No. 11-1832

IN THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

HISTORIC BOARDWALK HALL, LLC,

Petitioner-Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant

ON APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

BRIEF FOR THE APPELLANT
COMMISSIONER OF INTERNAL REVENUE

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GLOSSARY

ACCCA – Atlantic City Convention Center Authority

CRDA – New Jersey Casino Reinvestment Development Authority

FASB – Financial Accounting Standards Board

FPAA – notice of final partnership administrative adjustment

GE – General Electric Capital Corporation

GIC – guaranteed investment contract

HBH – Historic Boardwalk Hall, LLC

LLC – limited liability company

QRE – qualified rehabilitation expenditures

RFP – Request for Proposal

SMG – Spectacor Management Group

TIFD – TIFD III-E, Inc., a subsidiary of General Electric Capital Corporation

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STATEMENT OF JURISDICTION

On February 22, 2007, the Internal Revenue Service ("IRS") issued a notice of final partnership administrative adjustment ("FPAA") with respect to the 2000, 2001, and 2002 tax years of Historic Boardwalk Hall, LLC ("HBH"). (JA142-151.)[1] *See* Internal Revenue Code ("I.R.C.") § 6223(a)(2) (26 U.S.C.). The New Jersey Sports and Exposition Authority ("the Authority"), the tax matters partner of HBH, filed a petition for readjustment in the United States Tax Court on May 21, 2007, within 90 days after the issuance of the FPAA.

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[1] "JA" references are to the joint appendix submitted with this brief. "Tr." references are to the transcript of trial.

(JA65.) *See* I.R.C. §§ 6226(a)(1), 6231(a)(7). The Tax Court had jurisdiction under I.R.C. §§ 6226(f) and 7442.

The Tax Court entered its decision in this case on January 3, 2011. (JA3.) *See* I.R.C. § 7459(a). On March 29, 2011, within 90 days after entry of decision, the IRS filed a notice of appeal. (JA1-2.) *See* I.R.C. § 7483. This Court has jurisdiction under I.R.C. § 7482(a)(1). *See also* I.R.C. § 6226(g).

STATEMENT OF THE ISSUE

In December 1998, the New Jersey Sports and Exposition Authority, a tax-exempt instrumentality of the State of New Jersey, commenced renovation of a structure in Atlantic City known as the Historic Boardwalk Hall. The Authority subsequently engaged a broker to solicit offers from major corporations interested in purchasing the federal rehabilitation tax credits that the project was expected to generate. Pitney Bowes Credit Corporation (Pitney Bowes) ultimately agreed to purchase the credits. In an attempt to effect a sale of the credits that would not be invalidated by the IRS, the Authority formed a limited liability company (LLC), Pitney Bowes agreed to contribute approximately $18.2 million to the LLC in exchange for a 99.9-percent interest therein (with the Authority retaining a 0.1-percent interest as

the managing member), and the Authority purported to sell its interest in the Hall to the LLC in exchange for a note. The LLC, which elected to be treated as a partnership for tax purposes and is hereafter referred to as such, claimed the tax credits generated by the renovations and allocated 99.9 percent of them (as well as 99.9 percent of tax losses from operations) to the corporate purchaser, Pitney Bowes.

The issue presented on appeal is whether the Tax Court erred in upholding the above-described allocation of the federal tax credits and tax losses to Pitney Bowes against three alternative, but largely overlapping, grounds for disallowance asserted by the IRS: (1) the purported partnership was a sham, (2) Pitney Bowes, in substance, was not a partner of the partnership, and (3) the Authority failed to transfer the benefits and burdens of ownership of the property to the partnership.

STATEMENT OF RELATED CASES AND PROCEEDINGS

This case has not been before this Court previously, and we are not aware of any related cases or proceedings.

STATEMENT OF THE FACTS

A. Background

The Authority was created by the New Jersey legislature in 1971 to build, own, and operate the Meadowlands Sports Complex in East

Rutherford, New Jersey. (JA6.) In January 1992, the legislature further empowered the Authority to build, own, and operate a new convention center in Atlantic City and to acquire, renovate, and operate the existing facility known as the Historic Boardwalk Hall (or simply the East Hall). (JA6, 521.) The East Hall, completed in 1929, is perhaps best known for hosting the annual Miss America pageant beginning in 1933 and for decades thereafter. (JA968.) It was designated a National Historic Landmark in 1987. (JA9.)

The 1992 legislation contemplated that the Authority would engage the Atlantic City Convention Center Authority ("ACCCA"), the existing operator of the East Hall, to operate both the East Hall and the new convention center. (JA522; Tr. 150.) In October 1992, the Authority obtained a 35-year leasehold interest in the East Hall from the property's owner, the Atlantic County Improvement Authority, and it entered into the contemplated operating agreement with ACCCA the next month. (JA519, 1691-1711.) In July 1995, responsibility for the day-to-day operations of the East Hall and of the yet-to-be-completed new convention center was handed over to a private entity, Spectacor Management Group ("SMG"), pursuant to a management agreement between the Authority, ACCCA, and SMG. (JA523-576.)

B. Renovation of the East Hall

As construction of the new convention center progressed, Authority officials began planning for the future of the East Hall. (JA10.) The Authority ultimately decided to convert the East Hall into a special events facility, which would require extensive renovations. (*Id.*) The renovations were to be completed in four phases and were initially expected to cost about $78.5 million. (*Id.*; JA708, 711, 1003.)

Renovation of the East Hall commenced in December 1998. (JA10.) By that time, the Authority had entered into agreements with the New Jersey Casino Reinvestment Development Authority ("CRDA") pursuant to which the CRDA agreed to reimburse the Authority up to $4,146,745 for certain pre-design expenses and up to $32,574,000 for renovation costs.[2] (JA1712.) In a March 1999 document relating to a separate bond issuance, the Authority noted that it had received CRDA grants to pay for the first phase of the East Hall renovation and that "[f]unding for the remaining cost of the project and [sic] is expected to be obtained through the issuance by the Authority of Federally Taxable State Contract Bonds." (JA708.) The Authority issued those State

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[2] The CRDA is a State agency that uses funds generated from governmental charges imposed on the casino industry for economic development projects throughout New Jersey. (JA11 n.4.)

Contract Bonds – in the face amount of $49,915,000 – in June of 1999. (JA745, 1713.)

The first two phases of the renovation were completed prior to the 1999 Miss America Pageant, and Phase 3 commenced in October 1999. (JA1003.) By the end of 1999, the expected cost of the renovations had increased to about $90.6 million. (JA1713.) By that time, the CRDA had agreed to reimburse the Authority for all project costs in excess of the proceeds from the June 1999 bond issuance. (*Id.*; JA802.)

C. Selling the tax credits

1. The pitch

In August 1998, Paul Hoffman of Sovereign Capital Resources, LLC ("Sovereign") contacted Authority officials regarding a "consulting proposal" with respect to "the sale of the historic rehabilitation tax credits expected to be generated" by the East Hall renovations. (JA691.) Hoffman explained that, in the case of qualifying historic structures like the East Hall, the owner (or long-term lessee) is entitled to a tax credit equal to 20 percent of "qualified rehabilitation expenditures" (QRE), subject to a 5-year holding period after completion of the renovation. (JA691-92.) Although the Authority, as a tax-exempt entity, would have no use for the credits, Hoffman indicated

that there is a market for such credits among "Fortune 500 corporations with substantial federal income tax liabilities." (JA692.)

Hoffman further explained that, because the credits "cannot be transferred after the fact," the sale of the credits would be effected through a partnership arrangement between the Authority and the corporate purchaser. (JA692-94.) In essence, the Authority would contribute its interest in the East Hall to the partnership, the purchaser would contribute cash to the partnership, the partnership would allocate substantially all of the tax credits to the purchaser as earned, and the Authority would then have the right to buy out the purchaser after a sufficient waiting period. (JA693-95.) Hoffman also explained that, because the credits generally must be allocated to the partners in accordance with their interests in partnership profits and losses (*i.e.*, they generally cannot be the subject of a "special" allocation), substantially all of the partnership's profits and losses (typically 99 percent) are allocated to the corporate purchaser in these transactions. (JA694.)

Having initially estimated that the proceeds of the sale would exceed $11 million, Hoffman gave the following overview (JA691):

> To summarize briefly, the best way to view the equity generated by a sale of the historic tax credits is to think of it as an $11 million interest only loan that has no term and

> may not require any principal repayment. The anticipated interest rate will be approximately 3% annually, payable as a distribution from operating revenue. If operations are poorer than anticipated, then the investor is not paid. If operations are better than expected, *the investor will share minimally in the upside*. [Emphasis added.]

Hoffman reiterated that corporations engaging in these transactions typically do so through "either the[ir] tax, structured finance, or leasing departments … rather than a real estate section because the corporations view these transactions as highly structured financing deals." (JA692.)

Hoffman made clear that the Authority should "plan to issue enough bonds to meet the construction financing requirements of the project," as purchasers of historic tax credits typically "will provide no more than 10% of their equity to the partnership during the construction period." (JA695.) He also "assume[d] that [the Authority] would like to minimize the cash distribution to the investor and retain long-term ownership of [the East] Hall." (*Id.*) Sovereign arranged a meeting with Authority officials in October 1998 to discuss the proposal. (JA705.)

In March 1999, the Authority issued a Request for Proposal (as supplemented in April 1999, the "RFP") seeking "financial arranger" services with respect to the proposed transaction. (JA710-722.) The

RFP provided that the selected candidate "will … be expected to prepare a Tax Credit [O]ffering Memorandum, market the tax credits to potential investors and successfully close a partnership agreement with the proposed tax credit investor." (JA721.) The Authority received four responses to the RFP, and it selected Sovereign as the "financial arranger" for the transaction on June 4, 1999. (JA749-50.)

2. Making the numbers work

In September 1999, SMG (the operator of the East Hall) provided preliminary 5-year financial projections for the East Hall commencing in 2002, the first full year of operations following the expected completion date of the renovations in late 2001. (JA785-86.) SMG projected a net operating loss of approximately $1.7 million for each of the years 2002 through 2006. (JA786.) In response, Sovereign expressed concern that the figures "might prove excessively conservative" (JA793) and began suggesting ways "[t]o improve the operating results," such as "shifting the burden of some of the operating expenses from the [proposed] Partnership to [the Authority]." (JA804.) Sovereign recognized that, in order for the tax-credit deal to work, the proposed partnership "should have a profit motive and should be able to reasonably show that it is a going concern." (*Id.*)

By February 3, 2000, SMG was projecting much smaller net operating losses for the years 2002 through 2006, ranging from about $396,000 in 2002 to about $16,000 in 2006. (JA895.) Just 11 days later, SMG projected net operating *income* for the 5 years in question in the approximate amounts of $716,000, $833,000, $958,000, $1,092,000, and $1,236,000, respectively. (JA863.) About 90 percent of that turnaround was attributable to the removal of the projected utilities expense ($1 million for 2002, increasing by 3 percent each year) from the projections. (JA863, 895.) When the project accountants, Reznick Fedder & Silverman ("Reznick"), retained the utilities expense in their initial transaction projections (JA943), Hoffman instructed them to "[t]ake $1MM Utility Cost completely out of Expenses, [the Authority] will pay at upper tier." (JA954.) Even without the utilities expense, the projected net operating income figures were "acknowledged as being optimistic." (JA1129.)

3. Confidential information memorandum

In March 2000, the Authority sent a 174-page "confidential information memorandum" to 19 potential purchasers of the rehabilitation tax credits expected to be generated by the East Hall renovations. (JA13, 955-1128.) The memorandum indicated that the entire expected construction cost – $90,596,088 – would be funded by

the Authority, with such expenditures to be treated as capital contributions to the proposed partnership. (JA962, 1035.) The projected purchase price for the tax credits – $16,354,000, also in the form of capital contributions to the partnership – would be used for the following purposes, none of which was included in the construction cost: (1) payment of a"development fee" to the Authority ($14 million), (2) payment of legal, accounting, and syndication fees relating to the tax-credit transaction ($527,080), and (3) the establishment of a working capital reserve ($1,826,920). (JA13, 963, 1023, 1035.) The $16,354,000 purchase price was based on projected tax credits of about $17.6 million, allocation of 99.9 percent of those credits to the purchaser, and a purchase price of $0.93 per allocated credit. (JA1032.)

The memorandum included financial projections through 2009. (JA1017-1038.) Those projections assumed a cumulative, annual 3-percent priority distribution to the purchaser on its $16,354,000 "contribution" commencing in 2002 (the "preferred return"), which Sovereign described in a contemporaneous internal memorandum as "required by tax rules." (JA1024, 1135.) Although the financial projections showed sufficient net operating income (cash flow) to pay the preferred return ($490,620) on a substantially current basis, they also showed substantial tax losses through 2009 attributable to

depreciation deductions. (JA1024-25.) In that regard, the projections included calculations of the "projected value of tax losses, tax credits, and cash flow to [the] limited partner." (JA1026-27.)

4. Selection of Pitney Bowes as the purchaser

Four corporations submitted proposals in response to the confidential information memorandum: Bank of America, Chevron, First Union National Bank, and Pitney Bowes. (JA13, 1143.) With an eye towards ensuring that "the [proposed] partnership would be respected as such for US tax purposes," Pitney Bowes proposed that the Authority fund the construction costs through a loan, rather than equity contributions, to the partnership. (JA1145.)

On July 13, 2000, Pitney Bowes and the Authority executed a letter of intent reflecting their agreement that Pitney Bowes would pay $16.4 million for the credits through a series of capital contributions to Historic Boardwalk Hall, LLC ("HBH"), which the Authority had recently formed. (JA7, 1146, 1148.) Consistent with Pitney Bowes's earlier proposals, the letter provided that the Authority would fund the renovations through 40-year "acquisition" and "construction" loans to HBH in the aggregate amount of $90 million. (JA1148-49.) The letter also incorporated the 3-percent preferred return to the purchaser

(Pitney Bowes) as described in the information memorandum. (JA1152.)

5. Making the numbers work (again)

In a memorandum to Paul Hoffman dated July 22, 2000, Andy Bowden, the Reznick accountant who was preparing the financial projections, noted that the Authority's proposed acquisition and construction loans to HBH "have been set up to be paid from available cash flow" and that "[t]here was not sufficient cash to amortize this debt." (JA1160.) Hoffman subsequently instructed Bowden to increase baseline (2002) revenues by $1 million (from about $5 million to about $6 million) by adding a new revenue source ("naming rights") in the amount of $750,000 and by increasing existing revenue sources by $250,000. (JA243, 1021, 1196.) Baseline expenses, however, remained the same. (JA15.) Moreover, whereas the initial projections assumed that baseline revenues and expenses would increase by 3 percent per year, the final projections used a 3.5-percent inflator for revenues while retaining the 3-percent inflator for expenses. (JA14-15.) As a result of these changes, Reznick was able to project that, even after taking into account payment of the preferred return to Pitney Bowes, the acquisition loan would be fully paid off in 2040, at which time HBH

would be able to begin making sufficient annual payments on the construction loan to retire that loan shortly thereafter. (JA254-55.)

Reznick was also able to increase the amount of projected QRE by about $9 million by moving certain expenditures from the "ineligible" category to the "eligible" category. (JA245, 1023, 1208.) This resulted in an increase in projected tax credits from $17,602,667 to $19,412,173, which in turn resulted in an increase in Pitney Bowes's capital contribution from $16,400,000 to $18,195,797. (JA242.) The final projections showed larger taxable losses than the projections contained in the information memorandum due to interest expense on the acquisition loan and the construction loan (neither of which was contemplated in the information memorandum). (JA246-47.)

D. The initial closing

The initial closing of the tax-credit transaction occurred on September 14, 2000. On that date, Pitney Bowes made an initial capital contribution of $650,000 to HBH, and the parties executed multiple documents to implement the transaction.[3] (JA13-14, 17.)

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[3] Pitney Bowes actually entered into the transaction through a wholly-owned LLC called PB Historic Renovations, LLC. (JA7-8 & n.2.) For ease of reference, we refer to both Pitney Bowes and this wholly-owned LLC as Pitney Bowes.

1. HBH operating agreement

The primary agreement between Pitney Bowes and the Authority took the form of an amended and restated operating agreement with respect to HBH. (JA153-264.) The agreement provided that Pitney Bowes would hold a 99.9-percent ownership interest as the "investor member" and that the Authority would hold a 0.1-percent ownership interest as the "managing member." (JA157, 213.) It further provided that Pitney Bowes would make three additional contributions upon the satisfaction of various project-related conditions. (JA176-178.) Each of these contributions, as well as the initial $650,000 contribution, would be used by HBH to pay down the principal of the acquisition loan contemplated in the letter of intent. (JA178.) For its part, in addition to providing the acquisition and construction loans (discussed more fully below), the Authority agreed to pay all excess development costs (*i.e.*, it provided a completion guaranty) and agreed to fund any operating deficits through interest-free loans to HBH. (JA188.) The Authority also indemnified Pitney Bowes against any environmental liability relating to the East Hall, including the costs of any environmental remediation. (JA208.) Pitney Bowes was entitled to a priority distribution of any environmental insurance proceeds as a means of collecting on that indemnity. (JA195.)

The agreement set forth in detail the order of priority in which distributions of "net cash flow" (a defined term) would be made. (JA164, 195-96.) In addition to the 3-percent preferred return on Pitney Bowes's capital contributions, the agreement afforded priority to certain payments with respect to a $1.1 million "investor loan" Pitney Bowes had agreed to make to HBH. (JA165, 196.) Both the preferred return and the priority distributions with respect to the investor loan were payable before any payments could be made on the acquisition loan, the construction loan, and any operating deficit loans. (JA164, 196.)

The agreement also contained certain repurchase rights and obligations relating to the operations of HBH.[4] For instance, the Authority had the right to purchase Pitney Bowes's interest in the event the Authority wished to take certain actions otherwise prohibited under the agreement or, in the case of certain actions requiring Pitney Bowes's consent, in lieu of obtaining such consent (the "consent options"). (JA185-86.) In either case, the purchase price for Pitney Bowes's interest would equal the present value of any yet-to-be-realized

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[4] Additional put and call rights, exercisable only after the expiration of the 5-year recapture period for the tax credits, were set forth in separate agreements discussed *infra* at pp. 19-20.

tax benefits and cash distributions to Pitney Bowes, as projected through the end of the 5-year credit-recapture period. (*Id.*) Pitney Bowes had the right to compel the Authority to purchase its interest for the same price in the event of a material default by the Authority (the "default option"). (JA189.)

2. Lease amendment, sublease, and acquisition loan

The Authority and HBH also executed several documents relating to the purported transfer of tax ownership of the East Hall to HBH. First, the Authority entered into an amended and restated lease agreement with its lessor, the Atlantic County Improvement Authority, extending the term of its leasehold interest in the East Hall to 2087. (JA15, 381-403.) Next, the Authority and HBH executed (1) an agreement to lease evidencing the Authority's sale of a subleasehold interest in the East Hall to HBH, and (2) a sublease setting forth the terms of that interest, the duration of which was coterminous with the Authority's newly extended leasehold interest. (JA15, 410-441, 448-49.)

The Authority financed the entire purchase price for HBH's subleasehold interest – $53,621,405 – by means of the acquisition loan contemplated in the letter of intent. (JA16, 376-380.) The amount of the loan was intended to represent the construction costs incurred by the Authority as of the closing. (JA16.) Although the acquisition note

called for payment in equal annual installments over 40 years at an annual interest rate of 6.09 percent, it specified that, in the event HBH did not have sufficient cash to pay any installment (giving effect to the distribution provisions of its operating agreement), no interest would accrue on the shortfall. (JA376.) Instead, the shortfall would simply be added to the next year's installment. (*Id.*) HBH pledged its subleasehold interest in the East Hall as security for the loan. (JA16, 311-339.)

3. Development agreement and construction loan

In connection with the ongoing rehabilitation of the East Hall, the Authority and HBH entered into a development agreement and executed certain construction loan documents. Under the development agreement, HBH agreed to pay the Authority $14 million to continue doing what it had been doing "since December, 1998 … in anticipation of the formation of [HBH]." (JA18, 267.) The fee was payable upon completion of the renovations. (JA18.)

The Authority and HBH also executed documents reflecting the Authority's agreement to finance the remaining construction costs over 40 years at an annual interest rate of 0.1 percent. (JA369-375, 450-468.) As explained *infra* at pp. 21-22, although the parties anticipated

about $37.9 million of additional construction costs,[5] the upper limit of the construction loan was set at $57,215,733. (JA16, 450.) Like the acquisition note, the construction note called for payment in equal annual installments out of available cash, with no interest on any shortfalls. (JA369-70.) HBH granted a second mortgage on its subleasehold interest in the East Hall as security for the loan. (JA16, 340-368.)

4. Purchase option agreement and agreement to compel purchase

Pitney Bowes and the Authority memorialized certain buyout rights and obligations outside the HBH operating agreement in the form of a purchase option agreement and an agreement to compel purchase. (JA284-297.) Under the purchase option agreement, the Authority had the right to purchase Pitney Bowes's interest in HBH at any time during the 12-month period beginning 60 months after completion of the East Hall renovations (*i.e.*, after expiration of the tax-credit recapture period). (JA24-25.) If the Authority failed to exercise

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[5] The final projections actually contemplated about $27.4 million of remaining construction costs. (JA242.) Just prior to the initial closing, however, the parties identified $10.5 million of potential additional expenditures relating to, *inter alia*, environmental remediation and tenant improvements. (JA1209.)

its option, then Pitney Bowes had the right to compel the Authority to purchase its interest in HBH at any time during the 12-month period beginning 84 months after completion of the East Hall renovations. (JA25.) In either case, the purchase price would equal the greater of (1) 99.9 percent of the fair market value of 100 percent of the interests in HBH, or (2) any accrued and unpaid preferred return. (*Id.*)

The HBH operating agreement contained a provision requiring the Authority to obtain a guaranteed investment contract ("GIC") to secure the payment of the purchase price under the purchase option agreement (as well as repayment of the investor loan). (JA25, 187-88.) The Authority was required to purchase the GIC on or before the date of Pitney Bowes's second capital contribution. (JA188.) As Sovereign explained in a memorandum just prior to the initial closing, "[t]he GIC should be sized to pay off the Investor Loan of $1.1 million, accrued but unpaid interest on the loan, and [Pitney Bowes's] annual priority distributions." (JA1211.)

5. Tax benefits guaranty

HBH and Pitney Bowes entered into a tax benefits guaranty agreement. (JA27, 298-307.) Although HBH was the nominal obligor under the agreement, the Authority was required to fund any obligation of HBH thereunder. (JA27.) As the Tax Court explained,

the "ultimate purpose" of the agreement "was to require [the Authority] to make Pitney Bowes whole should any part of the tax benefits be successfully challenged by the IRS." (*Id.*)

E. HBH in operation

1. Construction phase

As indicated above, HBH's operating agreement provided that Pitney Bowes's capital contributions would be used to pay down the principal of the acquisition loan from the Authority. (JA178.) As the Tax Court explained, however, decreases in the amount of the acquisition loan were offset by corresponding increases in the amount of the construction loan:

> Pitney Bowes' capital contributions were to be used to pay down the principal on the acquisition note. … Shortly thereafter, a corresponding draw would be made on the construction note, and [the Authority] would advance those funds to [HBH]. Ultimately, these offsetting draws left [the partnership] with cash in the amount of Pitney Bowes' capital contributions, a decreased balance on the acquisition loan, and an increased balance on the construction loan. These funds were then used by [HBH] to pay assorted fees related to the transaction and to pay [the Authority] a developer's fee … .

(JA17-18.) The anticipated shifting of $19,295,797 ($18,195,797 capital contribution plus $1.1 million investor loan) from the acquisition loan to the construction loan is reflected in the financial projections attached to the operating agreement (JA242), and it explains why the parties set

the upper limit of the construction loan approximately $19.3 million higher than the anticipated amount of remaining construction costs as of the initial closing date. *See supra* pp. 18-19.

The Authority used $3,332,500 of Pitney Bowes's second capital contribution – to which it was entitled as the payee under the acquisition loan – not to fund a construction draw by HBH, but rather to purchase the requisite GIC as security for its potential obligation to purchase Pitney Bowes's interest in HBH. (JA18, 25-26, 1754.) Although this requirement was initially couched in terms of the Authority's potential obligation under the purchase option agreement (JA187-88), the Authority actually pledged its interest in the GIC as security for its potential obligation under the agreement to compel purchase (*i.e.*, Pitney Bowes's put option), subject to its right to apply the proceeds of the GIC towards payment of the required purchase price under the purchase option agreement, either of the consent options, or the default option. (JA1480.)

In 2000, HBH's operating expenses (*i.e.*, not taking into account interest and depreciation expense) exceeded its operating revenues by $990,013. (JA91, 1532.) In 2001, operating expenses exceeded operating revenues by $3,766,639. (JA104.) The September 2000 financial projections attached to the HBH operating agreement forecast

that HBH would generate $500,000 of net operating *income* in 2001. (JA246.) Thus, the projections for 2001 were off by $4,266,639.[6]

The East Hall project ultimately generated almost $10.7 million more qualified rehabilitation expenditures (QRE) in 2000 and 2001 than contemplated in the financial projections attached to the operating agreement. (JA250, 1536.) *See supra* note 5. Accordingly, the aggregate amount of Pitney Bowes's required capital contribution was increased to $20,198,460, and the amount of its investor loan was increased to $1,218,000. (JA1536.)

2. Post-construction phase

The East Hall renovation was completed "on time and on budget" in late 2001. (JA1757-58.) Pitney Bowes, however, did not make its third and largest capital contribution – in the amount of $10,467,849 – until October 30, 2002. (JA16-17.) Reznick prepared revised financial projections in connection with that contribution. Whereas Reznick had initially forecast $1,715,867 of net operating income for 2002, it now projected a net operating loss of $3,976,023 for 2002. (JA246, 1532.) As it turned out, the actual net operating loss for 2002 was $4,280,527.

[6] 2001 was the first year for which the accountants projected operating revenues and expenses.

(JA118.) Accordingly, the initial projections for 2002 were off by $5,996,394.

Notwithstanding the inaccuracy of the initial projections for 2001 and 2002, Reznick did not alter the projections for 2003 and later years from those contained in the initial projections. Thus, despite having to revise the initial projection for 2002 from net operating income of $1,715,867 to a net operating loss of $3,976,023, Reznick continued to project net operating income as follows:

2003	$1,797,320
2004	$1,882,266
2005	$1,970,846
2006	$2,063,208
2007	$2,159,504
Total	$9,873,144

(JA246, 1532.) Actual operating expenses exceeded actual operating revenue in each of those years, resulting in aggregate net operating losses for that period of $10,526,972.[7] (JA132, 1643, 1655, 1660, 1790.) The aggregate discrepancy between projected and actual results for the period was $20,400,116, more than 206 percent.

[7] The record does not contain audited financial statements for HBH beyond 2007.

In connection with the preparation of HBH's 2003 audited financial statements, Reznick "addressed a possible impairment issue under FASB 144." (JA1638.) FASB 144 requires the writedown of impaired assets to their true value upon the occurrence of a "triggering event" such as a loan default or net operating losses. (Tr. 1000.) Reznick considered the application of FASB 144 to HBH's leasehold improvements (*i.e.*, the East Hall) "[d]ue to the fact that [HBH] has experienced substantial operating losses and has not generated any operating cash flow since its inception." (JA1638.)

In a memorandum to HBH's audit file, Reznick explained why it ultimately decided not to write down the leasehold improvements:

> Per discussions with the client, it was determined that [HBH] was not structured to provide operating cash flow. Instead, the managing member, [the Authority], agreed to fund all operating deficits of [HBH] in order to preserve [the East Hall] as a facility to be used by the residents of the State of New Jersey. The managing member has the ability to fund the deficits as a result of the luxury and other taxes provided by the hospitality and entertainment industry in the state.

(JA1638.) Reznick concluded that, "[s]ince there is no ceiling on the amount of funds to be provided under the operating agreement," there was no triggering event that required the application of FASB 144. (*Id.*) It reached the same conclusion with regard to HBH's 2004 and

2005 financial statements.[8] (JA1654-55.) By the end of 2007, the balance of the Authority's operating deficit loan to HBH exceeded $28 million. (JA1659, 1665.)

F. Tax reporting, IRS audit, and Tax Court proceedings

1. HBH's 2000-2002 federal tax returns

On its 2000 federal tax return, HBH reported a net operating loss of $1,712,893, and it reported $38,862,877 of QRE. (JA70, 72.) HBH allocated 99.9 percent of the QRE, or $38,824,014, to Pitney Bowes. (JA74.) It also allocated $1,182,424 of the loss to Pitney Bowes.[9] (*Id.*)

On its 2001 return, HBH reported a net operating loss of $6,605,142, and it reported $68,865,639 of QRE. (JA76, 78.) HBH allocated 99.9 percent of the loss ($6,598,537) and 99.9 percent of the QRE ($68,796,773) to Pitney Bowes. (JA80.)

On its 2002 return, HBH reported a net operating loss of $9,135,373, and it reported $1,271,482 of QRE. (JA81, 83.) HBH

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[8] The record does not contain Reznick's audit files for HBH beyond 2005.

[9] Presumably, the allocation of a substantial portion ($530,469) of the 2000 loss to the Authority reflects HBH operations prior to the initial closing.

allocated 99.9 percent of the loss ($9,126,238) and 99.9 percent of the QRE ($1,270,211) to Pitney Bowes. (JA86.)

2. The notice of final partnership administrative adjustment

Following an audit of the foregoing returns, the IRS issued a notice of final partnership administrative adjustment (FPAA) reflecting its determination that all items allocated to Pitney Bowes on those returns should be reallocated to the Authority. (JA142-151.) The IRS based its determination on three separate, but related, grounds. (JA151.) First, it asserted that HBH should be disregarded for tax purposes – either under sham-partnership principles or under the anti-abuse provisions of Treas. Reg. § 1.701-2(b) – on the ground that it "was created for the express purpose of improperly passing along tax benefits to its limited partner." (*Id.*) The IRS also asserted that Pitney Bowes's interest in HBH "was not a bona fide partnership participation because [Pitney Bowes] had no meaningful stake in the success or failure of [HBH]." (*Id.*) As a final ground, the IRS asserted that HBH should not be treated as the owner of the East Hall for tax purposes, since the benefits and burdens of such ownership remained with the Authority. (*Id.*) The IRS further determined that accuracy-related penalties applied. (*Id.*)

3. Tax Court proceedings

The Authority, in its capacity as the tax matters partner of HBH, timely filed a petition for redetermination in the Tax Court on behalf of HBH. (JA31, 65.) Following a 4-day trial, the court issued an opinion in favor of HBH. (JA4-64.)

The Tax Court began by rejecting the IRS's argument that HBH should be disregarded for tax purposes as an economic sham.[10] (JA34-37.) In that regard, the court disagreed with the IRS's contention that the sole purpose of HBH was to facilitate a sale of tax credits. (JA41.) According to the court, HBH "had a legitimate business purpose – to allow Pitney Bowes to invest in the East Hall's renovation." (*Id.*) In determining that Pitney Bowes "invested" in the project through HBH, the court held that the tax benefit that Pitney Bowes realized from the credits must be taken into account, since "Congress enacted the rehabilitation tax credit in order to spur private investment in unprofitable historic rehabilitations." (JA45.)

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[10] The court also rejected the IRS's argument that it had the authority under Treas. Reg. § 1.701-2 to disregard HBH for tax purposes. (JA58-64.) The Commissioner does not appeal that aspect of the court's decision.

The court employed similar reasoning in rejecting the IRS's related argument that Pitney Bowes was not a bona fide partner in HBH. (JA47-52.) Thus, the court determined that Pitney Bowes had a meaningful stake in the success or failure of the enterprise by reference to its 3-percent preferred return *and* the tax credits that would inure to its benefit upon successful completion of the East Hall renovation. (JA51.)

Finally, the court determined that, contrary to the IRS's contention, the Authority had transferred sufficient benefits and burdens of ownership with respect to the East Hall to render HBH the owner of the property for tax purposes. (JA52-58.) In support of its conclusion, the court noted that (1) the parties treated the transaction as a sale, (2) possession of the East Hall vested in HBH, (3) HBH reported the East Hall's operating results on its partnership returns, and (4) bank accounts had been opened in HBH's name as operator of the property. (JA54-55.)

The Tax Court entered a decision in favor of HBH in accordance with its opinion, and this appeal followed.[11]

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[11] The Tax Court's decision on the merits rendered the penalties asserted in the FPAA inapplicable *per se*. (JA64.) In the event this (continued...)

SUMMARY OF ARGUMENT

Federal tax credits in general – and the historic rehabilitation tax credit in particular – are non-transferable. In situations where the credits would otherwise be earned by a tax-exempt entity that cannot use them, there is an incentive to attempt an indirect sale of the credits to a taxable entity. That is what the parties attempted to do in this case by means of a purported partnership between the seller of the credits, the New Jersey Sports and Exposition Authority, and the purchaser, Pitney Bowes. Although there was no substance to the parties' partnership arrangement, the Tax Court nevertheless accepted the arrangement at face value. In so doing, the court committed reversible error.

1. The Tax Court erred in rejecting the Commissioner's argument that Pitney Bowes was not, in substance, a partner in HBH. Partner status for federal tax purposes requires a meaningful stake in the success or failure of the enterprise, something Pitney Bowes cannot claim in this case. Pitney Bowes had no meaningful downside risk, since it was assured of receiving the benefit of its bargain – consisting

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[11](...continued)
Court rules in favor of the Commissioner, it should remand the case to the Tax Court for consideration of the asserted penalties.

of the monetary value of the purchased tax credits and a small, fixed return on its cash contributions – through a tax benefits guaranty agreement and purchase and sale options secured by a guaranteed investment contract. Moreover, Pitney Bowes faced no risk of incurring any obligations beyond its capital contributions, since the Authority agreed to fund all construction cost overruns and all operating deficits, indemnified Pitney Bowes against environmental liability and purchased insurance for Pitney Bowes's benefit to bolster that indemnity, and agreed to make Pitney Bowes whole not only for any lost tax benefits, but also for additional expenses and liability associated with any IRS audit.

Nor did Pitney Bowes share in any upside potential with respect to the East Hall. Its 99.9-percent interest in residual cash flow was illusory; even the result-driven financial projections for the project – grounded in economic fantasy – could not hide the fact that HBH's debt service on the Authority's "loans" to it would tie up any otherwise available cash flow for at least 40 years. Moreover, in the unlikely event (given HBH's overwhelming debt) that Pitney Bowes's interest attained any significant value, the Authority could purchase that interest at any time for an amount effectively capped at any accrued but unpaid preferred return (the payment of which, again, was covered

by a guaranteed investment contract). Without any upside potential or downside risk, Pitney Bowes was not a bona fide equity participant (*i.e.*, a partner) in HBH.

2. The Tax Court also erred in rejecting the Commissioner's related argument that HBH itself was a sham partnership. Many of the same factors that belie Pitney Bowes's claimed status as a partner in HBH also belie HBH's claimed status as a partnership. For a partnership to be recognized for federal tax purposes, the purported partners must have an intention to join together to share in the economic benefits and risks of a business enterprise. As discussed above, Pitney Bowes and the Authority negotiated an arrangement that precluded any such sharing of risk and reward. Accordingly, HBH served no legitimate non-tax business purpose.

3. The Tax Court also erred in rejecting the Commissioner's additional argument that the Authority did not, in substance, transfer ownership of the East Hall to HBH. In order to effect a transfer of property for tax purposes, the owner must transfer the underlying benefits and burdens of ownership with respect to the property. That clearly did not occur here. The Authority remained liable for key expenses of operating the East Hall, and it effectively retained the benefits of ownership through its ability to terminate Pitney Bowes's

alleged ownership stake (through HBH) without regard to fair market value. Indeed, the Authority continued to list the East Hall as an asset on its audited financial statements. The Tax Court, however, turned a blind eye to the substantive indicia of the Authority's continued ownership, giving undue weight to the formalities of the purported transfer.

For the foregoing reasons, the decision of the Tax Court should be reversed.

ARGUMENT

The Tax Court erred in upholding HBH's allocation of 99.9 percent of the federal rehabilitation tax credits generated by the East Hall renovations to Pitney Bowes

Standard of review

The Tax Court's ultimate characterization of a transaction for tax purposes is subject to *de novo* review. *Merck & Co., Inc., v. United States*, 652 F.3d 475, 480-81 (3d Cir. 2011); *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129, 142 (4th Cir. 2011) (both citing *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n.16 (1978)); *see also Sun Oil Co. v. Commissioner*, 562 F.2d 258, 262 (3d Cir. 1977). The court's subordinate factual findings are reviewed for clear error. *Merck*, 652 F.3d at 480-81.

A. Pitney Bowes was not, in substance, a partner in HBH

A partnership exists for federal tax purposes when two or more parties, in good faith and acting with a business purpose, intend to join together in the present conduct of an enterprise. *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949); *see also Commissioner v. Tower*, 327 U.S. 280, 286 (1946) (such an intent presupposes "a community of interest in the profits and losses" of the venture). This determination is based on a realistic appraisal of the totality of the circumstances. *TIFD III-E, Inc., v. United States*, 459 F.3d 220, 231 (2d Cir. 2006); *see Southgate Master Fund, LLC v. United States*, 2011 WL 4504781, at *13 n.60 (5th Cir. Sept. 30, 2011). The totality of the circumstances in this case establish that Pitney Bowes and the Authority were partners in name only. As Joseph Consolazio, the Authority's chief financial officer, candidly admitted in response to questioning from the bench, "I considered it a true partnership, Your Honor, because like I had mentioned, *we hired law firms to ensure that we prepared everything correctly*." (Tr. 214 [emphasis added].)

1. Recent guideposts

a. *TIFD III-E, Inc., v. United States*

In *TIFD*, the Second Circuit relied on *Culbertson* in disregarding the partner status of two foreign banks that had allegedly formed a

partnership (Castle Harbour) with a subsidiary of General Electric Capital Corporation (TIFD). The court noted that the IRS had relied on two separate theories in disregarding the partnership's allocations of income to the two banks: the "sham partnership" theory, which focuses on whether the formation of the partnership had economic substance, and the "bona fide partner" theory, which focuses on whether a partner in form was, in substance, something other than a bona fide equity participant in the venture. *See* 459 F.3d at 224 (citing *ASA Investerings P'ship v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000), and *Boca Investerings P'ship v. United States*, 314 F.3d 625 (D.C. Cir. 2003), as examples of sham-partnership cases); *cf. Merck*, 652 F.3d at 481 (recharacterizing purported sales as loans on the ground that "[t]he substance of a transaction, rather than its formal characterization, has always dictated its tax treatment"). The Second Circuit adopted the IRS's distinction between these two theories, *see id.* at 230-32 & n.13, and relied on the bona fide-partner theory – as embodied in *Culbertson*'s "totality of the circumstances" test – in upholding the IRS's recharacterization of the transaction.[12] The court noted that,

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[12] Other courts have merged the two theories. *See Southgate*, 2011 WL 4504781, at *13-18; *Boca Investerings*, 314 F.3d at 630; *but cf.* (continued...)

under the *Culbertson* analysis, the key inquiry is whether the purported partner had a meaningful stake in the success or failure of the enterprise. *Id.* at 231.

Applying the *Culbertson* test, the *TIFD* court found that the purported bank partners were, in substance, lenders to the entity formed by the GE subsidiary. 459 F.3d at 231. Specifically, the "banks' interest was overwhelmingly in the nature of a secured lender's interest, which would neither be harmed by poor performance of the partnership nor significantly enhanced by extraordinary profits." *Id.* The court noted that, in differentiating between equity contributions and loans, courts must ask "whether 'the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business.' " *Id.* at 232 (quoting *Gilbert v. Commissioner*, 248 F.2d 399, 406 (2d Cir. 1957); *see, e.g., Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968) (distinguishing "risk capital entirely subject to the fortunes of the

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[12](...continued)
Neonatology Assocs., P.A. v. Commissioner, 299 F.3d 221, 230 n.12 (3d Cir. 2002) (recognizing the distinction between the substance-over-form-doctrine and the sham-transaction doctrine and noting that the former "permit[s] a court to recharacterize the transaction in accordance with its substance"). We discuss the latter (sham-partnership) theory *infra* in Part B.

corporate venture" from an investment that "represents a strict debtor-creditor relationship").

In determining that the banks' interest lacked the indicia of an equity participation, the Second Circuit relied primarily on the lack of any meaningful downside risk and the lack of any meaningful participation in upside potential. Most importantly, "the banks ran no meaningful risk of being paid anything less than the reimbursement of their investment" at an agreed rate of return. 459 F.3d 233. In that regard, TIFD was required by the partnership agreement to maintain "core financial assets," consisting of high-grade commercial paper or cash, in an amount equal to 110 percent of the amount to which the banks were entitled when they exited the partnership. *Id.* at 228. Moreover, GE gave the banks its personal guaranty with regard to this required exit payment. *Id.* As for potential upside, the court noted that, although the banks nominally had a 98-percent interest in the partnership's "Operating Income," TIFD could effectively cap the banks' upside – *i.e.*, over and above the repayment of its investment at the agreed rate of return – at $2.85 million (on an investment of $117.5 million). *Id.* at 234-35. Alternatively, TIFD could buy out the banks at any time for a premium of only $150,000. *Id.* at 226, 235. These and other factors "compel[led] the conclusion that, for tax

purposes, the banks were not bona fide equity partners in" the alleged partnership. *Id.* at 240.[13]

b. *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*

More recently, the Fourth Circuit held that a partnership syndication of Virginia tax credits very similar to the federal tax credit at issue here was, in substance, a sale of those credits, resulting in taxable income to the partnership. *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011). The court based its holding on the partnership "disguised sale" rules, pursuant to which a transfer of money (or property) by a partner to a partnership, coupled with a related transfer of property (or money) by the partnership to the partner, will be treated as a transaction "occurring between the partnership and one who is not a partner," *i.e.*, as a taxable sale. *See* I.R.C. § 707(a)(1), (a)(2)(B).

After finding that the partnership's allocation of the tax credits to its purported partners constituted a transfer of property for purposes of the disguised-sale rule, 639 F.3d at 140-42, the court turned to the

[13] On remand, the district court in *TIFD* concluded that the banks should be respected as partners under the family partnership rules of I.R.C. § 704(e). *See TIFD III-E, Inc., v. United States*, 660 F. Supp. 2d 367 (D. Conn. 2009). The Government has appealed that decision.

regulations that provide detailed rules for determining when a disguised sale has occurred. *See* Treas. Reg. §§ 1.707-3, 1.707-6(a). Those regulations provide generally that, where a partner who transfers cash to a partnership would not have done so but for the partnership's subsequent transfer of property to the partner, the transaction will be treated as a sale only if the subsequent transfer by the partnership "is not dependent on the entrepreneurial risks of partnership operations." Treas. Reg. § 1.707-3(b)(1)(ii). The regulation then sets forth a list of factors "that may tend to prove the existence of a sale" under this general rule. Treas. Reg. § 1.707-3(b)(2). These factors, the court concluded, "strongly counsel for a finding that these transactions were sales." *Id.*

In so holding, the court of appeals rejected the Tax Court's contrary conclusion that "the Funds' investors, after giving their money but before receiving tax credits in exchange, faced the 'entrepreneurial risks' involved in the Funds' partnership operations." 639 F.3d at 145. As the court explained:

> We find persuasive the Commissioner's' contention that the only risk here was that faced by any advance purchaser who pays for an item with a promise of later delivery. It is not the risk of the entrepreneur who puts money into a venture with the hope that it might grow in amount but with the knowledge that it may well shrink. … [T]o the extent that a partner's profit from a transaction is

> assured without regard to the success or failure of the joint undertaking, there is not the requisite joint profit motive… .

Id. at 145-46 (citations and quotation marks omitted).

2. Application of these authorities to the instant case

TIFD and *Virginia Historic Tax Credit Fund* provide a highly pertinent frame of reference for analyzing the instant case. Many of the same factors upon which the Second Circuit relied in finding that the purported bank partners in *TIFD* were, in substance, lenders to the GE entity support the conclusion that Pitney Bowes was, in substance, not a partner in HBH but, instead, was a purchaser of tax credits from HBH.[14] That is because, as confirmed by the Fourth Circuit's analysis of the disguised-sale regulations – with their focus on "the entrepreneurial risks of partnership operations," Treas. Reg. § 1.707-3(b)(1)(ii) – in *Virginia Historic Tax Credit Fund*, the distinction between an equity contribution to a partnership, on one hand, and a transfer of funds to a partnership as payment of the sales price of partnership property, on the other, is the same as the principal

[14] Although certain aspects of Pitney Bowes's cash investment in HBH were debt-like (*e.g*., its 3-percent preferred return), this case does not fit neatly within the debt-equity dichotomy, since Pitney Bowes recovered its "principal," *i.e*., its purported capital contributions to HBH, in the form of tax credits rather than cash.

distinction between equity and debt. That is, recovery of an equity investment in a partnership is dependent on the entrepreneurial risks of partnership operations, whereas recovery of a loan to a partnership – or receipt of an asset purchased from a partnership – is not. Stated differently, an equity investor in a partnership (*i.e.*, a bona fide partner) has a meaningful stake in the success or failure of the enterprise, whereas a lender to, or purchaser from, the partnership does not. Just as the nominal partners in *TIFD* had no meaningful stake in the success or failure of the Castle Harbour partnership, it is clear from the record in this case that Pitney Bowes had no meaningful stake in the success or failure of HBH.

a. Pitney Bowes had no downside risk

Pitney Bowes, like the purported bank partners in *TIFD*, had no meaningful downside risk in that it was assured of receiving the benefit of its bargain. Delivery of the bulk of that benefit – the tax credits – was assured by means of a tax benefits guaranty agreement. (JA298-307.) Inasmuch as Pitney Bowes paid (in the form of capital contributions) $0.995 for each dollar of projected tax credit, the guaranty agreement ensured that Pitney Bowes's capital contributions would not be placed at the risk of the enterprise. Moreover, Pitney Bowes was not required to make the contributions in the first place

until the Authority verified the availability of the corresponding credits. (JA176-78.)

Delivery of the ancillary aspect of Pitney Bowes's benefit – the 3-percent preferred return on its capital contributions that was intended to coat the arrangement with a veneer of economic substance – was likewise assured by the requirement in the operating agreement (JA187-88) that the Authority purchase a GIC to secure its obligation to purchase Pitney Bowes's interest in HBH in the event Pitney Bowes exercised its option to compel purchase (JA291-297) or the Authority exercised its purchase option (JA284-290). As discussed *infra* at pp. 47-49 and 52 n.22, the purchase price of each of those options was essentially measured by Pitney Bowes's accrued and unpaid preferred return.

Pitney Bowes was also protected against the risk of incurring any obligations beyond its capital contributions.[15] It had no exposure to the

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[15] As explained above, the purported capital contributions themselves were not placed at the risk of the enterprise because the amount of those "contributions" was simply the product of the projected tax credits and the agreed price per credit (JA178) and because the tax benefits guaranty agreement, in effect, required the Authority to refund the purported contributions to the extent the tax credits generated by the rehabilitation were less than the amount projected, or in the event (continued...)

risks of construction or operation, as the Authority obligated itself to pay all excess development costs and to fund any operating deficits. (JA188.) It was protected against environmental liability by virtue of the Authority's indemnity obligation in that regard and its priority distribution right with respect to any environmental insurance proceeds. (JA195, 208.) And, should this proceeding result in the disallowance of its tax benefits, Pitney Bowes will be reimbursed not only for the lost benefits (as discussed above), but also for costs ancillary to that disallowance – *i.e.*, interest, any penalties, and litigation costs, as well as any taxes resulting from the Authority's payment of such amounts – pursuant to the tax benefits guaranty agreement. (JA300.) In short, Pitney Bowes was insulated from virtually all risk associated with its purported partnership with the Authority.

b. Pitney Bowes had no upside potential

Nor did Pitney Bowes have any meaningful stake in whatever upside potential may have existed with respect to the East Hall. Just as the bank partners' 98-percent interest in Castle Harbour's operating

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[15](...continued)
the allocation of the credits to Pitney Bowes were successfully challenged by the IRS in a court proceeding. (JA298-307.)

income in *TIFD* was illusory, so, too, was Pitney Bowes's 99.9-percent interest in HBH's residual net cash flow. Specifically, Pitney Bowes's 99.9-percent interest in residual cash flow would come into play only after payment of annual installments on the Authority's acquisition loan ($3,580,840 per year for 40 years, plus arrears), payment of annual installments on the Authority's construction loan (plus arrears),[16] *and* payment in full of the Authority's operating deficit loans to HBH (in excess of $28 million as of 2007). (JA196.) 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 required retirement of operating deficit loans. (JA246, 1532.)

The crushing weight of the acquisition loan, construction loan, and operating deficit loans also negated the theoretical possibility that Pitney Bowes could share in capital appreciation by virtue of its right to receive the fair market value of its interest (if greater than accrued but unpaid preferred return) upon the exercise by the Authority of its

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[16] Although the financial projections contemplated interest-only payments on the construction loan (at 0.1 percent, or about $55,000, per year) until retirement of the acquisition loan, the construction note, like the acquisition note, calls for level amortization over 40 years out of available cash flow, with shortfalls added to the next annual installment. (JA369-70.)

purchase option or the exercise by Pitney Bowes of its option to compel purchase. (JA284-297.) Since the last of the East Hall improvements was placed in service in 2002, the Authority could exercise its purchase option no earlier than 2007, and Pitney Bowes could exercise its option to compel purchase no earlier than 2009. As of December 31, 2007 (the last year for which audited financial statements are included in the record), HBH's liabilities exceeded its assets by $53 million. (JA1659.) That number had been growing by about $10 million per year since December 31, 2002. (JA117, 131, 1642, 1660, 1789.)

Moreover, this underwater state of affairs had been anticipated by the parties. In a July 2000 memorandum, the Authority's outside counsel noted that, "[d]ue to the structure of the transaction," fair market value was not expected to come into play in determining the purchase price of Pitney Bowes's interest under the purchase option. (JA1162.) Similarly, in an October 2000 memorandum, Dana Newman, Pitney Bowes's outside counsel, indicated that "[w]e do not anticipate that the fair market value of the Pitney Bowes interest will be significant in 2009," when Pitney Bowes would be entitled to exercise its option to compel purchase. (JA1476.) At trial, Ms. Newman testified that "the anticipation would have been based on the fact that

the project would have a lot of debt at that time, and so the value of the Pitney Bowes interest would be subordinate to that debt." (Tr. 812.)[17]

c. The Tax Court's analysis of the bona fide-partner issue does not withstand scrutiny

In rejecting the Commissioner's argument that, in substance, Pitney Bowes was simply a purchaser of the Authority's federal tax credits, not a bona fide partner of the purported HBH partnership, the Tax Court suggested that Pitney Bowes was subject to some risk as a result of its participation in the rehabilitation venture, both in terms of potential liability and in terms of realizing its 3-percent preferred return. (JA50-52.) The purported liability risk related to environmental hazards; as the court noted, "[t]he parties investigated potential environmental hazards and attempted to mitigate them." (JA50.) That risk, however, was *de minimis* inasmuch as the Authority agreed in the operating agreement to indemnify and hold Pitney Bowes harmless against any such liability claims and purchased an

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[17] The Authority received assurances from Pitney Bowes that it would execute any necessary documents waiving the right it otherwise would have had to any revenues from the sale of the naming rights to the East Hall. (JA1811-12.) This further confirms the understanding of the parties that Pitney Bowes would receive no economic benefit from its purported partnership interest other than the purchased tax benefits and the effectively guaranteed annual 3-percent return on its capital contributions.

environmental hazards insurance policy to secure its obligations under those indemnification provisions.[18] (JA21, 207-209.) *See ASA Investerings*, 201 F.3d at 514 (noting that disregarding *de minimis* risk in this context is consistent with the maxim that a transaction must *appreciably* affect the taxpayer's economic interest to be respected for tax purposes, citing *Knetsch v. United States*, 364 U.S. 361, 366 (1960)).

Equally unfounded is the Tax Court's further determination (JA51-52) that Pitney Bowes also had a meaningful stake in the success of the HBH enterprise because its annual, 3-percent preferred return on its capital contributions was dependent on the venture generating a sufficient amount of net cash flow to pay that return. The Tax Court failed to recognize in this regard that Pitney Bowes's option to compel the Authority to purchase its interest in HBH guaranteed that Pitney Bowes ultimately would receive the entire amount of any accrued but unpaid preferred return. (JA291-297.)[19] Thus, Pitney Bowes was

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[18] Prior to participating in the HBH venture, Pitney Bowes received a legal opinion that, as a passive investor, it would not be subject to any liability claims for environmental hazards associated with the East Hall project. (JA1163-1170.)

[19] In the event Pitney Bowes exercised its option to compel the Authority to purchase its interest in HBH, the Authority was obligated to pay Pitney Bowes the greater of the fair market value of Pitney

(continued...)

assured of payment of its annual, 3-percent preferred return without regard to the success or failure of the HBH venture.

Although the Tax Court paid lip service to the Supreme Court's decision in *Culbertson*, it glossed over the Commissioner's argument thereunder, *viz.*, that Pitney Bowes was not a bona fide partner in HBH because it had no meaningful stake in its success or failure. Indeed, the court failed to even mention *TIFD*, the case most closely associated with the bona fide-partner theory. Instead, the court seemed content to note that it had "applied the *Culbertson* factors" in upholding the partnership at issue in *Virginia Historic Tax Credit Fund*, a decision subsequently reversed by the Fourth Circuit on appeal. (JA48.) The closest it came to addressing the Commissioner's argument in this regard was its statement that Pitney Bowes's interest "is not more like debt than equity because Pitney Bowes … might not receive its preferred return until [the Authority] purchased [its] membership

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[19](...continued)
Bowes's interest or the amount of any accrued and unpaid preferred return, *i.e.*, the annual 3-percent return. (JA292.) The Authority was obligated to pay Pitney Bowes the same amount in the event it exercised its option to purchase Pitney Bowes's interest. (JA285.) The GIC purchased by the Authority ensured that it would have the funds that would be due Pitney Bowes if either of these options were exercised. (JA1478-1507.)

interest, if at all." (JA51-52.) To the extent the court was suggesting that this circumstance demonstrates that Pitney Bowes had a meaningful stake in the profitability of HBH's operations, such a suggestion is unfounded. Although it is true that the 3-percent preferred return was not likely to be paid on a current basis, its ultimate payment, as demonstrated above, was secured by the respective purchase and sale options and the GIC and, therefore, was not subject to the risk of HBH's operations.

The balance of the Tax Court's discussion of the bona fide-partner issue addresses factors that simply have no bearing on the issue whether Pitney Bowes had a meaningful stake in the success or failure of HBH. In particular, the court seemed to be swayed by the formalities of the transaction, including "the stated purpose behind HBH's formation, … the transaction documents, and the parties' respective roles." (JA52.) Those considerations breathe no life into Pitney Bowes's moribund claim to partner status with respect to HBH.

B. HBH was a sham

As indicated *supra* in note 12, some courts have invoked *Culbertson* in support of the sham-partnership theory, pursuant to which the court will disregard the purported partnership altogether for tax purposes rather than recharacterizing one partner's interest as

something other than a bona fide equity interest in the enterprise.[20] *See Southgate*, 2011 WL 4504781, at *13-18; *Boca Investerings*, 314 F.3d at 631-32; *ASA Investerings*, 201 F.3d at 511-16. This approach, a variant of the economic-substance (sham-transaction) doctrine, tends to focus on (1) whether the formation of the partnership made sense from an economic standpoint, as would be the case where the parties intended to join together to share in the profits and losses of the enterprise, and (2) whether there was otherwise a legitimate business purpose for the use of the partnership form. *See Southgate*, 2011 WL 4504781, at *13 (citing *Culbertson*, 337 U.S. at 742, and *Boca Investerings*, 314 F.3d at 631).[21] Under this approach, the Tax Court should have disregarded HBH as a sham partnership for many of the same reasons that it should have disregarded Pitney Bowes as a bona fide partner in HBH.

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[20] In the instant case, because Pitney Bowes was one of only two purported partners in HBH, recharacterizing its interest as something other than a bona fide equity interest would have the same effect as disregarding HBH as a sham.

[21] As the Fifth Circuit made clear in *Southgate*, “[t]he fact that a partnership’s *underlying business activities* had economic substance does not, standing alone, immunize the partnership from judicial scrutiny.” 2011 WL 4504781, at *13 (emphasis added).

1. Pitney Bowes and the Authority did not intend to join together to share in the economic benefits and risks of renovating and operating the East Hall

Many of the same factors that demonstrate that Pitney Bowes was not, in substance, an equity investor (*i.e.*, a partner) in HBH because it did not have a meaningful stake in HBH's operations compel a finding that HBH was itself a sham partnership. In that regard, the record shows that Pitney Bowes and the Authority did not have the requisite intent to share in the economic benefits and risks of the project as partners in a true partnership arrangement would. From the Authority's perspective, the purported partnership did not provide it with another party to share the expenses of rehabilitation or any losses from the operation of the completed structure, as it remained responsible for all excess development costs and all operating deficits. (JA188.) Indeed, the Authority incurred substantial additional expenses that it would not have incurred but for its purported partnership with Pitney Bowes. These expenses included the fee it paid Sovereign as the promoter of this tax-driven deal, substantial legal fees and accounting fees for tax opinion letters and other services, and the premiums it paid to purchase an environmental hazards liability insurance policy for Pitney Bowes's benefit. At bottom, the alleged

partnership with Pitney Bowes provided the Authority with no benefit other than allowing it to monetize the value of its unusable historic rehabilitation tax credits.

The Authority's willingness to shield Pitney Bowes from all risk of loss associated with the renovation and operation of the East Hall goes hand-in-hand with its *un*willingness to share whatever upside potential may have existed with respect to the property. Notwithstanding its putative 0.1-percent ownership interest in HBH, the Authority effectively retained the right to all of the profits, if any, from the operation or the sale of the East Hall by virtue of its right to purchase Pitney Bowes's interest for an amount capped by Pitney Bowes's accrued but unpaid preferred return.[22] Nowhere in its opinion did the Tax Court suggest that the Authority shared any upside potential in the East Hall with Pitney Bowes through HBH (*i.e.*, over

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[22] As discussed *supra* at pp. 44-46, although Pitney Bowes was theoretically entitled to the fair market value of its interest (if greater than accrued but unpaid preferred return) upon the Authority's exercise of its purchase option after the recapture period (JA285), neither party expected Pitney Bowes's interest to have any significant value at that time. Moreover, as discussed *infra* in Part C, the purchase price under the Authority's consent options (JA185-86) was not even theoretically tied to fair market value.

and above the interest-like 3-percent preferred return to which Pitney Bowes was entitled on its capital contributions).

Returning to Pitney Bowes's perspective, although the Tax Court stated (JA43) that "Pitney Bowes faced risks as a result of joining [HBH]," its explication of that statement does not withstand scrutiny. We have already addressed the more-imagined-than-real prospect of environmental liability. *See supra* pp. 46-47. The court also stated, however, that "[f]irst, and most importantly to its goals, [Pitney Bowes] faced the risk that the rehabilitation would not be completed." (JA43.) That assertion, unaccompanied by any explanation, ignores the fact that the bulk of Pitney Bowes's capital contributions occurred after the renovations were complete and that the Authority had guaranteed their completion in any event. (JA16-17, 188.) It also ignores the tax benefits guaranty agreement, pursuant to which the Authority obligated itself to make Pitney Bowes whole in the event the tax benefits realized by Pitney Bowes (tax credits *and* tax losses) were less than the projected benefits for any reason. (JA298-307.)

The court then turned the sham-partnership theory on its head by positing that the parties' attempt to eliminate any risk to Pitney Bowes actually *supports* a finding that the formation of the purported

partnership between Pitney Bowes and the Authority was imbued with substantive economic considerations. According to the court,

> [t]hese side agreements and guaranties must be looked at in context: they were necessary to attract an equity investor. These provisions are meant to protect Pitney Bowes from any unforeseen circumstances that could arise as a result of problems with the rehabilitation. … [T]hose agreements show that the East Hall and [HBH] did in fact affect the parties' economic positions – the agreements were meant to prevent the transaction from having a larger impact than the parties had bargained for.

(JA44.) Of course, the notion that these *risk-neutralizing* agreements were necessary to attract an *equity* investor is internally inconsistent. Moreover, under the Tax Court's anomalous view, a taxpayer may establish the bona fides of a purported partnership by negotiating away any risk of the venture that marks a true partnership arrangement.

2. HBH served no non-tax business purpose

HBH served no purpose other than to effect an indirect sale of the Authority's rehabilitation tax credits to Pitney Bowes. The Tax Court's assertion to the contrary – that HBH served the "legitimate business purpose" of "allow[ing] Pitney Bowes to invest in the East Hall's rehabilitation" (JA41) – begs the question by presupposing that Pitney Bowes's capital contributions to HBH constituted an "investment" in the East Hall project. But, as the court acknowledged (JA41-42), the bulk of Pitney Bowes's capital contribution went to the payment of a

$14 million "development fee" to the Authority – a cost that would not have been incurred absent the HBH arrangement (the Authority could hardly charge *itself* a development fee).[23] The remainder, as the court acknowledged elsewhere (JA18), went to pay "assorted fees related to the [tax-credit] transaction" and to fund the GIC that would be pledged as security for the payment of accrued and unpaid preferred return upon Pitney Bowes's exit from HBH. In short, Pitney Bowes's capital contributions added no value to the rehabilitation project, and Pitney Bowes had no stake in the success or failure of the enterprise. Its purported capital contributions thus were not an "investment" in the East Hall project but, instead, were nothing more than the purchase price for the tax benefits the project was expected to generate.

3. The Tax Court's reliance on *Sacks* is misplaced

Although the sham-partnership determination is made without regard to tax consequences and motivations, the Tax Court ultimately concluded that, because Congress enacted the rehabilitation tax credit

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[23] The court's observation elsewhere (JA43) that "[t]he regulations clearly indicate that a development fee is a qualified rehabilitation expenditure" is utterly beside the point. The relevant fact is that, since the Authority intended from the outset (before any talk of a "partnership") to act as its own developer, the development fee would not have been incurred but for the partnership arrangement.

to encourage taxpayer investment in historic rehabilitation projects, the bona fides of the alleged partnership between Pitney Bowes and the Authority could not be evaluated without reference to the tax benefits. The court relied on *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995), as authority for that proposition. That reliance is misplaced.

In *Sacks*, the Ninth Circuit held that a sale-leaseback transaction involving solar energy equipment had economic substance even though the Tax Court had found that, based on a discounted cash-flow analysis it performed, the investment had a negative rate of return before taking into account tax benefits (depreciation deductions and investment tax credits). 69 F.3d at 990-92. After noting that "[t]he Tax Court's determinations regarding useful life, salvage value, and discount rate do not appear to be supported by the record," such that "if it were necessary, we would probably conclude … that these findings are clearly erroneous," the court stated that "[i]n this particular sale-leaseback transaction, … even if these findings of fact were correct, we would still reject the sham determination." *Id.* at 991. Reasoning that "[t]he tax credits were intended to generate investments in alternative energy technologies that would not otherwise be made because of their low profitability," the court concluded that the transaction at issue – which otherwise had economic substance in the sense that the taxpayer

bore the risk of loss and enjoyed the potential upside – "did not become a sham just because its profitability was based on after-tax instead of pre-tax projections." *Id.* at 991, 992.

Putting aside for the moment the legal issue whether it is ever appropriate to apply the sham-transaction or sham-partnership analysis on an after-tax basis, the circumstances in *Sacks* were far different than those here. As the Commissioner argued below (JA41), *Sacks* is distinguishable on the ground that the transaction at issue there otherwise had economic substance in terms of risk and reward. *See American Elec. Power Co., Inc. v. United States*, 326 F.3d 737, 743 (6th Cir. 2003) (distinguishing *Sacks* on that basis); *ACM P'ship v. Commissioner*, 157 F.3d 231, 257 n.49 (3d Cir. 1998) (same). Although the Tax Court recognized that aspect of *Sacks* (JA39) and attempted to demonstrate that the alleged partnership between Pitney Bowes and the Authority similarly had indicia of economic substance independent of tax considerations, its attempt – for the reasons discussed above – does not pass muster.

In any event, the notion that a court may consider tax benefits in evaluating the economic substance of a transaction involving – or of a purported partnership engaged in – tax-favored activity finds no support apart from *Sacks*. *American Elec. Power*, *supra*, is instructive

in that regard. In that case, the Sixth Circuit, after distinguishing *Sacks* on its facts, refused to evaluate the profitability of a corporate-owned life insurance plan on an after-tax basis in accordance with "the *Sacks* court's dictum," even though "[l]ife insurance is tax-favored." 326 F.3d at 743, 744. Reasoning that "[t]o do so would swallow the sham analysis entirely," *id.* at 743, the court quoted at length from this Court's opinion in *In re CM Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002):

> The point of the analysis is to remove from consideration the challenged tax deduction, and evaluate the transaction on its merits, to see if it makes sense economically or is mere tax arbitrage. … Choosing a tax-favored investment vehicle is fine, but engaging in an empty transaction that shuffles payments for the sole purpose of generating a deduction is not.

326 F.3d at 743-44 (quoting *CM Holdings*, 301 F.3d at 105) (abridged).

The *CM Holdings* court distinguished *Sacks* on the ground that the Ninth Circuit had concluded that the transaction there was, in the words of the Supreme Court in *Gregory v. Helvering*, 293 U.S. 465, 469 (1935), "the thing which the statute intended." 301 F.3d at 106. That observation is consistent with the Tax Court's conclusion in an earlier case that the benefits of the investment tax credit – which includes the rehabilitation tax credit, *see* I.R.C. § 46(1) – should not be considered in evaluating the economic substance of a transaction unless the "*transaction*[ ] … [is] unmistakably within the contemplation of

congressional intent." *Friendship Dairies, Inc. v. Commissioner*, 90 T.C. 1054, 1064 (1988) (emphasis added) (quoting *Fox v. Commissioner*, 82 T.C. 1001, 1021 (1984)).

In the instant case, although Congress clearly intended to encourage the underlying *activity* (historic preservation), it cannot be said that the structure of this *transaction* – that is, the alleged partnership arrangement between Pitney Bowes and the Authority – is so "unmistakably within the contemplation of congressional intent," 90 T.C. at 1064, as to warrant departure from the normal application of the sham-partnership doctrine. 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.

C. HBH was not the owner of the East Hall for federal tax purposes

As indicated above, the historic rehabilitation tax credit is available only to the owner of the property at the time the qualifying rehabilitation expenses are incurred. *See* I.R.C. § 47. To be recognized as the owner of property for federal tax purposes, the taxpayer must

obtain both the benefits and burdens of ownership. *See Frank Lyon*, 435 U.S. at 572-73; *BB&T Corp. v. United States*, 523 F.3d 461, 474 (4th Cir. 2008); *Geftman v. Commissioner*, 154 F.3d 61 (3d Cir. 1998). The formation of HBH and the purported transfer of ownership of the East Hall by the Authority to HBH pursuant to a long-term sublease did not effect a transfer of the benefits and burdens of ownership of the property. Moreover, by virtue of its consent option, the Authority had the perpetual right to buy out Pitney Bowes without regard to the fair market value of its interest.[24] (JA185-86.)

1. Benefits and burdens of ownership

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. (JA418.) It also remained liable for all real estate taxes and governmental assessments for betterments. (*Id.*) Moreover, the Authority agreed to maintain, at its

[24] Although the Authority's purchase of Pitney Bowes's interest in HBH would not divest HBH of formal ownership of the East Hall, it would create a virtual identity of interest between HBH and the Authority, resulting in the Authority's complete dominion over the property.

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. (JA420-21.) HBH, on the other hand, bore virtually no burdens of ownership. Indeed, HBH was not even responsible for its own actions:

> Notwithstanding anything in this Lease to the contrary, *no adverse consequence under this Lease will occur to Tenant from any act of Tenant or from any failure of Tenant to act*, which act or failure is caused by [the Authority] as Managing Member of Tenant.

(JA429 [emphasis added].) That the terms of the sublease are inconsistent with a true transfer of ownership supports a finding that no such transfer occurred for tax purposes. *Cf. Sun Oil Co. v. Commissioner*, 562 F.2d 258, 263 (3d Cir. 1977) (purported seller in sale-leaseback transaction retained "essentially all burdens, risks, and responsibilities for the properties" under the terms of the lease).

In a similar vein, the Authority continued to enjoy all the benefits of ownership of the East Hall. Tellingly, the Authority and its auditors continued to treat the East Hall as an asset on the Authority's balance sheet notwithstanding the purported transfer to HBH. (JA1760,1778, 1781, 1783-84, 1800-1801, 1803-1804.) The only mention of HBH in these financial statements appears in a note stating that the Authority formed HBH "for the purpose of *financing and operating* the Historic

East Hall." (JA1761, 1779, 1782, 1785, 1802, 1805-1806 [emphasis added].) This circumstance further supports a finding that no transfer of ownership occurred. *See AWG Leasing Trust v. United States*, 592 F. Supp. 2d 953, 982 (N.D. Ohio 2008) (noting that "[i]n its audited financial statements," the purported seller "continue[d] to record the Facility as an asset on its balance sheet").

2. Perpetual consent option

Sun Oil also stands for the proposition that a purported seller's retained right to reacquire the property without regard to fair market value is inconsistent with a true sale. *See* 562 F.2d at 268 ("the options to repurchase provide Sunray with a built in latch-string by which it could spring legal title to the properties whenever it served its convenience without obligating Sunray to pay the fair market value"). In the instant case, the Authority's consent options (JA185-86) were neither limited to a particular window of exercise nor subject to a fair market value requirement. Indeed, by their terms, the consent options set a price equal to the present value of the tax benefits and cash flow projected to be realized by Pitney Bowes *through the 5-year recapture period*, and only to the extent not yet realized by Pitney Bowes. (*Id.*) By the time the recapture period ended, Pitney Bowes would have already received its bargained-for tax benefits through year 5, meaning

that the exercise price of the consent options after the recapture period would simply equal the accrued but unpaid preferred return through year 5. That preferred return was capped at 3 percent per annum on Pitney Bowes's capital contributions. (JA165.) As this Court recognized in *Sun Oil*, where a purported seller of property has the option to reacquire the property at a fixed price that in economic terms merely amounts to interest for the use of the other party's funds, no sale for tax purposes has occurred. 562 F.2d at 268. That is the situation here. *See* JA691.

3. The Tax Court's analysis again falls short

In its analysis of the ownership issue, the Tax Court began by observing that some factors weigh in favor of finding a sale and that others weigh against such a finding. (JA54.) Rather than examining those factors, however, it appears to have based its resolution of this issue on its "belie[f] that the presence of a purchase option" carried little weight "in the context of the rehabilitation tax credit." (JA57.) According to the court, because Congress's imposition of a 5-year recapture period "demonstrates an anticipation of repurchase," the Authority's purchase option "was not contrary to the purpose of the rehabilitation tax credit." (JA58.) The option to which the court referred, however, was not the consent option discussed above, but the

purchase option, which, unlike the consent option, was exercisable only during a 12-month window. (JA57.) In any event, the point remains that the Tax Court never came to grips with the critical fact that the benefits and burdens of ownership of the East Hall never were transferred by the Authority to HBH. As a result, the Authority remained the owner of the property for tax purposes. *See Sun Oil*, 562 F.2d at 262-69; *BB&T Corp.*, 523 F.3d at 474; *Geftman*, 154 F.3d at 77-81.

CONCLUSION

For the reasons discussed above, the decision of the Tax Court should be reversed, and the case should be remanded for consideration of the penalties asserted by the Commissioner.

CERTIFICATION OF BAR MEMBERSHIP

Pursuant to Local Rule 28.3(d), it is hereby certified that because the attorneys on this brief represent the Federal Government, the requirement that at least one attorney must be a member of the bar of this Court is waived.

Respectfully submitted,

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Dated: October 27, 2011

CERTIFICATE OF SERVICE

I certify that on October 27, 2011, I mailed ten paper copies of the foregoing brief for the appellant Commissioner of Internal Revenue to the Court, and I electronically filed a PDF copy by CM/ECF on the same day. I further certify that on October 27, 2011, the foregoing brief was served on counsel of record for the appellee, a Filing User, through the CM/ECF system.

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IN THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

HISTORIC BOARDWALK HALL, LLC,

Petitioner-Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant

ON APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

JOINT APPENDIX VOL. I pgs. 1-64

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MAR 29 2011

UNITED STATES TAX COURT

HISTORIC BOARDWALK HALL, LLC, NEW JERSEY SPORTS AND EXPOSITION AUTHORITY, TAX MATTERS PARTNER, Petitioner,	)	
v.	)	Docket No. 11273-07
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	

NOTICE OF APPEAL

Notice is hereby given that the Commissioner of Internal Revenue appeals to the United States Court of Appeals for the Third Circuit from the decision of this Court entered in the above-captioned proceeding on January 3, 2011.

Petitioner's principal office and principal place of business were located in Atlantic City, New Jersey, at the time the petition was filed with the Tax Court. Accordingly, venue is properly placed with the United States Court of Appeals for the Third Circuit.

Dated: MAR 29 2011

Gilbert S. Rothenberg
Acting Deputy Assistant Attorney
General for Appellate Matters
Department of Justice

WILLIAM J. WILKINS
Chief Counsel
Internal Revenue Service

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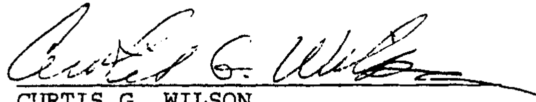
Case: 11-183 Document: 003110488380 Page: 39 Date Fi 04/01/2011



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UNITED STATES TAX COURT
WASHINGTON, DC 20217

HISTORIC BOARDWALK HALL, LLC, NEW JERSEY SPORTS AND EXPOSITION AUTHORITY, TAX MATTERS PARTNER,	)	
Petitioner,	)	
v.	)	Docket No. 11273-07.
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent	)	

D E C I S I O N

Pursuant to the determination of the Court as set forth in its Opinion, 136 T.C. No. 1, filed January 3, 2011, it is

ORDERED and DECIDED that the adjustments to the partnership items of Historic Boardwalk Hall, LLC, for the taxable years ending December 31, 2000, December 31, 2001, and December 31, 2002 are incorrect as determined and set forth in the Notice of Final Partnership Administrative Adjustment upon which this case is based. It is further

ORDERED and DECIDED that there are no penalties due from petitioner for the taxable years 2000, 2001, and 2002, under section 6662, I.R.C.

(Signed) Joseph Robert Goeke
Judge

ENTERED: **JAN 03 2011**

SERVED Jan 03 2011

136 T.C. No. 1

UNITED STATES TAX COURT

HISTORIC BOARDWALK HALL, LLC, NEW JERSEY SPORTS AND EXPOSITION AUTHORITY, TAX MATTERS PARTNER, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 11273-07. Filed January 3, 2011.

New Jersey Sports and Exposition Authority (NJSEA) and Pitney Bowes (PB) formed Historic Boardwalk Hall, LLC, to allow PB to invest in the historic rehabilitation of the East Hall, a popular convention center in Atlantic City, New Jersey.

The East Hall underwent a significant rehabilitation during the years at issue. On Forms 1065, U.S. Return of Partnership Income, for 2000, 2001, and 2002, Historic Boardwalk Hall claimed qualified rehabilitation expenditures and allocated those expenditures to PB, allowing PB to claim historic rehabilitation tax credits pursuant to sec. 47, I.R.C.

R issued an FPAA asserting alternative grounds for denying PB the claimed rehabilitation tax credits. R’s overarching argument is that NJSEA sold the rehabilitation tax credits to PB for a fee. R also

argues that the accuracy-related penalty pursuant to sec. 6662, I.R.C., applies.

Held: Historic Boardwalk Hall was not a sham and did not lack economic substance.

Held, further, PB did become a partner in Historic Boardwalk Hall.

Held, further, NJSEA did transfer the benefits and burdens of ownership of the East Hall to Historic Boardwalk Hall.

Held, further, the sec. 6662, I.R.C., penalty is not applicable.

Kevin M. Flynn and Michael Sardar, for petitioner.

Daniel A. Rosen, Curt M. Rubin, Molly H. Donohue, and Sashka T. Koleva, for respondent.

GOEKE, Judge: Respondent issued a notice of final partnership administrative adjustment (FPAA) to Historic Boardwalk Hall, LLC (Historic Boardwalk Hall). The issues for decision are:

(1) Whether Historic Boardwalk Hall is a sham;

(2) whether Pitney Bowes was a partner in Historic Boardwalk Hall;

(3) whether New Jersey Sports and Exposition Authority (NJSEA or petitioner) transferred the benefits and burdens of ownership of the East Hall to Historic Boardwalk Hall; and

(4) whether Historic Boardwalk Hall is liable for section 6662[1] accuracy-related penalties for years 2000, 2001, and 2002.

FINDINGS OF FACT

Some of the facts have been stipulated, and the stipulations of fact and the attached exhibits are incorporated herein by this reference. NJSEA was created by the New Jersey State Legislature in 1971 and is a State instrumentality. NJSEA was initially formed to build, own, and operate the Meadowlands Sports Complex in East Rutherford, New Jersey.

NJSEA's jurisdiction was expanded by the New Jersey State Legislature in January 1992 to include the Atlantic City Convention Center Project. That project authorized NJSEA to build, own, and operate a new convention center and to own and operate the East Hall (the East Hall is also known as Historic Boardwalk Hall).

To carry out the new Convention Center Project, the Atlantic County Improvement Authority (ACIA) and NJSEA entered into a lease for the East Hall whereby NJSEA leased the East Hall for a term of 35 years at a rent of $1 per year. Shortly thereafter, NJSEA entered into an operating agreement with the Atlantic City Convention Center Authority (ACCCA). ACCCA was initially formed

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[1] All section references are to the Internal Revenue Code (Code), and all Rule references are to the Tax Court Rules of Practice and Procedure.

to promote tourism in the Atlantic City region, and it would serve as day-to-day manager of the East Hall.

Later, NJSEA and ACCCA entered into a management agreement with Spectator Management Group (SMG). SMG was well known for managing, marketing, and developing public assembly facilities, including convention and special event centers. NJSEA contracted to have SMG manage the East Hall because NJSEA felt that a private company would be able to promote, oversee, and manage the East Hall, the West Hall (a facility adjacent to the East Hall), and the soon-to-be constructed convention center. The management agreement stated that SMG would provide operations, marketing, finance, employee supervision, administrative, and other general management services.

SMG managed the East Hall day to day. SMG maintained a system of accounts for Historic Boardwalk Hall, and Historic Boardwalk Hall’s annual audited financial statements were based on this system of accounts. Although SMG’s initial agreement was for a 3-year term, it has been extended.

1. Overview of the Transaction at Issue

Historic Boardwalk Hall was organized under the laws of the State of New Jersey as a limited liability company on June 26, 2000. NJSEA was the sole member of Historic Boardwalk Hall at formation. On September 14, 2000, PB Historic Renovations, LLC

(Pitney Bowes),[2] was admitted as a member of Historic Boardwalk Hall.

Historic Boardwalk Hall's purpose was to allow Pitney Bowes to invest in the rehabilitation of the East Hall. Because the East Hall was a historic structure, this rehabilitation project had the potential to earn section 47 historic rehabilitation credits.[3] Historic Boardwalk Hall's formation would allow Pitney Bowes, a private party, to earn these historic rehabilitation credits from the rehabilitation of a public, governmentally owned, building. Respondent argues that in substance the transaction was akin to NJSEA's selling rehabilitation credits to Pitney Bowes. To that end, respondent determined alternatively in the FPAA that Historic Boardwalk Hall is a sham, that Pitney Bowes was never a partner in Historic Boardwalk Hall, and that NJSEA never transferred ownership of the East Hall to Historic Boardwalk Hall. A finding for respondent on any of these theories would prevent the section 47 rehabilitation credits from flowing to Pitney Bowes; instead they would flow to NJSEA.

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[2]PB Historic Renovations, LLC, was a limited liability company whose sole member during all relevant periods was Pitney Bowes Credit Corp. During all relevant times, Pitney Bowes Credit Corp. was a wholly owned subsidiary of Pitney Bowes Corp. For simplicity, we refer to PB Historic Renovations, LLC, Pitney Bowes Credit Corp., and Pitney Bowes Corp. as Pitney Bowes.

[3]Sec. 47 allows for a Federal tax credit of 20 percent of the qualified rehabilitation expenditures with respect to any certified historic structure.

Petitioner contends instead that transactions like the one at issue were promoted and supported by Congress and are not shams.

2. East Hall History

Construction of the East Hall began in 1926 and was completed in 1929. It is located prominently at the center of the Atlantic City, New Jersey, Boardwalk and faces the Atlantic Ocean. The East Hall was a popular event space of exceptionally large dimensions, featuring an auditorium with a 130-foot ceiling and over 250,000 square feet of floor space.

After it was completed, the East Hall hosted a number of public events, including hockey matches, professional football games, and equestrian shows. The East Hall also hosted trade shows, conferences, meetings, and musical performances, including those of the Beatles and the Rolling Stones. Beginning in 1933, the East Hall hosted the Miss America pageant.

The East Hall was listed as a National Historic Landmark by the U.S. Department of the Interior on February 27, 1987. In January 1992 the New Jersey State Legislature authorized NJSEA to undertake construction of the new convention center and renovation of the East Hall. Once the new convention center was completed, it was expected to become the primary location for flat-floor conventions like the ones that had until that time been held in the East Hall. As a result, the East Hall would no

longer draw those types of events and would have no use unless renovated.

Once construction began on the new convention center, representatives of NJSEA and other New Jersey State officials began to study and make plans for the future of the East Hall. Because it had become run down, the only way to make the East Hall usable again was to convert it to a special events facility that could host concerts, sporting events, family shows, and other civic events. This conversion would require that the East Hall be substantially rehabilitated. State officials in New Jersey decided to rehabilitate the East Hall and convert it into a mixed-use space.

Rehabilitation of the East Hall began in December 1998. It was to be completed in four phases: (1) Construction of scaffolding suspended from the auditorium's ceiling to facilitate rehabilitation of the ceiling; (2) removal of auditorium ceiling tiles and abatement of asbestos; (3) reconstruction of the ceiling using glass-fiber reinforced tiles and high-performance acoustical perforated aluminum tiles; and (4) construction of a new permanent arena seating bowl, construction of support services and patron amenities beneath the seating bowl, and restoration and historically accurate painting of the Hall's interior.

To pay for a portion of the renovation costs, on June 15, 1999, NJSEA issued about $49.5 million of State bonds. In addition, NJSEA received approximately $22 million from the New Jersey Casino Reinvestment Development Authority.[4] In the absence of an equity investor, the rehabilitation would have been funded entirely by the State of New Jersey.

3. <u>Sovereign Capital Resources, LLC</u>

In late 1998, Paul Hoffman (Mr. Hoffman) of Sovereign Capital Resources, LLC (Sovereign), contacted representatives of NJSEA. Sovereign was founded by Mr. Hoffman and a partner in 1995. Mr. Hoffman contacted NJSEA because he had learned of the East Hall renovation; one of Sovereign's business lines was raising equity for historic rehabilitations. NJSEA engaged the services of Sovereign to act as its financial adviser in finding an equity investor for the East Hall's rehabilitation. Respondent argues that this was not an investment, but rather Sovereign was facilitating a sale of the historic tax credits generated by the East Hall rehabilitation.

NJSEA engaged several law firms to review and opine on certain aspects of the transaction: (1) Wolf, Block, Schorr,

[4]The New Jersey Casino Reinvestment Development Authority is a State agency created by the New Jersey State Legislature that uses funds generated from governmental charges imposed on the casino industry for economic development and community projects throughout the State. The funds given to NJSEA were in the form of a grant.

Solis-Cohen, LLP; (2) Gibbons, Del Deo, Dolan, Griffinger & Vecchione (Gibbons, Del Deo); and (3) Wolf & Sampson, P.C. NJSEA also engaged the accounting firm of Reznick Fedder & Silverman, P.C. (Reznick), to provide counsel on the rehabilitation credit transaction.

4. <u>Confidential Offering Memorandum</u>

Sovereign prepared a confidential offering memorandum as part of its services to NJSEA. The memorandum was prepared using information provided to Soverign by NJSEA, Reznick, and others and included financial information for the rehabilitation of the East Hall and for its operation after the rehabilitation was completed.

The financial projections in the confidential offering memorandum were based on certain assumptions, most importantly that revenue from the East Hall would increase 3 percent per year. The financials projected that the eventual partnership would have positive net operating income from 2002 through 2009. That net operating income would be zeroed out through lease payments, an increase in a “replacement reserve”, the investor member’s 3-percent priority distribution, and an incentive management fee, to the extent there was cash to make those payments.

The confidential offering memorandum also informed prospective investors that Historic Boardwalk Hall would have taxable losses for at least the years 2002 through 2009.

The financial projections attached to the amended and restated operating agreement, discussed more fully below, are different from those attached to the confidential offering memorandum.

The memorandum was sent to 19 corporations and described the transaction as a “sale” of tax credits. The memorandum indicated that the private investor’s equity investment would be used to pay a development fee to NJSEA, with any surplus remaining with Historic Boardwalk Hall. Four corporations showed interest in joining the transaction, and each submitted a bid detailing how much it would be willing to invest depending on the rehabilitation credits it would earn. Eventually Pitney Bowes’ offer was accepted and it was selected to invest in Historic Boardwalk Hall.

5. Formation of Historic Boardwalk Hall

Historic Boardwalk Hall, organized on June 26, 2000, elected to be treated as a partnership for Federal income tax purposes. NJSEA was the sole member at formation and executed an operating agreement for the East Hall, as explained above. When Pitney Bowes joined Historic Boardwalk Hall on September 14, 2000, NJSEA and Historic Boardwalk Hall signed an amended and restated

operating agreement (the AREA). The AREA identified NJSEA as managing member and Pitney Bowes as investor member of Historic Boardwalk Hall. Pursuant to the terms of the AREA, Pitney Bowes has a 99.9-percent ownership interest in Historic Boardwalk Hall. NJSEA owns the remaining 0.1 percent. Profits, losses, tax credits, and net cashflow are allocated to Historic Boardwalk Hall's members according to their ownership interests.

The AREA stated that Historic Boardwalk Hall was formed to acquire, develop, finance, rehabilitate, own, maintain, operate, license, and sell or otherwise dispose of the East Hall for use as a special events facility to hold events, including but not limited to, spectator sporting events. The AREA made clear that the potential rehabilitation tax credits were an integral part of the transaction but did not use the term "sale". It referred to both Pitney Bowes and NJSEA as members of Historic Boardwalk Hall.

Article 3.01 of the AREA reiterated the purpose of Historic Boardwalk Hall and also granted Historic Boardwalk Hall the authority to take actions necessary to carry out its purpose.

The AREA included an additional set of financial information. The most important difference between these financials and those attached to the confidential offering memorandum was the inflation factor applied to the East Hall's revenues. The financial projections attached to the AREA used a

3.5-percent inflator, rather than the 3.0-percent inflator in the confidential offering memorandum. Also, the operating assumptions underlying the updated financials assumed higher service income, parking revenue, and novelty revenue in the first year of operations. Operating expenses for the initial years remained the same.

As a result of higher projected revenues, the statement of projected cashflows attached to the AREA showed higher payments to the equity investor and also payments on the acquisition and construction loans discussed below. These financials, however, still resulted in a taxable net loss.

6. Lease and Sublease of the East Hall

As discussed above, NJSEA leased the East Hall from ACIA for a 35-year term. On September 14, 2000, NJSEA amended its lease agreement to extend the lease term until November 11, 2087. On that date, NJSEA and Historic Boardwalk Hall entered into two agreements. First, NJSEA as sublessor and Historic Boardwalk Hall as sublessee entered into a sublease of the East Hall whereby NJSEA subleased the property to Historic Boardwalk Hall. Second, NJSEA and Historic Boardwalk Hall entered into a lease agreement which the parties treated as a sale and purchase for Federal, State, and local income tax purposes. Pursuant to the lease agreement, Historic Boardwalk Hall purportedly acquired ownership of the East Hall.

Historic Boardwalk Hall paid for the East Hall by an acquisition note in the amount of $53,621,405. The acquisition note was secured by a mortgage on the property. The amount of the acquisition note represented the total expenditures that NJSEA had made through that date in renovating the East Hall. The acquisition note bears interest at 6.09 percent per year and provides for level annual payments of $3,580,840 through the year 2040, to the extent Historic Boardwalk Hall has sufficient cash to make the annual payments.

Also on September 14, 2000, NJSEA entered into a construction loan agreement with Historic Boardwalk Hall to lend amounts to the partnership from time to time to pay for the remainder of renovations to the East Hall. At that time, NJSEA agreed to lend $57,215,733 to Historic Boardwalk Hall. NJSEA's obligation to lend to Historic Boardwalk Hall was evidenced by a mortgage note and a second mortgage on the property.

7. <u>Contributions to Historic Boardwalk Hall</u>

Pitney Bowes made capital contributions to Historic Boardwalk Hall and also lent funds to the partnership. Pursuant to the AREA, Pitney Bowes was to make four capital contributions totaling $18,195,757.

Pitney Bowes made the following contributions to Historic Boardwalk Hall:

Date	Amount
9/14/00	$650,000
12/19/00	3,660,765
1/17/01[1]	3,400,000
10/30/02	10,467,849
2/12/04	[2]1,173,182

[1]The Dec. 19, 2000, and Jan. 17, 2001, capital contributions were together considered Pitney Bowes' second capital contribution, even though the contribution was made on two separate dates.

[2]A portion of Pitney Bowes' fourth capital contribution was paid and is currently being held in escrow.

Pitney Bowes also made an investor loan of $1.1 million to Historic Boardwalk Hall on September 14, 2000. The principal amount of the investor loan was increased to $1,218,000 on or around October 30, 2002.

Pitney Bowes was not required to make the second, third, or fourth capital contribution if certain requirements in the AREA were not satisfied.

The AREA provided that Pitney Bowes' capital contributions were to be used to pay down the principal on the acquisition note. Pitney Bowes' capital contributions were in fact used to pay down the principal on the acquisition note. Shortly thereafter, a corresponding draw would be made on the construction note, and NJSEA would advance those funds to Historic Boardwalk Hall. Ultimately, these offsetting draws left

Historic Boardwalk Hall with cash in the amount of Pitney Bowes' capital contributions, a decreased balance on the acquisition loan, and an increased balance on the construction loan. These funds were then used by Historic Boardwalk Hall to pay assorted fees related to the transaction and to pay NJSEA a developer's fee for its work managing and overseeing the East Hall's rehabilitation.

A portion of Pitney Bowes' second capital contribution was not returned to Historic Boardwalk Hall but rather was used by NJSEA to purchase the guaranteed investment contract (GIC). The GIC is discussed further below.

Historic Boardwalk Hall paid NJSEA $14 million as a development fee for its role overseeing the East Hall's rehabilitation. This came mainly from Pitney Bowes' third and fourth capital contributions and was paid pursuant to a development agreement between Historic Boardwalk Hall and NJSEA. The development agreement reiterated Historic Boardwalk Hall's purpose and imposed certain obligations on NJSEA as the developer, in exchange for a $14 million development fee. The development agreement obligated NJSEA to obtain all required Government approvals for the rehabilitation and to oversee the completion of the rehabilitation. This included: (1) Overseeing the contractors who were rehabilitating the East Hall; (2) ensuring that all amenities consistent with the overall

rehabilitation were put in place; (3) causing the completion of phase 3 of the rehabilitation; and (4) causing the rehabilitation such that it would earn rehabilitation tax credits. The development agreement further required NJSEA to obtain certification of the rehabilitation from the U.S. Department of the Interior and to maintain insurance over the rehabilitation as set forth in the AREA. NJSEA's development fee would not be earned until the rehabilitation was completed, and it was payable immediately upon completion.

8. Distributions From Historic Boardwalk Hall

The AREA provided for the distribution of Historic Boardwalk Hall's net cashflow. First, if certain title insurance or environmental insurance proceeds were paid, 100 percent went to Pitney Bowes. Second, any remaining net cashflow was used to make interest payments on Pitney Bowes' investor loan to Historic Boardwalk Hall.

Should there be any remaining net cashflow, 99.9 percent was to be distributed to Pitney Bowes until Pitney Bowes had received its 3-percent preferred return. The preferred return was equal to 3 percent of its adjusted capital contribution, which was determined at the end of Historic Boardwalk Hall's fiscal year.

Next, funds were distributed to Pitney Bowes to cover any Federal, State, and local income taxes paid on taxable income allocated to Pitney Bowes. Any remaining net cashflow was then

distributed to NJSEA for current and accrued but unpaid debt service on the acquisition and construction notes, and then to NJSEA to repay any operating deficit loans. Lastly, any remaining net cashflow was paid to Pitney Bowes and NJSEA in accordance with their membership interests.

9. <u>Environmental Concerns and Analysis</u>

The parties were concerned that the East Hall's rehabilitation would lead to certain environmental hazards. To that end, Pitney Bowes retained the law firm of Kelley Drye & Warran, LLP, to assess Historic Boardwalk Hall and Pitney Bowes' potential liability for environmental claims.

In order to determine any potential environmental issues, Historic Boardwalk Hall obtained reports that evaluated the East Hall for potential hazards and also provided remediation plans.

Environmental Partners, Inc., prepared a Phase I Environmental Site Assessment for Pitney Bowes. The report identified certain environmental hazards, including asbestos, possibly lead-based paint, underground storage tanks, and other chemical hazards. The report characterized the East Hall as an "unknown risk" and concluded that environmental liabilities could not be estimated at that time without more analysis of the East Hall.

L. Robert Kimball & Associates, Inc., also prepared a hazardous materials assessment (the Kimball report) of the East

Hall, focusing on asbestos, lead-based paint, hazardous materials storage, drainage, roof deterioration, and certain hazardous chemicals that might be present or become exposed by the East Hall's rehabilitation. The Kimball report then went on to evaluate how potential hazards should be dealt with and estimated what remediation would cost. The Kimball report estimated that remediation would cost more than $3 million.

The AREA contained certain representations by NJSEA to Pitney Bowes concerning the East Hall and its rehabilitation with regard to environmental hazards. First, NJSEA warranted to Pitney Bowes that there were no known environmental hazards other than those identified in the environmental assessments. NJSEA also warranted that if any new environmental hazards were uncovered, NJSEA would remediate them in its role as managing member. Second, NJSEA warranted that should it default in its role to remediate any environmental hazards, it would hold Pitney Bowes harmless and indemnify it for any costs incurred as a result of NJSEA's default. NJSEA also held environmental liability insurance. Historic Boardwalk Hall was a named insured on the insurance policy, and Pitney Bowes was later added as an additional insured.

10. <u>Future Transfers of Pitney Bowes' Interest</u>

NJSEA and Pitney Bowes contemplated Pitney Bowes' disposing of its membership interest and leaving Historic Boardwalk Hall.

To that end, they negotiated a number of possible ways to transfer Pitney Bowes' interest to NJSEA.

A. <u>Pitney Bowes Repurchase Option</u>

The AREA provided two options. First, article 5.03 gave Pitney Bowes the authority to require NJSEA to purchase Pitney Bowes' interest in Historic Boardwalk Hall. If Pitney Bowes exercised its option under this article, NJSEA would have to purchase its membership interest for a price equal to: (1) Pitney Bowes' capital contributions up to that point plus 15-percent interest; (2) Pitney Bowes' reasonable third-party fees and expenses with regard to the transaction; and (3) $100,000 as a reimbursement for Pitney Bowes' internal expenses with regard to the transaction. NJSEA had to make the $100,000 reimbursement payment only if phase 3 of the rehabilitation[5] was not placed in service for purposes of the rehabilitation tax credit by December 31, 2000, or if the rehabilitation tax credits were less than $650,000 for tax year 2000 for any reason. Pitney Bowes could exercise its repurchase option contained in article 5.03 only until January 15, 2001.

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[5]Phase 3 involved the rehabilitation of the East Hall's ceiling. This included replacing the ceiling tiles and the lighting system and installing a computer-controlled light system at the base of each ceiling bay that would allow for the projection of sunsets and other theatrical effects onto the new ceiling tiles.

B. NJSEA Management Purchase Option

Article 8.02(a) and (b) of the AREA imposed certain restrictions on NJSEA's authority as managing member. Article 8.02(a) prevented NJSEA from performing any act in violation of the law, performing any act in violation of any project documents, doing any act that required Pitney Bowes' consent, or borrowing or commingling any of Historic Boardwalk Hall's funds.

Article 8.02(b) prevented NJSEA from selling, refinancing, or disposing of Historic Boardwalk Hall's assets, materially modifying Historic Boardwalk Hall's insurance plan, amending any of the main transaction documents, borrowing any money other than the acquisition or construction loans, or taking any action that would adversely affect Pitney Bowes, either as a member or financially.

These prohibitions were not absolute. Both article 8.02(a) and (b) gave NJSEA the option to purchase Pitney Bowes' membership interest before taking any of the prohibited actions. To exercise its options, NJSEA would have to give written notice of its intent to purchase Pitney Bowes' interest and would have to actually purchase the interest within 90 days of providing such notice.

If it exercised its options, NJSEA would have to pay Pitney Bowes the present value of the projected tax benefits and the projected cashflow to be distributed to Pitney Bowes. The

projected cashflows were limited to the projected tax benefits up until the first date that NJSEA could exercise its purchase option (discussed below), and to the extent that Pitney Bowes had received any tax benefits or cashflows at the time NJSEA decided to purchase Pitney Bowes' interest. Thus, if NJSEA exercised its option under article 8.02(a) or (b), its payment obligation would be based on its projected obligations from that date until the earliest date it could have otherwise opted to purchase Pitney Bowes' membership interest.

C. Future Purchase Options

Lastly, the parties negotiated two additional agreements that would allow NJSEA to reacquire Pitney Bowes' membership interest in Historic Boardwalk Hall. On September 14, 2000, Pitney Bowes and NJSEA entered into two option contracts. These were the "purchase option agreement" and the "agreement to compel purchase".

The purchase option agreement gave NJSEA the right to purchase Pitney Bowes' membership interest in Historic Boardwalk Hall. NJSEA could execute the purchase option agreement at any time during a 12-month period beginning 60 months after the entire East Hall was placed in service for purposes of determining the historic rehabilitation credits. Thus, from 60 months to 72 months after the East Hall was placed in service,

NJSEA had the option to purchase Pitney Bowes' interest. The option would expire at the end of the 12-month period.

If the purchase option agreement was not executed, the agreement to compel purchase gave Pitney Bowes the right to require NJSEA to purchase Pitney Bowes' membership interest in Historic Boardwalk Hall. Pitney Bowes may exercise this option during a 12-month period beginning 84 months after the East Hall is placed in service for purposes of determining the historic rehabilitation credits. Like the purchase option agreement, the agreement to compel purchase was available only for 12 months.

Both options require NJSEA to pay Pitney Bowes the greater of: (1) 99.9 percent of the fair market value of 100 percent of the membership interests in Historic Boardwalk Hall; or (2) any accrued and unpaid preferred return.

At the time of trial, none of the options had been exercised, and Historic Boardwalk Hall continued to operate with Pitney Bowes and NJSEA as its only members.

11. Guaranteed Investment Contract

In order to secure NJSEA's payment if NJSEA reacquired Pitney Bowes' interest in Historic Boardwalk Hall, the AREA required NJSEA to purchase a GIC.

As discussed above, Pitney Bowes' capital contributions were initially used to pay down the principal on the acquisition loan. Shortly thereafter, a corresponding draw would be made on the

construction loan, leaving Historic Boardwalk Hall with the capital contribution. This did not occur with respect to Pitney Bowes' entire second capital contribution. Although the second capital contribution was used to pay down the acquisition loan, a corresponding draw was not made on the construction loan. NJSEA, retaining these funds, used a portion of the capital contribution to fund the purchase of the GIC.

First Union National Bank (First Union) was appointed escrow agent for both Pitney Bowes and NJSEA. NJSEA deposited about $3.2 million of Pitney Bowes' second capital contribution with First Union. First Union then entered into a master repurchase agreement with Transamerica Occidental Life Insurance Co. The master repurchase agreement was then pledged as collateral to secure NJSEA's payment obligation if, under either the purchase option or the agreement to compel purchase, it was required to purchase Pitney Bowes' membership interest in Historic Boardwalk Hall.

12. Tax Benefits Guaranty

NJSEA, Pitney Bowes, and Historic Boardwalk Hall foresaw the possibility that the Internal Revenue Service (IRS) would challenge the reporting of the East Hall's rehabilitation. Consequently, the AREA appointed NJSEA as Historic Boardwalk Hall's tax matters partner and provided for the appointment of counsel by NJSEA should the transaction be challenged. Pitney

Bowes had final approval over the appointment of counsel to represent Historic Boardwalk Hall.

Pitney Bowes and Historic Boardwalk Hall also executed a "Tax Benefits Guaranty Agreement" by which Historic Boardwalk Hall guaranteed the projected tax benefits allocable to Pitney Bowes. NJSEA was required to fund any payments made pursuant to the tax benefits guaranty.

The tax benefits guaranty provides that it was entered into to induce Pitney Bowes, as investor, to acquire an interest in Historic Boardwalk Hall. Its ultimate purpose was to require NJSEA to make Pitney Bowes whole should any part of the tax benefits be successfully challenged by the IRS.

13. Opinion Letters

NJSEA and Pitney Bowes sought and received opinion letters concerning various aspects of the transaction.

Wolf Block prepared a tax opinion letter (Wolf Block opinion) analyzing the East Hall transaction. The Wolf Block opinion analyzed numerous Federal tax issues and concluded in pertinent part that Historic Boardwalk Hall was properly classified as a partnership, Historic Boardwalk Hall owned the East Hall, and the transaction did not violate the economic substance or sham transaction doctrines.

The Wolf Block opinion relied on a number of other legal opinions in reaching those conclusions. These other opinion

letters analyzed various non-tax-related legal questions raised by the East Hall's rehabilitation and Pitney Bowes' investment. Gibbons, Del Deo opined that NJSEA had the authority to act on behalf of the State of New Jersey, that Historic Boardwalk Hall was a valid LLC, and that Pitney Bowes became a member of Historic Boardwalk Hall under State law. Wolf & Samson, P.C., issued a letter concerning how New Jersey State law and NJSEA's being financed by State bonds would affect NJSEA's obligations under the AREA to fund any deficits and any additional construction costs. Madison & Sutro, LLP, provided an opinion letter evaluating the proper classification of the acquisition note, the construction note, and Pitney Bowes' investor loan as debt rather than equity.

14. Rehabilitation and Operation of the East Hall

Bank accounts were established by SMG as agent for Historic Boardwalk Hall. After February of 2001, account statements show regular activity, including both deposits to and checks written on the account.

NJSEA had entered into contracts with various third parties regarding certain aspects of the East Hall's rehabilitation. These contracts were all assigned to Historic Boardwalk Hall at or around the time Pitney Bowes became a member in Historic Boardwalk Hall. These contracts dealt mainly with contractors

who were engaged to perform various pieces of the rehabilitation of the East Hall.

The renovation of the East Hall and its conversion to a special events arena was a success. Since its rehabilitation, the East Hall has held performances by a number of well-known entertainers, and its revenues in 2000, 2001, and 2002 exceeded those in the Reznick projections. However, the East Hall has operated at a deficit.

15. Procedural Posture

Historic Boardwalk Hall timely filed Forms 1065, U.S. Return of Partnership Income, for 2000, 2001, and 2002. The Forms 1065 showed income, deductions, and ultimately net losses for all 3 years. The deductions included the cost of wages for employees who were operating the East Hall. Historic Boardwalk Hall claimed the following qualified rehabilitation expenses:

Year	Expenditures
2000	$38,862,877
2001	68,865,639
2002	1,271,482

Schedules K-1, Partner's Share of Income, Credits, Deductions, etc., were issued to Pitney Bowes and NJSEA in accordance with their membership interests.

On February 22, 2007, respondent issued the FPAA covering the 2000, 2001, and 2002 tax years to Historic Boardwalk Hall. The FPAA determined that any items of income or loss or

separately stated items reported on Historic Boardwalk Hall's Forms 1065 and allocated to Pitney Bowes were reallocated to NJSEA. The FPAA also determined that underpayments of tax attributable to those adjustments would be subject to the section 6662 penalty.

The FPAA contained an "Explanation of Adjustments" which provided alternative arguments in support of the adjustments made in the FPAA, including that:

(1) Historic Boardwalk Hall was created for the express purpose of improperly passing along tax benefits to Pitney Bowes and is a sham;

(2) Pitney Bowes' stated partnership interest in Historic Boardwalk Hall was not bona fide because Pitney Bowes had no meaningful stake in the success or failure of Historic Boardwalk Hall;

(3) the East Hall was not "sold" to Historic Boardwalk Hall because the benefits and burdens of ownership did not pass to Historic Boardwalk Hall. Accordingly, any items of income or loss or separately stated items attributable to ownership of the East Hall were disallowed;

(4) respondent pursuant to his authority in the antiabuse provisions of section 1.701-2(b), Income Tax Regs., had determined that Historic Boardwalk Hall should be disregarded for Federal income tax purposes; and

(5) all or part of the underpayments of tax attributable to the adjustments in the FPAA were attributable to either negligence, a substantial understatement of income tax, or both.

Petitioner filed its petition in response to the FPAA on May 21, 2007. A trial was held from April 13-16, 2009, in New York, New York. Respondent submitted an expert report in support of his position.

OPINION

I. TEFRA in General

Partnerships do not pay Federal income taxes, but they are required to file annual information returns reporting the partners' distributive shares of tax items. Secs. 701, 6031. The individual partners then report their distributive shares of the tax items on their Federal income tax returns. Secs. 701-704. A limited liability company with two or more members is treated as a partnership unless it elects to be treated as a corporation. Sec. 301.7701-3(b)(1)(i), Proced. & Admin. Regs. Historic Boardwalk Hall did not elect to be treated as a corporation and thus is treated as a partnership for Federal income tax purposes.

To remove the substantial administrative burden occasioned by duplicative audits and litigation and to provide consistent treatment of partnership tax items among partners in the same partnership, Congress enacted the unified audit and litigation

procedures of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, sec. 402, 96 Stat. 648. See Randell v. United States, 64 F.3d 101, 103 (2d Cir. 1995); H. Conf. Rept. 97-760, at 599-600 (1982), 1982-2 C.B. 600, 662-663.

Under TEFRA, all partnership items are determined in a single partnership-level proceeding. Sec. 6226; see also Randell v. United States, supra at 103. The determination of partnership items in a partnership-level proceeding is binding on the partners and may not be challenged in a subsequent partner-level proceeding. See secs. 6230(c)(4), 7422(h). This precludes the Government from relitigating the same issues with each of the partners.

In partnership-level proceedings such as the case before us, the Court's jurisdiction is limited by section 6226(f) to a redetermination of partnership items and penalties on those partnership items. Section 6231(a)(3) defines the term "partnership item" as any item required to be taken into account for the partnership's taxable year under any provision of subtitle A of the Code to the extent the regulations provide that such item is more appropriately determined at the partnership level than at the partner level.

The question whether a partnership is a sham is a partnership item more appropriately determined at the partnership level. Petaluma FX Partners, LLC v. Commissioner, 131 T.C. 84,

95 (2008), affd. in pertinent part 591 F.3d 649 (D.C. Cir. 2010). Likewise, whether Pitney Bowes was a partner in Historic Boardwalk Hall is also a partnership item more appropriately determined at the partnership level. See Blonien v. Commissioner, 118 T.C. 541 (2002). Further, the determination whether NJSEA contributed the East Hall to Historic Boardwalk Hall is also a partnership item. Nussdorf v. Commissioner, 129 T.C. 30, 41-42 (2007). Lastly, respondent's determination that the transaction should be recast to carry out the intent of subchapter K is likewise a partnership item. Neither party disputes our jurisdiction over these items.

II. Burden of Proof

The Commissioner's determinations in an FPAA are generally presumed correct, and a party challenging an FPAA has the burden of proving that the Commissioner's determinations are in error. Rule 142(a); Welch v. Helvering, 290 U.S. 111, 115 (1933); Republic Plaza Props. Pship. v. Commissioner, 107 T.C. 94, 104 (1996). The burden of proof on factual issues that affect a taxpayer's liability for tax may be shifted to the Commissioner where the "taxpayer introduces credible evidence with respect to * * * such issue." Sec. 7491(a)(1).

Petitioner argues that the burden shifts to respondent under section 7491(a). Respondent disagrees and argues that petitioner has not satisfied the requirements of section 7491. A shift in

the burden of persuasion "has real significance only in the rare event of an evidentiary tie." Blodgett v. Commissioner, 394 F.3d 1030, 1039 (8th Cir. 2005), affg. T.C. Memo. 2003-212. We decide this case on the preponderance of the evidence, and the burden of proof is not a factor in our analysis. We will address each of respondent's arguments in turn.

III. Economic Substance

Respondent first argues that Historic Boardwalk Hall lacks economic substance. Both parties agree that an appeal in this case lies in the Court of Appeals for the Third Circuit. See sec. 7482. The Court of Appeals for the Third Circuit has stated that a court is to "analyze two aspects of a transaction to determine if it has economic substance: its objective economic substance and the subjective business motivation behind it." IRS v. CM Holdings, Inc., 301 F.3d 96, 102 (3d Cir. 2002). However, in CM Holdings, Inc. the court went on to state that these aspects do not constitute discrete prongs of a "'rigid two-step analysis'" but "'represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.'" Id. (quoting ACM Pship. v. Commissioner, 157 F.3d 231, 247 (3d Cir. 1998), affg. in part and revg. in part T.C. Memo. 1997-115). If, however, a transaction "'affects the taxpayer's net economic position, legal relations, or non-tax

business interests, it will not be disregarded merely because it was motivated by tax considerations.'" Id. (quoting ACM Pship. v. Commissioner, 157 F.3d at 247).

Respondent argues that Historic Boardwalk Hall is a sham because it lacked objective economic substance and that its partners lacked any business motivation other than transferring historic tax credits from NJSEA to Pitney Bowes. Respondent asks that we look to the individual partners to determine the economic substance of the transaction.

Respondent contends that Historic Boardwalk Hall lacked objective economic substance because the parties, in respondent's view, negotiated and executed a transaction in anticipation of a limited number of possible outcomes, none of which would appreciably affect Pitney Bowes' economic position other than through a reduction of its tax liabilities.

Respondent argues that the following are the only possible outcomes of Historic Boardwalk Hall's formation, assuming the parties act in an "economically rational manner".

(1) If the East Hall was profitable, NJSEA would be compelled to exercise its repurchase option immediately after the section 47 recapture period ended, terminating Pitney Bowes' interest in Historic Boardwalk Hall. Pitney Bowes would receive its 3-percent annual return until it exited Historic Boardwalk Hall through preferred net cashflow distributions.

(2) If the East Hall was unprofitable, Pitney Bowes would exercise its put option, compelling NJSEA to purchase its interest in Historic Boardwalk Hall for its 3-percent annual return. In this case, because East Hall is unprofitable and there are no preferred net cashflow distributions, Pitney Bowes receives its payment through the GIC.

Respondent contends that the parties knew that Historic Boardwalk Hall would not earn a profit and that the Reznick projections showing a profit were simply window dressing meant to give the transaction an appearance of legitimacy.

Respondent further argues that Pitney Bowes would never earn a profit on its investment in Historic Boardwalk Hall. In respondent’s view, although Pitney Bowes was entitled to its 3-percent return either through preferred distributions or the GIC, Historic Boardwalk Hall still lacked objective business substance because any return would be less than Pitney Bowes could have earned had it invested its capital contributions in other financial instruments. Taking into account the time value of money, respondent argues that Pitney Bowes’ investment results in a negative cashflow to Pitney Bowes.

Respondent also argues that other contractual provisions ensure that Historic Boardwalk Hall has no economic effect on its partners, including the tax benefits guaranty agreement, the operating deficit guaranty, the completion guaranty, and the fact

that all of Historic Boardwalk Hall's debts are nonrecourse to Pitney Bowes. Respondent concludes that the parties' economic positions were all fixed and unaffected by the return from Historic Boardwalk Hall in any circumstance.

Moving to the subjective test, respondent argues that Historic Boardwalk Hall served no subjective business purpose because it was intended solely to facilitate NJSEA's sale of rehabilitation tax credits and other favorable tax attributes to Pitney Bowes.

All of respondent's arguments concerning the economic substance of Historic Boardwalk Hall are made without taking into account the 3-percent return and the rehabilitation credits. Respondent argues that the rehabilitation credits must be ignored in evaluating the economic substance of Historic Boardwalk Hall. Respondent points to Friendship Dairies, Inc. v. Commissioner, 90 T.C. 1054 (1988), and argues that investment tax credits are never to be taken into account in determining the economic substance of a transaction.

Petitioner first argues that the economic substance doctrine is inapplicable to the Historic Boardwalk Hall transaction because Congress, in enacting and amending section 47, intended to use section 47 to spur corporations to invest in historic rehabilitation projects that otherwise would not be economically feasible. Petitioner further contends that the point of the

credit was to address the reality that most rehabilitation projects had an inherent lack of profitability--thus it would be inappropriate to disregard a transaction for lack of profitability when the purpose of section 47 is to make up for that lack of profitability.

Further, petitioner puts forth alternative arguments in support of its position that the Historic Boardwalk Hall transaction has economic substance. First, petitioner argues that the rehabilitation tax credits at issue can be taken into account in determining whether the transaction has economic substance and provided a net economic benefit to Pitney Bowes. Petitioner points to Sacks v. Commissioner, 69 F.3d 982 (9th Cir. 1995), revg. T.C. Memo. 1992-596, and argues that we must take the rehabilitation credits into account in determining the profitability of the transaction.

Second, petitioner argues that even if we do not take the rehabilitation tax credits into account, the Reznick projections show that the Historic Boardwalk Hall has economic substance because Pitney Bowes and the East Hall had a chance of earning a profit.

Petitioner also asserts the 3-percent return gives the transaction economic significance.

In Sacks v. Commissioner, supra, the Court of Appeals for the Ninth Circuit evaluated the economic substance of a solar

energy equipment sale-leaseback transaction. The Court of Appeals found that the transaction had economic substance on the basis of the following factors:

(1) The taxpayer's personal obligation to pay the price was genuine;

(2) the taxpayer paid fair market value for the equipment;

(3) the tax benefits would have existed for someone, and were not created out of thin air by the transaction;

(4) the business of selling solar energy was genuine; and

(5) the business consequences of a rise or fall in energy prices were genuinely shifted to the taxpayer.

Id. at 988. The Court of Appeals discussed whether the solar energy credits should be taken into account in determining the profitability of the transaction. The Commissioner had argued successfully in this Court that any financial analysis of the transaction had to be done without regard to the solar energy credits. On the basis of that argument, we found that the taxpayer's transaction lacked economic substance because it was cashflow negative unless the tax credits were taken into account and disallowed the claimed credits.

The Court of Appeals disagreed with that analysis, stating that the taxpayer's investment "did not become a sham just because its profitability was based on after-tax instead of pre-tax projections." Id. at 991. The Court of Appeals went on to

state that "Where a transaction has economic substance, it does not become a sham merely because it is likely to be unprofitable on a pre-tax basis", id., and that "Absence of pre-tax profitability does not show 'whether the transaction had economic substance beyond the creation of tax benefits,' where Congress has purposely used tax incentives to change investors' conduct", id. (citation omitted). The Court of Appeals rejected the Commissioner's argument that the tax benefits should be excluded from the economic analysis because "If the government treats tax-advantaged transactions as shams unless they make economic sense on a pre-tax basis, then it takes away with the executive hand what it gives with the legislative." Id. at 992. Ultimately, the Court of Appeals recognized that if the types of transactions that Congress intended to encourage had to be profitable on a pretax basis, then Congress would not have needed to provide incentives to get taxpayers to invest in them; in effect, the Commissioner was attempting to use the reason Congress created the tax benefits as a ground for denying them. Id.

The Court of Appeals for the Third Circuit has not directly addressed whether investment tax credits are to be taken into account in determining the economic substance of a transaction. In IRS v. CM Holdings, Inc., 301 F.3d 96 (3d Cir. 2001), the taxpayer attempted to rely on the opinion of the Court of Appeals for the Ninth Circuit in Sacks in arguing that a corporate-owned

life insurance plan had economic substance because Congress had explicitly sanctioned those types of tax strategies. However, the Court of Appeals for the Third Circuit distinguished Sacks because the Sacks opinion, in allowing depreciation deductions and investment credits with respect to a sale and leaseback of solar energy equipment, reasoned that both Federal and State legislatures had specifically encouraged investment in solar energy and thereby "skewed the neutrality of the tax system." Id. at 106 (quoting Sacks v. Commissioner, supra at 991).

Respondent argues that Sacks does not control since, unlike the transaction in Sacks, the East Hall transaction and Historic Boardwalk Hall are shams because they had no appreciable effect on the parties' economic positions.

As an initial matter, we do not agree with respondent that Pitney Bowes invested in the Historic Boardwalk Hall transaction solely to earn rehabilitation tax credits. We believe 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. Pitney Bowes, NJSEA, and Historic Boardwalk Hall had a legitimate business purpose--to allow Pitney Bowes to invest in the East Hall's rehabilitation.

Pitney Bowes invested in the East Hall rehabilitation. Most of Pitney Bowes' capital contributions were used to pay a

development fee to NJSEA for its role in managing the rehabilitation of the East Hall according to the development agreement between Historic Boardwalk Hall and NJSEA. Respondent's contention that Pitney Bowes was unnecessary to the transaction because NJSEA was going to rehabilitate the East Hall without a corporate investor overlooks the impact that Pitney Bowes had on the rehabilitation: no matter NJSEA's intentions at the time it decided to rehabilitate the East Hall, Pitney Bowes' investment provided NJSEA with more money than it otherwise would have had; as a result, the rehabilitation ultimately cost the State of New Jersey less. Respondent does not allege that a circular flow of funds resulted in Pitney Bowes receiving its 3-percent preferred return on its capital contributions. In addition, Pitney Bowes received the rehabilitation tax credits.

Historic Boardwalk Hall and the AREA imposed financial requirements on both Pitney Bowes and NJSEA. Pitney Bowes was required to make capital contributions, and NJSEA was required to manage the East Hall's rehabilitation and assure its completion. If NJSEA failed in its role as manager and the rehabilitation did not proceed according to the parties' plan, Pitney Bowes would not be required to make additional capital contributions. This would have left NJSEA responsible for a larger portion of the East Hall's rehabilitation.

Respondent points to the parties' use of the term "sale of tax credits" and argues that the term "development fee" and the payment of a development fee by Historic Boardwalk Hall to NJSEA is merely meant to disguise evidence showing the true nature of the transaction to be a sale of tax credits. We must look to the substance of the transaction, rather than the terms used by the parties. The regulations clearly indicate that a development fee is a qualified rehabilitation expense. Sec. 1.48-12(c)(2), Income Tax Regs. The opinion letters obtained by NJSEA and Pitney Bowes all discuss whether a development fee is the type of rehabilitation expense that is eligible to earn rehabilitation tax credits, and whether the amount of the development fee at issue was reasonable in this type of rehabilitation. Respondent does not argue that any portion of the rehabilitation credits claimed is inappropriate or attempt to disallow any of Historic Boardwalk Hall's claimed credits on the ground that the development fee was not a qualified rehabilitation expense.

Pitney Bowes faced risks as a result of joining Historic Boardwalk Hall. First, and most importantly to its goals, it faced the risk that the rehabilitation would not be completed.

In addition, both NJSEA and Pitney Bowes faced potential liability for environmental hazards from the rehabilitation. Although Historic Boardwalk Hall and Pitney Bowes were added as named insured parties to NJSEA's environmental insurance, there

was no guaranty that: (1) The insurance payout would cover any potential liability; and (2) if NJSEA was required to make up any difference, it would be financially able to do so.

Overall, respondent's argument that certain agreements prevented the East Hall transaction from affecting the partners' economic positions is incorrect. These side agreements and guaranties must be looked at in context: they were necessary to attract an equity investor. These provisions are meant to protect Pitney Bowes from any unforeseen circumstances that could arise as a result of problems with the rehabilitation. Respondent does not argue that the completion guaranty is a sham or is not a legitimate agreement between the parties. Instead, respondent argues that because Pitney Bowes' investment is limited to its capital contributions and because Pitney Bowes cannot be held responsible for additional funds to complete the East Hall rehabilitation, the East Hall transaction as a whole lacks economic substance. However, those agreements show that the East Hall and Historic Boardwalk Hall did in fact affect the parties' economic positions--the agreements were meant to prevent the transaction from having a larger impact than the parties had bargained for.

This is not a transaction in which the parties had competing interests that would work against the partnership's stated purpose. NJSEA and Pitney Bowes had a common goal: the

rehabilitation of the East Hall. NJSEA needed the rehabilitation to be successful in order to make the East Hall an attractive site for concerts and events after the construction of the new convention center. Pitney Bowes needed the rehabilitation to be successful so it would earn rehabilitation credits and its 3-percent return. Both would receive a net economic benefit if the rehabilitation was successful.

The legislative history of section 47 indicates that one of its purposes is to encourage taxpayers to participate in what would otherwise be an unprofitable activity. Congress enacted the rehabilitation tax credit in order to spur private investment in unprofitable historic rehabilitations. As respondent notes, the East Hall has operated at a deficit. Without the rehabilitation tax credit, Pitney Bowes would not have invested in its rehabilitation, because it could not otherwise earn a sufficient net economic benefit on its investment. The 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. Further, if not for the rehabilitation tax credit, NJSEA would not have had access to the nearly $14 million paid to it as a development fee for its efforts in rehabilitating the East Hall. Considering that the cost of the rehabilitation was

about $100 million, Pitney Bowes contributed about 15 percent of the cost of the rehabilitation.

Respondent attempts to read Friendship Dairies, Inc. v. Commissioner, 90 T.C. 1054 (1988), as holding that the investment tax credit is never taken into account in considering the economic substance of a transaction. Friendship Dairies does not make such a broad holding. Although we held in that case that the investment tax credits at issue could not be taken into account in evaluating the economic substance of that transaction, we did not explicitly hold that investment credits are never taken into account when applying the economic substance doctrine. We stated that

> "We acknowledge that many such tax-motivated transactions are congressionally approved and encouraged. * * * The determination whether a transaction is one Congress intended to encourage will require a broad view of the relevant statutory framework and some investigation into legislative history. The issue of congressional intent is raised only upon a threshold determination that a particular transaction was entered into primarily for tax reasons."

Id. at 1064 (quoting Fox v. Commissioner, 82 T.C. 1001, 1021 (1984)).

In Friendship Dairies, we disregarded a sale-leaseback transaction which had no chance of profitability. This case is distinguishable on its facts.

Ultimately, NJSEA had more money for the rehabilitation than it would have had if Pitney Bowes had not invested in Historic

Boardwalk Hall. Both parties would receive a net economic benefit from the transaction if the rehabilitation was successful. Pitney Bowes would earn a net economic benefit as a result of its entering into the East Hall's rehabilitation, while NJSEA would see higher revenues from other Atlantic City properties if the East Hall was a successful loss leader and began attracting large crowds after the rehabilitation was completed.

The rehabilitation of the East Hall was a success. Historic Boardwalk Hall has been operating and continues to operate day to day, with the East Hall being used as a convention facility. In conclusion, Historic Boardwalk Hall had objective economic substance.

IV. Whether Pitney Bowes Was a Partner in Historic Boardwalk Hall

Respondent next argues that Pitney Bowes was not a partner in Historic Boardwalk Hall. Respondent contends that Pitney Bowes' partnership interest should be disregarded because: (1) Pitney Bowes had no meaningful stake in Historic Boardwalk Hall's success or failure; and (2) Pitney Bowes' interest in Historic Boardwalk Hall is more like debt than equity. Ultimately, respondent's two arguments both center on the fact that Pitney Bowes' return was limited to 3 percent.

Section 761(a) defines "Partnership" as follows:

> SEC. 761(a). Partnership.--For purposes of this subtitle, the term "partnership" includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title [subtitle], a corporation or a trust or estate. * * *

Both petitioner and respondent point to Commissioner v. Culbertson, 337 U.S. 733 (1949), in support of their arguments. In Culbertson, the Supreme Court had to determine whether a valid partnership was formed. The Supreme Court listed several objective factors that influence the determination of whether a partnership is valid, including: (1) The agreement between the parties; (2) the conduct of the parties in executing its provisions; (3) the parties' statements; (4) the testimony of disinterested persons; (5) the relationship of the parties; (6) their respective abilities and capital contributions; (7) the actual control of income; and (8) the purposes for which the income is used. Id. at 742; see also Va. Historic Tax Credit Fund 2001 LP v. Commissioner, T.C. Memo. 2009-295. In Va. Historic Tax Credit, we applied the Culbertson factors and upheld a partnership which was formed to allow the partners to share and distribute State tax credits.

In Luna v. Commissioner, 42 T.C. 1067, 1077-1078 (1964), this Court stated that "while all circumstances are to be considered, the essential question is whether the parties

intended to, and did in fact, join together for the present conduct of an undertaking or enterprise", and cited Commissioner v. Culbertson, supra at 742, which stated:

> The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard * * * but whether, considering all the facts * * * the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. * * *

Petitioner argues that Historic Boardwalk Hall is a valid partnership and that Pitney Bowes was a partner in that partnership. Petitioner points to the partnership agreement, the parties' actions in negotiating that agreement, and the parties' actions after the agreement was executed. Petitioner contends that Pitney Bowes' extensive investigation of all aspects of the transaction and Historic Boardwalk Hall's business changes made after execution all support a conclusion that Pitney Bowes was a partner in Historic Boardwalk Hall.

We agree with petitioner. Pitney Bowes and NJSEA, in good faith and acting with a business purpose, intended to join together in the present conduct of a business enterprise. As we held above, Pitney Bowes and NJSEA joined together in a transaction with economic substance to allow Pitney Bowes to invest in the East Hall rehabilitation. Further, as we found above, the decision to invest provided a net economic benefit to Pitney Bowes through its 3-percent preferred return and

rehabilitation tax credits. Combined with our above holding that Historic Boardwalk Hall had economic substance, it is clear that Pitney Bowes was a partner in Historic Boardwalk Hall.

The parties' investigations and documentation both support a finding that the parties intended to join together in a rehabilitation of the East Hall. Although the confidential offering memorandum used the term "sale", it was used in the context of describing an investment transaction. The confidential offering memorandum accurately described the substance of the transaction: an investment in the East Hall's rehabilitation.

The parties' investigation likewise supports a finding of an effort to join together in rehabilitating the East Hall. The parties investigated potential environmental hazards and attempted to mitigate them. This included two analyses by consulting firms and adding Historic Boardwalk Hall and Pitney Bowes as named parties to NJSEA's insurance policies. NJSEA and Pitney Bowes sought and received a number of opinion letters evaluating various aspects of the transaction.

The executed transaction documents accurately represent the substance of the transaction. The AREA is between Pitney Bowes and NJSEA and provides a detailed description of Historic Boardwalk Hall's purpose--to rehabilitate and manage the East Hall. Since formation, Historic Boardwalk Hall has carried out

its goals. The AREA describes Pitney Bowes and NJSEA as members and also provides for transfers of their membership interests in later years. The development agreement between Historic Boardwalk Hall contractually obligates NJSEA to manage the East Hall's rehabilitation and accurately represents the substance of the transaction.

Since execution of those agreements, the parties have carried out their responsibilities under the AREA. NJSEA oversaw the East Hall's rehabilitation, and Pitney Bowes made its required capital contributions. The East Hall was actually rehabilitated, did reopen to the public, and has been successful. This rehabilitation provided benefits to both Pitney Bowes and NJSEA.

Respondent again asks us to ignore the rehabilitation tax credits at issue. Pitney Bowes joined Historic Boardwalk Hall in exchange for its 3-percent preferred return and the rehabilitation tax credits. The 3-percent preferred return and the rehabilitation tax credits provided a net economic benefit to Pitney Bowes. Even if we do ignore the tax credits, Pitney Bowes' interest is not more like debt than equity because Pitney Bowes is not guaranteed to receive a 3-percent return every year. Because the East Hall operated at a loss each year, Pitney Bowes was not guaranteed the 3-percent return at the end of a given year because there might not be sufficient cashflow to pay it.

In accord with the AREA, Pitney Bowes might not receive its preferred return until NJSEA purchased Pitney Bowes' membership interest, if at all.

Taking into account the stated purpose behind Historic Boardwalk Hall's formation, the parties' investigation of the transaction, the transaction documents, and the parties' respective roles, we hold that Historic Boardwalk Hall was a valid partnership.

V. Whether the East Hall Was "Sold" to Historic Boardwalk Hall

Respondent next argues that NJSEA did not transfer the East Hall to Historic Boardwalk Hall for Federal income tax purposes because NJSEA did not transfer the benefits and burdens of ownership.

Whether the benefits and burdens of ownership with respect to property have passed to the taxpayer is a question of fact that must be answered from the intentions of the parties as established by the written agreements read in light of the attending facts and circumstances. Arevalo v. Commissioner, 124 T.C. 244, 252 (2005), affd. 469 F.3d 436 (5th Cir. 2006); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981). We look to the substance of the agreement and not just the labels used by the parties. Arevalo v. Commissioner, supra at 252. The following factors are considered: (1) Whether legal title passes; (2) how the parties treat the transaction; (3) whether

equity was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property. Id.

Respondent argues that the burdens of ownership remained with NJSEA because it bore all of the burdens of the East Hall's operation and rehabilitation, including remaining liable for the East Hall's operating expenses, real estate taxes, workers' compensation, and property and other insurance coverage and for completion of the East Hall rehabilitation. Respondent contends that NJSEA also remained responsible for any excess development costs, interest, taxes, and the costs of any environmental problems. Respondent concurrently argues that NJSEA maintained the benefits of ownership because it had the authority, through its purchase option, to purchase Pitney Bowes' interest in Historic Boardwalk Hall at any time. Respondent points to Sun Oil Co. v. Commissioner, 562 F.2d 258 (3d Cir. 1977), revg. T.C. Memo. 1976-40, and argues that under the Court of Appeals for the Third Circuit's authority, a purchase option requires a finding that the benefits and burdens were not passed.

Petitioner argues that the transaction documents clearly show the parties' intent to sell the East Hall to Historic Boardwalk Hall. Petitioner also argues that NJSEA had a contractual obligation to deliver the East Hall to Historic Boardwalk Hall, that Historic Boardwalk Hall had an obligation to pay for the East Hall, and that Historic Boardwalk Hall had possession of the East Hall.

Some of the factors weigh in favor of finding a sale: (1) The parties treated the transaction as a sale; (2) possession of the East Hall vested in Historic Boardwalk Hall; (3) Historic Boardwalk Hall reported the East Hall's profits and stood to lose its income if the East Hall stopped operating as an event space. Others weigh against petitioner: (1) NJSEA remained liable for the East Hall's property taxes (2) because Historic Boardwalk Hall operated at a loss, NJSEA was not guaranteed to receive payments on the acquisition loan each year; (3) NJSEA could reacquire the East Hall by exercising its option under article 8.02 of the AREA.

We must evaluate whether the East Hall was transferred in the context of this specific rehabilitation transaction. We look at all the facts and circumstances surrounding the transaction at issue.

The East Hall has been operating as an event space, and all income and expenses of the East Hall have been reported on

Historic Boardwalk Hall's Forms 1065. Bank accounts were opened in Historic Boardwalk Hall's name by SMG as operator of the East Hall.

Respondent argues that the benefits and burdens were not transferred because NJSEA remained liable for the rehabilitation and the expense of managing the East Hall. Respondent points to statements by NJSEA executives that the East Hall would operate in the same manner as it had before Historic Boardwalk Hall was formed and argues that these statements support a conclusion that the benefits and burdens were not transferred to Historic Boardwalk Hall. Respondent misinterprets the context of these statements. They were made in relation to NJSEA's decision to assign some of its construction contracts to Historic Boardwalk Hall. The statements appear to have been made to third parties and were meant to assuage the concerns of those third parties that their contracts and dealings with regard to the East Hall would be affected by the contract assignment to Historic Boardwalk Hall.

Respondent's additional argument in the context of the East Hall's ownership concerns the article 8.02 purchase option. Respondent points to Sun Oil Co. v. Commissioner, supra, and contends that in the Court of Appeals for the Third Circuit, a purchase option such as the one in article 8.02 requires a

finding that the benefits and burdens of ownership remained with NJSEA. We do not believe that Sun Oil controls.

In that case, Sunray DX Oil Co. (Sunray) sold 320 parcels of land to a tax-exempt trust. Sunray then leased those parcels back. The Commissioner challenged Sunray's deductions for lease payments. This Court found in favor of the taxpayer, but the Court of Appeals for the Third Circuit reversed our decision.

The Court of Appeals focused on Sunray's ability to recover the land "sold" to the tax-exempt trust. Sunray had a number of options if it decided it wanted to recover a specific piece of land. First, it could simply swap another piece of land for that land, without the trust's being able to reject it. Second, Sunray could make an offer to repurchase a specific piece of land. Lastly, Sunray had a right of repurchasing the land for an amount equal to the present value of rent payments due 60 years in the future, which would be an almost negligible value.

The Court of Appeals focused on how these provisions did not truly transfer any rights to the trust. The Court of Appeals observed that because Sunray could, without any restrictions, swap any piece of land for one subject to the sale-leaseback at issue, the offer provisions in the contracts were rendered moot. Further, the Court of Appeals held that because Sunray could always repurchase the land for an almost negligible amount by its repurchase options, it could always recover the land without

paying the trust fair market value. The Court of Appeals stated: "The options to repurchase provide Sunray with a built in latch-string by which it could spring legal title to the properties whenever it served its convenience without obligating Sunray to pay fair market value." Sun Oil Co. v. Commissioner, 562 F.2d at 268.

As an initial matter, we note that Sun Oil is distinguishable on its facts. That case dealt with a sale-leaseback transaction entered into to generate artificial rent deductions. Further, we do not believe that the presence of a purchase option prevents our finding that the benefits and burdens of ownership of the East Hall were transferred to Historic Boardwalk Hall in the context of the rehabilitation tax credit.

A purpose of Historic Boardwalk Hall was to allow Pitney Bowes to invest in the rehabilitation of the East Hall and earn rehabilitation tax credits. The purchase option agreement gave NJSEA the right to purchase Pitney Bowes' membership interest in Historic Boardwalk Hall at any time during a 12-month period beginning 60 months after the entire East Hall was placed in service for purposes of determining the historic rehabilitation credits. The rehabilitation credits of Pitney Bowes would have been subject to recapture had it disposed of its partnership interest within 60 months after the renovated East Hall was

placed in service. See sec. 50; sec. 1.47-6(a)(1), Income Tax Regs. The statute demonstrates an anticipation of repurchase and creates a disincentive. Congress established a means to police early dispositions and created a deterrent to a premature buyout. For these reasons, NJSEA's purchase option was not contrary to the purpose of the rehabilitation tax credit.

In conclusion, we find that NJSEA transferred the benefits and burdens of ownership of the East Hall to Historic Boardwalk Hall.

VI. Respondent's Recasting of the Transaction

Respondent alternatively determined in the FPAA that it was necessary to recast the East Hall transaction to "achieve tax results that are consistent with the intent of subchapter K." Section 1.701-2(b), Income Tax Regs., gives the Commissioner the authority to recast transactions for Federal income tax purposes if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate Federal income tax liability in a manner that is inconsistent with subchapter K. Section 1.701-2(a), Income Tax Regs., provides that the following requirements are implicit in the intent of subchapter K:

> (1) The partnership must be bona fide and each partnership transaction or series of related transactions * * * must be entered into for a substantial business purpose;

> (2) The form of each partnership transaction must be respected under substance over form principles;
>
> (3) * * * the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income * * *

Requirement (3), however, contains an exception in certain situations. Some statutory and regulatory requirements imposed on partnerships by subchapter K may cause tax results that do not accurately reflect the partners' economic agreement or clearly reflect the partners' income, thus violating requirement (3) above. Section 1.701-2(a)(3), Income Tax Regs., provides that if a transaction satisfies requirements (1) and (2), requirement (3) will be treated as satisfied to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.

The determination of whether a transaction involving a partnership ought to be recast is made with consideration given to the statutory provision giving rise to the tax benefits and all pertinent facts and circumstances. Section 1.701-2(c), Income Tax Regs., provides a nonexclusive list of factors to be considered, including whether:

> (1) The present value of the partners' aggregate Federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly;

(2) The present value of the partners' aggregate Federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to reach a particular result are integrated and treated as steps in a single transaction * * *;

(3) One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities * * *, or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

(4) Substantially all of the partners * * * are related (directly or indirectly) to one another;

(5) Partnership items are allocated in compliance with the literal language of §§ 1.704-1 and 1.704-2, but with results that are inconsistent with the purpose of section 704(b) and those regulations * * * ;

(6) The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party); or

(7) The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or a related party).

Respondent argues that his decision to recast the East Hall transaction was correct because Historic Boardwalk Hall's principal purpose was to substantially reduce the present value of Pitney Bowes' aggregate tax liability in a manner inconsistent with the purpose of subchapter K.

Petitioner, however, contends that the East Hall transaction is wholly consistent with the purpose of subchapter K and further

argues that the East Hall transaction is analogous to examples of the proper use of partnerships in section 1.701-2, Income Tax Regs. Section 1.701-2(d), Income Tax Regs., lists various factual situations involving the use of a partnership and evaluates whether that use is or is not consistent with the intent of subchapter K.

Section 1.701-2(d), Example (6), Income Tax Regs., involves the formation of a partnership by A and B, two high-bracket taxpayers, and X, a corporation with net operating loss carryforwards. A, B, and X form partnership PRS to own and operate a building that qualifies for section 42 low-income-housing credits. PRS is financed with cash contributions by A and B and nonrecourse indebtedness, and the partnership agreement provides for special allocations of income and deductions, including depreciation, to A and B equally. This allocation is consistent with the allocation of other economically substantial partnership items attributable to the building. The section 42 low-income-housing credits are also allocated according to the partnership agreement. The partners and partnership comply with all applicable partnership regulations in their management and reporting of the partnership. These include sections 1.704-1(b)(2)(ii) and (iii), 1.704-2(e), and 1.752-3, Income Tax Regs.

The ultimate result reached by the Commissioner is that individuals A and B are allowed to deduct their distributive

shares of PRS' losses against their nonpartnership income and to apply the low-income-housing credits against their tax liabilities. Example (6) goes on to indicate that this allocation may not accurately reflect the partners' economic agreement or clearly reflect income. However, because the provisions that lead to this result, sections 1.704-1(b)(2)(ii) and (iii), 1.704-2(e), and 1.752-3, Income Tax Regs., clearly contemplated this result, then requirement (3), discussed above, is treated as having been satisfied.

The use of PRS results in partners A and B's aggregate Federal income tax liability being lower than if A and B had owned the building directly. This result flows from A and B's being able to use corporation X's otherwise allocable credits. Example 6 concludes that, even though the use of partnership PRS leads to this result, the PRS transaction is not inconsistent with the intent of subchapter K. As a result, the Commissioner cannot invoke section 1.701-2(b), Income Tax Regs., to recast the transaction.

Respondent disputes petitioner's reliance on Example (6) and argues that it is inapplicable. Respondent contends that Example (6) concerns a general partnership, unlike Pitney Bowes, NJSEA, and Historic Boardwalk Hall, where all partners have personal liability, none of the entities is tax exempt, section 42 does

not require a profit motive, and the taxpayers are at risk if the building declines in value.

Respondent argues that Historic Boardwalk Hall violated section 1.701-2(a)(1), Income Tax Regs., because there was no substantial business purpose for its formation. Respondent points to certain factors listed in section 1.701-2(c), Income Tax Regs., and concludes that section 1.701-2(a)(1), Income Tax Regs., has been violated. These factors include Pitney Bowes' aggregate tax liability's being lower as a result of Historic Boardwalk Hall's creation; thus, Pitney Bowes is substantially protected from any risk of loss and has little or no participation in the partnership's profits other than its preferred return. Respondent does not argue a breach of requirement (1) or (2) of section 1.701-2(a), Income Tax Regs.

We have previously rejected respondent's contentions in the context of his other arguments. We agree with petitioner that respondent's decision to recharacterize the East Hall transaction pursuant to section 1.701-2(b), Income Tax Regs., was inappropriate. NJSEA and Pitney Bowes had the legitimate business purpose, as discussed above, of allowing Pitney Bowes to invest in the East Hall's rehabilitation. The use of a partnership was necessary to allow a for-profit corporation to invest in the rehabilitation of a government-owned building. Although Pitney Bowes' aggregate tax liability was reduced as a

result of this transaction, Congress intended to use the rehabilitation tax credit to draw private investments into public rehabilitations.

Further, the regulations clearly contemplate a situation in which a partnership is used to transfer valuable tax attributes from an entity that cannot use them--corporation X--to individuals who can--taxpayers A and B. See sec. 1.701-2(d), Example (6), Income Tax Regs.

VII. Section 6662 Accuracy-Related Penalty

Respondent determined in the FPAA that Historic Boardwalk Hall should be liable for the accuracy-related penalty pursuant to section 6662. Because we find respondent's other determinations to be incorrect, the section 6662 penalty is inapplicable.

VIII. Conclusion

Respondent's determinations in the FPAA were incorrect. To reflect the foregoing,

An appropriate decision will be entered.