

Washed Out with the Tide: The Third Circuit Invalidates a Transfer of Historic Rehabilitation Tax Credits, Part Two.

In my initial [post](#) discussing *Historic Boardwalk Hall LLC v. Commissioner*, 2012 U.S. App. LEXIS 18107 (3d Cir. Aug. 27, 2012), I furnished a broad brush summary of the Third Circuit's opinion, which held that Pitney-Bowes Credit Corp. was not entitled to the benefit of historic rehabilitation credits that had been allocated to it from an entity taxed as a partnership because Pitney-Bowes Credit was not a bona fide partner. This post will drill into the case in more detail.

At the outset, I should note that this is not an economic substance doctrine case. While the government had raised economic substance as an alternate basis to challenge the claimed tax treatment, it conceded at oral argument that the case should focus on whether Pitney-Bowes Credit was a bona fide partner. As a consequence, the Court of Appeals assumed that the transaction before it had economic substance and focused on the basic question of whether Pitney Bowes Credit was entitled to be treated as a partner.

In assessing whether Pitney-Bowes Credit was a bona fide partner, the Third Circuit asked two basic questions that were designed to focus on the extent of its assumption of risk: did it have meaningful downside risk and did it enjoy meaningful upside potential? The answer to both questions was a resounding no.

On the issue of downside risk, there were several problems. First, the way that the operating agreement was set up, the installment contributions of Pitney-Bowes Credit were contingent upon certifications that sufficient rehabilitation costs had been incurred that would qualify as Qualified Rehabilitation Expenses. *Id.* at *28-*31. Second, the parties negotiated a tax benefits guaranty, which entitled Pitney-Bowes Credit to receive a payment equal to the amount of any tax benefits that it lost due to an IRS challenge, any additional tax liability that it incurred relating to partnership items, any interest and penalties it incurred, and up to \$75,000 for the cost of defending the tax treatment of the partnership items. The same agreement also provided for a payment sufficient to pay Pitney-Bowes Credit for the federal income taxes that would be due on payments made under the agreement. *Id.* at *40-*41. The Court of Appeals cited both of these aspects of the arrangement of the parties in concluding that Pitney-Bowes Credit had no meaningful downside risk. *Id.* *85-*88. In addition, the Court noted that there was no risk that any of the bargained for benefits would be jeopardized by the failure to complete the project because it was already fully funded. *Id.* at *88-*89.

Turning to upside potential, the Third Circuit concluded that there was no meaningful upside potential; although Pitney-Bowes Credit had a 99.1% interest in residual cash flow, in the Court's view that interest was illusory under the circumstances. Two independent factors drove this conclusion: first, even optimistic projections showed no potential for residual cash flow; second, the New Jersey Sports and Exposition Authority had a right to buy out Pitney-Bowes Credit using a formula that had not relationship to the market value of its partnership interest, and the Court concluded that this right would be exercised if there was ever any prospect that Pitney-Bowes Credit would enjoy residual cash flow from the project. *Id.* at *98-*100.

The bottom line: to assure that a partnership designed to create tax benefits works, the partners will have to bear some degree of economic risk to be deemed bona fide partners. How much risk is needed remains unclear.

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