

Resources

Third Circuit Applies Tax Shelter Theory in Historic Tax Credit Case

September 7, 2012

Recently, the United States Court of Appeals for the Third Circuit issued an opinion overruling the Tax Court in *Historic Boardwalk Hall, LLC v. Commissioner*, Case No. 11-1832 (August 27, 2012). Relying on tax shelter case law defining the concept of “partnership,” and conducting a debt/equity analysis, the court ruled that a historic tax credit investor was not a true partner in Historic Boardwalk Hall, LLC (HBH), and, therefore, was not entitled to an allocation of historic rehabilitation tax credits under Section 47 of the Internal Revenue Code. *Historic Boardwalk Hall* had undertaken the rehabilitation of the East Hall in Atlantic City, New Jersey, although the project was started, and generally continued to be controlled by the New Jersey Sports and Exposition Authority (the Authority). Although the taxpayer’s brief suggested that Congress intended to foster partnerships between for-profit and tax-exempt entities, the court did not explicitly address that issue.

In *Historic Boardwalk Hall* the Third Circuit focused its analysis on whether the tax credit investor held an equity interest in HBH, noting that an ownership interest is required to claim rehabilitation credits. In its debt/equity analysis, the Third Circuit accepted the government’s argument that “The key point is that the ‘recovery of an equity investment in a partnership is dependent on the entrepreneurial risks of partnership operations, whereas recovery of a loan to a partnership—or receipt of an asset from a partnership—is not.’” On the other hand, the court acknowledged that preferred returns generally are structured with some downside risk protection. Nonetheless, the court concluded that the risk protection in this case went too far.

Four factors weighed heavily on the decision. First, multiple revisions of profit projections demonstrated that the participants reasonably knew the operations of the partnership would not produce a profit unless the operating expenses were heavily subsidized by the Authority. Indeed, the court described the projections as “smoke and mirrors.” Second, the investor negotiated substantial protections not only to ensure the project was completed in accordance with Code Section 47 (without recapture), but also to eliminate all of its downside risk in HBH. Third, put and call options on the investor’s interest, backed by a guaranteed investment contract purchased by the Authority to defease its obligations under the options, effectively capped the investor’s upside participation and ensured that the Authority would have sufficient funds to purchase the investor’s interest as soon as the credits were safe from recapture. Fourth, the investor only delivered its purported equity contributions after the underlying credits had been earned.

Going Forward

The exact mix of risk protection and upside limitation crossed the debt/equity line in *Historic Boardwalk*. Developers and investors in historic renovation projects will need to reevaluate the structure of the typical investment to take into account this case. The aggressive structuring in *Historic Boardwalk* both underscores the need for thoughtful analysis regarding the participation of a passive investor in a rehabilitation project, and also provides a set of guidelines against which future transactions can be measured to ensure that the investor legally is entitled to claim the rehabilitation credits. Generally, we can expect a more conservative approach with a reduced menu of options and indemnities available to the investors, as well as alterations in the pricing of the transactions to take account of the changes in relative risks and rewards in the investment.

Dykema’s Real Estate Tax Incentives & Economic Development team members are available to assist taxpayers in a broad array of tax matters, including the structuring of investments in historic rehabilitations and new markets development projects.

Please contact **Anthony Ilardi** at 248-203-0863, **Pam MacDougal** at 616-776-7570, or **Bill Lentine** at 313-568-5371, with questions about tax matters.

Third Circuit Applies Tax Shelter Theory in Historic Tax Credit Case (Cont.)

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