No. 12-

IN THE

Supreme Court of the United States

HISTORIC BOARDWALK HALL, LLC, NEW JERSEY SPORTS AND EXPOSITION AUTHORITY, TAX MATTERS PARTNER,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

The New Jersey Sports and Exposition Authority and a limited liability company owned by Pitney Bowes Corporation formed a *bona fide* partnership, *i.e.,* Historic Boardwalk Hall, LLC, to renovate the Historic Boardwalk Hall, a certified historic building located in Atlantic City, New Jersey. The renovation of the Historic Boardwalk Hall gave rise to federal historic rehabilitation tax credits that were properly allocated to the Pitney Bowes Corporation-owned entity under the Internal Revenue Code.

The federal historic rehabilitation tax credit in 26 U.S.C. § 47 was first enacted by Congress decades ago with the express purpose of stimulating the investment of public corporations in the renovation and preservation of our nation's historic structures. Through 2011, the 20 percent historic rehabilitation tax credit encouraged approximately $99 billion in historic rehabilitation, and generated about 2.2 million new jobs and billions of dollars in direct and secondary economic benefits. Public corporations have invested in many thousands of federal historic rehabilitation tax credit projects and most of these investments have been made through partnership transactions indistinguishable from the one in the present case. This is the first litigated case in the country where the Internal Revenue Service has made a broad based challenge to the allocation of Congressionally-sanctioned federal historic rehabilitation tax credits by a partnership to a partner. The impact of this case on past, present and future historic rehabilitation tax credit projects is undisputed.

The questions presented are:

1. Whether the allocation of federal historic rehabilitation tax credits by a partnership to a partner by operation of law under the Internal Revenue Code can be disallowed by treating the allocation of the credits as a "repayment" of the partner's capital contribution by the partnership or as a "sale" of "property" by the partnership to the partner.

2. Whether Congressionally-mandated federal tax attributes, in this case, historic rehabilitation tax credits, can be taken into account as a key component of an analysis which denies a taxpayer those very tax attributes.

RULE 29.6 STATEMENT

Historic Boardwalk Hall, LLC is a New Jersey limited liability company that is treated as a partnership for federal income tax purposes. The members (hereinafter, "partners") of Historic Boardwalk Hall, LLC are the New Jersey Sports and Exposition Authority, which is a political subdivision of the State of New Jersey, and PB Historic Renovation, LLC, a Delaware limited liability company, owned by Pitney Bowes Corporation.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner New Jersey Sports and Exposition Authority, the tax matters partner for Historic Boardwalk Hall, LLC, respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit in this case.

OPINIONS BELOW

The opinion of the United States Court of Appeals for Third Circuit is reported at 694 F.3d 425, and reproduced in the appendix hereto ("App.") at 1a. The opinion of the United States Tax Court is reproduced at App. 80a. The order of the Court of Appeals denying a petition for rehearing and rehearing *en banc* is reproduced at App. 139a.

JURISDICTION

The Third Circuit rendered its decision on August 27, 2012, and denied a timely petition for rehearing and rehearing *en banc* on October 22, 2012. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

Section 47 of the Internal Revenue Code, 26 U.S.C. § 47, is reproduced at App. 141a.

STATEMENT OF THE CASE

A. Statutory Background

This case involves the 20 percent federal historic rehabilitation tax credit ("HRTC") set forth in 26 U.S.C. § 47 in connection with the rehabilitation of an iconic building located on the Boardwalk in Atlantic City, New Jersey known as the "Historic Boardwalk Hall" or the "East Hall." The legislative history and Congressional purpose underlying the HRTC is critically important to the legal analysis throughout this petition. Indeed, Congress enacted 26 U.S.C. § 47 with the inarguable intention of using the tax laws as a forceful instrument in motivating private investors, like Pitney Bowes Corporation in this case, to invest in the renovation of historic buildings, like the East Hall. In enacting 26 U.S.C. § 47, Congress intended to create a tax incentive to spur private investment in the rehabilitation and preservation of our nation's historic buildings that did not exist under typical market forces.

The origins of the HRTC are found in the enactment of the National Historic Preservations Act ("NHPA") on October 15, 1966. 16 U.S.C. §§ 470-470w (1966). NHPA was enacted to ensure that urban planning and industrial development did not overrun the historical and cultural importance in preserving our country's "irreplaceable heritage" in its historic buildings. 16 U.S.C. § 470(b)(4). In the years following the passage of NHPA, Congress enacted several tax incentives to purposely direct and motivate private investment in the rehabilitation of buildings of historical significance. The most important of these incentives, and by far the most economically and socially successful, was the HRTC.

The Tax Reform Act of 1976 ("TRA 76"), Pub. L. 94-455, 90 Stat. 1520 (October 4, 1976), and the Revenue Act of 1978 (the "1978 Act"), Pub. L. No. 95-600, 92 Stat. 2763 (November 6, 1978), furthered the goals of NHPA by creating new tax incentives for private sector investment in certified historic buildings. TRA 76 allowed for rapid amortization of historic structures (*see* 26 U.S.C. § 191 (1976)), and the 1978 Act provided for a 10 percent tax credit for historic rehabilitations (*see* 26 U.S.C. § 48(g) (1978)).

In expressing Congress' motives in passing tax credit legislation designed to spur private investment in historic rehabilitations, Senator J. Glenn Beall stated on the floor of the Senate in 1976:

> The time has clearly come for us to harness the constructive energies in our nation's tax system so as to bring private funds and commercial interests actively and enthusiastically into the field of historic preservation. The time has clearly come for the Congress to wipe away many of the existing tax incentives which run directly counter to our national goals.

122 Cong. Rec. 24320 (July 28, 1976) (remarks of Senator J. Glenn Beall).

The HRTC reached its modern form with the passage of the Economic Recovery Tax Act of 1981 ("ERTA"), Pub. L. No. 97-54, 95 Stat. 172 (August 13, 1981). ERTA provided for a 25 percent tax credit for qualified rehabilitation expenditures made in the renovation of certified historic structures. 26 U.S.C. § 46(a)(2)(f) (1981).

The Tax Reform Act of 1986 (the "1986 Act"), Pub. L. 99-514, 101 Stat. 2085 (October 22, 1986), made sweeping changes to the tax law, many of which were unfavorable to real estate investors, but, significantly, retained the HRTC. Under the 1986 Act, the HRTC was adjusted to its current rate of 20 percent of the qualified rehabilitation expenditures incurred in renovating a certified historic building. *See* 26 U.S.C. § 47(a)(2).

In leading a spirited defense of the HRTC on the Senate floor during the passage of the 1986 Act, Senator John Heinz remarked that the HRTC program was "an unqualified success, working just as Congress intended to stimulate investment in our nation's cities and towns to preserve the best of our older buildings." 1331 Cong. Rec. S10940-04, 1985 WL 720617 (1985). Without the HRTC, Senator Heinz stated, "market forces would channel investment away from historic buildings, which would deprive Americans of the economic and cultural benefits of historic preservation." *Id.*

The Congressional report for the 1986 Act specifically discussed the HRTC and echoed Senator Heinz's words by stating:

> The Congress concluded that the incentives granted to rehabilitations in 1981 remain justified. Such incentives are needed because the social and aesthetic values of rehabilitating and preserving older structures are not necessarily taken into account in investor's profit projections. A tax incentive is needed because market forces might otherwise channel

> investments away from such projects because of the extra costs of undertaking rehabilitations of older or historic buildings.

Pub. L. No. 99-514; 99th Congress, H.R. 3838 (Part 2 of 19 Parts); JCS-10-87 *General Explanation of the Tax Reform Act of 1986,* p. 149 (1987). In short, the HRTC was intended by Congress to be a vital component of the economic and decisional analysis of an investor seeking to invest in the rehabilitation of historic property.

Legal guidance from the Internal Revenue Service (the "IRS") also has recognized the important Congressional purpose underlying the HRTC. For example, in October 2000, the IRS issued a legal publication regarding the HRTC entitled *Tax Aspects of Historic Preservation* (October 2000), http://www.IRS.gov/file_source/pub/irs-utl/faqrehab.pdf (last visited January 14, 2013). The publication, which was issued contemporaneously with the closing of the partnership transaction in this case, is presented in question and answer format, and discusses numerous technical issues involving the historic rehabilitation tax credit with citations to the Internal Revenue Code and the Treasury Regulations. One of the questions and answers provides the IRS's analysis and direction for taxpayers with a rehabilitation project identical to the one in this case involving the Historic Boardwalk Hall, LLC, the New Jersey Sports and Exposition Authority (a tax exempt governmental entity), and Pitney Bowes Corporation. Specifically, the IRS states as follows:

> **How can property owned by a tax exempt entity utilize rehabilitation tax credits?**
>
> The rehabilitation tax credit would be of no use to a tax exempt entity. However, in many instances, tax exempt entities are involved in rehabilitation projects by forming a limited partnership and maintaining a minority ownership interest as a general partner. In these situations, the limited partners would be entitled to the rehabilitation tax credit and the tax exempt entity is able to ensure that their organizational goals are being met.

Id. at 1.

It is abundantly clear from the foregoing IRS legal publication that the IRS expressly recognized and encouraged the use of partnerships for HRTC projects involving taxable and tax exempt entities. The IRS's legal position reflected in the publication was consistent with the long-standing Congressional mandate to encourage private investment in the rehabilitation of historic buildings.

As noted above, this case involves the allocation of HRTCs between partners of a partnership. Under Subchapter K of Chapter 1 of Subtitle A of the Internal Revenue Code, a partnership as such is not subject to income tax, but each partner takes into account separately its distributive share of the partnership's items of income, gain, loss, deduction or credit. 26 U.S.C. §§ 701 and 702(a). Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-

level tax. Treas. Reg. § 1.701-2(a). As part of that flexibility, partners are allowed to determine their allocable shares of items of income, gain, loss, deduction and credit of the partnership by agreement of the partners, unless such allocations do not have substantial economic effect. 26 U.S.C. §§ 704(a) and (b).

Congress first defined the term "partnership" for purposes of the federal income tax in Section 1111(a) of the Revenue Act of 1932, and the statutory definition has remained virtually unchanged:

> 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, a corporation or a trust or estate.

26 U.S.C. §§ 761(a) and 7701(a)(2). This definition is intentionally broad and meant to encompass many forms of business or investment association, not just those that are considered partnerships under state law. By regulations effective as of January 1, 1997, the Treasury provided that any domestic limited liability company, such as Historic Boardwalk Hall, LLC, with two or more members, is a partnership unless it elects to be taxed as a corporation. Treas. Reg. §§ 301.7701-3(a) and (b). Under the statutory scheme of the Internal Revenue Code, then, Historic Boardwalk Hall, LLC is a partnership for federal income tax purposes, its members are partners for federal income tax purposes, and the HRTCs are allocated between its partners according to their agreement.

B. The Renovation Of The Historic Boardwalk Hall

The New Jersey Sports and Exposition Authority ("NJSEA") is an instrumentality of the State of New Jersey which was created by the New Jersey Legislature under the Sports Authority Law in 1971. NJSEA was formed to build, own and operate the Meadowlands Sports Complex in East Rutherford, New Jersey. NJSEA's jurisdiction was expanded by the Legislature in 1992 to authorize NJSEA to own and operate the yet to be constructed New Atlantic City Convention Center, and to own and operate the Historic Boardwalk Hall, which is also known as the East Hall. The East Hall is an iconic structure located on the center of the Boardwalk in Atlantic City. In October 1992, the Atlantic City Improvement Authority ("ACIA"), a state agency, leased the East Hall to NJSEA for 35 years at a rental of $1.00 per year.

The construction of the East Hall was completed in 1929. When completed, the East Hall was an architectural marvel. Beginning in 1933, and for decades thereafter, the East Hall was the site of The Miss America Pageant. Legendary musical groups such as the Beatles and the Rolling Stones also performed at the East Hall. The East Hall was listed as a National Historic Landmark by the U.S. Department of Interior (the "DOI") on the National Register of Historic Places on February 27, 1987.

By the mid-1990's, the East Hall had become run down. NJSEA decided that it would renovate the East Hall to bring back its historic luster, and to convert the East Hall to a state-of-the-art, world-class special events facility. The renovations to the East Hall began

in December 1998. The renovations, which were complex and substantial, were completed in four phases with the approval of the DOI.

NJSEA secured public funding for the renovations to the East Hall totaling approximately $90 million. To provide needed additional funding, NJSEA sought an equity investor for the project. A confidential information memorandum (the "Memorandum") was prepared and sent to 19 corporations. The Memorandum described that the renovation project qualified for HRTCs under the Internal Revenue Code.

Four public corporations expressed interest in investing in the rehabilitation of the East Hall. Pitney Bowes Corporation ("Pitney Bowes"), through PB Historic Renovation, LLC ("PBHR"), a limited liability company that it formed, was selected as the investor for the renovation project. Ultimately, the cost of the renovations was about $114 million; the difference between the public funding of $90 million and this greater amount was largely made up by the capital contributed by PHBR.

Historic Boardwalk Hall, LLC ("HBH") was formed as a limited liability company under the laws of New Jersey on June 26, 2000 with NJSEA as its sole member. PBHR acquired a partnership interest in HBH on September 14, 2000. On that date, NJSEA and PHBR signed an Amended And Restated Operating Agreement (the "AREA"). The AREA identified NJSEA and PBHR as the managing member and investor member, respectively, of HBH. Upon PBHR acquiring an interest in HBH, HBH was treated as a partnership for federal income tax purposes under Treas. Reg. §§ 301.7701-2 and 301.7701-3.

The AREA provided that HBH was formed to acquire, develop, finance, rehabilitate, maintain and operate the East Hall as a special events facility. Pursuant to the AREA, PBHR has a 99.9 percent ownership interest in HBH, and NJSEA has a .1 percent interest. All profits, losses, HRTCs, and net cash flows are allocated to the partners under the AREA based on their respective ownership interests.

On September 14, 2000, NJSEA amended its sublease with ACIA for the East Hall to extend the lease term to 2087 for $1.00 rent paid in advance. On the same date, NJSEA and HBH entered into an 87-year lease agreement for the East Hall, which lease was a sale and purchase for federal, state, and local income tax purposes. Pursuant to the lease agreement, HBH acquired the East Hall from NJSEA. HBH paid the purchase price for the East Hall by an acquisition note, secured by a first mortgage on the property. NJSEA also entered into a construction loan agreement with HBH to lend amounts to the partnership from time to time to pay for the completion of the renovations to the East Hall. NJSEA's obligation to lend amounts to HBH was evidenced by a mortgage note and a second mortgage on the property.

PBHR made capital contributions to HBH totaling approximately $19.3 million. PBHR also made an investor loan to the partnership of about $1.2 million. HBH used the capital contributions from PBHR to pay down a portion of the acquisition loan from NJSEA. Under the AREA, PBHR is entitled to an annual preferred return equal to 3 percent of its adjusted capital contribution to HBH.

Pitney Bowes' corporate executives and independent legal counsel conducted an exhaustive due diligence investigation relating to the decision to invest in HBH. Pitney Bowes' investigation included a critical analysis of real estate title, structural, and engineering issues relating to the East Hall; an extensive study of environmental hazards and ways to remediate them; an examination of property, flood, casualty, general liability, crime, and other insurance coverage for the Hall; an analysis of the risks and potential economic returns; and review of bond, tax, corporate, and other legal issues. The nature and thoroughness of Pitney Bowes' due diligence investigation demonstrated its intent to join together with NJSEA as partners in the business operations of HBH.

HBH timely completed the renovations to the East Hall, and its conversion to a special events facility was an unqualified success. HBH opened its own bank accounts, hired and paid employees, and maintained its own books and records of income and expenses. Many first-run entertainers performed at the East Hall after the renovations were completed. The East Hall also became a highly competitive venue for boxing, rivaled only by Las Vegas and Madison Square Garden. The rehabilitated East Hall is once again a source of great pride for the Atlantic City community, and the East Hall has reclaimed its revered status on the Boardwalk.

HBH filed Forms 1065, U.S. Returns of Partnership Income, with the IRS for taxable years 2000, 2001, and 2002. HBH reported qualified rehabilitation expenditures on its Forms 1065 for 2000, 2001, and 2002 under 26 U.S.C. § 47(a)(2), in the amounts of $38,862,877, $68,865,639, and $1,271,482, respectively. *See* App. 105a. The HRTCs

for each of these years were equal to 20 percent of the foregoing qualified rehabilitation expenditures. Pursuant to the AREA and the Internal Revenue Code, PBHR was properly allocated 99.9 percent of the HRTCs.

The IRS audited HBH with respect to its Forms 1065 for 2000, 2001, and 2002. Following the audit, the IRS issued a Notice of Final Partnership Administrative Adjustment (the "FPAA") to NJSEA, as the tax matters partner of HBH, under 26 U.S.C. § 6223(a)(2). The FPAA asserted that "any item of income, loss or separately stated items (expense, deduction or tax credit) reported by Historic Boardwalk Hall, LLC on [its] partnership returns for taxable years 2000, 2001 and 2002" should be reallocated from PBHR to NJSEA. NJSEA filed a timely petition with the United States Tax Court challenging the determinations of the IRS.

C. The Tax Court Opinion

Notwithstanding the clear statement of Congressional intent in sanctioning and encouraging HRTC investments precisely like the renovation project involving HBH, NJSEA, and PBHR, the IRS, in the Tax Court, challenged the allocation of the HRTCs to PBHR on four grounds. Specifically, the IRS asserted that: (i) HBH was a sham and lacked economic substance; (ii) PHBR was not a *bona fide* partner in HBH; (iii) the benefits and burdens of the ownership of the East Hall were not transferred to HBH by NJSEA; and (iv) the formation of HBH violated the partnership anti-abuse provisions of Treas. Reg. § 1.701-2(b).

Following a trial and post-trial briefing, the Tax Court (Judge Joseph Robert Goeke, presiding) issued a 61 page

opinion rejecting all of the IRS's arguments, and held in favor of NJSEA, the tax matters partner for HBH.

D. The Third Circuit's Opinion

The IRS appealed the Tax Court's decision to the Third Circuit. In the Third Circuit, the IRS shifted gears and argued that PBHR is not a *bona fide* partner in HBH as its main contention, choosing not to argue that HBH was a "sham partnership" that did not have economic substance. App. 46a-47a, n. 50. The Third Circuit reversed the Tax Court in an opinion that conflicts with this Court's precedent and decisions of other circuits, does violence to the tax law, and wreaks havoc on thousands of other HRTC projects involving partnership investments totaling billions of dollars.[1]

NJSEA petitioned for a rehearing explaining the court's analysis was indefensible and unquestionably wrong. Among other things, (i) the opinion constituted a holding that a partner who has no right to a return of its capital contribution either directly or indirectly from a partnership nonetheless has no risk with respect to its capital, and therefore is not a partner for federal income tax purposes; (ii) the opinion incorrectly treats the allocation of HRTCs by operation of law as a "sale" or "repayment" of capital from a partnership to a partner; and (iii) the opinion erroneously includes the HRTCs themselves as a component of its "substance over form"

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1. *See Third Annual Report on the Economic Input of the Federal Historic Tax Credit*, at 8 (Rutgers University, July 2012), http://www.nps.gov/tps/tax-incentives/taxdocs/economic-impact-2012-pdf (last visited January 14, 2013)(discussing the substantial positive economic impact of HRTCs and HRTC projects across the country).

analysis, inexplicably finding a partner's entitlement to the HRTCs as a ground for denying them. The petition for rehearing was denied.

REASONS FOR GRANTING THE PETITION

This case involves issues of tax law of exceptional national importance for at least three reasons: First, the Third Circuit's finding that a partner, in this case, PBHR, who has absolutely no right to a return of its capital from the partnership, *i.e.*, HBH, somehow has no risk with respect to its capital, and therefore is not a partner for federal income tax purposes, is undeniably incorrect under the Internal Revenue Code, and squarely conflicts with this Court's holding in *Commissioner v. Culbertson*, 337 U.S. 733 (1949).

Second, the Third Circuit's ruling that the allocation of HRTCs by operation of law from HBH to PBHR should be considered a "sale" or "repayment" of "property" from HBH to PBHR is utterly baseless under the tax law, and is at odds with this Court's holding in *Randall v. Loftsgaarden,* 478 U.S. 647 (1986). Third, the Third Circuit's consideration of the HRTCs themselves as a component of its "substance over form" analysis, which leads to the unfathomable finding that PBHR's entitlement to the HRTCs should itself be used as a basis for denying them, does nothing less that turn the Internal Revenue Code upside down, and stymies the specific Congressional purpose for HRTCs and this Court's long-standing substance over form jurisprudence.

This case should not be viewed as just a tax dispute between NJSEA and the IRS.[2] Indeed, this is the first litigated case in the country in which the IRS has made a sweeping challenge to the allocation of federal HRTCs from a partnership to a partner in the very type of rehabilitation project that formed the basis for Congressional enactment of the HRTC statute. In a true sense, this case represents a dramatic legal clash between the Legislative Branch's clearly-stated intent in enacting the HRTC statute to encourage private investment in the restoration of historic properties, the Executive Branch's enforcement actions directly contrary to that intent, and the Judicial Branch's interpretation of important tax laws that bear broadly on not simply this case but rather thousands of HRTC partnership investment transactions across the nation involving billions of dollars. For all the reasons discussed herein, this Court should grant review.

I. The Third Circuit's Risk Analysis Conflicts With The *Culbertson* Case And Does Violence To The Internal Revenue Code.

The court of appeals found that PBHR was not a valid partner in HBH because PBHR allegedly did not have a meaningful stake in the success or failure of HBH. At the heart of the court's opinion is the legally defective ruling that PBHR was "certain to recoup [its capital] contributions" from HBH because it received the allocation of the HRTCs from the partnership. App.

2. NJSEA provided a tax indemnity (tied to certain revenue sources) to Pitney Bowes for any tax, penalties, and interest that may be due as a result of a successful IRS challenge to the HRTC project. Hence, the taxpayers of New Jersey are the ultimate payors if the court of appeals' flawed decision is not corrected.

63a. On the basis of this egregious misapplication of federal tax law, the Third Circuit held that PBHR had no downside risk and therefore was not a partner in HBH. No other court in the country has ever made the broad and unsupportable legal ruling of the Third Circuit. Unless corrected, it will have a catastrophic effect on innumerable HRTC partnership investment projects, as well as other partnerships.

The Third Circuit's ruling is in direct conflict with this Court's holding in *Commissioner v. Culbertson*, 337 U.S. 733 (1949). Under *Culbertson*, a partnership exists if, based on the totality of the facts and circumstances, it is determined that "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." *Id*. at 742. The question that *Culbertson* asks is simply whether under all the facts the parties intended to conduct a business together and share in the profits and losses therefrom. *Id*. at 741.[3]

In considering the "totality of the facts and circumstances" analysis under *Culbertson*, the Third Circuit first looked to the case of *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006), which is known as the *Castle Harbour* case, and its particular interpretation of *Culbertson*. In applying *Castle Harbour* to the case at hand, however, the court makes the fundamental error of treating the allocation of HRTCs as a repayment of capital by HBH to PBHR. In doing so, the court subverts the *Culbertson* analysis entirely, by making the results dictate the analysis itself.

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3. The Tax Court found that PHBR was a partner in HBH based on a *Culbertson* analysis. *See* App. 121a-26a.

In *Castle Harbour*, a subsidiary of General Electric Capital Corporation ("GECC"), *i.e.*, TIFD III-E, Inc., formed an eight-year partnership (Castle Harbour) with two Dutch banks with the intention of allocating 98 percent of the partnership's operating income away from GECC to the (tax indifferent) Dutch banks. Although the Dutch banks were allocated 98 percent of the operating income under the partnership agreement, TIFD had the unilateral right to reduce the banks' percentage participation from 98 percent to 1 percent and to transfer the partnership's profits to a different entity for TIFD's own benefit, thereby essentially eliminating the banks' ability to profit from the partnership. *Id.* at 229, 235.

Further, under the Castle Harbour partnership agreement and related documents, the Dutch banks were entitled to receive cash distributions from the partnership equal to their original capital contributions to the partnership, plus a guaranteed annual return of approximately 9 percent. *Id.* at 226-27. These distribution rights were payable to the banks regardless of the profitability of Castle Harbour, and were guaranteed in full by GECC.

The *Castle Harbour* court found that the Dutch banks had no downside risk because they were entitled to the distributions from the partnership regardless of Castle Harbour's profitability, and were furthered protected by the GECC guarantees. The Dutch banks had no upside potential because of the managing partner's ability to restrict the banks' right to profits of the venture by assigning assets away from the partnership. *Id.* at 224. At bottom, the Second Circuit's holding in *Castle Harbour* was based on its finding that the Dutch banks' interest in

the partnership was closer to that of a secured creditor rather than a partner. *Id.* at 241. That is, the intent of the parties was to create a debtor-creditor relationship, not a joint business enterprise. Unlike *Castle Harbour*, the IRS concedes in this case that PBHR's investment in HBH was not debt. App. 58, n. 53. Thus, the very core of the Second Circuit analysis that the Dutch banks' partnership investment should be recharacterized as a debtor relationship has no application herein.

The Second Circuit's formula for analyzing downside risk under its application of *Culbertson* is based squarely on the *partner's* risk in receiving the return of its capital in cash distributions *from the partnership*. The court found that under the *Castle Harbour* partnership agreement the Dutch banks were entitled to a repayment of their capital, together with an annual rate of return of 9 percent, *from the partnership*. Thus, the court concluded that the Dutch banks' were not partners because the partnership agreement required *the partnership* to repay the capital to the banks.

Based on the foregoing discussion of *Castle Harbour*, the conflict in the Third Circuit's holding with *Culbertson* is remarkably obvious for two reasons. First, PBHR made a capital contribution of $19.3 million to HBH. PBHR's capital contribution was clearly consistent with the express Congressional purpose in enacting 26 U.S.C. § 47, namely, to encourage private investment in the rehabilitation of historic buildings by providing tax credits to make such investments economically profitable. The nature of the PBHR's investment and the HBH transaction itself is wholly unlike *Castle Harbour*, where, contrary to legislative intent, partnership tax rules were

used to assign taxable income away from a United States taxpayer to foreign taxpayers.

Second, unlike the Dutch banks in *Castle Harbour*, PBHR has *no* right under the AREA to receive, or to compel HBH to repay, all or any part of its capital contribution. PHBR has the right to earn the 3 percent preferred return from HBH under the AREA, but payment of the preferred return is subject to HBH's cash flows and is not therefore guaranteed. Thus, PBHR is at risk for its entire $19.3 million capital contribution to HBH. This "downside risk" shows a clear intent of PBHR to share in the losses of HBH with NJSEA. To say that PBHR is not a partner in HBH directly contradicts *Culbertson*.

Relying on *Castle Harbour*, the Third Circuit wrongfully treated the *allocation* of HRTCs to PBHR *by operation of law*, *i.e.*, under the Internal Revenue Code, as a *repayment of capital* to PBHR by HBH. *See, e.g.,* App. 63a, 68a. In other words, the court incorrectly found that the allocation of the HRTCs to PBHR under 26 U.S.C. §§ 701, 702, and 704 constituted *a repayment* of capital to PBHR by HBH, and that this allocation was no different than the partnership's guaranteed cash repayment of capital to the Dutch banks in *Castle Harbour*.

HBH did not "possess" or "own" the HRTCs, and it neither transferred nor paid them to PBHR. As shown above, the "*Culbertson* risk analysis" looks to the relationship between the partner (*e.g.,* the Dutch banks in *Castle Harbour*) and the partnership and asks whether the circumstances requiring repayment of capital to the partner by the partnership were consistent with the intent

of partners in a partnership. In *Castle Harbour*, the court found that the partnership agreement mandated the partnership's repayment of capital to the Dutch banks, so the Dutch banks were creditors, not partners. Here, PBHR received the benefit of the HRTCs *from the United States Treasury* by operation of law. Under *no* circumstances could this federal tax benefit be considered a payment or transfer to PBHR by HBH, or by NJSEA. Because the *Culbertson* analysis, as applied in *Castle Harbour,* looks to the relationship between the partner (here, PBHR) and the partnership (HBH), the only relevant inquiry is the risk that PBHR bears with respect to recovery of its capital investment from HBH. PBHR's entire capital contribution of $19.3 million was and remains at risk to the operations of HBH. Thus, PBHR shares in the losses of HBH, under both *Culbertson* and *Castle Harbour*, and is a true partner in the partnership.

II. HRTCs Are Tax Benefits From The United States Treasury And Are Not "Property" That Can Be "Transferred" Or "Sold."

The Third Circuit's clear misapplication of *Culbertson* and *Castle Harbour* illustrates the second reason to grant the petition: the disregard of this Court's precedent regarding whether a federal tax benefit is property for tax purposes. This disregard is evident in the Third Circuit's reliance on *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011). The Third Circuit's focus on *Virginia Historic* is odd to say the least, because the Fourth Circuit did not even address the *Culbertson* analysis in its decision. In fact, the Fourth Circuit assumed that the purported partners were valid partners for purposes of its analysis. A review of the

Third Circuit's reliance on *Virginia Historic* shows just how dangerously far from *Culbertson* the Third Circuit has strayed, and how cavalierly it reaches the conclusion that HRTCs are property for federal income tax purposes.

The issue in *Virginia Historic* was whether the simultaneous transfers of cash by partners in a partnership in exchange for *state law* historic rehabilitation tax credits were income generating "disguised" sales for federal income tax purposes under 26 U.S.C. § 707, thereby resulting in federal taxable income to the partnership.[4] *Virginia Historic* involved a tiered partnership structure in which investment funds (the "Funds") were created to become .01 percent limited partners in an historic property development partnership in Virginia. In 1999, the Funds purchased Virginia state historic tax credits, which was permitted by Virginia in that year alone. In subsequent years, the Funds made capital contributions to the historic development partnership and received a disproportionate allocation of the Virginia state historic tax credits, as allowed by Virginia tax law.

The Fourth Circuit concluded under the particular facts in *Virginia Historic* that the *state* tax credits therein constituted "property" for purposes of applying the federal disguised sale rules under 26 U.S.C. § 707. Ultimately, the court found that the transfer of the state tax credits resulted in a disguised sale under this statute.[5]

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4. The disguised sale rules in 26 U.S.C. § 707 were not raised by the IRS at any time in the HBH case.

5. As noted above, in *Virginia Historic,* the Fourth Circuit expressly did not decide whether the investors in the Funds were *bona fide* partners. Rather, the court assumed that a

The Fourth Circuit's opinion in *Virginia Historic* quite clearly turns on the determination that Virginia state historic rehabilitation tax credits are "property" for purposes of applying the federal disguised sale rules under 26 U.S.C. § 707. *Id.* at 140-42. The partnership in *Virginia Historic* correctly raised this issue as a necessary element to the IRS's analysis in imputing income to the partnership:

> The Funds argue that § 707 cannot be applied to recharacterize their transactions with investors because these transactions did not involve an exchange of money for "property." Specifically, they argue that Virginia's historic rehabilitation tax credits are not "property" because they are nontransferable and non-heritable under state law. There was thus, they argue, no "transfer of money or other property" from the Funds to the investors. *See* I.R.C. § 707(a)(2)(B)(ii) … Finding it necessary to our § 707 analysis, however, we consider it for the first time on appeal.

Id. at 140.

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valid partnership existed as a necessary condition precedent to applying 26 U.S.C. § 707's disguised sale rules. The Third Circuit disputed NJSEA's argument that the court in *Virginia Historic* assumed that a valid partnership existed in order to apply the disguised sale provisions. App. 61a, n. 54. The Fourth Circuit, however, made clear that this is precisely what it did. Indeed, the court stated: "*Assuming, without deciding, that a 'bona fide' partnership existed,* we nevertheless find that the [IRS] properly recharacterized the transactions as 'sales' under I.R.C. § 707." *Id.* at 137. (emphasis added).

Finding it necessary to determine whether *state* tax credits are "property" for federal income tax purposes, the Fourth Circuit then devoted two pages of its opinion to analyzing "whether [Virginia's historic rehabilitation tax credits] embody some of the most essential property rights," including "the right to use the property, to receive income produced by it, and to exclude others from it," and "the breadth of the control the taxpayer could exercise over the property." *Id.* at 141 (citations and internal quotations omitted). The court then reviewed these essential rights, and found that the state tax credits were property for purposes of the disguised sale rules of 26 U.S.C. § 707, and so could be transferred.[6]

The Third Circuit, purporting to rely on *Virginia Historic*, wrongfully holds that federal HRTCs are property that were transferred to PBHR by HBH (which is impossible as a matter of law), or were sold to PBHR by HBH (which is equally impossible). *See, e.g.,* App. 62a, n. 54, 63a, 68a. This holding is a key to the Third Circuit's *Culbertson* analysis. If HBH were obligated to transfer or sell property (in the form of the HRTCs) to PBHR, or to pay cash if it did not fulfill that obligation, then PBHR's position would be much closer to that of the Dutch banks in *Castle Harbour:* lenders that had no intent to put their capital contribution to the risk of the enterprise, and that had legal recourse for the return of the capital from the enterprise. In reaching its conclusion, the Third Circuit elided the critical steps of analyzing whether federal HRTCs are "property" for purposes of the *Culbertson*

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6. The Fourth Circuit appears to have equated, the *allocation* of tax attributes with a *transfer* of those attributes, an equation that appears nowhere in the tax law.

analysis and whether the allocation of HRTCs pursuant to 26 U.S.C. §§ 702 and 704 is a "transfer" or "sale" of the HRTCs.

By skipping these steps, and assuming the answers without any analysis, the Third Circuit creates extraordinary new law for federal tax attributes that has never before existed, and cannot be found in any case, statute, IRS ruling or other legal authority. No supporting precedent exists for the court's ruling because it is so fundamentally contrary (and damaging) to established federal income tax law, which has *never* held that the allocation of a federal tax attribute to a partner under the Internal Revenue Code constitutes a transfer of the attribute to the partner by the partnership, or that a federal tax benefit is property which can be bought and sold.

The Third Circuit's opinion is in direct conflict with this Court's ruling in *Randall v. Loftsgaarden,* 478 U.S. 647 (1986). There, the Court ruled that the receipt of a federal tax benefit, such as a deduction or credit, is *not* a taxable event that transfers money or other property to the recipient. *Id.* at 656-57. In finding that the HRTCs are "property" that were "sold" or "repaid" to PBHR by HBH, the Third Circuit is squarely at odds with established precedent of this Court and universally accepted principles of tax law. On the basis of *Randall* and the other authorities discussed herein, this Court should grant review.

III. A Partner's Entitlement To Congressionally-Mandated Federal HRTCs Should Not Be Considered As Part Of The Analysis Which Denies Those Very HRTCs.

In a more general sense, the Third Circuit applied a "substance over form" analysis to determine whether PBHR was a *bona fide* partner in HBH. App. 46a-47a, n. 50. The driving consideration in the court's ruling that PBHR was not a partner in HBH was PBHR's entitlement to the HRTCs. In other words, the court based its holding that PBHR had no downside risk, and therefore was not in substance a partner in HBH, on its determination that the allocation of the HRTCs to PBHR was a "repayment" of its capital contribution by the partnership.

The substance over form doctrine has its roots in *Gregory v. Helvering,* 293 U.S. 465 (1935). In *Gregory,* the Court expressed the time for application of substance over form as follows: "But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." *Id.* at 469. What was done in this case was that PBHR, a taxpayer, invested $19.3 million in the renovation of the East Hall, an irreplaceable part of our country's cultural history. This investment was precisely what Congress intended in enacting the HRTC statute, namely, encouraging and allowing private investors to receive allocation of the HRTCs under the tax law. By using the HRTCs themselves as the linchpin of its substance over form analysis disallowing the HRTCs, the Third Circuit has done exactly what Congress did not intend.

There can be no dispute that the Congressionally established and sanctioned HRTCs themselves cannot be taken into account as a key component of the analysis which denies a taxpayer those very tax attributes. Stated differently, when the substance over form doctrine is applied, the analysis must be performed without taking into account the actual federal tax benefits in question, because the entitlement to those tax benefits is the issue to be determined. By way of analogy, in cases involving the ownership of real property, courts typically invoke the "benefits and burdens of ownership" test. In doing so, courts do *not* include the right to receive the tax attributes of an owner, *i.e.*, depreciation, interest expense, and investment tax credits, as part of the analysis of whether the benefits and burdens of ownership have been transferred from one party to another. *See, e.g.*, *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1242-43 (1981); *Harmston v. Commissioner*, 61 T.C. 216, 228 (1973), *aff'd*, 528 F.2d 55 (9th Cir. 1976). The reason that courts do not consider the tax benefits as part of their benefits and burdens of ownership analysis is because the very question to be decided is which party is entitled to the tax benefits.[7]

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7. The IRS has made the precise point that tax benefits should not be taken into account in rulings guidelines that it has issued for determining the ownership of property subject to a leveraged lease. For example, in Rev. Proc. 75-21, 1975-1 C.B. 715, Condition (6) of the guidelines states: "The lessor must represent and demonstrate that it expects to receive a profit from the transaction, *apart from the value of or benefits obtained from the tax deductions, allowances, credits and other tax attributes arising from such transaction.*" (emphasis added). The reason for excluding the value of the tax benefits in the foregoing analysis is obvious: the ruling being requested from the IRS is that the lessor-requestor is entitled to the tax benefits.

Similarly, it makes absolutely no sense (and was wrong) for the Third Circuit to have taken the HRTCs into account in determining whether the business arrangement among PBHR, NJSEA, and HBH is a valid partnership for federal income tax purposes, because of the aim of the substance over form analysis is to determine who is entitled to the tax credits. To put it bluntly, the court, in its opinion, assumed that PBHR was entitled to the tax credits in order to determine that PBHR was *not* entitled to the credits. This illogical and meritless ruling has vast and harmful consequences to innumerable HRTC partnership investment projects throughout the country, and to the tax law as a whole. Indeed, when Congress enacts tax benefits, such as HRTCs, to purposely motivate investor conduct, it clearly does not expect that the courts will use those very tax benefits as a ground for denying them.

CONCLUSION

For all the foregoing reasons, the petition for writ of certiorari should be granted.

Respectfully submitted,

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January 17, 2013

APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS, THIRD CIRCUIT, FILED AUGUST 27, 2012

UNITED STATES COURT OF APPEALS,
THIRD CIRCUIT

No. 11-1832

HISTORIC BOARDWALK HALL, LLC, NEW JERSEY SPORTS AND EXPOSITION AUTHORITY, TAX MATTERS PARTNER

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant.

Argued June 25, 2012
Filed August 27, 2012

Before: SLOVITER, CHAGARES, and JORDAN, Circuit Judges.

OPINION OF THE COURT

JORDAN, Circuit Judge

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This case involves the availability of federal historic rehabilitation tax credits ("HRTCs") in connection with the restoration of an iconic venue known as the "East Hall" (also known as "Historic Boardwalk Hall"), located on the boardwalk in Atlantic City, New Jersey. The New Jersey Sports and Exposition Authority ("NJSEA"), a state agency which owned a leasehold interest in the East Hall, was tasked with restoring it. After learning of the market for HRTCs among corporate investors, and of the additional revenue which that market could bring to the state through a syndicated partnership with one or more investors, NJSEA created a New Jersey limited liability company, Historic Boardwalk Hall, LLC ("HBH"), and subsequently sold a membership interest in HBH[1] to a

1. An LLC "offers the best of both worlds—the limited liability of a corporation and the favorable tax treatment of a partnership." C*anterbury Holdings, LLC v. Comm'r*, 98 T.C.M. (CCH) 60, 61 n.1 (2009). Generally, an LLC is a pass-through entity that does not pay federal income tax. *See* I.R.C. § 701; Treas. Reg. § 301.7701-3(a). Rather, profits and losses "pass through" the LLC to its owners, called members, who pay individual income tax on their allocable shares of the tax items. *See* I.R.C. §§ 701-04, 6031. Although an LLC with just one owner is, for tax purposes, disregarded as an entity separate from its owner for tax purposes, an LLC with two or more members is classified as a partnership for tax purposes unless it elects to be treated as a corporation. Treas. Reg. § 301.7701-3(b)(1). Once HBH, as a duly formed New Jersey limited liability company, had two members, it did not elect to be treated as a corporation and thus was classified as a partnership for tax purposes for the tax years in which it had more than one member. Thus, as the parties do, we refer to HBH as a partnership when analyzing whether one of its stated members was a bona fide partner.

wholly-owned subsidiary of Pitney Bowes, Inc. ("PB").[2] Through a series of agreements, the transactions that were executed to admit PB as a member of HBH and to transfer ownership of NJSEA's property interest in the East Hall to HBH were designed so that PB could earn the HRTCs generated from the East Hall rehabilitation. The Internal Revenue Service ("IRS") determined that HBH was simply a vehicle to impermissibly transfer HRTCs from NJSEA to PB and that all HRTCs taken by PB should be reallocated to NJSEA.[3] The Tax Court disagreed, and sustained the allocation of the HRTCs to PB through its membership interest in HBH. Because we agree with the IRS's contention that PB, in substance, was not a bona fide partner in HBH, we will reverse the decision of the Tax Court.

I. Background

A. *Background of the HRTC Statute*

We begin by describing the history of the HRTC statute. Under Section 47 of the Internal Revenue Code

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2. PB's membership interest in HBH was through PB Historic Renovations, LLC, whose sole member was Pitney Bowes Credit Corp. At all relevant times, Pitney Bowes Credit Corp. was a wholly-owned subsidiary of PB. For ease of reference, we will refer to PB Historic Renovations, LLC, Pitney Bowes Credit Corp., and PB as "PB."

3. The alphabet-soup of acronyms in this case is perhaps beyond parody, but the acronyms are a more efficient means of referring to various corporate and state entities, as well as the tax credits and other concepts, so we reluctantly fall into the soup.

of 1986, as amended (the "Code" or the "I.R.C."), a taxpayer is eligible for a tax credit equal to "20 percent of the qualified rehabilitation expenditures ["QREs"[4]] with respect to any certified historic structure.[5] "I.R.C. § 47(a)(2). HRTCs are only available to the owner of the property interest. *See generally* I.R.C. § 47; *see also* I.R.S. Publication, *Tax Aspects of Historic Preservation*, at 1 (Oct. 2000), *available at* http://www.irs.gov/pub/irs-utl/faqrehab.pdf. In other words, the Code does not permit HRTCs to be sold.

The idea of promoting historic rehabilitation projects can be traced back to the enactment of the National Historic Preservation Act of 1966, Pub. L. No. 89-665, 80 Stat. 9156 (1966), wherein Congress emphasized the

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4. The Code defines a QRE as:

> [A]ny amount properly chargeable to [a] capital account—(i) for property for which depreciation is allowable under [I.R.C. §] 168 and which is—(I) nonresidential real property, (II) residential real property, (III) real property which has a class life of more than 12.5 years, or (IV) an addition or improvement to property described in subclause (I), (II), or (III), and (ii) in connection with the rehabilitation of a qualified rehabilitated building.

I.R.C. § 47(c)(2)(A).

5. The Code defines a "certified historic structure" as "any building (and its structural components) which—(i) is listed in the National Register, or (ii) is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary as being of historic significance to the district." I.R.C. § 47(c)(3).

importance of preserving "historic properties significant to the Nation's heritage," 16 U.S.C. § 470(b)(3). Its purpose was to "remedy the dilemma that 'historic properties significant to the Nation's heritage are being lost or substantially altered, often inadvertently, with increasing frequency.'" *Pye v. United States*, 269 F.3d 459, 470 (4th Cir. 2001) (quoting 16 U.S.C. § 470(b)(3)). Among other things, the National Historic Preservation Act set out a process "which require[d] federal agencies with the authority to license an undertaking 'to take into account the effect of the undertaking on any ... site ... that is ... eligible for inclusion in the National Register' prior to issuing the license." *Id*. (quoting 16 U.S.C. § 470f). It also authorized the Secretary of the Interior to "expand and maintain a National Register of Historic Places." 16 U.S.C. § 470a(a)(1)(A).

The Tax Reform Act of 1976 furthered the goals of the 1966 legislation by creating new tax incentives for private sector investment in certified historic buildings. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976). The pertinent provisions of the 1976 Act indicate that Congress wanted to encourage the private sector to restore historic buildings, and, to provide that encouragement, it established incentives that were similar to the tax incentives for building new structures. *See, e.g.*, 122 Cong. Rec. 34320 (1976). Specifically, to equalize incentives affecting the restoration of historic structures and the construction of new buildings, it included a provision allowing for the amortization of rehabilitation expenditures over five years, or, alternatively, an accelerated method of depreciation with respect to the

entire depreciable basis of the rehabilitated property. *See* I.R.S. Publication, *Rehabilitation Tax Credit*, at 1-2 (Feb. 2002), *available at* http://www.irs.gov/pub/irs-mssp/rehab.pdf (hereinafter referred to as "*IRS-Rehab*").

The Revenue Act of 1978 went further to incent the restoration of historic buildings. It made a 10% rehabilitation credit available in lieu of the five-year amortization period provided by the 1976 Act. *See* Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (1978); *see also IRS-Rehab*, at 1-2. In 1981, Congress expanded the rehabilitation credit to three tiers, so that a taxpayer could qualify for up to a 25% credit for certain historic rehabilitations. *See* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981); *see also IRS-Rehab*, at 1-2.

The Tax Reform Act of 1986 made extensive changes to the tax law, including the removal of many tax benefits that had been available to real estate investors. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986); *see also* Staff of J. Comm. on Tax'n, 99th Cong., *General Explanation of the Tax Reform Act of 1986* (Comm. Print. 1987) (hereinafter referred to as "*General Explanation of TRA 86*"). The HRTC survived, although it was reduced to its modern form of a two-tier system with a 20% credit for QREs incurred in renovating a certified historic structure, and a 10% credit for QREs

incurred in renovating a qualified rehabilitated building[6] other than a certified historic structure. *See* Tax Reform Act of 1986 § 251, 100 Stat. at 2183; *see also* I.R.C. § 47. A Congressional report for the 1986 Act discussed the rationale for keeping the HRTC:

> In 1981, the Congress restructured and increased the tax credit for rehabilitation expenditures [because it] was concerned that the tax incentives provided to investments in new structures (*e.g.*, accelerated cost recovery) would have the undesirable effect of reducing the relative attractiveness of the prior-law incentives to rehabilitate

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6. The Code defines a "qualified rehabilitated building" as:

> [A]ny building (and its structural components) if—(i) such building has been substantially rehabilitated, (ii) such building was placed in service before the beginning of the rehabilitation, (iii) in the case of any building other than a certified historic structure, in the rehabilitation process—(I) 50 percent or more of the existing external walls of such building are retained in place as external walls, (II) 75 percent or more of the existing external walls of such building are retained in place as internal or external walls, and (III) 75 percent or more of the existing internal structural framework of such building is retained in place, and (iv) depreciation (or amortization in lieu of depreciation) is allowable with respect to such building.
>
> I.R.C. § 47(c)(1)(A). Additionally, "[i]n the case of a building other than a certified historic structure, a building shall not be a qualified rehabilitated building unless the building was first placed in service before 1936." *Id.* § 47(c)(1)(B).

and modernize older structures, and might lead investors to neglect older structures and relocate their businesses.

The Congress concluded that the incentives granted to rehabilitations in 1981 remain justified. Such incentives are needed because the social and aesthetic values of rehabilitating and preserving older structures are not necessarily taken into account in investors' profit projections. A tax incentive is needed because market forces might otherwise channel investments away from such projects because of the extra costs of undertaking rehabilitations of older or historic buildings.

General Explanation of TRA 86, at 149.

Evidently mindful of how the tax incentives it had offered might be abused, Congress in 2010 codified the "economic substance doctrine," which it defined as "the common law doctrine under which tax benefits ... with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose."[7] I.R.C. § 7701(o)(5)(A). At the same

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7. Specifically, the codification of the economic substance doctrine provides:

> In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if ... (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

time, however, Congress was at pains to emphasize that the HRTC was preserved. A Congressional report noted:

> If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed. ... Thus, for example, it is not intended that a tax credit (e.g., ... section 47[, which provides for HRTCs,] ...) be disallowed in a transaction pursuant to which, *in form and substance*, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.

Staff of J. Comm. on Tax'n, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, In Combination with the "Patient Protection and Affordable Care Act,"* at 152 n.344 (Comm. Print 2010) (emphasis added). In sum, the HRTC statute is a deliberate decision to skew the neutrality of the tax system to encourage taxable entities to invest, both in form and substance, in historic rehabilitation projects.

I.R.C. § 7701(o)(1). Section 7701(o) applies to all transactions entered into after March 30, 2010. Thus, the common-law version of the economic substance doctrine, and not § 7701(o), applies to the transaction at issue here.

B. *Factual Background of the East Hall Renovation*

1. *NJSEA Background*

In 1971, the State of New Jersey formed NJSEA to build, own, and operate the Meadowlands Sports Complex in East Rutherford, New Jersey. The State legislature expanded NJSEA's jurisdiction in 1992 to build, own, and operate a new convention center in Atlantic City and to acquire, renovate, and operate the East Hall. Completed in 1929, the East Hall was famous for hosting the annual Miss America Pageant, and, in 1987, it was added to the National Register of Historic Places as a National Historic Landmark.

In October 1992, before renovations on the East Hall began, NJSEA obtained a 35-year leasehold interest in the property for $1 per year from the owner, the Atlantic County Improvement Authority. About a month later, NJSEA entered into an agreement with the Atlantic City Convention Center Authority, the then-operator of the East Hall, to operate both the East Hall and the new convention center. In July 1995, NJSEA and the Atlantic City Convention Center Authority handed over management responsibility for both the East Hall and the yet-to-be-completed convention center to a private entity, Spectacor Management Group ("Spectacor").

2. *Commencement of the East Hall Renovation*

Once construction started on the new convention center in the early 1990s, NJSEA began planning for the future of the East Hall and decided to convert it into

a special events facility. That conversion was initially anticipated to cost $78,522,000. Renovations were to be performed in four phases, with the entire project expected to be completed in late 2001.

The renovation project began in December of 1998. By that time, NJSEA had entered into agreements with the New Jersey Casino Reinvestment Development Authority[8] pursuant to which the Casino Reinvestment Development Authority agreed to reimburse NJSEA up to $4,146,745 for certain pre-design expenses and up to $32,574,000 for costs incurred in the East Hall renovation. In a March 1999 document prepared in connection with a separate bond issuance,[9] NJSEA noted that it had received grants from the Casino Reinvestment Development Authority to pay for the first phase of the East Hall renovation and that "[f]unding for the remaining cost of the project ... is expected to be obtained through the issuance by [NJSEA] of Federally Taxable State Contract Bonds." (J.A. at 708.) In June 1999, NJSEA issued $49,915,000 in State Contract Bonds to fund the East Hall renovation.

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8. The Casino Reinvestment Development Authority, as described by the Tax Court, "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." (Joint Appendix ("J.A.") at 11 n.4.)

9. The proceeds from that bond issuance by NJSEA, described as the 1999 Luxury Tax Bonds, were not directly applied to the East Hall renovation. Rather, the 1999 Luxury Tax Bonds were issued to effect the refunding of certain amounts from an earlier bond issuance.

The first two phases of the renovation were completed prior to the Miss America Pageant held in September 1999, and Phase 3 began the following month. Through 1999, NJSEA had entered into rehabilitation contracts for approximately $38,700,000, and had expended $28,000,000 of that amount. Also at about that time, the estimate of the total cost of the project increased to $90,600,000. NJSEA's 1999 annual report stated that the Casino Reinvestment Development Authority had agreed to reimburse NJSEA for "all costs in excess of bond proceeds for the project." (*Id*. at 1714.) Thus, by the end of 1999, between the proceeds it had received from the bond issuance and funds provided—or to be provided—by the Casino Reinvestment Development Authority, NJSEA had assurances that the East Hall rehabilitation project was fully funded.

3. *Finding a Partner*

a) *The Proposal from Sovereign Capital Resources*

In August 1998, a few months prior to the beginning of renovations on the East Hall, Paul Hoffman from Sovereign Capital Resources ("Sovereign")[10] wrote to NJSEA regarding a "consulting proposal ... for the sale of the historic rehabilitation tax credits expected to be generated" by the East Hall rehabilitation. (*Id*. at 691.) That proposal was "designed to give [NJSEA

10. Sovereign describes itself as "a boutique consulting firm that facilitates equity financing and offers financial advisory services for historic rehabilitation ... tax credit transactions." (J.A. at 696.)

representatives] a better perspective on the structure of the historic tax credit sale, as well as the [potential] financial benefits (estimated in excess of $11 million) to the project." (*Id.*) As an initial summary, Hoffman stated that "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." (*Id.*) Hoffman noted that although NJSEA, as a tax-exempt entity, would have no use for the 20% federal tax credit generated by QREs incurred in renovating historic structures, there were "entities that actively invest in [HRTC] properties ... and are generally Fortune 500 corporations with substantial federal income tax liabilities." (*Id.* at 692.) Hoffman explained that because "[t]he [HRTC] is earned when the building is placed into service" and "cannot be transferred after the fact," "the corporate investor should be admitted into the partnership that owns the project as soon as possible." (*Id.*)

Hoffman next sketched out the proposed transactions that would allow NJSEA to bring an investor interested in HRTCs into co-ownership of the East Hall and yet provide for NJSEA to "retain its long-term interests in the [East Hall]." (*Id.* at 693.) First, NJSEA would sublease its interest in the East Hall to a newly created partnership in which NJSEA would be the general partner and a corporate investor would be the limited partner. The sublease agreement would be treated as a sale for tax purposes since the sublease would extend longer than the useful life of the property under tax rules. Next, that partnership would allocate 99% of its profit and loss to the

limited partner corporate investor so that such investor could claim substantially all of the tax credits, but only be allocated a "small portion" of the cash flow. (*Id.* at 694.) Finally, after a sufficient waiting period, NJSEA would be given a purchase option to buy-out the corporate investor's interest. With all that said, however, Hoffman warned that "[c]orporate purchasers of [HRTCs] rarely accept construction risk," and "[t]ypically ... provide no more than 10% of their equity to the partnership during the construction period." (*Id.* at 695.) Thus, Hoffman "recommend[ed] that NJSEA plan to issue enough bonds to meet the construction financing requirements of the project." (*Id.*)

Hoffman then provided a valuation of the HRTCs. He estimated that NJSEA could expect an investor to contribute approximately $0.80 to $0.90 per each dollar of HRTC allocated to the investor. In valuing the HRTCs, Hoffman "assume[d] that NJSEA would like to minimize the cash distribution to the investor and retain long-term ownership of [the East Hall]." (*Id.*) He also listed four "standard guarantees" that "[i]nvestors in the tax credit industry" would "require" as part of the transaction: (1) a construction completion guaranty; (2) an operating deficit guaranty; (3) a tax indemnity; and (4) an environmental indemnity. (*Id.* at 696.) Additionally, Hoffman noted that "the investor will expect that either NJSEA or the State of New Jersey be obligated to make debt service on the bond issuance if operating revenue is insufficient to support the debt payments." (*Id.*)

NJSEA decided to further explore the benefits described by Sovereign. In March 1999, NJSEA issued a request for proposal (as supplemented by an addendum on April 30, 1999, the "RFP") from "qualified financial advisors ... in connection with a proposed historic rehabilitation tax credit transaction ... relating to the rehabilitation of the East Hall." (*Id*. at 710.) The RFP provided that the selected candidate would "be required to prepare a Tax Credit offering Memorandum, market the tax credits to potential investors and successfully close a partnership agreement with the proposed tax credit investor." (*Id*. at 721.) In June 1999, after receiving four responses, NJSEA selected Sovereign as its "[f]inancial [a]rranger" for the "Historic Tax Credit transaction." (*Id*. at 750.)

b) *The Initial and Revised Five-Year Projections*

In September 1999, as the second phase of the East Hall renovation had just been completed, Spectacor, as the East Hall's operator, produced draft five-year financial projections for the East Hall beginning for the 2002 fiscal year.[11] Those projections estimated that the East Hall would incur a net operating loss of approximately $1.7 million for each of those five years. Sovereign received a copy of the projections, and, in a memo dated October 1, 1999, responded that it was "cautious about [Spectacor's] figures as they might prove excessively conservative."

11. Because it was projected that the East Hall renovation would be completed in late 2001, fiscal year 2002 was anticipated to be the East Hall's first full year of operations.

(*Id*. at 793.) In a December 10, 1999 memo to NJSEA representatives, Sovereign said that, for the yet-to-be-created partnership between NJSEA and an HRTC investor to earn the desired tax credits, the partnership "should be able to reasonably show that it is a going concern."[12] (*Id*. at 804.) To that end, Sovereign suggested that "[t]o improve the operating results, NJSEA could explore shifting the burden of some of the operating expenses from the [partnership] to the Land Lessor (either [the Atlantic County Improvement Authority] or NJSEA depending upon [how the partnership was structured])." (*Id*.)

Approximately two months later, Sovereign received revised estimates prepared by Spectacor. Those pro forma statements projected much smaller net operating losses, ranging from approximately $396,000 in 2002 to $16,000 in 2006. Within two weeks, Spectacor made additional revisions to those projections which resulted in estimated net operating income for those five years, ranging from approximately $716,000 in 2002 to $1.24 million in 2006. About 90% of the remarkable financial turnaround the East Hall thus was projected to enjoy on paper was due to the removal of all projected utilities expenses for each of the five years ($1 million in 2002, indexed for 3% inflation each year thereafter). When the

12. A "going concern" is "[a] commercial enterprise actively engag[ed] in business with the expectation of indefinite continuance." Black's Law Dictionary 712 (8th ed. 2004). Evidently and understandably, Sovereign viewed year after year of large losses from the operations of the East Hall as inconsistent with an ordinary expectation of indefinite continuance.

accountants for the project, Reznick, Fedder & Silverman ("Reznick"), included those utilities expenses in their compiled projections one week later, Sovereign instructed them to "[t]ake [the] $1MM Utility Cost completely out of Expenses, [because] NJSEA [would] pay at [the] upper tier and [then] we should have a working operating model." (*Id*. at 954.)

c) *Confidential Offering Memorandum*

On March 16, 2000, Sovereign prepared a 174-page confidential information memorandum (the "Confidential Memorandum" or the "Memo") which it sent to 19 potential investors and which was titled "The Sale of Historic Tax Credits Generated by the Renovation of the Historic Atlantic City Boardwalk Convention Hall." (*Id*. at 955.) Although the executive summary in the Confidential Memorandum stated that the East Hall renovation would cost approximately $107 million, the budget attached to the Memo indicated that the "total construction costs" of the project were $90,596,088. (*Id*. at 1035). Moreover, the Memo stated that "[t]he rehabilitation [was] being funded entirely by [NJSEA]." (*Id*. at 962). The difference between the $107 million "estimated ... renovation" (*id*. at 961), and the "total construction costs" of $90,596,088 was, as the Memo candidly put it, the "[p]roceeds from the sale of the historic tax credits" (*id*. at 963). The Memo did not contemplate that those proceeds, estimated to be approximately $16,354,000, would be applied to "total construction costs" but rather indicated that the funds would be used for three things: (1) payment of a $14,000,000 "development fee" to NJSEA; (2) payment of

$527,080 in legal, accounting, and syndication fees related to the tax-credit transaction; and (3) the establishment of a $1,826,920 working capital reserve.

The Memo also provided financial projections through 2009. Those projections assumed that the investor would receive a 3% priority distribution (the "Preferred Return") from available cash flow on its $16,354,000 contribution, which contemporaneous NJSEA executive committee notes described as "required by tax rules." (*Id.* at 1135.) The financial projections provided for sufficient net operating income—ranging from $715,867 in 2002 to $880,426 in 2009—to pay a portion of the Preferred Return on an annual basis (varying from $465,867 in 2002 to $490,620 in 2009), but also showed substantial tax losses through 2009 that were mainly attributable to depreciation deductions.

d) *Selection of Pitney Bowes*

Four entities, including PB, responded to the Confidential Memorandum and submitted offers "regarding the purchase of the historic tax credits anticipated to be generated by the renovation" of the East Hall. (*Id.* at 1143.) In a May 2000 letter supplementing its offer, PB recommended that NJSEA fund the construction costs through a loan to the partnership, rather than in the form of capital contributions, so that "the managing member could obtain a pre-tax profit and therefore the partnership would be respected as such for U.S. tax purposes." (*Id.* at 1145.)

On July 13, 2000, PB and NJSEA executed a letter of intent ("LOI") reflecting their agreement that PB would make "capital contributions"[13] totaling $16.4 million over four installments in exchange for a 99.9% membership interest in HBH, which NJSEA had recently formed. The LOI further indicated that PB would also make an "Investor Loan" of $1.1 million. Consistent with PB's earlier recommendation, the LOI said that NJSEA, as the managing member retaining a 0.1% interest in HBH, would provide approximately $90 million in the form of two loans: (1) a purchase money obligation that represented the amount of QREs incurred by NJSEA in the East Hall renovation prior to PB's investment (the "Acquisition Loan"); and (2) a loan to finance the remainder of the projected QREs (the "Construction Loan"). According to the LOI, it was anticipated that the project would qualify for a minimum of $17,602,667 in HRTCs: $9,379,981 in 2000 and $8,222,686 in 2001. The LOI also noted that a 3% Preferred Return would be paid to PB. Although the LOI contemplated that PB would receive 99.9% of any available cash flow, HBH's financial projections from 2000 to 2042 forecasted no cash flow available for distribution during that time frame. Similarly, while the LOI mentioned that PB would receive 99.9% of the net proceeds from a sale of HBH, a pre-closing memo from NJSEA's outside counsel to NJSEA suggested that, "[d]ue to the structure of the transaction," the fair market value of PB's interest in HBH would be insignificant. (J.A. at 1162.) Thus, for its investment of $17.5 million ($16.4 million in capital

13. Although we use the term "capital contributions" because that was the term used by the parties in this context, we do not attribute any dispositive legal significance to it as used herein.

contributions and the $1.1 million Investor Loan), PB would receive, in addition to the 3% Preferred Return, 99.9% of the approximately $17.6 million worth of HRTCs that would be generated from the QREs.

e) *Additional Revisions to Financial Projections*

Prior to the closing on PB's commitment to purchase a membership interest in HBH, an accountant from Reznick who was preparing HBH's financial projections, sent a memo to Hoffman indicating that the two proposed loans from NJSEA to HBH "ha[d] been set up to be paid from available cash flow" but that "[t]here was not sufficient cash to amortize this debt." (*Id.* at 1160.) To remedy the problem, Hoffman instructed the accountant to increase the projection of baseline revenues in 2002 by $1 million by adding a new revenue source of $750,000 titled "naming rights," and by increasing both "parking revenue" and "net concession revenue" by $125,000 each. Additionally, whereas the initial projections assumed that baseline revenues and expenses would both increase by 3% on an annual basis, the revised projections used at closing assumed that baseline revenues would increase by 3.5% annually, while maintaining the 3% estimate for the annual increases in baseline expenses. With those modifications, Reznick was able to project that, even after paying PB its 3% Preferred Return, HBH could fully pay off the Acquisition Loan by 2040, at which point HBH would then be able to make principal payments on the Construction Loan.

Also prior to closing, by moving certain expenditures from the "non-eligible" category to the "eligible" category,[14] Reznick increased by about $9 million the amount of projected QREs that the East Hall renovation would generate. That increase in QREs resulted in an approximately $1.8 million increase in projected HRTCs from $17,602,667 to $19,412,173. That uptick in HRTCs, in turn, resulted in an increase in PB's anticipated capital contribution from $16,400,000 to $18,195,797.[15]

4. *Closing*

On September 14, 2000,[16] NJSEA and PB executed various documents to implement the negotiated transaction, and PB made an initial contribution of $650,000 to HBH.

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14. Reznick apparently used the terms "eligible" and "non-eligible" construction expenditures to differentiate between costs that were QREs and those that were not.

15. The LOI provided that PB's contribution would be "adjusted ... upward by $0.995 per additional $1.00 of Historic Tax Credit in the event that ... the QREs for the Project after 1999 support[ed] Historic Tax Credits in excess of the projected Historic Tax Credits." (J.A. at 1148.)

16. Although it is unclear from the record exactly when Phase 3 of the four-phase rehabilitation project was completed, the March 2000 Confidential Memorandum estimated that Phase 3, which began in October 1999, would be completed by August 2000. That same memo stated that NJSEA anticipated that the entire renovation would be completed by December 2001, and, in fact, the East Hall reopened in October 2001. Thus, it is likely that Phase 3 of the renovation was entirely completed by the time NJSEA and PB executed the various documents effecting PB's investment in HBH.

a) *The HBH Operating Agreement*

The primary agreement used to admit PB as a member of HBH and to restate HBH's governing provisions was the amended and restated operating agreement (the "AREA"). The AREA stated that the purpose of HBH was "to acquire, develop, finance, rehabilitate, own, maintain, operate, license, lease, and sell or otherwise dispose of a[n] 87-year subleasehold interest in the Historic East Hall ... for use as a special events facility." (*Id.* at 157.) The AREA provided that PB would hold a 99.9% ownership interest as the "Investor Member," and NJSEA would hold a 0.1% ownership interest as the "Managing Member." The AREA also provided that PB, in addition to its $650,000 initial contribution, would make three additional capital contributions totaling $17,545,797 (collectively, with the initial capital contribution, $18,195,797). Those additional contributions were contingent upon the completion of certain project-related events, including verification of the amount of rehabilitation costs that had been incurred to date that would be classified as QREs to generate HRTCs. According to Section 5.01(c)(v) of the AREA, each of the four contributions were to be used by HBH to pay down the principal of the Acquisition Loan contemplated by the LOI. Pursuant to the AREA, NJSEA, in addition to providing HBH with the Acquisition Loan and the Construction Loan, agreed to pay all "Excess Development Costs" (the "Completion Guaranty"),[17] fund

17. The AREA defined the term "Excess Development Costs" as "all expenditures in excess of the proceeds of the [Acquisition and Construction] Loans and the Capital Contributions of the Members which are required to complete rehabilitation of the

all operating deficits through interest-free loans to HBH (the "Operating Deficit Guaranty"), and indemnify PB against any loss incurred by PB as a result of any liability arising from "Hazardous Materials" relating to the East Hall,[18] including remediation costs (the "Environmental Guaranty").

The AREA also set forth a detailed order of priority of distributions from HBH's cash flow. After distributing any title insurance proceeds or any environmental insurance proceeds to PB, cash flow was to be distributed as follows: (1) to PB for certain repayments on its $1.1 million "Investor Loan" contemplated by the LOI; (2) to PB and NJSEA, in accordance with their respective membership interests, until PB received an amount equal to the current and any accrued and unpaid 3%

[East] Hall," including, but not limited to, "(1) any interest, taxes, and property insurance premiums not payable from proceeds of the Loans or Capital Contributions, and (2) any construction cost overruns and the cost of any change orders which are not funded from proceeds of the Loans or Capital Contributions of the Members." (J.A. at 161.)

18. The term "Hazardous Materials" under the AREA included, among other things, "any 'hazardous substance', 'pollutant' or 'contaminant' as defined in any applicable federal statute, law, rule or regulation now or hereafter in effect ... or any amendment thereto or any replacement thereof or in any statute or regulation relating to the environment now or hereafter in effect," and "any hazardous substance, hazardous waste, residual waste or solid waste, as those terms are now or hereafter defined in any applicable state or local law, rule or regulation or in any statute or regulation relating to the environment now or hereafter in effect." (J.A. at 162.)

Preferred Return as mentioned in the LOI; (3) to PB for an amount equal to the income tax liability generated by income earned by HBH that was allocated to PB, if any; (4) to NJSEA for an amount equal to the current and any accrued and unpaid payments of interest and principal owed on the Acquisition Loan and the Construction Loan; (5) to NJSEA in an amount equal to any loans it made to HBH pursuant to the Operating Deficit Guaranty; and (6) the balance, if any, to PB and NJSEA, in accordance with their respective membership interests.

Additionally, the AREA provided the parties with certain repurchase rights and obligations.[19] In the event that NJSEA desired to take certain actions that were prohibited under the AREA or otherwise required it to obtain PB's consent to take such actions, NJSEA could instead—without the consent of PB—purchase PB's interest in HBH. In the papers submitted to us, the ill-fitting name the parties gave to this ability of NJSEA to buy out PB without PB's consent is the "Consent Option." The purchase price under the Consent Option is not measured by any fair market value of PB's interest, if any such value were even to exist, but rather is equal to the then-present value of any yet-to-be realized projected tax benefits and cash distributions due to PB through the end of the five-year tax credit recapture period.[20] In

19. Those rights and obligations are distinct from the put and call options set forth in separate agreements which were executed the same day and which are discussed *infra* in Section 1.B.4.e.

20. In this context, the term "tax credit recapture" is apparently used to convey the concept that a taxpayer is required

the event that NJSEA committed a material default as defined by the AREA, PB had the right to compel NJSEA to purchase its interest (the "Material Default Option") for that same price.[21]

To protect PB's interest, Section 8.08 of the AREA mandated that NJSEA obtain a guaranteed investment contract (the "Guaranteed Investment Contract").[22] The Guaranteed Investment Contract had to be "reasonably satisfactory to [PB], in the amount required to secure the payment of the purchase price" to be paid by NJSEA in

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to repay to the IRS a portion of a tax credit it had previously claimed with respect to a property interest because that property interest did not continue to qualify for the tax credit for the requisite period of time. Specifically, if the East Hall were disposed of or "otherwise cease[d] to be [an HRTC] property with respect to" HBH within five years after the East Hall was placed into service, any HRTCs allocated to PB through its membership interest in HBH would be recaptured by, in effect, increasing PB's tax (through its membership interest in HBH) by the amount of the total HRTCs taken multiplied by a "recapture percentage," which varies based on the holding period of the property. *See* I.R.C. § 50(a). The amount of HRTCs subject to recapture would decrease by 20% for each of the first five years after the East Hall was placed in service. *See id.* § 50(a)(1)(B).

21. At the time that the IRS challenged this series of transactions, neither the Consent Option nor the Material Default Option had been exercised.

22. A "guaranteed investment contract" is "[a]n investment contract under which an institutional investor [here, NJSEA] invests a lump sum ... with an insurer that promises to return the principal (the lump sum) and a certain amount of interest at the contract's end." Black's Law Dictionary 845 (8th ed. 2004).

the event that NJSEA exercised the option to purchase PB's interest under another purchase option agreement that NJSEA had.[23] (*Id*. at 187-88; *see supra* note 19.) The AREA also provided that the Guaranteed Investment Contract had to be obtained on or before the payment of PB's second capital contribution. In a memo dated two days prior to closing, Sovereign explained to NJSEA that "[t]he [Guaranteed Investment Contract] should be sized to pay off the Investor Loan of $1.1 million, accrued but unpaid interest on the [Investor Loan], and [PB's] annual priority distributions." (*Id*. at 1211.)

b) *Lease Amendment and Sublease*

NJSEA also executed several documents that purported to transfer ownership of its interest in the East Hall to HBH. First, NJSEA entered into an amended and restated agreement with its lessor, Atlantic County Improvement Authority, to extend the term of NJSEA's leasehold interest in the East Hall from 2027 to 2087.[24]

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23. That option, known as the call option, was one of two vehicles (the other being the Consent Option) that was available to NJSEA if it wanted to buy out PB's interest in HBH. PB had a corresponding put option which gave it the right to compel NJSEA to buy out PB's interest. As noted earlier, *supra* note 19, the put and call options are discussed *infra* in Section 1.B.4.e.

24. It appears that the leasehold interest was extended so that its term was longer than the depreciable basis of the improvements to be made on the East Hall for tax purposes. That extension was in accord with Hoffman's ultimate plan for NJSEA to transfer ownership of the East Hall (for tax purposes) to the newly created partnership, a plan he laid out in Sovereign's consulting proposal to NJSEA (albeit the actual lease extension

After that agreement, NJSEA and HBH entered into a "Sublease" with NJSEA, as landlord, and HBH, as tenant. (*Id*. at 413.)

c) *Acquisition Loan and Construction Loan*

As contemplated in the LOI, NJSEA provided financing to HBH in the form of two loans. First, NJSEA and HBH executed a document setting forth the terms of the Acquisition Loan, reflecting NJSEA's agreement to finance the entire purchase price that HBH paid to NJSEA for the subleasehold interest in the East Hall, which amounted to $53,621,405. That amount was intended to represent the construction costs that NJSEA had incurred with respect to the East Hall renovation prior to PB making its investment in HBH. The Acquisition Loan provided for HBH to repay the loan in equal annual installments for 39 years, beginning on April 30, 2002, with an interest rate of 6.09% per year; however, if HBH

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was longer than that suggested in that proposal). (*See* J.A. at 693 ("Since the useful life of commercial improvements is 39.5 years, the tax industry consensus is that the sub-lease should be for a period of 50 years."). Extending the lease term beyond the useful life of the improvements was necessary so that when NJSEA entered into a sublease with HBH in connection with the East Hall, HBH, as Hoffman put it, could "be recognized as the 'owner' for tax purposes" (*id.*), and thus would be eligible to incur QREs that, in turn, would generate HRTCs. *See* I.R.C. § 47(c)(2)(B)(vi) ("The term '[QRE]' does not include ...any expenditure of a lessee of a building if, on the date the rehabilitation is completed, the remaining term of the lease (determined without regard to any renewal periods) is less than the recovery period determined under [I.R.C. § 168(c)].").

did not have sufficient cash available to pay the annual installments when due, the shortfall would accrue without interest and be added to the next annual installment. HBH pledged its subleasehold interest in the East Hall as security for the Acquisition Loan.

Second, NJSEA and HBH executed a document setting forth the terms of the Construction Loan, reflecting NJSEA's agreement to finance the projected remaining construction costs for renovating the East Hall, to be repaid by HBH in annual installments for 39 years, beginning on April 30, 2002, at an annual interest rate of 0.1%. Although the parties only anticipated $37,921,036 of additional construction costs,[25] the maximum amount that HBH could withdraw from the Construction Loan provided by NJSEA was $57,215,733. That difference, $19,294,697, was nearly identical to the total investment that PB was to make in HBH ($18,195,797 in capital contributions and $1,100,000 for the Investor Loan). *See infra* Section I.B.5.a. Similar to the Acquisition Loan, the Construction Loan provided for equal annual installments out of available cash flow, but, if sufficient cash was not available, any shortfall would accrue without interest and be added to the next annual installment. HBH gave

25. The final projections prepared during the week prior to closing contemplated $27,421,036 of remaining construction costs. During that week, Sovereign sent a memo to PB identifying an additional $10.5 million of "[p]otential additional expenditure[s]" that included environmental remediation costs ($3.0 million), tenant improvements ($2.5 million), and an additional rehabilitation contingency ($5.0 million). (J.A. at 1209.) If those expenditures were treated as QREs, the memo indicated that the transaction would generate an additional $2.1 million in HRTCs.

NJSEA a second mortgage on its subleasehold interest in the East Hall as security for the Construction Loan.

d) *Development Agreement*

HBH and NJSEA also entered into a development agreement in connection with the ongoing rehabilitation of the East Hall. The agreement stated that HBH had "retained [NJSEA as the developer] to use its best efforts to perform certain services with respect to the rehabilitation ... of the [East] Hall ... including renovation of the [East] Hall, acquisition of necessary building permits and other approvals, acquisition of financing for the renovations, and acquisition of historic housing credits for the renovations." (*Id.* at 267.) The agreement noted that "since December 1998, [NJSEA] ha[d] been performing certain of [those] services ... in anticipation of the formation of [HBH]." (*Id.*) The agreement provided that HBH would pay a $14,000,000 development fee to NJSEA, but that fee was not to be earned until the rehabilitation was completed. Prior to the execution of the development agreement, as NJSEA was spending over $53 million towards the renovation of the East Hall, it did not pay itself any development fee or otherwise account for such a fee.

e) *Purchase Option and Option to Compel*

Concurrent with the AREA and the sublease agreement, PB and NJSEA entered into a purchase option agreement (the "Call Option") and an agreement to compel purchase (the "Put Option"). The Call Option provides NJSEA the right to acquire PB's membership interest in

HBH, and the Put Option provides PB the right to require NJSEA to purchase PB's membership interest in HBH. Under the Call Option, NJSEA had the right to purchase PB's interest in HBH at any time during the 12-month period beginning 60 months after the East Hall was placed in service.[26] If NJSEA did not exercise the Call Option, then PB had the right to exercise the Put Option at any time during the 12-month period beginning 84 months after the East Hall was placed in service. For both the Put Option and the Call Option, the purchase price was set at an amount equal to the greater of (1) 99.9% of the fair market value of 100% of the membership interests in HBH; or (2) any accrued and unpaid Preferred Return due to PB. As already noted, *supra* Section I.B.4.a, the AREA mandated that NJSEA purchase the Guaranteed Investment Contract to secure funding of the purchase price of PB's membership interest, should either of the options be exercised.[27]

f) *Tax Benefits Guaranty*

As contemplated by the Confidential Memorandum, HBH and PB entered into a tax benefits guaranty agreement (the "Tax Benefits Guaranty"). Pursuant to that guaranty, upon a "Final Determination of a Tax

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26. The 60-month period was likely imposed so that, if NJSEA did exercise the Call Option, any of the HRTCs that PB had previously been allocated through its membership interest in HBH would not be subject to recapture. *See supra* note 20.

27. Neither of those options were exercised prior to the IRS's challenge.

Benefits Reduction Event,"[28] HBH agreed to pay to PB an amount equal to the sum of (1) any reduction in projected tax benefits, "as revised by the then applicable Revised Economic Projections,"[29] as a result of an IRS challenge; (2) any additional tax liability incurred by PB from partnership items allocated to it by HBH as a result of an IRS challenge; (3) interest and penalties imposed by the IRS on PB in connection with any IRS challenge; (4) an amount sufficient to compensate PB for reasonable third-party legal and administrative expenses related to such a challenge, up to $75,000; and (5) an amount sufficient to pay any federal income tax liability owed by PB on receiving any of the payments listed in (1) through (4). (*Id*. at 300.) Although HBH was the named obligor of the Tax Benefits Guaranty, the agreement provided that "NJSEA ... shall fund any obligations of [HBH] to [PB]" under the Tax Benefits Guaranty. (*Id*. at 303.)

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28. Pursuant to the Tax Benefits Guaranty, a "Tax Benefits Reduction Event means as of any Final Determination for any taxable year the amount by which the Actual Tax Benefits for such year are less than the Projected Tax Benefits." (J.A. at 300.) A "Final Determination" was defined as the earliest to occur of certain non-construction related events which, "with respect to either [HBH] or [PB], ... result[] in loss of Projected Tax Benefits." (*Id*. at 299.)

29. The "Revised Economic Projections" refer to the revised projections made by Reznick that "reflect the actual Tax Credits and federal income tax losses ... at the time of payment of the Second, Third and Fourth Installments." (*Id*. at 300.)

5. *HBH in Operation*

a) *Construction in Progress*

Pursuant to an Assignment and Assumption Agreement executed on the day of closing between NJSEA, as assignor, and HBH, as assignee, various agreements and contracts—including occupancy agreements, construction contracts, architectural drawings, permits, and management and service agreements—were assigned to HBH. HBH opened bank accounts in its name, and it deposited revenues and paid expenses through those accounts.

As previously indicated, *supra* Section I.B.4.a, PB's capital contributions were, pursuant to the AREA, supposed to be used to pay down the Acquisition Loan. Although that did occur, any decrease in the balance of the Acquisition Loan was then offset by a corresponding increase in the amount of the Construction Loan. As the Tax Court explained:

> Shortly [after PB's capital contributions were used to pay down the principal on the Acquisition Loan], a corresponding draw would be made on the [C]onstruction [Loan], and NJSEA would advance those funds to [HBH]. Ultimately, these offsetting draws left [HBH] with cash in the amount of [PB's] capital contributions, a decreased balance on the [A]cquisition [L]oan, and an increased balance on the [C]onstruction [L]oan. These funds were then used by [HBH]

> 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.

(*Id*. at 17-18.) Also as discussed above, *supra* Section I.B.4.c, the parties set the upper limit of the Construction Loan approximately $19.3 million higher than the anticipated amount of the total remaining construction costs as of the closing date, which would allow HBH to use PB's approximately $19.3 million in contributions to pay NJSEA a development fee and expenses related to the transaction without being concerned that it would exceed the maximum limit on the Construction Loan provided by NJSEA.

PB made its second capital contribution in two installments, a $3,660,765 payment in December 2000, and a $3,400,000 payment the following month. Once those contributions were received by NJSEA and used to pay down the principal on the Acquisition Loan, NJSEA, instead of using the entire capital contribution to fund a corresponding draw by HBH on the Construction Loan, used $3,332,500 of that amount to purchase the required Guaranteed Investment Contract as security for its potential obligation or opportunity to purchase PB's interest in HBH.[30]

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30. As noted, *supra* Section 1.B.4.a, the AREA required that NJSEA purchase the Guaranteed Investment Contract in the amount required to secure the purchase price to be paid by NJSEA if it exercised its Call Option. However, pursuant to a pledge and escrow agreement entered into by NJSEA, PB, and an

HBH experienced a net operating loss[31] for both 2000[32] ($990,013) and 2001 ($3,766,639), even though projections had indicated that HBH would generate net operating income of $500,000 in 2001.[33] For the tax years ending in 2000 and 2001, HBH reported approximately $107.7 million in QREs, about $10.75 million more QREs than contemplated in the financial projections attached to the AREA.[34] *See supra* note 25. As a result, PB's

escrow agent in January 2001, NJSEA also pledged its interest in the Guaranteed Investment Contract as security for its potential purchase obligation in the event that PB exercised its Put Option, subject to NJSEA's right to apply the proceeds of that contract toward payment of the purchase price if it exercised its Call Option or Consent Option, or if PB exercised its Material Default Option.

31. We use the terms "net operating income" or "net operating loss" to mean the net income or loss before interest and depreciation expenses.

32. HBH's statement of operations for 2000 covered the period June 26, 2000 (date of inception) through December 31, 2000.

33. HBH's accountants did not make financial projections for operating revenues and expenses prior to 2001.

34. It was possible for HBH to claim QREs that were incurred prior to its purported acquisition of the East Hall. *See* Treas. Reg. § 1.48-12(c)(3)(ii) ("Where [QREs] are incurred with respect to a building by a persons (or persons) other than the taxpayer [*i.e.* NJSEA] and the taxpayer [*i.e.* HBH] subsequently acquires the building, ... the taxpayer acquiring the property shall be treated as having incurred the [QREs] actually incurred by the transferor ..., provided that ... [t]he building ... acquired by the taxpayer was ... not placed in service ... after the [QREs] were incurred and prior to the date of acquisition, and ... [n]o credit with respect to such [QREs] is claimed by anyone other than the taxpayer acquiring the property."). Additionally, even if "total construction costs" were

required aggregate capital contribution was increased by approximately $2 million to $20,198,460 and the Investor Loan was increased by $118,000 to $1,218,000.[35]

b) *Post-Construction Phase*

According to NJSEA's 2001 annual report, the "$90 million renovation"[36] of East Hall "was completed on time and on budget" and reopened "in October 2001." (*Id.* at 1757, 1758.) Approximately a year later, PB made its third—and largest—capital contribution of $10,467,849. Around the time that contribution was made, Reznick prepared revised financial projections. Whereas, at closing, Reznick had forecasted $1,715,867 of net operating

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only approximately $90.6 million as projected, it would also have been possible to generate over $107 million in QREs. *See id.* § 1.48-12(c)(2) (noting that QREs could include, among other things, "development fees," "legal expenses," and certain "[c]onstruction period interest" expenses). In any event, as discussed *infra*, the IRS has not challenged the amount of the QREs reported by HBH, but rather the allocation of any HBH partnership items to PB.

35. As contemplated by the LOI, *see supra* note 15, the AREA provided that "if the 2000 or 2001 Tax Credits which [HBH] will be entitled to claim with respect to such rehabilitation are greater than the Projected Tax Credits ... the aggregate amount of [PB's] Capital Contribution shall be increased by $.995 for each $.999 by which the Tax Credits exceed the Projected Tax Credits." (J.A. at 178.) It is unclear from the record why a portion of the required increase in capital contributions was instead applied to increase the Investor Loan.

36. The "$90 million" figure is at odds with the statement in the Confidential Memorandum that the renovation project would cost $107 million. The difference approximates the sum eventually invested by PB. *See supra* Section I.B.3.c.

income for 2002, the accountants now projected a net operating loss of $3,976,023. Ultimately, after reality finished with the pretense of profitability, HBH's net operating loss for 2002 was $4,280,527. Notwithstanding the discrepancy between the initial and actual budgets for 2002, Reznick did not alter projections for 2003 and future years. For years 2003 through 2007,[37] Reznick projected an aggregate net operating income of approximately $9.9 million. HBH actually experienced an aggregate net operating loss of over $10.5 million for those five years. In early 2004, PB made a portion of its fourth and final capital contribution, paying $1,173,182 of its commitment of $2,019,846.[38]

When Reznick was preparing HBH's 2003 audited financial statements, it "addressed a possible impairment issue under FASB 144."[39] (*Id.* at 1638.) FASB 144 requires a write down of an impaired asset to its actual value

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37. The record does not contain audited financial statements for HBH beyond 2007.

38. After paying that portion of the fourth installment, PB had made $19,351,796 of its $20,198,460 required capital contribution. The notes to HBH's 2007 audited financial statements indicate that the $846,664 balance, plus interest, was still due, and was being reserved pending the outcome of litigation with the IRS. The Tax Court also said that a "portion of [PB's] fourth capital contribution ... is currently being held in escrow." (J.A. at 17.)

39. FASB is an acronym for the Financial Accounting Standards Board, an organization that establishes standards which are officially recognized as authoritative by the SEC for financial accounting and which govern the preparation of financial reports by nongovernmental entities. The number "144" refers to the number assigned to the particular standard at issue here.

"whenever events or changes in circumstances indicate that its carrying amount may not be recoverable," such as when there is "[a] current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset." *Statement of Financial Accounting Standards No. 144*, Financial Accounting Standards Board, 9 (Aug. 2001), http://www.fasb.org/pdf/fas144.pdf) (hereinafter referred to as "FASB 144"). In a memo to HBH's audit file, Reznick considered a write down of HBH's interest in the East Hall pursuant to FASB 144, "[d]ue to the fact that [HBH] has experienced substantial operating losses and has not generated any operating cash flow since its inception." (J.A. at 1638.) In the end, however, Reznick was persuaded by the powers at HBH that HBH was never meant to function as a self-sustaining venture and that the State of New Jersey was going to make good on HBH's losses. In deciding against a write down, Reznick explained:

> Per discussions with the client, it was determined that [HBH] was not structured to provide operating cash flow. Instead, the managing member, [NJSEA], 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. [NJSEA] 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.

(*Id.*) "Since there is no ceiling on the amount of funds to be provided [by NJSEA to HBH] under the [AREA]," Reznick concluded "there [was] no triggering event which require[d] [a write down] under FASB 144." (*Id.*) That same discussion and conclusion were included in separate memos to HBH's audit files for 2004 and 2005.[40] By the end of 2007, the operating deficit loan payable to NJSEA was in excess of $28 million.

6. *The Tax Returns and IRS Audit*

On its 2000 Form 1065,[41] HBH reported an ordinary taxable loss of $1,712,893, and $38,862,877 in QREs.[42] On its 2001 Form 1065, HBH reported an ordinary taxable loss of $6,605,142 and $68,865,639 in QREs. On its 2002

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40. The record does not contain Reznick's audit files for HBH beyond 2005.

41. As detailed earlier, *supra* note 1, since HBH was a duly formed New Jersey limited liability company, had two members by the end of its 2000 tax year, and did not elect to be treated as a corporation, it was classified as a partnership for tax purposes for the tax years at issue here. *See* Treas. Reg. § 301.7701-3(b)(1). Partnerships do not pay federal income taxes, but rather are required to file a Form 1065, which is an annual information return of the partnership. A Form 1065 also generates a Schedule K-1 for each partner, which reports a partner's distributive share of tax items. The individual partners then report their allocable shares of the tax items on their own federal income tax returns. *See* I.R.C. §§ 701-04, 6031.

42. HBH's 2000 Form 1065 stated that it began business on June 26, 2000.

Form 1065, HBH reported an ordinary taxable loss of $9,135,373 and $1,271,482 of QREs. In accordance with its membership interest in HBH, PB was issued a Schedule K-1 allocating 99.9% of the QREs for each of those tax years (collectively referred to herein as the "Subject Years").[43]

Following an audit of the returns of the Subject Years, the IRS issued to HBH a notice of final partnership administrative adjustment ("FPAA"). That FPAA determined that all separately stated partnership items reported by HBH on its returns for the Subject Years should be reallocated from PB to NJSEA. The IRS made that adjustment on various alternative, but related, grounds, two of which are of particular importance on appeal: first, the IRS said that HBH should not be recognized as a partnership for federal income tax purposes because it was created for the express purpose of improperly passing along tax benefits to PB and should be treated as a sham transaction; and, second, it said that PB's claimed partnership interest in HBH was not, based on the totality of the circumstances, a bona fide partnership participation because PB had no meaningful

43. While PB was also allocated 99.9% of the ordinary taxable loss for both 2001 and 2002, it appears it was only allocated approximately 69% of the ordinary taxable loss for 2000. Although it is unclear from the record, PB could have only been allocated 99.9% of the loss from the time it joined as a member in HBH in September 2000, although, as noted above, it was allocated 99.9% of the QREs for HBH's entire taxable year in 2000.

stake in the success or failure of HBH.[44] The IRS also determined that accuracy-related penalties applied.

C. *The Tax Court Decision*

NJSEA, in its capacity as the tax matters partner of HBH,[45] filed a timely petition to the United States Tax Court in response to the FPAA.[46] Following a four-day

44. The FPAA provided two additional grounds for reallocating partnership items from PB to NJSEA. It determined that no sale of the East Hall occurred between NJSEA and HBH for federal income tax purposes because the burdens and benefits of ownership of the East Hall interest did not pass from NJSEA, as the seller, to HBH, as the purchaser. Although the IRS has appealed the Tax Court's rejection of that argument, *see infra* note 47, we will not address that contention in view of our ultimate disposition. The FPAA also determined that HBH should be disregarded for federal income tax purposes under the anti-abuse provisions of Treas. Reg. § 1.701-2(b). The Tax Court also rejected that determination, and the IRS has not appealed that aspect of the decision.

45. A partnership such as HBH "designates a tax matters partner to handle tax questions on behalf of the partnership," and that "partner is empowered to settle tax disputes on behalf of the partnership." *Mathia v. Comm'r*, 669 F.3d 1080, 1082 n.2 (10th Cir. 2012).

46. "Upon receiving an FPAA, a partnership, via its tax matters partner, may file a petition in the Tax Court .... Once an FPAA is sent, the IRS cannot make any assessments attributable to relevant partnership items during the time the partnership seeks review ...." *Mathia*, 669 F.3d at 1082. Once that petition is filed, a partnership-level administrative proceeding is commenced, governed by the Tax Equity and Fiscal Responsibility Act of 1982.

trial in April 2009, the Tax Court issued an opinion in favor of HBH.

The Tax Court first rejected the Commissioner's argument that HBH is a sham under the economic substance doctrine. *See supra* note 7 and accompanying text. As the Court saw it, "all of [the IRS's] arguments concerning the economic substance of [HBH] [were] made without taking into account the 3-percent return and the [HRTCs]." (*Id*. at 37.) The Court disagreed with the IRS's assertion that "[PB] invested in the [HBH] transaction solely to earn [HRTCs]." (*Id*. at 41.) Instead, the Court "believe[d] that the 3-percent return and the expected tax credits should be viewed together," and "[v]iewed as a whole, the [HBH] and the East Hall transactions did have economic substance" because the parties "had a legitimate business purpose—to allow [PB] to invest in the East Hall's rehabilitation." (*Id*.) In support of that determination, the Tax Court explained:

> Most of [PB's] 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

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Under that Act, all partnership items are determined in a single-level proceeding at the partnership level, which is binding on the partners and may not be challenged in a subsequent partner-level proceeding. *See* I.R.C. §§ 6230(c)(4), 7422(h). This streamlined process "remove[s] the substantial administrative burden occasioned by duplicative audits and litigation and ... provide[s] consistent treatment of partnership tax items among partners in the same partnership." (J.A. at 31-32.)

> agreement between [HBH] and NJSEA. [The Commissioner's] contention that [PB] was unnecessary to the transaction because NJSEA was going to rehabilitate the East Hall without a corporate investor overlooks the impact that [PB] had on the rehabilitation: no matter NJSEA's intentions at the time it decided to rehabilitate the East Hall, [PB's] 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. [The Commissioner] does not allege that a circular flow of funds resulted in [PB] receiving its 3-percent preferred return on its capital contributions. In addition, [PB] received the rehabilitation tax credits.

(*Id*. at 41-42.)

The Tax Court further explained that "[PB] faced risks as a result of joining [HBH]. First ... it faced the risk that the rehabilitation would not be completed," and additionally, "both NJSEA and [PB] faced potential liability for environmental hazards from the rehabilitation." (*Id*. at 43.) While recognizing that HBH and PB were insured parties under NJSEA's existing environmental insurance policy, the Tax Court noted that "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." (*Id*. at 43-44.) In sum, because "NJSEA had more money for the rehabilitation than it would have had if [PB] had not

invested in [HBH]," and "[b]oth parties would receive a net economic benefit from the transaction if the rehabilitation was successful," the Tax Court concluded that HBH had "objective economic substance." (*Id*. at 46-47.)

The Tax Court used similar reasoning to reject the Commissioner's assertion that PB was not a bona fide partner in HBH. Specifically, the Court rejected the Commissioner's contentions that "(1) [PB] had no meaningful stake in [HBH's] success or failure; and (2) [PB's] interest in [HBH] is more like debt than equity." (*Id*. at 47.) After citing to the totality-of-the-circumstances partnership test laid out in *Commissioner v. Culbertson*, 337 U.S. 733, 69 S. Ct. 1210, 93 L. Ed. 1659, 1949-2 C.B. 5 (1949), the Court determined that "[PB] and NJSEA, in good faith and acting with a business purpose, intended to join together in the present conduct of a business enterprise" (J.A. at 49). After "[t]aking into account the stated purpose behind [HBH's] formation, the parties' investigation of the transaction, the transaction documents, and the parties' respective roles," the Tax Court held "that [HBH] was a valid partnership." (*Id*. at 52.)

Regarding the formation of a partnership, the Court said that, because "[PB] and NJSEA joined together in a transaction with economic substance to allow [PB] to invest in the East Hall rehabilitation," and "the decision to invest provided a net economic benefit to [PB] through its 3-percent preferred return and rehabilitation tax credits," it was "clear that [PB] was a partner in [HBH]." (*Id*. at 49-50.) The Court opined that, since the East Hall operated

at a loss, even if one were to "ignore the [HRTCs], [PB's] interest is not more like debt than equity because [PB] [was] not guaranteed to receive a 3-percent return every year ... [as] there might not be sufficient cashflow to pay it." (*Id*. at 51.)

The Tax Court also placed significant emphasis on "the parties' investigation and documentation" to "support [its] finding that the parties intended to join together in a rehabilitation of the East Hall." (*Id*. at 50.) According to the Court, the Confidential Memorandum "accurately described the substance of the transaction: an investment in the East Hall's rehabilitation." (*Id.*) The Court then cited to the parties' investigation into mitigating potential environmental hazards, as well as the parties' receipt of "a number of opinion letters evaluating various aspects of the transaction, to "support[] [its] finding of an effort to join together in the rehabilitation of the East Hall." (*Id.*) The Court decided that "[t]he executed transaction documents accurately represent[ed] the substance of the transaction ... to rehabilitate and manage the East Hall." (*Id.*) Also, the Court found it noteworthy that "the parties ... carried out their responsibilities under the AREA[:] NJSEA oversaw the East Hall's rehabilitation, and [PB] made its required capital contributions."[47] (*Id*. at 51.)

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47. Rejecting a third alternative ground brought by the IRS, *see supra* note 44, the Tax Court determined that NJSEA had transferred the benefits and burdens of its interest in the East Hall to render HBH the owner of the East Hall for tax purposes, *see supra* note 24. To support that conclusion, the Court observed that (1) "[t]he parties treated the transaction as a sale"; (2) "possession of the East Hall vested in [HBH]"; (3) "[HBH] reported the East

Hence, the Tax Court entered a decision in favor of HBH. This timely appeal by the Commissioner followed.

II. Discussion[48]

The Commissioner[49] alleges that the Tax Court erred by allowing PB, through its membership interest in HBH, to receive the HRTCs generated by the East Hall renovation. He characterizes the transaction as an impermissible "indirect sale of the [HRTCs] to a taxable entity.... by means of a purported partnership between the seller of the credits, [NJSEA], and the purchaser, [PB]." (Appellant's Opening Br. at 30.) While the Commissioner raises several arguments in his effort to reallocate the HRTCs from NJSEA to PB, we focus primarily on his contention that PB should not be treated as a bona fide partner in HBH because PB did not have a meaningful

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Hall's profits and stood to lose its income if the East Hall stopped operating as an event space"; and (4) "[b]ank accounts were opened in [HBH's] name by [Spectacor] as operator of the East Hall." (J.A. at 54-55.) Because of our ultimate resolution, we will not specifically address the Tax Court's analysis of that contention.

48. The Tax Court had jurisdiction pursuant to I.R.C. §§ 6226(f) and 7442, and we have jurisdiction pursuant to I.R.C. § 7482(a)(1). We exercise *de novo* review over the Tax Court's ultimate characterization of a transaction, and review its findings of fact for clear error. *Merck & Co., Inc. v. United States*, 652 F.3d 475, 480-81 (3d Cir. 2011).

49. The current Commissioner of Internal Revenue is Douglas Shulman.

stake in the success or failure of the partnership.[50] We

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50. The Commissioner also contends that HBH was a sham. Specifically, the Commissioner invokes a "sham-partnership theory," which he says is "a variant of the economic-substance (sham-transaction) doctrine." (Appellant's Opening Br. at 50.) That theory, according to the Commissioner "focus[es] on (1) whether the formation of the partnership made sense from an economic standpoint, as would be the case [under the *Culbertson* inquiry], and (2) whether there was otherwise a legitimate business purpose for the use of the partnership form." (*Id.*)

HBH contends that the IRS's sham-partnership theory, which HBH asserts is "merely a rehash of the factual claims that [the IRS] made in challenging [PB's] status as a partner in HBH," is distinct from the sham-transaction doctrine (also known as the economic substance doctrine) that was litigated before the Tax Court. Amicus Real Estate Roundtable (the "Roundtable") agrees, submitting that the Commissioner's sham-partnership argument "inappropriately blur[s] the line between the [economic substance doctrine] and the [substance-over-form doctrine]," the latter of which applies when the form of a transaction is not the same as its economic reality. (Roundtable Br. at 7.) The point is well-taken, as the economic substance doctrine and the substance-over-form doctrine certainly "are distinct." *Neonatology Assocs., P.A. v. Comm'r*, 299 F.3d 221, 230 n.12 (3d Cir. 2002); *see generally Rogers v. United States*, 281 F.3d 1108, 1115-17 (10th Cir. 2002) (noting differences between the substance-over-form doctrine and the economic substance doctrine). The substance-over-form doctrine "is applicable to instances where the 'substance' of a particular transaction produces tax results inconsistent with the 'form' embodied in the underlying documentation, permitting a court to recharacterize the transaction in accordance with its substance." *Neonatology Assocs.*, 299 F.3d at 230 n.12. On the other hand, the economic substance doctrine "applies where the economic or business purpose of a transaction is relatively insignificant in relation to the comparatively large tax benefits that accrue." *Id.*

agree that PB was not a bona fide partner in HBH.

As the Roundtable correctly explains, "[t]he fact that [a] taxpayer might not be viewed as a partner (under the [substance-over-form doctrine]) or that the transaction should be characterized as a sale (again, under the [substance-over-form doctrine]) [does] not mean that the underlying transaction violated the [economic substance doctrine]." (Roundtable Br. at 7.) Put another way, even if a transaction has economic substance, the tax treatment of those engaged in the transaction is still subject to a substance-over-form inquiry to determine whether a party was a bona fide partner in the business engaged in the transaction. *See Southgate Master Fund, L.L.C. ex rel. Montgomery Capital Advisors, LLC v. United States*, 659 F.3d 466, 484 (5th Cir. 2011) ("The fact that a partnership's underlying business activities had economic substance does not, standing alone, immunize the partnership from judicial scrutiny [under *Culbertson*]."); *id*. ("If there was not a legitimate, profit-motivated reason to operate as a partnership, then the partnership will be disregarded for tax purposes even if it engaged in transactions that had economic substance.").

At oral argument, the IRS conceded that this case "lends itself more cleanly to the bona fide partner theory," under which we look to the substance of the putative partner's interest over its form. Oral Argument at 11:00, *Historic Boardwalk Hall, LLC v. Comm'r* (No. 11-1832), *available at* http://www.ca3.uscourts.gov/oralargument/audio/11-1832Historic%20Boardwalk%20LLC%20v%20Commissioner%20IRS.wma. Accordingly, we focus our analysis on whether PB is as a bona fide partner in HBH, and in doing so, we assume, without deciding, that this transaction had economic substance. Specifically, we do not opine on the parties' dispute as to whether, under *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995), we can consider the HRTCs in evaluating whether a transaction has economic substance.

A. *The Test*

A partnership exists when, as the Supreme Court said in *Commissioner v. Culbertson*, two or more "parties in good faith and acting with a business purpose intend[] to join together in the present conduct of the enterprise." 337 U.S. at 742; *see also Comm'r v. Tower*, 327 U.S. 280, 286-87, 66 S. Ct. 532, 90 L. Ed. 670, 1946-1 C.B. 11 (1946) ("When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both."); *Southgate Master Fund, L.L.C. ex rel. Montgomery Capital Advisors v. United States*, 659 F.3d 466, 488 (5th Cir. 2011) ("The *sine qua non* of a partnership is an intent to join together for the purpose of sharing in the profits and losses of a genuine business.").

The *Culbertson* test is used to analyze the bona fides of a partnership and to decide whether a party's "interest was a bona fide equity partnership participation." *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 232 (2d Cir. 2006) (hereinafter "*Castle Harbour*"). To determine, under *Culbertson*, whether PB was a bona fide partner in HBH, we must consider the totality of the circumstances,

> considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and

> the purposes for which it is used, and any other facts throwing light on their true intent.

337 U.S. at 742. That "test turns on the fair, objective characterization of the interest in question upon consideration of all the circumstances." *Castle Harbour*, 459 F.3d at 232.

The *Culbertson* test "illustrat[es] ... the principle that a transaction must be judged by its substance, rather than its form, for income tax purposes." *Trousdale v. Comm'r*, 219 F.2d 563, 568 (9th Cir. 1955). Even if there are "*indicia* of an equity participation in a partnership," *Castle Harbour*, 459 F.3d at 231, we should not "accept[] at face value artificial constructs of the partnership agreement," *id.* at 232. Rather, we must examine those indicia to determine whether they truly reflect an intent to share in the profits or losses of an enterprise or, instead, are "either illusory of insignificant." *Id.* at 231. In essence, to be a bona fide partner for tax purposes, a party must have a "meaningful stake in the success or failure" of the enterprise. *Id.*

B. *The Commissioner's Guideposts*

The Commissioner points us to two cases he calls "recent guideposts" bearing on the bona fide equity partner inquiry. (Appellant's Opening Br. at 34.) First, he cites to the decision of the United States Court of Appeals for the Second Circuit in *Castle Harbour*, 459 F.3d 220. The *Castle Harbour* court relied on *Culbertson* in disregarding the claimed partnership status of two

foreign banks. Those banks had allegedly formed a partnership, known as Castle Harbour, LLC, with TIFD III-E, Inc. (“TIFD”), a subsidiary of General Electric Capital Corporation, with an intent to allocate certain income away from TIFD, an entity subject to United States income taxes, to the two foreign banks, which were not subject to such taxes. *Id.* at 223. Relying on the sham-transaction doctrine, the district court had rejected the IRS’s contention that the foreign banks’ interest was not a bona fide equity partnership participation “because, in addition to the strong and obvious tax motivations, the [partnership] had some additional non-tax motivation to raise equity capital.” *Id.* at 231. In reversing the district court, the Second Circuit stated that it “[did] not mean to imply that it was error to consider the sham test, as the IRS purported to rely in part on that test. The error was in failing to test the banks’ interest also under *Culbertson* after finding that the [partnership’s] characterization survived the sham test.” *Id.* The Second Circuit focused primarily on the *Culbertson* inquiry, and specifically on the IRS’s contention that the foreign banks “should not be treated as equity partners in the Castle Harbour partnership because they had no meaningful stake in the success or failure of the partnership.” *Id.* at 224.

Applying the bona fide partner theory as embodied in *Culbertson’s* totality-of-the-circumstances test, the *Castle Harbour* court held that the banks’ purported partnership interest was, in substance, “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.*

at 231. Although it acknowledged that the banks' interest "was not totally devoid of *indicia* of an equity participation in a partnership," the Court said that those indicia "were either illusory or insignificant in the overall context of the banks' investment," and, thus, "[t]he IRS appropriately rejected the equity characterization." *Id.*

The *Castle Harbour* court observed that "consider[ing] whether an interest has the prevailing character of debt or equity can be helpful in analyzing whether, for tax purposes, the interest should be deemed a bona fide equity participation." *Id.* at 232. In differentiating between debt and equity, it counseled that "the significant factor ... [is] whether the funds were advanced with reasonable expectation of repayment regardless of the success of the venture or were placed at the risk of the business." *Id.* (citation and internal quotation marks omitted). Thus, in determining whether the banks' interest was a bona fide equity participation, the Second Circuit focused both on the banks' lack of downside risk and lack of upside potential in the partnership. It agreed with the "district court['s] recogni[tion] that the banks ran no meaningful risk of being paid anything less than the reimbursement of their investment at the [agreed-upon rate] of return." *Id.* at 233. In support of that finding, the Court noted that:

> [TIFD] was required ... to keep ... high-grade commercial paper or cash, in an amount equal to 110% of the current value of the [amount that the banks would receive upon dissolution of the partnership.] The partnership, in addition, was obliged for the banks' protection to maintain

> $300 million worth of casualty-loss insurance. Finally, and most importantly, [General Electric Capital Corporation]—a large and very stable corporation—gave the banks its personal guaranty, which effectively secured the partnership's obligations to the banks.

Id. at 228.

Regarding upside potential, however, the Second Circuit disagreed with the district court's conclusion that the banks had a "meaningful and unlimited share of the upside potential." *Id*. at 233. That conclusion could not be credited because it "depended on the fictions projected by the partnership agreement, rather than on assessment of the practical realities." *Id*. at 234. Indeed, the Second Circuit stated that "[t]he realistic possibility of upside potential—not the absence of formal caps—is what governs this analysis." *Id*. In reality, "the banks enjoyed only a narrowly circumscribed ability to participate in profits in excess of" the repayment of its investment, *id*., because TIFD had the power to either effectively restrict the banks' share of profits at 1% above an agreed-upon return of $2.85 million, or to buy out their interest at any time at a "negligible cost" of approximately $150,000, *id*. at 226, 235. The return on the banks' initial investment of $117.5 million was thus limited to $2.85 million plus 1%—"a relatively insignificant incremental return over the projected eight-year life of the partnership," *id*. at 235. In sum, "look[ing] not so much at the labels used by the partnership but at true facts and circumstances," as *Culbertson* directs, the *Castle Harbour* court was

"compel[led] [to] conclu[de] that the ... banks' interest was, for tax purposes, not a bona fide equity participation." *Id.* at 241.

The second, more recent, precedent that the Commissioner directs us to as a "guidepost" is *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011) (hereinafter "*Virginia Historic*"). There, the United States Court of Appeals for the Fourth Circuit held that certain transactions between a partnership and its partners which sought to qualify for tax credits under the Commonwealth of Virginia's Historic Rehabilitation Credit Program (the "Virginia Program")[51] were, in substance, sales of those credits which resulted in taxable income to the partnership. *Id.* at 132. In *Virginia Historic*, certain investment funds (the "Funds") were structured "as partnerships that investors could join by contributing capital." *Id.* at 133. Through four linked partnership entities with one "source partnership" entity (the "Source Partnership"), "[t]he Funds would use [the] capital [provided by investors] to partner with historic property developers ["Operating Partnerships"] renovating smaller projects, in exchange for state tax

51. The Virginia Program, much like the federal HRTC statute, was enacted to encourage investment in renovating historic properties. *Virginia Historic*, 639 F.3d at 132. Similar to federal HRTCs, the credits under the Virginia Program could be applied to reduce a taxpayer's Virginia income tax liability, dollar-for-dollar, up to 25% of eligible expenses incurred in rehabilitating the property. *Id.* Also like federal HRTCs, credits under the Virginia program could not be sold or transferred to another party. *Id.* at 132-33.

credits." *Id*. The confidential offering memorandum given to potential investors provided that, "[f]or every $.74-$.80 contributed by an investor, [one of the] Fund[s] would provide the investor with $1 in tax credits. If such credits could not be obtained, the partnership agreement promised a refund of capital to the investor, net of expenses." *Id*. at 134 (citation and internal quotation marks omitted). Additionally, "the partnership agreement stated that the Funds would invest only in completed projects, thereby eliminating a significant area of risk" to the investors. *Id*. "[T]he Funds reported the money paid to Operating Partnerships in exchange for tax credits as partnership expenses and reported the investors' contributions to the Funds as nontaxable contributions to capital." *Id*. at 135.

The IRS "challenged [the Funds'] characterization of investors' funding as 'contributions to capital'" because the IRS believed that the investors were, in substance, purchasers of state income tax credits, and thus the money that the Funds received from the investors should have been reported as taxable income. *Id*. At trial, the Commissioner supported his position with two theories. First, he relied on the substance-over-form doctrine, saying that the investors were not bona fide partners in the Funds but were instead purchasers; and, second, he said that the transactions between the investors and the partnerships were "disguised sales" under I.R.C. § 707.[52]

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52. Under I.R.C. § 707(a)(2)(A),

> [i]f (i) a partner performs services for a partnership or transfers property to a partnership, (ii) there is a related direct or indirect allocation and distribution to

Id. at 136. The Tax Court rejected both of those assertions, and found that the investors were partners in the Funds for federal tax purposes. *Id.* at 136-37.

The Fourth Circuit reversed the Tax Court. "Assuming, without deciding, that a 'bona fide' partnership existed," the *Virginia Historic* court found that "the Commissioner properly characterized the transactions at issue as 'sales'" under the disguised-sale rules. *Id.* at 137. The Fourth Circuit first turned to the regulations that provide guidance in determining whether a disguised sale has occurred. *See id.* at 137-39 (citing to, *inter alia*, Treas. Reg. §§ 1.707-3, 1.707-6(a)). Specifically, it explained that a transaction should be reclassified as a sale if, based on all the facts and circumstances, (1) a partner would not have transferred money to the partnership but for the transfer of property—the receipt of tax credits—to the partner; and (2) the latter transfer—the receipt of tax credits—"is not dependent on the entrepreneurial risks of partnership operations." *Id.* at 145 (quoting Treas. Reg. § 1.707-3(b)(1)). The Fourth Circuit concluded that the risks cited by the Tax Court—such as the "risk that developers would not complete their projects on time because of construction, zoning, or management issues,"

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such partner, and (iii) the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, such allocation and distribution shall be treated as a transaction [between the partnership and one who is not a partner].

"risk ... [of] liability for improper construction," and "risk of mismanagement or fraud at the developer partnership level"—"appear[ed] both speculative and circumscribed." *Id.* While the Fourth Circuit acknowledged that "there was ... no guarantee that resources would remain available in the source partnership to make the promised refunds," it determined "that the Funds were structured in such a way as to render the possibility of insolvency remote." *Id.*

In holding "that there was no true entrepreneurial risk faced by investors" in the transactions at issue, the *Virginia Historic* court pointed to several different factors:

> First, investors were promised what was, in essence, a fixed rate of return on investment rather than any share in partnership profits tied to their partnership interests.... Second, the Funds assigned each investor an approximate .01% partnership interest and explicitly told investors to expect no allocations of material amounts of ... partnership items of income, gain, loss or deduction. Third, investors were secured against losing their contributions by the promise of a refund from the Funds if tax credits could not be delivered or were revoked.
>
> And fourth, the Funds hedged against the possibility of insolvency by promising investors that contributions would be made only to completed projects and by requiring the Operating Partnerships to promise refunds, in

> some cases backed by guarantors, if promised credits could not be delivered.

Id. (internal citations and quotation marks omitted). In sum, the Fourth Circuit deemed "persuasive the Commissioner's contention that the only risk ... was that faced by any advance purchaser who pays for an item with a promise of later delivery. It [was] 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." *Id.* at 145-46 (citing *Tower*, 327 U.S. at 287; Staff of J. Comm. on Tax'n, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 226 ("To 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." (alteration in original))). Accordingly, it agreed with the Commissioner that the Funds should have reported the money received from the investors as taxable income. *Id.* at 146.

The Fourth Circuit concluded its opinion with an important note regarding its awareness of the legislative policy of providing tax credits to spur private investment in historic rehabilitation projects:

> We reach this conclusion mindful of the fact that it is "the policy of the Federal Government" to "assist State and local governments ... to expand and accelerate their historic preservation programs and activities." 16 U.S.C. § 470-1(6). And we find no fault in the

> Tax Court's conclusion that both the Funds and the Funds' investors engaged in the challenged transactions with the partial goal of aiding Virginia's historic rehabilitation efforts. But Virginia's Historic Rehabilitation Program is not under attack here.

Id. at 146 n.20.

C. *Application of the Guideposts to HBH*

The Commissioner asserts that *Castle Harbour* and *Virginia Historic* "provide a highly pertinent frame of reference for analyzing the instant case." (Appellant's Opening Br. at 40.) According to the Commissioner, "[m]any of the same factors upon which the [*Castle Harbour* court] relied in finding that the purported bank partners ... were, in substance, lenders to the GE entity also support the conclusion that [PB] was, in substance, not a partner in HBH but, instead, was a purchaser of tax credits from HBH."[53] (*Id*.) That is so, says the Commissioner, because, as confirmed by the *Virginia Historic* court's reliance on the "entrepreneurial risks of partnership operations," Treas. Reg. § 1.707-3(b)(1), "the distinction between an equity contribution to a partnership ... and a transfer of funds to a partnership as payment of the sales price of

53. The Commissioner acknowledges that "[a]lthough certain aspects of [PB'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 [PB] recovered its 'principal,' *i.e.* its purported capital contributions to HBH, in the form of tax credits rather than cash." (Appellant's Opening Br. at 40 n.14.)

partnership property [, *i.e.*, tax credits,]... is the same as the principal distinction between equity and debt" (Appellant's Opening Br. at 40-41). The key point is that the "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." (*Id*. at 41.) In other words, "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." (*Id.*) In sum, the Commissioner argues that, just as the banks in *Castle Harbour* had no meaningful stake in their respective partnerships, and the "investors" in *Virginia Historic* were more like purchasers than participants in a business venture, "it is clear from the record in this case that [PB] had no meaningful stake in the success or failure of HBH." (*Id.*)

In response, HBH asserts that "[t]here are a plethora of errors in the IRS's tortured effort ... to apply *Castle Harbour* and *Virginia Historic* ... to the facts of the present case." (Appellee's Br. at 38.) First, HBH argues that it is "abundantly apparent" that *Castle Harbour* "is completely inapposite" to it because the actual provisions in Castle Harbour's partnership agreement that minimized the banks' downside risk and upside potential were more limiting than the provisions in the AREA. (Appellee's Br. at 35.) HBH contends that, unlike the partnership agreement in *Castle Harbour*, "[PB] has *no* rights under the AREA to compel HBH to repay all or any part of its capital contribution," PB's 3% Preferred

Return was "not guaranteed," and "NJSEA has no ... right to divest [PB] of its interest in any income or gains from the East Hall." (*Id.*)

As to *Virginia Historic*, HBH argues that it "has no application whatsoever" here. (*Id.* at 38.) It reasons that the decision in that case "assumed that valid partnerships existed as a necessary condition to applying I.R.C. § 707(b)'s disguised sale rules" (*id.* at 36), and that the case was "analyzed ... *solely* under the disguised sale regime"—which is not at issue in the FPAA sent to HBH (*id.* at 38).

Overall, HBH characterizes *Castle Harbour* and *Virginia Historic* as "pure misdirections which lead to an analytical dead end" (*id.* at 32), and emphasizes that "[t]he question ... *Culbertson* asks is simply whether the parties intended to conduct a business together and share in the profits and losses therefrom" (*id.* at 39). We have no quarrel with how HBH frames the *Culbertson* inquiry. But what HBH fails to recognize is that resolving whether a purported partner had a "meaningful stake in the success or failure of the partnership," *Castle Harbour*, 459 F.3d at 224, goes to the core of the ultimate determination of whether the parties "'intended to join together in the present conduct of the enterprise,'" *id.* at 232 (quoting *Culbertson*, 337 U.S. at 742). *Castle Harbour's* analysis that concluded that the banks' "indicia of an equity participation in a partnership" was only "illusory or insignificant," *id.* at 231, and *Virginia Historic's* determination that the limited partner investors did not face the "entrepreneurial risks of partnership operations," 639 F.3d at 145 (citation and internal quotation marks

omitted), are both highly relevant to the question of whether HBH was a partnership in which PB had a true interest in profit and loss,[54] and the answer to that

54. We reject, moreover, any suggestion that the disguised-sale rules and the bona fide-partner theory apply in mutually exclusive contexts. *Virginia Historic* did not "assume[] that valid partnerships existed as a necessary condition" prior to applying the disguised-sale rules. (Appellee's Br. at 36.) Rather, as the *Virginia Historic* court observed, "[t]he Department of the Treasury specifically contemplates that its regulations regarding disguised sales can be applied *before* it is determined whether a valid partnership exists." 639 F.3d at 137 n.9 (citing Treas. Reg. § 1.707-3).

More importantly, HBH simply ignores why many of the principles espoused in *Virginia Historic* are applicable here. It is true that the challenged transaction here does not involve state tax credits and that the IRS has not invoked the disguised-sale rules, but distinguishing the case on those grounds fails to address the real issue. *Virginia Historic* is telling because the disguised-sale analysis in that case "touches on the same risk-reward analysis that lies at the heart of the bona fide-partner determination." (Appellant's Reply Br. at 9.) Under the disguised-sale regulations, a transfer of "property ... by a partner to a partnership" and a "transfer of money or other consideration ... by the partnership to the partner" will be classified as a disguised sale if, based on the facts and circumstances, "(i) [t]he transfer of money or other consideration would not have been made but for the transfer of property; and (ii) [i]n cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations." Treas. Reg. § 1.707-3(b)(1).

Thus, the disguised-sale analysis includes an examination of "whether the benefit running from the partnership to the person allegedly acting in the capacity of a partner is 'dependent upon the entrepreneurial risks of partnership operations.'" (Appellant's

question turns on an assessment of risk participation. We are persuaded by the Commissioner's argument that PB, like the purported bank partners in *Castle Harbour*, did not have any meaningful downside risk or any meaningful upside potential in HBH.

Reply Br. at 9 (quoting Treas. Reg. § 1.707-3(b)(1)(ii)).) That entrepreneurial risk issue also arises in the bona fide-partner analysis, which focuses on whether the partner has a meaningful stake in the profits and losses of the enterprise. Moreover, many of the facts and circumstances laid out in the pertinent treasury regulations that "tend to prove the existence of a [disguised] sale," Treas. Reg. § 1.707-3(b)(2), are also relevant to the bona fide-partner analysis here. *See, e.g., id.* § 1.707-3(b)(2)(i) ("That the timing and amount of a subsequent transfer [*i.e.*, the HRTCs] are determinable with reasonable certainty at the time of an earlier transfer [*i.e.*, PB's capital contributions];"); *id.* § 1.707-3(b)(2)(iii) ("That the partner's [*i.e.*, PB's] right to receive the transfer of money or other consideration [*i.e.*, the HRTCs] is secured in any manner, taking into account the period during which it is secured;"); *id.* § 1.707-3(b)(2)(iv) ("That any person [*i.e.*, NJSEA] has made or is legally obligated to make contributions [*e.g.*, the Tax Benefits Guaranty] to the partnership in order to permit the partnership to make the transfer of money or other consideration [*i.e.*, the HRTCs];"); *id.* § 1.707-3(b)(2)(v) ("That any person [*i.e.*, NJSEA] has loaned or has agreed to loan the partnership the money or other consideration [*e.g.*, Completion Guaranty, Operating Deficit Guaranty] required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;"). Although we are not suggesting that a disguised-sale determination and a bona fide-partner inquiry are interchangeable, the analysis pertinent to each look to whether the putative partner is subject to meaningful risks of partnership operations before that partner receives the benefits which may flow from that enterprise.

1. *Lack of Meaningful Downside Risk*

PB had no meaningful downside risk because it was, for all intents and purposes, certain to recoup the contributions it had made to HBH and to receive the primary benefit it sought—the HRTCs or their cash equivalent. First, any risk that PB would not receive HRTCs in an amount that was at least equivalent to installments it had made to-date (*i.e.*, the "Investment Risk") was non-existent. That is so because, under the AREA, PB was not required to make an installment contribution to HBH until NJSEA had verified that it had achieved a certain level of progress with the East Hall renovation that would generate enough cumulative HRTCs to at least equal the sum of the installment which was then to be contributed and all prior capital contributions that had been made by PB. (*See* J.A. at 176, 242 (first installment of $650,000 due at closing was paid when NJSEA had already incurred over $53 million of QREs which would generate over $10 million in HRTCs); *id*. at 176-77 (second installment, projected to be $7,092,588, was not due until, among other events, a projection of the HRTCs for 2000 (which were estimated at closing to be $7,789,284) based on a "determination of the actual rehabilitation costs of [HBH] that qualify for Tax Credits in 2000"); *id*. at 177 (third installment, projected to be $8,523,630, was not due until the later of, among other events, (1) "evidence of Substantial Completion of Phase 4 ...."; and (2) a projection of the HRTCs for 2001 (which were estimated at closing to be $11,622,889) based on a "determination of the actual rehabilitation costs of [HBH] that qualify for Tax Credits in 2001");

id. (fourth installment, projected to be $1,929,580, was not due until, among other events, PB received a "K-1 for 2001 evidencing the actual Tax Credits for 2001," a tax document that would not have been available until after the estimated completion date of the entire project).) While PB did not have the contractual right to "compel HBH to repay all or any part of its capital contribution" (Appellee's Br. at 35), PB had an even more secure deal. Even before PB made an installment contribution, it knew it would receive at least that amount in return.

Second, once an installment contribution had been made, the Tax Benefits Guaranty eliminated any risk that, due to a successful IRS challenge in disallowing any HRTCs, PB would not receive at least the cash equivalent of the bargained-for tax credits (*i.e.*, the "Audit Risk"). The Tax Benefits Guaranty obligated NJSEA[55] to pay PB not only the amount of tax credit disallowed, but also any penalties and interest, as well as up to $75,000 in legal and administrative expenses incurred in connection with such a challenge, and the amount necessary to pay any tax due on those reimbursements. *Cf. Virginia Historic*, 639 F.3d at 145 (noting the fact that "investors were secured against losing their contributions by the promise of a refund from the Funds if tax credits could not be delivered or were revoked" "point[ed] to the conclusion that there was no true entrepreneurial risk faced by investors").

55. Although HBH was the named obligor under the Tax Benefits Guaranty, the agreement provided that "NJSEA ... shall fund any obligations of [HBH] to [PB]" under the Tax Benefits Guaranty. (J.A. at 303.)

Third, any risk that PB would not receive all of its bargained-for tax credits (or cash equivalent through the Tax Benefits Guaranty) due to a failure of any part of the rehabilitation to be successfully completed (i.e., the "Project Risk") was also effectively eliminated because the project was already fully funded before PB entered into any agreement to provide contributions to HBH. (*See* J.A. at 962 (statement in the Confidential Memorandum that "[t]he rehabilitation is being funded entirely by [NJSEA]"); *id*. at 1134 (notes from a NJSEA executive committee meeting in March 2000 indicating that "[t]he bulk of the Investor's equity is generally contributed to the company after the project is placed into service and the tax credit is earned, the balance when stabilization is achieved"); *id*. at 1714 (notes to NJSEA's 1999 annual report stating that the Casino Reinvestment Development Authority had "agreed to reimburse [NJSEA] [for] ... all costs in excess of bond proceeds for the project").) That funding, moreover, included coverage for any excess development costs.[56] In other words, PB's contributions were not at all necessary for the East Hall project to be completed. *Cf. Virginia Historic*, 639 F.3d at 145 (noting that the fact that "the Funds hedged against the possibility of insolvency

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56. PB had no exposure to the risk of excess construction costs, as the Completion Guaranty in the AREA provided that NJSEA was obligated to pay all such costs. Additionally, even after the renovation was completed, PB need not worry about any operating deficits that HBH would incur, as NJSEA promised to cover any such deficits through the Operating Deficit Guaranty. Furthermore, as detailed *infra* note 58, PB ran no real risk of incurring any environmental liability in connection with the East Hall renovation.

by promising investors that contributions would be made only to completed projects" "point[ed] to the conclusion that there was not true entrepreneurial risk faced by investors"). Furthermore, HBH's own accountants came to the conclusion that the source of the project's funds—NJSEA (backed by the Casino Reinvestment Development Authority)—was more than capable of covering any excess development costs incurred by the project, as well as any operating deficits of HBH, and NJSEA had promised that coverage through the Completion Guaranty and the Operating Deficit Guaranty, respectively, in the AREA. (*See* J.A. at 1638 (memo to audit file noting that, because "[NJSEA] has the ability to fund the [operating] deficits as a result of the luxury and other taxes provided by the hospitality and entertainment industry in the state," and "there is no ceiling on the amount of funds to be provided [by NJSEA to HBH]," "no triggering event [had occurred] which require[d] [a write down] under FASB 144").) *Cf. Virginia Historic*, 639 F.3d at 145 (noting that although "[i]t [was] true ... there was ... no guarantee that resources would remain available in the source partnership to make the promised refunds ... it [was] also true that the Funds were structured in such a way as to render the possibility of insolvency remote").) Thus, although the Tax Court determined that PB "faced the risk that the rehabilitation would not be completed" (J.A. at 43), the record belies that conclusion. Because NJSEA had deep pockets, and, as succinctly stated by Reznick, "there [was] no ceiling on the amount of funds to be provided [by NJSEA to HBH]" (*id*. at 1638), PB was not subject to any legally significant risk that the renovations would falter.[57]

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57. Although the question of the existence of a risk is a factual issue we would review for clear error, there was certainly

In short, PB bore no meaningful risk in joining HBH, as it would have had it acquired a bona-fide partnership interest. *See ASA Investerings P'ship v. Comm'r*, 201 F.3d 505, 514, 340 U.S. App. D.C. 55 (D.C. Cir. 2000) (noting that the Tax Court did not err "by carving out an exception for de minimis risks" when assessing whether the parties assumed risk for the purpose of determining whether a partnership was valid for tax purposes, and determining that the decision not to consider de minimis risk was "consistent with the Supreme Court's view ... that a transaction will be disregarded if it did 'not *appreciably* affect [taxpayer's] beneficial interest except to reduce his tax'" (alteration in original) (quoting *Knetsch v. United States*, 364 U.S. 361, 366, 81 S. Ct. 132, 5 L. Ed. 2d 128, 1961 C.B. 34, 1961-1 C.B. 34 (1960))).[58]

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no error in acknowledging that there were risks associated with the rehabilitation. The relevant question, here, however, is not the factual one of whether there was risk; it is the purely the legal question of how the parties agreed to divide that risk, or, in other words, whether a party to the transactions bore any legally significant risk under the governing documents. That question—whether PB was subject to any legally meaningful risk in connection with the East Hall rehabilitation—depends on the AREA and related documents and hence is a question of law that we review *de novo*.

58. The Tax Court thought that "[PB] faced potential liability for environmental hazards from the rehabilitation." (J.A. at 43.) Specifically, it theorized that PB could be on the hook for environmental liability (1) if environmental insurance proceeds did not cover any such potential liability, and (2) NJSEA was unable to cover that difference. In reality, however, PB was not subject to any real risk of environmental liability because of the Environmental Guaranty and the fact that PB had a priority distribution right to any environmental insurance proceeds that

PB's effective elimination of Investment Risk, Audit Risk, and Project Risk is evidenced by the "agreement ... of the parties." *Culbertson*, 337 U.S. at 742. PB and NJSEA, in substance, did not join together in HBH's stated business purpose—to rehabilitate and operate the East Hall. Rather, the parties' focus from the very beginning was to effect a sale and purchase of HRTCs. (*See* J.A. at 691 (Sovereign's "consulting proposal ... for the sale of historic rehabilitation tax credits expected to be generated" by the East Hall renovation); *id*. at 955 (Confidential Memorandum entitled "The Sale of Historic Tax Credits Generated by the Renovation of the Historic Atlantic City Boardwalk Convention Hall"); *id*. at 1143 (cover letter from Sovereign to NJSEA providing NJSEA "with four original investment offers from institutions that have responded to the [Confidential] Memorandum regarding the purchase of the historic tax credits expected to be generated by" the East Hall renovation).)[59]

HBH received (HBH's counsel at oral argument indicated that HBH carried a $25 million policy). Moreover, PB received a legal opinion that it would not be subject to any environmental liability associated with the East Hall renovation.

59. Although we do not "[p]ermit[] a taxpayer to control the economic destiny of a transaction with labels" when conducting a substance-over-form inquiry, *Schering-Plough, Corp. v. United States*, 651 F. Supp. 2d 219, 242 (D.N.J. 2009), the labels chosen are indicative of what the parties were trying to accomplish and thus those labels "throw[] light on [the parties'] true intent," *Culbertson*, 337 U.S. at 742.

That conclusion is not undermined by PB's receipt of a secondary benefit—the 3% Preferred Return on its contributions to HBH. Although, in form, PB was "not guaranteed" that return on an annual basis if HBH did not generate sufficient cash flow (Appellee's Br. at 35), in substance, PB had the ability to ensure that it would eventually receive it. If PB exercised its Put Option (or NJSEA exercised its Call Option), the purchase price to be paid by NJSEA was effectively measured by PB's accrued and unpaid Preferred Return. *See infra* note 63 and accompanying text. And to guarantee that there would be sufficient cash to cover that purchase price, NJSEA was required to purchase the Guaranteed Investment Contract in the event that NJSEA exercised its Call Option.[60] *Cf. Virginia Historic*, 639 F.3d at 145 (noting the fact that "investors were promised what was, in essence, a fixed rate of return on investment rather than any share in partnership profits tied to their partnership interests" "point[ed] to the conclusion that there was not true entrepreneurial risk faced by investors"). Thus, the Tax Court's finding that PB "might not receive its preferred return ... at all" unless NJSEA exercised its Call Option (J.A. at 51-52), was clearly erroneous because it ignored the reality that PB could assure its return by unilaterally exercising its Put Option.[61]

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60. As noted *supra* in Section I.B.4.a, the Guaranteed Investment Contract was "sized to pay off" the accrued but unpaid Preferred Return, as well as the outstanding balance on the Investor Loan with accrued interest. (J.A. at 1211.)

61. It is true, of course, that PB could not exercise its Put Option until seven years from the date that the East Hall was

HBH, of course, attacks the Commissioner's assertion that PB lacked downside risk, claiming that "the IRS's theory that a valid partnership cannot exist unless an investor-partner shares in all of the risks and costs of the partnership has no basis in partnership or tax law," and "is contrary to the standard economic terms of innumerable real estate investment partnerships in the United States for every type of real estate project." (Appellee's Br. at 44.) HBH also asserts that many of the negotiated provisions—such as the Completion Guaranty, Operating Deficit Guaranty, and the Preferred Return—are "typical in a real estate investment partnership." (*Id.* at 45.) The Commissioner has not claimed, however, and we do not suggest, that a limited partner is prohibited from capping its risk at the amount it invests in a partnership. Such a cap, in and of itself, would not jeopardize its partner status for tax purposes. We also recognize that a limited partner's status as a bona fide equity participant will not be stripped away merely because it has successfully negotiated measures that minimize its risk of losing a portion of its investment in an enterprise. Here, however, the parties agreed to shield PB's "investment" from any meaningful risk. PB was assured of receiving the value of the HRTCs and its Preferred Return regardless of the success or failure of the rehabilitation of the East Hall and HBH's subsequent operations. And that lack of meaningful risk weighs heavily in determining whether PB is a bona fide partner in HBH. *Cf. Virginia Historic*,

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placed in service. However, PB would have no interest in exercising that option within the first five years anyway because the HRTCs that PB received would be subject to recapture during that period. *See supra* note 20.

639 F.3d at 145-46 (explaining that "entrepreneurial risks of partnership operations" involves placing "money into a venture with the hope that it might grow in amount but with the knowledge that it may well shrink"); *Castle Harbour*, 459 F.3d at 232 (noting that "Congress appears to have intended that 'the significant factor' in differentiating between [debt and equity] be 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'" (quoting *Gilbert v. Comm'r*, 248 F.2d 399, 406 (2d Cir. 1957))).

2. *Lack of Meaningful Upside Potential*

PB's avoidance of all meaningful downside risk in HBH was accompanied by a dearth of any meaningful upside potential. "Whether [a putative partner] is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprise." *Culbertson*, 337 U.S. at 747. PB, in substance, was not free to enjoy the fruits of HBH. Like the foreign banks' illusory 98% interest in *Castle Harbour*, PB's 99.9% interest in HBH's residual cash flow gave a false impression that it had a chance to share in potential profits of HBH. In reality, PB would only benefit from its 99.9% interest in residual cash flow after payments to it on its Investor Loan and Preferred Return and the following payments to NJSEA: (1) annual installment payment on the Acquisition Loan ($3,580,840 annual payment for 39 years plus arrears); (2) annual installment

payment on the Construction Loan;[62] and (3) payment in full of the operating deficit loan (in excess of $28 million as of 2007). Even HBH's own rosy financial projections from 2000 to 2042, which (at least through 2007) had proven fantastically inaccurate, forecasted no residual cash flow available for distribution. Thus, although in form PB had the potential to receive the fair market value of its interest (assuming such value was greater than its accrued but unpaid Preferred Return) if either NJSEA exercised its Call Option or PB exercised its Put Option, in reality, PB could never expect to share in any upside.[63] *Cf. Castle Harbour*, 459 F.3d at 234 ("The

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62. The Construction Loan called for annual interest-only payments until April 30, 2002, and thereafter, called for annual installments of principal and interest that would fully pay off the amount of the principal as then had been advanced by April 30, 2040. Under the original principal amount of $57,215,733 with an interest rate of 0.1% over a 39-year period, and assuming no arrearage in the payment of principal and interest, the annual installment of principal and interest would be approximately $1.5 million.

63. To put it mildly, the parties and their advisors were imaginative in creating financial projections to make it appear that HBH would be a profit-making enterprise. For example, after Sovereign said that it was "cautious about [Spectacor's projections of net losses for HBH since] they might prove excessively conservative" (J.A. at 793), and suggested that NJSEA "could explore shifting the burden of some of [HBH's] operating expenses ... to improve results" (*id.* at 804), Spectacor made two sets of revisions to HBH's five-year draft projections that turned an annual average $1.7 million net operating loss to annual net operating gains ranging from $716,000 to $1.24 million by removing HBH's projected utilities expenses for each of the

realistic possibility of upside potential—not the absence of formal caps—is what governs [the bona fide equity participation] analysis."). Even if there were an upside, however, NJSEA could exercise its Consent Option, and cut PB out by paying a purchase price unrelated to any

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five years. Similarly, when an accountant from Reznick informed Hoffman that the two proposed loans from NJSEA to HBH "ha[d] been set up to be paid from available cash flow" but that "[t]here was not sufficient cash to amortize this debt" (*id.* at 1160), Hoffman instructed that accountant to remedy that issue by increasing the projection of baseline revenues in 2002 by $1 million by adding a new revenue source of $750,000 titled "naming rights," and by increasing both "parking revenue" and "net concession revenue" by $125,000 each (*id.* at 1196). Overall, although Reznick projected near closing that HBH would generate an aggregate net operating income of approximately $9.9 million for 2003 through 2007, HBH actually experienced an aggregate net operating loss of over $10.5 million for those five years.

Despite the smoke and mirrors of the financial projections, the parties' behind-the-scenes statements reveal that they never anticipated that the fair market value of PB's interest would exceed PB's accrued but unpaid Preferred Return. (*See id.* at 1162 (pre-closing memo from NJSEA's outside counsel to NJSEA that "[d]ue to the structure of the transaction," the fair market value would not come into play in determining the amount that PB would be owed if NJSEA exercised its Call Option).) That admission is hardly surprising because the substance of the transaction indicated that this was not a profit-generating enterprise. *Cf. Virginia Historic*, 639 F.3d at 145 (noting that the fact that "the Funds ... explicitly told investors to expect no allocation of material amounts of ... partnership items of income, gain, loss, or deduction" "point[ed] to the conclusion that there was no true entrepreneurial risk faced by investors" (citation and internal quotation marks omitted)).

fair market value.[64] *See supra* Section I.B.4.a. In sum, "the structure of the ... transaction ensured that [PB] would never receive any [economic benefits from HBH]." *Southgate Master Fund*, 659 F.3d at 486-87. And "[i]n light of *Culbertson's* identification of 'the actual control of income and the purposes for which it [was] used' as a metric of a partnership's legitimacy, the terms of the [AREA and the structure of the various options] constitute compelling evidence" that PB was not a bona fide partner in HBH. *Id*. at 486 (quoting *Culbertson*, 337 U.S. at 742).

3. *HBH's Reliance on Form over Substance*

After attempting to downplay PB's lack of any meaningful stake in the success or failure of the enterprise, HBH presses us to consider certain evidence that it believes "overwhelmingly proves that [PB] is a partner in HBH" under the *Culbertson* totality-of-the-circumstances test. (Appellee's Br. at 38.) That "overwhelming" evidence includes: (1) that HBH was duly organized as an LLC under New Jersey law and, as the AREA provides, "was formed to acquire, develop, finance, rehabilitate, maintain, operate, license, and sell or otherwise to dispose of the East Hall" (*id*. at 40; *see* J.A. at 157); (2) PB's "net economic benefit" from the HRTCs and the 3% Preferred Return (Appellee's Br. at 41); (3) PB's representatives' "vigorous[] negotiat[ion] [of] the terms of the AREA" (*id*. at 41); (4) "the nature and thoroughness" of PB's "comprehensive due diligence investigation in

64. Thus, contrary to HBH's assertion, NJSEA effectively did have the "right to divest [PB] of its interest in any income or gains from the East Hall." (Appellee's Br. at 35.)

connection with its investment in HBH" (*id.* at 42); (5) PB's "substantial financial investment in HBH" (*id.*); (6) various business agreements that had been entered into between NJSEA and certain third parties that were all assigned to, and assumed by, HBH (*id.* at 43); (7) bank and payroll accounts that were opened in HBH's name and insurance agreements that were amended to identify HBH as an owner and include PB as an additional insured; and (8) the fact that, following closing, "NJSEA kept in constant communication with [PB] regarding the renovations to the East Hall, and the business operations of the Hall" (*id.*).

Much of that evidence may give an "outward appearance of an arrangement to engage in a common enterprise." *Culbertson*, 337 U.S. at 752 (Frankfurter, J., concurring). But "the sharp eyes of the law" require more from parties than just putting on the "habiliments of a partnership whenever it advantages them to be treated as partners underneath." *Id.* Indeed, *Culbertson* requires that a partner "*really and truly intend*[] to ... shar[e] in the profits and losses" of the enterprise, *id.* at 741 (majority opinion) (emphasis added) (citation and internal quotation marks omitted), or, in other words, have a "meaningful stake in the success or failure" of the enterprise, *Castle Harbour*, 459 F.3d at 231. Looking past the outward appearance, HBH's cited evidence does not demonstrate such a meaningful stake.

First, the recitation of partnership formalities—that HBH was duly organized, that it had a stated purpose under the AREA, that it opened bank and payroll accounts, and that it assumed various obligation—misses the point.

We are prepared to accept for purposes of argument that there was economic substance to HBH. The question is whether PB had a meaningful stake in that enterprise. *See Castle Harbour*, 459 F.3d at 232 ("The IRS's challenge to the taxpayer's characterization is not foreclosed merely because the taxpayer can point to the existence of some business purpose or objective reality in addition to its tax-avoidance objective."); *Southgate Master Fund*, 659 F.3d at 484 ("The fact that a partnership's underlying business activities had economic substance does not, standing alone, immunize the partnership from judicial scrutiny [under *Culbertson*]. The parties' selection of the partnership form must have been driven by a genuine business purpose." (internal footnote omitted)). To answer that, we must "look beyond the superficial formalities of a transaction to determine the proper tax treatment." *Edwards v. Your Credit, Inc.*, 148 F.3d 427, 436 (5th Cir. 1998) (citation and internal quotation marks omitted).

Second, evidence that PB received a "net economic benefit" from HBH and made a "substantial financial investment in HBH" can only support a finding that PB is a bona fide partner if there was a meaningful intent to share in the profits and the losses of that investment. The structure of PB's "investment," however, shows clearly that there was no such intent. Recovery of each of the contributions that made up the "substantial financial investment" was assured by the provisions of the AREA and the Tax Benefits Guaranty. And, as the Commissioner rightly notes, PB's net after-tax economic benefit from the transaction—in the form of the HRTCs (or the cash equivalent via the Tax Benefits

Guaranty) and the effectively guaranteed Preferred Return—"merely demonstrates [PB's] intent to make an economically rational use of its money on an after-tax basis." (Appellant's Reply Br. at 13.) Indeed, both parties in a transaction such as this one will always think they are going to receive a net economic benefit; otherwise, the transaction would never occur. If in fact that was the test, there would be a green-light for every tax-structured transaction that calls itself a "partnership."

Third, the fact that NJSEA "kept in constant communication" regarding the East Hall is hardly surprising. As discussed earlier, *supra* Section II.C.1, each installment contribution from PB was contingent upon NJSEA verifying that a certain amount of work had been completed on the East Hall so that PB was assured it would not be contributing more money than it would be guaranteed to receive in HRTCs or their cash equivalent. The mere fact that a party receives regular updates on a project does not transform it into a bona fide partner for tax purposes.

Fourth, looking past the form of the transaction to its substance, neither PB's "vigorous[] negotiat[ion]" nor its "comprehensive due diligence investigation" is, in this context, indicative of an intent to be a bona fide partner in HBH. We do not doubt that PB spent a significant amount of time conducting a thorough investigation and negotiating favorable terms. And we acknowledge that one of the factors cited by *Culbertson* is "the conduct of the parties in execution of its provisions." 337 U.S. at 742. But the record reflects that those efforts were made so that

PB would not be subject to any real risks that would stand in the way of its receiving the value of the HRTCs; not, as HBH asserts, "to form a true business relationship." (Appellee's Br. at 41.) We do not believe that courts are compelled to respect a taxpayer's characterization of a transaction for tax purposes based on how document-intensive the transaction becomes. Recruiting teams of lawyers, accountants, and tax consultants does not mean that a partnership, with all its tax credit gold, can be conjured from a zero-risk investment of the sort PB made here.

In the end, the evidence HBH cites focuses only on form, not substance. From the moment Sovereign approached NJSEA, the substance of any transaction with a corporate investor was calculated to be a "sale of ... historic rehabilitation tax credits." (J.A. at 691.) *Cf. Castle Harbour*, 459 F.3d at 236 (finding that the banks' interest "was more in the nature of window dressing designed to give ostensible support to the characterization of equity participation ... than a meaningful stake in the profits of the venture"). And in the end, that is what the substance turned out to be.

Like the *Virginia Historic* court, we reach our conclusion mindful of Congress's goal of encouraging rehabilitation of historic buildings. *See* 639 F.3d at 146 n.20. We have not ignored the predictions of HBH and *amici* that, if we reallocate the HRTCs away from PB, we may jeopardize the viability of future historic rehabilitation projects. Those forecasts, however, distort the real dispute. The HRTC statute "is not under attack

here." *Id*. It is the prohibited sale of tax credits, not the tax credit provision itself, that the IRS has challenged. Where the line lies between a defensible distribution of risk and reward in a partnership on the one hand and a form-over-substance violation of the tax laws on the other is not for us to say in the abstract. But, "[w]here, as here, we confront taxpayers who have taken a circuitous route to reach an end more easily accessible by a straightforward path, we look to the substance over form." *Southgate Master Fund*, 659 F.3d at 491 (citation and internal quotation marks omitted). And, after looking to the substance of the interests at play in this case, we conclude that, because PB lacked a meaningful stake in either the success or failure of HBH, it was not a bona fide partner.

III. Conclusion

For the foregoing reasons, we will reverse the Tax Court's January 3, 2011 decision, and remand the case for further proceedings consistent with this opinion.

APPENDIX B — DECISION OF THE UNITED STATES TAX COURT, FILED JANUARY 3, 2011

UNITED STATES TAX COURT

HISTORIC BOARDWALK HALL, LLC, NEW JERSEY SPORTS AND EXPOSITION AUTHORITY, TAX MATTERS PARTNER,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

No. 11273-07

January 3, 2011, Filed

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

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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.

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 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.

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.

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. 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. Sovereign Capital Resources, LLC

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.

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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.

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

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. Contributions to Historic Boardwalk Hall

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	1,173,182[2]

[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. Environmental Concerns and Analysis

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. Future Transfers of Pitney Bowes' Interest

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. Pitney Bowes Repurchase Option

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.

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.

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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.

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, 389 U.S. App. D.C. 64 (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, 54 S. Ct. 8, 78 L. Ed. 212, 1933-2 C.B. 112 (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, 69 S. Ct. 1210, 93 L. Ed. 1659, 1949-2 C.B. 5 (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 latchstring 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)-(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)-(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.

APPENDIX C — ORDER DENYING PETITION FOR REHEARING OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT, FILED OCTOBER 22, 2012

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 11-1832

HISTORIC BOARDWALK HALL, LLC, NEW JERSEY SPORTS AND EXPOSITION AUTHORITY, TAX MATTERS PARTNER

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

On Appeal from the United States Tax Court
(No. 11273-07)
Judge: Hon. Joseph Robert Goeke

SUR PETITION FOR REHEARING WITH SUGGESTION FOR REHEARING *EN BANC*

Present: McKEE, *Chief Judge*, SLOVITER, SCIRICA, RENDELL, AMBRO, FUENTES, SMITH, FISHER, CHAGARES, JORDAN, HARDIMAN, GREENAWAY, JR., and VANASKIE, *Circuit Judges*

The petition for rehearing filed by appellee in the above-entitled case having been submitted to the judges

who participated in the decision of this Court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular service not having voted for rehearing, the petition for rehearing by the panel and the Court *en banc*, is DENIED.

BY THE COURT:

/s/ Kent A. Jordan
Circuit Judge

Dated: October 22, 2012

tyw/cc: Robert S. Fink, Esq.
Kevin M. Flynn, Esq.
Tamara W. Ashford, Esq.
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APPENDIX D — RELEVANT STATUTE, INTERNAL REVENUE CODE

26 USCS § 47

§ 47. Rehabilitation credit.

(a) General rule.

For purposes of section 46 [26 USCS § 46], the rehabilitation credit for any taxable year is the sum of--

(1) 10 percent of the qualified rehabilitation expenditures with respect to any qualified rehabilitated building other than a certified historic structure, and

(2) 20 percent of the qualified rehabilitation expenditures with respect to any certified historic structure.

(b) When expenditures taken into account.

(1) In general.
Qualified rehabilitation expenditures with respect to any qualified rehabilitated building shall be taken into account for the taxable year in which such qualified rehabilitated building is placed in service.

(2) Coordination with subsection (d).
The amount which would (but for this paragraph) be taken into account under paragraph (1) with respect to any qualified rehabilitated building shall be reduced (but not below zero) by any amount of qualified rehabilitation expenditures taken into account under

subsection (d) by the taxpayer or a predecessor of the taxpayer (or, in the case of a sale and leaseback described in section 50(a)(2)(C) [26 USCS § 50(a)(2)(C)], by the lessee), to the extent any amount so taken into account has not been required to be recaptured under section 50(a) [26 USCS § 50(a)].

(c) Definitions.
For purposes of this section--

(1) Qualified rehabilitated building.

(A) In general. The term 'qualified rehabilitated building' means any building (and its structural components) if--

(i) such building has been substantially rehabilitated,

(ii) such building was placed in service before the beginning of the rehabilitation,

(iii) in the case of any building other than a certified historic structure, in the rehabilitation process--

(I) 50 percent or more of the existing external walls of such building are retained in place as external walls,

(II) 75 percent or more of the existing external walls of such building are retained in place as internal or external walls, and

(III) 75 percent or more of the existing internal structural framework of such building is retained in place, and

(iv) depreciation (or amortization in lieu of depreciation) is allowable with respect to such building.

(B) Building must be first placed in service before 1936. In the case of a building other than a certified historic structure, a building shall not be a qualified rehabilitated building unless the building was first placed in service before 1936.

(C) Substantially rehabilitated defined.

(i) In general. For purposes of subparagraph (A)(i), a building shall be treated as having been substantially rehabilitated only if the qualified rehabilitation expenditures during the 24-month period selected by the taxpayer (at the time and in the manner prescribed by regulation) and ending with or within the taxable year exceed the greater of--

(I) the adjusted basis of such building (and its structural components), or

(II) $ 5,000.

The adjusted basis of the building (and its structural components) shall be determined as of the beginning of the 1st day of such 24-month period, or of the

holding period of the building, whichever is later. For purposes of the preceding sentence, the determination of the beginning of the holding period shall be made without regard to any reconstruction by the taxpayer in connection with the rehabilitation.

(ii) Special rule for phased rehabilitation. In the case of any rehabilitation which may reasonably be expected to be completed in phases set forth in architectural plans and specifications completed before the rehabilitation begins, clause (i) shall be applied by substituting '60-month period' for '24-month period'.

(iii) Lessees. The Secretary shall prescribe by regulation rules for applying this subparagraph to lessees.

(D) Reconstruction. Rehabilitation includes reconstruction.

(2) Qualified rehabilitation expenditure defined.

(A) In general. The term 'qualified rehabilitation expenditure' means any amount properly chargeable to capital account--

(i) for property for which depreciation is allowable under section 168 [26 USCS § 168] and which is--

(I) nonresidential real property,

(II) residential rental property,

(III) real property which has a class life of more than 12.5 years, or

(IV) an addition or improvement to property described in subclause (I), (II), or (III), and

(ii) in connection with the rehabilitation of a qualified rehabilitated building.

(B) Certain expenditures not included. The term 'qualified rehabilitation expenditure' does not include--

(i) Straight line depreciation must be used. Any expenditure with respect to which the taxpayer does not use the straight line method over a recovery period determined under subsection (c) or (g) of section 168 [26 USCS § 168]. The preceding sentence shall not apply to any expenditure to the extent the alternative depreciation system of section 168(g) [26 USCS § 168(g)] applies to such expenditure by reason of subparagraph (B) or (C) of section 168(g)(1) [26 USCS § 168(g)(1)].

(ii) Cost of acquisition. The cost of acquiring any building or interest therein.

(iii) Enlargements. Any expenditure attributable to the enlargement of an existing building.

(iv) Certified historic structure, etc. Any expenditure attributable to the rehabilitation of a certified historic structure or a building in a registered historic district, unless the rehabilitation is a certified rehabilitation (within the meaning of subparagraph (C)). The preceding sentence shall not apply to a building in a registered historic district if--

(I) such building was not a certified historic structure,

(II) the Secretary of the Interior certified to the Secretary that such building is not of historic significance to the district, and

(III) if the certification referred to in subclause (II) occurs after the beginning of the rehabilitation of such building, the taxpayer certifies to the Secretary that, at the beginning of such rehabilitation, he in good faith was not aware of the requirements of subclause (II).

(v) Tax-exempt use property.

(I) In general. Any expenditure in connection with the rehabilitation of a building which is allocable to the portion of such property which is (or may reasonably be expected to be) tax-exempt use property (within the meaning of section 168(h) [26 USCS §

168(h)], except that "50 percent" shall be substituted for "35 percent" in paragraph (1)(B)(iii) thereof).

(II) Clause not to apply for purposes of paragraph (1)(C). This clause shall not apply for purposes of determining under paragraph (1)(C) whether a building has been substantially rehabilitated.

(vi) Expenditures of lessee. Any expenditure of a lessee of a building if, on the date the rehabilitation is completed, the remaining term of the lease (determined without regard to any renewal periods) is less than the recovery period determined under section 168(c) [26 USCS § 168(c)].

(C) Certified rehabilitation. For purposes of subparagraph (B), the term 'certified rehabilitation' means any rehabilitation of a certified historic structure which the Secretary of the Interior has certified to the Secretary as being consistent with the historic character of such property or the district in which such property is located.

(D) Nonresidential real property; residential rental property; class life. For purposes of subparagraph (A), the terms 'nonresidential real property,' 'residential rental property,' and 'class life' have the respective meanings given such terms by section 168 [26 USCS § 168].

(3) Certified historic structure defined.

(A) In general. The term ‘certified historic structure’ means any building (and its structural components) which--

(i) is listed in the National Register, or

(ii) is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary as being of historic significance to the district.

(B) Registered historic district. The term ‘registered historic district’ means--

(i) any district listed in the National Register, and

(ii) any district--

(I) which is designated under a statute of the appropriate State or local government, if such statute is certified by the Secretary of the Interior to the Secretary as containing criteria which will substantially achieve the purpose of preserving and rehabilitating buildings of historic significance to the district, and

(II) which is certified by the Secretary of the Interior to the Secretary as meeting

substantially all of the requirements for the listing of districts in the National Register.

(d) Progress expenditures.

(1) In general.
In the case of any building to which this subsection applies, except as provided in paragraph (3)--

(A) if such building is self-rehabilitated property, any qualified rehabilitation expenditure with respect to such building shall be taken into account for the taxable year for which such expenditure is properly chargeable to capital account with respect to such building, and

(B) if such building is not self-rehabilitated property, any qualified rehabilitation expenditure with respect to such building shall be taken into account for the taxable year in which paid.

(2) Property to which subsection applies.

(A) In general. This subsection shall apply to any building which is being rehabilitated by or for the taxpayer if--

(i) the normal rehabilitation period for such building is 2 years or more, and

(ii) it is reasonable to expect that such building will be a qualified rehabilitated building in

the hands of the taxpayer when it is placed in service.

Clauses (i) and (ii) shall be applied on the basis of facts known as of the close of the taxable year of the taxpayer in which the rehabilitation begins (or, if later, at the close of the first taxable year to which an election under this subsection applies).

(B) Normal rehabilitation period. For purposes of subparagraph (A), the term ‘normal rehabilitation period’ means the period reasonably expected to be required for the rehabilitation of the building--

(i) beginning with the date on which physical work on the rehabilitation begins (or, if later, the first day of the first taxable year to which an election under this subsection applies), and

(ii) ending on the date on which it is expected that the property will be available for placing in service.

(3) Special rules for applying paragraph (1).
For purposes of paragraph (1)--

(A) Component parts, etc. Property which is to be a component part of, or is otherwise to be included in, any building to which this subsection applies shall be taken into account--

(i) at a time not earlier than the time at which it becomes irrevocably devoted to use in the building, and

(ii) as if (at the time referred to in clause (i)) the taxpayer had expended an amount equal to that portion of the cost to the taxpayer of such component or other property which, for purposes of this subpart [26 USCS §§ 46 et seq.], is properly chargeable (during such taxable year) to capital account with respect to such building.

(B) Certain borrowing disregarded. Any amount borrowed directly or indirectly by the taxpayer from the person rehabilitating the property for him shall not be treated as an amount expended for such rehabilitation.

(C) Limitation for buildings which are not self-rehabilitated.

(i) In general. In the case of a building which is not self-rehabilitated, the amount taken into account under paragraph (1)(B) for any taxable year shall not exceed the amount which represents the portion of the overall cost to the taxpayer of the rehabilitation which is properly attributable to the portion of the rehabilitation which is completed during such taxable year.

(ii) Carry-over of certain amounts. In the case of a building which is not a self-rehabilitated building, if for the taxable year--

(I) the amount which (but for clause (i)) would have been taken into account under paragraph (1)(B) exceeds the limitation of clause (i), then the amount of such excess shall be taken into account under paragraph (1)(B) for the succeeding taxable year, or

(II) the limitation of clause (i) exceeds the amount taken into account under paragraph (1)(B), then the amount of such excess shall increase the limitation of clause (i) for the succeeding taxable year.

(D) Determination of percentage of completion. The determination under subparagraph (C)(i) of the portion of the overall cost to the taxpayer of the rehabilitation which is properly attributable to rehabilitation completed during any taxable year shall be made, under regulations prescribed by the Secretary, on the basis of engineering or architectural estimates or on the basis of cost accounting records. Unless the taxpayer establishes otherwise by clear and convincing evidence, the rehabilitation shall be deemed to be completed not more rapidly than ratably over the normal rehabilitation period.

(E) No progress expenditures for certain prior periods. No qualified rehabilitation expenditures shall be taken into account under this subsection for

any period before the first day of the first taxable year to which an election under this subsection applies.

(F) No progress expenditures for property for year it is placed in service, etc. In the case of any building, no qualified rehabilitation expenditures shall be taken into account under this subsection for the earlier of--

(i) the taxable year in which the building is placed in service, or

(ii) the first taxable year for which recapture is required under section 50(a)(2) [26 USCS § 50(a)(2)] with respect to such property,

or for any taxable year thereafter.

(4) Self-rehabilitated building.
For purposes of this subsection, the term 'self-rehabilitated building' means any building if it is reasonable to believe that more than half of the qualified rehabilitation expenditures for such building will be made directly by the taxpayer.

(5) Election.
This subsection shall apply to any taxpayer only if such taxpayer has made an election under this paragraph. Such an election shall apply to the taxable year for which made and all subsequent taxable years. Such an election, once made, may be revoked only with the consent of the Secretary.