No. 11-1832

IN THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

HISTORIC BOARDWALK HALL, LLC,

Petitioner-Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant

ON APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

REPLY BRIEF FOR THE APPELLANT
COMMISSIONER OF INTERNAL REVENUE

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GLOSSARY

FPAA – notice of final partnership administrative adjustment

GIC – guaranteed investment contract

HBH – Historic Boardwalk Hall, LLC

INTRODUCTION

The New Jersey Sports and Exposition Authority (the "Authority"), a tax-exempt instrumentality of the State of New Jersey, obtained ownership of the Historic Boardwalk Hall in Atlantic City, New Jersey (the "Hall" or "East Hall") in 1992 in order to undertake what eventually became a $90 million renovation of the Hall. Although the Authority had no need whatsoever for private-sector funds in order to complete the renovations, it was told that it could reduce its cost by about $14 million by monetizing the value of the federal historic rehabilitation tax credits the project was expected to generate – credits for which the Authority, as a tax-exempt entity, had no use. The only catch was that the Authority had to cast the monetization in the form of a partnership arrangement with the taxable entity seeking to use the credits.

At issue in this case is whether the Authority and the winning bidder, Pitney Bowes, entered into a partnership not only in form, but in substance, *i.e.*, whether their formal relationship as partners in Historic Boardwalk Hall, LLC ("HBH") should be given effect for federal tax purposes. Also at issue is whether the formal transfer of ownership of the Hall from the Authority to HBH should likewise be given effect for federal tax purposes. A negative answer to either of

those questions would render HBH's allocation of rehabilitation tax credits (as well as tax losses) to Pitney Bowes invalid.

In our opening brief ("OB"), we demonstrated that the purported partnership arrangement between the Authority and Pitney Bowes should be disregarded for tax purposes on two separate, but largely overlapping, grounds: Pitney Bowes was not a bona fide partner in HBH, and HBH itself was a sham entity in substance. We further demonstrated that, in any event, HBH should not be treated as the owner of the Hall for tax purposes because the Authority retained the benefits and burdens of ownership of the Hall, notwithstanding its formal transfer of ownership thereof to HBH. We now respond to the Authority's answering brief ("AB") and, where appropriate, to the amicus briefs filed in support of the Authority by the National Trust for Historic Preservation (the "Trust") and the Real Estate Roundtable (the "Roundtable"), respectively.

ARGUMENT

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

As explained in our opening brief (OB:35), the "bona fide partner" theory focuses on whether a purported partner was, in substance, something other than a bona fide equity participant in the venture. *See*

TIFD III-E, Inc., v. United States, 459 F.3d 220, 224 (2d Cir. 2006). This inquiry is informed by the familiar passage from *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949), to the effect that a partnership exists for federal tax purposes when two or more parties, in good faith and acting with a business purpose, intend to join together in the present conduct of an enterprise. *See* OB:34. The requisite intent of a given party in this regard objectively manifests itself in the form of a meaningful stake in the success or failure of the enterprise. *TIFD*, 459 F.3d at 231; *see TIFD III-E, Inc., v. United States*, 2012 WL 181599, *10 n.8 (2d Cir. Jan. 24, 2012) (*TIFD II*) ("Applying *Culbertson*, we thus found that the taxpayer's claimed subjective intent was insufficient to defeat the plain objective facts.");[1] *cf. Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129, 145-46 (4th Cir. 2011) (relying on similar principles in applying statutory disguised-sale rule).

In our opening brief (OB:41-46), we demonstrated that Pitney Bowes had no meaningful stake in the success or failure of HBH because it had neither downside risk nor upside potential with respect

[1] In *TIFD II*, the Second Circuit – for many of the same reasons it cited in its initial *TIFD* opinion – reversed the district court's holding on remand that each of the purported partners "own[ed] a capital interest" in the partnership within the meaning of I.R.C. § 704(e)(1).

to its purported investment in the venture. In response to this argument, the Authority expends most of its energy (AB:32-44) arguing that *TIFD* and *Virginia Historic Tax Credit* have no relevance to this case and that Pitney Bowes should be respected as a partner in HBH for tax purposes based on its negotiation of, and its realization of a net (after-tax) economic benefit from, the tax-credit transaction. As demonstrated below, none of the Authority's arguments on this point – whether in support of the Tax Court's decision or in rebuttal to the Commissioner's arguments on brief – has any merit.

1. The Authority's discussion of *TIFD* and *Virginia Historic Tax Credit* does nothing to undercut their relevance to this case

The Authority maintains that *TIFD* and *Virginia Historic Tax Credit* have no relevance to this case because the former is factually distinguishable and the latter was decided on a different legal ground. Both arguments are misconceived.

a. The Authority's attempt to marginalize *TIFD* as factually distinguishable is unavailing

In our opening brief (OB:40), we noted that "[m]any of the same factors upon which the Second Circuit relied in finding that the purported bank partners in *TIFD* were, in substance, lenders … support the conclusion that Pitney Bowes was, in substance, not a

partner in HBH but, instead, was a purchaser of tax credits … ." In particular, the Second Circuit explained that "the banks ran no meaningful risk of being paid anything less than the reimbursement of their investment" at an agreed rate of return, *id*. at 37 (quoting *TIFD*, 459 F.3d at 233), and their 98-percent interest in the potential upside of the underlying assets was more nominal than real. *See* 459 F.3d at 228, 234 (noting that, although the banks' interest "ostensibly had unlimited upside potential," "[t]he realistic possibility of upside potential – not the absence of formal caps – is what governs this analysis"). We then demonstrated that, like the nominal partners in *TIFD*, Pitney Bowes was assured of recovering its investment at an agreed rate of return, and its purported right to the lion's share of any potential upside was illusory. *See* OB:41-42, 43-46.

The Authority baldly asserts that *TIFD* "is completely inapposite" (AB:35) because the formal means by which the banks' downside risk and upside potential were minimized differed from the means by which such minimization was accomplished in this case. In this regard, the Authority maintains that, unlike the situation in *TIFD*, Pitney Bowes "has *no* rights under the [HBH operating agreement] to compel HBH to repay all or any part of its capital contribution," its 3-percent preferred return "is not guaranteed," and the Authority has no right "to divest

[Pitney Bowes] of its interest in any income or gains from" the property. *Id*. (emphasis in original). But, as we demonstrated in our opening brief (OB:41-46), the substantive equivalent of each of those aspects of the *TIFD* arrangement is present in this case.

First, Pitney Bowes's recovery of its entire "capital contribution," either in the form of tax credits or their cash equivalent, was ensured by a tax benefits guaranty agreement for which the Authority was financially responsible. *See* OB:41. Moreover, Pitney Bowes's 3-percent preferred return was effectively guaranteed by its option to compel the Authority to purchase its interest (JA291-297) at a price essentially measured by any accrued but unpaid preferred return, and by the Authority's obligation to use a portion of Pitney Bowes's "capital contribution" to purchase a guaranteed investment contract (GIC) "sized to pay off" (JA1211) that purchase price. *See* OB:42. And, because the purchase price under the Authority's call option was determined in the same manner – *i.e.*, by reference to accrued but unpaid preferred return, with a fair-market-value alternative that both parties anticipated would be negligible – the Authority could cut off Pitney Bowes's putative 99.9-percent interest in residual income and residual sale or refinancing proceeds of the Hall at no additional cost by exercising its call option or, failing that, by exercising its "consent"

option (under which the purchase price is not even theoretically tied to fair market value). *See id.* at 44-46, 52 n.22.[2] Thus, the Authority's argument that the facts in *TIFD* "bear no resemblance to those herein," AB:32, does not hold up. Indeed, it is apparent that, in substance, Pitney Bowes was no more a partner in HBH than the banks were partners in the partnership at issue in *TIFD*.

b. The Authority's attempt to marginalize *Virginia Historic Tax Credit* as legally inapposite is misconceived

In our opening brief, we argued (OB:40) that *Virginia Historic Tax Credit* is relevant to this case because it demonstrates that "the distinction between an equity contribution to a partnership, on one hand, and a transfer of funds to a partnership as payment of the sales price of partnership property, on the other, is the same as the principal distinction between equity and debt" that was at issue in *TIFD*, *viz.*, "recovery of an equity investment in a partnership is dependent on the

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[2] That the Authority did not exercise its purchase option when it became exercisable in 2007 is hardly surprising, given the fact that HBH had been under IRS audit since March 2003 and received the IRS's final determination with respect to that audit in February 2007. (JA142, 1636.) Moreover, since it was then apparent that the Hall would not generate any residual income for Pitney Bowes, the Authority had no need to exercise its right to cut off Pitney Bowes's interest in any such income.

entrepreneurial risks of partnership operations, whereas recovery of a loan to a partnership – or receipt of an asset purchased from a partnership – is not." As the Fourth Circuit stated:

> … [T]he only risk here was that faced by any advance purchaser who pays for an item with a promise of later delivery. It is not the risk of the entrepreneur who puts money into a venture with the hope that it might grow in amount but with the knowledge that it may well shrink. …

Virginia Historic Tax Credit, 639 F.3d at 145-46. Pitney Bowes had even less risk, since the tax benefits guaranty agreement essentially required the Authority to refund its "capital contributions" to the extent it did not receive the tax benefits it bargained for.

The Authority contends that *Virginia Historic Tax Credit* "has no application whatsoever to the instant case" (AB:38) because it was decided under the statutory disguised-sale rule rather than the judicially created substance-over-form doctrine. In support of that argument, the Authority suggests that the statutory rule and the judicial theory apply in mutually exclusive contexts, erroneously stating that the Fourth Circuit "assumed that valid partnerships existed *as a necessary condition to applying I.R.C. § 707(b)'s disguised sale rules*." *Id.* at 36 (emphasis added). But, as the Fourth Circuit expressly noted, "[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 (emphasis in original). To wit: "If a person purports to transfer property to a partnership in a capacity as a partner, the rules of this section apply for purposes of determining whether the property was transferred in a disguised sale, *even if it is determined after the application of the rules of this section that such person is not a partner*." *Id*. (quoting Treas. Reg. § 1.707-3(a)(3); emphasis supplied by court). Thus, the Authority's suggestion of mutual exclusivity is plainly wrong.

In its amicus brief, the Trust likewise fails to address the substance of the Commissioner's argument, *viz*., that *Virginia Historic Tax Credit* is relevant to this case because it touches on the same risk-reward analysis that lies at the heart of the bona fide-partner determination. Nowhere does the Trust acknowledge that, consistent with the bona fide-partner analysis, the regulations implementing the disguised-sale rule focus on whether the benefit running from the partnership to the person allegedly acting in the capacity of a partner is "dependent on the entrepreneurial risks of partnership operations." Treas. Reg. § 1.707-3(b)(1)(ii). Instead, the Trust appears to question the Fourth Circuit's holding that "transfers of state tax credits c[an] be the subject of a disguised sale." Trust Br. 31; *see id.* at 31-32 & n.15. That issue, of course, is not present in this case.

2. The Authority's analysis of the bona fide-partner issue does not withstand scrutiny

The Authority's attempt to support Pitney Bowes's bona fide-partner status fares no better than its attempt to downplay the significance of *TIFD* and *Virginia Historic Tax Credit*. Like the Tax Court, the Authority dutifully pays homage to *Culbertson* and its focus on intent, but it makes no attempt to demonstrate how the factors it deems to be indicative of the requisite intent on the part of Pitney Bowes translate into a meaningful stake in the success or failure of the HBH enterprise. In particular, neither the due diligence demonstrated by Pitney Bowes in pursuing the tax-credit transaction, nor the fact that it received a net (after-tax) benefit from the transaction, supports a finding that Pitney Bowes intended to be and was, in substance, a bona fide partner in HBH, rather than a purchaser of tax credits. *See TIFD*, 459 F.3d at 240-41.

a. Pitney Bowes's diligence in investigating and negotiating the tax-credit transaction is not indicative of an intent to be a bona fide partner in HBH

Due diligence and active negotiations with respect to a transaction do not establish that the form of that transaction matches its substance for tax purposes. In particular, Pitney Bowes's thorough investigation and negotiation of the tax-credit transaction does nothing

to solidify its claim that what it walked away with at the end of the day was, in substance, a partnership interest. Indeed, inasmuch as Pitney Bowes's efforts in that regard were largely dedicated to not only insulating itself from the risk of additional liability, but also ensuring that the recovery of its "investment" and the interest-like return thereon would not be subject to the risks of the enterprise, its diligence detracts from, rather than supports, any claim that it had a meaningful stake in the success or failure of the enterprise. Thus, although it can certainly be said that the parties' actions in pursuing the transaction "demonstrate the[ir] intent … to form a true business relationship," AB:41, those actions do not demonstrate that the substantive nature of that business relationship was intended to be that of two partners rather than that of a seller and a purchaser of tax credits. *See Virginia Historic Tax Credit*, 639 F.3d at 145-46 (true nature of transactions between partnerships and their putative limited partners was that of sales of state rehabilitation tax credits).

The emptiness of the Authority's argument in this regard is readily demonstrated by the decisions of courts denying the claimed tax benefits associated with so-called "lease-in, lease-out" (LILO) transactions and "sale-in, lease-out" (SILO) transactions under the substance-over-form doctrine. *See, e.g., BB&T Corp. v. United States*,

523 F.3d 461 (4th Cir. 2008) (LILO case); *Wells Fargo & Co. v. United States*, 641 F.3d 1319 (Fed. Cir. 2011) (SILO case). These tax-driven arrangements are among the most complex, heavily-negotiated, document-intensive transactions imaginable, typically involving assets (such as mass transit railcars) worth hundreds of millions of dollars. Under the Authority's reasoning, courts would be compelled to respect the form of these transactions based on the extensive due diligence and negotiations they entail. Such an approach is clearly untenable.

b. Pitney Bowes's "investment" in, and receipt of a net (after-tax) economic benefit from, the tax-credit transaction is not indicative of an intent to be a bona fide partner in HBH

The Authority roams further astray in asserting (AB:41, 42-43) that the economics of the tax-credit transaction lend credence to Pitney Bowes's claim of bona fide-partner status. As explained above, Pitney Bowes's "substantial financial investment in HBH" could "support[ ] … [a finding] that [Pitney Bowes] is a partner in HBH," as the Authority claims (AB:42), only if Pitney Bowes's recovery thereof were subject to the risks of the enterprise. In fact, recovery of its "investment" was assured by means of a tax benefits guaranty agreement. And that Pitney Bowes would receive (if the tax benefits were upheld) a net after-tax economic benefit from the transaction in the form of tax

credits, tax losses, and its interest-like preferred return, far from "demonstrat[ing] [Pitney Bowes's] intent to become a partner in HBH," *id.* at 42-43, merely demonstrates Pitney Bowes's intent to make an economically rational use of its money on an after-tax basis.[3] Similarly, that the Authority allegedly "kept in constant communication with Pitney Bowes" regarding HBH matters after the September 2000 closing, *id.* at 43, is not indicative of an intent on the part of Pitney Bowes to be a partner in HBH, but rather is attributable to the fact that its obligation to make installment payments of its "capital contribution" was conditioned on the receipt of updated information from the Authority regarding matters – such as IRS audit activity – that might imperil the promised tax credits. (JA176-78, 1576-79, 1636; Tr. 212-13.)

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[3] In that regard, Pitney Bowes's 3-percent preferred return was not dependent on the success of the venture. On the contrary, as demonstrated in our opening brief (OB:42, 47-49, 52 n.22), Pitney Bowes's option to compel the Authority to purchase its interest effectively guaranteed that Pitney Bowes would receive its 3-percent preferred return even if operations of the Hall failed to produce even a dime of net cash flow.

3. The Authority's attack on the Commissioner's risk-reward analysis is meritless

As indicated above, we demonstrated in our opening brief (OB:41-46) that Pitney Bowes had no meaningful stake in the success or failure of HBH because it had neither downside risk nor upside potential with respect to its purported investment in the venture. The Authority's cursory rejoinder (AB:44-46) is replete with mischaracterizations of both the Commissioner's argument and the relevant facts.

a. Pitney Bowes had no meaningful downside risk

Attempting to divert attention from the tenuousness of its position, the Authority begins (AB:44) by falsely accusing the Commissioner of arguing that "a valid partnership cannot exist unless an investor-partner shares in all of the risks and costs of the partnership." Our opening brief makes clear that the relevant inquiry is whether a putative partner has a *meaningful* stake in the success or failure of the enterprise, which would include meaningful downside risk. Indeed, it is the Authority, not the Commissioner, that stakes out an extreme position on the risk spectrum by suggesting that a putative partner must be respected as such for tax purposes unless it is shielded from *all* – even *de minimis* – risk. In that regard, the Authority points to the remote possibility of an environmental disaster (*id.* at 45) and to

the even remoter possibility that (1) Pitney Bowes, as a passive member of a limited liability company, would face third-party liability as the result of such a disaster,[4] and (2) the combination of insurance proceeds and the Authority's deep pockets would be insufficient to make Pitney Bowes whole in that situation. As explained in our opening brief (OB:46-47), any such environmental risk was *de minimis* rather than meaningful. *See ASA Investerings P'ship v. Commissioner*, 201 F.3d 505, 514 (D.C. Cir. 2000) (disregarding *de minimis* risk and observing that no monetary transaction is entirely without risk); *see also TIFD II*, 2012 WL 181599, *9 ("The 'risks' in question were in the nature of *appearance* of risk, rather than *real* risk.") (emphasis in original).

The remainder of the Authority's arguments in this regard are equally infirm. For instance, the Authority accurately states that its completion guaranty in favor of Pitney Bowes "d[id] not eliminate all risk that the renovations to the East Hall would be successfully completed so that [Pitney Bowes] would earn the historic tax credits,"

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[4] As noted in our opening brief (OB:47 n.18), Pitney Bowes received a legal opinion that, as a passive investor, it would not be subject to any liability claims for environmental hazards associated with the East Hall project. (JA1163-1170.)

AB:45, but it ignores the critical fact that Pitney Bowes would be made whole in that situation under the tax benefits guaranty agreement.[5] And its statement that Pitney Bowes's preferred return "was clearly subject to the operational risks of HBH," *id.*, flies in the face of the parties' various agreements. In particular, it ignores Pitney Bowes's option to compel the Authority to purchase its interest at a price equal to the *greater* of the interest's fair market value (anticipated to be negligible) or any accrued but unpaid portion of its annual 3-percent preferred return. (JA292.) It similarly ignores the Authority's obligation to use a portion of Pitney Bowes's "capital contribution" to purchase a GIC "sized to pay off" (JA1211) that purchase price (or the purchase price under the Authority's call option, which was determined in the same manner).

b. Pitney Bowes had no meaningful upside potential

The Authority's attempt to rebut the "reward" side of the Commissioner's risk-reward argument – *viz.*, that Pitney Bowes had no

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[5] The Trust makes the same mistake in suggesting (Trust Br. 29) that Pitney Bowes's realization of the economic benefit of the tax credits was dependent on the successful renovation of the Hall. On the contrary, under the tax benefits guaranty agreement, Pitney Bowes was assured of receiving either the tax benefits or their cash equivalent. (JA298-307.)

meaningful upside potential – fares no better. The Authority's assertion that the Commissioner "wrongfully refuses to recognize the 3 percent preferred return and the historic tax credits as part of [Pitney Bowes's] upside benefit from the investment in HBH," AB:46, demonstrates a fundamental misapprehension of the relevant inquiry. The issue is not whether, if the tax benefits were upheld, Pitney Bowes stood to realize a net economic benefit from its "investment." Rather, the issue is whether the economic benefit, consistent with that attendant to a true equity interest, included a meaningful participatory interest in the potential growth of HBH's profits and capital. A return of capital (in the form of the promised tax credits) with an effectively guaranteed return capped at 3 percent is not a meaningful participatory interest by any stretch of the imagination.

Moreover, any aspects of Pitney Bowes's investment that were participatory in form were illusory in substance. Although the put and call options, in form, required the payment of the fair market value of Pitney Bowes's interest (if that was greater than the amount of its accrued but unpaid preferred return), neither party expected Pitney Bowes's interest to have any significant value during the periods in which those options were exercisable, due to the enormous amount of debt to which the underlying property was subject. *See* OB:44-46, 52

n.22. Thus, in practical terms, Pitney Bowes's return on its "investment" was capped at 3 percent.

In addition, although Pitney Bowes, in form, had a 99.9-percent interest in HBH's residual cash flow and in any residual proceeds from the sale or refinancing of the property, that interest was illusory as well. Any argument to the contrary ignores the Authority's ability to purchase Pitney Bowes's interest without regard to fair market value (either as a practical matter, in the case of its call option, or literally, in the case of its consent option). (JA185-86, 284-290.) Further, even the wildly optimistic financial projections for the deal forecast no residual cash flow available for distribution through 2042, and those figures do not take into account the required retirement of operating deficit loans (in excess of $28 million as of the end of 2007). (JA1659, 1665.) *See* OB:43-44. And Pitney Bowes's interest in residual sale or refinancing proceeds would come into play only if those proceeds were sufficient to pay off all amounts owing to the Authority under the acquisition loan, the construction loan, and the operating deficit loans (which had grown to about $140 million in the aggregate by the end of 2007). In this regard, the record contains no indication that Pitney Bowes's due diligence led it to conclude that it would receive any meaningful economic benefit other than the effectively guaranteed 3-percent

preferred return (which derived from the use of its funds to purchase a GIC, not from partnership operations) and the tax benefits. *See* OB:45-46.[6]

B. HBH was a sham

We also demonstrated in our opening brief that HBH's allocation of tax credits and tax losses to Pitney Bowes may be disallowed under the sham-partnership theory. Whereas the bona fide-partner analysis operates to recharacterize a putative partnership interest in accordance with its substance, the sham-partnership analysis operates to disregard the existence of a partnership as an entity where there is no substance to the partnership form. In that sense, the sham-partnership theory is a variant of the economic-substance (sham-transaction) doctrine, under which a transaction may be disregarded for tax purposes as devoid of economic substance. *See ASA Investerings*, 201 F.3d at 512 & n.4 (finding that the Tax Court's "decision rejecting the bona fides of the *partnership* was the equivalent of a finding that it was, for tax purposes, a 'sham,'" and noting that "one might logically enough place the Tax Court's findings here under the 'sham transaction' heading,

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[6] Indeed, that Pitney Bowes went so far as to agree to waive any claim to revenues from the sale of naming rights to the Hall, OB:46 n.17, confirms the understanding of the parties in this regard.

viewing the formation of the partnership as the transaction") (emphasis in original).[7]

1. The Authority's claim that the Commissioner raised the sham-partnership theory for the first time on appeal is baseless

In its answering brief (AB:47-48), the Authority asserts that the Commissioner raised the sham-partnership theory for the first time on appeal, even as it acknowledges that the IRS asserted in its administrative determination (FPAA) that the formation of HBH was a sham transaction, *id.*, and that the Tax Court rejected the argument that "HBH is a sham," *id.* at 47. The Commissioner did, in fact, raise the sham-partnership theory below. *See* Doc. 57, Opening Br. for Resp't, at 79 (heading entitled "The Sham Partnership Doctrine"). As a conceptual matter, however, we submit that there is no meaningful distinction between arguing that the formation of HBH was a sham transaction, on one hand, and arguing that HBH is itself a sham that should be disregarded under the sham-partnership theory, on the

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[7] In its amicus brief, the Roundtable insists that the sham-partnership theory is *not* a variant of the economic-substance doctrine, suggesting instead that it falls under the umbrella of the substance-over-form doctrine. But the Roundtable fails to explain why a theory that operates to disregard a partnership, rather than recast it as some other arrangement or relationship, is more akin to the substance-over-form doctrine than the economic-substance doctrine.

other. *See ASA Investerings*, 201 F.3d at 512 & n.4 (referring to the "ultimate unity of the [sham] tests," "whether the 'sham' be in the entity or the transaction").[8] As the Commissioner asserted below, "[a] partnership failing to serve a non-tax business purpose is a sham," and "[p]artnerships lacking economic substance serve no nontax business purpose." Opening Br. for Resp't at 79 (citing *ASA Investerings*, 201 F.3d at 512, and *Commissioner v. Tower*, 327 U.S. 280, 291 (1946)). Accordingly, it makes no difference whether the Commissioner's characterization of HBH as a sham is evaluated under the entity-specific sham-partnership theory or under generic sham-transaction principles as applied to the formation of HBH to effect the transfer of tax credits to Pitney Bowes. Each analysis compels the same conclusion: HBH should be disregarded for tax purposes because its sole purpose was to effect an indirect sale of the Authority's federal rehabilitation tax credits to Pitney Bowes.

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[8] Contrary to the Authority's suggestion (AB:48), the D.C. Circuit did not repudiate this aspect of *ASA Investerings* in *Saba P'ship v. Commissioner*, 273 F.3d 1135 (D.C. Cir. 2001). Rather, the *Saba* court assumed, based on the parties' representations, that disregarding *the transactions engaged in by the purported partnerships* under the sham-transaction doctrine, on one hand, and disregarding the partnerships under the sham-partnership doctrine, on the other, would yield different tax consequences. *See id.* at 1140.

2. The tax-credit transaction is not exempt from sham-transaction analysis

The Authority erroneously posits that the tax-credit transaction is altogether immune from sham-transaction principles. In our opening brief (OB:58-59), we cited *Friendship Dairies, Inc. v. Commissioner*, 90 T.C. 1054, 1064 (1988), for its holding that the benefit of the investment tax credit – which includes the rehabilitation tax credit, *see* I.R.C. § 46(1) – should not be considered in evaluating the economic substance of a transaction unless the "transaction[ ] … is unmistakably within the contemplation of congressional intent." The Authority asserts, however (AB:50), that, if Congress had the instant tax-credit transaction in mind when it enacted the rehabilitation tax credit, then the sham-transaction doctrine is wholly inapplicable. It then makes the remarkable assertion (*id.* at 50-51) that "HBH presented overwhelming evidence in the trial court which unequivocally proved that the formation and operation of HBH was indisputably within the intendment of I.R.C. § 47," such that the sham-transaction doctrine is inapplicable. The Authority does not identify any of the "overwhelming evidence" it presented at trial that would "unequivocally prove" this claim of congressional intent; instead, it simply recites the unremarkable proposition (*id.* at 51) that Congress enacted § 47 "to

encourage private sector investment in the rehabilitation of historic structures that may not otherwise appear economically viable."

As we explained in our opening brief (OB:59), although Congress clearly intended to encourage the activity of historic preservation, there is not the slightest indication in the legislative history that it thereby intended to sanction transactions like the one at issue here, where a state instrumentality sells its federal tax credits to the highest corporate bidder under the guise of undertaking a true joint venture with that corporation. Indeed, the recent Joint Committee explanation of the 2010 codification of the economic substance doctrine indicates that Congress does not enact tax credits with the intention of giving taxpayers carte blanche to structure credit-generating transactions without regard to economic substance. *See* Staff of the Joint Comm. on Taxation, 111th Cong., *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patient Protection and Affordable Care Act,"* 152 n.344 (JCX-18-10) (Mar. 21, 2010) ("it is not intended that a tax credit" such as the rehabilitation credit "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") (emphasis added). The Authority's bald assertion that the

transaction at issue "was precisely 'the thing which the statute intended,'" AB:51, is utterly unfounded. On the contrary, Pitney Bowes made no "investment" in the rehabilitation of the Hall, but, instead, purchased the Authority's unusable tax credits.

Indeed, in assuming that Pitney Bowes made an "investment" in the Hall and then relying on such "investment" to argue that the instant transaction is precisely what Congress had in mind in enacting the historic rehabilitation tax credit, the Authority is simply begging the question presented by this case. As we have demonstrated herein and in our opening brief, Pitney Bowes made no investment in the Hall. Although it allegedly had a 99.9-percent ownership interest in HBH, it could never be called upon to help fund construction cost overruns or operating deficits. Indeed, it did not even place its purported capital contributions at the risk of the venture. Nor did it stand to benefit from the financial success, if any, of the Hall. If Congress wanted to allow the States to monetize their federal rehabilitation tax credits in the manner New Jersey has attempted here, it would have authorized straightforward sales of the credits by the States to all comers. Since it has not done so, it is nonsensical to attribute to Congress an intent to permit such a sale indirectly by means of a sham partnership between a State and the purchaser of its tax credits.

3. The Authority's sham-transaction analysis does not withstand scrutiny

Retreating from its claim that sham-transaction principles are wholly inapplicable to the tax-credit transaction, the Authority erroneously maintains (AB:51) that "the IRS's sham transaction theory still fails." In support of this claim, the Authority asserts (*id.*) that Pitney Bowes "invested capital of approximately $19.3 million" and that HBH "obtained the use of these funds for purposes of renovating the East Hall." We have already demonstrated that Pitney Bowes's cash outlay had none of the hallmarks of an "investment" in the rehabilitation project. Moreover, the notion that HBH obtained those funds for use in the rehabilitation project does not square with the record.

As the Tax Court found, Pitney Bowes's "capital contributions" were used for the payment of costs that would not have been incurred absent the tax-credit transaction: $14 million for the payment of a "development fee" to the Authority, $3,332,500 for the acquisition of a GIC to fund the payment of accrued and unpaid preferred return upon Pitney Bowes's exit from HBH, and the remainder for the payment of

"assorted fees related to the [tax-credit] transaction." (JA18.)[9] The Authority's rejoinder – that "funds invested in a real estate project are fungible," AB:53 – misses the point: Pitney Bowes's "investment" added no value to the rehabilitation project, as it was offset by a corresponding amount of costs that would not have been incurred but for that "investment." In that regard, the Authority's assertion that "without [Pitney Bowes's] capital, the funds for payment of the development fee to [the Authority] would have come from the taxpayers of New Jersey," *id.*, is wrong; absent the tax-credit transaction, there would not have been a development fee in the first place (the Authority could hardly charge *itself* a development fee). *See* OB:54 n.19. Similarly, the Authority's assertion that "HBH would not have had sufficient funds to pay the East Hall's total rehabilitation costs" without Pitney Bowes's "investment," AB:51, is not supported by the

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[9] Although the Authority accuses the Commissioner of "misleadingly alleg[ing] that a portion of [Pitney Bowes's] investment was directed to pay [the] development fee," AB:53, the Tax Court specifically found that "[m]ost of Pitney Bowes' capital contributions were used to pay a development fee to [the Authority]." (JA41-42.) Even the Trust acknowledges (Trust Br. 30) that "HBH applied approximately $14 million of Pitney Bowes' contributions to [the] development fee."

accompanying record citations and, in fact, is contradicted by the record. (JA802, 1714.) *See* OB:6.

Finally, we note that Pitney Bowes's diligence in investigating the tax-credit transaction – which the Authority views as indicative of a subjective business purpose, AB:54 – is no more relevant to the sham-transaction analysis than it is to the bona fide-partner analysis. *See supra* pp. 10-12. As the Authority itself points out (AB:53), the business-purpose inquiry under the sham-transaction analysis focuses on the parties' subjective motivations for entering into the transaction. Pitney Bowes undertook its due diligence, of course, *after* it had decided to enter into the transaction.

4. The Authority's reliance on *Sacks* is misplaced

In our opening brief (OB:55-59), we demonstrated that the Tax Court erroneously relied on *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995), as justification for taking Pitney Bowes's tax benefits into account in determining objective economic substance and subjective business purpose. In response (AB:56-57), the Authority attempts to garner support for the application of *Sacks* by reciting the grounds on which this Court distinguished that case in *ACM P'ship v. Commissioner*, 157 F.3d 231, 257 n.49 (3d Cir. 1998), and *In re CM Holdings, Inc.*, 301 F.3d 96, 106 (3d Cir. 2002), and then asserting that

those grounds for distinction do not exist in the instant case. This attempt fails for two reasons. First, nothing in *ACM P'ship* or *CM Holdings* even remotely suggests that, in distinguishing *Sacks*, this Court somehow implicitly endorsed the reasoning of that case – something that no other Court of Appeals has done in the 16 years since its issuance. Second, the Authority's attempt to align this case factually with *Sacks* is unavailing. *See* OB:57.

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

An additional reason for disallowing HBH's allocation of rehabilitation tax credits to Pitney Bowes is that in substance, the Authority (rather than HBH) owned the East Hall throughout the rehabilitation period. Specifically, as demonstrated in our opening brief (OB:60-62), the purported transfer of the East Hall by the Authority to HBH pursuant to a long-term sublease did not effect a transfer of the benefits and burdens of ownership of the property. That conclusion is reinforced by the fact that, through its "consent" option, the Authority retained the right to purchase Pitney Bowes's interest without regard to fair market value, which would result in an identity of interest between HBH and the Authority as a practical matter. *See id.* at 62-63. The Authority's response to the Commissioner's ownership

argument, like its responses to the Commissioner's other two arguments, emphasizes form at the expense of substance.

1. The Authority's reliance on the term of the sublease is misplaced

That most of the points relied upon by the Authority in support of the Tax Court's ruling on the ownership issue (AB:58-61) relate to the formalities of the transfer is self-evident. There is, however, one statement that merits a specific response: the assertion (*id*. at 59-60) that "[t]he 87-year term of the sublease, standing alone, is undeniable evidence of a sale." To the extent the Authority is suggesting that the term of the sublease, by itself, establishes that a sale occurred for tax purposes, it cites no authority for that proposition, and we submit that there is none to be found. Indeed, it is absurd to suggest that an arrangement whereby a purported seller retains the benefits and burdens of ownership of the property somehow becomes a sale if the duration of the purported purchaser's empty interest is long enough. *See, e.g.*, *BB&T* and *Wells Fargo*, *supra* pp. 11-12 (disregarding lengthy subleases under substance-over-form doctrine).

2. The Authority glosses over the Commissioner's "benefits and burdens" argument

In our opening brief (OB:60-61), we listed numerous burdens of ownership of the East Hall expressly retained by the Authority. In

response (AB:61), the Authority makes a blanket assumption, unsupported by any citation to the record, that "[t]hese types of net lease provisions … are common in real estate transactions" and then cites two *equipment-leasing* cases for the broad proposition that net-lease provisions – undefined in scope in either of the cases – are irrelevant to the analysis. It then dismisses the Commissioner's citation (OB:61) to *Sun Oil Co. v. Commissioner*, 562 F.2d 258, 261, 263 (3d Cir. 1977) – in which this Court held that a purported seller that immediately leased the property back pursuant to a net-lease arrangement retained "essentially all burdens, risks, and responsibilities for the properties"– on the ground that factual distinctions make the case wholly irrelevant (AB:61-62). In that regard, the Authority takes the same simplistic approach to *Sun Oil* that it takes with respect to *TIFD* in the context of the bona fide-partner theory.

3. The Authority mischaracterizes the nature of its "consent" options

We also demonstrated in our opening brief (OB:62-63) that the Authority's "consent" options – which were neither limited to a particular window of exercise nor subject to a fair market value requirement – were analogous to the "built in latch-string" that this

Court found to be inconsistent with a true sale in *Sun Oil*, 562 F.2d at 268. The Authority demurs (AB:63-64), citing the parties' self-serving testimony to the effect that "the likelihood of its exercise was infinitesimally minute." But nothing in *Sun Oil* indicates that the likelihood of exercise has any bearing on the analysis. Moreover, the Authority's claim that Pitney Bowes could forestall any exercise of the option by consenting to the otherwise option-triggering action proposed to be taken by the Authority, *id*., assumes that the Authority was required to solicit and/or accept Pitney Bowes's consent in the first place, an assumption that is not supported by the language of the relevant provisions of the operating agreement. (JA185, 186.) And its claim that "[t]he parties agreed that the consent option had no validity after the [5-year] recapture period," AB:64, is simply not true. *See* Tr. 764 (counsel for Pitney Bowes testifying that "the point of concern was that five year period, but the language does not appear to have [the consent option] expire at a certain point," and acknowledging the possibility that "the Sports Authority would have the same overall issue about having governance authority over the transaction" after the expiration of the 5-year period).

D. Postscript

As a final point, and in particular in response to the amicus brief filed by the Trust, we urge the Court to follow the lead of the Fourth Circuit in *Virginia Historic Tax Credit* in recognizing that the flexibility afforded the partnership form by federal tax law is not limitless, even where its use is defended as a means of facilitating tax-favored activity. As that court stated in upholding the Commissioner's adjustments, "Virginia's Historic Rehabilitation Program is not under attack here." 639 F.3d at 146 n.20. Similarly, it is the prohibited sale of federal tax credits – not the rehabilitation tax credit provision itself – that is under attack here. It is up to Congress to authorize such sales should it determine that the current system is not sufficiently encouraging historic rehabilitation activity.

CONCLUSION

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

Respectfully submitted,

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JANUARY 2012

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Dated: January 31, 2012

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I certify that on January 31, 2012, I mailed ten paper copies of the foregoing reply brief for the appellant Commissioner of Internal Revenue to the Court, and I electronically filed a PDF copy by CM/ECF on the same day. I further certify that on January 31, 2012, the foregoing reply brief was served on counsel of record for the appellee, a Filing User, and on counsel of record for each of the amici curiae, each of whom is a Filing User, through the CM/ECF system.

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