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HISTORY AND THE HILL



Oral Arguments in 3rd Circuit Boardwalk Case Rattle HTC Industry

By John Leith-Tetrault, National Trust Community Investment Corporation

As we all recently learned from the Supreme Court ruling on the Obama administration's health care legislation, it can be difficult to predict a decision from what the judges say in oral arguments. That didn't prevent a wave of concern from washing over the historic tax credit (HTC) industry on June 25 when 3rd Circuit Court of Appeals judges in *Historic Boardwalk Hall LLC et al v. Commissioner* (Boardwalk v. Commissioner) pursued a line of questions that focused on whether the taxpayer had taken sufficient risks to be considered a true partner in the rehabilitation of the historic Boardwalk Hall in Atlantic City, N.J. The ruling, not expected until this fall, could have far reaching implications for the HTC and the structure of other federal credit transactions, including low-income housing tax credits, new markets tax credits and renewable energy tax credits.

Background

Built in Atlantic City between 1926 and 1929, Boardwalk Hall was certified as a National Historic Landmark in 1987. The hall was, for many decades, the site of the Miss America Pageant. 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 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. The long-term lease was treated as a sale for federal income tax purposes.

Boardwalk Hall LLC was a single-entity transaction that did not utilize the lease pass-through structure permitted under Section 50(d) of the Internal Revenue Code. The project incurred nearly \$104 million in qualified rehab expenditures in 2000, 2001 and 2002, and Pitney Bowes ultimately was 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. The operating agreement provided for a 3 percent investor priority return and contained put and call arrangements.

NJSEA's affiliate played the role of developer and provided all of the typical HTC transaction guaranties including protection against the disallowance or recapture of the tax credits, cost overruns and operating deficits. It engaged the development team, managed construction and placed

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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. The tax credit equity was used to pay down an acquisition note issued by the LLC to pay for improvements and also indirectly funded a developer fee of \$14 million.

In contesting the Boardwalk Hall transaction, the IRS made several arguments in Tax Court and the Court of Appeals that echoed many of its arguments in *Virginia Tax Credit Fund v. Commissioner* including:

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

It is important to note that *Virginia Tax Credit Fund v. Commissioner* was a case concerning the structure of a state tax credit fund. *Boardwalk v. Commissioner* is the first the time the IRS has used these arguments in a federal HTC transaction.

On January 3, 2011, the Tax Court ruled in favor of the taxpayer in the Boardwalk case. Then in the wake of the subsequent 4th Circuit Court of Appeals reversal of the Virginia Historic case in favor of the IRS, the IRS decided to appeal *Boardwalk v. Commissioner* to the 3rd Circuit. Both the National Trust for Historic Preservation and the Real Estate Roundtable submitted amicus briefs in favor of the taxpayer.

The Oral Arguments

Philadelphia attorney Harold Berk attended the June 25, 2012 oral argument and provided the HTC industry with a play-by-play description of the give and take. He reports that most of the aggressive questioning from judges Solviter, Chagares and Jordan was directed at taxpayer counsel, Kevin Flynn. Judge Solviter began by asking whether the investor, Pitney Bowes, had any real risks since the managing member had guaranteed cost overruns and the tax credits in the event of recapture or disallowance. All three judges asked what was the downside risk for Pitney Bowes. Further questions led to a discussion of the unusual use in this case of a guaranteed investment contract (GIC), funded by investor capital contributions, which effectively guaranteed the 3 percent priority return in case there was insufficient cash flow to pay it. Judge Jordan stated that if Pitney Bowes was guaranteed against all risks, its status was more like that of a creditor rather than a true partner.

The judges were troubled by the fact that the project was fully
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Novogradac Journal of Tax Credits Information

Correspondence and editorial submissions:
Alex Ruiz / 415.356.8088

Inquiries regarding advertising opportunities:
Emil Bagalso / 415.356.8037

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funded before the HTC transaction was entered into, resulting in an increase of the project budget with most of the \$18.2 million in HTC equity going to fund a developer fee. Questions also focused on another unusual feature of this deal, an early buyout (consent option) that could be exercised by the managing member in certain extraordinary circumstances. This compliance period exit option was in addition to the usual post-compliance period put and call arrangements. Judge Jordan provided the only positive note for the taxpayer and the industry when he observed that the IRS has provided no guidance on how to structure HTC transactions, and asked whether that was an important mitigating factor in this case.

On rebuttal, IRS counsel Arthur Catterall summarized the IRS position: Congress could have, but did not, authorize sale of tax credits, rather it provided for allocation of credits through an ownership structure, and allocation of credits requires that the partner be a bona fide partner subject to risks of the transaction.

Speculation on the Outcome and Industry Implications

Conventional wisdom before the appeals court oral arguments in *Boardwalk Hall v. Commissioner* was that the extreme facts in *Virginia Tax Credit Fund v. Commissioner* led to the IRS's 4th Circuit victory, and that the same arguments should not be applied to disallow federal credits in a more conventionally structured, syndicated transaction. The oral arguments in the Boardwalk appeal have raised concerns that this may not be the case.

"I would not be surprised at a reversal, though possibly with some relief for Pitney Bowes following Judge Jordan's comments about the IRS not providing guidance on deal structure and investor protection," Berk said.

Bill Machen of Holland and Knight agreed. "It is unfortunate that the IRS appears to be basing its arguments primarily on the 4th Circuit's decision in the Virginia Historic case and the 2nd Circuit's recent decision in the so-called 'Castle Harbour' case. Neither seems appropriate," he said. "The Virginia Historic decision rested on the notion that state historic credits could be classified as "property" for federal income tax purposes and that a purported allocation of state credits should be properly characterized as a disguised sale of property. To argue that federal credits also can be viewed as property is to start down a very slippery slope fraught with many difficult conceptual issues."

Machen stressed the differences between the cases, chiefly that the Castle Harbour case involved a classic example of a tax-engineered transaction designed solely to achieve tax benefits for the participants that were not intended by the law. "A syndicated HTC transaction, on the other hand, results in the use of a targeted tax incentive to create a tangible project deemed to have a benefit to society," Machen said. "With respect to assuming risks, the fact

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is that investors in all types of syndicated real estate transactions, including historic rehabilitation, low-income housing and new markets credit deals, always have insisted on being protected against construction completion risks, environmental risks, operating deficits and tax risks. Without such protection, the investment would not be made.”

“Hopefully, if the Boardwalk decision is overturned, the IRS will issue a revenue procedure or other guidance providing some clear-cut criteria on the nature and extent of risk abatement provisions that will not result in a conclusion that an investor in a targeted incentive tax credit transaction is not a true equity participant.”

Forrest Milder of Nixon Peabody took a more hopeful position, saying that we shouldn’t be too quick to expect the court to rule in favor of the IRS. He noted that while many questions critical of the taxpayer were posed by Judge Jordan, he was also the jurist who asked the government’s attorneys if it was “fair” to first tell the parties “here” that they get no tax credits if they are too protected. He also wondered, “Why should the ax fall here?”

In an effort to mitigate the impact on the federal HTC market, the Historic Tax Credit Coalition has reached out to the Tax Policy Division of the Treasury Department to discuss both the Virginia and Boardwalk Hall cases to see if the issues raised in both cases could be placed on the IRS priority guidance list for this year. Patrick Robertson of C2 Group said he hopes to have this meeting in August. ❖



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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