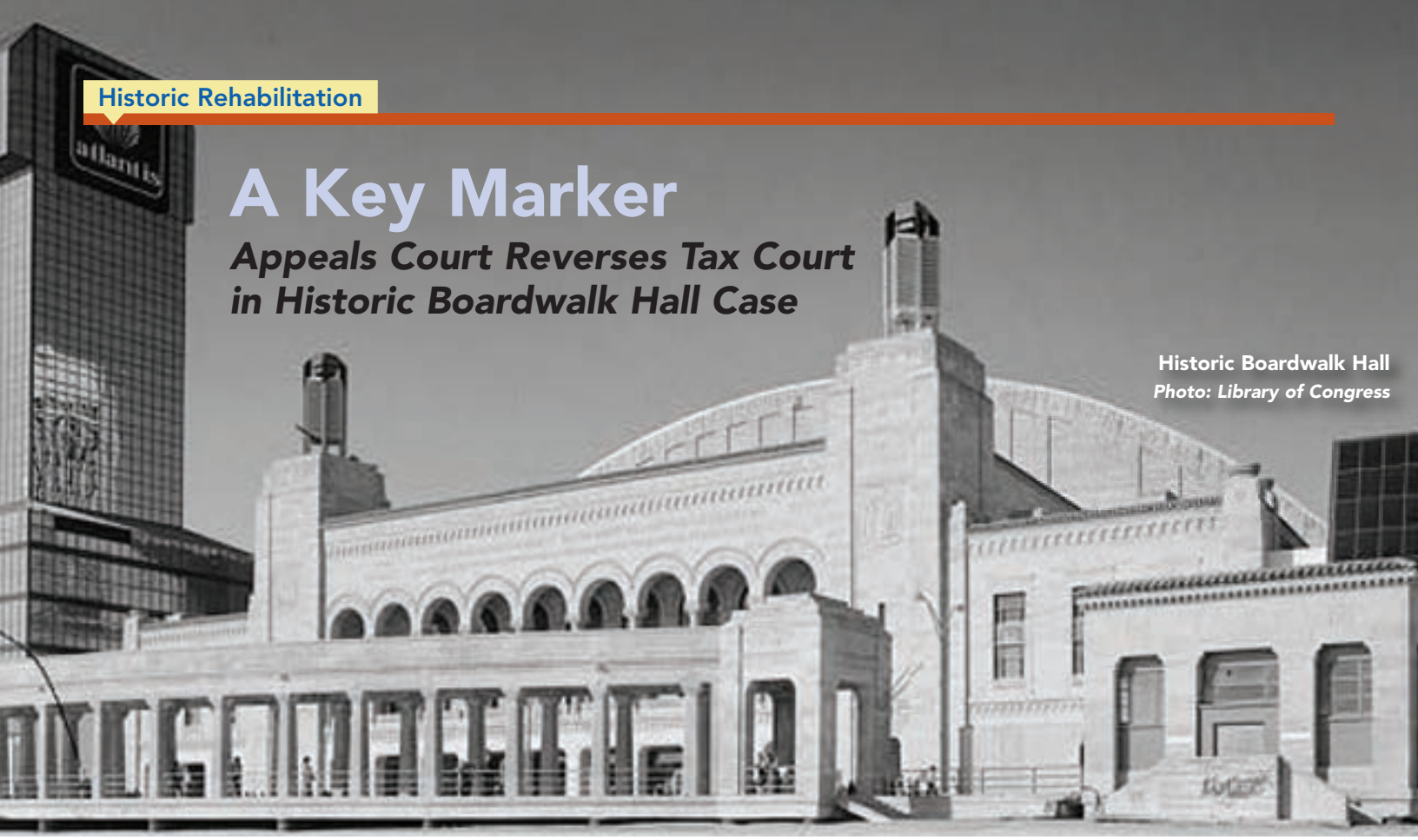
A Key Marker

Appeals Court Reverses Tax Court in Historic Boardwalk Hall Case



Historic Boardwalk Hall
Photo: Library of Congress

A U.S. appeals court has reversed a U.S. Tax Court decision in the *Historic Boardwalk Hall* case, holding that the investor in a transaction challenged by the Internal Revenue Service wasn't entitled to receive federal historic rehabilitation tax credits (HRTCs) because it wasn't a bona fide partner in a partnership for federal income tax purposes. According to the court, this was because the investor lacked a meaningful stake in the success or failure of the enterprise generating the tax credits.

The momentous decision has roiled the tax credit industry *(see article on p. 10)*.

The case involved the historic former convention center in Atlantic City, N.J., called East Hall (also known as Historic Boardwalk Hall). In December 1998, the New Jersey Sports and Exposition Authority (NJSEA), a state agency with a leasehold interest in the property, began a renovation of the facility. In 2000, as construction continued, it formed a limited liability company – Historic Boardwalk Hall, LLC (HBH) – to rehabilitate, own, and operate the facility. HBH's sole members were an affiliate of Pitney Bowes, Inc. (PB), the tax credit investor, and NJSEA, the managing member.

NJSEA subleased its interest in East Hall to HBH, which completed the rehabilitation project, which generated federal historic tax credits allocated 99.9% to PB. The investor, which made capital contributions, was also promised a 3% preferred return from available cash flow.

In early 2007, the IRS challenged the transaction and issued a notice to NJSEA and to the partnership (HBH, an LLC, was treated as a partnership for federal tax law purposes because it didn't elected to be treated as a corporation; PB thereby was treated as a limited partner in a partnership). The Service said the transaction was a sham and a disguised sale of tax credits to PB, and proposed adjustments to the tax benefits claimed on HBH's's federal income tax returns for tax years 2000-2002, including to disallow all the tax credits to PB. HBH and NJSEA filed a challenge in U.S. Tax Court, which ruled in January 2011 that the transaction had economic substance and was legitimate and that PB was a bona fide partner that bore financial risk despite various guarantees and protections. The IRS appealed to the Third Circuit, which issued its opinion on August 27, 2012.

Reliance on Several Test Cases

In its opinion, the Third Circuit held that PB wasn't a bona fide partner in a partnership for federal tax law purposes because it lacked "meaningful" downside risk and lacked "meaningful" potential upside from HBH beyond the tax credits and preferred return. The court asserted that HBH wasn't a true entrepreneurial venture

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Historic Tax Credit Industry Participants Dismayed by Third Circuit Decision

The Third Circuit's decision in the *Historic Boardwalk Hall* case has dismayed and roiled the tax credit industry, with participants scrambling to figure out how the structure of pending and future transactions utilizing federal historic rehabilitation tax credits – and perhaps even other types of tax credits – may need to be changed from the practices to date to satisfy federal tax law as interpreted by the court.

As of mid-September, there appeared to be no consensus yet about what changes should be made among law firms, investors, developers, and other participants. John Leith-Tetrault, President of the National Trust Community Investment Corporation (NTCIC) and a founder of the Historic Tax Credit Coalition, called the situation "fluid." NTCIC, an affiliate of the National Trust for Historic Preservation, syndicates federal and state historic tax credits and federal new markets, low-income housing, and solar tax credits.

Leith-Tetrault called the Third Circuit decision "disappointing. It highlights the inefficiency of providing guidance through court decisions. It's not helpful when the IRS takes an isolated case and asks the court to rule on it. Whether it meets the requirements of a partnership or the historic tax credit, the courts tend to rule on a factual basis. It's difficult to apply the ruling to other transactions which don't have the same facts. It leaves the industry in a position of having to figure out how it applies or whether it applies to how business is normally done."

Boston tax attorney Forrest Milder, a partner with Nixon Peabody LLP, wrote in a memo issued by the firm that the decision "has implications for all transactions in which a developer and an investor share business and tax benefits."

Washington, D.C. tax attorney Jerry Breed, a partner at Bryan Cave LLP, said the decision "will have a significant effect on historic credit transactions going forward and how they're structured."

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because there was never a realistic chance that the project would be profitable, and that there was not entrepreneurial risk for PB.

According to the Third Circuit opinion, "PB and NJSEA, in substance, did not join together in HBH's stated business purpose – to rehabilitate and operate the East Hall. Rather, the parties' focus from the very beginning was to effect a sale and purchase of HRTCs."

The Third Circuit relied heavily in its analysis on three prior judicial decisions, none of which involved federal historic tax credits. These were *Culbertson*, and two decisions cited by the IRS as guideposts for the court, *Castle Harbour* and *Virginia Historic*.

Applying *Culbertson*, the Third Circuit indicated that the totality of the circumstances must be considered in analyzing the transaction and to determine whether PB was a bona fide partner.

In *Castle Harbour*, the Second Circuit sided with the IRS to disregard the claimed status of two foreign banks as partners in a partnership, holding that the banks' purported partnership interest in substance was by its nature a secured lender's interest. In determining whether the banks' interest was a bona fide equity participation, the Second Circuit "focused both on the banks' lack of downside risk and lack of upside potential in the partnership," according to the Third Circuit opinion.

In *Virginia Historic*, the Fourth Circuit reversed a U.S. Tax Court decision in favor of the IRS, ruling that the transfer of Virginia state historic tax credits from upper-tier partnerships to investors wasn't an allocation of tax credits to limited partners in exchange for capital contributions but rather a disguised sale of property (tax credits) generating taxable income for the partnership. The Fourth Circuit asserted that the investors didn't face entrepreneurial risk.

No Meaningful Risk, Potential Upside

The Third Circuit held that PB had virtually no risk of loss on its investment because of multiple protections. It noted that:

- PB had no risk that the rehabilitation project wouldn't be successfully completed because it was already fully funded before PB entered into an agreement to provide capital contributions.

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Moreover, NJSEA, backed by another state agency, provided a completion guarantee and would cover any operating deficits for East Hall;

- PB didn't have to make capital contributions until there were sufficient cumulative rehab expenditures to generate cumulative historic tax credits at least equal to the total of PB's next and prior capital contributions. PB made its first of four capital contributions in September 2000, by which time at least two of four construction phases had been completed;
- A tax benefits guaranty from NJSEA eliminated any risk that PB wouldn't receive its full projected tax credits or cash-equivalent in the event of a successful IRS challenge disallowing the tax credits;
- Full payment to PB of its preferred return and for its interest in the partnership, in the event NJSEA exercised its call option to buy out PB, was assured by a guaranteed investment contract; and,
- PB was protected from any environmental liability that might occur.

The court said that there was a "dearth" of any meaningful upside potential for PB beyond the tax credits and preferred return. While PB was also to be allocated 99.9% of residual cash flow after certain payments, the court noted that HBH's financial projections forecast none available for distribution to PB.

The Third Circuit also noted that PB was unlikely to gain any extra financial benefit if it exercised its put option to sell its partnership interest to NJSEA.

According to the court, "the parties' behind-the-scenes statements reveal that they never anticipated that the fair market value of PB's interest would exceed PB's accrued but unpaid Preferred Return."

The court didn't analyze whether the transaction had economic substance. But it held that HBH was never really a true business venture, pointing out that early financial projections forecast operating losses for the renovated East Hall (projections later revised to show profitability) and that the facility actually ran operating deficits after completion.

(Third Circuit opinion: http://tinyurl.com/9texwhk) TCA

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Industry participants lamented that the Third Circuit's opinion didn't provide any explicit guidance or guideposts regarding the minimum level of risk and minimum potential upside for investors that the court would deem to be significant and acceptable for federal tax law purposes. Indeed, in its opinion, the court said, "Where the line lies between a defensible distribution of risk and reward in a partnership on the one hand and a form-over-substance violation of the tax laws on the other is not for us to say in the abstract."

The court did say it wasn't attacking the historic tax credit statute; said it wasn't suggesting that a limited partner can't cap its risk at the level of its investment; and noted that a limited partner does not jeopardize its status as a bona fide equity participant by negotiating measures to minimize its risk of loss of a part of its investment in an enterprise.

Leith-Tetrault indicated that the Coalition will be asking the U.S. Treasury Department to issue guidance spelling out a "safe harbor" structure for partnerships for historic tax credit transactions that would be respected as valid for federal tax law purposes, in the wake of the *Historic Boardwalk Hall* and *Virginia Historic* decisions.

What Next?

Forrest Milder's memo said the decision "does present four basic questions when analyzing the degree of risk/reward an investor needs in order to be considered a partner:

- How much, and how early, should the investor make its initial investment in the venture?
- What risk-limiting features can be provided to the investor to limit its downside?
- What conditions can the investor impose on further capital contributions?
- What kind of upside should be available to the investor?"

Breed felt that the typical structure for historic

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tax credit transactions will be changed to provide investors with both downside risk and potential upside. He noted that the former could be accomplished, for example, by changing pay-in schedules to require investors to put in more capital during or at the start of construction, or by changing the guarantees (construction completion, operating deficit, tax credit recapture) now provided by developers to protect investors. Breed indicated that investors could be provided potential upside, for example, by providing them with, in addition to residual benefits, a significant percentage of the current cash flow from a project that would mean a substantial amount of cash if the project is very successful but nothing if the project underperforms and the cash flow isn't there.

Breed suggested that some people "down the road" might discontinue the annual preferred return that is now commonly promised to historic credit investors, which is generally equal to 2% to 3% of the amount of the investor's investment and is payable from available cash flow.

Breed felt pricing for historic tax credits "could go down" if investors eventually have to take on increased risk. Leith-Tetrault, though, said it was "too early" to tell what if any pricing impact the Third Court decision might have.

Leith-Tetrault indicated that any ultimate changes made to historic credit transaction structures will need to be acceptable to developers, investors, accountants, and tax attorneys.

In the Meantime

When interviewed September 13, NTCIC had five pending transactions moving toward closing that Leith-Tetrault noted were being reviewed for possible changes in light of the Historic Boardwalk decision. Four of them plan to utilize federal historic and new markets tax credits; one, federal solar tax credits.

Some practitioners were concerned that the Third Circuit opinion might also affect transactions utilizing federal new markets, renewable energy, or low-income housing tax credits. At a minimum, the structure of current and future transactions utilizing these other credits were expected to be scrutinized closely through the lens of *Historic Boardwalk*.

Breed felt there likely shouldn't be any impact for typical low-income housing tax credit transactions, noting LIHTC transactions enjoy special treatment under federal tax law in that they don't need to have a profit motive. He also downplayed the risks for new markets transactions, explaining that the typical structure for these is much different than that for historic tax credit transactions.

Breed didn't feel that the decision strikes a fatal blow to the historic credit industry. "The industry's going to get through this," he noted. "There may be some things that change in terms of structuring. But does this destroy the industry? I don't think so. Does it make it more difficult to do deals? Yes. And while guidance with respect to the parameters of the decision would be extremely helpful, it is unlikely that such guidance will be issued in the near future. So we will need to figure out how to get deals done under the Historic Boardwalk Hall test." TCA