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CLIENT ALERT

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Use of Tax Credits Clarified

As part of the Reconciliation Act of 2010, in combination with the Patient Protection and Affordable Care Act (collectively the "Act"), Congress codified the long standing judicial "economic substance doctrine" with the enactment of new Internal Revenue Code §7701 (o). Under the economic substance doctrine, a taxpayer is entitled to the tax benefits from a transaction only if 1) the transaction changes the taxpayer's economic position in a meaningful way, and 2) the taxpayer has a substantial non-federal income tax purpose for entering into the transaction. The codification of the economic substance doctrine had been previously proposed for years as a method of deterring tax shelters.

A lingering question has been whether a transaction that generated substantial tax credits, but little or no potential for economic gain, would be subject to application of the economic substance doctrine. We now have some guidance. The Joint Committee on Taxation explanation of the Act's codification of the economic substance doctrine provides that the economic substance doctrine is not meant to disallow tax credits as long as the taxpayer is undertaking the type of investment Congress intended to encourage with the credits:

> "If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed. See, e.g., Treas. Reg. sec. 1.269-2, stating that characteristic of circumstances in which an amount otherwise constituting a deduction, credit, or other allowance is not available are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate. Thus, for example, it is not intended that a tax credit (e.g., section 42 (low-income housing credit), section 45 (production tax credit), section 45D (new markets tax credit), section 47 (rehabilitation credit), section 48 (energy credit), etc.) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage." Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," As Amended, in Combination with the Patient Protection and Affordable Care Act, JCX-18-10, March 21, 2010, 150 fn. 344 (the "Technical Explanation of the Act").

There was little guidance previously on whether or how the judicial economic substance doctrine would be applied in the tax credit area. For low-income housing tax credits, Treasury Regulation §1.42-4 provides some relief by stating that the credits will not be disallowed under Internal Revenue Code § 183. Internal Revenue Code § 183, which applies to individuals and S corporations (and is interpreted to also apply to partnerships), denies deductions for any activities not engaged in for profit. However, Treasury Regulation §1.42-4 states that low-income housing tax credits may be disallowed under other principles, noting economic substance as an example.

Other tax credits, such as rehabilitation, new markets and energy tax credits do not have an equivalent of Treasury Regulation §1.42-4 to provide any relief. Nevertheless, the Ninth Circuit in Sacks v. Comm'r, 69 F.3d 982, 991 (9th Cir. 1995), stated that the economic substance doctrine should not apply to deny energy credits since Congress enacted the credits to encourage the very transactions that generated the credits. But neither Congress nor the Internal Revenue Service issued firm guidance as to the application of the economic substance doctrine to tax credits.

With the new guidance in the Technical Explanation of the Act, taxpayers should be able to enter into credit transactions with the knowledge that the credits will be allowed even if the transaction is otherwise not profitable, so long as the investment is the type Congress intended to encourage. Tax credits, such as low-income housing tax credits, new markets tax credits, rehabilitation credits, and energy credits, are Congressionally enacted incentives to encourage taxpayers to enter into activities that, without such tax credits, may otherwise not be economically feasible for the taxpayers to undertake. The Technical Explanation of the Act should therefore give taxpayers engaged in tax credit transactions a level of comfort that the transactions will not be attacked under the economic substance doctrine.

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