railroad Co. Test and must recognize the payment as income. Rev. Rul. 2007-31, 2007-21 I.R.B. 1275; Coordinated Issue Paper, "State and Local Location Tax Incentives" (LMSB-04-0408-028 (May 23, 2008).

32 Some Tier I issues have received those designations largely because of the complex and novel but not necessarily abusive issues they present. Others, however, are being treated as akin to tax shelters or inherently abusive transactions.

33 Under this strategy, the corporation maintains that, rather than following the form of the transaction and reducing its I.R.C. § 164 deduction for state taxes paid by the amount of the incentive, for federal tax purposes, it should treat the incentive as a capital contribution from the state or local government coupled with a deemed payment of tax to the government. The corporation claims an I.R.C. § 164 deduction for the amount of taxes that would have been owed absent the incentive, and asserts that the incentive amount is an accession to wealth which is nevertheless excludable from income as a non-shareholder contribution to capital under I.R.C. § 118. The taxpayer then reduces its basis in property (which may be land) by the amount of the tax incentive under I.R.C. § 362(c).

provisions for the grant recipients being accountable to the public, such as requiring an advisory board of members of the community to serve on the corporation's board of directions.[34]

[34] This is similar to the current structure found in the Federal New Market Tax Credit under Section 45D of the Code. Although the State could use existing business entities to accomplish these same goals, by requiring a special corporate form for participation in the programs by affiliate grant recipients, it would be hard for the IRS to claim that the participation of a corporate general partner (the grant recipient) in a project partnership was purely for federal income tax purposes, as state law would serve as an independent justification for its form. The IRS and recent tax legislation by Congress has been placing much more emphasis on independent business justifications for tax and syndication structures. See for example, IRC Section 6700.

Exhibit 3-B

Memorandum

Bryan Cave LLP
One Metropolitan Square
211 North Broadway
Suite 3600
St. Louis, MO 63102-2750
Tel (314) 259-2000
Fax (314) 259-2020
www.bryancave.com

Date:	October 28, 2010
To:	Steven Stogel Sen. Chuck Gross
From:	Daniel C. White, Bryan Cave LLP Sean Clancy, Rosenblum, Goldenhersh, Silverstein & Zafft, P.C. Carl Lang, Rosenblum, Goldenhersh, Silverstein & Zafft, P.C.
Re:	Missouri State Tax Credit Review Commission: Recommendation to Improve Tax Efficiencies of Missouri Low Income Housing Tax Credit (Mo. Rev. Stat. §§ 135.350 - .363)

This memorandum outlines certain federal income tax issues creating inefficiency in the Missouri Low Income Housing Tax Credit ("MO LIHTC"), which is available to directly support the provision of affordable housing located in the State of Missouri "State" and proposes certain changes to Missouri law to eliminate these inefficiencies. Projects qualifying for the MO LIHTC require subsidy due to the rent restrictions imposed on the completed projects to provide for affordable housing. Under present law, a project owned by a partnership that qualifies for MO LIHTC must allocate the credit to a partner in the project partnership. The allocatee, typically a syndicator, usually transfer it to the ultimate end using taxpayer.[1] As a general rule, the transfer of the credit usually results in ordinary income to a syndicator/transferor.[2]

While not related to federal income tax, other inefficiencies in the MO LIHTC are created by the fact that the credit is available in ten equal annual installments and the credits are subject to recapture for a ten-year period.[3] According to the Missouri State Auditor, the project only receives

---

1 See Missouri Revised Statutes §135.363.1. The allocatee could utilize the credit itself, though in our experience this is the less common structure.

2 Cf. C.C.A. 200211042. (transferrable Missouri Credits are not property, and the sale of a right to reduce state tax liability generates ordinary income). This would not result if the syndicator sells its entire partnership interests to the end user. I.R.C. §741.

3 Missouri Revised Statutes §135.355.2.

$0.35 for every $1.00 of tax credit granted.[4] Starting in 2010, MHDC requires a minimum $0.40 capital contribution for every dollar of credit granted.[5]

If a partnership interest entitled to MO LIHTC is purchased by a syndicator and the credits are resold to an end user, further federal income tax inefficiencies arise. If the syndicator sells a portion of the interest in the project partnership, the syndicator may recover a portion of its tax basis in the acquired partnership interest.[6] However, the end user is not entitled to recover basis when the MO LIHTC is utilized against its Missouri tax liability because the partnership interest has not been sold.[7] If the end user sells the interest, it likely results in a capital loss which is of limited value since it may only be offset against capital gain.[8]

These inefficiencies are best illustrated in an example. Assume a project is awarded $1 million of MO LIHTC, which are realized at a rate of $100,000 per year over ten years. A State Tax Credit Investor invests $400,000 into the project to receive the right to 100% of the MO LIHTC over ten years. Assume the State Tax Credit Investor sells the first-year credit amount for $70,000 and nets $41,300 after income taxes.[9] If the State Tax Credit Investor is not presently subject to tax (e.g., a corporation with net operating losses), the entire $70,000 would be retained.[10] If the tax cost from the sale of the credits were eliminated, there would be additional equity available for the project.[11] It is important to note in this example that the State Tax Credit Investor is not able to offset a significant portion of gain from the sale of the MO LIHTC against any of its initial $.40 per credit investment unless a portion of its partnership interest is sold in the same year that the MO LIHTC are sold.[12] In each instance when a partnership interest is sold, the losses are capital, not ordinary.

---

4 Missouri Auditor's Report No. 2008-23, Analysis of Low Income Housing Tax Credit Program (April 2008)

5 2011 Developer's Guide to MHDC Multi-Family Programs, pg. 28.

6 A syndicator would need to sell a portion of its partnership interest as MO LIHTC may only be sold to an owner with an interest in the Project. Upon a sale of said interest, the syndicator normally realizes a capital loss upon the sale of the partnership interest. I.R.C. §741. See also Pollack v. Commissioner, 69 T.C. 142 (1977), (sale of a limited partnership interest acquired to carry out ordinary income activities generated a capital loss upon a sale).

7 The end user that uses the credit to satisfy a tax liability does recover basis in the purchased credit at the time it is utilized to satisfy a tax obligation.

8 Although capital gains may offset capital losses, a taxpayer is only allowed to recognize a net capital loss of no more than $3,000 in a single tax year. I.R.C. §1211.

9 $70,000 of ordinary income less 6% Missouri income tax and 35% federal income tax at the highest marginal corporate or individual rate is $41,300. Note: Currently, Missouri Revised Statutes §135.363.1 requires the buyer to purchase a direct or indirect interest in the project partnership. Normally, a nominal partnership interest is purchased to satisfy this statutory requirement. See footnote 5.

10 The seller may owe alternative minimum tax from the transaction. These structures may be subject to challenge as lacking economic substance or otherwise. In a recent case, the Tax Court held that one such arrangement was valid. See Virginia Historic Tax Credit Fund 2001, L.P. v. Commissioner, T.C. Memo 2009-295.

11 An $28,700 per year over ten years discounted using a present value would result in higher capital contributions per dollar of credit.

12 A capital loss may be realized to the extent an interest was sold to a buyer to satisfy the requirements of Missouri Revised Statutes §135.363. But, this is normally a nominal amount in such case.

I. New Legislative Provisions for Missouri Low Income Housing Tax Credit

The proposed change to Missouri law would make MO LIHTC a transferable tax credit[13]. Under the proposal, the project would apply for MO LIHTC in the same manner provided under current law. The project would negotiate with either a State Agency or the City where the project is located ("Political Subdivision") to set up the following three-party arrangement ("State Agency Approach"):[14]

1. During the application process, Developer and Missouri Housing Development Commission (MHDC), agree that all MO LIHTC are to be assigned to a Political Subdivision ("Credit Recipient") upon completing the project.
2. If the project properly constructs the affordable housing, the Credit Recipient receives the transferable MO LIHTC.
3. Credit Recipient sells MO LIHTC for cash, free of all federal income tax consequences, to syndicators and other taxpayers.[15]
4. Pursuant to the negotiated arrangement, Credit Recipient grants all or a portion of these sales proceeds to a corporate general partner (controlled by Developer) who has elected to be taxed as a Subchapter S corporation,[16] in a transaction that qualifies as a non-taxable, non-owner contribution to capital.[17] *See Exhibit #1 for a detailed tax analysis of the non-taxable non-owner contribution to capital issues.*
5. The corporate general partner makes a capital contribution to the project partnership with the grant proceeds on a tax-free basis.[18]
6. The corporate general partner has no basis in its partnership interest in the project partnership.[19]

For an illustration of how these modifications would apply to an existing project, please see the example set forth in the recommendation to the modification of the Missouri Historic Tax Credit, dated as of the date hereof.

II. Amendments to Existing Missouri Law

In addition to the changes in Missouri Revised Statutes section 135.350 to 135.363 to effect the structure illustrated above, Missouri Revised Statutes section 135.350 must be amended to permit non-profit entities as transferors, sellers, or assignors of MO LIHTC. Missouri Revised Statutes

13 This proposal otherwise works in the same manner, whether the ten-year timing of the receipt of MO LIHTC is the same as under present law or if all credits are available when the project is placed in service. Likewise, it would work the same whether or not the revised MO LIHTC is subject to recapture.

14 A tax analysis follows to show how this structure is supported by existing federal tax law. A private ruling is recommended with the IRS to confirm this analysis.

15 I.R.C. §115. As a political subdivision of the State of Missouri, no federal income tax would be generated by the sale under the Tenth Amendment to the US Constitution also.

16 I.R.C. §1361. The S corporation general partner will incur only one level of tax upon its liquidation.

17 See Edwards v. Cuba Railroad Co., 268 U.S. 628 (1925). Internal Revenue Code §118(a). See Exhibit #1

18 I.R.C. §721.

19 I.R.C. §362(e).

section 355.131 should also be amended to state that a general not-for-profit corporation may conduct any activities that lessen the burdens of government or promote social welfare, including those activities described in this new law.[20] We recommend that Missouri Revised Statutes §135.355(2), related to recapture, be repealed (prospectively and retrospectively) to facilitate future transfers of the MO LIHTC in the certificate form.[21]

III. Effect on Currently Outstanding MO LIHTC

Because the MO LIHTC is currently available over ten years, partnership interests are held today that are entitled to up to 9 years of future tax credits. In order not to devalue these interests in the hands of the current holders, these credits should be transferable and if any recapture risk is eliminated, this should also apply. If the existing holder of the partnership interest is a syndicator or end user (other than an end user who purchased the credits directly), the holder should be permitted to tender to the state a partnership interest entitled to the credits to satisfy a Missouri tax liability in the same manner as tendering the credits themselves. The State and the Project Partnership would then cancel the tendered interest for a nominal sum. In the alternative, the State could sell the interest to the general partner or managing member or their designee. Upon the tender of the partnership interest, the taxpayer would be permitted to recover basis in the interest. There is a risk that a capital shift occurs, resulting in taxable income to the other partners in the Project Partnership in an amount equal to the capital account of the interest that is cancelled.[22] We believe the better answer is that there is no income recognized by the other partners or that the amount of the income recognized is based on the proportionate value of the interest surrendered after the MO LIHTC has been utilized because there is no concurrent section 721 transaction.

---

20 Political subdivisions will have the option then of using a non-profit corporation to accomplish state objectives.

21 Low-income housing projects receiving MO LIHTC will also be receiving federal low-income housing credits under I.R.C. §42. We believe that the federal tax recapture rules create enough incentive to protect project compliance for state purposes.

22 See Treas. Reg. §1.721-1(b)(1).