No. 11-1832

IN THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

HISTORIC BOARDWALK HALL, LLC,

Petitioner-Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant

ON APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

BRIEF FOR THE APPELLANT
COMMISSIONER OF INTERNAL REVENUE

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GLOSSARY

ACCCA – Atlantic City Convention Center Authority

CRDA – New Jersey Casino Reinvestment Development Authority

FASB – Financial Accounting Standards Board

FPAA – notice of final partnership administrative adjustment

GE – General Electric Capital Corporation

GIC – guaranteed investment contract

HBH – Historic Boardwalk Hall, LLC

LLC – limited liability company

QRE – qualified rehabilitation expenditures

RFP – Request for Proposal

SMG – Spectacor Management Group

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

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STATEMENT OF JURISDICTION

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

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

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

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

STATEMENT OF THE ISSUE

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

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

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

STATEMENT OF RELATED CASES AND PROCEEDINGS

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

STATEMENT OF THE FACTS

A. Background

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

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

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

B. Renovation of the East Hall

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

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

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

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

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

C. Selling the tax credits

1. The pitch

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

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

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

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

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

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

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

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

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

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

2. Making the numbers work

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

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

3. Confidential information memorandum

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

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

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

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

4. Selection of Pitney Bowes as the purchaser

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

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

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

5. Making the numbers work (again)

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

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

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

D. The initial closing

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

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

1. HBH operating agreement

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

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

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

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

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

2. Lease amendment, sublease, and acquisition loan

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

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

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

3. Development agreement and construction loan

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

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

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

4. Purchase option agreement and agreement to compel purchase

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

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

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

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

5. Tax benefits guaranty

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

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

E. HBH in operation

1. Construction phase

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

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

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

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

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

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

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

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

2. Post-construction phase

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

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

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

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

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

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

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

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

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

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

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

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

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

1. HBH's 2000-2002 federal tax returns

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

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

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

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

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

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

2. The notice of final partnership administrative adjustment

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

3. Tax Court proceedings

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

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

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

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

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

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

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

SUMMARY OF ARGUMENT

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

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

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

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

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

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

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

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

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

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

ARGUMENT

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

Standard of review

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

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

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

1. Recent guideposts

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2. Application of these authorities to the instant case

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

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

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

a. Pitney Bowes had no downside risk

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

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

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

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

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

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

b. Pitney Bowes had no upside potential

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

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

income in *TIFD* was illusory, so, too, was Pitney Bowes's 99.9-percent interest in HBH's residual net cash flow. Specifically, Pitney Bowes's 99.9-percent interest in residual cash flow would come into play only after payment of annual installments on the Authority's acquisition loan ($3,580,840 per year for 40 years, plus arrears), payment of annual installments on the Authority's construction loan (plus arrears),[16] *and* payment in full of the Authority's operating deficit loans to HBH (in excess of $28 million as of 2007). (JA196.) Even the wildly optimistic financial projections forecast *no residual cash flow available for distribution through 2042*, and those figures do not take into account the required retirement of operating deficit loans. (JA246, 1532.)

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

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

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

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

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

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

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

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

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

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

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

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

(continued...)

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

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

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

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

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

B. HBH was a sham

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2. HBH served no non-tax business purpose

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

In the instant case, although Congress clearly intended to encourage the underlying *activity* (historic preservation), it cannot be said that the structure of this *transaction* – that is, the alleged partnership arrangement between Pitney Bowes and the Authority – is so "unmistakably within the contemplation of congressional intent," 90 T.C. at 1064, as to warrant departure from the normal application of the sham-partnership doctrine. To the contrary, there is no authority that supports the notion that Congress intended to allow a State to shift part of the cost of rehabilitating a State-owned historic structure to the Federal government by selling its Federal rehabilitation tax credits to the highest corporate bidder under the guise of undertaking a true joint venture with that corporation.

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

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

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

1. Benefits and burdens of ownership

The sublease agreement by which the Authority purportedly transferred ownership of the East Hall to HBH reveals just how little changed upon execution of that agreement. The Authority remained liable for key East Hall operating expenses, including all water, gas, sewer, electricity, light, heat, and power. (JA418.) It also remained liable for all real estate taxes and governmental assessments for betterments. (*Id.*) Moreover, the Authority agreed to maintain, at its

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

sole cost and expense, workers' compensation, property, and other insurance coverage for the premises and improvements, and other insurable property and equipment located on the premises. (JA420-21.) HBH, on the other hand, bore virtually no burdens of ownership. Indeed, HBH was not even responsible for its own actions:

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

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

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

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

2. Perpetual consent option

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

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

3. The Tax Court's analysis again falls short

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

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

CONCLUSION

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

CERTIFICATION OF BAR MEMBERSHIP

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

Respectfully submitted,

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Dated: October 27, 2011

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

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