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Court: Tax Equity Partnerships Promote Congressional Intent

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Tax credit investors received a big boost from the U.S. Tax Court in *Historic Boardwalk Hall LLC v. Commissioner*, 136 TC No. 1 (January 3, 2011). The court upheld a partnership structured to generate historic rehabilitation tax credits for a corporate investor notwithstanding the investor's limited risks and clear tax motivation. Where Congress enacts tax credits consciously to spur investment in unprofitable project areas, taxpayers act appropriately in pursuing transactions that make business sense only on an after-tax basis. The case has positive implications for renewable energy sector investors looking to avail themselves of production tax credits, investment tax credits, accelerated depreciation deductions, and other tax incentives.

Renovating Boardwalk Hall

In the late 1990s, New Jersey Sports and Exposition Authority (NJSEA) was preparing a multi-million dollar renovation of Boardwalk Hall in Atlantic City. Built in 1929, the 250,000 square foot facility has hosted the Beatles, the 1964 Democratic National Convention, WrestleMania, and most famously, the Miss America Pageant. Even better, Boardwalk Hall is a "certified historic structure" whose rehabilitation expenses are eligible for a 20% tax credit under Section 47 of the Internal Revenue Code.

As a tax-exempt state authority, the NJSEA has no use for rehabilitation tax credits. But facing a $100 million renovation, NJSEA could ill-afford to leave more than $20 million in tax incentives on the table. Accordingly, NJSEA solicited 19 taxpaying corporations for bids to "purchase" the credits at some discount off face-value. Eventually, the investment bid of a Pitney Bowes Corp. subsidiary (Pitney Bowes) was accepted and Historic Boardwalk LLC was born.

Tax Equity Partnership

NJSEA and Pitney Bowes formed the LLC in 2000. Pitney Bowes contributed $18.1 million and lent an additional $1.2 million in exchange for a 99.9% LLC ownership interest. The LLC acquired tax ownership of the facility, and thus the ability to allocate the tax credits to Pitney Bowes, through a $53.6 million capital lease from NJSEA. The LLC financed the acquisition through a $57.2 million loan from NJSEA. Pitney Bowes's capital contribution was paid to NJSEA as a combination of debt service and a $14 million development fee.

The LLC paid out its cash flow in layers of priority: first to Pitney Bowes as interest on its loan, then 99.9% to Pitney Bowes and 0.01% to NJSEA until Pitney Bowes had received a 3% preferred return on its capital contributions, then to NJSEA as debt service, and last 99.9% to Pitney Bowes and 0.01% to NJSEA as profits. Business projections, however, cast doubt on whether the LLC could ever be profitable enough to make distributions under the last, "profit" layer.

Other arrangements limited Pitney Bowes's potential profits or losses. A series of offsetting puts and

calls made it likely that NJSEA would buy out Pitney Bowes after the five-year tax credit recapture period had expired. NJSEA stood behind the eventual receipt of the tax credits, or an equal amount of cash, through a construction completion guaranty and even a "Tax Benefits Guaranty Agreement."

In the end, the LLC completed its renovation of Boardwalk Hall and claimed $109 million of qualified rehabilitation expenditures. The resulting $21.8 million in tax credits were allocated to the members in accordance with their "ownership interests," i.e., 99.9% to Pitney Bowes and 0.01% to NJSEA.

The IRS's "Economic Substance" Challenge

Enter the Internal Revenue Service (IRS), which denied the LLC's allocation of tax credits to Pitney Bowes on several grounds that all turned on whether the LLC had "economic substance" to the members, including the possibility of profit or loss from owning Boardwalk Hall. Ordinarily, tax benefits are ignored when determining whether a transaction could yield a profit and therefore had economic substance.

On that basis, the IRS asserted that Pitney Bowes had no real stake in the LLC other than its receipt of tax credits. The various agreements assured Pitney Bowes of its fixed return and protected it against liability on the debt or operating losses. The offsetting puts and calls made it likely that NJSEA would buy out Pitney Bowes once the credit recapture period expired. Economic projections indicated the facility would have trouble yielding profits for its members. (This turned out to be true—Boardwalk Hall has consistently operated at a pre-tax loss.) Even the 3% preferred return to Pitney Bowes was insufficient, according to the IRS, as this was well below any market rate of return on non-tax motivated investments.

Congressional Intent to Promote Investment in Unprofitable Activity

The Tax Court disagreed and took a sunnier view of tax credit investing. The court found that the transaction had economic substance through the 3% preferred return, a potential for profit, and the bona fide business of owning and renovating Boardwalk Hall. More importantly, the court found that Congress enacted the rehabilitation tax credit to spur private investment in what would otherwise be an unprofitable activity. If the government attacks investors who respond to that incentive, "it takes away with the executive hand what it gives with the legislative." The "normal" rule that the transaction must be profitable on a pre-tax basis does not apply.

Of note to renewable energy investors, the court relied on *Sacks v. Commissioner*, 69 F. 3d 982 (9th Cir. 1995). There, the Ninth Circuit Court of Appeals approved of a solar energy equipment sale-leaseback transaction that was economical only after taking into account congressionally enacted solar energy tax credits. Congress, the court said, had purposely used tax incentives to change investors' conduct. The IRS should not use lack of pre-tax profits, the reason Congress created the tax benefits in the first place, as a ground for denying them.

The Tax Court implied that its logic was narrowly tailored to situations where the intent of Congress was clear. The decision took pains to distinguish two other cases striking down tax-motivated transactions where Congress did not specifically incentivize unprofitable investments: *Friendship Dairies, Inc. v. Commissioner*, 90 T.C. 1054 (1988) (sale-leaseback transaction of computer equipment under the "old," non-energy related investment tax credit enacted to encourage capital investment generally but not any specific, unprofitable activity) and *In re C.M. Holdings*, 301 F.3d 96 (3d Cir. 2002) (leveraged contribution to corporate-owned life insurance that generated deductions).

Will the Decision Stand Up?

On close reading, the Tax Court's reasoning is less than iron-clad in some parts. The IRS may choose to appeal to the Third Circuit, or the IRS may assert new arguments in a future case with similar facts. For example, the Tax Court was silent on whether Pitney Bowes's 3% preferred return was more debt rather than equity in view of its payment priority over the LLC's acquisition debt to NJSEA. If this were the case, and it really were unlikely that the LLC would make any distributions under the final "profit"

layer, then Pitney Bowes might not be an equity partner entitled to allocation of the credits. Moreover, no mention is made of whether Pitney Bowes's ownership truly was 99.9% (entitling it to 99.9% of the tax credits) notwithstanding its limited potential for profit or loss. Finally, the court's distinction of the facts from those of *Friendship Dairies* was terse and attenuated.

Lessons for Renewable Energy

Even though *Historic Boardwalk Hall LLC* concerns historic rehabilitation credits, it is good news for renewable energy developers and investors. Not only are tax equity partnerships in the energy sector similar to those in this case, but the intent of Congress to overcome profitability concerns through tax incentives is even more clear with respect to renewable energy investments. The court approved of various methods to assure investors of their tax benefits while protecting them against unforeseen loss. This should give parties greater flexibility in negotiating deals that give each side what they really want without fear of an "economic substance" attack from the IRS. Tax credit investors should now hold their heads high knowing they are doing the work of angels…or at least Congress.

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