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Third Circuit Strikes Down Historic Tax Credit Deal

In *Historic Boardwalk Hall, LLC, New Jersey Sports and Exposition Authority, Tax Matters Partner v. Commissioner of Internal Revenue*, the U.S. Court of Appeals for the Third Circuit invalidated the allocation of federal historic tax credits (HTCs) to the tax credit investor, calling into question long-standing, industry-standard syndication structures for not only HTCs but also low-income housing tax credits (LIHTCs) and other federal tax credit programs. The decision has potentially far-reaching effects because the court held that the tax credit investor was not a true partner for tax purposes in the limited liability company owning the convention center (the "Owner").

Background

The HTC syndication at issue in the Third Circuit's opinion stems from the rehabilitation of an Atlantic City convention center (known as East Hall) and appears to have played out along fairly standard industry lines. After being approached by a tax credit consultant on the East Hall project, the project's sponsor, the New Jersey Sports and Exhibition Authority (the "Sponsor"), decided to raise additional funds through an HTC syndication. A large corporate tax credit investor (the "Investor") agreed to make a capital contribution to the Owner, in return for a 99.99% membership interest (including a 3% preferred return) in the Owner and an allocation of the underlying HTCs. The Investor was obligated to make its capital contributions based on the achievement of progress milestones, while the Sponsor provided construction completion, operating deficit, environmental and tax credit recapture guarantees. In due diligence, projections demonstrated non-tax economic returns to the Investor, although the court did note that some of the assumptions were overly optimistic and, in practice, the Owner ran substantial operating deficits.

The Investor could exit the Owner under various option arrangements. If the HTC syndication went to its full five-year term as contemplated, then, under the exit put/call option (secured by a guaranteed investment contract), the Investor would receive (under either the put or the call leg) for its Owner membership interest the greater of fair market value of, or any unpaid preferred return on the membership interest. If there were a material Owner default or a managerial deadlock prior to the full five-year term, then the Investor could put (in the event of a material default) or be bought out (in the event of deadlock) for an amount equal to the then-present value of any yet-to-be realized projected tax benefits and cash distributions due to the Investor through the end of the five-year tax credit recapture period.

The court noted that the Owner did not need the Investor's capital contribution to complete the East Hall rehabilitation. Most of the Investor's capital contribution was used to pay a developer fee to the Sponsor. This developer fee became part of the syndication package once it was determined that the Investor's capital contribution, together with the preexisting financing sources, would generate funds in excess of the initially contemplated construction cost.

The Court's Analysis

Based on the bundle of downside protections, guarantees and buyout arrangements, the court ruled that the Investor was not a true partner for tax purposes in the Owner. The various contractual relationships interwoven into the overall syndication structure severed the Investor from risks and rewards of the Owner's construction and operation of the East Hall real estate. In reaching this conclusion, the court relied on the following factors:

1. **Lack of Meaningful Downside Risk (Investment Risk):** The risk that the Investor would not receive HTCs in an amount that was at least equivalent to its capital contributions was "non-existent," because the Investor was not obligated to make capital contributions until the Owner had incurred qualified rehabilitation expenditures sufficient to generate HTCs to cover the aggregate capital contributions made to date.

2. **Lack of Meaningful Downside Risk (Audit Risk):** Once the Investor had made its capital contributions, the recapture guarantee eliminated any risk that, due to a successful IRS challenge in disallowing any HTCs, the Investor would not receive at least the cash equivalent of the HTCs.

3. **Lack of Meaningful Downside Risk (Project Risk):** Risk associated with failure to complete any part of the rehabilitation was eliminated because the rehabilitation was already fully funded (including excess development costs) before the Investor entered into an agreement to make capital contributions to the Owner. In addition, the Sponsor was fully capable of funding any operating deficits as required by the operating deficit guarantee.

4. **"Guarantee" of the 3% Preferred Return:** Although in theory subject to risks of the Owner's business, the Investor was assured to receive any unpaid preferred return through the payment of the exercise price under the exit put/call (which was backed by a guaranteed investment contract).

5. **Lack of Meaningful Upside Potential:** A lack of meaningful upside potential complemented the Investor's "avoidance of all meaningful downside risk" in the Owner. Based on the original projections and subsequent actual operations, the court saw little chance of the Investor participating in any East Hall value beyond the 3% preferred return.

Moving Forward

Historic Boardwalk Hall, LLC raises doubt about the current syndication structures used to offer tax credits to equity investors. The result in this case raises some difficult questions, including the following:

1. What does it take to be a true partner for tax purposes? The court specifically declined to provide any guidance on this point and gave no indication of whether one factor ranks higher than another. The court's analysis focuses on the Investor's intent to share in the risks and rewards of the Owner's underlying real estate business. The economic substance of the Investor's investment in the Owner is relevant only to the extent that it supports or refutes this intent. Further guidance will be needed to determine the extent to which some or all of the downside protections and upside caps (including the need to provide an increased cash on cash return) must be loosened or removed, in order to support the status of a tax credit investor as a true partner.

2. Will it be possible to do new deals under the new order established in *Historic Boardwalk Hall, LLC*? Tax credits will continue to serve as an important and vital source of project equity. However, syndication structures will need to evolve in order to allow accountants, law firms and other tax credit professionals to provide opinions and financial projections at a confidence level acceptable to the investor market in tax credits. If these evolutionary changes impose significant risk on or provide increased benefits to the tax credit investors, tax credit pricing could be affected.

3. What is the effect on deals in construction? Many preexisting deals are in construction and, of those, many are relying on timely capital contributions from tax credit investors to complete construction. Transaction documents should be reviewed carefully to determine whether a recapture event has occurred and/or whether there is a continuing obligation for the tax credit investor to fund, along with all of the attendant consequences associated with each decision branch.

4. What is the audit risk associated with existing deals? It is difficult to understand the IRS's motives in pursuing *Historic Boardwalk Hall, LLC*, given the long-standing, well-developed tax credit syndication market and the crucial role it plays in funding historic preservation, affordable housing and other important real estate development. Whether the IRS intends to embark on a concerted audit program of tax credit deals, armed with this new weapon in its arsenal, remains unclear. If the IRS does take an aggressive audit position, the sheer volume of tax credit transactions patterned along the same lines as the deal in *Historic Boardwalk Hall, LL*C will bring many market participants and factors into play.

5. Does the decision in *Historic Boardwalk Hall, LLC* affect the market for LIHTCs and other tax credits? Given that LIHTC syndications are structurally very similar, it is likely that the same issues raised by this decision in the context of HTCs will also arise with respect to LIHTC syndications. New Markets Tax Credits should be much less affected, as NMTC syndicates do not primarily rely on partnership allocations to direct the tax benefits.

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