



The "Meaningful Stake" Debate: Third Circuit Reverses Tax Court Decision in Historic Boardwalk

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On August 27, 2012, the United States Court of Appeals for the Third Circuit reversed the holding of the United States Tax Court in the case of *Historic Boardwalk Hall, LLC v. Commissioner*, 136 T.C. 1 (2011). Relying heavily on the decision of the Second Circuit in *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006) (“*Castle Harbour*”) and the decision of the Fourth Circuit in *Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, No. 10-1333 (4th Cir. 2011) (“*Virginia Historic*”), the Third Circuit found that Pitney Bowes, Inc. (“Pitney Bowes”), a private sector investor in Historic Boardwalk Hall, LLC (“Historic Boardwalk”), had no meaningful stake in Historic Boardwalk, and, therefore, was not a bona fide partner of the partnership for federal income tax purposes. As a result, all allocations of historic rehabilitation tax credits previously allocated to Pitney Bowes were reallocated to the New Jersey Sports and Exposition Authority (the “New Jersey Sports Authority”) as the owner of East Hall.

Factual Background

The historic rehabilitation tax credits that were originally allocated to Pitney Bowes were issued in connection with the rehabilitation of the iconic Atlantic City venue known as “East Hall.” East Hall, which was located on the boardwalk in Atlantic City, hosted the annual Miss America Pageant. In 1987, it was listed as a National Historic Landmark and added to the National Register of Historic Places.

The New Jersey Sports Authority, an agency of the State of New Jersey, was tasked with restoring the site. In furtherance of that objective, the New Jersey Sports Authority obtained a 35-year leasehold interest in East Hall from the Atlantic County Improvement Authority for \$1 per year. The renovation of the venue, which began in December of 1998, was scheduled to be completed in four phases and finalized in 2001. The New Jersey Sports Authority issued State Contract Bonds to cover a portion of the renovations, and the New Jersey Casino Reinvestment Development Authority agreed to fund all costs in excess of the bond proceeds. Nevertheless, after learning of the market for historic rehabilitation tax credits and the additional revenue that the transfer of such credits could generate for the state, the New Jersey Sports Authority engaged in a series of transactions to obtain and transfer historic rehabilitation tax credits associated with the renovation of East Hall and the qualified rehabilitation expenditures incurred therewith.

The New Jersey Sports Authority and Pitney Bowes entered into a Letter of Intent with respect to the transfer of the historic rehabilitation tax credits. In it, the New Jersey Sports Authority agreed to sublease its interest in East Hall to Historic Boardwalk, a newly formed partnership. The term of the sublease would exceed the useful life of the property

and be treated as a sale for tax purposes, thereby making Historic Boardwalk the deemed tax owner of East Hall. The New Jersey Sports Authority would serve as the general partner of Historic Boardwalk, holding a 0.1% partnership interest therein. Pitney Bowes, in turn, would be the sole limited partner of Historic Boardwalk with a 99.9% partnership interest and a 99.9% right to the profits, losses and tax credits flowing to Historic Boardwalk.

In exchange for its partnership interest in Historic Boardwalk, Pitney Bowes agreed to make a series of capital contributions to Historic Boardwalk totaling approximately \$16.4 million. Each installment was conditioned upon the completion of certain project-related events, including verification that a certain amount of qualified rehabilitation expenditures had been incurred prior to the contribution date. Pitney Bowes's partnership interest entitled the corporation to a 3% preferred return (the "Preferred Return") and approximately \$17.6 million worth of historic rehabilitation tax credits that would be generated from the qualified rehabilitation expenditures. While Pitney Bowes was to receive 99.9% of any available cash flow from Historic Boardwalk, the partnership's financial projections from 2000 to 2042 forecasted no cash flow available for distribution to Pitney Bowes.

The New Jersey Sports Authority and Pitney Bowes entered into the Amended and Restated Operating Agreement of Historic Boardwalk (the "Operating Agreement"), and in that document, the New Jersey Sports Authority agreed to (i) pay all development costs in excess of any loan proceeds and the capital contributions of Pitney Bowes; (ii) fund all operating deficits; and (iii) indemnify Pitney Bowes against any loss arising from hazardous materials relating to East Hall. Apart from the distribution of the Preferred Return, the Operating Agreement's distribution waterfall provided that Pitney Bowes would not receive distributions of available cash from Historic Boardwalk until the outstanding principal and interest on the New Jersey Sports Authority's acquisition and construction loans had been repaid and the New Jersey Sports Authority had received a return of funds contributed to cover operating deficits. Further, the Operating Agreement included certain repurchase rights and obligations of the New Jersey Sports Authority. In the event that the New Jersey Sports Authority violated the terms of the Operating Agreement or wished to take action contrary to its terms, it could purchase the interest of Pitney Bowes pursuant to a "Consent Option" for an amount equal to the projected tax benefits and cash distributions due to Pitney Bowes. In addition, if the New Jersey Sports Authority exercised its repurchase right or obligation, the amount of the payment to Pitney Bowes was secured through a guaranteed investment contract (the "Guaranteed Investment Contract") held by the New Jersey Sports Authority.

In addition to the Operating Agreement, the parties entered into a purchase option agreement (the "Call Option") and an agreement to compel purchase (the "Put Option"). The Call Option provided the New Jersey Sports Authority with the right to acquire the interest of Pitney Bowes at any time during the 12-month period beginning 60 months after East Hall was placed in service. If the New Jersey Sports Authority did not exercise the Call Option, Pitney Bowes could exercise the Put Option and compel the New Jersey Sports Authority to purchase its membership interest during the 12-month period beginning 84 months after East Hall was placed in service. In either case, the purchase price for the 99.9% partnership interest of Pitney Bowes was equal to the greater of: (i) 99.9% of the fair market value of 100% of the membership interest in Historic Boardwalk; or (ii) the remaining amount of the Preferred Return due to Pitney Bowes. The Guaranteed Investment Contract secured not only the purchase price for the Consent Option, but also the purchase price under the Put and Call Options.

Finally, Historic Boardwalk and Pitney Bowes entered into a tax benefits guaranty agreement (the "Tax Benefits Guaranty"). The Tax Benefits Guaranty provided Pitney Bowes with assurance that it would receive, at a minimum, the projected tax benefits of the project. In addition, the Tax Benefits Guaranty served to indemnify Pitney Bowes for taxes, penalties, interest and third-party legal fees incurred by it in the event of an Internal Revenue Service ("IRS") challenge. The New Jersey Sports Authority, which, according to the Court, had virtually unlimited financial resources, agreed to fund any obligations of Historic Boardwalk arising from the Tax Benefits Guaranty.

On its K-1 for each of 2000, 2001 and 2002, Pitney Bowes was allocated 99.9% of the qualified rehabilitation expenditures incurred by Historic Boardwalk. Following an IRS audit, however, the historic rehabilitation tax credits claimed by Pitney Bowes were denied and reallocated to the New Jersey Sports Authority. In its final partnership administrative adjustment, the IRS cited two reasons for taking such action: first, the Historic Boardwalk partnership was a sham with the improper purpose of passing along tax benefits to Pitney Bowes; second, Pitney Bowes did not hold a bona fide partnership interest in Historic Boardwalk because it had no meaningful stake in the success or failure of the partnership.

Tax Court Holding

The New Jersey Sports Authority, on behalf of Historic Boardwalk, appealed the determination of the IRS in its final partnership administrative adjustment to the United States Tax Court, and the Tax Court held in favor of Historic Boardwalk. The Tax Court rejected the argument of the IRS that Historic Boardwalk lacked economic substance. Rather, the Tax Court found that the Preferred Return gave substance to the parties' transaction beyond the allocation of the historic rehabilitation tax credits. Citing *Commissioner v. Culbertson*, 337 U.S. 733 (1949), the Tax Court reasoned that the partnership allowed the parties to invest together for the purpose of renovating and completing the East Hall project, and the 3% return and rehabilitation credits provided Pitney Bowes with an economic incentive to engage in the project. Further, the Tax Court found that Pitney Bowes assumed a certain level of risk with respect to the environmental hazards of the renovation since there could be no guarantee that insurance proceeds would be sufficient to cover any such liability or that the New Jersey Sports Authority would have enough cash to make up any shortfall. The Tax Court denied any contention by the IRS that the investment of Pitney Bowes more closely resembled debt than equity, finding that Historic Boardwalk operated at a loss, so there could be no guarantee of sufficient cash flow to pay the 3% return.

The Tax Court entered a decision in favor of Historic Boardwalk and denied the claim of the IRS that the historic rehabilitation tax credits should be reallocated to the New Jersey Sports Authority. The Commissioner of the Internal Revenue Service timely appealed the decision of the Tax Court to the Third Circuit.

Third Circuit Reversal

In its appeal to the Third Circuit, the IRS made several arguments with respect to its position that Pitney Bowes should be denied the tax benefits of the historic rehabilitation tax credits. The Third Circuit focused on two primary arguments: first, the contention that Historic Boardwalk was a sham partnership that was formed to disguise a sale of historic rehabilitation tax credits from the New Jersey Sports Authority, a tax-exempt entity, to Pitney Bowes, a taxable entity; second, that Pitney Bowes was not a bona fide partner in Historic Boardwalk because it did not have a meaningful stake in the success or failure of the partnership. The Third Circuit agreed with the latter argument and held that Pitney Bowes was not a bona fide partner in Historic Boardwalk for tax purposes.

Similar to the Tax Court, the Third Circuit cited the rule of law in *Culbertson* that a partnership exists when two or more parties join together in good faith and with a business purpose in the present conduct of an enterprise. Taking this concept further, however, the Third Circuit cited a more recent case, *Southgate Master Fund, L.L.C. ex rel. Montgomery Capital Advisors v. United States*, 659 F.3d 466 (5th Cir. 2011), to establish that the key to finding such a business purpose is the sharing of profits and losses.

A similar analysis was conducted by the Second Circuit in *Castle Harbour*, and the Third Circuit relied heavily on the *Castle Harbour* decision in reaching its own decision. *Castle Harbour* involved an alleged partnership between two foreign banks and a General Electric subsidiary. Looking at all of the facts and circumstances surrounding the formation of the partnership, the Second Circuit held that the parties' intent was to allocate certain income away from the General Electric subsidiary, which was subject to United States income taxation, to the two foreign banks, which were not subject to such taxes. Using the debt versus equity classification as a guidepost, the Second Circuit held that the substance of the parties' transaction was overwhelmingly similar to a secured lender's interest and that the two foreign banks would neither benefit from nor be harmed by the partnership's performance.

The Third Circuit also relied on the *Virginia Historic* decision of the Fourth Circuit. In that decision, the Fourth Circuit held that capital contributions made by partners to partnerships in exchange for Virginia's historic rehabilitation tax credits were, in substance, disguised sales of such credits. The Fourth Circuit's decision was based on two contentions: first, the partners would not have made the capital contributions to the partnership but for the receipt of state tax credits in return (as evidenced by the de minimis (.01%) partnership interests they received for their contributions); second, the receipt of the tax credits was guaranteed to them and not otherwise affected by the success or failure of the partnership. In fact, the investors were secured against losing their contributions by a promise of a refund in the event they did not receive the Virginia tax credits. Like the Second Circuit in *Castle Harbour*, the Fourth Circuit's determination in *Virginia Historic* rested heavily on the existence of entrepreneurial risk and the sharing of the enterprise's risk and reward.

Applying the reasoning of the Second and Fourth Circuits, the Third Circuit focused on the meaningfulness of Pitney Bowes's investment in Historic Boardwalk in light of all relevant facts and circumstances. Agreeing with the IRS, it found that Pitney Bowes neither bore the risk of any loss associated with the partnership nor benefited from any of its success.

To begin, the Third Circuit stated that Pitney Bowes had no meaningful downside risk in Historic Boardwalk because it was certain to recover the contributions it had made through the receipt of historic rehabilitation tax credits or their cash equivalent. Under the terms of the Operating Agreement, Pitney Bowes was not required to make installments of its capital contributions until a certain amount of qualified rehabilitation expenditures had been incurred. As such, Pitney Bowes knew it would receive an equivalent amount of historic rehabilitation tax credits even before making its capital contributions to Historic Boardwalk. As an additional measure, Historic Boardwalk and Pitney Bowes had entered into the Tax Benefits Guaranty, whereby the New Jersey Sports Authority, a very creditworthy guarantor, was indirectly compelled to make Pitney Bowes whole in the event of any reduction in credits to, or an IRS challenge against, Historic Boardwalk. Lastly, East Hall was placed in service and the historic rehabilitation tax credits were earned before Pitney Bowes made the bulk of its capital contributions to Historic Boardwalk. The funds contributed by Pitney Bowes were not necessary for the completion of the project and, in fact, the project had been fully funded before it ever entered into an agreement with the New Jersey Sports Authority. In light of these facts, the Third Circuit held that Pitney Bowes took on little no risk with respect to its investment in Historic Boardwalk.

The Third Circuit further noted that the existence of the Preferred Return did not undermine its conclusion. While, in form, Pitney Bowes bore the risk that Historic Boardwalk would not have sufficient cash available to make the Preferred Return distributions, it ultimately would be made whole upon the exercise of the Put or Call Option, both of which required that any accrued but unpaid Preferred Return amounts be included in the purchase price. On top of that, the Guaranteed Investment Contract assured that the New Jersey Sports Authority would have the cash to pay the purchase price required by the Put and Call Options. Both Pitney Bowes's investment in Historic Boardwalk and its Preferred Return were shielded from loss, indicating that, in substance, Pitney Bowes had no meaningful risk of loss with respect to Historic Boardwalk.

The Third Circuit stated that "lack of meaningful risk weighs heavily in determining whether [Pitney Bowes] is a meaningful partner." However, the analysis of Pitney Bowes's meaningful upside potential weighed just as heavily on the Court's determination. In fact, quoting *Culbertson*, the Third Circuit stated 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." It is unclear whether the Court intended to create a conjunctive or disjunctive test, but it analyzed both Pitney Bowes's downside risk and upside potential and found that neither test had been satisfied.

Looking to the distribution waterfall in the Operating Agreement and the financial projections for the project, which had proven to be overly optimistic, the Third Circuit determined that Pitney Bowes had no opportunity to share in any upside of Historic Boardwalk. To receive its 99.9% share of the partnership's cash flow, Pitney Bowes would have to wait until all outstanding loan principal and interest payments, which, annually, exceeded \$5 million for a period of 39 years, and any operating deficit amounts covered by the New Jersey Sports Authority had been repaid. Further, the exercise of the Call Option or the Consent Option by the New Jersey Sports Authority or the Put Option by Pitney Bowes would foreclose Pitney Bowes's opportunity to share in any upside potential of Historic Boardwalk. Consequently, the Third Circuit further determined that Pitney Bowes had no meaningful stake in the success of the partnership.

Counsel for Historic Boardwalk relied heavily on the form of the transaction (e.g., due diligence of the parties, legal existence of the limited liability company, etc.) to make its claim that Pitney Bowes was a legitimate partner in the partnership for tax purposes. Nevertheless, the Third Circuit held that the substance of the transaction, not its form, was controlling in this instance. In conclusion, the Court stated that "because [Pitney Bowes] lacked a meaningful stake in either the success or failure of Historic Boardwalk, it was not a bona fide partner."

Conclusion

The decision of the Third Circuit will invariably have an effect on the structure and economics of historic rehabilitation tax credit transactions. Investors in such credits may have to assume additional risk to obtain a meaningful stake of the

partnership's entrepreneurial risk. Whether such added risk entitles investors to a larger share of partnership profits or a lower pricing model for historic rehabilitation tax credits is yet to be seen. Williams Mullen and its Business Tax Group will continue to watch the federal tax credit market for any developments arising from the Third Circuit's *Historic Boardwalk* decision. For further inquiries into the *Historic Boardwalk* case and its potential effect, please contact one of the authors of this tax alert or a member of our firm's Tax Credit practice group.

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