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Appellate Court Rejects Tax Credit Transaction

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The rehabilitation of historic structures is generally a costly proposition. In light of this reality, Congress attempted to encourage historic restoration projects by providing that taxpayers can earn Federal tax credits by engaging in them. However, 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 the tax credits (or is a tax-exempt entity with no use for tax credits whatsoever). Notwithstanding common parlance in the real estate industry of "buying" and "selling" tax credits, the reality is that tax credits generally cannot be sold.

In order to address this problem, developers engaged in the rehabilitation of historic structures often attempt to take advantage of historic rehabilitation tax credits by entering into a joint venture with a "tax credit investor." The arrangement is typically structured so that the developer retains most of the economics in the property, while the investor receives the lion's share of the tax credits in exchange for its investment. In 2011, the Tax Court case of *Historic Boardwalk Hall, LLC v. Commissioner* (previously addressed in this column) affirmed the allocation of Federal historic rehabilitation tax credits to an investor in this type of transaction.

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Unfortunately for taxpayers, a recent decision by the Court of Appeals for the Third Circuit overturned the Tax Court's decision in *Historic Boardwalk*. What does this mean for the ability of real estate developers to engage in tax credit transactions?

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 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. Certain States have also enacted provisions enabling taxpayers to receive State tax credits upon rehabilitating historic structures. Whereas Federal historic rehabilitation tax credits cannot be sold, certain State statutes providing for State historic rehabilitation tax credits do enable their sale.

Historic Boardwalk Hall, LLC v. Commissioner

Historic Boardwalk Hall, LLC v. Commissioner[1] involved 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 any significant profits, but the NJSEA was advised that a private investor could be enticed to contribute capital in exchange for receiving the tax credits.

An arrangement was structured in which the NJSEA transferred East Hall to a newly formed LLC and loaned the LLC an amount equal to the estimated construction costs. Pitney Bowes ("PB"), 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 PB were mostly used to fund a development fee to the NJSEA. PB would receive its 99.9% pro rata share of historic rehabilitation tax credits earned by the LLC (as well as 99.9% of excess cash flow, although there was not anticipated to be any excess cash flow). PB also would be entitled to a 3% preferred return.

The arrangement was structured in a manner so as to minimize the risk incurred by PB. NJSEA agreed to (1) pay PB for any reduction in projected tax benefits and for any interest and penalties incurred by PB as a result of an IRS challenge (the "Tax Benefits Guarantee"), (2) pay all excess development costs (the "Completion Guarantee"), (3) fund all operating deficits through interest-free loans to the LLC (the "Operating-Deficit Guarantee"), and (4) indemnify PB against any loss relating to hazardous materials (the "Environmental Guarantee").

In addition, the arrangement provided the NJSEA with a call option and provided PB with a put option, both of which had an exercise price equal to the greater of (1) 99.9% of the fair market value of the LLC's membership interests (which realistically would have little value, if any) and (2) any accrued and unpaid preferred return due to PB. The NJSEA's call option would be exercisable for a 12-month period beginning after five years, and PB's put option would be exercisable for a 12-month period beginning after seven years. In order to ensure that the NJSEA would have sufficient funds to acquire PB's membership interests in the event that either option would be exercised, the NJSEA was required to purchase a "Guaranteed Investment Contract" (an investment with an institutional investor that would provide it with a guaranteed return sufficient to enable it to pay the exercise price).

The IRS argued that no tax credits should be allocated to PB since (1) the arrangement lacked "economic substance" and (2) PB was not a bona fide partner of the LLC.

Tax Court Decision

In rejecting the IRS's arguments and upholding the arrangement, the Tax Court found that PB and the NJSEA "in good faith and acting with a business purpose, intended to join together in the present conduct of a business enterprise." It also noted that PB's contribution had a real world impact since it reduced the cost of the project for the NJSEA. The Tax Court explained that PB benefited from the arrangement in that it received the 3% preferred return and the tax credits. Interestingly, the Tax Court appears to have taken the Federal tax credits into account when considering the economic substance and business purpose of the arrangement, explaining that "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." The Tax Court also noted that PB incurred the risk that the rehabilitation would not be completed and the risk of environmental hazards (in the event that the LLC's insurance would not cover liability incurred for an environmental hazard and the NJSEA would be unable to make up the difference).

Court of Appeals Decision

The Court of Appeals for the Third Circuit recently overturned the Tax Court's decision, agreeing with the IRS that PB was not a bona fide partner in the LLC. The Third Circuit began by synthesizing the case law regarding the standard for determining whether a partner in a partnership should be treated as a bona fide partner for tax purposes into the premise that, "in essence, to be a bona fide partner for tax purposes, a party must have a meaningful stake in the success or failure of the enterprise."

With respect to the East Hall transaction, the Third Circuit first determined that PB had no "meaningful" downside risk, since:

- PB's contribution would be made in installments, and PB would not be required to make each installment until it verified that its contributions would not exceed the tax credits that had been earned to date.
- The project was already "fully funded" before PB's investment, and the NJSEA's Competition Guarantee and Operating Deficit Guarantee obligated the NJSEA to pay any excess construction costs and operating deficits, respectively.
- The NJSEA's Tax Benefits Guarantee shielded PB from risk of an IRS audit.
- Although PB might not receive its 3% preferred return on an annual basis, it would receive the preferred return upon the exercise of either the call option or the put option.

Next, the Third Circuit explained that PB lacked any "meaningful" upside potential, given that the NJSEA had a call option to acquire PB's interest for an amount that realistically would be equal to only PB's accrued and unpaid preferred return. The Third Circuit found that PB's 99.9% interest in the LLC's residual cash flow merely "gave a false impression" that PB had a chance to share in the profits. Upon determining that PB lacked any meaningful risk or upside potential, the Third Circuit concluded that PB had no "meaningful stake in the success or failure of the enterprise" and, as a result, was not a bona fide partner and was not entitled to the allocation of any tax credits.

The Third Circuit concluded by noting that "we reach our conclusion mindful of Congress's goal of encouraging rehabilitation of historic buildings" and that "[w]e have not ignored the predictions of [the LLC] and *amici* that, if we reallocate the [historic rehabilitation tax credits] away from PB, we may jeopardize the viability of future historic rehabilitation projects." However, the Third Circuit explained, "[i]t is the prohibited sale of tax credits, not the tax credit provision itself, that the IRS has challenged."

Conclusion

There is no doubt that the Third Circuit's decision in *Historic Boardwalk* is troubling for tax credit transactions. However, open questions remain as to what the implications of this case will be. Although the Tax Court by its rules will follow the Third Circuit's decision in cases where an appeal would be made to the Third Circuit, it remains to be seen whether the Tax Court will also follow it in other cases.

In addition, it may be possible to distinguish the facts in *Historic Boardwalk* from many other tax credit transactions. First, the project was already fully funded before PB made its investment, which had the effect of (1) undermining the contention that there was a business purpose for PB's investment and (2) reducing the risk that the project would not be completed. Second, the arrangement in *Historic Boardwalk* involved a put option and a call option that realistically would end

up having the same exercise price (of an amount equal to the accrued and unpaid preferred return due to PB), which made it virtually certain that one of the options would be exercised. Many other tax credit transactions involve only a put option (which makes it less certain that the tax credit investor's interest will be bought out). Third, the NJSEA was required to enter into the Guaranteed Investment Contract which would ensure that it would have sufficient funds to pay the preferred return upon the exercise of one of the options. By removing all variability in the economic outcome for PB, these factors collectively made the transaction similar to a sale of the tax credits.

Perhaps most significant, though, was the fact that operating East Hall was not expected to become a profitable venture, which meant that there was no meaningful upside potential for PB. This element of the East Hall arrangement stands in contrast to many other rehabilitations of historic structures, in which the tax credit investor has a realistic potential for a significant upside if it were to retain its interest for the long term. In sum, the Third Circuit's reversal of the Tax Court in *Historic Boardwalk* will certainly be disturbing news for real estate developers and tax credit investors, but only time will tell as to the full extent of the ramifications of this decision.

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[1] *Historic Boardwalk Hall, LLC v. Commissioner*, 136 T.C. 1 (2011), *rev'd*, 110 AFTR 2d 2012-5710 (3d Cir. 2012).