Steve Leimberg's Business Entities Email Newsletter - Archive Message #135
Date: 05-Feb-13
From: Steve Leimberg's Business Entities Newsletter
Subject: **Jeffrey Galant & Dana Mark on Historic Boardwalk: Substance is Key Regarding Partner Status**

"The core issue in Historic Boardwalk was whether an investor in a partnership would be considered to be a partner and as such would be eligible to receive an allocation of historic rehabilitation credits. More specifically, the question was whether the parties, a New Jersey state agency and a subsidiary of Pitney Bowes Corporation, acting with a business purpose, intended to join together as partners in a profit-making activity and share the gains and losses.

In reaching its decision, the Court was not unmindful of Congress' goal of encouraging rehabilitation of historic structures, pointing out, however, that such statute was not in question here. The issue for the Court was whether the transaction as a whole involved the prohibited sale of tax credits.

The recurrent theme throughout the Court's decision is its reliance on the principle that for income tax purposes a transaction must be judged by its substance rather than its form, and to be a bona fide partner for tax purposes, a party must have a meaningful stake in the success or failure of the enterprise."

Now, **Jeffrey Galant** and **Dana Mark** provide **LISI** members with their analysis of Historic Boardwalk Hall, LLC v. Commissioner, a case that focuses on what it means to be a partner.

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Dana L. Mark, a tax and estate planning lawyer, is Special Counsel at **McCarter & English LLP** in New York. She has been selected as both a *SuperLawyer* and a *Best Lawyer,* and has been named by *SuperLawyers*, as one of the top 50 Women Lawyers in the metropolitan New York area. She is an ACTEC fellow and an elected member of the American Law Institute. She is a

member of the board of directors of the Ovarian Cancer Research Fund, Inc. Her practice is concentrated on estate planning (including the estate planning of same sex couples), estate administration and philanthropy.

Before we get to their commentary, **Michel Nelson** recently updated the charts that appeared in Estate Planning Newsletter #2058. Click this link to view the revised chart: Michel Nelson's Chart

Here is Dana and Jeffrey's commentary:

EXECUTIVE SUMMARY:

The owner of a "certified historic structure" is entitled to a credit of 20 percent of amounts spent on rehabilitating the property as provided in section 47 of the Internal Revenue Code. Generally, if the owner is a partnership such credit will be allocated among the partners in accordance with the partnership agreement. *Historic Boardwalk Hall, LLC v. Commissioner*[1] concerned whether an investor in the property-owning partnership was a "partner" to whom such credit could be allocated. This commentary discusses *Historic Boardwalk* and what it means to be a partner.

FACTS:

Recently, the Third Circuit in *Historic Boardwalk* applied the *Culbertson*[2] test for determining partner status, closely following the analysis used by the Second Circuit in *Castle Harbour*[3]. The core issue in *Historic Boardwalk* was whether an investor in a partnership would be considered to be a partner and as such would be eligible to receive an allocation of historic rehabilitation credits. More specifically, the question was whether the parties, a New Jersey state agency and a subsidiary of Pitney Bowes Corporation, acting with a business purpose, intended to join together as partners in a profit-making activity and share the gains and losses.

Culbertson, which involved a purported partnership among a father and his sons in connection with a family cattle business, mandates a substance over form inquiry. It requires that a court, which needs to determine whether a partnership exists or whether a party is a partner, evaluate the "totality of the circumstances" including an analysis of "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."

Castle Harbour

In *Castle Harbour*[4], the Second Circuit analyzed the key elements of whether certain parties in question, two foreign banks that were not subject to U.S. income taxation, had stakes in the partnership that were meaningful enough to treat them as partners for U.S. tax purposes. The case involved a purposeful attempt to use the partnership allocation rules to ameliorate the adverse tax effects that the U.S. taxpayer would suffer as a result of having exhausted the depreciation of aircraft that it was leasing to various domestic carriers.

The partnership in *Castle Harbour* had attempted to allocate taxable income to the foreign banks so that such income would escape taxation in the U.S. The Court analyzed whether the foreign banks actually participated in the partnership profits and losses, that is, whether the banks' participations in the partnership bore entrepreneurial risk. Entrepreneurial risk looks to a party's ability to recover its investment in the partnership as well as share in partnership profits, both of which depend on the success of the partnership.

The Second Circuit determined, after analyzing the banks' potential risks and rewards as investors in the partnership, that the foreign banks were not partners since their investments in the partnership were basically guaranteed against loss and they were indemnified against U.S. taxation. Furthermore, notwithstanding that certain returns were guaranteed to the foreign banks, there was no upside potential for them that would flow from partnership appreciation or gains.

COMMENT:

Historic Boardwalk

Historic Boardwalk, conceptually like *Castle Harbour* although much different on the facts, was another attempt to utilize the partnership allocation rules, in this case to obtain the advantage of historic rehabilitation credits. The case concerned the ability of a partnership to allocate historic rehabilitation credits

allowed by Section 47[5] to a purported partner, in this case a wholly owned subsidiary of Pitney Bowes Corporation ("PB"). Congress, in support of the Section 47 credit, has indicated a strong public policy to encourage and incentivize owners of private property to restore and rehabilitate their historic properties. The property owner is the taxpayer entitled to the credit and the credit is not transferable.

The broad question presented concerned whether the nontransferability of the credit could in effect be circumvented by having a partnership own the property, and thereby apportion the credit among the partners using the partnership allocation rules.[6] Or, to be more specific, the issue in *Historic Boardwalk* was whether it was feasible to allocate the credit to PB as a partner of the New Jersey state agency (the "Agency")[7] that contributed the historic property to the partnership. (The actual property is located in Atlantic City and is known as East Hall.[8]) In structuring the partnership, the Agency contributed East Hall to a New Jersey limited liability company known as "HBH"[9]. Being tax-exempt, the credit was of no use to the Agency.

The core issue boiled down to whether PB was a partner in HBH, the entity that ultimately owned East Hall.[10] The Third Circuit, applying the relevant factors laid out in *Culbertson*, and as deeply analyzed in *Castle Harbour*, closely examined the governing documents regarding PB's participation in HBH with the purpose of determining the extent of PB's stake in HBH, and whether its stake was meaningful. This required an analysis of PB's potential risk of entrepreneurial loss as well as its potential for entrepreneurial gain. The result of this inquiry would perforce determine whether PB was a partner of HBH entitled to the Section 47 credit.

After perusing the governing documents, the Third Circuit found that PB was relieved from substantially all risk in the venture, including investment risk, tax audit risk and the risk of project failure. The Court pointed out that the risks must be examined in light of the actual legal risk faced by PB based on the governing documentation, rather than some theoretical economic risk.

The Court found that the investment risk was non-existent since PB was not required to make its contribution to HBH until after the Agency had completed work sufficient to generate credits in an amount at least equal to the amount PB was required to contribute. Furthermore, as it became apparent, PB's total contributions amounted to about $18 million and its allocated share of the

credits was also about $18 million. Thus, after taxes PB was not out-of-pocket. PB was also entitled to a 3% preferred return, which was guaranteed through a put arrangement.

As it turned out there was no available cash flow to satisfy the 3% preferred return on an annual basis, so the unpaid amounts accumulated. The guarantor of these items was the Agency, which was well funded and basically a deep pocket. To fund its put obligation, i.e., in order to satisfy the 3% accumulating preferred return, the Agency was obligated to purchase a guaranteed investment contract. Thus, the guaranteed and funded 3% preferred return operated independently of the partnership's success.

By way of a tax benefits guaranty between the Agency and PB, PB was guaranteed the credits or their economic equivalent, if the credits for any reason were disallowed by the government. Further, the tax benefits guaranty obligated the Agency to pay PB not only the amount of tax credit disallowed, but also penalties and interest, as well as up to $750,000 in legal and administrative expenses plus a gross-up of the amount necessary to pay any tax due on such reimbursements. As a result of the tax benefits guaranty, the Court found that PB lacked any audit risk.

The risk of project failure basically did not exist at the time PB became involved since the project was well along its way and fully funded through government participation and a successful bond issue. Finally, PB was indemnified against any environmental liability that could arise out of the project.[11]

Based on the foregoing factual nature of PB's participation in the partnership, the Third Circuit concluded that PB was not a bona fide partner in HBH as it did not have any meaningful downside risk or any meaningful upside potential.

HBH argued strenuously that PB was a partner for tax purposes because in creating HBH the Agency carefully followed the appropriate formalities such as duly organizing the limited liability company under New Jersey law; also, that the clear and overriding purpose of establishing HBH was to facilitate the rehabilitation of East Hall, a purpose of great significance to Congress and the federal tax system; furthermore, PB's participation as demonstrated by the substantial due diligence and negotiations that it performed as well as its overall involvement as signified by its being in constant communications regarding the rehabilitation project; and, finally, PB's deriving of a net

economic benefit from the investment.[12]

Unfortunately for PB, the Third Circuit, applying substance over form, gave short shrift to these arguments. The Court stated:

> Much of that evidence may give an "outward appearance of an arrangement to engage in a common enterprise." 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." Indeed, *Culbertson* requires that a partner "really and truly intend to share in the profits and losses of the enterprise, or, in other words, have a 'meaningful stake in the success or failure" of the enterprise. Looking past the outward appearance, HBH's cited evidence does not demonstrate such a meaningful stake.[13]

Conclusion

In reaching its decision, the Court was not unmindful of Congress' goal of encouraging rehabilitation of historic structures, pointing out, however, that such statute was not in question here. The issue for the Court was whether the transaction as a whole involved the prohibited sale of tax credits. The recurrent theme throughout the Court's decision is its reliance on the principle that for income tax purposes a transaction must be judged by its substance rather than its form, and to be a bona fide partner for tax purposes, a party must have a meaningful stake in the success or failure of the enterprise.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Dana Mark

Jeffrey Galant

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CITATIONS:

[1] 136 T.C. 1 (2011), reversed 694 F.3d 425, (3rd Cir. 2012)

[2] *Commissioner v. Culbertson*, 337 U.S. 733 (1949).

[3] *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006); on remand 660 F. Supp. 2d 367 (D. Conn., 2009) reversed 666 F.3d 836 (2d Cir. 2012).

[4] Galant & Mark: Partnership Characteristics - Confusion Reigns, Steve Leimberg's Business Entities Newsletter #129, February 27, 2012. Also available at http://ssrn.com/abstract=2012556

[5] Section references are to the Internal Revenue Code of 1986, as amended.

[6] In *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011), the Commissioner asserted not only that the Fund's investors were not bona fide partners but that the transactions between the investors and the partnerships were disguised sales under Section 707. The Commissioner needed only one basis to prevail and, without deciding that a bona fide partnership existed, the Court found that the transactions at issue were, in substance, sales.

[7] The other partner was the New Jersey state agency tasked with funding and overseeing the rehabilitation project.

[8] East Hall was popularly known as the venue of the Miss America contest.

[9] HBH was established as a New Jersey limited liability company and was treated as a partnership for federal income tax purposes.

[10] The government initially claimed that HBH was a sham since it lacked both economic substance and business purpose. At oral argument, however, the government conceded that the appropriate focus should be on whether PB was a *bona fide* partner. *Historic Boardwalk*, footnote 50 at page 54.

[11] HBH argued that the government's position was contrary to both law and practice in that "innumerable real estate investment partnerships in the United States" were based on negotiated terms that substantially limited investor risk such as the completion guaranty, operating deficit guaranty and preferred return present in this case. The problem the Third Circuit had was in the elimination of all material risk. *Historic Boardwalk*, pages 76-77.

[12] The Court noted that both parties in a transaction such as this will always think they are going to receive a net economic benefit otherwise the transaction would never occur and stated that "[i]f in fact that was the test, there would be a green-light for every tax-structured transaction that calls itself a 'partnership'." Page 83.

[13] *Historic Boardwalk*, pages 81-82.

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