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HISTORY AND THE HILL



Taxpayer Victory in Boardwalk Hall Decision May Have Broad HTC Industry Impact

By John Leith-Tetrault, National Trust Community Investment Corporation

It's unlikely many found reading *Historic Boardwalk Hall LLC et al v. Commissioner* (*Boardwalk Hall v. Commissioner*) more interesting than watching a Miss America swimsuit contest. However, this January 3, 2011 Tax Court ruling in favor of the taxpayer will certainly have more impact on the economic reuse of the nation's historic buildings than the renowned beauty pageant that used the facility beginning in 1933.

Boardwalk Hall v. Commissioner is the first Tax Court case to focus squarely on many of the federal historic tax credit legal structuring issues that have been the subject of Internal Revenue Service (IRS) audits during the past few years. While the issues discussed in the case echo many of the themes debated in the Virginia Historic Tax Credit Fund [*Virginia Historic Tax Credit Fund 2001, LLC v. Commissioner, No. 10-1333 (4th Cir.)*] case (scheduled for oral appeal in late January), *Boardwalk Hall v. Commissioner* provides guidance in the context of a federal rather than a state HTC transaction.

Background

Built in Atlantic City between 1926 and 1929, the facility's East Hall was certified as a National Historic Landmark in 1987, the *crème de la crème* of National Register of Historic Places listings. The purpose of the subject historic rehabilitation was to renovate the deteriorated exhibition facility so that it could play a complementary role in the larger Atlantic City Convention Center project that also involved new construction. In 1992 the New Jersey Legislature authorized the New Jersey Sports and Exposition Authority (NJSEA) to expand its purpose beyond the Meadowlands Stadium (home

of the New York Giants) to include the Atlantic City Convention Center. A for-profit subsidiary of NJSEA formed a single-member limited liability company (LLC) to perform the rehabilitation work and entered into a 35-year lease arrangement (later extended to 2087) with the Atlantic County Improvement Authority (ACIA), which hired Spectator Management Group (SMG) to operate the facility. Boardwalk Hall LLC was a single-entity transaction that did not utilize the lease pass-through structure.

The project incurred nearly \$104 million in qualified rehab expenditures in 2000, 2001 and 2002, and Pitney Bowes was ultimately admitted to the LLC as the investor member. The investor paid in equity of about \$18.2 million for a 99.9 percent interest in the profits and losses of the LLC and the right to an allocation of 99.9 percent of the federal HTC credits generated by the rehabilitation of the facility. The operating agreement provided for a 3 percent priority return and contained put and call arrangements, discussed in more detail below. NJSEA's affiliate played the role of developer, provided all of the typical guaranties (including the disallowance or recapture of the tax credits), engaged the development team, managed construction and placed the building in service.

Other project financing included \$49.5 million in state bonds issued by NJSEA, and \$22 million from the New Jersey Reinvestment Development Authority. Except for the tax credit equity, the entire project was funded from public sources. The tax credit equity was used to pay down the acquisition note and also indirectly facilitated a developer fee of \$14 million. The operations of the project have been an eco-

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conomic success, performing better than the projections prepared at the time of the investor's admission, but the LLC has reported operating losses on an after-tax basis.

The Legal Issues

In contesting the Boardwalk Hall transaction, the IRS made several arguments including:

1. the deal lacked economic substance;
2. the structure amounted to a "sale" of the credits;
3. the investor was not a member of the LLC for federal income tax purposes; and
4. the LLC did not own the property and was not entitled to the credits.

The Court agreed with the taxpayer on all counts in a carefully reasoned opinion.

On the key finding on economic substance, Judge Joseph Robert Goeke wrote, "We believe that the 3 percent return and the expected tax credits should be viewed together. Viewed as a whole, the Historic Boardwalk Hall and the East Hall transactions did have economic substance."

Asked for his reaction to the case, Jerry Breed, of Bryan Cave said, "The language 'as a whole' is crucial. The Tax Court clearly believed that the rehabilitation credit alone would not establish economic substance; the credit requires a taxpayer to establish the prospect of a non-tax economic return. The Sacks case [*Sacks v. Commissioner*, 69 F.3d 982 (9th Cir.1995)] was cited favorably, but not endorsed as a complete response to the IRS attack. If the taxpayer had invested 'solely' for the tax benefit, the result would likely have been a finding of lack of economic substance and a decision in favor of the IRS."

History and the Hill asked a group of the industry's leading tax law and accounting firms how the Boardwalk Hall case would impact potential Treasury endorsement of Footnote 344, the Joint Committee on Taxation's technical explanation of the meaning economic substance in the context of tax credit transactions. The consensus was that it would reinforce Treasury's recent announcement that it would not issue an angel list of tax credit transactions that would not need to show a pre-tax motivation. With little prospect of Congress revisiting codification of economic substance, which could provide the opportunity to obtain official report language, it appears that Footnote 344, by itself, will not eliminate the need for an investor priority return in HTC transactions.

The Court considered the public policy promoted by the enactment of the federal historic rehabilitation credit in determining whether the transaction had economic substance. Also in the

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opinion, Goeke wrote, "Congress enacted the rehabilitation tax credit in order to spur private investment in unprofitable historic rehabilitations." The fact that the investment may be unprofitable or produce an unacceptably low return without the tax incentive did not drive a conclusion that the transaction lacked economic substance. The Court was not at all concerned with the extensive involvement of governmental entities. It discussed, but was not troubled by the completion, operating deficit and tax credit guaranties provided by the managing member, rejecting the IRS' argument that the investor member was not a true partner because it did not have economic risk. Further, the IRS apparently did not challenge the use of \$14 million of the \$18.2 million in tax credit-generated equity to pay a developer fee or the use of a deferred developer fee to generate tax credit basis.

Lastly the decision in this case endorsed the use of a put and call mechanism to facilitate an investor sale of its interest after the five-year recapture period. The transaction included several purchase options, including

1. an option on the part of NJSEA to purchase the investor's interest for a price equal to the present value of the projected tax and cash benefits if NJSEA elected to sell the facility or take certain other actions that were otherwise not permitted,
2. a call option under which NJSEA could purchase the investor's interest at any time during a 12-month period beginning 60 months after the placed in service date, and
3. a put option under which the investor could require NJSEA to purchase the investor's interest beginning 84 months after the placed-in-service date.

The purchase price under the second and third options was equal to the greater of fair market value of the investor's interest or any accrued but unpaid priority return. Because both the put and the call were calculated by reference to the greater of fair market value or the preferred return, the case does not provide guidance with respect to the tax treatment of fixed price put options.

Implications for the Federal Historic Tax Credit

Boardwalk Hall v. Commissioner is clearly a significant case with high precedential value for the historic tax credit industry for a variety of reasons. History and the Hill reached out to a number of leading industry lawyers on this point. Bill Machen, a partner at Holland & Knight, said, "The focus of this court decision on the facts in a syndicated federal historic tax credit transaction makes Boardwalk Hall potentially more far reaching in its impact on our industry than the decision in the Virginia Historic Tax Credit Fund [see History and the Hill, February 2010] case that involved a state credit transaction. It should provide investors with considerable comfort. It will be interesting to see whether the IRS files an appeal."

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Jill Goldstein, a partner at Kutak Rock, said, "The case is positive for the industry, but we should continue to be vigilant in structuring and documenting these deals. The court made a point of mentioning the 3 percent preferred return several times. It also noted favorably that the operating agreement appropriately described the parties' roles as "members" in the owner. Finally, the extensive due diligence and underwriting review undertaken by the investor (including receipt of legal opinions) was cited as supporting the investor's status as a partner in the investment." ❖



John Leith-Tetrault has 32 years of experience in community development financing, banking, community organizing, historic preservation, training and organizational development. He has held senior management positions with Neighborworks, Enterprise Community Partners, Bank of America and the National Trust for Historic Preservation. Mr. Leith-Tetrault is the founding president of the National Trust Community Investment Corporation and serves as the Chairman of the Historic Tax Credit Coalition. He can be reached at (202) 588-6064 or jleith@ntcicfunds.com.

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