United States Court of Appeals

for the

Third Circuit

Case No. 11-1832

HISTORIC BOARDWALK HALL, LLC, NEW JERSEY SPORTS AND EXPOSITION AUTHORITY, TAX MATTERS PARTNER,

– v. –

COMMISSIONER OF INTERNAL REVENUE,

Appellant.

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BRIEF FOR PETITIONER-APPELLEE NEW JERSEY SPORTS AND EXPOSITION AUTHORITY, TAX MATTERS PARTNER

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United States Court of Appeals for the Third Circuit

Corporate Disclosure Statement and Statement of Financial Interest

No. 11-1832

New Jersey Sports & Exposition Authority,

Appellee,

v.

Commissioner of Internal Revenue,

Appellant.

Instructions

Pursuant to Rule 26.1, Federal Rules of Appellate Procedure any nongovernmental corporate party to a proceeding before this Court must file a statement identifying all of its parent corporations and listing any publicly held company that owns 10% or more of the party's stock.

Third Circuit LAR 26.1(b) requires that every party to an appeal must identify on the Corporate Disclosure Statement required by Rule 26.1, Federal Rules of Appellate Procedure, every publicly owned corporation not a party to the appeal, if any, that has a financial interest in the outcome of the litigation and the nature of that interest. This information need be provided only if a party has something to report under that section of the LAR.

In all bankruptcy appeals counsel for the debtor or trustee of the bankruptcy estate shall provide a list identifying: 1) the debtor if not named in the caption; 2) the members of the creditors' committee or the top 20 unsecured creditors; and, 3) any entity not named in the caption which is an active participant in the bankruptcy proceedings. If the debtor or the bankruptcy estate is not a party to the proceedings before this Court, the appellant must file this list. LAR 26.1(c).

The purpose of collecting the information in the Corporate Disclosure and Financial Interest Statements is to provide the judges with information about any conflicts of interest which would prevent them from hearing the case.

The completed Corporate Disclosure Statement and Statement of Financial Interest Form must, if required, must be filed upon the filing of a motion, response, petition or answer in this Court, or upon the filing of the party's principal brief, whichever occurs first. A copy of the statement must also be included in the party's principal brief before the table of contents regardless of whether the statement has previously been filed. Rule 26.1(b) and (c), Federal Rules of Appellate Procedure.

If additional space is needed, please attach a new page.

Pursuant to Rule 26.1 and Third Circuit LAR 26.1, NJ Sports & Exposition Authority makes the following disclosure: (Name of Party)

1) For non-governmental corporate parties please list all parent corporations:

N/A: Appellee is a political subdivision of the State of New Jersey.

2) For non-governmental corporate parties please list all publicly held companies that hold 10% or more of the party's stock:

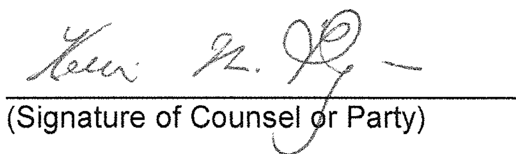
N/A: see 1, above.

3) If there is a publicly held corporation which is not a party to the proceeding before this Court but which has as a financial interest in the outcome of the proceeding, please identify all such parties and specify the nature of the financial interest or interests:

Pitney Bowes invested with the New Jersey Sports & Exposition Authority in a partnership that is the subject matter of this proceeding.

4) In all bankruptcy appeals counsel for the debtor or trustee of the bankruptcy estate must list: 1) the debtor, if not identified in the case caption; 2) the members of the creditors' committee or the top 20 unsecured creditors; and, 3) any entity not named in the caption which is active participant in the bankruptcy proceeding. If the debtor or trustee is not participating in the appeal, this information must be provided by appellant.

N/A



(Signature of Counsel or Party)

Dated: 5/12/11

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In The
United States Court of Appeals
For The Third Circuit

HISTORIC BOARDWALK HALL, LLC,
NEW JERSEY SPORTS AND EXPOSITION AUTHORITY,
TAX MATTERS PARTNER,

Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant.

On Appeal FromThe Decision
Of The United States Tax Court

BRIEF FOR APPELLEE

STATEMENT OF JURISDICTION

On February 22, 2007, the Internal Revenue Service (the "IRS") issued a Notice of Final Partnership Administrative Adjustment (the "FPAA") to the New Jersey Sports and Exposition Authority ("NJSEA"), the tax matters partner for the Historic Boardwalk Hall, LLC ("HBH"). (JA142-51)[1]. *See* Internal Revenue

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[1] In this brief, the Joint Appendix and trial transcript will be cited as "JA" and "Tr.", respectively.

Code ("I.R.C." or the "Code") (26 U.S.C.) §§ 6223(a)(2), 6231(a)(7).[2] NJSEA filed a timely petition for readjustment of the FPAA with the United States Tax Court on May 21, 2007. *See* I.R.C. § 6226(a)(1).

On January 3, 2011, the Tax Court issued its decision and opinion in favor of HBH on all issues raised in the FPAA. (JA3-64). *See* I.R.C. §§ 7459(a) and (b). The IRS filed a notice of appeal to the decision on March 29, 2011. (JA1-2). *See* I.R.C. § 7483. This Court has jurisdiction of this appeal under I.R.C. § 7482(a)(1).

STATEMENT OF THE ISSUES

The historic rehabilitation tax credit contained in I.R.C. § 47 was first enacted by Congress decades ago with the express purpose of stimulating private investment in the preservation and renovation of our nation's historic structures. Notwithstanding the clear statement of Congressional intent in sanctioning and encouraging the credit, the IRS, in its FPAA, attacked the allocation of the credit in a renovation project involving HBH, NJSEA, and PB Historic Renovation, LLC ("PBHR") on four grounds. Specifically, the IRS asserted that: (i) HBH was a sham and lacked economic substance; (ii) PBHR was not a *bona fide* partner in HBH; (iii)

[2] Unless otherwise indicated, "I.R.C" references herein are to the Internal Revenue Code of 1986, as amended.

the benefits and burdens of the ownership of the Historic Boardwalk Hall (sometimes referred to herein as the "East Hall" or the "Hall") were not transferred to HBH by NJSEA; and (iv) the formation of HBH violated the partnership anti-abuse provisions of Treas. Reg. § 1.701-2(b). (JA30).

In a soundly-reasoned opinion clearly supported by the facts and the law, the Tax Court rejected all of the IRS's arguments. On appeal, the IRS revisits three of the issues decided below but in a different sequence, *to wit*, the IRS claims that: (i) PBHR was not a valid partner in HBH; (ii) HBH was a sham;[3] and (iii) HBH was not the owner of the East Hall. The IRS's arguments on appeal have no merit and should be rejected.

STATEMENT OF RELATED CASES AND PROCEEDINGS

This case has not been before this Court previously, and appellee is not aware of any other related case or proceeding.

STATEMENT OF THE FACTS

I. BACKGROUND

NJSEA is an instrumentality of the State of New Jersey which was created by the New Jersey Legislature under the Sports Authority Law in 1971. (JA357). NJSEA was formed to build, own, and operate the Meadowlands Sports

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[3] *But see* Argument IV *infra* where HBH disputes that the IRS is entitled to raise a new issue, *i.e.*, "sham partnership," for the first time on appeal.

Complex in East Rutherford, New Jersey, which, when completed, included Giants Stadium, the Meadowlands Racetrack, and the IZOD Center. (JA6; Tr. 136-37). NJSEA's jurisdiction was expanded by the Legislature on January 13, 1992 to include the Atlantic City Convention Center Project. The Convention Center Project authorized NJSEA to own and operate the (yet to be constructed) New Atlantic City Convention Center, and to own and operate the East Hall. (JA6, 519-62).

In October 1992, as part of the Convention Center Project, NJSEA entered into a lease for the East Hall with the Atlantic City Improvement Authority ("ACIA"), whereby the East Hall was leased to NJSEA for a term of 35 years at a rental of $1.00 per year. The lease contained two 30-year options for renewal at the same rent. (JA6, 1691-1711). In November 1992, NJSEA entered into an operating agreement for the East Hall with the Atlantic City Convention Center Authority ("ACCCA"), a public entity formed to promote tourism in the Atlantic City region. Under the operating agreement, ACCCA was to act as day-to-day manager of the East Hall with assistance from NJSEA. (JA6-7; Tr. 142-43).

By 1995, NJSEA decided that a private company should be hired to promote, oversee, and manage the East Hall, the West Hall (a property adjacent to the East Hall), and the soon-to-be completed new convention center. Spectacor

Management Group ("SMG"), a worldwide leader in managing convention centers, special events facilities, and stadiums was selected. On July 10, 1995, NJSEA, ACCCA, and SMG signed a management agreement making SMG the day-to-day manager of the facilities. (JA7, 523-76).

II. THE HISTORIC BOARDWALK HALL

Construction of the Historic Boardwalk Hall began in 1926, and was completed in 1929. The Hall is located prominently at the center of the Boardwalk in Atlantic City facing the Atlantic Ocean. When completed, the Hall was an architectural marvel. Its auditorium was the largest clear-span open space in the world. The Hall's barrel-vaulted ceiling rose 130 feet overhead, and its usable floor space covered 250,000 square feet. (JA9, 961, 968-69, 971-73).

The East Hall, after it was completed, was used for a variety of public events including hockey matches, professional football games, equestrian shows, conferences, and trade shows. Beginning in 1933, and for decades thereafter, the Hall was the site of The Miss America Pageant. Legendary musical groups such as The Beatles and The Rolling Stones also performed at the Hall. The Hall was listed as a National Historic Landmark by the U.S. Department of the Interior on the National Register of Historic Places on February 27, 1987. (JA9, 969).

III. DECISION TO RENOVATE THE HISTORIC BOARDWALK HALL

In January 1992, the New Jersey Legislature authorized NJSEA to construct the New Atlantic City Convention Center. (JA9). Construction of the new convention center was completed in 1998. (Tr. 143-44). Representatives of NJSEA, and other New Jersey officials, knew that the new convention center, when completed, would fully satisfy Atlantic City's needs for traditional, flat-floor convention space. Consequently, discussions were begun to study and make plans for the future of the East Hall, which by the mid-1990's had become run down. The decision was made by NJSEA and New Jersey public officials to renovate the East Hall to bring back its historic luster, and to convert the Hall to a state-of the art, world-class special events facility that would host headliner musical performers, sporting events and teams, family shows, and other civic events. (JA10; Tr. 835-38). The decision to renovate the Hall was supported, in part, by a "Re-Use Analysis Report" prepared by Deloitte & Touche ("Deloitte') in December 1995. The Deloitte report concluded that the Hall, if renovated and converted to a special events center, would operate at a profit. (JA577-689).

The renovations of the East Hall began in December 1998. (JA10). Since the Hall is a National Historic Landmark, its renovations had to be approved by the U.S. Department of the Interior (the "DOI"), and had to comply with the

DOI's *Standards for the Treatment of Historic Properties.* NJSEA filed its *Historic Preservation Certification Application Part 2 - Description of the Rehabilitation* with the DOI on September 15, 1999, and the application was approved. (JA1215, 1301-32). Around the time that NJSEA commenced the renovations, and because of their escalating costs, NJSEA considered the benefits to qualifying the renovations for historic rehabilitation tax credits under I.R.C. § 47, and raising additional capital by involving a private investor in the project. (Tr. 164-66).

The renovations to the East Hall were substantial. The architectural plans provided that the renovations would be completed in four phases; specifically: (i) construction of scaffolding suspended from the auditorium's ceiling to facilitate renovation of the ceiling; (ii) removal of the auditorium's ceiling tiles and abatement of asbestos; (iii) reconstruction of the ceiling using glass-fiber reinforced tiles and high performance acoustical perforated aluminum tiles; and (iv) construction of a new permanent arena seating bowl, and support services and amenities beneath the seating bowl; renovation of the ice-skating rink; and restoration and historically accurate painting of the Hall's interior. (JA10).

IV. NJSEA'S DECISION TO SEEK AN EQUITY INVESTOR

In late-1998, representatives of NJSEA were contacted by Paul Hoffman ("Hoffman") of Sovereign Capital Resources, LLC ("SCR"). Hoffman

had learned that the East Hall was being renovated, and his company, SCR, specialized in raising equity for historic rehabilitations. In June 1999, NJSEA engaged SCR to act as its financial advisor in finding an equity investor for the Hall's rehabilitation. (JA11).

In addition, NJSEA engaged several law firms to provide legal services and opine on important aspects of the rehabilitation project. These firms included: Wolf, Block, Schorr, Solis-Cohen LLP ("Wolf Block") (tax counsel); Gibbons, Del Deo, Dolan, Griffinger & Vecchione (corporate counsel); and Wolf & Samson, P.C. (bond counsel). NJSEA also engaged the certified public accounting firm of Reznick Fedder & Silverman, P.C. ("Reznick"), a real estate accounting firm with particular expertise in historic rehabilitation projects. (JA11-12, 1260-1449).

SCI prepared a confidential information memorandum (the "Memorandum") as part of the services it provided to NJSEA. The Memorandum included financial projections prepared by Reznick. The financial projections reflected that the eventual partnership would have positive net operating income for 2002 through 2009, but taxable losses for those years after depreciation and the payment of various partnership obligations. (JA12, 1018-38).

The Memorandum (and certain other SCR documents) referred to the "sale" of historic tax credits in connection with the rehabilitation project. Hoffman

explained that his use of this term was merely "shorthand industry lingo." Federal historic tax credits, like depreciation, cannot be "sold"; the tax credits are an attribute of being an owner in a partnership that rehabilitates an historic building. (Tr. 167-68, 483-84). Indeed, the Memorandum, as the Tax Court correctly found, accurately described the substance of the transaction as an *equity investment* in the East Hall's rehabilitation. (JA50). Moreover, the ultimate partnership agreement, and the other operative closing documents, clearly stated that the transaction involved an equity investment in HBH by NJSEA and PBHR. (JA11, 153).

The Memorandum was sent to 19 corporations, and four corporations expressed interest in investing in the rehabilitation of the East Hall. Pitney Bowes Credit Corporation, a wholly-owned subsidiary of Pitney Bowes Corporation, (collectively, "Pitney Bowes"), was selected as the investor for the renovation project. (JA13). One of the reasons that Pitney Bowes was selected was because NJSEA and Pitney Bowes had a prior, favorable business relationship. In 1996, NJSEA had executed a $50 million operating lease with Pitney Bowes to retrofit the heating, cooling, and lighting systems at the Meadowlands, and the parties also had engaged in some smaller business transactions. (Tr. 169-70).

V. FORMATION AND PURPOSE OF HISTORIC BOARDWALK HALL, LLC

HBH was formed as a limited liability company under the laws of the State of New Jersey on June 26, 2000. NJSEA was the sole member of HBH upon its formation. HBH is treated as a partnership for tax purposes under Treas. Reg. §§ 301.7701-2 and 301.7701-3. (JA13).

PBHR, whose sole member is Pitney Bowes, invested in and acquired a partnership interest in HBH on September 14, 2000. On that date, NJSEA and PHBR signed an Amended And Restated Operating Agreement (the "AREA"). The AREA identified NJSEA and PBHR as the managing member and investor member, respectively, of HBH. (JA13-14).

Article 3.01 of the AREA describes the purpose of HBH; it states that HBH was formed to acquire, develop, finance, rehabilitate, maintain, operate, license, lease, and sell or otherwise dispose of the East Hall as a special events facility. Pursuant to the AREA, PBHR has a 99.9 ownership interest in HBH, and NJSEA has a .1 percent interest. (JA13-14).

VI. SALE OF THE LEASEHOLD INTEREST

On September 14, 2000, NJSEA amended its lease agreement with ACIA for the East Hall to extend the lease to November 11, 2087. On September 14, 2000, NJSEA and HBH entered into an agreement to lease whereby NJSEA sold

the subleasehold interest in the East Hall to HBH for $53,621,405. Pursuant to the agreement to lease, HBH acquired the Hall from NJSEA for 87 years, and the parties treated this lease as a sale for federal, state, and local income tax purposes. (JA15).

HBH paid the $53,621,405 purchase price for the East Hall by an acquisition note, secured by a first mortgage on the property. The purchase price represented the total expenditures that NJSEA had made to renovate the Hall through September 14, 2000. The acquisition note bears interest at 6.09 percent per year, the applicable federal rate at the time of the acquisition, and provides for level annual payments of $3,580,840 through 2040. (JA16).

On September 14, 2000, NJSEA also entered into a construction loan agreement with HBH to lend amounts to HBH from time to time to pay for the completion of the renovations to the East Hall. The amount of the construction loan was $57,215,733. NJSEA's obligation to lend amounts to HBH was evidenced by a mortgage note and a second mortgage on the property. (JA16).

VII. CAPITAL CONTRIBUTIONS TO HBH AND THE INVESTOR LOAN

Pursuant to the AREA, PBHR agreed to make four capital contributions to HBH totaling $18,195,757. The four capital contributions were made on the following dates: (i) $650,000 (September 14, 2000); (ii) $3,660,767

(December 19, 2000) and $3,400,000 (January 17, 2001); [4] (iii) $10,467,849 (October 30, 2002); and (iv) $1,173,182 (February 12, 2004). (JA17). The AREA required that PBHR's capital contributions be used by HBH to pay down principal on the acquisition note, and PBHR's capital contributions were so used. (JA17, 95, 108, 122-23).

The AREA also provided that PBHR would make an investor loan to HBH of $1,100,000. The size of the investor loan was increased to $1,218,000 on or about October 30, 2002. The loan was memorialized by note bearing interest at the rate of 7.1 percent through December 31, 2009, and 8.22 percent thereafter. (JA16-17, 123).

VIII. **CASH FLOW DISTRIBUTIONS UNDER THE AREA**

Article 11.01(c) of the AREA describes the schedule of priorities for the distribution of the net cash flow of HBH to PBHR and NJSEA. First, PBHR is entitled to receive 100 percent of certain title insurance and environmental insurance proceeds. Second, net cash flow is used to pay interest on PBHR's investor loan to HBH.

Third, net cash flow is distributed 99.9 percent to PBHR until PBHR

[4] The capital contributions made on December 19, 2000 and January 17, 2001, together comprised the second installment although made on different dates. (JA17).

has received its current and any accrued but unpaid 3 percent preferred return. PBHR's preferred return is equal to 3 percent of PBHR's adjusted capital contribution, determined at the end of HBH's taxable year. Fourth, net cash flow is paid to PBHR to cover any taxes on taxable income allocable to PBHR.

Fifth, net cash flow is distributed to NJSEA to pay current and accrued debt service on the acquisition and construction notes, and then to NJSEA to repay any operating deficit loans. Lastly, net cash flow is paid to PBHR and NJSEA in accordance with their membership interests in HBH. (JA19-20).

IX. **PREFERRED RETURN**

The AREA provides that PBHR is entitled to a preferred return equal to 3 percent of its adjusted capital contribution determined annually at the end of HBH's taxable year. (JA19, 38-39). The preferred return gives PBHR a cash-on-cash return independent of any tax benefits from PBHR's investment in HBH. (Tr. 670-71, 738-39). The financial projections prepared by Reznick showed that HBH would have sufficient net cash flow to pay the preferred return beginning in 2001, and that by 2003 the amount of the preferred return would be approximately $545,000 annually. (JA246).

X. **THE DEVELOPMENT AGREEMENT**

HBH entered into a development agreement with NJSEA under which

NJSEA was entitled to earn a development fee of $14 million. The development agreement required that NJSEA, *inter alia*, (i) oversee the many contractors who were renovating the East Hall; (ii) obtain all required governmental approvals from the DOI and other agencies for the renovations; (iii) ensure that all amenities for the project were constructed; (iv) guarantee that the project would be completed timely; (v) maintain insurance for the renovations; and (vi) complete the renovations in a manner that would allow HBH to earn the historic tax credits. (JA268-69).

NJSEA was not entitled to receive, and did not receive, the development fee until the rehabilitation project was completed. As the Tax Court found, a development fee is clearly a "qualified rehabilitation expenditure" for purposes of the historic tax credit. (JA43). *See* Treas. Reg. § 1.48-12 (c)(2). Further, the IRS neither argued nor proved at trial that the development fee was not proper under the Code or was unreasonable in amount.

XI. **THE OPTIONS**

On September 14, 2000, the NJSEA and PBHR entered into a purchase option agreement (the "call option") and an agreement to compel purchase (the "put option"). The call option gave NJSEA the right to purchase PBHR's membership interest in HBH for a period of 12 months commencing 60 months after the entire East Hall was placed in service for purposes of determining the historic

rehabilitation tax credits. If the call option was not exercised by NJSEA, the put option granted PBHR the right to require NJSEA to purchase PBHR's membership interest in HBH for a period of 12 months beginning 84 months after the East Hall was placed in service. (JA25).

Both options were fair market value options. In other words, the options required NJSEA to pay PBHR the greater of (a) 99.9 percent of the fair market value of 100 percent of the membership interests in HBH, or (b) any accrued but unpaid preferred return. (JA25).

The AREA also contained a consent option. The consent option gave NJSEA the right to purchase PBHR's membership interest in HBH only if PBHR did not give its prior written consent to certain actions that might be taken by NJSEA. (JA184-86). The parties considered it remote, at best, that the consent option would ever be utilized, and the consent option only was effective during the five-year recapture period for the historic tax credits. (Tr. 215-21, 743, 759, 764-66).

None of the options have been exercised and HBH continues to operate with PBHR and NJSEA as its only members. (JA25).

XII. TAX BENEFITS GUARANTY

PBHR and HBH executed a tax benefits guaranty agreement which states that HBH will indemnify PBHR in the event that there is a reduction in the

historic rehabilitation tax credits as the result of a challenge by the IRS. NJSEA is required to fund any payment made under the agreement. (JA27).

XIII. **THE FINANCIAL PROJECTIONS**

Reznick prepared financial projections for the East Hall historic rehabilitation project. Preliminary financial projections were included with the Memorandum issued by SCR, and then the projections were updated for the AREA. (JA14-15).

NJSEA asked SMG, a worldwide leader in managing special events facilities, to prepare pro formas of income and expenses for the future operations of the East Hall as a special events facility. (Tr. 183-84, 937-43; JA805-922). SMG had substantial experience, and sources of data, with which to prepare the pro formas. Preparation of the pro formas and the financial projections was a multi-month process involving several drafts that were continually being refined to gather solid data and reasonable projections for the future operations of the East Hall. In preparing the pro formas, SMG gave particular attention to financial information it had from the operations of similarly sized convention center facilities in the Northeast. (Tr. 839-44).

Reznick reviewed and tested the income and expense information that it received from SMG and NJSEA for accuracy and reasonableness. (Tr. 938-45).

Moreover, financial executives of Pitney Bowes, and an independent certified public accountant that Pitney Bowes had engaged, reviewed and commented on the projections. (Tr. 668-70, 727-28). Independent counsel for NJSEA and PBHR also reviewed the projections and found them to be reasonable. (Tr. 422-23, 725-30).

The IRS did not present an expert or any other witness at trial to challenge the assumptions or conclusions in the projections. The IRS, however, has criticized the fact that the projections included with the Memorandum used an annual revenue inflator of 3 percent while the projections attached to the AREA contained a revenue inflator of 3.5 percent. (JA14-15). The IRS's attack is a pure red herring because the Hall's actual operating revenues for 2000, 2001, and 2002, substantially exceeded the revenue amounts projected in both the Memorandum and the AREA. In other words, the Hall's year-to-year operating revenues grew at rates much greater than 3.5 percent. (*Compare* JA246 with Lines 1, JA70, 76, 81).

XIV. PITNEY BOWES' INVESTIGATION OF THE INVESTMENT IN HBH

Pitney Bowes' corporate executives and independent legal counsel conducted an exhaustive due diligence investigation relating to the decision to invest in HBH. (Tr. 657-73, 723-55). Pitney Bowes' personnel first inspected the physical condition of the East Hall facility. The company also hired a construction

consultant to review the architectural plans for the renovations, and the structural aspects of the project. (Tr. 732-33). Jon Castaldo ("Castaldo"), a financial officer of Pitney Bowes (who had no tax experience), investigated the economics and risks of the rehabilitation project. Castaldo concluded that the investment in HBH was economically sound, the returns were sufficient, and that Pitney Bowes should proceed with the investment. (Tr. 665).

Pitney Bowes' outside legal counsel, Dana Newman ("Newman"), of Pillsbury Winthrop Pittman Shaw, LLP, approached the transaction as a real estate investment similar to many other real estate investments, both with and without historic tax credits, that she had handled for clients. (Tr. 735-36). In this regard, Newman required that Pitney Bowes engage a separate New Jersey law firm to examine real estate title issues relating to the East Hall. Moreover, Newman and Pitney Bowes required that HBH, as the named insured for the Hall, obtain title insurance of $25 million. (Tr. 736-37; JA20, 475-82).

Newman and Pitney Bowes, and NJSEA, spent considerable time and expense investigating environmental hazards relating to the East Hall. Pitney Bowes retained the law firm of Kelly Drye & Warren, LLP to assess Pitney Bowes' exposure to liability for environmental claims. Upon counsel's advice, Pitney Bowes obtained Phase I and Phase II environmental reports, and a hazardous

materials report. The reports identified environmental hazards, including asbestos, possible lead-based paint, seeping underground storage tanks, and proposed plans for remediation. (Tr. 667-68, 730-32; JA20, 483-502, 1171-95).

Pitney Bowes required that NJSEA make environmental representations and warranties in the AREA, and insisted that HBH obtain a $25 million environmental insurance policy. Pitney Bowes was named as an additional insured on this policy. (Tr. 731-32; JA21). Pitney Bowes also hired an insurance consultant to independently examine property, flood, crime, general liability, and other insurance policies of HBH. Pitney Bowes was added as a named insured on these policies. (Tr. 733-34; JA1740-46).

Newman reviewed and negotiated the terms of the AREA and other closing documents with NJSEA in connection with PBHR's investment in HBH. Newman also reviewed and commented on the tax opinion prepared by Wolf Block. Newman discussed the legal issues addressed in the tax opinion with Pitney Bowes, including those that were ultimately asserted in the FPAA. Newman advised Pitney Bowes that the opinion was legally sound and its conclusions were correct. (Tr. 723-24, 741-56).

XV. **HBH IN OPERATION**

In accordance with an Assignment And Assumption Agreement

between HBH and NJSEA, at or around the date of the closing, construction contracts, occupancy agreements and management and service agreements, which had been entered into between NJSEA and various third parties, were all assigned to HBH, the owner of the East Hall. (JA28, 275-83). In addition, after September 14, 2000, parties that contracted to use the Hall's facilities executed written agreements with HBH. (Tr. 196, 844).

SMG changed all of the accounting and financial functions for the East Hall after the closing to recognize HBH as the legal entity that owned and operated the Hall. New bank accounts were opened for HBH, and revenues were deposited, and expenses were paid, through the accounts. (Tr. 196, 845; JA28, 1687-90). Payroll accounts were established to make certain that employees working for HBH were paid by HBH. (Tr. 196-97).[5]

The rehabilitation of the East Hall, and its conversion to a special events facility, was an unqualified success. Many first-run entertainers have performed at the Hall since the renovations have been completed, including Bruce Springsteen, Paul McCartney, Simon and Garfunkel, Barbra Streisand, Britney Spears and others. The East Hall also has been competitive as a venue for boxing,

[5] The HBH partnership income tax returns for 2001 and 2002 reflect that HBH paid wages of approximately $2.6 million and $3.5 million, respectively, for these years. (JA76, 81, lines 9).

rivaled only by Las Vegas and Madison Square Garden. Significantly, the Hall's revenues from operations have greatly exceeded those in the Reznick projections. In sum, the rehabilitated East Hall is once again a source of great pride for the Atlantic City community, and the Hall has reclaimed its iconic status on the Boardwalk. (Tr. 196-97, 846-47).

XVI. <u>THE PROCEEDINGS BEFORE THE TAX COURT</u>

The case before the Tax Court involved I.R.C. § 47 which provides for a 20 percent historic rehabilitation tax credit. The credit applies to "qualified rehabilitation expenditures" incurred in connection with the "substantial rehabilitation" of a "certified historic structure." I.R.C. § 47(a)(2), (c)(l). Qualified rehabilitation expenditures are those costs chargeable to the capital account for, as relevant herein, depreciable nonresidential real property. I.R.C. § 47(c)(2)(A)(i)(I). A "certified historic structure" includes a building, like the East Hall, listed in the National Register of Historic Places. I.R.C. § 47(c)(3)(A)(i).

The rehabilitation of the East Hall generated historic rehabilitation tax credits allocable to PBHR in the amounts of $7,764,802, $13,759,355, and $254,042 for taxable years 2000, 2001, and 2002, respectively. (JA74, 80, 86). In its FPAA, the IRS did not claim that the rehabilitation of the Hall did not give rise to historic tax credits. Moreover, the IRS did not challenge HBH's determination or

calculation of qualified rehabilitation expenditures, or the applicability of other technical aspects of I.R.C. § 47 to the rehabilitation of the Hall. Rather, the IRS made several broadly based and unfounded arguments premised on the erroneous claim that HBH is a sham. Following a trial and post-trial briefing, the Tax Court found, in a thorough opinion unassailable in its factual findings and legal reasoning, that the IRS's position was unsupportable. Appellee urges this Court to affirm the decision of the Tax Court.

SUMMARY OF ARGUMENT

This case involves an historic rehabilitation investment transaction among HBH, and its members, NJSEA and PBHR. HBH was formed to acquire, develop, finance, rehabilitate, maintain, operate, license, lease, and sell or otherwise dispose of the East Hall as a special events facility. The renovation of the Hall, which is listed on the National Register of Historic Places, gave rise to historic rehabilitation tax credits under I.R.C. § 47, which HBH properly allocated to PBHR. Congress enacted I.R.C. § 47 with the inarguable purpose of using the tax laws to motivate private investors like PBHR. Specifically, in passing I.R.C. § 47, Congress intended to create an incentive to spur private investment in the rehabilitation and preservation of historic buildings that did not exist under typical market forces.

The testimony of witnesses at trial and the other evidence in the record proved beyond any doubt that NJSEA and PBHR, in investing in HBH, entered into an arm's-length, heavily-negotiated business transaction that had true economic, financial, and tax consequences. The Tax Court, in a thoroughly-reasoned opinion, steeped in the facts presented at trial, and following the decisional authority of this Court, rejected all of the IRS's arguments. The Tax Court's opinion should be affirmed by this Court in all respects. The arguments raised in this appeal are summarized below.

1. HBH is a valid partnership, and PBHR and NJSEA are *bona fide* partners in HBH. The determination of whether a partnership exists for tax purposes is based on the totality of the facts and circumstances. The evidence herein proves beyond dispute that HBH was lawfully organized to own, operate, and rehabilitate the East Hall, and that PBHR and NJSEA joined together with a business purpose in the present conduct of this enterprise. The exhaustive pre-investment due diligence of PBHR, the successful rehabilitation of the East Hall, and operation of the Hall following the renovations, among many other factors, clearly demonstrate that PBHR and NJSEA are true partners in HBH.

2. The IRS's FPAA wrongfully claims that the formation of HBH was a sham transaction. The evidence at trial, however, overwhelmingly proved

that the historic rehabilitation tax credit investment transaction among HBH, NJSEA, and PBHR had objective economic substance and subjective business purpose. PBHR made an investment of approximately $20 million in HBH which substantively affected its net economic position. As part of its investment in HBH, PBHR had the right to receive a 3 percent cash-on-cash preferred return, and it obtained its allocable share of the historic rehabilitation tax credits. The rehabilitation tax credits must be taken into account in determining the economic substance of PBHR's investment in HBH. To do otherwise, as the IRS erroneously argues, would thwart the very purpose that Congress enacted the historic rehabilitation tax credit statute. Under the totality of the evidence in this case, there can be no dispute that the formation of HBH was not a sham transaction.

3. The benefits and burdens of ownership of the East Hall were transferred from NJSEA to HBH. The transfer occurred on September 14, 2000, when NJSEA and HBH entered into an agreement to lease whereby NJSEA sold and HBH purchased the 87-year sublease for the East Hall. The parties treated the agreement to lease as a sale for federal, state, and local income tax purposes. HBH paid the purchase price for the Hall by an acquisition note secured by a first mortgage on the property. During the years before the Court, HBH had a meaningful equity interest in its investment in the East Hall. Moreover, throughout

these years, and thereafter, HBH operated as a successful public special event facility with its own bank accounts, financial statements, employees, contractual agreements with customers, vendors, licensees, and other third parties. In sum, the totality of the facts and circumstances proves that the beneficial ownership of the East Hall was transferred from NJSEA to HBH.

ARGUMENT

I. STANDARD OF REVIEW

Although this Court reviews the Tax Court's legal conclusions based on a *de novo* standard of review, it reviews the factual determinations underlying those legal conclusions on a "clear error" standard. *PNC Bancorp*, *Inc. v. Commissioner*, 212 F.3d 822, 827 (3d Cir. 2000). In applying the clear error standard, the Court must "accept the ultimate factual determination[s]" of the Tax Court unless those determinations are either "completely devoid of minimum evidentiary support displaying some hue of credibility, or . . . bear[] no rational relationship to the supportive evidentiary data." *Krasnov v. Dinan,* 465 F.2d 1298, 1302 (3d Cir. 1972). *See also Behrend v. Comcast Corp.,* 655 F.3d 182, 189 (3d Cir. 2011) ("For a [trial] court's finding of fact to be clearly erroneous the standard is high").

II. CONGRESS SOUGHT TO STIMULATE PRIVATE INVESTMENT IN HISTORIC REHABILITATIONS IN ENACTING THE HISTORIC TAX CREDIT

A. Introduction

This case involves the historic rehabilitation tax credit, and the legislative history and Congressional purpose underlying the rehabilitation tax credit should inform the analysis throughout. The origins of the credit are found in the enactment of the National Historic Preservations Act ("NHPA") on October 15, 1966. 16 U.S.C. §§ 470-470w (1966). NHPA was enacted to assure that urban planning and industrial development did not overrun the historical and cultural importance in preserving our country's "irreplaceable heritage" in its historic buildings. 16 U.S.C. 470(b)(4). In the years following the passage of NHPA, Congress enacted several tax incentives to purposely direct and motivate private investment in the rehabilitation of buildings of historical significance. The most important of these incentives, and by far the most successful, is the historic tax credit.

B. TRA 76 And The 1978 Act

The Tax Reform Act of 1976 ("TRA 76"), Pub. L. 94-455, 90 Stat. 1520 (October 4, 1976), and the Revenue Act of 1978 (the "1978 Act"), Pub. L. No. 95-600, 92 Stat. 2763 (November 6, 1978), furthered the goals of NHPA by creating

new tax incentives for private sector investment in certified historic buildings. For example, TRA 76 allowed for rapid amortization of historic structures, *see* I.R.C. § 191 (1976), and the 1978 Act provided for a 10 percent tax credit for historic rehabilitations, *see* I.R.C. § 48(g) (1978).

In expressing Congress' motives in passing legislation designed to spur private investment in historic rehabilitations, Senator J. Glenn Beall stated on the floor of the Senate in 1976:

> The time has clearly come for us to harness the constructive energies in our nation's tax system so as to bring private funds and commercial interests actively and enthusiastically into the field of historic preservation. The time has clearly come for the Congress to wipe away many of the existing tax incentives [*e.g.*, tax deductions for building demolitions] which run directly counter to our national goals.

122 Cong. Rec. 24320 (July 28, 1976) (remarks of Senator J. Glenn Beall).

C. **ERTA And The 1986 Act**

The historic rehabilitation tax credit reached its modern form with the passage of the Economic Recovery Tax Act of 1981 ("ERTA"), Pub. L. No. 97-54, 95 Stat. 172 (August 13, 1981). ERTA provided for a 25 percent credit for qualified rehabilitation expenditures made in the renovation of historic structures. I.R.C. § 46(a)(2)(f) (1981).

The Tax Reform Act of 1986 (the "1986 Act"), Pub. L. 99-514, 101

Stat. 2085 (October 22, 1986), made sweeping changes to the tax law, many of which were unfavorable to real estate investors, but retained the historic tax credit. The tax credit was adjusted to its current rate of 20 percent for certified historic buildings under the 1986 Act. *See* I.R.C. § 47(a)(2).

In leading a spirited defense of the historic rehabilitation tax credit on the Senate floor during the passage of the 1986 Act, Senator John Heinz remarked that the historic tax credit program was "an unqualified success, working just as Congress intended to stimulate investment in our nation's cities and towns to preserve the best of our older buildings." 1331 Cong. Rec. S10940-04, 1985 WL 720617 (1985). Without the credit, Senator Heinz stated, "market forces would channel investment away from historic buildings, which would deprive Americans of the economic and cultural benefits of historic preservation." *Id*.

The Congressional report for the 1986 Act discussing the historic rehabilitation tax credit echoed Senator Heinz's words by stating:

> The Congress concluded that the incentives granted to rehabilitations in 1981 remain justified. Such incentives are needed because the social and aesthetic values of rehabilitating and preserving older structures are not necessarily taken into account in investor's profit projections. A tax incentive is needed because market forces might otherwise channel investments away from such projects because of the extra costs of undertaking rehabilitations of older or historic buildings.

Pub. L. No. 99-514; 99th Congress, H.R. 3838 (Part 2 of 19 Parts); JCS-10-87

General Explanation of the Tax Reform Act of 1986, p. 149 (1987). In short, the historic tax credit was intended to be a vital component of the economic analysis for an investment in the rehabilitation of historic property.

D. **Section 7701(o)**

On March 30, 2010, I.R.C. § 7701(o) was enacted to codify the economic substance doctrine for post-codification transactions. Significantly, in enacting I.R.C. § 7701(o), Congress purposefully emphasized that codification of the economic substance doctrine in no way altered Congress' long-standing desire to motivate private investment in historic rehabilitations. Specifically, Congress stated as follows:

> 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 . . . 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 Provision of the "Reconciliation Act of 2010," as amended, In Combination with the "Patient Protection and Affordable Care Act,"* at 152, n. 344 (JCX-18-10) (March 21, 2010).

E. <u>IRS Legal Authority Regarding The Historic Tax Credit</u>

In October of 2000, the IRS issued two written publications containing legal analysis of the historic rehabilitation tax credit. The first document is entitled *Tax Aspects of Historic Preservation* (October 2000) (JA1450), and the second document is captioned *Differences Between the Historic Rehabilitation Tax Credit and Low Income Housing Tax Credit* (October 2000) (JA1467).[6]

The publication *Tax Aspects of Historic Preservation* is presented in a question and answer format, and discusses numerous technical issues involving the historic rehabilitation tax credit and includes references to the Code and Treasury Regulations. One of the questions and answers provides the IRS's analysis and direction for taxpayers with a rehabilitation project identical to the one involving HBH, NJSEA, and PBHR. Specifically, the IRS states as follows:

> **How can property owned by a tax exempt entity utilize rehabilitation tax credits?**
>
> The rehabilitation tax credit would be of no use to a tax exempt entity. However, in many instances, tax exempt entities are involved in rehabilitation projects by forming a limited partnership and maintaining a minority ownership interest as a general partner. In these situations, the limited partners would be entitled to the rehabilitation tax credit and the tax exempt entity is able to

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[6] The low income housing credit was enacted as part of the 1986 Act and is found at I.R.C. § 42.

ensure that their organizational goals are being met.

(JA1453).

In the IRS's publication *Differences Between the Historic Rehabilitation Tax Credit and Low Income Housing Credit,* the IRS addresses the issue of profit motive, and takes a position contrary to the one asserted in the FPAA. In comparing the historic rehabilitation tax credit and the low income housing credit on the question of profit motive, the IRS states as follows:

Historic Rehabilitation Tax Credit	**Low Income Housing Tax Credit**
* * *	* *
Profit Motive: The IRS has not specifically ruled on whether a participant in a rehabilitation tax credit transaction must have a profit motive.	**Profit Motive:** The Treasury Regulations specifically provide that a profit motive is not required in order to claim the low income housing tax credit. The transaction, however, must not be a "sham" and the person or entity claiming the low income housing tax credit must have a bona fide ownership interest in the property.

(JA1473).

It is abundantly apparent from the foregoing legal publications, which were issued contemporaneously with the closing of the HBH, NJSEA, and PBHR investment, that the IRS expressly recognized, agreed with, and encouraged the use

of partnership arrangements for historic tax credit rehabilitation projects involving taxable and tax exempt entities, and that the IRS was uncertain whether profit motive even applied in an historic tax credit transaction. The IRS's legal position in 2000 was consistent with the Congressional mandate to encourage private investment in the rehabilitation of historic buildings. The IRS's legal arguments at trial, and in this appeal, are directly contrary to these two publications and, more importantly, are plainly at odds with Congress' clearly-stated purpose in enacting the historic rehabilitation tax credit.

III. <u>PBHR IS A PARTNER IN HBH</u>

A. <u>Introduction</u>

In the Tax Court, the IRS's primary argument was that HBH is a sham lacking in economic substance. (JA34). Shifting gears, the IRS now alleges that PBHR is not a *bona fide* partner in HBH as its main contention. The IRS bases its argument on two cases, which it refers to as "guideposts." These cases are *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006), and *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011). Rather than guideposts, these two cases are pure misdirections which lead to an analytical dead end. Indeed, *TIFD* was decided on facts that bear no resemblance to those herein, and *Virginia Historic* is premised on a statutory provision of the Code that was not

even raised in the FPAA issued to HBH.

B. The *Castle Harbour* Case

The IRS's reliance on the case of *TIFD III-E, Inc. v. United States*, which is known as the *Castle Harbour* case, should be summarily rejected because its facts are so vastly and readily distinguishable from the case at hand. In *Castle Harbour*, a subsidiary of General Electric Capital Corporation, *i.e.*, TIFD III-E, Inc. ("TIFD"), formed an eight-year partnership (*i.e.*, Castle Harbour) with two Dutch banks with the intention of allocating certain income away from General Electric to the (tax indifferent) Dutch banks. After analyzing the partnership's operating agreement, the United States Court of Appeals for the Second Circuit found that the Dutch banks should be characterized as lenders to Castle Harbour rather than holders of equity interests in the partnership. *TIFD III-E, Inc.,* 459 F.3d at 240.

The key factor that led to the court's ruling was that although the Dutch banks had a theoretically unlimited upside income potential if the assets of the partnership appreciated, TIFD had the unilateral right under the partnership agreement to reduce the banks' percentage participation in the profits of the partnership from 98 percent to 1 percent, and to transfer those profits to a different entity for TIFD's own benefit. This ability to divest the banks of their profit was a pivotal element in the court's decision that the banks were not partners in the

partnership. *TIFD III-E, Inc.* 459 F.3d at 229, 235.

In addition, the partnership agreement in *Castle Harbour* guaranteed the Dutch banks reimbursement of their initial investment in the partnership over its eight-year life, plus an annual return of approximately 9 percent, regardless of the partnership's profits or losses. *TIFD III-E, Inc.*, 459 F.3d at 226-27. Further, the banks could terminate the partnership if certain payments were not made to them. *Id*.[7] The partnership's guarantee to repay the banks' their capital investment, and the annual rate of return, was not subordinated to the general creditors of the partnership. *Id*. at 237.

The Second Circuit examined the foregoing provisions of the Castle Harbour partnership agreement as if it were reviewing a corporate instrument to ascertain whether it was debt or equity, and determined that the banks' interest was that of a secured creditor and not that of a partner. *TIFD III-E, Inc.*, 459 F.3d at 241. Consequently, the Second Circuit reversed and remanded the case. On remand, the district court held that the banks were capital partners in Castle Harbour under I.R.C. § 704(e)(1). *TIFD III-E, Inc. v. United States*, 660 F.Supp. 2d 367 (D. Conn. 2009).[8]

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[7] TIFD also had the right to terminate the partnership. *Id*. at 235.

[8] This district court's decision on remand has been appealed by the IRS.

It is abundantly apparent that the *Castle Harbour* case is completely inapposite to the case at bar. Clearly, PBHR has *no* rights under the AREA to compel HBH to repay all or any part of its capital contribution. Moreover, PBHR has *no* authority to terminate HBH in the event of any form of missed payment (or for any other reason). In fact, there are no guaranteed payments to PBHR by HBH under the AREA. PBHR has the right to earn the 3 percent preferred return from HBH, but it is not guaranteed. The only way that PBHR could have required any form of payment would have been by exercising its put option with NJSEA, and thereby foregoing any future income or gains from HBH. PBHR's put option with NJSEA, which was not exercised, did not provide for the return of PBHR's capital contribution from HBH.

As noted above, the decisive factor in the Second Circuit's decision in *Castle Harbour* was TIFD's ability to prevent the Dutch banks' participation in partnership profits from income producing assets by transferring the income from those assets to a separate entity for TIFD's own benefit. *TIFD III-E, Inc.*, 459 F.3d at 229, 235. NJSEA has no such right to divest PBHR of its interest in any income or gains from the East Hall. PBHR has the absolute right to 99.9 percent of the income from the sale of and the value of any refinancing of the Hall. In sum, the *Castle Harbour* case is wholly dissimilar to the instant case, and the facts herein

unequivocally establish that PBHR is a true partner in HBH.[9]

C. **The *Virginia Historic Tax Credit Fund* Case**

The IRS's attempted reliance on the case of *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, is both incorrect and puzzling because the decision is based on the "disguised sale" rules under I.R.C. § 707(b), a provision that was not raised in the FPAA issued to HBH and which has absolutely no bearing herein. Further, in *Virginia Historic,* the United States Court of Appeals for the Fourth Circuit expressly did not decide whether the investors in the partnerships therein (the "Funds") were *bona fide* partners, but rather assumed that valid partnerships existed as a necessary condition to applying I.R.C. § 707(b)'s disguised sale rules. *Virginia Historic,* 639 F.3d at 137.

In *Virginia Historic*, the Funds were formed to acquire interests in certain lower-tier partnerships that owned historic projects which were eligible for Virginia state historic rehabilitation tax credits. To be clear, *Virginia Historic* did not involve federal historic rehabilitation tax credits under I.R.C. § 47. For a period of time, Virginia allowed state historic tax credits to be sold, but subsequently

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[9] In *Castle Harbour*, the Second Circuit was critical of the district court, and found that the trial judge committed legal error in not considering the banks' interest in the partnership under the case of *Commissioner v. Culbertson*, 337 U.S. 733 (1949). *TIFD III-E,* 459 F.3d at 230-32. Significantly, the Tax Court's analysis and holding that PBHR is a *bona fide* partner in HBH is based exclusively on *Culbertson*. (JA45).

required that the credits only be allocated to partners. *Virginia Historic*, 639 F. 3d at 133-34. Virginia's historic tax rehabilitation credit law differed from the federal historic tax credit law in a number of respects, including provisions that allowed a onetime transfer of the state tax credits prior to the enactment of final regulations, and the division of the state historic tax credits among the partners "'as the partners or the shareholders may mutually agree'" without regards to other partnership attributes. *Id.* at 133 (internal citations omitted).

The Funds in *Virginia Historic* obtained numerous investors to contribute capital to the partnerships, and these investors were allocated Virginia historic tax credits on Schedules K-1. *Id.* at 135. The investors' status as partners in the Funds was transitory, lasting only about a year, and the investors, who had only nominal percentage interests in the partnerships, were allocated virtually no other tax attributes related to the historic projects and received no other economic return from the Funds or the projects. *Id.* at 145.

On appeal, the IRS made two arguments, *i.e.*,: (i) the investors were not *bona fide* partners in the Funds, and (ii) even if they were, the Funds should have reported the receipt of the investors' contributions as taxable income rather than as non-taxable capital contributions under I.R.C. § 707. As previously noted, the Fourth Circuit, in reaching its decision, assumed that a valid partnership existed, and

then analyzed the case *solely* under the disguised sale regime of I.R.C. § 707(b) and Treas. Reg. § 1.707-3. Applying the disguised sale rules, the court found that the Virginia state historic tax credits were "property" under the facts of the case,[10] and that the investors' contributions constituted taxable income to the Funds. A critical element in the court's decision was the fact that the Treasury Regulations provided for a "presumption" of a sale giving rise to taxable income in the Funds' circumstances. *Virginia Historic*, 639 F.3d at 143-44.

The FPAA issued to HBH raised four legal arguments premised on the IRS's claim that HBH is a sham lacking in economic substance. (JA142-51). On appeal, the IRS is pursing three of the arguments asserted in the FPAA. The FPAA did not make a claim under the disguised sale rules of I.R.C. § 707(b), and no such issue was litigated in the Tax Court. Thus, the *Virginia Historic* case has no application whatsoever to the instant case.

D. The Evidence Overwhelmingly Proves That PBHR Is A Partner In HBH

There are a plethora of errors in the IRS's tortured effort on brief to apply the *Castle Harbour* and *Virginia Historic* cases to the facts of the present case. In *Castle Harbour*, as noted heretofore, the court reviewed the relationship between

[10] The court made clear that it was not deciding that historic tax credits "always constitute 'property'" *Id*. at 141, n. 15.

the Dutch bank partners and the Castle Harbour partnership, and determined the banks' interest vis-a-vis the partnership was that of a lender rather than an equity investor. In a purposely confounding discussion, the IRS describes what it claims to be the rights and obligations of PBHR and NJSEA, *as partners*, and misleadingly attempts to compare them to the relationship between the Dutch bank *partners* and the Castle Harbour *partnership* challenged in *Castle Harbour*, while at the same time admitting that PBHR's investment in HBH was not debt. Then, the IRS asks this Court to rely on a decision, *i.e.*, *Virginia Historic*, that is based on a Code section that is not even at issue in this case. These arguments are all unfounded diversions that ignore the soundness of the Tax Court's factually-based determination that PBHR is a valid partner in HBH.

The law on whether a partnership exists for federal income tax purposes is well-settled. Under the case of *Commissioner v. Culbertson*, 337 U.S. 733 (1949), a partnership exists if, based on the totality of the facts and circumstances, it is determined that "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." *Id*. at 742. The question that *Culbertson* asks is simply whether the parties intended to conduct a business together and share in the profits and losses therefrom. *Id*. at 741. *See also Luna v. Commissioner*, 42 T.C. 1067, 1077-78 (1964) (same; citing

Culbertson).

Culbertson provides the following nonexclusive list of facts and circumstances that can be considered in this inquiry:

> ... the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent ...

Id. at 742. The evidence herein, as the Tax Court correctly found, clearly establishes that HBH was formed and has operated as a valid partnership, and that PBHR and NJSEA are both true partners in HBH. (JA47-52).

HBH was organized as a limited liability company under the laws of the State of New Jersey on June 26, 2000. HBH was formed to acquire, develop, finance, rehabilitate, maintain, operate, lease, and sell or otherwise to dispose of the East Hall as a special events facility. PBHR invested in and acquired its membership interest in HBH on September 14, 2000.

The Tax Court found that HBH had economic substance, and that PBHR and NJSEA, in good faith and acting with a business purpose, joined together in the present conduct of a business enterprise. (JA49). *See Culbertson* 337 U.S.

at 741.[11] PBHR's decision to invest in HBH provided it with, *inter alia*, the opportunity to participate in the East Hall renovation project, the 3 percent preferred return, and the historic rehabilitation tax credits. The net economic benefit to PBHR from these items clearly demonstrates, as the Tax Court held, that PBHR was motivated by a business purpose and became a *bona fide* partner in HBH. (JA49-50).

Prior to investing in HBH, representatives of Pitney Bowes vigorously negotiated the terms of the AREA and the other operative legal documents. These negotiations were conducted at arm's-length, with participation by both legal counsel and principals of Pitney Bowes and NJSEA, and demonstrate the intent of the parties to form a true business relationship. (Tr. 170-71, 658-61, 664-65, 723-24, 744-48). The AREA that was executed by PBHR and NJSEA at the conclusion of these negotiations was a substantial and meaningful legal document that provides a detailed and accurate description of HBH's purpose, *i.e.*, the rehabilitation and operation of the East Hall, and the rights and responsibilities of PBHR and NJSEA in this enterprise. (JA50, 153).

[11] As stated previously, the IRS's primary argument in the Tax Court was that HBH was a sham devoid of economic substance. The Tax Court addressed this issue first in its opinion. The court found that HBH was not a sham, and that it had economic substance. This finding was one of the factors that the court relied upon in holding that PBHR was a true partner in HBH. (JA49).

Pitney Bowes, through its officers, employees, and attorneys, conducted a comprehensive due diligence investigation in connection with its investment in HBH. Pitney Bowes' due diligence included a critical analysis of real estate title, structural, and engineering issues relating to the East Hall; an exhaustive study of environmental hazards and ways to remediate them; an examination of property, flood, casualty, general liability, crime, and other insurance coverage for the Hall; an analysis of the risks and potential economic returns; and a review of bond, tax, corporate, and other legal issues. (Tr. 617-18, 658-61, 664-68, 723-24, 730-37; JA50). The nature and thoroughness of Pitney Bowes' due diligence investigation establish its intent to join together with NJSEA as partners in the business operations of HBH. *Culbertson*, 337 U.S. at 742-43.

In addition, PBHR invested capital of approximately $19.3 million in HBH, and made a loan to HBH of $1,218,000. PBHR's substantial financial investment in HBH clearly supports the fact that PBHR is a partner in HBH. For its investment, PBHR received the right to a 3 percent cash-on-cash preferred return; a 99.9 percent interest in any income or losses from the operations of HBH, or the proceeds from the sale of, or any value from the refinancing of the East Hall; and the historic rehabilitation tax credits. As the Tax Court found, the 3 percent preferred return and the tax credits provided a net economic benefit to PBHR, and are factors

which demonstrate PBHR's intent to become a partner in HBH. (JA51).

Following the closing among HBH, NJSEA, and PBHR on September 14, 2000, significant business changes were made which further establish that HBH is a valid partnership, and that PBHR is a *bona fide* partner in HBH. For example, in accordance with the Assignment And Assumption Agreement, occupancy agreements, construction contracts, and management and service agreements that had been entered into between NJSEA and various third parties were all assigned to, and assumed by, HBH. (JA28).

Further, insurance agreements were amended to accurately identify HBH as the owner of the East Hall and the named insured, and to include PBHR as an additional insured. (Tr. 844-45). All accounting and financial functions of the East Hall were changed to recognize HBH as the owner and operator of the Hall. (JA28). New HBH bank accounts were opened for the revenues and expenses associated with the operations of the Hall, and HBH payroll accounts were established to pay employees. (JA28; Tr. 196, 845).

Following the closing on September 14, 2000, NJSEA kept in constant communication with Pitney Bowes regarding the renovations to the East Hall, and the business operations of the Hall. (Tr. 211). Significantly, the renovations to the East Hall were timely completed, the Hall reopened to the public as a special events

facility, and its operations have been a success. (JA51). In sum, the formation of HBH and the rehabilitation of the Hall provided business benefits to both PBHR and NJSEA as partners in HBH. (JA51). *Culbertson*, 337 U.S. at 741-42.

E. <u>The IRS's Risks/Benefits Arguments Must Fail</u>

The IRS argues on brief that PBHR allegedly had no downside risk, and therefore should not be considered a partner in HBH. These same factual claims were raised at trial and rejected by the Tax Court. (JA47-52). The IRS's argument is disingenuously simplistic and factually erroneous, and ignores the everyday realities of partnership real estate investment projects.

As part of its argument, the IRS refers to negotiated agreements such as the completion guaranty, operating deficit guaranty, insurance agreements, etc. as alleged evidence that PBHR was protected from all risk. The IRS's position is plainly incorrect. The fact that PBHR negotiated for contractual protections from some of the risks of ownership does not mean that PBHR, in fact, eliminated all of those risks. Moreover, the IRS's theory that a valid partnership cannot exist unless an investor-partner shares in all of the risks and costs of the partnership has no basis in partnership or tax law. It also is contrary to the standard economic terms of innumerable real estate investment partnerships established in the United States for every type of real estate project. Several factors illustrate the fundamental flaw in

the IRS's argument.

First, simply because HBH obtained insurance coverage for such things as environmental hazards does not mean that PBHR, as a partner in HBH, did not face the real risk of environmental damage and liability. If an environmental disaster occurred, PBHR had no guarantee that an insurance recovery would pay the costs of the damage and PBHR's exposure to liability claims, or that NJSEA would be financially capable of making up any shortfall. (JA43-44).

Second, the fact that PBHR negotiated agreements such as the completion guaranty and operating deficit guaranty does not eliminate all risk that the renovations to the East Hall would be successfully completed so that PBHR would earn the historic tax credits. Moreover, it is typical in a real estate investment partnership that an investor will seek such guarantees from the developer as a condition to making its investment. Third, contrary to the IRS's claim, the limitation on PBHR's capital contribution has no bearing on PBHR's risk. Indeed, it is typical in a real estate investment partnership that an investor's capital contribution is fixed at an agreed upon amount.

Fourth, the payment to PBHR of its 3 percent preferred return was clearly subject to the operational risks of HBH. Fifth, the existence of put and call options between partners, like PBHR and NJSEA, does not affect risk at all. The

options merely provide a mechanism for the purchase of a partner's interest by another partner. In any event, neither NJSEA nor PBHR exercised their options.

The IRS's claim that PBHR had no upside benefit is equally unavailing. The IRS, on appeal, as it did in the court below, wrongfully refuses to recognize the 3 percent preferred return and the historic tax credits as part of PBHR's upside benefit from the investment in HBH. (JA51). Moreover, the put and call options, which, once again, were not exercised, included a fair market value determination and do not create a cap on what PBHR could have received if an option was exercised. Lastly, in investing in HBH, PBHR received, as an upside benefit, the right to 99.9 percent of the future income from the operations of HBH and the proceeds from the sale of and any refinancing of the East Hall.

F. Conclusion

The Tax Court's decision that HBH is a valid partnership, and that PBHR and NJSEA are *bona fide* partners in HBH, is based on *Culbertson's* facts and circumstances test. The IRS is now asking this Court to reconsider the trial court's factual findings, which are subject to a clear error of standard of review. *PNC Bancorp, Inc.,* 212 F.3d at 827. The IRS's position is wholly without merit and should be rejected by this Court.

IV. HBH IS NOT A SHAM

A. Introduction

The IRS's second argument on brief is that HBH is a sham. The Tax Court rejected this argument in a well-reasoned opinion based on long-standing precedent in this Court. (JA34-47). Not happy with this precedent, the IRS now asks the Court to consider for the first time a new issue which it claims is a "variant" of the sham transaction doctrine, *i.e.*, the so-called "sham partnership" doctrine. (Appellant Br. at 49).

The IRS's argument under the sham partnership doctrine is merely a rehash of the factual claims that it made in challenging PBHR's status as a partner in HBH. The IRS's new argument should be rejected for all of the reasons stated heretofore. More importantly, however, the IRS's current position purposely ignores important decisional law in this Court, namely, *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), and *In Re CM Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002). Relying on these cases, the Tax Court properly held that the formation of HBH was not a sham transaction.

HBH maintains that the IRS is not permitted to raise the sham partnership doctrine for the first time on appeal. The FPAA issued to HBH clearly states it was the IRS's position that the transaction resulted in the formation of HBH

was a “sham transaction.” (JA151). The sham transaction issue was litigated, briefed, and decided by the court below. (JA33-47). The sham transaction doctrine is distinct from the sham partnership doctrine now raised by the IRS on appeal. *See, e.g., Saba Partnership v. Commissioner*, 273 F.3d 1135, 1140 (D.C. Cir. 2001) (recognizing that the doctrines are different as a matter of law). The IRS should not be allowed to belatedly assert the sham partnership doctrine as a new issue. *See Lloyd v. HOVENSA, LLC*, 369 F.3d 263, 272-73 (3d Cir. 2004) (“’it is inappropriate for an appellate court to consider a contention raised on appeal that was not initially presented to the district court’”).

B. **<u>The Sham Transaction Analysis</u>**

The “sham transaction” or “economic substance” doctrine was addressed by this Court in *ACM Partnership v. Commissioner*, 157 F.3d at 247. There, the Court described its analysis under the sham transaction doctrine as follows:

> The inquiry into whether the taxpayer’s transactions had sufficient economic substance to be respected for tax purposes turns on both the ‘objective economic substance of the transactions’ and the ‘subjective business motivation’ behind them. However, these distinct aspects of the economic sham inquiry do not constitute discrete prongs of a rigid two-step analysis, but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax

purposes.

(internal citations omitted). *See also In Re CM Holdings, Inc.*, 301 F.3d at 102.

The sham transaction theory discussed in *ACM Partnership* is founded on the analysis of the Supreme Court in the seminal case of *Gregory v. Helvering*, 293 U.S. 465 (1935). *See ACM Partnership*, 157 F.3d at 246-47. In *Gregory v. Helvering*, the Supreme Court considered a distribution of shares of a corporation to an individual taxpayer through a transaction that had the formal structure of a reorganization, therefore making the distribution of shares to the individual tax-free. The Supreme Court stated that: "It is quite true that if a reorganization in reality was effected ..., the ulterior purpose mentioned will be disregarded ... But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." *Gregory*, 293 U.S. at 469 (internal citations omitted). The Supreme Court found that the reorganization was not what the statute intended: "The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute." *Id.* at 470.

In *ACM Partnership*, this Court, as part of its sham transaction analysis, adopted the foregoing "intent of the statute" reasoning of the Supreme Court in *Gregory v. Helvering*. *See ACM Partnership*, 157 F.3d at 248, n. 31 (citing

Gregory v. Helvering). In other words, the IRS cannot disregard a transaction that results in actual changes in a taxpayer's economic position merely because it was motivated in part by tax considerations. *Id.* *See also CM Holdings,* 301 F.3d at 106 ("If Congress intends to encourage an activity, and to use taxpayers' desire to avoid taxes as a means to do it, then a subjective motive of tax avoidance is permissible.").

C. The Transaction Among HBH, NJSEA, And PBHR Was Clearly What Section 47 Intended, And Was Not A Sham

The critical dichotomy discussed above, namely, whether the transaction is what the statute intended, or whether the transaction lies outside the intent of the statute, is the necessary first step of *ACM Partnership's* sham transaction analysis for the HBH partnership. In other words, if the transaction is what I.R.C. § 47 intended, the sham transaction doctrine simply does not apply. Only if the transaction lies outside the intent of the statute is it necessary to inquire as to the economic substance and business purpose of the transaction. *ACM Partnership*, 157 F.3d at 248, n. 31. *See also Gregory v. Helvering*, 293 U.S. at 469-70.

HBH presented overwhelming evidence in the trial court which unequivocally proved that the formation and operation of HBH was indisputably

within the intendment of I.R.C. § 47. Congress enacted I.R.C. § 47 (and its predecessor historic preservation tax statutes) to encourage private sector investment in the rehabilitation of historic structures that may not otherwise appear economically viable. PBHR's investment in HBH, and HBH's renovation of the East Hall, was precisely "the thing which the statute intended." *Gregory v. Helvering*, 293 U.S. at 469. On this basis, the sham transaction doctrine, and its economic substance-business purpose duality, does not apply herein, regardless of any tax motives of PBHR in entering into the transaction.

If this Court determines that it is necessary to review the economic substance and business purpose issues, the IRS's sham transaction theory still fails. From an objective economic perspective, PBHR's investment in HBH affected its economic position in a significant way. *See CM Holdings,* 301 F.3d at 103. PBHR invested capital of approximately $19.3 million in HBH, and made a loan to HBH in the principal amount of $1,218,000. HBH, in turn, obtained the use of these funds for purposes of renovating the East Hall. PBHR's substantial investment in HBH meant that the renovations cost the State of New Jersey less. Indeed, without the investment of PBHR, HBH would not have had sufficient funds to pay the East Hall's total rehabilitation costs of about $100 million. (JA42-43; Tr. 157-60, 164-65). As such, the PBHR's investment also served the interests of

NJSEA.

For its investment, PBHR, from an objective economic perspective, received the historic rehabilitation tax credits, a 3 percent cash-on-cash preferred return (which was cumulative), and a 99.9 percent interest in any upside from the operations of the East Hall for 87 years (or its refinancing or disposition). Pitney Bowes critically examined the objective economics of the investment in HBH, and concluded that the investment was economically sound, the returns were sufficient, and that Pitney Bowes should make the investment. (Tr. 665).

Despite the IRS claims to the contrary, Congress unquestionably intended that the historic rehabilitation tax credits be taken into account in evaluating the economic substance of an investor's participation in a historic rehabilitation project, like PBHR's investment in HBH. (*See* Argument II, *supra*). The tax credits are an economic incentive that Congress made available to motivate private sector investment in rehabilitation projects that otherwise may not have appeared economically profitable. *See Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995). The IRS produced an economist as an expert witness at trial. Even the IRS's expert conceded that PBHR's investment in HBH had economic substance when the tax credits were taken into account. (Tr. 1061-61, 1065, 1135-36, 1147-44).

The second prong of the sham transaction analysis examines the subjective motivations underlying the transaction. *ACM Partnership*, 157 F.3d at 252-53. The subjective motivations of PBHR and NJSEA for investing in HBH establish the requisite business purpose. The business purpose of NJSEA in investing HBH was to access new sources of capital to complete the renovations of the East Hall that would not have been available without the formation of the partnership.

The IRS misleadingly alleges that a portion of PBHR's investment was directed to pay a development fee to NJSEA. PHBR's investment was actually used to pay down principal on the acquisition loan. (JA17, 95, 108, 122-23). In any event, the IRS's argument ignores the fact that funds invested in a real estate project are fungible. Moreover, NJSEA was clearly entitled to earn a development fee for the substantial services that it performed in renovating the East Hall. Indeed, without PBHR's capital, the funds for payment of the development fee to NJSEA would have come from the taxpayers of New Jersey.

PBHR, from the outset, approached its investment in HBH with a business purpose, and PBHR's subjective motivations for investing in HBH were several. First, by investing in HBH, PHBR was entitled to receive the 3 percent cash-on-cash preferred return. Second, it obtained the benefits of ownership in a

significant and valuable real estate asset, *to wit*, the East Hall, including any upside potential from its operations, refinancing or sale. Third, Pitney Bowes, through PBHR, received the historic rehabilitation tax credits. Obtaining the tax credits must be included as a permissible "non-tax business purpose" for the investment. To do otherwise would directly contradict the will of Congress under I.R.C. § 47. Pitney Bowes subjective business purpose for investing in HBH is also exhibited in the depth and rigorousness of its due diligence investigation in connection with the investment. Pitney Bowes examined real estate title, architectural, structural, engineering, environmental, insurance, legal and other issues with care before deciding to invest in the renovations of the East Hall. All of the foregoing factors demonstrate that PBHR had a substantial business purpose for investing in HBH.

D. The *Sacks* Case

In its opinion, the Tax Court discussed the importance of *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995) to its sham transaction analysis. (JA38-41). The targeted tax credits in *Sacks* were solar energy credits enacted by Congress and the State of Arizona legislature in response to the energy crisis of the 1970's. *Sacks*, 69 F.3d at 983-84. In *Sacks*, the taxpayer entered into sale-leaseback transactions for solar water heaters. The taxpayer purchased the solar water heaters with cash and promissory notes, leased them back to the seller,

and then the water heaters were leased to homeowners. The taxpayer claimed federal and state energy tax credits, as well as depreciation and interest deductions, with respect to his investment.

The IRS challenged the solar energy tax credits and deductions on the grounds that the transaction was an alleged sham. In analyzing whether the transaction was a sham, the United States Court of Appeals for the Ninth Circuit acknowledged that the sale and leaseback transaction would not have been profitable on a pre-tax basis, but was profitable once the solar energy tax credits were taken into account. Significantly, the court held that the tax credits *must* be considered in determining the profitability of the taxpayer's investment. Specifically, the court found:

> Absence of pre-tax profitability does not show 'whether the transaction had economic substance beyond the creation of tax benefits,' *where Congress has purposely used tax incentives to change investors' conduct.* Congress and the Arizona legislature purposely skewed the neutrality of the tax system, even more than the usual tax credits and accelerated depreciation designed to encourage more investment in capital goods than would otherwise be made, because they sought to induce people to invest in solar energy.

Sacks, 69 F.3d at 991. (internal citations omitted) (emphasis added).

The Ninth Circuit rejected the IRS's argument (which is being made again herein) that targeted tax credits should not be a component of the economic

substance analysis. Indeed, the court stated that: "If the government treats tax-advantaged transactions as shams unless they make economic sense on a pre-tax basis, then it takes away with the executive hand what it gives with the legislative." *Sacks*, 69 F.3d at 992. Similarly, in ruling that the taxpayer's investment in *Sacks* was not a sham, the court held that the IRS's sham transaction argument was the equivalent of "...us[ing] the reason Congress created the tax benefits as a ground for denying them. That violates the principle that statutes ought to be construed in light of their purpose. *Cabell v. Markham,* 148 F.2d 737 (2d Cir. 1945) (L. Hand, J.)." *Id*.

This Court addressed the significance of *Sacks* in *ACM Partnership* with respect to transactions intended to take advantage of tax benefits that are specifically authorized by Congress. The Court distinguished *Sacks* by stating that in *Sacks*, where there was no pre-tax profitability, "the transaction had economic substance because it involved a sale and leaseback of equipment used for legitimate business purposes and it resulted in concrete changes in the parties' economic positions." *ACM Partnership*, 157 F.3d at 257, n. 49. The formation of HBH, and PBHR's and NJSEA's investment therein, similarly, and significantly, altered the net economic positions of these parties.

The Court's discussion of *Sacks* was even more explicit in *CM*

Holdings. In *CM Holdings*, 301 F.3d at 106, the Court held that the transaction in *Sacks* was one which achieved what the energy tax credit statutes intended and had economic substance, by stating: "*Sacks* involved the question of whether depreciation deductions and investment credits were allowed on a transaction involving the sale and leaseback of solar energy equipment. The Ninth Circuit reasoned that both federal and state legislatures had specifically encouraged investment in solar energy and thereby 'skewed the neutrality of the tax system.'" (internal citations omitted). In other words, the investment in *Sacks* accomplished "the thing which the statute intended." *Gregory v. Helvering*, 293 U.S. at 469. The same must certainly be said of the transaction involving HBH, PBHR, and NJSEA.

The IRS makes a feeble and strained attempt to relegate *Sacks* to anonymity by claiming that it was not followed in *American Electric Power Co., Inc. v. United States*, 326 F.3d 737 (6th Cir. 2003), and is allegedly not consistent with *Friendship Dairies, Inc. v. Commissioner*, 90 T.C. 1054 (1988). *American Electric* involved interest deductions for loans against insurance policies and not targeted tax credits; hence, it has no bearing to this case. In its opinion, the Tax Court correctly observed that *Friendship Dairies,* which also does not involve targeted tax credits, is distinguishable on its facts, and does not stand for the broad holding that the IRS seeks to ascribe to it. (JA46).

For all of the reasons discussed herein, respondent's sham transaction argument has no merit and should be rejected.

V. THE BENEFITS AND BURDENS OF OWNERSHIP OF THE HISTORIC BOARDWALK HALL PASSED FROM NJSEA TO HBH

A. Introduction

In its FPAA, the IRS claimed that the benefits and burdens of ownership of the East Hall were not transferred from NJSEA to HBH pursuant to the agreement to lease between NJSEA and HBH which the parties treated as a sale for federal, state, and local income tax purposes. The IRS's position is completely unsupportable under the facts of this case which prove, as the Tax Court found, that HBH acquired ownership of the Hall. (JA52-58).

B. The Facts Establish A Sale Occurred

The issue of whether the benefits and burdens of ownership have been transferred is a factual inquiry. In this regard, in *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981), the Tax Court stated that this determination is "a question of fact which must be ascertained from the intention of the parties as evidenced by the written agreements read in light of the attending facts and circumstances." *Id.* at 1237-38. *See also Frank Lyon Co. v. United States*, 435 U.S. 561, 571-73 (1978); *Arevalo v. Commissioner*, 469 F.3d 436, 439 (5th Cir.

2006). The Tax Court identified the following factors to be considered in *Grodt & McKay*:

> (1) Whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property.

Id. at 1237-39.

On September 14, 2000, NJSEA and HBH entered into a sublease agreement whereby the East Hall was subleased to HBH from September 14, 2000 to November 10, 2087. Also on September 14, 2000, NJSEA and HBH entered into an agreement to lease pursuant to which NJSEA sold the subleasehold interest in the Hall to HBH for $53,621,405. (JA410-49). The lease was treated as a sale and purchase for federal, state, and local income tax purposes. HBH paid the purchase price for the Hall by an acquisition note secured by a first mortgage on the property.

By the agreement to lease, NJSEA had a contractual obligation to deliver the East Hall to HBH, and HBH had a binding obligation to pay for the East Hall. (JA54). Possession of the Hall passed to HBH pursuant to this agreement, and legal title to the Hall vested in HBH. The 87-year term of the sublease,

standing alone, is undeniable evidence of a sale. Indeed, the term greatly exceeds the useful life of the property for depreciation purposes under I.R.C. § 168, which is 39 years. Further, a key element of ownership under the benefits and burdens analysis is the question of which party has the right to any residual value in the property. *See, e.g., Levy v. Commissioner*, 91 T.C. 838, 860 (1988). Pursuant to NJSEA's sale of the subleasehold interest to HBH, HBH acquired from NJSEA the ownership and use of the East Hall in a profit-seeking venture for 87 years, which is clearly the entirety of the Hall's useful life. This fact plainly demonstrates that HBH acquired ownership of the Hall.

The audited financial statements of HBH for 2000, 2001, and 2002 state that HBH is the owner of the East Hall. (JA95, 108, 122). Significantly, the financial statements establish that HBH had a material equity investment in the Hall in those years. In this regard, the statements show that the value of HBH's ownership interest in the Hall exceeded its debt on December 31, 2000, December 31, 2001, and December 31, 2002. (JA90, 103, 117).

During 2000, 2001, and 2002, and thereafter, HBH has operated as a special events facility. HBH has earned income and paid expenses attributable to the operations of the East Hall. Parties who contract to use the Hall enter into written agreements with HBH for the facility. Payments from these parties to HBH

are deposited into bank accounts owned by HBH. HBH has numerous employees who work for the company. For example, in 2001 and 2002, HBH paid wages to its employees of approximately $2.6 million and $3.5 million, respectively. (JA76, 81, lines 9).

HBH, as the owner of the East Hall, will receive any proceeds from the sale or refinancing of the Hall. HBH also will receive any property, casualty, environment or other insurance paid out concerning the Hall. In sum, the totality of the facts and circumstances conclusively proves that the benefits and burdens of ownership of the Hall were transferred by NJSEA to HBH. *Grodt & McKay*, 77 T.C. at 1237-39. *See also Frank Lyon*, 435 U.S. at 571-73.

C. <u>The IRS's Arguments Are All Misdirected</u>

The IRS makes various arguments devoid of any merit concerning its claim that HBH is not the owner of East Hall. For example, the IRS alleges that because NJSEA was liable for certain expenses under the sublease that ownership of the Hall was not transferred to HBH. These types of net lease provisions, however, are common in real estate transactions, and are nothing more than a "neutral" factor in a benefits and burdens of ownership analysis. *See*, *e.g.*, *Levy v. Commissioner*, *Id.; Estate of Thomas v. Commissioner*, 84 T.C. 412, 433 (1985).

The IRS also erroneously claims that the benefits and burdens of

ownership of the East Hall were not acquired by HBH based on this Court's holding in *Sun Oil Co. v. Commissioner*, 562 F.2d 258 (3d Cir. 1977). This argument must fail for a number of reasons. First, as the Tax Court found, *Sun Oil* is disguishable on its facts. (JA55-57). *Sun Oil* involved 320 sale-leaseback transactions between Sunray DX Oil Co. ("Sunray") and a trust that were used to generate rent deductions under I.R.C. § 162. The sale-leaseback transactions in *Sun Oil* are wholly dissimilar to the Congressionally-sanctioned historic rehabilitation tax credit project at issue in this case.

Further, Sunray, as lessee, had considerable rights over the trust, as lessor, that simply do not exist between NJSEA and HBH. Most pivotal, as the Court found, was Sunray's "extraordinary and absolute" right to substitute other land for the property subject to the sale-leaseback transactions, without first making a "rejectable offer" to the trust. *Sun Oil*, 562 F.2d at 264. No comparable rights of any kind exist between NJSEA and HBH.

The IRS deliberately confounds the analysis under *Sun Oil* with an erroneous discussion of what it claims to be a "perpetual" consent option between NJSEA and PBHR. At the outset, it must be emphasized that a consent option between NJSEA and PBHR has absolutely nothing to do with the benefits and burdens of ownership issue between NJSEA and HBH. In other words, a consent

option that may have existed between NJSEA and PBHR, *in their capacity as partners*, has no bearing on the question of whether HBH, as *purchaser-sublessee*, acquired ownership of the East Hall from NJSEA, the *seller-sublessor*.

The IRS seeks to elevate the importance of the consent option to some lofty perch when, in point of fact, NJSEA and PBHR knew that the likelihood of its exercise was infinitesimally minute. In this regard, it is significant to note that NJSEA and PBHR negotiated separate, stand-alone agreements for the call option and the put option. (JA284-97). The parties, however, included the consent option in Article 8.02 of the AREA with the understanding and belief that there was no realistic circumstances under which it would be used.

Specifically, Articles 8.02(a) and (b) of the AREA set forth limitations on NJSEA's authority to take certain actions as the managing member of HBH. (JA184-86). These Articles also include an exception to the limitations if NJSEA purchases PBHR's interest in HBH by a consent option. The exception was included to address NJSEA's concern that consistent with its governmental purpose, NJSEA might be required to take some unstated and unknown action that was determined to be in the best interests of the State of New Jersey. The AREA does not identify what this action might be. In this regard, any circumstances that might have given rise to the exercise of the consent option were clearly theoretical rather

than real. Further, if PBHR provided written consent to the action that NJSEA intended to take, NJSEA would not have the right to exercise the consent option. Hence, the consent option was included in the AREA for an extraordinary and ineffably remote purpose which the parties never thought would come to pass. (Tr. 215-21, 743, 749, 764-66; JA184-86).

The consent option was not perpetual as the IRS claims. The consent option was only effective within the five-year recapture period for historic rehabilitation tax credits under the Code. The parties agreed that the consent option had no validity after the recapture period. (Tr. 215-21, 743, 759, 764-66). As stated previously, none of the options have been exercised, and PBHR and NJSEA remain partners in HBH.

D. <u>Conclusion</u>

In sum, the totality of the facts and circumstances conclusively proves that the beneficial interest in the East Hall was transferred from NJSEA to HBH, and HBH became, and still is, the owner of the East Hall.

CONCLUSION

For all of the foregoing reasons, the decision of the Tax Court should be affirmed.

Dated: New York, New York
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Respectfully submitted,

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CERTIFICATE OF BAR MEMBERSHIP

I, Kevin M. Flynn, hereby certify that I am a member of the bar of this Court, having been admitted in May 17, 2011.

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3. The undersigned hereby further certifies that the foregoing brief filed electronically with the Court is in PDF searchable format.

/s/ Kevin M. Flynn
KEVIN M. FLYNN
Attorney for Appellee

Dated: December 15, 2011

CERTIFICATE OF SERVICE

This is to certify that on December 15, 2011, I mailed ten copies of the foregoing Brief For Appellee, Historic Boardwalk Hall, New Jersey Sports and Exposition Authority, Tax Matters Partner, to the Court by first class mail, and I electronically filed a PDF copy of the brief by CM/ECF on the same date. I further certify that on December 15, 2011, service of this brief was made on counsel of record for appellant, a Filing User, by the CM/ECF system.

/s/ Kevin M. Flynn
Kevin M. Flynn
Attorney for Appellee

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