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Memorandum

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to:
(Large Business & International)
(HMT:7:1529)

from: Associate Area Counsel (Detroit)
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subject: Rehabilitation Tax Credit Issue

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

$M =
$N =
$P =
$Q =
$R =
$S =
$T =
$U =
$V =
$W =
$Y =
$Z =
ABC Developer =
ABC Group =
ABC Management =
Company A =
Company B =

Company C =
Date 1 =
Date 2 =
Date 3 =
The Fund =
The Historic Property =
Individual I =
Individual J =
Individual K =
HTC Partnership =
L Period =
M% =
N% =
O% =
P% =
Q% =
R% =
S% =
T% =
U% =
V% =
W% =
X% =
XYZ Fee =
Year 1 =
Year 2 =
Year 3 =
Year 4 =

ISSUES

1. Whether the Fund is a partner in HTC Partnership for Federal tax purposes.
2. Alternatively, whether HTC Partnership should be disregarded for Federal income tax purposes as it is a sham.
3. Alternatively, whether HTC Partnership is the owner of the Historic Property for Federal tax purposes.

CONCLUSIONS

1. The Fund should not be treated as a partner in HTC Partnership for Federal tax purposes.
2. Alternatively, HTC Partnership should be disregarded for Federal income tax purposes as it is a sham.
3. Alternatively, HTC Partnership should not be considered the owner of the Historic Property for Federal tax purposes.

FACTS

The Transactions in Connection with the Development Project

Company B wholly owned Company A on Date 1. Company A owns the Historic Property and wanted to rehabilitate it as part of a development project. The Historic Property is a "certified historic structure" for purposes of I.R.C. § 47. However, Company B was owned by a combination of individuals subject to the passive activity loss limitations of I.R.C. § 469, and, in Year 3, a tax-exempt entity became an indirect owner of Company A, and therefore, none of Company A's owners were able to benefit from the Rehabilitation Credit provided by I.R.C. § 47.

Company B is related to ABC Group, which develops and manages real property. Individual J runs ABC Group and holds the largest ownership interest in Company B. The other owners of Company B are also associated with ABC Group. ABC Developer and ABC Management are part of ABC Group.

On Date 1, Company A leased the Historic Property to HTC Partnership (the structure of which is described below). The lease term began on the date the Historic Property was placed in service (during Year 3) and ended on Date 2. Pursuant to the lease, HTC Partnership was responsible for construction of improvements to, and maintenance and repair of the Historic Property. The amount of rent due under the lease gradually increased from $R in Year 3 to $S in Year 4 and thereafter. The lease also provided for additional rent payments, which were calculated as a percentage of HTC Partnership's operating income, not to exceed 100% of HTC Partnership's net cash flow. The percentage used to determine additional rent gradually decreased from M% in Year 3 to N% in Year 4.

HTC Partnership entered into an agreement with ABC Developer, whereby ABC Developer would oversee the development and rehabilitation of the Historic Property. In exchange, ABC Developer would receive a development fee for its services upon completion of the rehabilitation, which fee was estimated to be $T. HTC Partnership entered into an agreement with ABC Management, whereby ABC Management would manage the Historic Property. In exchange, ABC Management would receive a management fee equal to O% of total monthly gross receipts, an XYZ Fee, and a supervision fee of P% of the cost of major capital improvements.

Company A loaned HTC Partnership the amount necessary to fund the rehabilitation of the Historic Property. On Date 1, HTC Partnership borrowed $U from Company A. On Date 3, HTC Partnership borrowed $V from Company A. HTC Partnership gave Company A a leasehold mortgage on the Historic Property as security for the loan.

Construction began in Year 1 and was completed in Year 2. The Historic Property was placed in service in Year 3. The renovation of the Historic Property gave rise to rehabilitation tax credits under I.R.C. § 47 in Year 3.

The Structure of HTC Partnership

Company B and the Fund are the members of HTC Partnership, with Company B serving as the managing member.[1] Company B owns P% of HTC Partnership and the Fund owns Q%. Company C created the Fund.

The Fund made a $Y capital contribution in Year 1. The Fund made capital contributions of $Z in Year 3.

The amount of the Fund's capital contribution to HTC Partnership was designed to equal $0.90 for each dollar of Federal historic tax credits HTC Partnership expected to receive. If the historic tax credits were more or less than anticipated, the Fund's remaining capital contributions would be adjusted accordingly and, to the extent the Fund already overpaid its capital contribution, it would be refunded. Similarly, if the historic tax credits are recaptured, the Fund is entitled to a refund equal to all interest, taxes and penalties payable by the Fund as a result of the recapture, plus expenses incurred by the Fund in connection with the recapture. Any refund pursuant to the foregoing provisions would be paid by HTC Partnership or Company B.

In the event of foreclosure or bankruptcy, or if the Historic Property has not received Part 3 approval[2] within 15 months of substantial completion, or if the Historic Property would qualify for less than V% of the projected credits, the Fund could require Company B to purchase its ownership interest for a purchase price equal to W% of the Fund's paid-in capital contributions, less tax credits claimed and not recaptured times the $0.90, plus an amount equal to all fees, costs and expenses incurred by the Fund in connection with its investment in HTC Partnership (the "Repurchase Obligation").

The Fund is entitled to an annual priority return of R% of its then paid-in capital contribution. The priority return is payable from net cash flow or the proceeds of a capital transaction. Company B does not receive a priority return.

All of the members are entitled to a tax distribution, which equals the amount of the member's tax liability attributable to the allocation of taxable income or gain to the member from HTC Partnership. Unpaid tax distributions owed to the Fund accrue interest, but unpaid tax distributions to Company B do not. If there is insufficient net cash flow to pay the tax distribution to the Fund, Company B must loan the necessary

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[1] In Year 1, Company B transferred its membership interest in HTC Partnership to its wholly-owned limited liability company, which is a disregarded entity for tax purposes. Upon such transfer, the disregarded entity became the member of HTC Partnership and served as the managing member. For purposes of simplicity, this memorandum refers to Company B as the member at all points in time.

[2] After the rehabilitation work is completed, the owner must submit a Part 3 application form requesting final approval of the completed work. The National Park Service evaluates the completed project and compares it with the work proposed in the Part 2 application form. If it meets the Standards, the National Park Service approves the project as a certified rehabilitation eligible for the 20% rehabilitation tax credit.

amount to HTC Partnership. The tax distributions cease after the expiration of the section 47 tax credit recapture period.

Operating profits and losses and credits are allocated to the members in accordance with their ownership interest. All net cash flow available for distribution is paid as follows:

- Payment of the tax distribution;
- Payment of the priority return to the Fund for the current year plus payment of all outstanding priority returns for prior years;
- Payment of additional rent pursuant to the lease;
- Payment to ABC Developer of any accrued and unpaid development fee;
- To the repayment of member loans; and
- The balance shall be allocated and distributed to the members in accordance with their membership interests.

Net cash flow is net of all operating expenses and other cash expenditures, including the management fee to ABC Management and payments due on the loan from Company A.

Proceeds from a capital transaction are allocated first to the members' negative capital accounts and then to increase the members' capital accounts so that proceeds distributed in accordance with the members' membership interests would also be distributed in accordance with their capital accounts. Losses from a capital transaction are allocated first to the members' positive capital accounts and then to the members in accordance with the manner in which they bear the economic risk of such losses (or if no member bears an economic risk in accordance with their ownership interests). Proceeds from a liquidation or capital transaction are to be distributed, after repayment of certain debts, liabilities, and expenses of HTC Partnership, to the members in accordance with their membership interests[3] unless such distribution is not in accordance with their respective capital account balances.

The Put and Call Options

The Fund has a put option to sell its interest in HTC Partnership to Company B and Company B has a call option to purchase the Fund's interest in HTC Partnership. The put option can be exercised within the L Period beginning upon the expiration of the section 47 tax credit recapture period. The call option can be exercised within the L Period beginning upon the expiration of the put option.

[3] The operating agreement originally provided that proceeds from a capital transaction would be allocated S% to the Fund and T% to Company B, but was amended on Date 3 to allocate the proceeds in accordance with membership interests.

The put price equals S% of the Fund's paid-in capital contributions plus any unpaid amounts due the Fund, including any unpaid priority returns paid on an after-tax basis. The call price equals the fair market value of the Fund's membership interest plus any unpaid amounts due the Fund, including any unpaid priority returns paid on an after-tax basis. Fair market value is to be determined by an appraiser selected by Company B, which appraiser is to take into account the Fund's residual interest in sale proceeds of S%,[4] limitations on the Fund's management control, lack of marketability, transferability, and liquidity, limitations on the Fund's ability to cause liquidation or a sale of the property, and the terms of the lease. The discount and capitalization rate to be used by the appraiser have to be at least U%.

Risk and Responsibilities of the Members

Company B is the managing member of HTC Partnership, while the Fund is an investor member. Company B has full authority to manage and control the affairs and business of the Company, whereas the Fund shall not take part in the management or control of HTC Partnership and shall not have authority to bind HTC Partnership.

Company B is responsible for any excess development costs (i.e., development costs exceeding paid-in capital contributions, mortgage proceeds, insurance or condemnation award proceeds, or net operating income). Development costs include any operating deficits occurring prior to the achievement of stabilized operations. Thereafter, if an operating deficit exists at any time during the period commencing on Date 1 and ending on the date of expiration of the put period, Company B shall loan HTC Partnership the funds necessary to pay such deficit, up to $W in the aggregate, in the form of a subordinated loan bearing no interest.

Company B represented that, to its knowledge, no environmental issues existed and it would not cause any environmental issues. Company A agreed to indemnify the Fund and its members from any environmental liabilities.

All liabilities of HTC Partnership are nonrecourse to the Fund. The Fund's liability is limited to its capital contribution. It has no other liability to contribute money to HTC Partnership. It is not personally liable for the obligations of HTC Partnership. It is not obligated to make loans to HTC Partnership. In addition, the Fund's liability to the other members of HTC Partnership is limited to the amount of its unpaid capital contribution.

The Guaranty

On Date 1, Company B and three of its members, as individuals (the "Individual Guarantors" and collectively with Company B, the "Guarantors"), guaranteed certain

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[4] As noted in the prior footnote, the operating agreement originally provided that proceeds from a capital transaction would be allocated S% to the Fund and T% to Company B, but was amended on Date 3 to allocate the proceeds in accordance with membership interests. However, no evidence has been provided to show that the option agreement was similarly updated.

obligations of Company B as managing member. Pursuant to this guaranty, Company B as managing member was jointly and severally liable, whereas the Individual Guarantors were severally liable. The Guarantors guaranteed development obligations, operating obligations, environmental obligations, the refund obligations, the Repurchase Obligation, put obligations, and lease obligations under the operating agreement for HTC Partnership.

As security for their guaranty, the Guarantors gave the Fund a security interest in their interest in Company B and HTC Partnership. The Individual Guarantors were required to maintain a certain net worth and a certain liquid net worth, as follows:

- Individual J: net worth in excess of $N and an unencumbered and unrestricted liquid net worth in excess of $M;
- Individual I: net worth in excess of $P and an unencumbered and unrestricted liquid net worth in excess of $M;
- Individual K: net worth in excess of $Q and an unencumbered and unrestricted liquid net worth in excess of $M.

The Tax Benefits

ABC Group hired a promoter and considered several plans that would allow for a joint venture using the historic tax credits. The pro forma for the plan they chose projected that the investor would pay $.90 for each dollar of historic tax credit, would receive a priority return of R%, and could, in certain circumstances, receive an additional return of S% after the section 47 tax credit recapture period expired.

Company C syndicates historic rehabilitation tax credits as part of its business. Company C, who created the Fund, made it clear prior to the transaction that it expected to get its money back plus interest in the event of a recapture since it will not have gotten the benefit of the tax credits. Company C stated in an e-mail: “Without credits, we are a mezzanine equity investor of sorts. X% for the cost of our money and no other payments is about as mild as it gets in the HTC industry.”

A document reflecting the structure of the transaction indicated that the transaction would be structured to ensure the Fund did not receive distributions in excess of its priority return. The additional rent payments, loan payments, development fee, and management fees were designed to capture most of the cash flow being generated.

As noted above, the renovation of the Historic Property generated rehabilitation tax credits under I.R.C. § 47 in Year 3. HTC Partnership claimed qualified rehabilitation expenditures on its partnership return for Year 3, Q% of which flowed through to the Fund.

LAW AND ANALYSIS

1. General Overview of the Rehabilitation Tax Credit

I.R.C. § 47 provides a rehabilitation tax credit. In the case of the rehabilitation of a certified historic structure, the amount of the credit equals 20 percent of the qualified rehabilitation expenditures. I.R.C. § 47(a)(2). A "certified historic structure" is "any building (and its structural components) which – (i) is listed in the National Register, or (ii) is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary as being of historic significance to the district." I.R.C. § 47(c)(3). A "qualified rehabilitation expenditure" is any amount properly chargeable to a capital account for:

(i) property for which depreciation is allowable under section 168 and which is –
- (I) nonresidential real property,
- (II) residential rental property,
- (III) real property which has a class life of more than 12.5 years, or
- (IV) an addition to or improvement to property described in subclause (I), (II), or (III), and

(ii) in connection with the rehabilitation of a qualified rehabilitated building.

I.R.C. § 47(c)(2)(A). A certified historic structure is a "qualified rehabilitated building" if it has been substantially rehabilitated and was placed in service before the beginning of the rehabilitation, and depreciation (or amortization in lieu of depreciation) is allowable with respect to the building. I.R.C. § 47(c)(1). In order to be substantially rehabilitated, the qualified expenditures during the 24-month period selected by the taxpayer must exceed the greater of the adjusted basis of such building (and its structural components), or $5,000. In the case of a leased building, this test is applied by aggregating the lessee(s)' and lessor's adjusted bases and qualified expenses. Treas. Reg. § 1.48-12(b)(2)(iii)(B) and (vi).

However, qualified rehabilitation expenditures do not include expenditures for which the taxpayer does not use straight line depreciation, cost of acquisition, and enlargements. I.R.C. § 47(c)(2)(B)(i)-(iii). In addition, an expenditure attributable to the rehabilitation of a certified historic structure is not qualified unless the rehabilitation is a certified rehabilitation. I.R.C. § 47(c)(2)(B)(iv).

Under I.R.C. § 47(c)(2)(b)(vi), a lessee is eligible to claim the rehabilitation tax credit if, when the lessee incurs the cost of rehabilitation, and on the date the rehabilitation is completed, the remaining term of the lease (determined without regard to any renewal periods) is less than the recovery period determined under section 168(c). Under I.R.C. § 168(c) the recovery period for residential rental property is 27.5 years and the recovery period for nonresidential real property is 39 years.

Generally, the rehabilitation credit is available to the taxpayer "for the taxable year in which such qualified rehabilitated building is placed in service." I.R.C. § 47(b)(1). Recapture provisions apply if the property is transferred within 5 years of being placed in service. I.R.C. § 50(a)(1).

There is no provision in the Internal Revenue Code or legislative history that expressly permits the sale of tax attributes.

2. The Fund Was Not, In Substance, a Partner in HTC Partnership

Sixty years ago, the Supreme Court in *Commissioner v. Culbertson* laid the foundation for determining, under the Federal tax laws, whether a partnership interest in form should be respected as a partnership interest in substance:

> [C]onsidering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

337 U.S. 733, 742 (1949). Therefore, 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. *Id.*; *see also Commissioner v. Tower*, 327 U.S. 280, 286 (1946) (such an interest 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*, 659 F.3d 466, 484 n.60 (5th Cir. 2011). The totality of the circumstances in this case establishes that the Fund was a partner in name only.

a. Recent Guideposts

i. 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 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 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 TIFD III-E*, 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 & Co., Inc. v. United States*, 652 F.3d 475, 481 (3d Cir. 2011) (recharacterizing purported sales as loans on the ground that "[t]he substance of the transaction, rather than its formal characterization, has always dictated its tax treatment"). The Second Circuit adopted the IRS's distinction between these two theories, 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.[5] *See TIFD III-E*, 459 F.3d at 230-32, 232 n.13 (noting that, even if an interest has economic substance, the IRS may reject the taxpayer's characterization of the interest based on the totality of the circumstances test). The court noted that, 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.d 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 corporate venture" from an investment that "represents a strict debtor-creditor relationship").

In determining 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. *TIFD III-E*, 459 F.3d at 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

[5] Other courts have merged the two theories. *See Southgate*, 659 F.3d at 483-91; *Boca Investerings*, 314 F.3d at 630; *but cf. 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"). The latter (sham-partnership) theory is discussed *infra*.

$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.[6]

ii. *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). Because the court found that the state tax credits constituted property under the specific facts of the case before it, the court held that the transaction was a sale under the partnership "disguised sale" rules under I.R.C. § 707(a)(2)(B). Under the disguised sale rules, 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. *Id.* at 138-39.

In finding that the partnership's allocation of the state tax credits to its purported partners constituted a transfer of property for purposes of the disguised sale rule, the court turned to Treas. Reg. § 1.707-3, which provides detailed rules for determining when a disguised sale has occurred. *Id.* at 140-45. The regulation provides 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." *Virginia Historic*, 639 F.3d at 144.

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." *Id.* 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

[6] 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). However, that decision was recently overturned by the United States Court of Appeals for the Second Circuit. *TIFD III-E, Inc. v. United States*, 666 F.3d 836 (2d Cir. 2012).

> 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).

b. Application of *Culbertson* to the Fund in the Instant Case

The courts' application of *Culbertson* in *TIFD* illustrates clearly that the Fund, under the same standard, was not a participant in the enterprise that Company B was conducting through the HTC Partnership, and therefore the Fund is not a bona fide partner in the HTC Partnership under the *Culbertson* standard. 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 the Fund was, in substance, not a partner in HTC Partnership.[7] As confirmed by the Fourth Circuit's focus on "the entrepreneurial risks of partnership operations" in *Virginia Historic*'s disguised sale analysis, an equity investor in a partnership (i.e. a bona fide partner) must have 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 the Fund had no meaningful stake in the success or failure of HTC Partnership.

i. *The Fund Had No Downside Risk*

The Fund, like the purported bank partners in *TIFD*, has no meaningful downside risk in that it is assured of receiving the benefit of its bargain. Delivery of the bulk of that benefit – the tax credits – is assured. The Fund's contributions are refundable if the historic tax credits are less than anticipated or recaptured. In addition, the Fund could require Company B to repurchase its interest if the historic tax credits to be received were less than V% of projected credits or if certain other events occurred. Both the refund and repurchase obligations are guaranteed by the Guarantors. Inasmuch as the Fund paid (in the form of capital contributions) $0.90 for each dollar of projected tax credit, these provisions ensured that the Fund's capital contributions would not be placed at the risk of the enterprise. The Fund would receive at least $0.90 back for each dollar of tax credit that was not obtained or was recaptured. Moreover, the Fund did not have to make a true outlay of capital. The Fund's capital contributions were timed so that all but $Y came after the rehabilitation was complete.

Delivery of the ancillary aspect of the Fund's benefit – the R% priority return on its capital contributions as compensation for the use of its capital– is likewise assured in a

[7] Although certain aspects of the Fund's cash investment in HTC Partnership were debt-like (e.g., its priority return), this case does not fit neatly within the debt-equity dichotomy, since the Fund recovered its "principal," i.e., its purported capital contribution to HTC Partnership, in the form of tax credits rather than cash.

manner that insulates the Fund from any entrepreneurial risks of the partnership. Even if HTC Partnership fails and cannot pay the return, it is guaranteed by the Guarantors.[8] Likewise, the S% residual return was payable pursuant to the put option regardless of the profitability of HTC Partnership and was guaranteed by the Guarantors.

The Fund is also protected against the risk of incurring any obligations beyond its capital contributions, and the capital contributions themselves are refundable if the tax credits available are either less than anticipated or subject to recapture. Furthermore, the Fund has no obligation to make any additional contributions regardless of the partnership's liabilities and obligations. Company B is responsible for any excess development costs, operating deficits, environmental liabilities, and all other liabilities. To the extent Company B cannot meet these obligations, they are guaranteed by the Guarantors. In short, the Fund is insulated from virtually all risk associated with its purported partnership with Company B.

ii. The Fund Had No Upside Potential

The Fund did not have any meaningful stake in whatever upside potential may have existed with respect to HTC Partnership. If HTC Partnership is successful, the Fund will not receive more than the R% priority return. Just as the bank partners' 98% interest in Castle Harbour's operating income in TIFD was illusory, so too is the Fund's Q% interest in HTC Partnership's residual net cash flow. Specifically, net cash flow is the remaining income after deduction of all operating expenses and other cash expenditures, including the management fee to ABC Management and payments due on the loan from Company A. The Fund's Q% interest in residual net cash flow comes into play only after payment of the tax distribution, the priority return, additional rent, the development fee, and member loans. Moreover, the rent and loan payments, as well as the development fee and management fees, were designed to capture most of the cash flow being generated so that the Fund would not receive any distributions in excess of its R% priority return. Additional rent equaled a percentage of gross operating income, but was not to exceed 100% of the net cash flow, thus siphoning off net cash flow while ensuring obligations beyond net cash flow were not created.

These same factors negate the theoretical possibility that the Fund could share in capital appreciation by virtue of its right to receive the "fair market value" of its interest upon exercise by Company B of the call option. In addition, as "fair market value" was to take into account a residual interest of S%, limitations on the Fund's management control, ability to require liquidation, and ability to cause a sale of the property, lack of marketability, transferability, and liquidity, and the terms of the lease, it is unlikely "fair market value" would exceed S%. The parties obviously anticipated a return of S%, as evidenced by the pro forma reference to a residual return of S% after the section 47 tax credit recapture period expired.

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[8] The put price includes any unpaid priority return and the Guarantors guaranteed the put obligations.

In sum, the Fund has no ability to share in any upside potential from the Historic Property, because the Fund's upside is effectively collared at the R% preferred return and S% residual return. The Fund is guaranteed a sum certain, namely, a fixed R% priority return and S% residual return to be paid by HTC Partnership and/or Company B, along with the bargained-for tax benefits whose value is ensured by the refund and repurchase obligations. Furthermore, both the priority and residual return are guaranteed by the Guarantors, as are the refund and Repurchase Obligations. *TIFD III-E*, 459 F.3d at 236 (noting, "The banks had essentially bargained for and received a secure guarantee of the reimbursement of their investment at the agreed Applicable Rate of return."). The Fund, notwithstanding its Q% interest in HTC Partnership, has no management rights, and the Fund's fixed R% priority return and S% residual return is unaffected by HTC Partnership's profits or losses.

Given these facts and the governing case law, the Fund is not a partner in HTC Partnership for Federal tax purposes.

3. <u>HTC Partnership Is a Sham</u>

For Federal tax purposes, "the term 'partnership' includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not . . . a corporation or a trust or estate." I.R.C. §§ 761(a), 7701(a)(2). In determining whether a partnership exists for Federal tax purposes the relevant inquiry is whether the parties "really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both." *Tower*, 327 U.S. at 287. As discussed *supra*, 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. *Culbertson*, 337 U.S. at 742.

As indicated *supra* in note 5, 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.[9] *See Southgate*, 659 F.3d at 483-91; *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*, 659 F.3d at 483. (citing *Culbertson*, 337 U.S. at 742, and *Boca Investerings*, 314 F.3d at 631). Under this approach, HTC Partnership should

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

be disregarded as a sham partnership for many of the same reasons that the Fund should be disregarded as a bona fide partner in HTC Partnership.

a. The Fund and Company B Did Not Intend to Join Together to Share in the Economic Benefits and Risks of Renovating and Operating the Historic Property

Many of the same factors that demonstrate the Fund was not, in substance, an equity investor (i.e., a partner) in HTC Partnership because it did not have a meaningful stake in the partnership's operations compel a finding that HTC Partnership was itself a sham partnership. In that regard, the facts in this case show that the Fund and Company B 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 Company B'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 operating deficits, and in fact provided all of the funding necessary to complete the rehabilitation in the form of loans to the HTC Partnership. In addition, Company B agreed to indemnify and hold harmless the Fund from all environmental liabilities. The mortgage loans and all other liabilities were nonrecourse to the Fund. The Fund's liability was limited to its capital contribution and the Fund had no obligation to make additional contributions. At bottom, the alleged partnership with the Fund provided Company B with no benefit other than allowing it to monetize the value of its unusable historic rehabilitation tax credits.

Company B's willingness to shield the Fund from all risk of loss associated with the renovation and operation of the Historic Property goes hand-in-hand with its unwillingness to share whatever upside potential may have existed with respect to the property. As discussed above, the transaction was structured so that no profits would remain in the partnership, but would instead be siphoned off by Company B's affiliates through rent, loan payments, development fees, and management payments. Company B effectively retained the right to any long-term profits that may be generated from the operation or sale of the Historic Property by virtue of its right to purchase the Fund's interest after the recapture period expired.[10]

Returning to the Fund's perspective, it did not expect to face any risk. As already noted it was not liable for excess development costs, operating deficits, environmental liabilities, or any other liabilities. In fact, the Fund's liability was limited to its capital contribution. Furthermore, the Fund's capital contributions were not at risk as they were protected by the guaranty and were timed so that all but $Y came after the rehabilitation was complete. As discussed above, the Fund expected a guaranteed return of its principal through the tax credits and a guaranteed return on its investment through a R% priority return and S% residual return. At bottom, the alleged partnership with

[10] As discussed *supra*, although the Fund was theoretically entitled to the fair market value of its interest upon Company B's exercise of its purchase option after the recapture period, neither party expected the Fund to receive a residual return of more than S%.

Company B provided the Fund with no benefit other than allowing it to obtain tax credits in exchange for its capital contribution and achieve a guaranteed return like that of a lender.

Based on the foregoing, the Fund and Company B did not really and truly intend to join together for the purpose of sharing in the profits and losses of the enterprise.

b. HTC Partnership Served No Non-Tax Business Purpose

There was not otherwise a legitimate business purpose for the use of the partnership form. HTC Partnership served no purpose other than to effect an indirect sale of the rehabilitation tax credits to the Fund.

Company C is in the business of syndicating historic rehabilitation tax credits. In the event of a recapture, Company C expected to get its money back plus interest. The Fund never intended to participate in the rehabilitation of the Historic Property;[11] it simply wanted the historic tax credits. If it was not allowed the credits, it wanted its money back. Thus, the HTC Partnership was not created to allow for a partnership between Company B and the Fund with respect to the rehabilitation project, but to allow for a transfer of the credits. The Fund's purported capital contributions were not an "investment" in the rehabilitation project but, instead, were nothing more than the purchase price for the tax benefits the project was expected to generate. No evidence of any non-tax business purpose for the formation of the partnership exists.

c. *Sacks* Is Inapplicable

In *Sacks v. Commissioner*, 69 F.3d 982, 990-92 (9th Cir. 1995), the Ninth Circuit held that a sale-leaseback transaction involving solar energy equipment had economic substance even though the Tax Court 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). 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."

[11] In fact, the Fund's capital contributions were not made until after rehabilitation was complete.

Even assuming the Ninth Circuit analysis was correct in applying the sham-transaction or sham-partnership analysis on an after-tax basis, the circumstances in *Sacks* were far different from those here. *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). In this case, by contrast, the transaction has no economic substance in terms of risk and reward to the Fund, and no true partnership existed between Company B and the Fund.

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.* Two circuits, in analyzing the economic substance of American Depository Receipts (ADR) transactions, determined that it was inappropriate to deduct the cost of foreseeable foreign taxes imposed on the transaction in determining the expected pre-tax profit of the transaction. *See Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001) and *IES Industries, Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001). These holdings address the calculation of pre-tax profit to be used in determining whether transactions resulted in pre-tax economic losses; they do not stand for the proposition that United States tax credits may serve as a substitute for economic profit. As such, these cases do not adopt the court's holding in *Sacks* 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.

American Electric Power is instructive with respect to the application of *Sacks* outside the Ninth Circuit. 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 the Third Circuit'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.

American Elec. Power, 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 the Fund and HTC Partnership – 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 third party to claim tax credits for a rehabilitation activity in which it did not participate, either by contributing to its cost or by assuming some portion of its risk.

Therefore, to the extent *Sacks* applies, it is distinguishable as the transaction at issue there otherwise had economic substance in terms of risk and reward. As discussed herein, the Fund did not share in the risks and rewards of the partnership. *Sacks* is further distinguishable for the same reason as it was distinguishable in *CM Holdings* – the Ninth Circuit found the transaction at issue to be thing which the statute intended, whereas here, as discussed above, the transaction is not unmistakably within the contemplation of congressional intent.

Furthermore, it appears venue in this case would lie in the Sixth Circuit.[12] *See* I.R.C. § 7482; *Peat Oil & Gas Assocs. v. Commissioner*, T.C. Memo. 1993-130. As the Sixth Circuit has rejected the notion that a court may consider tax benefits in evaluating the economic substance of a transaction involving tax-favored activity, *Sacks* should not apply regardless of the tax-favored nature of Federal rehabilitation tax credits. *American Elec. Power*, 326 F.3d at 743-44. Even if venue in this case does not lie in the Sixth Circuit, so long as venue does not lie in the Ninth Circuit, *Sacks* may not apply; it is possible other circuits would adopt the same reasoning as the Sixth Circuit in *American Electric Power*, rather than adopt *Sacks*.

4. **HTC Partnership Was Not the Owner of the Historic Property 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 Co. v. United States*, 435 U.S. 561, 572-73 (1978); *BB&T Corp. v. United States*, 523 F.3d 461, 474

[12] See the discussion under Case Development, Hazards and Other Considerations below.

(4th Cir. 2008); *Geftman v. Commissioner*, 154 F.3d 61 (3d Cir. 1998). The formation of HTC Partnership and the purported transfer of ownership of the Historic Property by Company A to HTC Partnership pursuant to a long-term lease did not effect a transfer of the benefits and burdens of ownership of the property.

In *Frank Lyon*, the Supreme Court explained the rationale underlying tax ownership:

> This Court, almost 50 years ago, observed that “taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed-the actual benefit for which the tax is paid.” In a number of cases, the Court has refused to permit the transfer of formal legal title to shift the incidence of taxation attributable to ownership of property where the transferor continues to retain significant control over the property transferred. In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed.

435 U.S. at 572-73 (internal citations omitted).

Whether a taxpayer bears the burdens and benefits of ownership is a factual question, determined from the parties’ intent, established by the substance of written agreements read in light of attending facts and circumstances. *Arevalo v. Commissioner*, 124 T.C. 244, 251-252 (2005), *aff'd*, 469 F.3d 436 (5th Cir. 2006); *Sprint Corp. v. Commissioner*, 108 T.C. 384, 397 (1997); *Grodt & McKay*, 77 T.C. at 1237.

ABC Group, through its related entities (Company A and Company B), created and developed the rehabilitation project. Thus, prior to the transactions at issue, ABC Group bore all of the Historic Property’s operational and rehabilitation burdens. After the creation of HTC Partnership, nothing in substance changed: ABC Group continued to bear all of the burdens, risks, and ownership responsibilities.

In form, HTC Partnership leased from Company A the Historic Property. However, through a circular flow of contracts, ABC Group remained responsible for rehabilitating and operating the property. Through a development agreement, ABC Developer was responsible for the development of the property. Through a management agreement, ABC Manager was responsible for the operation of the property. Thus, ABC Group, through its employees and agents, remained responsible for the Historic Property’s operation and rehabilitation completion.

The money for the development came from loans from Company A, who secured these loans through a leasehold mortgage on the property. In fact, other than the $Y capital contribution from the Fund, these loans represented HTC Partnership’s only capital. The Fund’s remaining contributions were not paid until Year 3, by which point rehabilitation had been completed. In addition, the obligations of HTC Partnership were guaranteed by the Individual Guarantors (all individuals connected with ABC Group). Thus, if any financial difficulties arose, ABC Group bore all of the responsibility.

Even after the Fund's capital contributions were paid in to HTC Partnership, ABC Group still bore financial responsibility if difficulties arose due to the refund and repurchase obligations. In addition, Company B, not the Fund, was liable for excess development costs, operating deficits, environmental liabilities, mortgage loans or any other liabilities. These obligations were backed by the guaranty.

Moreover, the rent and loan payments, as well as the development fee and management fees, were designed to ensure that profits from the operation did not go to HTC Partnership, but rather remained with ABC Group. Therefore, not only did HTC Partnership lack responsibility for the rehabilitation and operation of the Historic Property, the income from the foregoing did not inure to its benefit.

Thus, the rehabilitation and operations took place as if no transfer to HTC Partnership had occurred. The parties succeeded in ABC Group retaining the benefits and burdens of ownership.

5. **The Tax Court's Opinion in *Historic Boardwalk* Misapplies the Law and Therefore Should Not Control the Outcome in This Case.**

Historic Boardwalk Hall, LLC v. Commissioner, 136 T.C.1 (2011) is a recent Tax Court case in which the Tax Court upheld the validity of a transaction very similar in structure to the case at issue here. In *Historic Boardwalk,* Pitney Bowes entered into a partnership (Historic Boardwalk Hall, LLC) with the New Jersey State Exposition Authority (NJSEA) that purported to rehabilitate a building owned by NJSEA and leased to the partnership. The facts demonstrated that NJSEA had the wherewithal to fund the rehabilitation of the building entirely on its own, and that NJSEA, as a tax-exempt state instrumentality, had no use for the Rehabilitation Tax Credits that the partnership allocated entirely to taxable partner Pitney Bowes. In finding against the government, the court held (1) Historic Boardwalk Hall was not a sham and did not lack economic substance; (2) Pitney Bowes was a partner in Historic Boardwalk Hall; (3) NJSEA did transfer the benefits and burdens of ownership to Historic Boardwalk Hall; and (4) the transaction should not be recast under the anti-abuse provisions. *Historic Boardwalk*, 136 T.C. 1.

With respect to its first holding, the court applied the *Sacks* case to determine the rehabilitation tax credit could be taken into account in determining economic substance, noting Congress enacted section 47 to spur private investment. *Id.* at 26. The court distinguished *Friendship Dairies* as a sale-leaseback transaction that had no chance of profitability. *Id.* at 26-27. The court found both parties to the East Hall transaction would receive a net economic benefit if the transaction was successful: Pitney Bowes would earn rehabilitation credits and its 3-percent return, and NJSEA would benefit from higher revenues from other Atlantic City properties. *Id.* at 27. For the same reasons we set forth *supra* in our discussion of *Sacks*, we do not believe the Tax Court applied the case correctly in *Historic Boardwalk*.

With respect to its second holding, the court found "Pitney Bowes and NJSEA, in good faith and acting with a business purpose, intended to join together in the present conduct of a business enterprise," noting its prior conclusions that the transaction had economic substance and Pitney Bowes received an economic benefit from its 3-percent return and receipt of tax credits. *Id.* at 29. The court further found that the stated purpose behind Historic Boardwalk Hall's formation, the parties' investigation of the transaction, the transaction documents, and the parties' respective roles all reflected a valid partnership. *Id.* In connection with these findings, the court rejected the government's argument that the transaction was more like debt than equity, noting Pitney Bowes was not guaranteed the three percent return at the end of a given year because there might not be sufficient cash flow to pay it, and therefore, Pitney Bowes might not receive its preferred return until NJSEA purchased Pitney Bowes' membership interest, if at all. *Id.* at 30.

With respect to its third holding, the court found factors in favor of a sale outweighed the factors to the contrary and determined the presence of a purchase option did not prevent the benefits and burdens of ownership from transferring. *Id.* at 31-34.

Finally, the court rejected the government's contention that the anti-abuse provisions under section 1.701-2 apply. The court cited Example 6 of section 1.701-2(d) and noted the section 1.701-2(c) factors cited by the government were already rejected by the court in connection with its analysis of the previous arguments. *Id.* at 34-37.

In an opinion filed August 27, 2012, the Court of Appeals for the Third Circuit reversed the Tax Court's decision in *Historic Boardwalk*. *Historic Boardwalk Hall, LLC v. Commissioner*, No. 11-1832, 2012 U.S. App. LEXIS 18107 (3d Cir. August 27, 2012). We believe the Appellate Court's decision provides significant support to our conclusion that the Tax Court incorrectly decided *Historic Boardwalk* and that the Tax Court's reasoning does not apply here. We are sending you a copy of the Court of Appeals opinion with this memorandum.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Other Considerations

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Please call if you have any further questions.

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