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HISTORY AND THE HILL

The IRS' Appeal of Boardwalk Hall v. Commissioner Raises Concerns in the HTC Industry

By John Leith-Tetrault, National Trust Community Investment Corporation

On October 27, the Internal Revenue Service (IRS) submitted its brief to the United States Court of Appeals for the Third Circuit asking the court to reverse the January 3, 2011 Tax Court decision in the case of *Historic Boardwalk Hall, LLC v. Commissioner* (Boardwalk), which upheld the position of the taxpayer. The IRS appeal will be followed by the taxpayer's brief on December 15 and the filing of an amicus brief on December 22 by Miller and Chevalier on behalf the National Trust for Historic Preservation and other preservation organizations. The amicus brief is being shaped through consultation between Miller and law firms active with the Historic Tax Credit Coalition including Bryan Cave, Squire Sanders, Kutak Rock, and Holland and Knight.

The outcome of this appeal may have far-reaching impact on the historic tax credit industry. Unlike the facts in *Virginia Tax Credit Fund v. Commissioner* (4th Circuit), which the IRS won on appeal, Boardwalk involves a conservatively structured operating partnership in which the investor held a 99.99 percent interest throughout the five-year period following completion. The pending appeals court decision may well answer the question that the IRS continues to pose in a number of circumstances: whether traditional historic tax credit (HTC) structures that rely on managing member guaranties, fixed priority returns and standard put and call exit strategies to attract limited partner capital can meet the requirements for characterization as a federal tax partnership.

Background

Built in Atlantic City between 1926 and 1929, the East Hall was certified as a National Historic Landmark in 1987, the crème de la crème of National Register listings. The Hall owes its historic designation from its use beginning in 1933 as the site for the Miss America Contest. The purpose of the 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 included new construction. In 1992 the New Jersey Legislature authorized the New Jersey Sports and Exposition and Authority (Authority) 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 the Authority formed a single-member LLC to perform the rehabilitation work, and entered into a 35-year lease arrangement (later extended to 2087) with the Atlantic County Improvement Authority and hired Spectator Management Group (SMG) to operate the facility. Historic Boardwalk Hall LLC (HBH) was a single-entity transaction that did *not* utilize the lease pass-through structure. The Authority guaranteed all of the managing member obligations of its for-profit affiliate. These guaranties figure prominently in the IRS appeal. Pitney Bowes was the tax credit investor, Sovereign Capital (now Cityscape) was the syndicator and Reznick Group prepared the projections.

The project incurred nearly $104 million in qualified rehab expenditures in 2000, 2001 and 2002. 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 re-

continued on page 2

continued from page 1

habilitation of the facility. Pitney Bowes, in exchange for the partnership interests, contributed an amount equal to $.9995 for each dollar of federal HTC credit projected to be generated by the partnership. The operating agreement provided for a 3 percent priority return and contained put and call arrangements, discussed in more detail below. The Authority's for-profit affiliate played the role of managing member and developer, provided all of the typical HTC transaction guaranties, engaged the development team, managed construction and placed the building in service.

Other project financing included $49.9 million in taxable bonds issued by the Authority, and $22 million from the New Jersey Reinvestment Development Authority, which is capitalized from casino industry taxes. Except for the tax credit equity, the entire project was funded from public sources. The purchase of HBH's subleasehold interest in the Boardwalk Hall was financed by a $53.6 million acquisition loan from the Authority which approximated rehabilitation costs already incurred by the Authority at the time of closing. The interest rate was set at 6.09 percent to be paid in equal installments over 40 years, but the debt service payments were to be made on a cash available basis with any unpaid principal or interest to be added to the following year's installment with no interest accrual on the deferred payment amount.

Additionally, the Authority and HBH executed a construction/permanent loan in the maximum amount of $57 million to finance the balance of the rehabilitation costs at a rate of .01 percent over 40 years with similar soft "cash available" and deferral arrangements. The tax credit equity was used to pay down the acquisition note, defray syndication costs and facilitated payment of a developer fee of $14 million.

The transaction included an unusual option for the Authority to purchase the investor's interest at any time for a price equal to the present value of the projected tax and cash benefits if the Authority elected to sell the facility or take certain other actions that were otherwise not permitted by the operating agreement. The agreement also included fairly standard put and call options under which the Authority could purchase the investor's interest at any time during a 12-month period beginning 60 months after the placed-in-service date, and Pitney Bowes could require the Authority to purchase its interests beginning 84 months after the placed-in-service date. The purchase price under both the put and call options was equal to the greater of fair market value of the investor's interest or any accrued but unpaid priority return. To back up its obligation to guaranty the possible investor put option, the Authority purchased a guaranteed investment contract (GIC).

Outline of IRS Appeals Brief

In a dramatic opening factual background section, the IRS uses

continued on page 3

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continued from page 2

emails and memos from the files of various development team members in an attempt to paint a picture of a deliberate engineering of the financial projections and the terms of the LLC operating agreement to show economic substance and to assure that the investor, Pitney Bowes, would neither benefit from the upside potential nor suffer the downside risks of the operations of Boardwalk Hall. The IRS' recitation of the facts tries to demonstrate that the partners in the transaction knew that the project would not make a profit, and that the 3 percent priority return was not a true pretax motivation for Pitney Bowes. The earlier Tax Court ruling relied heavily on the existence of the 3 percent priority return in upholding the taxpayer's position.

In the initial summary of its arguments, on page 30 of its brief, the IRS makes the broad statement that "federal tax credits in general and historic tax credits in particular, are not transferrable." Its arguments in the Boardwalk appeal share some of the themes that were successful in their appeal of the 4th Circuit case: Pitney Bowes was not a partner, HBH LLC was a sham, and HBH did not own the property for federal tax purposes.

The IRS asserts that the traditional managing member protections and guaranties typical of an HTC transaction such as construction completion, environmental liability, operating deficits, tax credit capture, deferral of significant equity pay-ins until after credit delivery and, in this instance, a GIC, virtually eliminated any downside risks of the investor. They also argue that the amount and repayment terms of the loans eliminated any potential upside.

For the above reasons, on page 60 of the brief, the government maintains that the sale of the leasehold interests in the property did not "transfer both the benefits and burdens of ownership to the HBH" so the LLC was not a true partnership. In support of this position the IRS stated, "The sublease agreement by which the Authority purportedly transferred ownership of the East Hall to HBH reveals just how little changed upon execution of that agreement. The Authority remained liable for key East Hall operating expenses, including all water, gas, sewer, electricity, light, heat, and power … It also remained liable for all real estate taxes and governmental assessments for betterments … Moreover, the Authority agreed to maintain, at its sole cost and expense, workers' compensation, property, and other insurance coverage for the premises and improvements, and other insurable property and equipment located on the premises."

As part of the government's attack on the real possibility of Pitney Bowes receiving its 3 percent priority return, the IRS stated on page 44 of the brief, "Even the wildly optimistic financial projections forecast no residual cash flow available for distribution through 2042, and those figures do not take into account the re-

continued on page 4

continued from page 3

quired retirement of operating deficit loans."

To counter the Tax Court's reliance on the *Sacks v. Commissioner* case, the IRS, on page 59 of its brief, argues: "To the contrary, there is no authority that supports the notion that Congress intended to allow a State to shift part of the cost of rehabilitating a State-owned historic structure to the Federal government by selling its Federal rehabilitation tax credits to the highest corporate bidder under the guise of undertaking a true joint venture with that corporation." This statement is consistent with a theme throughout the brief that the IRS is troubled by the nonprofit sponsorship of this transaction. Curiously however, the government's brief never references nor relies on arguments related to the code's "disqualified lease rules" meant to limit not-for-profit involvement in HTC transactions.

Industry Comments

This case is being followed with great interest by attorneys active in closing HTC transactions. Given the broad potential impact of an IRS victory in Boardwalk coming on the heels of the Virginia case, there is considerable industry concern. Jerry Breed, of Bryan Cave, said, "While the HBH case and the Virginia case are markedly different, the Virginia case considers the federal tax consequences of an investment in state historic credits and HBH considers whether a federal historic tax credit investor should be recognized as a partner in a partnership that owns a building that qualifies for federal historic tax credits. Both cases consider the fundamental issue of the level of economic involvement in a project that is required to establish entitlement to claim historic credits."

"The Virginia case determined that the state credit investor "purchased" "property" (state credits) in a disguised sale, while the IRS argues in HBH that the transaction could be viewed as an impermissible indirect sale of federal credits," Breed said. "To win, the taxpayer in HBH must convince the 3rd Circuit that it acquired sufficient economic interest in the operating partnership to establish entitlement to claim credits. While it is clear that the mere act of allocating credit is not sufficient to establish entitlement to claim credits, the threshold of sufficient economic interest in a congressionally incentivized credit remains open."

Bill Machen, of Holland and Knight, said, "The appeal by the IRS of the very strong pro-taxpayer decision in the Tax Court represents a misguided effort to apply doctrines that are intended to combat transactions that are engineered solely to produce tax benefits without any business purpose or economic substance to a transaction that was structured to achieve the very result Congress intended when it enacted the historic tax credit. Unlike the cases cited by the IRS in its brief, HBH was a classic public-private partnership that produced a tangible asset and resulted in the restoration and return to prominence of an important historic property. The attempt to read the decision by the Fourth Circuit in the Virginia Historic Tax Credit Fund case as suggesting that federal tax credits constitute "property" that can be bought and sold is particularly egregious."

The Amicus Brief

History and the Hill spoke with David Blair, of Miller and Chevalier, who is drafting the amicus brief for the National Trust. He said that the brief may respond to a number of the issues raised by the IRS in its Boardwalk appeal. Among those issues is the question of how much economic substance is enough in this type of a transaction in light of congressional intent for the federal historic tax credit. Another issue is the applicability of 4th Circuit decision in the Virginia case to a partnership that utilized the federal HTC as opposed to a state HTC. Lastly there is the issue of whether the HBH LLC can be characterized as a "sham partnership" given that the LLC had real partnership interests.

The decision in this appeal is not expected for many months, but there is a lot at stake, not just for the federal HTC, but all similar credit transactions including the low-income housing tax credit, new markets tax credit and renewable energy tax credits. The decision in Boardwalk, along with expected congressional hearings on tax reform should make 2012 a watershed year for the HTC. ❖

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continued on page 5

continued from page 4

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