CLIENT ALERT

Third Circuit Reverses Tax Court, Clarifies Scope of Economic Substance Doctrine in *Historic Boardwalk Hall, LLC v. Commissioner*

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The Third Circuit handed the IRS another victory on the issue of who qualifies as a "bona fide partner" for tax purposes in *Historic Boardwalk Hall, LLC v. Comm'r*, No. 11273-07 (3d Cir. August 27, 2012). Reversing the Tax Court, the Third Circuit held that Pitney Bowes was a partner in form, not in substance, in an LLC that completed a project qualifying for historic rehabilitation tax credits, and could not claim the rehabilitation tax credits, regardless of whether the transaction otherwise had economic substance. The decision adds to a string of recent IRS victories in cases attacking highly-structured, tax-advantaged partnerships. The decision also clarifies that substance over form analysis of a transaction is separate from whether a transaction has economic substance. This clarification promises to be important when the IRS and taxpayers litigate the meaning of the newly-codified economic substance doctrine and the new economic substance penalty.

Historic Boardwalk Hall involved New Jersey's project to rehabilitate historic East Hall on the Atlantic City Boardwalk, which is known as the venue for the annual Miss America pageant. Although the project qualified for historic building rehabilitation credits, the state instrumentality responsible for the rehabilitation had no use for income tax credits. Accordingly, it entered into a partnership, Historic Boardwalk Hall LLC (the "LLC"), with a corporate investor, Pitney Bowes. The LLC allocated the credits to Pitney Bowes. The IRS challenged whether Pitney Bowes could use the credits.

The Tax Court held for the taxpayer, finding that the LLC had a legitimate business purpose and that Pitney Bowes was a bona fide partner in the LLC. Focusing on the Supreme Court precedent *Commissioner v. Culbertson*, the Tax Court found that Pitney Bowes was a bona fide partner because the parties in good faith and acting with a business purpose intended to join together to conduct business, and Pitney Bowes took on risks and intended to earn a return from that business.

On appeal, the Third Circuit reversed, holding that Pitney Bowes was not a bona fide partner in the LLC. Also applying *Culbertson*, the Third Circuit characterized the issue as a question of whether the substance of Pitney Bowes' interest was consistent with that interest's purported form. It relied on three recent IRS victories involving highly structured, tax advantaged partnerships: *TIFD III-E v. United States* (*Castle Harbour*), *Va. Historic Tax Credit Fund 2001, LP v. Commissioner*, and *Southgate Master Fund v. United States*.

The Third Circuit found that Pitney Bowes' interest was not, in substance, the interest of a partner because Pitney Bowes' upside potential did not vary with the value of the LLC property or business and Pitney Bowes' risks were insignificant. Pitney Bowes' upside was fixed through a secured put option, assuring it a three percent preferred return, and through a call option held by New Jersey, which eliminated Pitney Bowes' upside if the LLC earned more than expected. Pitney Bowes' downside risk was insignificant because it was virtually guaranteed to receive back the value of its investment in the LLC, either as rehabilitation tax credits or pursuant to a Tax Benefit Guarantee Agreement. The Court dismissed the risk that the Tax Court had relied upon, that the LLC would not complete the project making the credits unavailable, because the project was already fully funded before Pitney Bowes invested.

Importantly, the Third Circuit took pains to explain that it was not relying on the economic substance doctrine or deciding whether the transaction had economic substance. Its analysis that substance over form is a separate and distinct doctrine from economic substance will become critical in future cases because the Code now imposes a 40 percent accuracy-related penalty on non-disclosed transactions that fail the now-codified economic substance test set forth in section 7701(o). *See* Code section 6662(b)(6) and (i). This also allowed the Court to sidestep the potential application of the Ninth Circuit's decision in *Sacks v. Commissioner*,which held that if Congress intended to subsidize a category of investment through a tax credit, a court should take the value of the credit into account when evaluating the economic substance of a taxpayer's investment in that category.

The decision in *Historic Boardwalk Hall* is another example of the IRS successfully attacking a partnership structure based on debt-equity principles. Like the courts in *Castle Harbour*, *Southgate*, and *Va. Historic*, the Third Circuit cast a critical eye on the overall transaction and asked whether the purported partner had a stake in the success or failure of a common enterprise, or merely shared the more circumscribed risk of a creditor. In the case of preferred partnership interests, such as in *Historic Boardwalk Hall*, this can be a difficult line to identify. Moreover, with the codification of the economic substance doctrine in section 7701(o), and the enactment of the economic substance penalty under section 6662(b)(6) and (i), the opinion is significant as a statement of the now critical distinction between the doctrine of economic substance and other "soft doctrines" like substance-over-form.

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