

Allocations of Tax Credits

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Overview

It is impossible to evaluate whether or not a tax credit was properly allocated without first understanding the nature of the credit, the nature of the debt being used to finance the property (recourse or nonrecourse), and the complex rules of IRC section 704(b) concerning economic effect, substantiality, and the allocation of non-recourse deductions. A basic understanding of the principles presented in this chapter is necessary in order to determine if the allocation of credits should be respected.

The Tax Code has numerous provisions for tax credits. The credits most commonly seen in the partnership context are the low-income housing credit under IRC section 42 and the rehabilitation tax credit under IRC section 47. The rehabilitation credit is part of the investment tax credit. Both the investment tax credit and the low-income housing credit fall under the IRC section 38, General Business Credit.

The regulations treat the allocation of the investment tax credit (which includes the rehabilitation credit) differently from other credits. For this reason, the allocation of the rehabilitation credit will be discussed separately.

TAX CREDITS IN GENERAL

In general, tax credits do not impact the partner's capital account. They,

therefore, have no effect on the dollar entitlements of the partners in terms of cash distributions or cash upon liquidation. Thus, an allocation of a credit cannot have substantial economic effect and must be allocated according to the partners' interests in the partnership.

There is no specific, mechanical, safe harbor for allocating tax credits. The regulations state that if a partnership expenditure that gives rise to a tax credit also gives rise to valid allocations of loss or deduction, then the credit will be allocated in the same manner as the loss or deduction which decreases the partners' capital accounts. The regulations also state that identical principles apply with credits that arise from gross receipts of the partnership. Treas. Reg. section 1.704-1(b)(4)(ii).

Example 1

Development Corp., a real estate developer, is a partner in a low-income housing partnership. The other partner is an investment partnership. Profits and losses are split 50/50, with the depreciation and low income housing credit specially allocated 99 percent to the investment partnership and 1 percent to Development Corp. The debt is recourse debt from an unrelated lender and both partners are general partners. Assume that the partnership's allocation of depreciation, 99 percent to the investment partnership, has substantial economic effect under IRC 1.704-1.

Since a partnership expenditure gives rise to the tax credit (the building's qualified basis) also give rise to a valid allocation of partnership deduction (depreciation) which reduces the capital accounts, the allocation of tax credit 99 percent to the investment partnership partner will be respected.

In the above example, the allocation of credit is respected because its associated allocation of depreciation deduction is respected. The allocation of credit

parallels the allocation of depreciation.

In analyzing whether or not credits are properly allocated, it is critical to determine if the “other valid allocation” to which the credit is tied is to be analyzed using the economic effect rules of Treas. Reg. section 1.704-1(b)(2) or the rules in Treas. Reg. section 1.704-2 concerning the allocation of non-recourse deductions.

In the above example, if the debt were non-recourse, the depreciation deductions would lack economic substance to the extent that they were attributable to the debt because no partner bears the economic risk of loss for them. Non-recourse deductions must be allocated either in accordance with the partners’ interests in the partnership under Treas. Reg. section 1.704-1(b)(3) or under the safe harbor non-recourse deduction provisions under Treas. Reg. section 1.704-2(e).

The second requirement of the non-recourse safe harbor presents an area of concern in evaluating the allocation of a tax credit in a non-recourse context. This consistency requirement stipulates that allocations of non-recourse deductions are allocated in a manner that is reasonably consistent with some other “significant” partnership item (other than a minimum gain chargeback) having substantial economic effect. This item must be attributable to the property securing the non-recourse debt.

Example 2

The facts are the same as in Example 1, but the debt is non-recourse debt. The partnership agreement meets the non-recourse debt safe harbor under Treas. Reg. section 1.704-2(e). The partnership agreement calls for allocating depreciation in accordance with the allocation of a significant partnership item that has both substantial economic effect and related to the property secured by the non-recourse debt. The allocation of the credit in accordance with the allocation of depreciation will be respected.

Banks often become investors in low income housing partnerships. If a bank acts as a non-recourse lender in addition to being a partner, the bank is considered to bear the economic risk of loss to the extent that the liability is not borne by another partner. Treas. Reg. section 1.752-2(c) (1).

Example 3

A real estate development corporation and a bank form a partnership to develop low-income housing. The bank acts as the lender and provides non-recourse financing. The partnership agreement calls for profits and losses to be split equally with all of the depreciation and credit being allocated to the bank. In this case, the special allocation of depreciation and tax credit to the bank would be evaluated under the economic effect rules since the bank bears the economic risk of loss. If the partnership agreement adheres to the requirements economic effect (Treas. Reg. section 1.704-1(b)(2)(ii)(b)), and if there is no substantiality problem, the special allocations to the bank will be respected.

REHABILITATION CREDIT

Unlike the low-income housing tax credit, the rehabilitation tax credit does have an impact on the partners' capital accounts. The partnership must reduce the depreciable basis of the building by the amount of the rehabilitation tax credit. Similarly, a partner must reduce his capital account by his ratable share of the rehabilitation tax credit.

The rule for allocating the rehabilitation tax credit is found in Treas. Reg. section 1.46-3(f)(2). The general rule is that each partner's share of the rehabilitation costs is based on the general profit ratio of the partnership. This ratio should reflect the partners' real economic sharing arrangement.

The exception to the general rule is that a special allocation is possible if:

1. All related items of income, gain, loss, and deduction with respect to the property are specially allocated in the same manner and
2. Such allocation is either made in accordance with the partner's interest in the partnership or has substantial economic effect.

Example 3 in Treas. Reg. section 1.46-3(f)(3) discusses a partnership engaged in the business of renting equipment whose cost qualified for the investment tax credit. Under the partnership agreement, the income, gain or loss on disposition, depreciation and other deductions attributable to the equipment are specially allocated 70 percent to one partner and 30 percent to the other partner. The conclusion is that if this

allocation is made in accordance with the partners' interests in the partnership or has substantial economic effect, the cost of the equipment (and therefore the tax credit) will be taken into account 70 percent by one partner and 30 percent by the other partner.

These regulations do not permit the flexibility of separately allocating items being generated by the same property. It would not be possible to sever the depreciation and credits from other items of deduction or income being generated by the same property. All related items of income gain, loss, and deduction from a particular property must be allocated together. Additionally, such allocation must meet the other requirements of IRC section 704(b).

Example 4

A real estate professional and a bank form a partnership to rehabilitate and rent a historic building. The bank is also acting as the partnership's lender. The bank is to receive 99 percent of the depreciation deductions and 99 percent of the rehabilitation credit. All other profits and losses are to be split 50/50. The partnership will maintain capital accounts in accordance with the regulations, positive capital account balances will be respected upon liquidation, and the partnership agreement contains an unlimited deficit restoration agreement. The debt is recourse debt.

In this example, the allocation of the tax credit 99 percent to the bank will not be respected because a) it is not in accordance with the general profit sharing ratio of the partnership and b) the income, loss, and deductions are not allocated in the same manner. The credit will be reallocated in accordance with the partners' interest in the partnership (50 percent each).