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IRS wins again on appeal of rehabilitation credit

BY JANET A. MEADE, CPA, PH.D.
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In the IRS's second successful appeal of historic rehabilitation credits for private investors in public projects, the Third Circuit reversed and remanded the Tax Court's decision in *Historic Boardwalk Hall LLC*. The IRS victory follows earlier success in *Virginia Historic Tax Credit Fund*, 639 F.3d 129 (4th Cir. 2011). Prior coverage of the two cases appeared in Tax Matters (April 2011, page 52, and June 2011, page 66, respectively).

The Third Circuit's decision is likely to affect the syndication of several federal tax credits, including low-income housing credits, new markets credits, and renewable energy credits. Unlike the Fourth Circuit's earlier decision in *Virginia Historic Tax Credit Fund*, which the IRS won on appeal and which concerned transitory participation by partners in a state tax credit fund, *Boardwalk* involved a federal tax credit and a conservatively structured operating partnership. The Third Circuit's decision suggests that credit structures relying on managing member guaranties, fixed priority returns, and put-and-call exit strategies fail the risk-sharing requirement necessary for a bona fide partnership.

In 1992, the state of New Jersey authorized the New Jersey Sports and Exposition Authority (NJSEA) to rehabilitate and operate East Hall, a government-owned convention center on Atlantic City's Boardwalk listed as a National Historic Landmark. To generate the funds needed for the project, the NJSEA created Historic Boardwalk Hall (HBH), an LLC treated for tax purposes as a partnership. The NJSEA served as the managing member with a 0.1% ownership interest, and Pitney Bowes invested $17.5 million in return for an investor interest of 99.9%. HBH's operating agreement allocated 99.9% of the approximately $17.6 million worth of rehabilitation credits from the project to Pitney Bowes, plus a 3% preferred return. The NJSEA, as a tax-exempt authority, received no tax benefit from the credits allocated to it.

The NJSEA and Pitney Bowes also signed a contract containing put and call options. The call option gave the NJSEA the right to purchase Pitney Bowes' interest, while the put option gave Pitney Bowes the right to demand that the NJSEA purchase its interest. Neither option could be exercised prior to HBH's holding the property for 60 months, the holding period required by Sec. 47 to avoid recapture of the rehabilitation credits. In separate agreements, the NJSEA guaranteed the projected tax credits to Pitney Bowes and indemnified it against construction risks, environmental hazards, and operating deficits.

The Tax Court (136 T.C. 1 (2011)) sustained the allocation of credits to Pitney Bowes, finding that the partnership served a legitimate business purpose by allowing Pitney Bowes to invest in the renovation. It viewed the 3% return and the rehabilitation credits as a whole, and it pointed out that even though the NJSEA had agreed to indemnify Pitney Bowes for most risks of the project, there was no guaranty that it would be financially able to do so. It concluded that HBH was a valid partnership and that Pitney Bowes was a bona fide partner.

On appeal, the IRS argued that the guaranties of the NJSEA virtually eliminated any downside risk to Pitney Bowes, while the put and call options for repayment of its investment deprived it of any meaningful upside potential. The IRS also asserted, as it had in the Tax Court case, that the partnership was a sham, that HBH did not own the property, and that Pitney Bowes was not a bona fide partner for federal tax purposes.

The Third Circuit, siding with the IRS, found that Pitney Bowes was not a bona fide partner because it did not share sufficiently in the economic risks of the project. The court first considered whether, under the totality-of-thecircumstances test of *Culbertson*, 337 U.S. 733 (1949), the NJSEA and Pitney Bowes had intended to join together in the conduct of a business enterprise.

It then turned to two decisions of the Second and Fourth Circuits. In *TIFD III-E, Inc. (Castle Harbour)*, 459 F.3d 220 (2d Cir. 2006), the Second Circuit found that a purported partnership interest more closely resembled debt than equity, in that it was largely unaffected by the partnership's success or failure. In *Virginia Historic Tax Credit Fund*, the Fourth Circuit applied the disguised-sale rules of Sec. 707(b) to reach a similar conclusion.

The Third Circuit concluded that because Pitney Bowes lacked a meaningful stake in either the success or failure of HBH, it was not a bona fide partner. The court rejected arguments by HBH that the partnership was a legitimate business duly organized under New Jersey law, that Pitney Bowes was a bona fide partner that had made a substantial financial investment in HBH, that NJSEA and Pitney Bowes communicated regularly about the project, and that Pitney Bowes had spent significant time investigating and negotiating the terms of its interest. It found that this evidence related to the form of the overall transaction and did not prove that Pitney Bowes had a meaningful stake in the success or failure of the partnership or disprove that in substance the transaction was a sale of historic rehabilitation tax credits.

Historic Boardwalk Hall, LLC, No. 11-1832 (3d Cir. 8/27/12)

*By **Janet A. Meade**, CPA, Ph.D., University of Houston.*
