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A Dark Future For Historic Tax Credits After *Historic Boardwalk*

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After *Historic Boardwalk*, it is clear that investment structures that are designed to completely eliminate all risk from the transaction using layers of guaranties, indemnities, and purchase options will be subjected to scrutiny.

A recent appellate court decision has cast a shadow over investments in historic rehabilitation projects. In *Historic Boardwalk Hall, LLC*, 694 F.3d 425, 110 AFTR2d 2012-571 (CA-3. 2012), *rev'g and remanding*, 136 TC 1 (2011), the Third Circuit held that an institutional investor in a partnership engaged in the rehabilitation of a notable historic property was not a "bona fide partner" in the partnership. As a result, the federal tax credits allocated to that investor were disallowed.

The Third Circuit's decision, which reversed a taxpayer-favorable Tax Court opinion, not only has had a chilling effect on new investments in historic rehabilitation, it has raised significant concerns as to the Service's audit intentions with respect to investments already made. In addition, certain of the Service's arguments in the case, which the Third Circuit accepted, focused on the fact that the other partner in the partnership—the project's sponsor and developer—was a tax-exempt governmental organization. That raises concerns that the IRS will begin to focus on historic credit partnerships with tax-exempt entities.

While the IRS National Office has attempted to quell investors' fears, no guidance has been forthcoming. Instead, adding fuel to the fire, the IRS recently disclosed an internal legal memorandum that applied its arguments in *Historic Boardwalk* to an historic rehabilitation partnership with a more generalized set of facts.[1]

In the absence of published guidance from the IRS regarding the "dos and don'ts" for a partnership dependent on historic tax credits, taxpayers and practitioners will need to consider the potential impact of *Historic Boardwalk* and make appropriate changes to the traditional partnership structures to which investors have become accustomed. Those changes will involve increasing the risk profile to the investor, limiting sponsor/developer guaranties and, if possible, devising a realistic upside from the partnership through a greater share of partnership cash flows and distributions.

Historic Boardwalk facts

[1] IRS Field Attorney Advice, IRS FAA 20124002F (8/30/12).

The property at issue in *Historic Boardwalk* is the historic Boardwalk Hall, a popular and famous landmark in Atlantic City, New Jersey. In 1992, the New Jersey Sports and Exposition Authority (NJSEA) was charged by the state with rehabilitating Boardwalk Hall and converting it into a special events facility. NJSEA is a state agency that owns a leasehold interest in Boardwalk Hall. In what turned out to be a key fact for the IRS and the Third Circuit, the rehabilitation project was already fully funded by the State of New Jersey before any solicitations were made to outside institutional investors. In other words, the rehabilitation of Boardwalk Hall was bound to occur—with or without private funds.

In the normal course of things, the Boardwalk Hall rehabilitation would generate federal historic rehabilitation credits.[2] Specifically, Section 47 provides an income tax credit equal to 20% of the "qualified rehabilitation expenditures" (QREs) with respect to any certified historic structure.[3] And, therein lies the rub. Because NJSEA was a tax-exempt governmental entity, it had no use for federal income tax credits. NJSEA was not permitted to sell the tax credits.

This situation left NJSEA with two alternatives: One, it could forgo any benefits from the credits. Two, it could find an investor willing to contribute capital to the rehabilitation project in exchange for credits, effecting this investment through a partnership between NJSEA and the investor.[4] Nothing in the tax rules required NJSEA to forgo the tax benefits. Indeed, it is clear that Congress enacted the federal tax credits to stimulate outside investment with the historic credits as the proverbial "carrot."[5] Moreover, the IRS has recognized that a partnership would be used in these circumstances to "syndicate" the credits:

> How can property owned by a tax-exempt entity use rehabilitation tax credits?
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> The rehabilitation tax credit is of no use to a tax-exempt entity. In many instances, however tax-exempt entities are involved in rehabilitation projects by forming a limited partnership and maintaining a minority ownership interest as a

[2] Some states provide tax credits for historic rehabilitation projects. See, e.g., Va. Code Ann. § 58.1-339.2. However, as discussed below, the IRS has undertaken a course similar to Historic Boardwalk with respect to state historic credit partnerships. See. e.g., Virginia Historic Tax Credit Fund 2001 LP 639 F.3d 129, 107 AFTR2d 2011-1523 (CA-4. 2011) (recasting state tax credit allocations to investors as disguised sales under Section 707). *rev'g*, TCM 2009-295.

[3] Section 47(a)(2).

[4] A third alternative, leasing the property to an investor and electing to pass the tax credits through to the investor, see Section 50(d)(5) and Reg. 1.48-4 is unavailable to a tax-exempt entity such as NJSEA unless the tax-exempt entity is subject to tax under Section 511. See Reg. 1.48-1(i). As discussed below, the transaction described in IRS FAA 20124002F, *supra* note 1, was a pass-through lease arrangement involving a tax-indifferent, but not a tax-exempt, lessor.

[5] See, e.g., Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, page 149 ("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 investors' 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.").

general partner. In these situations, the limited partners are entitled the tax credit and the tax-exempt entity is able to ensure that its organizational goals are being met.[6]

In line with an IRS publication,[7] the availability of the historic credits presented an opportunity to attract an investor willing to participate in the rehabilitation. Accordingly, NJSEA engaged a broker to find an investor. Ultimately, Pitney Bowes Corporation ("Pitney Bowes"), through its subsidiaries, agreed to invest in the Boardwalk Hall rehabilitation. The investment was accomplished through a newly formed limited liability company. Historic Boardwalk Hall, LLC (HBH), which was treated as a partnership between NJSEA and Pitney Bowes for federal income tax purposes. The HBH transaction included a number of aspects that the IRS and ultimately the Third Circuit criticized:

- *Offering memorandum*. NJSEA engaged Sovereign Capital Resources (Sovereign) as its tax credit broker in the initial correspondence with NJSEA. Sovereign described a "consulting proposal ... for the sale of the historic rehabilitation tax credits expected to be generated" by the Boardwalk Hall rehabilitation. A summary by Sovereign describing the tax credit investor's investment said: "the best way to view the equity generated by a sale of the historic tax credits is to think of it as an $11 million interest only loan that has no term and may not require any principal repayment." A 174-page confidential information memorandum that Sovereign sent to potential investors was titled "Sale of Historic Tax Credits Generated by the Renovation of the Historic Atlantic City Boardwalk Convention Hall."

- *Capital contribution amount*. Pitney Bowes initially agreed to make a capital contribution to HBH of approximately $18.2 million. This was sized on the basis of $0.93 for each $1.00 in historic credits to be allocated to Pitney Bowes (a total of $19,412.173 in projected credits), Pitney Bowes agreed to make an additional capital contribution with respect to any additional credit-generating QREs equal to $0.995 for each additional $1.00 in historic credits allocated to Pitney Bowes. Thus, the capital contributions made by Pitney Bowes were tied directly to the amount of historic credits to be allocated to it.

- *Capital contribution timing*. Pitney Bowes agreed to make installment payments of its capital contribution over several years as the rehabilitation progressed. The first installment of $650,000 (approximately 3.5% of the projected total) was paid at closing. At that time, NJSEA already had incurred over $53 million of QREs that would generate over $10 million in historic credits. The remaining installments of the capital contribution were contingent upon the completion of certain project-related events, including verification of the amount of QREs to date. Pitney Bowes was obligated to make the additional installments only if the

[6] IRS, "Tax Aspects of Historic Preservation" (Oct. 2000), at 1, available at www.irs.gov/pub/irs-uti/faqrehab.pdf (cited in Historic Boardwalk, *supra* note 2 at 694 F.3d 430).

[7] *Id*.

QREs generated historic credits in an amount at least equal to the amount of Pitney Bowes contribution. Thus, the timing of Pitney Bowes capital contribution, and its obligation to make additional installments of that contribution, were tied directly to the amount of historic credits to be allocated to it.

- *Profits interest*. Pursuant to HBH's operating agreement, Pitney Bowes was given a 99.9% ownership interest and a right to 99.9% of the allocations of profits, losses, and tax credits.[8] After its rehabilitation, Boardwalk Hall was expected to be operated as a special events facility and to generate revenues. Pitney Bowes was entitled to a 3% preferred return on its capital contribution and also was entitled to 99.9%, of the residual cash flows from HBH. Although its preferred return was assured in several respects, it was unlikely that Pitney Bowes would ever receive any distributions of residual cash now from HBH. That is, Pitney Bowes would receive distributions only after (1) interest was paid on a \$1.1 million loan it made to HBH, (2) payment of its 3% preferred return, which had priority over other distributions from HBH, (3) funds were distributed to Pitney Bowes to pay tax liabilities from allocations of taxable income from HBH, and (4) payments for service of HBH's substantial debt.[9]

- *NJSEA guaranties*. NJSEA and HBH agreed to a number of features designed to limit Pitney Bowes' risk with respect to its investment. First, NJSEA agreed to pay all development costs to complete the rehabilitation in excess of the construction debt and capital contributions (the "completion guaranty"). Second, NJSEA agreed to fund all operating deficits through interest-free loans to HBH (the "operating deficit guaranty"). Third, NJSEA warranted to Pitney Bowes that there were no known environmental hazards, agreed to remediate any uncovered hazards, and agreed to indemnify Pitney Bowes and to name it as an additional insured on its environmental liability insurance policy (the "environmental guaranty"). Fourth, HBH provided a full tax indemnity to Pitney Bowes, backed up by a guaranty from NJSEA, covering the projected tax benefits allocated to

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[8] Because NJSEA is a tax-exempt entity, the allocations of partnership items had to be structured in a manner consistent with the "qualified allocation" rules of Section 168(h)(6)(B). See, e.g., Section 50(b)(4)(D). Under those rules, a "qualified allocation" will be respected and not result in a disallowance of any amount of the historic credits, provided it is consistent with the tax-exempt entity's being allocated "the same distributive share of each item of income, gain, loss, deduction, credit, and basis and such share remains the same during the entire period the entity is a partner in the partnership." Section 168(h)(6)(B). Thus, in adopting those rules, Congress recognized that tax credit partnerships involving tax-exempt entities are permissible provided they comply with those rules. It is indisputable that the allocations to Pitney Bowes and NJSEA compiled with the tax-exempt use rules.

[9] Though in form a sublease, HRH's acquisition of Boardwalk Hall from NJSEA was treated as a sale for federal tax purposes. In connection with this "sale," HBH provided a \$53.6 million acquisition note that required level annual payments of \$3.6 million through 2040 together with interest. Also, in exchange for a construction note, NJSEA agreed to lend HBH another \$57.2 million to complete the rehabilitation of Boardwalk Hall.

Pitney Bowes and any penalties and interest assessed by the IRS (the "tax benefits guaranty").[10]

- *Purchase options*. The transaction included a number of purchase options. First, in the event that NJSEA wanted to take certain actions that were prohibited under the agreements or required consent, NJSEA was permitted—without Pitney Bowes' consent—to buy Pitney Bowes' interest in HBH for an amount equal to the then present value of any yet-to-be realized projected tax benefits and cash distributions (e.g., the 3% preferred return) due to Pitney Bowes through the end of the five-year recapture period for the historic credits (the "consent option").[11] Second, NJSEA had the right to buy Pitney Bowes' interests in HBH at any time during the 12-month period beginning 60 months after the Boardwalk Hall rehabilitation was placed in service for tax purposes—i.e., at the end of the five-year recapture period (the "call option"). Third, if NJSEA did not exercise the call option, Pitney Bowes had the right to compel NJSEA to purchase its interest during the 12-month period beginning 84 months after the Boardwalk Hall rehabilitation was placed in service (the "put option"). Both options required NJSEA to pay Pitney Bowes the greater of (1) 99.9% of the fair market value of 100% of the membership interests in HBH or (2) any accrued and unpaid preferred return remaining due to Pitney Bowes. None of those options actually was exercised prior to the Service's challenge.[12]

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[10] The trigger for the tax benefits guaranty was a final determination resulting in a reduction of Pitney Bowes' projected tax benefits. HBH agreed to pay Pitney Bowes (1) any reduction in projected tax benefits as a result of an IRS challenge, (2) any additional tax liability incurred by Pitney Bowes from partnership items allocated to it by HBH as a result of an IRS challenge, (3) interest and penalties imposed by the IRS on Pitney Bowes in connection with any IRS challenge, (4) an amount sufficient to compensate Pitney Bowes for reasonable third-party legal and administrative expenses related to such a challenge, up to $75,000, and (5) an amount sufficient to pay any federal income tax liability owed by Pitney Bowes on receiving any such indemnification payments. Thus, the tax benefits guaranty represented a full tax indemnity and was designed to make Pitney Bowes completely whole for any IRS disallowance of the historic credits. Stated differently, NJSEA is completely on the hook in the Historic Boardwalk litigation even though the credits were claimed on Pitney Bowes' tax returns.

[11] The five-year recapture period would begin on the placed-in-service date of the rehabilitation project. See Section 50(a). Under Section 50(a)(1), the historic credits vested at a rate of 20% per year. If the rehabilitation project were sold, disposed of, or otherwise ceased to be "investment credit property" (e.g., by a casualty or change in use), the credits would be subject to recapture at the varying recapture rates. Section 50(a)(1)(B); see Regs. 1.47-2 and 1.47-6(a)(1). In addition, a recapture event might occur in the case of any changes in the partnership interests: for example, if Pitney Bowes sold its partnership interest in HBH or its proportionate share of gross profits in HBH changed significantly. See Reg. 1.47-6(a)(2).

[12] Two other options were available but did not feature prominently in the Service's arguments or in the court opinions. One, for a limited period following the transaction's closing, Pitney Bowes could require NJSEA to purchase its interests in HBH for an amount equal to its capital contributions to date, 15% interest thereon, third-party fees and expenses, and internal expenses in certain cases (i.e., a delay in the placed-in-service date or if the actual tax credits were less than projected). Two, in the event NJSEA committed a material default under the agreements, Pitney Bowes had the right to compel NJSEA to purchase its interest for an amount equal to the then-present value of any yet-to-be realized projected tax benefits and cash distributions due to Pitney Bowes through the end of the five-year recapture period. Neither option was exercised.

- *Guaranteed investment contract*. To secure NJSEA's payment under the call option or the put option, HBH's operating agreement required NJSEA to purchase a guaranteed investment contract (the GIC). The GIC was required to be "reasonably satisfactory to [Pitney Bowes], in the amount required to secure the payment of the purchase price" under the call option. NJSEA deposited approximately $3.2 million of Pitney Bowes capital contribution with an escrow agent for both Pitney Bowes and NJSEA (First Union National Bank), which then entered into a master repurchase agreement with a life insurance company (Transamerica Occidental Life Insurance Co.). The master repurchase agreement then was pledged as collateral to secure NJSEAs payment obligations under both the call option and the put option. The GIG was sized to pay off Pitney Bowes $1.1 million loan to HBH, accrued but unpaid interest on that loan, and Pitney Bowes' 3% preferred return. Thus, the GIC assured that Pitney Bowes would receive payment of its 3% preferred return regardless of HBH's or NJSEAs circumstances.

IRS audit

HRH reported a total of $109 million in QREs on its 2000-2002 partnership returns and allocated 99.9% of those to Pitney Bowes (giving rise to approximately $21.8 million in historic credits). On 2/22/07, after an audit, the IRS issued a statutory notice reallocating all the credits and losses to NJSEA. The IRS made that adjustment on a number of alternative grounds, only two of which actually factored into the Third Circuit's decision. One, the IRS determined that HBH should be disregarded as a sham partnership under the economic substance doctrine. Two, the IRS determined that Pitney Bowes was not a "bona fide partner" and, therefore, its partnership interest in HBH should be disregarded. In general, the IRS viewed Pitney Bowes' investment in HBH as a sale of tax credits and sought to disregard the allocations of those credits to Pitney Bowes through the partnership. Because NJSEA was a tax-exempt entity, the end result of the audit was that no historic tax credits could be claimed on the Boardwalk Hall rehabilitation—not by Pitney Bowes, not by NJSEA, not by anyone.[13]

The backstory to *Historic Boardwalk*

The theories that the IRS used to disallow the historic credits in *Historic Boardwalk* were not novel. Partnership considerations always have featured prominently in the proper planning and structuring of tax credit transactions. In addition, because tax credit transactions are inherently uneconomical and unprofitable, practitioners and investors have worried that the IRS might challenge tax credit transactions under the economic substance doctrine, which at the time

[13] In addition to these two grounds, the IRS determined that (1) the benefits and burdens of ownership for tax purposes did not pass from NJSEA to HBH in the purported sale and, therefore. HBH was not the tax owner of Boardwalk Hall, and (2) the partnership anti-abuse provisions of Reg. 1.701-2 applied to disregard HBH as a partnership. The Tax Court rejected both grounds in its opinion. Historic Boardwalk Hall, LLC, 136 TC 1. The IRS did not appeal the Tax Court's holding regarding the partnership anti-abuse provision. The Third Circuit declined to address the tax ownership argument on appeal. This article does not address these two alternative grounds, but practitioners should be aware that the IRS will likely raise the anti-abuse provision or tax ownership in future audits of historic rehabilitation credits involving partnerships. See, e.g., IRS FAA 20124002F, *supra* note 1 (advising that credits should be disallowed on bona fide partner, sham partnership, and tax ownership grounds).

was gaining prominence in the context of aggressive tax shelters. The IRS was well-attuned to the efforts of partnerships by developers to "monetize" federal and state tax credits and the features used in those transactions to limit risk, as well as the limited profitability. In light of the Congressional mandate and broad support for tax credit programs, however, the IRS took a hands-off approach to tax credit transactions. Practitioners and investors responded by letting their guard down, structuring transactions not only to limit commercial risk but to eliminate it completely. In addition, the terminology used to describe the partnership transactions took an unfortunate turn—the "sale of tax credits" becoming a common theme.

The historic credit has been in the Code since the Revenue Act of 1978 and it took its modern form as a 20% credit in the Tax Reform Act of 1986. Despite this history, historic credits received little attention from the IRS and litigation was non-existent until 2007, when the IRS began a two-front assault on historic tax credit partnerships involving historic credits. The first front was opened with respect to the *Historic Boardwalk* partnership as the Service's test case. The second front was opened through a series of legal memoranda and advisories from the IRS National Office in 2007,[14] and ultimately became a test case in litigation with respect to the partnership in *Virginia Historic Tax Credit Fund 2001 LP,* TCM 2009-295, *rev'd and remanded* 639 F.3d 129, 107 AFTR2d 2011 - 1523 (CA-4, 2011).[15]

Virginia Historic was docketed in the Tax Court in January 2008, ten months after *Historic Boardwalk.* The issues in *Virginia Historic* involved a similar argument by the IRS—that the tax credit investors were not bona fide partners in the subject partnership. The IRS also made a tag-along argument that the disguised sale rules under Section 707 applied. *Virginia Historic* followed a fast track. In December 2009, the Tax Court rejected the Service's arguments under existing partnership precedent and determined that the investors were bona fide partners and the disguised sale rules did not apply. By the time the Tax Court decided *Historic Boardwalk* in January 2011, the IRS had appealed the Tax Court's decision in *Virginia Historic* to the Fourth Circuit, though a decision had not been issued.

The Fourth Circuit issued its *Virginia Historic* opinion in March 2011. The court accepted, without deciding, that the tax credit investors were bona fide partners in the subject partnership, but concluded that the state historic credits were "property" and, therefore, triggered the disguised sale rules of Section 707. Because of certain features in the partnership structure—i.e., the investments were made only with respect to completed projects and investors were entitled to refunds if the tax credits were not delivered or were revoked—the Fourth Circuit concluded that the investors did not have any "entrepreneurial risk" with respect to their investment. Although the IRS did not raise the disguised sale rules in *Historic Boardwalk*, and the Fourth Circuit's opinion was therefore not directly applicable, this element of "entrepreneurial risk" ultimately set the tone for the Third Circuit's analysis.

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[14] See 2007 Gen. Couns. Adv. Memo. AM 2007-002 (1/26/07); Chief Couns. Adv. Memo, ILM 200704030 (1/26/07) and ILM 200704028 (1/26/07). See also IRS Release, "Fraudulent Telephone Tax Refunds. Abusive Roth IRAs Top Off 2007 'Dirty Dozen' Tax Scams." IR-2007-37 (2/20/07) (IRS lists state tax credit partnerships as one of the "dirty dozen tax scams").

[15] State tax credit allocations to investors recast as disguised sales under Section 707.

Another development is also noteworthy. As discussed above, historic rehabilitation projects are inherently uneconomical and unprofitable. In recognition of this fact, Congress enacted the historic credits to encourage private investment.[16] During the tax years at issue in *Historic Boardwalk*, the IRS and the courts applied the common law version of the economic substance doctrine, which generally required a transaction to be accompanied by a subjective business purpose and objective economic substance.[17] If applicable, the economic substance doctrine would disregard the transaction, including the partnership itself as a sham and any tax benefits from that transaction would he disallowed.[18] The economic substance doctrine generally required a reasonable expectation of a profit before consideration of the tax benefits.[19] In the context of federal tax credit transactions, however, a pre-tax profit generally is non-existent. For this reason, if the economic substance doctrine were applied to federal tax credits such as historic credits, the transaction might be treated as a sham. In the context of a different investment tax credit, the Ninth Circuit recognized the congressional purposes underlying federal tax credits and held that a pretax profit was not required for economic substance purposes, provided the transaction had other economic effects to the investor.[20]

In 2010, before the Tax Court decided *Historic Boardwalk*, Congress codified the economic substance doctrine as Section 7701(o).[21] The Technical Explanation explained that the codification (and, presumably, the economic substance doctrine that it codified) was not intended to disallow "the tax benefits of a transaction [that] is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate...."[22] The Technical Explanation specifically listed the historic credits in Section 47 and stated that "it is not intended that a tax credit ...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."[23] Following the codification, consistent with the Technical Explanation, the IRS issued a directive to its examiner and managers that restricted audits of tax credits such as the historic credits:

> Does the transaction involve tax credits (e.g., low income housing credit, alternative energy credits) that are designed by Congress to encourage certain

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[16] See note 5, *supra*.

[17] See, e.g., CM Holdings, Inc , 301 F.3d 96, 90 AFTR2d 2002-5850 (CA-3, 2002).

[18] See. e.g., Santa Monica Pictures, LLC, TCM 2005-104.

[19] See. e.g., Gilman, 933 F.2d 143, 67 AFTR2d 91-1016 (CA-2. 1991).

[20] Sacks, 69 F.3d 982. 76 AFTR 2d 95-7138 (CA-9, 1995), *rev'g*, TCM 1992-596.

[21] The Health Care and Education Reconciliation Act of 2010, P.L. 111-152 (3/25/13), section 1409, applicable to transactions entered into after the date of enactment.

[22] Staff of the Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in Combination with the "Patient Protection and Affordable Care Act,"* page 152, n.344.

[23] *Id*.

> transactions that would not be undertaken but for the credits? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.[24]

Thus, as a general matter, Congress and the IRS have recognized that the economic substance doctrine should be applied sparingly in the context of federal tax credits such as historic credits. Even though the economic substance codification was not directly applicable to the facts of *Historic Boardwalk* because that transaction occurred before 3/25/10, the Third Circuit considered the effect of the codification and the Technical Explanation above in analyzing the economic substance doctrine.

Tax Court decision in *Historic Boardwalk*

On 1/3/11, the Tax Court decided *Historic Boardwalk* in favor of HBH and against the IRS. The Tax Court's decision was issued in the form of a precedential "division opinion"; as opposed to a fact-based memorandum opinion.[25] In the Tax Court, the Service's principal argument was that the partnership transaction was a sham and did not have economic substance. The issue of whether Pitney Bowes was a bona fide partner in HBH was a secondary issue.

First, the Tax Court concluded that the transaction had objective economic substance. Significantly, relying on the Ninth Circuit's opinion in *Sacks*, 69 F.3d 982, 76 AFTR2d 95-7138 (CA-9, 1995), *rev'g*, TCM 1992-596, the Tax Court concluded that Congress enacted Section 47 to spur private investment in unprofitable historic rehabilitation: "Without the rehabilitation tax credit, Pitney Bowes would not have invested in [the Boardwalk Hall] rehabilitation because it could not otherwise earn a sufficient net economic benefit on its investment. The purpose of the credit is directed at just this problem: because the [Boardwalk] Hall operates at a deficit, its operations alone would not provide an adequate economic benefit that would attract a private investor."[26] Stated differently, the Tax Court recognized that a pre-tax profit under the economic substance doctrine is not required with respect to the type of incentivized tax credit provided for in Section 47. Moreover, the Tax Court recognized that the historic credits should be taken into account as cash in the pre-tax profit analysis, together with Pitney Bowes' 3% preferred return, under the economic substance doctrine:

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[24] IRS Large Business & International Division, LB&I-4-0711-015, "Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties (7/15/11); see also IRS Chief Counsel Notice, IRS CC-2012-008 (4/3/12) (providing instructions to Chief Counsel attorneys relative to the LB&I directive).

[25] Historic Boardwalk Hall, LLC, 136 TC 1 (2011), *rev'd and remanded*, 694 F.3d 425, 110 AFTR2d 2012-571 (CA-3, 2012). Though the Tax Court's decision was reversed, certain portions of its opinion, including its economic substance holding, were not affected by the Third Circuit's decision. Because the Tax Court is a court of national jurisdiction, its holding on economic substance continues to govern its proceedings in all circuits, including the Third Circuit, and its legal holdings in respect of the partner issue continue to apply in cases appealable to circuits other than the Third Circuit, even those holdings that were reversed. See, e.g., Golsen, 54 TC 742 (1970), *aff'd*. 445 F.2d 985, 27 AFTR2d 71-1583 (CA-10, 1971).

[26] Historic Boardwalk, *supra* note 25 at 136 TC 27.

> As an initial matter, we do not agree with [the IRS] ... that Pitney Bowes invested in the ... transaction solely to earn rehabilitation tax credits. We believe the 3-percent return and the expected tax credits should be viewed together. Viewed as a whole, the ... transactions did have economic substance.[27]

Consistent with *Sacks*, the Tax Court concluded that the Pitney Bowes' investment had other economic effects. Specifically, it found that Pitney Bowes faced the risk that the project would not be completed and also faced potential liability for environmental hazards from the rehabilitation. The Tax Court rejected the Service's reliance on the various side agreements and guaranties from NJSEA designed to limit Pitney Bowes' risk, finding that "those agreements show that the [Boardwalk] Hall and [HBH] ... did in fact affect the parties' economic positions—the agreements were meant to prevent the transaction from having a larger impact than the parties had bargained for."[28]

The Tax Court also concluded that there was a subjective business purpose for the partnership transaction: "Pitney Bowes, NJSEA, and [HBH] had a legitimate business purpose—to allow Pitney Bowes to invest in the [Boardwalk] Hall's rehabilitation.[29] The court concluded that the economic substance doctrine did not apply.

Second, applying the factors for determining a partnership set forth in *Culbertson*, 337 U.S. 733, 37 AFTR 1391 (1949), the Tax Court determined that Pitney Bowes was a partner in HBH. In doing so, the Tax Court followed its opinion in *Virginia Historic*, where "we applied the *Culbertson* factors and upheld a partnership which was formed to allow the partners to share and distribute State tax credits."[30] The Tax Court held that "Pitney Bowes and NJSEA, in good faith and acting with a business purpose, intended to join together in the present conduct of a business enterprise" and "the decision to invest provided a net economic benefit to Pitney Bowes through its 3-percent preferred return and rehabilitation tax credits."[31] Among other things, the Tax Court relied on the parties investigation and documentation (including the analysis of potential environmental liabilities), the executed transaction documents, and the fact that the parties' actions after the transactions were executed in concluding that Pitney Bowes was a bona fide partner in HBH.[32]

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[27] *Id* at 24.

[28] *Id*. at 26.

[29] *Id*.

[30] *Id*. at 28.

[31] *Id*. at 29.

[32] Even though the confidential offering memorandum described a "sale" of tax credits, the Tax Court found that "it was used in the context of describing an investment transaction. The confidential offering memorandum accurately described the substance of the transaction; an investment in the [Boardwalk] Hall's rehabilitation." *Id*. Thus, the Tax Court Judge made specific factual findings relating to the intent of the parties and characterized the evidence in light of its findings and evaluation of witnesses' credibility at trial. As explained below, the third Circuit disregarded all of the Tax Court's findings and substituted its own findings and evaluation of the evidence.

Appeal to Third Circuit

In its brief to the Third Circuit, the IRS prefaced that [i]n situations where the credits would otherwise be earned by a tax-exempt entity that cannot use them, there is an incentive to attempt an indirect sale of the credits to a taxable entity."[33]

The Service's principal argument was that Pitney Bowes was not, in substance, a partner in HBH because it had "no meaningful stake in the success or failure of the enterprise," i.e., it had no "meaningful downside risk" and no "upside potential" with respect to Boardwalk Hall.[34] The IRS focused its legal arguments on what it referred to as two recent "guideposts"—the decision of the U.S. Court of Appeals for the Second Circuit in *TIFD III-E, Inc*. ("*Castle Harbour*"), 459 F.3d 220, 98 AFTR2d 2006-5616 (CA-2, 2006)[35] and the Fourth Circuit's opinion in *Virginia Historic*.

The IRS also argued on appeal that the partnership was a sham under the economic substance doctrine.[36] Contrary to its position in the Tax Court, the IRS argued against the Ninth Circuit's holding in Sacks. "[T]he notion that a court may consider tax benefits in evaluating the economic substance of a transaction involving—or of a purported partnership engaged in—tax-favored activity finds no support apart from Sacks."[37] In any event, the IRS claimed that "Sacks is distinguishable on the ground that the transaction at issue there otherwise had economic substance in terms of risk and reward."[38] In the absence of published guidance taxpayers and practitioners will need to make changes to the traditional partnership structures.

Third Circuit argument

The argument before a three-judge panel of the Third Circuit, held on 6/25/12, turned out to be one sided.[39] The judges immediately focused on the references to the "sale of tax credits"

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[33] See Brief for the Appellant Commissioner of Internal Revenue, Historic Boardwalk Hall, LLC v. Commissioner, case no. 11-1832, at 30 (10/27/11).

[34] *Id*. at 30-31. Contrary to the order of its arguments in the Tax Court, the Service's principal argument on appeal was that Pitney Bowes was not a bona fide partner in HBH.

[35] In Castle Harbour, the Second Circuit concluded that two foreign banks were not partners in a partnership because their interest was more in the nature of debt than equity. In this respect, the banks had no downside risk because they were guaranteed to a return of their investment and a specified return, which was secured by high-grade commercial paper or cash and a personal guaranty from the U.S. partner. While the banks had a theoretical upside by reason of their 98% interest in partnership operating income, the U.S. partner could effectively cap the banks' upside—over and above the repayment of its investment and the specified return—because it could buy out the banks at any time for a small premium.

[36] See Brief for the Appellant Commissioner of Internal Revenue, *supra* note 33, at 32.

[37] *Id*. at 57.

[38] *Id*.

[39] See Trivedi, "Historic Boardwalk Oral Arguments Focus on Economic Risk," 2012 TNT 123-1 (6/26/12).

in the confidential offering memorandum and other correspondence: "You can't sell tax credits, right?"[40] The judges' focus then turned to Pitney Bowes' risk in the partnership transaction: "One could say, looking at this, that all risk from the transaction has effectively been taken out."[41] On the other hand, Judge Kent Jordan, who would author the Third Circuit's opinion, expressed his displeasure with the Service's failure to provide guidance to tax credit partnerships and asked: "Why should the ax fall here?"[42] The Government's attorney responded, "This particular case is particularly egregious."[43] He explained that "the number one thing is this guaranteed investment contract."[44]

Third Circuit decision

On 8/27/12, the Third Circuit issued a rare 85-page opinion reversing the Tax Court by concluding that Pitney Bowes was not a bona fide partner in HBH.[45] The Third Circuit's opinion focused heavily on *Castle Harbour* and *Virginia Historic*—as the IRS did—then accepted much of the Service's analysis of the facts in preference to the Tax court's findings.

In the absence of published guidance, taxpayers and practitioners will need to make changes to the traditional partnership structures.

The Third Circuit determined that *Castle Harbour* and *Virginia Historic* provided "guideposts" for its analysis. It explained that "resolving whether a purported partner had a 'meaningful stake in the success or failure of the partnership: *Castle Harbour*, 459 F.3d at 224, goes to the core of the ultimate determination of whether the parties "intended to join together in the present conduct of the enterprise," *id*. at 232..."[46] In addition, the Third Circuit found that *Castle Harbour's* analysis (concluding that the banks' "indicia of an equity participation in a partnership" was only "illusory or insignificant"), and *Virginia Historic's*, determination that the limited partner investors did not face the "entrepreneurial risks of partnership operations," were "both highly relevant to the question of whether HBH was a partnership in which [Pitney Bowes] had a true interest in profit and loss…."[47] The court emphasized that "the answer to that question turns on an assessment of risk participation."[48] Following this view of the applicable

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[40] Oral Argument at 00:50, available at www.ca3.uscourts.gov/oralargument/audit/11-1832Historic%20Boardwalk%20LLC%20v%20Commissioner%20IRS.wma.

[41] *Id*. at 16:55.

[42] *Id*. at 30:01.

[43] *Id*. at 32:11.

[44] *Id*. at 32:17.

[45] Historic Boardwalk Hall, LLC, 694 F.3d 425, 110 AFTR2d 2012-571 (CA-3, 2012).

[46] *Id*. at 694 F.3d 454.

[47] *Id*. (internal citations omitted).

[48] *Id*. at 454-455.

law, the court proceeded to analyze whether Pitney Bowes had "any meaningful downside risk" or "any meaningful upside potential" in its investment in HBH."[49]

Meaningful downside risk. The Third Circuit concluded that Pitney Bowes had "no meaningful downside risk because it was, for all intents and purposes, certain to recoup the contributions it had made to HBH and to receive the primary benefit it sought—the [historic credits] or their cash equivalent."[50]

The court identified three separate risks associated with Pitney Bowes investment in HBH:

1. The risk that Pitney Bowes would not receive an allocation of historic credits in an amount that was at least equivalent to the installments of its capital contribution to HBH ("investment risk").

2. After the credits were allocated to Pitney Bowes, the risk that it would not receive at least the cash equivalent of the bargained-for tax credits if the IRS disallowed the credits ("audit risk").

3. The risk that Pitney Bowes would not receive all of its bargained-for tax credits (or cash equivalent) due to a failure of any part of the rehabilitation to be successfully completed ("project risk").

With respect to investment risk, the Third Circuit focused on the timing of Pitney Bowes' installments of its capital contribution, which were contingent on levels of QREs, that would generate credits sufficient to fully cover those installments. Thus, referring to Pitney Bowes as PB throughout its opinion, the Third Circuit concluded: "While PB did not have the contractual right to 'compel HBH to repay all or any part of its capital contribution' … PB had an even more secure deal. Even before PB made an installment contribution, it knew it would receive at least that amount in return."[51]

With respect to audit risk, the Third Circuit focused on the tax benefits guaranty, which it found fully assured Pitney Bowes of receiving a return of at least the cash equivalent of its investment and other expenses in the case of a successful IRS challenge. With respect to project risk, the court focused on the fact that the project costs were already fully funded by the state of New Jersey before Pitney Bowes entered its agreement to provide its capital contribution to HBH, and the fact that NJSEA provided both a completion guaranty and an operating deficit guaranty. The court found that NJSEA, backed by the state of New Jersey, was fully capable of fulfilling its obligations under the guaranties.[52] The Third Circuit concluded that "PB bore no

[49] *Id*. at 455.

[50] *Id*.

[51] *Id*. at 456 (internal citation omitted).

[52] The Third Circuit stated that "PB's contributions were not at all necessary for the [Boardwalk] Hall project to be completed." *Id*. at 456-457. The Third Circuit expressly rejected the Tax Court's findings to the contrary that Pitney Bowes was at risk that the rehabilitation would not be completed.

meaningful risk in joining HBH as it would have had it acquired a bona fide partnership interest."[53] Instead, citing to the confidential offering memorandum, the Third Circuit concluded that the transaction was really a sale of tax credits.

The Third Circuit was not persuaded that Pitney Bowes' 3% preferred return was relevant to the partner risk analysis and, in any event, that Pitney Bowes was at risk of not receiving its 3% preferred return. The Third Circuit found that Pitney Bowes was assured of receiving its preferred return because of its ability to exercise the put option, which was effectively measured by Pitney Bowes' accrued and unpaid preferred return. Moreover, the GIC provided assurance that there would be sufficient cash to cover the purchase price to be paid by NJSEA. In this regard, the Third Circuit, quoting *Virginia Historic*, said the fact that "investors were promised what was, in essence, a fixed rate of return on investment rather than any share in partnership profits tied to their partnership interests' … 'point[ed] to the conclusion that there was not true entrepreneurial risk faced by investors..."[54] Thus, even though the 3% preferred return was to be paid in the first instance from partnership net cash flows, the Third Circuit determined that the fact it was guaranteed by arrangements outside of the partnerships operations eliminated any "entrepreneurial" aspect associated with that return.

Meaningful upside potential. The Third Circuit concluded that "PB's avoidance of all meaningful downside risk in HBH was accompanied by a dearth of any meaningful upside potential."[55] The court observed that "[w]hether [a putative partner] is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprise."[56] It concluded that "PB in substance, was not free to enjoy the fruit of HBH."[57]

The Third Circuit focused on Pitney Bowes 99.9% interest in HBH's residual cash flows concluding that this interest" gave a false impression that it had a chance to share in potential profits in HBH."[58] Because of the prioritization of distributions and HBH's heavy debt service, the court determined that no residual cash flows were projected.[59]

Moreover, even though Pitney Bowes had the potential to receive the fair market value of its interest (assuming such value was greater than its accrued but unpaid preferred return) if either NJSEA exercised its call option or Pitney Bowes exercised its put option, the Third Circuit

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[53] Historic Boardwalk Hall, LLC, *supra* note 45 at 694 F.3d 457 (internal citation omitted).

[54] *Id*.

[55] *Id* at 459.

[56] *Id*., quoting Culbertson, 337 U.S. 733, 747, 37 AFTR 1391 (1949).

[57] *Id*. at 459.

[58] *Id*.

[59] The Third Circuit criticized the financial projections that were done in connection with the transaction as "rosy" and "fantastically inaccurate," but noted that even those projections anticipated no residual cash flows available for distribution. *Id* at 459-460.

found that “in reality, PB could never expect to share in any upside.”[60] The court cited the parties “behind-the-scenes statements” that they never anticipated that the fair market value of Pitney Bowes’ interest would exceed its accrued but unpaid preferred return because “this was not a profit-generating enterprise.”[61] In any event, even if there were an upside, the court concluded that “NJSEA could exercise its Consent Option, and cut PB out by paying a purchase price unrelated to any fair market value.”[62] Thus, the Third Circuit concluded that the structure of the transaction—i.e., the various options—ensured that Pitney Bowes would never receive any economic benefits from HBH.

Interestingly, the Third Circuit did not discuss Pitney Bowes’ 3% preferred return in the context of its “meaningful upside potential” discussion, even though that was the focal point of the Tax Court’s analysis. It appears that the Third Circuit incorporated, without stating its analysis of the preferred return in the context of its “meaningful downside risk” analysis. That is, because the preferred return was guaranteed by the put option and GIG, the Third Circuit refused to accept it as an upside from partnership operations. This unstated holding by the Third Circuit, if accepted, would have a broader impact than just the *Historic Boardwalk* case.[63]

Because it concluded that Pitney Bowes did not have meaningful downside risk or meaningful upside potential in its investment in HBH, the Third Circuit concluded that Pitney Bowes was not a bona fide partner in HBH and, therefore, was not entitled to an allocation of the historic credits.

Economic substance. In a long, multi-page footnote, the Third Circuit assumed, without deciding, that the partnership transaction had economic substance. In doing so, the court drew a line between the economic substance doctrine and the substance-over-form partner question: “[E]ven if a transaction has economic substance, the tax treatment of those engaged in the transaction is still subject to a substance-over-form inquiry to determine whether a party was a bona fide partner in the business engaged in the transaction.”[64] The court expressly declined to opine on the parties dispute as to whether, under *Sacks*, credits may be considered in evaluating whether a transaction has economic substance. Thus, the Third Circuit allowed the Tax Court’s holding to stand despite its reversal on the bona fide partner issue.

Field Advice Memorandum

Not long ago, the IRS Chief Counsel released a legal memorandum drafted by one of its field offices.[65] The memorandum addressed a partnership that had leased historic rehabilitation

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[60] Historic Boardwalk Hall, LLC, *supra* note 45 at 694 F.3d at 460.

[61] *Id*. at fn. 63

[62] *Id*. at 460.

[63] See Hunt, TCM 1990-248 (rejecting the Service’s contentions that preferred returns guaranteed by other partners were in substance akin to debt and interest rather than a partnership interest).

[64] Historic Boardwalk Hall, LLC, *supra* note 45 at 694 F.3d at 448 fn. 50.

[65] FAA 20124002F, *supra* note 1.

property. The owner of the property elected to pass the historic credits through to the lessee-partnership.[66] The developer-partner was a company owned by a combination of individuals subject to the passive activity loss limitations of Section 469, which effectively precluded them from benefiting from the credits.[67] The memorandum concludes that the investor was not a bona fide partner in the partnership, that the partnership should be disregarded as a sham under the economic substance doctrine, and that the partnership was not the owner of the rehabilitation project for federal tax purposes. While some of the general features of the transaction were similar to the partnership in *Historic Boardwalk*, many of the key features were different.[68]

- The legal memorandum was dated three days after the Third Circuit issued its decision in *Historic Boardwalk*. It copies the government's Third Circuit brief almost verbatim. In many cases, the memorandum appears to have copied certain facts from the *Historic Boardwalk* brief even though those facts do not appear to apply to the subject transaction.[69] This circumstance undermines the credibility and competence of the legal memorandum.

- The memorandum incorporates the same economic substance arguments that were made in the government's brief, even though the Third Circuit ultimately declined to address those arguments. By including this discussion, the legal memorandum suggests that the IRS will continue to assert economic substance with respect to historic credit partnerships despite the Tax Court's economic substance holding in *Historic Boardwalk* and the Third Circuit's reluctance to disturb that holding.

- The memorandum states that the investor's capital contribution was designed to equal $0.90 for each dollar of federal historic credits the partnership expected to receive. While the investor was entitled to a refund of its capital contribution if the historic credits turned out to be less than anticipated, or in the case of a recapture event, the memorandum does not suggest that the investor had a full tax indemnity comparable to the one in *Historic Boardwalk*. Thus, investment risk may have been limited but audit risk appears to have been retained by the investor.[70]

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[66] See note 4, *supra*.

[67] The memorandum indicate that a tax-exempt entity became an indirect owner of the partnership at a later point.

[68] The memorandum contains about nine pages of redacted material in the section for case development, hazards, and other considerations. It is not clear to what issue this redacted material relates. However, the memorandum (p.18, n.12) includes an unredacted cross-reference to the redacted section with respect to a discussion of appellate venue in the context of the economic substance doctrine and the *Sacks* case.

[69] The memorandum copied the tax ownership discussion from the government's Third Circuit brief, even though the subject transaction was a pass-through lease in which tax ownership was not required.

[70] The availability of a refund in the case of a recapture event does not relate to audit risk as the memorandum suggests. Recapture generally would arise only in a narrow set of circumstances involving a disposition, casualty, or change in use. See, e.g., Reg. 1.47-2(a).

- The transaction described in the memorandum included a put option and a call option. The developer's call option was set at fair market value plus any unpaid priority return due the investor. The investor's put option was set as a percentage of the investor's paid-in capital contribution plus any unpaid priority return due the investor—presumably, the put price was projected to be "out of the money" when the transaction was entered into. Unlike *Historic Boardwalk*, there was no consent option or other mechanism to "cut off" the investor's interest, and there was no GIC to guarantee payment.

- The economics of a pass-through lease differ fundamentally from the economics of the transaction in *Historic Boardwalk*. Despite the fundamental differences, the legal memorandums treated the pass-through lease and direct ownership of the rehabilitation property the same.

In general, the legal memorandum treats the facts in the subject transaction to be exactly the same as the "egregious" facts that the government relied on in *Historic Boardwalk*. The legal memorandum did not attempt to analyze any of the key factual differences between the subject transaction and the *Historic Boardwalk* facts. This application raises a concern that the IRS will attempt to apply *Historic Boardwalk*, in a "cookie-cutter" manner, to the more traditional fact patterns associated with historic credit partnerships.

Key take-aways from *Historic Boardwalk*

The *Historic Boardwalk* opinion has taken the tax credit world—particularly the historic credit world—by storm. Despite calls for guidance from practitioners, and expressions of support for the credit from the IRS, the IRS has been slow to react and non-committal on any guidance. The Service's equivocation is fueling concerns by practitioners and investors that the IRS is playing a game of "gotcha"—promoting the historic credit program on the one hand, while maintaining a state of uncertainty for future audits on the other.[71] Assuming the IRS holds to the *status quo ante*, what are the implications for future planning purposes and for investments already made and potentially subject to audit?

To be a bona fide partner in an historic credit partnership under *Historic Boardwalk*, the investor must demonstrate one of two things—either "meaningful downside risk" or "meaningful upside potential." The investor need not demonstrate both risk and upside potential. Rather, an investor will be treated as a partner in a partnership if he or she has a "meaningful stake" in its "success *or* failure." Although the Third Circuit was not entirely clear on this point, because it dismissed Pitney Bowes' arguments regarding both risk and upside potential, it is nonetheless apparent that upside potential can salvage a risk-free investment but the lack thereof will not invalidate a risk-existent investment. If this were not true, the "bona fide partner" analysis would swallow up the economic substance doctrine.

Is it realistic to rely on upside potential alone? If the rehabilitation property is a real profit-generating enterprise, the answer is yes. In those circumstances, an interest in the residual

[71] See Trivedi, "Practitioners Urge Development of Historic Rehabilitation Credit Partnership Guidance," 2013 TNT 42-11 (3/2/13).

cash flows or a buy-out right at fair market value may establish upside potential. But, the reality is that this generally is not the case. In *Historic Boardwalk*, the Third Circuit determined that the residual cash flows were not realistic—they were not even apparent in the "rosy" and "fantastically inaccurate projections that accompanied the closing. Moreover, no one expected the purchase options to be exercised at fair market value. At the same time, however, the Third Circuit refused to consider what appeared to be genuine upside for Pitney Bowes—the 3% preferred return—because the court apparently viewed that return as non-entrepreneurial. While a prioritized return standing alone would seemingly pass muster under *Historic Boardwalk*, the fact is that most historic rehabilitation partnerships have been structured with "greater of purchase options that assure receipt of the preferred return.[72] Most investors are unwilling to rely on operating cash flows alone for their preferred return. Thus, if the *Historic Boardwalk* approach to upside potential prevails, the realities of the marketplace may not support the type of "meaningful upside potential" that the Third Circuit suggests.

If upside potential is not realistic under *Historic Boardwalk*, the key takeaway is that the partner analysis ultimately will turn on "an assessment of risk participation," exactly as the Third Circuit suggested. The facts of Historic Boardwalk presented an easier case for the IRS because the multiple layers of guaranties, indemnities, and GICs, each backed by a governmental agency, were perceived by the Third Circuit judges as effectively *eliminating all* risk from the transaction. But, in a different case, how much risk is enough risk? The Third Circuit provided some guidance with respect to this question.

In response to the Service's arguments regarding risk, HBH argued to the Third Circuit that the Service's position 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."[73] The Third Circuit responded that sharing in *all* risks and costs of the partnership was not required. "The Commissioner has not claimed, however, and we do not suggest, that a limited partner is prohibited from capping its risk at the amount it invests in a partnership. Such a cap, of and of itself, would not jeopardize its partner status for tax purposes."[74] Thus, the Third Circuit (and, purportedly, the IRS) accepts that limiting investment to the agreed-upon capital contributions is appropriate and will not affect partner status.

In addition, the Third Circuit stated that "[w]e also recognize that a limited partner's status as a bona fide equity participant will not he stripped away merely because it has successfully negotiated measures that minimize its risk of losing a portion of its investment in an enterprise."[75] Thus, at least the Third Circuit accepts that traditional risk-limiting measures are permissible—e.g., environmental indemnities and other similar protections. The problem in

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[72] For example, the put and call options in the Chief Counsel legal memorandum, discussed above, included a mechanism tied to the receipt of any unpaid and due preferred return.

[73] See Brief for Petitioner-Appellee New Jersey Sports and Exposition Authority, Tax Matters Partner, Historic Boardwalk Hall, LLC v. Commissioner, case no. 11-1832, at 44 (12/15/11).

[74] Historic Boardwalk Hall, LLC, *supra* note 45, 694 F.3d at 459.

[75] *Id*.

Historic Boardwalk, according to the Third Circuit, is that the parties shielded Pitney Bowes' investment from any meaningful risk—it was assured of receiving the value of the historic credits and its preferred return regardless of the success or failure of the rehabilitation of Boardwalk Hall and HBH's subsequent operations.

The linchpins in the Third Circuit's analysis appear to have been centered on the contingent nature of the capital contributions and the elimination of audit risk. That is, in the Third Circuit's view, completion of the rehabilitation project was assured by the completion guaranty and the creditworthiness of NJSEA. As a result, the rehabilitation project was almost certain to be placed in service and to generate the projected level of historic credits. In addition, Pitney Bowes was not obligated to pay the installments of its contributions until after QREs reached levels that would cover those contributions with allocations of historic credits. If the IRS challenged the credits after they were allocated to Pitney Bowes, Pitney Bowes was fully protected through the tax benefits guaranty (i.e., the cash equivalent of the credits under the Third Circuit analysis).

There are several options for addressing the Service's and Third Circuit's risk concerns.

First, although the Third Circuit discounted Pitney Bowes non-contingent, initial payment of $650,000 because an equivalent amount of credits had already been generated, a significant up-front payment that is not subject to an absolute clawback through a tax indemnity arrangement would seemingly pass muster under *Historic Boardwalk*. It is not clear, however, what level of up-front payment would be acceptable as significant for this purpose.[76] An up-front payment that is significant in an absolute and relative sense should be respected. Second, investors may consider making at least a portion of their capital contributions in advance of the rehabilitation work and credit-generating QREs, and eliminating refund and clawback provisions.[77] Third, the comprehensive tax indemnity in *Historic Boardwalk*, backed by a guaranty from a governmental agency, likely will attract scrutiny. However, a tax indemnity limited to recapture events and "bad acts," such as the one described in FAA 20124002F, should be permissible and should not jeopardize partner status.

The GIC proved to be a lightning rod in *Historic Boardwalk*. The operating agreement for HBH required NJSEA to acquire the GIC. The GIC was funded from a portion of Pitney Bowes capital contribution. In effect, the GIC economically defeased NJSEA's payment obligations under the call option and the put option and assured that Pitney Bowes would receive

[76] In Rev. Proc. 2007-65, 2007-50 IRB 967, the IRS provided safe harbor guidance for certain wind credit partnerships. This safe harbor requires a 20% minimum unconditional Investment (fixed and reasonably anticipated contingent capital contributions) to be made up front and maintained through the duration of the investors ownership in the partnership. The safe harbor provides that the investment may not be protected against loss of any portion of this minimum investment through any arrangement, directly or indirectly, with the developer or other interested party.

[77] The transaction described in FAA 20124002F contains a refund mechanism—i.e., the investor was entitled to a refund of overpayments if the credits came in lower than projected. Unlike this refund mechanism, in Historic Boardwalk. Pitney Bowes was entitled to reduce its future installments of capital contributions, but was not entitled to a refund of prior installments. The problem in Historic Boardwalk. however, was that the level of OREs already incurred effectively assured the credits that had been projected.

its 3% preferred return in all events. In other contexts, the IRS has raised similar challenges where purchase option payments are economically defeased.[78] Defeasing the call or put option price is asking for trouble after *Historic Boardwalk*.

Another feature in *Historic Boardwalk* that attracted attention was the consent option. While the parties disputed, and the two courts diverged, regarding the scope of this option, this option ultimately provided the IRS and the Third Circuit an opportunity to apply the *Castle-Harbour* decision. That is, in the view of the IRS and the Third Circuit, the consent option permitted NJSEA to cut off any upside potential that Pitney Bowes might otherwise have had in HBH through the fair market value purchase options. In general, practitioners and investors should avoid call options with a purchase price "unrelated to any fair market value."[79]

After the Third Circuit's decision in *Historic Boardwalk*, the economic substance doctrine remains a threat to historic credit partnerships. The fact is that rehabilitation projects are inherently unprofitable and will not yield a pre-tax profit. Unless the rationales of *Sacks* and the Joint Committee on Taxation's Technical Explanation are applied, it is questionable whether any partnership investment involving subsidized tax credits would have objective economic substance. Although the Tax Court firmly rejected the Service's position, and the Third Circuit saw no reason to disturb the Tax Court's holding, the IRS has signaled both from its litigating position in *Historic Boardwalk* and the recently released FAA 20124002F that it will continue to raise the economic substance doctrine. Thus, despite the Service's purported policies of restraint vis-à-vis the economic substance doctrine, its actions provide little comfort.

Conclusion

The Third Circuit's decision in *Historic Boardwalk* presents significant issues with respect to historic rehabilitation projects and the syndication of historic credits through partnerships. The thrust of the analysis in *Historic Boardwalk* comes down to risk—whether investors are willing to give up some certainty with respect to their investments and accept some material level of risk. After *Historic Boardwalk*, it is clear that structures that are designed to completely eliminate all risk from the transaction using layers of guaranties, indemnities, and purchase options will be subjected to scrutiny. Taxpayers must be able to articulate and demonstrate genuine risks with respect to their transactions. This does not mean that taxpayers must put their entire investment at risk or otherwise undermine the limited liability nature of their investment. It does mean, however, that repayment of the entire investment cannot be assured in all circumstances. Ultimately, unless and until the IRS issues guidance for historic credit partnerships, the determination of what level of risk may be considered "material" or "significant" will continue to be subjected to a high level of uncertainty.•

[78] See. e.g., Notice 2005-13, 2005-1 CB 630 ("sale-in, lease-out' or "SILO" transactions); Rev. Rul. 2002-69, 2002-44 IRS 760 ("lease-in, lease-out" or "LILO" transactions)

[79] Historic Boardwalk Hall, LLC, *supra* note 45, 694 F.3d at 460.

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