ROBERTS & HOLLAND LLP

April 27, 2011

Tax Court Finds Tax Credit Transaction to Have Economic Substance

By: Ezra Dyckman and Daniel W. Stahl

In order to encourage the rehabilitation of historic structures, Congress provided that taxpayers could receive Federal tax credits by engaging in these restoration projects. The good news is that these tax credits are dollar for dollar credits against Federal tax, which potentially could transform the unprofitable undertaking of fixing up a cherished, but dilapidated, landmark into a worthwhile investment opportunity. The bad news is that the developer who would earn these tax credits often has nowhere near the amount of income that would be needed to take full advantage of them.

In order to avoid this conundrum, developers that rehabilitate historic structures often enter into some kind of arrangement with a "tax credit investor" in which the investor gets at least some return on its investment and receives the lion's share of the Federal tax credits. Suppose that the IRS were to come in and say that this transaction is really just an impermissible attempt to sell tax credits. Who would win? In a recent Tax Court case, the victor was the taxpayer.

Historic Rehabilitation Tax Credits

Internal Revenue Code section 47 entitles a taxpayer to Federal tax credits in an amount equal to 20% of qualifying rehabilitation expenditures (amounts properly chargeable to capital account) incurred with respect to a certified historic structure. The tax credits are received in the tax year in which the structure is placed in service. A taxpayer can also obtain a lesser amount of tax credits for qualifying rehabilitation expenses incurred while rehabilitating certain buildings that are not certified historic structures, but which were placed in service before 1936. Certain States have also enacted provisions enabling taxpayers to receive State tax credits upon rehabilitating historic structures.

Historic Boardwalk Hall, LLC v. Commissioner

In the recently decided case of *Historic Boardwalk Hall, LLC v. Commissioner*,[1] the Tax Court considered a tax credit transaction related to the rehabilitation of East Hall, a certified National Historic Landmark in New Jersey that had been used to host musical performances, trade shows, and conferences. The restoration, which was to be performed by the New Jersey Sports and Exposition Authority (the "NJSEA"), would generate Federal historic rehabilitation tax credits. The project was not expected to generate significant profits, but the NJSEA was advised that a private investor could be enticed to contribute capital in exchange for the receipt of these tax credits.

An arrangement was structured in which the NJSEA sold East Hall to a newly formed LLC in exchange for a note, and then Pitney Bowes ("Pitney"), a private investor, contributed capital to the LLC in exchange for 99.9% of the LLC interests. The NJSEA received a 0.1% managing member interest. The amounts contributed by Pitney were used to fund a development fee to the NJSEA and to pay off liabilities of the LLC. Under the LLC agreement, Pitney would receive a 3% preferred return. Profits and losses, as well as tax credits, would be allocated to the members in accordance with their LLC interests. After approximately five years, the NJSEA would have an option to purchase Pitney's membership interest and Pitney would have an option to compel the NJSEA to purchase its membership interest. Upon the exercise of either option, Pitney would be entitled to receive any accrued and unpaid preferred return.

The IRS argued that the arrangement should be disregarded for reasons that were centered around the absence of both "objective economic substance" and "subjective business purpose," and that none of the tax credits that were obtained should be allocated to Pitney. The IRS noted that the fact that Pitney's only return on the investment (without taking into account the Federal tax credits) was the 3% preferred return demonstrated that the arrangement lacked an objective economic substance. The IRS viewed Pitney as having negative cash flow from the arrangement since it

Ezra Dyckman *is a partner in, and* ***Daniel W. Stahl*** *is an associate of, the law firm of Roberts & Holland LLP.*

could have earned a greater return by investing elsewhere. In addition, the IRS also focused on the various ways in which the parties attempted to guarantee Pitney a fixed return on its investment, including a commitment by the NJSEA to compensate Pitney if the IRS would successfully challenge Pitney's receipt of the tax credits.

The Tax Court disagreed with the IRS and upheld the allocation of the tax credits to Pitney. In support of the arrangement having an objective economic substance, the Tax Court noted that Pitney received an annual 3% return and that its capital contributions had the very real effect of reducing the outlays that the NJSEA had to make for the project. Moreover, the Tax Court rejected the IRS's contention that the sole purpose of Pitney's investment was to receive the tax credits, stating the following: "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." Surprisingly, this language indicates that the Tax Court took into account Pitney's receipt of the Federal tax credits for purposes of determining whether the arrangement had economic substance for Federal tax purposes. In addition, the Tax Court found it significant that Pitney incurred risks including (i) the possibility that the rehabilitation would not be completed and the tax credits would not be obtained and (ii) potential liability for environmental hazards (notwithstanding insurance and the NJSEA's obligation to indemnify Pitney).

The Tax Court also rejected the IRS's contention that the arrangement lacked a subjective business purpose, explaining that the NJSEA and Pitney shared a "common goal" in the successful rehabilitation of East Hall, albeit for different reasons (i.e., the NJSEA wanted East Hall to be an attractive site for popular events, and Pitney wanted to receive the tax credits and its 3% preferred return). Significantly, the Tax Court rejected the IRS's argument that the fact that Pitney would not have invested in East Hall but for the tax credits demonstrated that the transaction had no business purpose. On the contrary, the Tax Court explained, "Congress enacted the rehabilitation tax credit in order to spur private investment in unprofitable historic rehabilitations" and "[t]he purpose of the credit is directed at just this problem: because the East Hall operates at a deficit, its operations alone would not provide an adequate economic benefit that would attract a private investor."

Conclusion

There recently has been a lot of talk about the economic substance doctrine stemming from Congress's codification in 2010 of this longstanding judicial doctrine as section 7701(o) of the Code. Section 7701(o)(5)(A) defines the "economic substance doctrine" as "the common law doctrine under which tax benefits with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose." Yet, despite the new presence of the economic substance doctrine in the Code, section 7701(o)(5)(C) is explicit in that "[t]he determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted." This codification has a very real effect on taxpayers, however, in that Congress provided for the imposition of a 20% accuracy-related penalty on any portion of an understatement attributable to "any disallowance of claimed tax benefits by reason of a transaction lacking economic substance." The normal "reasonable cause" exception to accuracy-related penalties and fraud penalties cannot be used to avoid this new economic substance penalty, which becomes a [draconian] 40% penalty if "the relevant facts affecting the tax treatment are not adequately disclosed in the return."

With this backdrop, cases such as *Historic Boardwalk Hall* that apply the economic substance doctrine should be informative as to the manner in which section 7701(o) will be applied notwithstanding the fact that the tax years in question were prior to the enactment of section 7701(o). Developers and prospective Federal tax credit investors should find the Tax Court's deference towards Congress's intent in enacting the tax credits to be of great significance. At the same time, there are questions as to the extent to which the Tax Court's holding can be extended to other economic substance cases that do not involve this helpful factor. Nevertheless, the fact that the Tax Court concluded that an arrangement had economic substance despite implicitly acknowledging that the investment would not have been made but for the Federal tax credits makes *Historic Boardwalk Hall* a very important case.

[1] 136 T.C. No. 1 (2011).