A NATIONAL GOAL: HOW COURTS CAN REHABILITATE CONGRESS'S INTENT AFTER *HISTORIC BOARDWALK HALL*

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INTRODUCTION

In 1925, the Patrick Henry Hotel's ballroom was the embodiment of a Fitzgerald novel. Rooms were rarely vacant, and guests enjoyed drinks and dancing beneath the ballroom's ornate crystal chandeliers.[1] But, 84 years after Roanoke's post-World War I "Golden Age," those same chandeliers were dark.[2] The building that once housed the Patrick Henry Hotel stood lifeless, dilapidated, and facing foreclosure.[3]

When bidding began on this former gem of Virginian history, many Roanoke residents were concerned for its fate.[4] To their relief, a local developer recognized an opportunity to revitalize the surrounding community by rehabilitating the building.[5]

Through an over $25 million rehabilitation project—funded by private investment and reliant upon community support—the Patrick Henry Hotel was restored to its former glory.[6] Today, as a mixed use building, the Patrick Henry Hotel not only provides 132 renovated apartments to students from a nearby college, but its lobby also hosts a coffee shop, bar, and restaurant.[7] The hotel has become Roanoke's centerpiece project for reviving its urban

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[1] *Best Historic Rehabilitation*, VA. BUS. (June 28, 2012), http://www.virginiabusiness.com/news/article/best-historic-rehabilitation1 (last visited: Apr. 1, 2017).

[2] *Id*; U.S. DEPT. OF THE INT., National Register of Historic Places Registration Form for Patrick Henry Hotel, No. 128-235 (Apr. 29, 1991), http://www.dhr.virginia.gov/registers/Cities/Roanoke/1280235_Patrick_Henry_Hotel_1991_Final_Nomination.pdf.

[3] VA. BUS., *supra* note 1.

[4] *See* Jenny Kincaid Boone, *Lender Buys Roanoke's Former Patrick Henry Hotel in Foreclosure Sale*, ROANOKE TIMES (Aug. 4, 2009), http://www.roanoke.com/webmin/news/lender-buys-roanoke-s-former-patrick-henry-hotel-in-foreclosure/article_08d238e4-066b-5b82-99c1-61d97f9e40d6.html.

[5] VA. BUS., *supra* note 1.

[6] *Id. See also Patrick Henry Hotel in Roanoke, VA*, PLYMOUTH SOUNDINGS, LLC, http://plymouthsoundings.com/portfolio/patrick-henry-hotel/ (last visited Jan. 4, 2017).

[7] VA. BUS., *supra* note 1.

community—but "[t]he Patrick Henry Hotel would sit vacant without [Historic Rehabilitation] tax credits."[8]

In 1976, Congress passed Section 47 of the Internal Revenue Code[9] to facilitate what it declared "an important national goal" of preserving historic structures and neighborhoods in the face of rapid urban expansion and development.[10] Before passing the Historic Rehabilitation Tax Credit, Congress had relied on policies expressed in the National Historic Preservation Act ("NHPA")[11], which created a "comprehensive federal program" to promote preservation.[12] However, Congress realized historic preservation was an expensive endeavor and the government could not fund large-scale preservation on its own.[13] To achieve historic preservation, Congress needed to incentivize private entities to invest in inherently unprofitable projects.[14] By emphasizing its intent to facilitate restoration of historic buildings, Congress made clear that the purpose of the Historic Rehabilitation Tax Credit was not revenue-related, but rather policy-based.[15]

Since its enactment, the Historic Rehabilitation Tax Credit has generated private investment in historic areas across the country, resulting in economic and social revitalization in urban and rural communities alike.[16] In Virginia alone, federal Historic Rehabilitation Tax Credits have stimulated more than $2.1 billion of private investment in over 1,000 rehabilitation projects.[17] This investment translates to more than 31,000 jobs and $133 million dollars in state and local tax revenue in a span of only seventeen years.[18] Nationwide,

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8 JOHN ACCORDINO & FABRIZIO FASULO, VCU CTR. FOR URBAN & REG'L DEV., ECONOMIC IMPACT OF HISTORIC REHABILITATION TAX CREDIT PROGRAMS IN VIRGINIA 36 (2014), https://preservationvirginia.org/programs/economicimpact1; PLYMOUTH SOUNDINGS, LLC, *supra* note 6.

9 26 U.S.C. § 47 (2012).

10 STAFF OF J. COMM. ON TAXATION, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 [Pub. L. No. 94-455] 643 (Comm. Print 1976) [hereinafter TAX REFORM ACT EXPLANATION].

11 National Historic Preservation Act, Pub. L. No. 89-665, 84 Stat. 825 (codified as amended at 54 U.S.C. §§ 100101 et sec. (2012)).

12 Carolyn Ells Cheverine & Charlotte Mariah Hayes, Note, *Rehabilitation Tax Credit: Does it Still Provide Incentives?*, 10 VA. TAX REV. 167, 172 (1990).

13 TAX REFORM ACT EXPLANATION, *supra* note 10, at 643 ("Congress believes that the achievement of this goal is largely dependent upon whether private funds can be enlisted in the preservation movement.").

14 *Id*.

15 *See* OMB, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2016 at 219 (2015), http://www.whitehouse.gov/omb/budget/Analytical_Perspectives/ (describing tax preferences as "alternatives to other policy instruments, such as spending or regulatory programs").

16 *See generally* NAT'L PARK SERV., FEDERAL TAX INCENTIVES FOR REHABILITATING HISTORIC BUILDINGS, ANNUAL REPORT FOR FISCAL YEAR 2009 (2010) [hereinafter NPS, FEDERAL TAX INCENTIVES REPORT FOR 2009].

17 ACCORDINO & FASULO, *supra* note 8, at 13.

18 *Rehabilitation Tax Credits*, VA. DEP'T OF HISTORIC RES. (updated Feb. 16, 2016), http://www.dhr.virginia.gov/tax_credits/tax_credit.htm.

the Historic Rehabilitation Tax Credit has saved 41,000 historic buildings and generated $78 billion in private investment.[19] A survey of Virginia investors reveals that over 50% of rehabilitation investments would not have occurred without tax credit opportunities.[20]

Despite the credit's apparent benefits, a recent IRS challenge to historic rehabilitation partnerships has "cast a shadow" over new historic rehabilitation investments.[21] In *Historic Boardwalk Hall, LLC v. Commissioner*[22], the New Jersey Sports and Exposition Authority ("NJSEA"), a tax-exempt state entity, and Pitney Bowes, a private investor, entered into Historic Boardwalk Hall, LLC. ("HBH"), a partnership formed to perform the restoration of East Hall on the Atlantic City Boardwalk.[23] Since East Hall is registered as a National Historic Landmark, the restoration expenses were eligible for Historic Rehabilitation Tax Credits under Section 47.[24] However, because NJSEA is a tax-exempt entity, it had no use for the credits.[25] For this reason, it solicited a private investor with which to syndicate on the restoration project: HBH created an arrangement whereby Pitney Bowes contributed capital to the restoration of East Hall and ultimately enjoyed the credits earned by the project.[26]

HBH successfully restored East Hall into a special events arena.[27] In the year East Hall was placed in service, HBH claimed the Historic Rehabilitation Tax Credits, allocating them to Pitney Bowes in accordance with the partnership agreement.[28] However, the IRS reallocated the credits to NJSEA based on the argument that NJSEA had in substance sold the credits to Pitney Bowes through the HBH partnership.[29] NJSEA, as the partner responsible for tax matters, appealed this reallocation to the Tax Court, arguing that HBH

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19 NAT'L PARK SERV. U.S. DEP'T. OF THE INTERIOR, FEDERAL TAX INCENTIVES FOR REHABILITATING HISTORIC BUILDINGS: ANNUAL REPORT FOR FISCAL YEAR 2015 at 1, 6 (2016), https://www.nps.gov/TPS/tax-incentives.htm.

20 ACCORDINO & FASULO, *supra* note 8, at 20.

21 Timothy L. Jacobs, *A Dark Future for Historic Tax Credits after* Historic Boardwalk, TAXATION EXEMPTS 16 (July-Aug 2013).

22 694 F.3d 425 (3d Cir. 2012), *rev'g*, 136 T.C. 1 (2011), *cert. denied* 133 S. Ct. 2734 (2013).

23 Historic Boardwalk Hall, LLC v. Comm'r, 136 T.C. 1, 3–4 (2011), *rev'd*, 694 F.3d 425 (3d Cir. 2012).

24 *Id.* at 3. *See also id.* at 4–5 for a comprehensive history of East Hall's construction and use.

25 Tax exempt entities cannot use credits, since they have no taxable income to offset. *See, e.g.*, Jacobs, *supra* note 21, at 17.

26 *See Historic Boardwalk Hall*, 136 T.C. at 6–10.

27 *Id.* at 16.

28 *Id.* at 16–17.

29 *Id.* at 17. The IRS put forth three supporting arguments for its claim that NJSEA had sold the credits to Pitney Bowes: first, that Historic Boardwalk Hall was a sham partnership; second, that Pitney Bowes was not a bona fide partner in Historic Boardwalk Hall; and third, that NJSEA failed to actually transfer the benefits and burdens of ownership of the East Hall to Historic Boardwalk Hall and therefore remained the owners of the Hall. This comment will address only the IRS's first two arguments. *Id.*

was the type of partnership "promoted and supported by Congress" and was not a sham.[30]

Reviewing the facts of the partnership and restoration "as a whole" in the context of Section 47 and its legislative history, the Tax Court held that both NJSEA and Pitney Bowes had a "legitimate business purpose" in forming HBH, and that the partnership was formed in line with Congress's intent to "use the [Historic Rehabilitation Tax Credit] to draw private investments into public rehabilitations."[31] For these reasons, the Tax Court declared the IRS's reallocation of the Credits was inappropriate and allowed Pitney Bowes to claim them.[32] However, when the IRS appealed the Tax Court's Decision Memo to the Third Circuit Federal Court of Appeals, the Third Circuit considered only Pitney Bowes's and NJSEA's business purpose in forming the partnership to determine whether HBH was a bona fide partnership.[33] Based on the limited inquiry of whether Pitney Bowes had any "meaningful downside risk or any meaningful upside potential in [Historic Boardwalk Hall]," the Third Circuit held that Pitney Bowes and NJSEA did not in substance enter into a partnership, and therefore reversed the Tax Court's decision.[34] As a result, no Historic Rehabilitation Tax Credits could ever be claimed on the East Hall restoration project.[35]

By assessing Pitney Bowes's and NJSEA's intent in forming the Historic Boardwalk Hall partnership, both the Tax Court and the Third Circuit evaluated the East Hall transactions under the economic substance doctrine.[36] The disparity in the court's decisions illustrates the effect that a court's definition of "transaction" can have on the outcome of the doctrine's application. Fundamentally, while the Tax Court looked at the substance of the entire investment, the Third Circuit considered only the substance of the partnership formation.[37] By allowing the IRS to narrowly apply the economic substance doctrine to a single aspect of a historic rehabilitation investment, the Third Circuit added increased unpredictability to the existing market forces that necessitate tax preferences.

This paper will explain that, to sustain Congress's intent of promoting preferred investment activities against unfavorable market forces through tax preferences, courts should evaluate the "substance" of tax-preferred behavior in terms of the entire investment transaction rather than only the partnership-

30 *Id.* at 4.

31 *Id.* at 24, 37.

32 Historic Boardwalk Hall, LLC v. Comm'r, 136 T.C. 1, 37 (2011), *rev'd*, 694 F.3d 425 (3d Cir. 2012).

33 Historic Boardwalk Hall, LLC v. Comm'r, 694 F.3d 425, 447–49 (3d Cir. 2012).

34 *Id.* at 454–55, 463.

35 Jacobs, *supra* note 21, at 17, 25 (explaining first that NJSEA had no use for the Credits, since as a tax-exempt organization it had no income to offset, and then that the Third Circuit's decision left Pitney Bowes "[un]entitled to an allocation of the [H]istoric [C]redits").

36 *Historic Boardwalk Hall*, 694 F.2d at 454, 461; *Historic Boardwalk Hall*, 136 T.C. at 19–21.

37 *Compare Historic Boardwalk Hall,* 136 T.C. at 24, *with Historic Boardwalk Hall,* 694 F.2d at 448–49.

formation transaction, because IRS challenges at sub-transaction levels prevent courts from fully considering the "substance" of tax-preferred investments. Specifically, given the rationale for incentivizing particular transactions, risk is an inappropriate criterion to use when analyzing the allocation of tax preferences under the economic substance doctrine.

Part One will explain Congress's use of the Internal Revenue Code as a policy instrument through the implementation of tax preferences and how tax preferences can be exploited to become abusive tax shelters. Part Two will address how courts have developed judicial doctrines to distinguish legitimate tax shelters from abusive ones, and how the codification of the economic substance judicial doctrine will impact this distinction. Part Three will provide a history of the Historic Rehabilitation Credit. Part Four will summarize the case of *Historic Boardwalk Hall*, a monumental challenge of historic rehabilitation tax credits by the IRS, which applied the economic substance doctrine to reallocate credits claimed by a private investor under Section 47. Part Five will conclude that the Tax Court's consideration of the *Historic Boardwalk Hall* investment at the level of the entire project rather than the partnership-formation level better served Congress's intent of historic preservation and will ultimately preserve the effectiveness of the Historic Rehabilitation Tax Credit as an incentive for private investment in rehabilitation projects.

I. THE INTERNAL REVENUE CODE AS A POLICY TOOL

The Internal Revenue Code ("Revenue Code") is commonly understood to exist only for the purpose of raising revenue through taxation—but it does have other goals. Congress also uses the Revenue Code to incentivize investment and spending behavior through tax preferences,[38] which are credits and deductions applicable to certain expenses.[39] In this sense, tax preferences serve as a powerful policy tool comparable to direct spending programs.[40]

A. *Tax Preferences: The Revenue Code's Policy-Making Tool*

The term "tax preference" describes an income tax provision passed by Congress to pursue social and economic goals.[41] Through a tax preference,

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38 Alternatively, "tax preferences" are also referred to as "tax expenditures," especially in government budget reports. While these terms can be used interchangeably, this comment will exclusively refer to "tax preferences."

39 CONG. RESEARCH SERV., S. PRT. 112-45, TAX EXPENDITURES: COMPENDIUM OF BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS 2 (2012).

40 *See* OMB, *supra* note 15, at 219.

41 Jason S. Oh, *The Social Cost of Tax Expenditure Reform*, 66 TAX L. REV. 63, 63 (2012) (citing STANLEY S. SURREY, PATHWAYS TO TAX REFORM 6 (1973)).

Congress rewards taxpayers who invest in certain projects and activities by applying a credit or deduction to the relevant investment expenses.[42] In other words, Congress "rewards" the taxpayer with tax savings; the credit or deduction serves as a "carrot" to incentivize particular investments.[43]

Tax preferences allow Congress to indirectly regulate taxpayers' spending behavior.[44] Each taxpayer faces alternatives when allocating his or her own income. By increasing after-tax rates of return through decreased income taxes, Congress can attract investors to particular activities.[45] Familiar tax preferences include the mortgage interest deduction for home ownership and accelerated depreciation for business investments;[46] by offering tax forgiveness on one transaction but not another, these tax expenditures encourage the taxpayer to invest in home ownership rather than home rental and entrepreneurship rather than personal consumption, respectively.[47]

In effect, tax preferences operate like spending provisions.[48] Rather than imposing direct spending measures to subsidize investment activities, Congress can grant tax forgiveness to partaking investors.[49] Some scholars have commented that tax expenditures have allowed the government to effectively

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42 *Id.* at 63–64; CONG. RESEARCH SERV., S. PRT. 112-45, *supra* note 39, at 2.

43 Jacobs, *supra* note 21, at 17 (citing TAX REFORM ACT EXPLANATION, *supra* note 10, at 149); Oh, *supra* note 41, at 65.

44 *See, e.g.*, Lawrence Zelenak, *When Good Preferences Go Bad: A Critical Analysis of the Anti-Tax Shelter Provisions of the Tax Reform Act of 1986*, 67 TEX. L. REV 499, 502–03 (1989) [hereinafter Zelenak, *Good Preferences*]; Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L. REV. 973, 1021 (1986) ("[T]he tax system is the cheapest method of communicating with certain taxpayers, . . .").

45 *See*, *e.g.*, NFIB Business v. Sebelius, 132 S. Ct. 2566, 2613 (2012) (Ginsburg, J., concurring) ("The minimum provision advances [Congress's healthcare] objective by giving potential recipients of health care a financial incentive to acquire insurance. Per the minimum coverage provision, an individual must either obtain insurance or pay a toll constructed as a tax penalty."); Zelenak, *Good Preferences*, *supra* note 44, at 503 (footnotes omitted) (explaining that Congress can encourage investment in activities through reduced tax on income from tax-preferred activities by "permitting taxpayers to exclude some portion of economic income from taxable income and[/or] allowing them to deduct expenses in excess of actual expenses in determining taxable income").

46 26 U.S.C. §§ 163(h)(3), 167 (2012).

47 CONG. RESEARCH SERV., S. PRT. 112-45, *supra* note 39, at 359–60; TAX REFORM ACT EXPLANATION, *supra* note 10, at 98–99.

48 Zelinsky, *supra* note 44, at 973 (explaining that tax preferences are "government outlays in the form of foregone revenues").

49 *Id.* at 978.

provide cash grants through the Revenue Code without passing direct expenditure provisions.[50] Despite these criticisms, tax preferences facilitate benefits that may otherwise be foregone in a capitalist society.[51]

Congress passes tax preferences when market forces prevent transactions that produce positive externalities for society.[52] Congress is aware that certain markets and transactions face barriers to entry or inherent unprofitability, despite their social desirability.[53] Consider, for example, low-income housing projects. Potential investors must face zoning laws and union-controlled labor costs that increase the price of investment, in addition to the reality of low potential profit return. Based on market forces alone, an investor is more likely to invest in an office building than a low-income community; society ends up with a market failure of too many luxury buildings and not enough of the low-income housing it needs.[54] To ensure that low-income housing communities are built, Congress attracts investors by reducing the after-tax rate of return through the Low Income Housing Credit.[55]

Despite their good intentions and effective incentives, tax preferences have provided opportunities for taxpayers to engage in abusive tax shelters by exploiting loopholes within the tax preference statutes.[56] Abusive tax shelter operators attempt to claim credits under a tax preference while failing to actually accomplish the goals Congress intended the credit to achieve. Such abusive activity has cast suspicion upon legitimate claims of tax-preferred investments.[57]

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50 *Compare generally* Williams D. Jordan, *Stanley S. Surrey's Pathways to Tax Reform: The Concept of Tax Expenditures*, 52 TEX. L. REV. 1041 (1973) (book review) (opposing tax preferences in favor of more direct government intervention), *with* Donald Lubick & Gerard Brannon, *Stanley S. Surrey and the Quality of Tax Policy Argument*, 38 NAT'L TAX J. 251, 257–58 (1985) (describing the Reagan Administration's reduction of tax preferences as a pursuit of a "drastic reduction in [the] social objectives of government").

51 Zelenak, *Good Preferences*, *supra* note 44, at 505.

52 Zelinsky, *supra* note 44, at 1034 (discussing the justification for providing a credit for hiring economically disadvantaged Vietnam veterans).

53 *Id.*

54 *See* Zelenak, *Good Preferences*, *supra* note 44, at 505–06 (explaining the effect of barriers to entry on investors faced with a hypothetical choice between "widgets" and "gidgets.").

55 26 U.S.C. § 42 (2012). *See also* CONG. RESEARCH SERV., S. PRT. 113-32, TAX EXPENDITURES: COMPENDIUM OF BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS 373 (Comm. Print 2014) ("The Low Income Housing Tax Credit . . . was created by the Tax Reform Act of 1986 . . . to provide an incentive for the development or rehabilitation of affordable rental housing.") (citation omitted); Zelenak, *Good Preferences*, *supra* note 44, at 503 ("If a pre-tax income from the activity remains constant while the tax on that income decreases, the activity's after-tax rate of return increases. This increased return attracts investors to the activity.").

56 Calvin H. Johnson, *Why Have Anti-Tax Shelter Legislation? A Response to Professor Zelenek*, 67 TEX. L. REV. 591, 600 (1989).

57 *See* Zelenak, *Good Preferences*, *supra* note 44, at 510 (1989). *See also* DEPT. OF TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS iv (1999) ("Corporate tax shelters breed disrespect for the tax system—both by the people who participate in the tax shelter market and by others who perceive unfairness.").

B. *How Abusive Tax Shelters Exploit Well-Intended Tax Preferences*

Tax shelters are formed when losses from one activity are used to offset income earned from another activity.[58] Despite its infamous connotation, a tax shelter is not inherently abusive.[59] An abusive tax shelter exploits loopholes in the text of the statute and facts of the transaction to claim a tax credit without actually achieving the intended policy goal of the tax preference: "Unlike a legitimate shelter, which furthers the congressional goals of the preference on which the shelter is based, an abusive shelter serves no public purpose."[60] In other words, if a taxpayer can show legitimate grounds for its preferred credits, the taxpayer should be able to retain them, no matter what source of income they ultimately offset.[61] Thus, it is not the fact of the reduced tax that makes a tax shelter "abusive," but rather its failure to achieve the tax preference's intent.[62]

Ultimately, a taxpayer should be able to deduct losses from legitimate shelters but not those resulting from an abusive one.[63] This is inherent in the

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58 Zelenak, *Good Preferences*, *supra* note 44, at 501.

59 *See, e.g.*, Linda D. Jellum, *Codifying and "Miscodifying" Judicial Anti-Abuse Tax Doctrines*, 33 VA. TAX REV. 579, 584 (2014).

60 Zelenak, *Good Preferences*, *supra* note 44, at 524. *See also* Gregory v. Helvering, 293 U.S. 465, 469–70 (1935) ("[T]he question for determination [of whether a tax shelter is abusive] is whether what was done, apart from the tax motive, was the thing which the statute intended."); Ethan S. Burger et al., *KPMG and "Abusive" Tax Shelters: Key Ethical Implications for Legal and Accounting Professionals*, 31 J. LEGAL PROF. 43, 68 (2007) (quoting Senator Levin, co-sponsor of the Tax Shelter and Tax Haven Reform Act of 2005, conceding that legitimate tax shelters exist where Congress creates them for a specific purpose, and explaining that the 2005 Reform Act is targeted at shelters that have '"no economic purpose–no business purpose–except to try to avoid paying one's taxes."' (citing *Interview with Senator Carl Levin*, FRONTLINE (Feb. 2004), http://www.pbs.org/wgbh/pages/frontline/shows/tax/interviews/levin.html)).

61 *See* Frank Lyon Co. v. United States, 435 U.S. 561, 580 (1978) ("That fact that favorable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallowing those consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction.") (footnote omitted); Zelenak, *Good Preferences*, *supra* note 44, at 512 ("[A] system designed to encourage such investment should be as ready to grant a tax preference in once case as in the other.") (footnote omitted).

62 *See* Zelenak, *Good Preferences*, *supra* note 44, at 524; STAFF OF THE J. COMM. ON TAXATION, 111TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 111TH CONGRESS 378 (Comm. Print 2011) [hereinafter CONG. EXPLANATION OF TAX LEGIS. IN 111TH CONGRESS] (explaining that abusive tax shelters occur when "taxpayers . . . engage in [transactions based on highly technical tax law provisions to produce tax consequences not contemplated by Congress and] enlarge the tax gap by gaining unintended tax relief and by undermining the overall integrity of the tax system.").

63 *See* Chellappan v. Comm'r, 55 T.C.M. (CCH) 826, 827–28 (1988) (recognizing IRS's challenge to transactions as abusive tax shelters despite taxpayer claims that a prior IRS review had deemed the transactions a legitimate tax shelter).

Revenue Code's alternative purpose of implementing policies by incentivizing behavior.[64] In response to these abuses of tax incentives, courts have developed a number of doctrines to identify abusive tax shelters and eliminate the use of loopholes that do not further Congress's policy goals.

II. THE DEVELOPMENT OF JUDICIAL DOCTRINES TO DENY ABUSIVE TAX SHELTERS

The government's initial effort to eliminate abusive tax shelters was to close loopholes in the existing tax code through the passage of additional statutes and regulations.[65] While such a rules-based approach to regulating tax shelters effectively provides certainty and notice for tax planning purposes, more rules also tend to create more loopholes.[66] Moreover, legislation can be effective only in preventing a class of tax shelters—Congress cannot react to each creative exploitation of the tax code by passing a new statute.[67] For this reason, Congress looked to the courts for additional support in the form of judicial doctrines.

A. *Applying Judicial Doctrines*

In addition to statutory attempts to reduce loopholes, judicial doctrines have allowed the IRS to deny tax benefits to individual abusive shelters.[68] Judicial doctrines are unique from statutory restrictions in that they allow the IRS to challenge the real economic impact of investments, rather than their apparent form.[69] This serves as an additional tool for restricting abusive tax shelters, which rely on their "superficial similarity to legitimate shelters."[70] Judicial doctrines allow for the invalidation of tax shelters that meet the literal requirements of a statute but fail to actually achieve its intended result.[71]

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64 OMB, *supra* note 15, at 219.

65 Jellum, *supra* note 59, at 585–86.

66 *See, e.g.*, *id.* at 586 ("[A]s the government has enacted more and more rules, the tax laws have consequently increased in length, detail, and complexity.") (footnote omitted).

67 Kuper v. Comm'r, 533 F.2d 152, 159 (5th Cir. 1976) ("[A]ll of the combinations conceivable by a resourceful tax bar cannot be perceived in advance . . . ."); Jellum, *supra* note 59, at 586.

68 CONG. EXPLANATION OF TAX LEGIS. IN 111TH CONGRESS*, supra* note 62, at 369; Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 5–6 (2000).

69 Jellum, *supra* note 59, at 589–90, 590 n.61 ("[S]uggesting that courts would not have developed the economic substance doctrine if they had been using the textualist method of statutory interpretation" (citing Noel B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1, 26 (2004)).

70 Zelenak, *Good Preferences*, *supra* note 44, at 524.

71 CONG. EXPLANATION OF TAX LEGIS. IN 111TH CONGRESS, *supra* note 62, at 369. *See also* Jellum, *supra* note 59, at 583. (discussing how "literalism" allows for the creation of abusive tax shelters where

While judicial doctrines have become widely applied, they are not without criticism.[72] Principally, judicial doctrines undermine the certainty that statutes provide and are generally harder to interpret.[73] Advocates of judicial doctrines claim that they allow courts to be reactive to individual cases rather than mechanical; critics argue that these same reactive characteristics allow malleability in the IRS's challenges and therefore create uncertainty in the formation of business transactions.[74] Finally, there are multiple, distinct doctrines that address similar issues, and even courts tend to be unsure of which doctrine they are applying when evaluating transactions.[75]

Notwithstanding these criticisms, judicial doctrines continue to allow Congress and courts to cooperate in the regulation of tax shelters.[76] Recently, Congress has incorporated a judicial doctrine, the economic substance doctrine, into the Revenue Code through codification.[77] While judges are not bound to apply a judicial doctrine, they must apply a statute incorporating the doctrine if they determine it is applicable; however, making this determination is often easier said than done.[78] Codification of the economic substance doctrine has been controversial, and it remains to be seen whether codification will succeed in resolving the uncertainty inherent in the use of judicial doctrines.

B. *The Economic Substance Doctrine: The IRS's Principal Anti-Tax Shelter Weapon*

While judicial doctrines in tax law are numerous and largely interrelated, the economic substance doctrine has risen to prominence as a means of evaluating and invalidating claimed tax benefits.[79] The economic substance doctrine looks beyond a transaction's literal terms to determine

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"transactions [are] in compliance with the literal language of the applicable tax laws even though they [produce] results contrary to the law's spirit" (citation omitted)).

72 *See, e.g.*, Bankman, *supra* note 68, at 6.

73 Jellum, *supra* note 59, at 587.

74 *Compare* DEPT. OF TREASURY, *supra* note 57, at 46, *with* Martin J. McMahon, Jr., *Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code*, 54 SMU L. REV. 195, 195 (2001) (stating that the application of judicial doctrines "in reality turns more on an ex-post analysis of the specific facts than on an ex ante exposition of the principles that will bring one or another of the doctrines into play").

75 *See* Jellum, *supra* note 59, at 591 (cautioning that "the doctrines' boundaries are nondistinct and their terminology is inconsistent" (footnote omitted)). *See also* McMahon, *supra* note 74, at 195 ("While there may be abstract differences in these doctrines, and the courts in particular cases frequently find that one applies while another does not, any fair minded person would have to admit that those differences often are fairly gossamer.").

76 *See* Jellum, *supra* note 59, at 586.

77 26 U.S.C. § 7701(o) (2012).

78 *See* Jellum, *supra* note 59, at 621, 625.

79 *See* Bankman, *supra* note 68, *at* 6.

whether there is underlying "substance" to the transaction.[80] In other words, the doctrine seeks to determine whether the transaction has actually achieved what it claims.[81] In determining whether a transaction has economic substance, the court must contemplate the purpose of both the transaction and the statute.[82] In this sense, the doctrine can be considered a "purposivist" form of interpreting the statute that supports the claimed benefits.[83]

The economic substance doctrine employs a two-pronged test to determine whether an investment has the necessary practical economic effect, or "substance," to retain its claimed benefits (e.g., tax credits).[84] These prongs are commonly differentiated as the "objective prong" and the "subjective prong."[85]

1. The Objective Prong

The objective prong of the economic substance doctrine asks "whether the transaction has any practical economic effects other than the creation of income tax losses."[86] When applying the doctrine, the court inquires whether the party would have entered the transaction but-for the tax-preferred benefits.[87] If the court finds the transaction lacks a "non-tax effect," the claimed tax benefits may be revoked for lacking economic substance.[88]

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80 *See, e.g.*, ACM P'ship v. Comm'r, 73 T.C.M. (CCH) 2189, 2215 (1997), *aff'd*, 157 F.3d 231 (3d Cir. 1998) ("The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction."); *See also* Jellum, *supra* note 59, at 590 ("[S]atisfying the literal words of the statute is not sufficient." (footnote omitted)).

81 STEPHEN SCHWARZ & DANIEL J. LATHROPE, FUNDAMENTALS OF CORPORATE TAXATION 12 (Robert E. Clark et al. eds., 8th ed. 2012).

82 *See ACM P'ship* 73 T.C.M. at 2215 ("The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress . . . ."); Jerald David August, *The Codification of the Economic Substance Doctrine Part 1*, BUS. ENTITIES, Sept.–Oct. 2010, at 15 ("Code compliance and business purpose must yield to the result achieved."). *See also* Philip Sancilio, Note, *Clarifying (Or Is It Codifying?) the "Notably Abstruse": Step Transactions, Economic Substance, and the Tax Code*, 113 COLUM L. REV. 138, 147 (2013) ("Many courts treat the doctrine as protecting the congressional intent or purpose embodied in the Code." (footnote omitted)).

83 Bankman, *supra* note 68, at 11.

84 *E.g.*, Sochin v. Comm'r, 843 F.2d 351, 354 (9th Cir. 1988).

85 Sacks v. Comm'r, 69 F.3d 982 (9th Cir. 1995) (citing *Sochin*, 843 F.2d at 354).

86 ACM P'ship v. Comm'r, 157 F.3d 231, 248 (3d Cir. 1998) (quoting Jacobson v. Comm'r, 915 F.2d 832, 837 (2d Cir. 1990)).

87 *See, e.g.*, Knetch v. United States, 364 U.S. 361, 366 (1960) (citation omitted) (The transaction "did 'not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax . . . . [T]here was nothing of substance to be realized by [the taxpayer] . . . beyond a tax deduction."').

88 *See, e.g.*, *ACM P'Ship*, 157 F.3d at 248 (refusing to recognize claimed tax benefits where "'the transaction lacked practical economic effects other than the creation of income tax losses'" (quoting *Jacobson*, 915 F.2d at 837)).

The IRS often calls on the courts to "reconfigure transactions based on their economic impact, rather than the transaction's literal form."[89] Therefore, when applying the objective prong of the economic substance doctrine, courts also invoke another doctrine, called substance-over-form.[90] Under the substance-over-form doctrine, courts will reject transactions that apparently meet each requirement of the tax statute (i.e., pass in form), but in reality were created solely for the purpose of tax avoidance (i.e., lack substance).[91] This ensures that the transaction satisfies both the statute's language and its purpose.[92]

Unresolved definitions within the objective prong have led to uncertain outcomes in its application. Courts remain problematically divided as to the meanings and requirements of both "practical economic effect" and "non-tax effects."[93] For example, even where the taxpayer could prove that the transaction had the potential to realize an economic gain contemplated by the statute, courts have invalidated the claimed tax benefits because they were deemed too significant relative to the anticipated profit.[94] These conflicts have left at least one scholar asking, "how much effect is enough," to satisfy the objective prong of the economic substance doctrine.[95]

2. The Subjective Prong

While the objective prong looks to the actual effects of the transaction, the subjective prong queries the parties' intent in entering the transaction—namely, whether the parties had a non-tax intent underlying their transaction.[96] This prong incorporates another judicial doctrine, the business purpose doctrine, which focuses on the motives underlying a transaction.[97] Where the court finds that "the taxpayer was motivated by no business purposes other

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89 Jellum, *supra* note 59, at 590.

90 Sancilio, *supra* note 82, at 142–43.

91 *See, e.g.*, Sacks v. Comm'r, 69 F.3d 982, 986 (9th Cir. 1995) ("[A] transaction with no economic effects, in which the underlying documents are a device to conceal its true purpose, does not control the incidence of taxes." (citing Gregory v. Helvering, 293 U.S. 465, 469 (1935)); August, *supra* note 82, at 15.

92 Jellum, *supra* note 59, at 590–91.

93 CONG. EXPLANATION OF TAX LEGIS. IN 111TH CONGRESS, *supra* note 62, at 370–71.

94 *See, e.g.*, Goldstein v. Comm'r, 364 F.2d 734, 739–40 (2d Cir. 1966).

95 Bankman, *supra* note 68, at 12.

96 CONG. EXPLANATION OF TAX LEGIS. IN 111TH CONGRESS, *supra* note 62, at 370, 370 n.944; Bankman, *supra* note 68, at 12.

97 Bankman, *supra* note 68, at 12; Jellum, *supra* note 59, at 595 ("Together, the business purpose doctrine and economic substance principle form the economic substance doctrine."). Note that courts, including the Third Circuit, often refer to the subjective prong of the economic substance doctrine as "business purpose."

than obtaining tax benefits in entering the transaction," the claimed benefits arising from that transaction may be reallocated or denied.[98]

Problematically, subjective intent can only be determined by considering objective evidence, and, in evaluating complex investments transactions, party intent is rarely easy to decipher. Moreover, courts have not yet resolved how to deal with an investment where the achievement of a business purpose seemed "reasonable" to the parties involved, but would not be reasonable on objective review.[99]

Prior to 2010, the circuit courts were split as to the application of the two-pronged test;[100] while some circuits required both objective and subjective substance to preserve the claimed benefits, others deemed the satisfaction of at least one prong sufficient.[101] Congress cited this circuit split, in part, as a motivating factor for codifying the doctrine.

C. *Codification of Economic Substance Doctrine under 7701(o)*

In 2010, Congress, claiming to recognize the expressed concerns of inconsistency and uncertainty inherent in the application of the economic substance doctrine, provided a statutory definition.[102] Congress attempted to sneak what ultimately became Section 7701(o)[103] into the Revenue Code by burying it within a set of amendments to the Affordable Care Act[104]; even still, it was one of the most controversial tax provisions passed in the bill.[105] Both Congress and the IRS assured taxpayers that codification would have minimal effects on tax planning and evaluation—but few tax attorneys were convinced.[106]

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98 Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985).

99 August, *supra* note 82, at 14.

100 CONG. EXPLANATION OF TAX LEGIS. IN 111TH CONGRESS, *supra* note 62, at 370.

101 *Compare, e.g.*, *In re* CM Holdings, Inc., 301 F.3d 96, 102 (3d Cir. 2002) (requiring courts to "analyze two aspects of a transaction to determine if it has economic substance: its objective economic substance and the subjective business motivation behind it"), *with Rice's Toyota World*, 752 F.2d at 91–92 ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists." (citations omitted)).

102 Jellum, *supra* note 59, at 616–17.

103 26 U.S.C. § 7701(o) (2012).

104 Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1067–70 (2010).

105 *See* Jellum, *supra* note 59, at 616–17.

106 *Compare* CONG. EXPLANATION OF TAX LEGIS. IN 111TH CONGRESS, *supra* note 62, at 378 ("The provision *clarifies* and enhances the application of the economic substance doctrine.") (emphasis added), *with* August, *supra* note 82, at 5–6 ("[S]ome were concerned that the characteristics of new Section 7701(o) could put many mainstream business transactions at risk of losing their desired tax outcomes, including transactions that were specifically permitted by statute, or would result in transactions being left on the shelf for fear of the possible reaction by the IRS." (footnote omitted)).

By passing Section 7701(o), Congress proclaimed that it was "provid[ing] greater clarity and uniformity in the application of the economic substance doctrine in order to improve its effectiveness at deterring unintended [tax] consequences."[107] Emphatically throughout the text of the statute and its legislative history, Congress assured taxpayers that the purpose of the statute was limited to clarifying the existing doctrine.[108]

Congress's goal of clarifying the economic substance doctrine was achieved in one regard: Section 7701(o) now mandates that the two prongs of the judicial economic substance doctrine be applied conjunctively.[109] Under Section 7701(o), taxpayers can rely on the IRS to challenge any investment it finds to lack either objective or subjective economic substance.[110]

Section 7701(o)'s legislative history also reaffirms the notion that the economic substance doctrine is not relevant to tax-preferred investments: "Rather the test is whether the transaction triggering the tax credit is one in which 'in form and substance' the taxpayer made 'the type of investment' or undertook 'the type of activity' that the credit was intended to 'encourage.'"[111] The IRS has affirmed this limited application of the economic substance doctrine to tax-preferred investments through an IRS Directive.[112]

107 CONG. EXPLANATION OF TAX LEGIS. IN 111TH CONGRESS, *supra* note 62, at 378.

108 *See* 26 U.S.C. § 7701(o)(5)(C) (2012) ("The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner *as if this subsection had never been enacted*.") (emphasis added); STAFF OF THE J. COMM. ON TAXATION, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," AS AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT" 155 (Comm. Print 2010) ("The provision is *not intended to alter or supplant any other rule of law*, including any common-law doctrine or provision of the Code . . . .") (emphasis added).

109 26 U.S.C. § 7701(o)(1) (2012).

110 CONG. EXPLANATION OF TAX LEGIS. IN 111TH CONGRESS , *supra* note 62, at 378 ("[N]ew section 7701(o) provides that in the case of any transaction to which the economic substance doctrine is relevant, such transaction is treated as having economic substance only if (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (2) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction." (footnote omitted)).

111 Thomas W. Giegerich, *The Monetization of Business Tax Credits*, 12 FLA. TAX REV. 709, 787 (2012).

112 CONG. EXPLANATION OF TAX LEGIS. IN 111TH CONGRESS, *supra* note 62, at 378–79 n.1034 (referring to Treas. Reg. § 1.269-2, "[i]f the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed"); 4 INTERNAL REVENUE MANUAL, ch. 46, ex. 4.46.4-4 [Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties] (2016), https://www.irs.gov/irm/ (instructing examiners that a challenge under the economic substance doctrine likely is not appropriate where the "[t]ransaction . . . generates targeted tax incentives [and] is, in form and substance, consistent with Congressional intent in providing the incentives" and requiring examiners to receive explicit approval for challenges of transactions claiming tax credits "that are designed by Congress to encourage certain transactions that would not be undertaken but for the credits").

However, the statute also expressly incorporates all judicial precedent applying the economic substance doctrine;[113] therefore, precedent applying the judicial doctrine to tax preferences persists under the statute.[114]

Additionally, despite promises from Congress and the IRS that codification would not change the economic substance doctrine's application, at least one provision ensures it will. At common law, if claimed benefits were disregarded on the basis of economic substance, the taxpayer could avoid a penalty additional to the lost benefits by arguing that they were claimed in good-faith reliance on counsel's advice.[115] Section 7701(o), on the other hand, incorporates a strict liability penalty of at least 20% on all undisclosed benefits deemed invalid under the economic substance doctrine.[116] These heightened stakes are sure to affect not only the application of the doctrine, but also investment behavior—despite what the government claims.

But this is the extent of clarification that the statute provides. Alarmingly, the statute's text provides only that "[t]he term 'transaction' includes a series of transactions."[117] Congress did little to resolve the lower courts' conflict in defining "transaction" under the step-transaction doctrine.[118] The IRS has expressly stated that it does "not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply."[119] As long as "transaction" is undefined, application of the economic substance doctrine remains inherently unclear.

D. *Defining the Transaction: A Crucial but Unclear Step*

The economic substance doctrine tells the court how to evaluate investments, but it does not explain which transactions make up the investment to be measured.[120] Determining which transactions will make up the ultimate investment to be analyzed is a crucial preliminary step because "by expanding or contracting the number of related events, a decision maker could reach virtually any result it wanted under the [economic substance] doctrine."[121]

Under the step-transaction doctrine, the court may choose to isolate or combine intermediate steps of a transaction in order to determine which steps

113 *See* 26 U.S.C. § 7701(o)(5)(A), (C) (2012).

114 *See, e.g.*, Sacks v. Comm'r, 69 F.3d 982, 988 (9th Cir. 1995).

115 CONG. EXPLANATION OF TAX LEGIS. IN 111TH CONGRESS, *supra* note 62, at 373.

116 *Id.* at 381–82.

117 26 U.S.C. § 7701(o)(5)(D) (2012).

118 CONG. EXPLANATION OF TAX LEGIS. IN 111TH CONGRESS, *supra* note 62, at 379 ("The provision does not alter the court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine.").

119 Rev. Notice 2010-62, 2010-40 I.R.B 411, 412.

120 Bankman, *supra* note 68, at 15.

121 *Id.*

make up a single transaction for tax purposes.[122] Courts have developed three different tests for determining how to collapse the steps of a transaction—not one of these tests have been adopted or even favored by Congress.[123] The first of these is the "binding commitment test."[124] Under this test, a transaction includes each of the steps that the taxpayer has formally bound itself to complete.[125] Courts have also defined a transaction under the "mutual interdependence test." Under this test, steps are combined as a single transaction "if one of the transactions would have been pointless without the completion of the entire series of transactions."[126] Finally, the "end result test" combines steps when the taxpayer entered a series of steps with the intent of achieving a final result.[127]

As Congress has not explicitly adopted any of these methods, a single investment may be defined at least three different ways—potentially providing three different results.[128] What constitutes a transaction in one court may merely be considered a step in another. The failure of the courts, Congress, and Treasury to establish a method for defining a "transaction" exacerbates the unpredictability faced by taxpayers considering potential investments. It also may serve as a tool for the IRS to pick-and-choose the "transactions" within a claimed tax preference to challenge under the economic substance doctrine.

E. *The Economic Substance Doctrine Applied to Tax Preferences*

As the economic substance doctrine serves as a method of interpreting tax statutes, it "cannot apply where a sensible reading of text, legislative intent, and purpose suggest it should not apply."[129] The rationale behind tax-preferred investments is directly in conflict with the requirements of the economic substance doctrine.[130] The economic substance doctrine challenges

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122 *See* Minn. Tea Co. v. Comm'r, 302 U.S. 609, 613–14 (1938) (disregarding intermediate steps as "meaningless and unnecessary incident[s]" because "[a] given result at the end of a straight path is not made a different result because reached by following a devious path"); Sancilio, *supra* note 82, at 148. This case is considered the foundation of the step-transaction doctrine. *Id.*

123 Jellum, *supra* note 59, at 603; Allen D. Madison, *The Tension Between Textualism and Substance-Over-Form Doctrines in Tax Law*, 43 SANTA CLARA L. REV. 699, 730–31 (2003).

124 *See* Comm'r v. Gordon, 391 U.S. 83, 96 (1968).

125 *See, e.g., id.*; Jellum, *supra* note 59, at 603; Sancilio, *supra* note 82, at 151 ("The binding commitment test looks to a more or less formal obligation to complete a series of steps." (footnote omitted)).

126 Madison, *supra* note 123, at 730.

127 Jellum, *supra* note 59, at 603.

128 *See* True v. United States, 190 F.3d 1165, 1175 (10th Cir. 1999) ("[T]he circumstances need only satisfy one of the tests in order for the step transaction doctrine to operate.").

129 Bankman, *supra* note 68, at 13.

130 ACM P'ship v. Comm'r, 73 T.C.M. (CCH) 2189, 2215 (1997), *aff'd*, 157 F.3d 231 (3d. Cir. 1998) ("The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a

transactions for lacking a business purpose, but Congress specifically creates tax preferences because little-to-no business purpose otherwise exists for the desired activity.[131] Therefore, where an investment falls within a statute's text, purpose, and intent for creating a tax preference, courts should not apply the economic substance doctrine.[132]

A tax-preferred investment will inherently fail the objective prong of the economic substance doctrine, because tax preferences are passed to counter market forces that prevent a favorable before-tax return on the transaction.[133] Without consideration of the tax-preferred credits, a taxpayer making such an investment cannot anticipate any benefit from its investment; often, the only benefit the taxpayer can expect are the promised tax benefits.[134]

Courts have attempted to retain the relevancy of the economic substance doctrine to tax-preferred investments by interpreting "practical economic effects" to include post-tax returns where it is apparent that the tax-payer was responding to Congressionally-intended tax incentives. Consider *Sacks v. Commissioner*,[135] where the Ninth Circuit refused the IRS's economic substance challenge when a taxpayer stood to earn no profit from a transaction involving solar water heaters.[136] Rather, the taxpayer could only expect "profit" in the form of deductions and credits from a tax preference passed in the wake of the oil crisis.[137] Instead of denying the economic substance doctrine's applicability to tax-preferred transactions, the court proffered a special definition of objective substance in tax-preference transactions: "Absence of pre-tax profitability does not show 'whether the transaction had economic substance beyond the creation of tax benefits' where Congress has purposely used tax incentives to change the investors' conduct."[138] Under the *Sacks* rule, courts must consider anticipated tax preference benefits within the economic substance doctrine's objective prong.

However, the issue remains that tax-preferred investments will also fail the subjective prong of the economic substance doctrine. To punish a taxpayer's tax-preferred investment for its apparent lack of non-tax purpose is

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taxpayer seeks to claim tax benefits, *unintended by Congress*, by means of transactions that serve no economic purpose other than tax savings.") (emphasis added).

131 Bankman, *supra* note 68, at 27.

132 *See* Frank Lyon Co. v. United States, 435 U.S. 561, 583–84 (1978) ("[W]here, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business *or regulatory realities*, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.") (emphasis added).

133 CONG. EXPLANATION OF TAX LEGIS. IN 111TH CONGRESS, *supra* note 62, at 378–79 n.1034.

134 Sacks v. Comm'r, 69 F.3d 982, 992 (9th Cir. 1995).

135 69 F.3d 982 (9th Cir. 1995).

136 *Id.* at 990–91.

137 *Id*. at 991–92.

138 *Id*. at 991 (quoting Casebeer v. Comm'r, 909 F.2d 1360, 1365 (9th Cir. 1990)).

to challenge the taxpayer for following express Congressional intent.[139] Congress, recognizing a deficit of business purpose in activities it seeks to promote, creates tax preferences to incentivize investment in unprofitable, but socially beneficial, markets and transactions.[140] Therefore, a taxpayer who enters a tax-preferred transaction solely because the tax benefits make it profitable is responding exactly how Congress intended.[141] By allowing the Treasury to challenge a transaction falling within the express intent and purpose of Congress, the court effectively authorizes executive usurpation of legislative authority to create policies through the Revenue Code.[142]

As the law stands today, subject to strict liability, the economic substance doctrine may be applied to tax-preferred transactions, but courts must consider after-tax profits when evaluating their objective substance. Still, the possibility of a challenge under the economic substance doctrine alone, given the strict liability rule, is enough to freeze socially valuable tax preference investments. To preserve tax preferences under challenge by the economic substance doctrine, courts must consider the claimed tax preferences in accordance with their authorizing statutes. The Historic Rehabilitation Tax Credit provides a clear example of the need for courts to evaluate challenges to claimed tax preferences in harmony with their authorizing statutes.

III. THE HISTORIC REHABILITATION TAX CREDIT

The Historic Rehabilitation Tax Credit[143] is just one of a number of policy-sourced, tax-preferred investment credits in the Revenue Code.[144] In the 1960's, Congress began an effort to preserve America's historic sites and neighborhoods in the face of nationwide commercialization and development.[145] These efforts culminated in the National Historic Preservation Act, which authorized the Secretary of the Interior to create a national historic

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139 Jellum, *supra* note 59, at 584 (explaining that "Congress actively encourages tax shelters in some situations" (citing Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389, 395–96 (2010)).

140 Oh, *supra* note 41, at 65.

141 Bankman, *supra* note 68, at 13. *See also* Zelenak, *Good Preferences*, *supra* note 44, at 515 ("The very purpose of an incentive preference is to encourage taxpayers to make investments that they would not make except for the preference.").

142 Sacks v. Comm'r, 69 F.3d 982, 992 (9th Cir. 1995).

143 26 U.S.C. § 47 (2012).

144 *See, e.g.*, CONG. RESEARCH SERV., S. PRT. 112-45, *supra* note 39, at 2.

145 *See* 16 U.S.C. § 470(b)(5) (2012) ("[I]n the face of ever-increasing extensions of urban centers, highways, and residential, commercial, and industrial developments, the present governmental and nongovernmental historic preservation programs and activities are inadequate to insure future generations a genuine opportunity to appreciate and enjoy the rich heritage of our Nation[.]"). This section was eliminated in 2014 when portions of Title 16 were transferred to Title 54. Pub. L. No. 113-287, 128 Stat. 3094 (2014). Operative provisions relating to historic preservation remain. *Id.* §§ 300101 et. seq.

registry and created matching grants for the preservation of historic buildings.[146]

Ten years after passing the National Historic Preservation Act, Congress became concerned that its existing tax preferences were incentivizing new industries and construction at the expense of existing historic sites.[147] Congress also recognized that it was generally a cheaper option to bulldoze and start construction anew than to attempt to rehabilitate an existing structure for new purposes.[148] Moreover, historical rehabilitation projects were, as they are now, "inherently uneconomical and unprofitable."[149] And, although Congress had deemed historic preservation a national priority, the Act did little to incentivize private investment in preservation.[150] When it came time to build, private investors were faced with a choice, but market forces alone provided no incentive to invest in historic rehabilitation investors were unable to appreciate the positive externalities of rehabilitated buildings.[151]

In response to these concerns, Congress created the Historic Rehabilitation Tax Credit to carry out the intent it expressed in the National Historic Preservation Act:

> [T]o accelerate [the Nation's] historic preservation programs and activities, to give maximum encouragement to agencies and individuals undertaking preservation by private means, and to assist State and local governments and the National Trust for Historic Preservation in the United States to expand and accelerate their historic preservation programs and activities.[152]

In order to stimulate private investment in historic property, Congress provided a broad swath of incentives: rapid accelerated depreciation for purchases of certified historic property, which exceeded the depreciation allowable for non-certified property; denial of deductions for demolition expenses incurred in destroying any part of certified property; and denial of accelerated

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146 Cheverine & Hayes, *supra* note 12, at 171–73 (citing 16 U.S.C. §§ 470a (repealed 2014), 470f (transferred to 54 U.S.C. §§ 302101-08, 303101-03 (2016)).

147 *Id.* at 168–69.

148 *See* Miriam Joels Silver, Note, *Federal Tax Incentives for Historic Preservation: A Strategy for Conservation and Investment*, 10 HOFSTRA L. REV. 887, 889 (1982) ("Unless the added expense of preservation can be made at least reasonable, if not profitable, by the use of federal tax incentives similar to those available under the TRA, the private sector may be forced to abandon history and opt for the practicality of the bulldozer and the wrecking ball used so frequently prior to the NHPA and the TRA.").

149 Jacobs, *supra* note 21, at 20.

150 Cheverine & Hayes, *supra* note 12, at 173.

151 *See* CONG. RESEARCH SERV., S. PRT. 112-45, *supra* note 39, at 393.

152 16 U.S.C. § 470(b)(7) (2012). This section was eliminated in 2014 when portions of Title 16 were transferred to Title 54. Pub. L. No. 113-287, 128 Stat. 3094 (2014). *See also* TAX REFORM ACT EXPLANATION, *supra* note 10, at 102 (explaining that a "certified historic structure" is defined in terms of the National Register, which was established by the NHPA).

depreciation on any structure replacing historic property.[153] Thus, the original Historic Rehabilitation Tax Credit not only incentivized private investment in historic property, but also discouraged investment in non-historic property.[154]

In 1981, the Reagan administration sought to reduce Congress's power to regulate the economy through the Revenue Code.[155] This goal was largely realized by Congress through the Economic Recovery Tax Act of 1981,[156] which drastically reduced existing tax preferences in favor of a more *laissez-faire* taxation system.[157] Many investment credits were repealed, but tax-preferences for historic rehabilitation remained, reduced to a 25% credit for expenses incurred in rehabilitating certified structures.[158] Five years later, credits available to business investors again faced a slew of repeals under the Tax Reform Act of 1986.[159] Again, the historic rehabilitation tax credit, though reduced now to only a 20% credit for expenditures, persisted.[160] In retaining the credit, Congress noted that "a tax incentive is needed because market forces might otherwise channel investments away from such projects because of the extra costs of undertaking rehabilitations of older or historic buildings."[161]

Today, the credit exists as it was passed in 1986.[162] However, Congress has broadened its applicability.[163] For example, Congress has expanded the use of the historic rehabilitation tax credit to incentivize private investment in the preservation of historic buildings in New Orleans following Hurricane Katrina.[164] Congress has also expanded the credit in areas where it has simply

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153 TAX REFORM ACT EXPLANATION, *supra* note 10, at 102–03.

154 Cheverine & Hayes, *supra* note 12, at 176–78.

155 Ronald Reagan, President of the United States, White House Report on the Program for Economic Recovery (Feb. 18, 1981), http://www.reagan.utexas.edu/archives/speeches/1981/21881c.htm ("The goal of this Administration is to nurture the strength and vitality of the American people by reducing the burdensome, intrusive role of the Federal Government; by lowering tax rates and cutting spending; and by providing incentives for individuals to work, to save, and to invest. It is our basic belief that only by reducing the growth of government can we increase the growth of the economy.").

156 Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981).

157 *See* STAFF OF THE J. COMM. ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981 17 (Comm. Print 1981).

158 *Id.* at 113.

159 *E.g.*, Historic Boardwalk Hall, LLC v. Comm'r, 694 F.3d 425, 430 (3d Cir. 2012).

160 STAFF ON THE J. COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 150 (Comm. Print 1987).

161 *Id.* at 149.

162 *Compare* Tax Reform Act of 1986, Pub. L. No. 99-514, § 251(a)(4)(A), 100 Stat. 2085, 2183 (1986), *with* 26 U.S.C. § 47(a) (2012).

163 CONG. RESEARCH SERV., S. PRT. 113-32, *supra* note 55, at 384.

164 *Id.* (noting that the provision was extended by the Gulf Zone Opportunity Act of 2005, Pub. L. No. 109-135, 119 Stat. 2577 (2005)).

decided it was not being utilized enough.[165] Incentivizing investment in historic rehabilitation remains not only an important, bipartisan policy goal for Congress, but also a useful tool in repairing and preserving the nation's communities.

Historic Rehabilitation Tax Credit claims are subject to several limitations, and they "receive[] more administrative oversight than most other tax provisions."[166] This is because both the National Park Service and the IRS must approve elements of every Historic Rehabilitation Tax Credit claim.[167] Investors wishing to claim the credit must have both the historic property and their rehabilitation plan approved by the National Park Service, both when the project is proposed and after the project is completed.[168] Additionally, only projects that have been deemed "substantially rehabilitated" by the IRS are eligible for claiming the credits.[169] Finally, Rehabilitation Credits are subject to recapture rules, ensuring that only those projects that are successful for at least five years after completion earn credits.[170]

There are also limitations on who can claim the Historic Rehabilitation Tax Credit. The Historic Rehabilitation Tax Credit can only be claimed by the taxpayer entity—either a single owner or a partnership—that owns the property.[171] Therefore, the Historic Rehabilitation Credit Tax Credit can neither be bought nor sold.[172] However, Congress has recognized that historic rehabilitation has become "dependent" upon private investment.[173] Since the credit's enactment, private corporations have been a significant source of capital investment in historic rehabilitation credits.[174] For this reason, the IRS

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165 *See* STAFF OF THE J. COMM. ON TAXATION, 110TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 110TH CONGRESS 224–25 (Comm. Print 2009) ("The Congress is concerned that the rehabilitation tax credit may not be providing an incentive to rehabilitate buildings . . . . [T]he Congress believes that increasing the present-law percentage of permitted tax-exempt use . . . will encourage the rehabilitation of *more* buildings.") (emphasis added).

166 CONG. RESEARCH SERV., S. PRT. 113-32, *supra* note 55, at 385.

167 *See, e.g.*, 26 U.S.C. § 47(c)(3)(A) (2012); Treas. Reg. § 1.48-12(d)(1)(ii) (2013); Kenneth A. Alperin, *What You Should Know About The Historic Rehabilitation Tax Credit*, 19 PRAC. TAX LAW. 31, 33 (2005) ("The United States Department of the Interior plays a major role in determining whether a building is eligible for the Historic Rehabilitation Credit . . . .").

168 CONG. RESEARCH SERV., S. PRT. 113-32, *supra* note 55, at 385.

169 26 U.S.C. § 47(c)(1)(A) (2012); Treas Reg. § 1.48-12(b)(1) (2013).

170 Treas. Reg. §§ 1.48-12(e)(3), (f)(3) (2013). *See also* Mark Primoli, Internal Revenue Service, *Technical Preservation Services: Frequently Asked Questions*, NAT'L PARK SERV., ¶ 39, https://www.nps.gov/tps/tax-incentives/before-apply/irs-faq3.htm ("The rehabilitation credits are subject to recapture if the building is sold or ceases to be business use property.") (last visited Jan. 6, 2017).

171 Treas. Reg. § 1.48-12(c)(3)(ii)(A)(2) (2013).

172 Primoli, *supra* note 170, at ¶ 39.

173 S. COMM. ON THE BUDGET, 99TH CONG., TAX EXPENDITURES: RELATIONSHIPS TO SPENDING PROGRAM AND BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS 100 (Comm. Print 1986).

174 Dennis L. Cohen, *IRS Issues Important Historic Rehabilitation Tax Credit Guidance*, COZEN O'CONNOR (Jan. 9, 2014) (last visited Jan. 5, 2017), https://www.cozen.com/news-resources/publications/2014/irs-issues-historic-rehabilitation-tax-credit-guidance.

has expressly endorsed the partnership of tax-exempt entities and private investors to ensure that "the limited partners [are] entitled to the rehabilitation tax credit and the tax exempt entity is able to ensure that their organizational goals are being met."[175]

Syndication in historic rehabilitation provided dual benefits for both the private investing partner and the tax-exempt partner.[176] So long as the tax-exempt organization and the private investor formed a partnership that owned the project, and the project was actually completed within the requirements of Section 47, the credits—which would otherwise go unused—could be claimed by the private investor.[177] In return, the tax-exempt entity received the benefit of capital investment reducing what are often otherwise taxpayer-derived expenses.[178] Ultimately, entire communities can count on the benefits of new jobs, enhanced property values, and new revenue sources as a result of successful historic rehabilitation projects.[179] Or at least they could until 2014, when the IRS successfully used the economic substance doctrine to deny such a partnership's claim to Historic Rehabilitation Tax Credits.[180].

IV. *HISTORIC BOARDWALK HALL*: A MONUMENTAL CHALLENGE TO HISTORIC REHABILITATION

Since the Historic Rehabilitation Tax Credit's enactment in 1976, transactions involving the credit have generally gone unchallenged.[181] Perhaps the IRS recognized Congress's ultimate intent in using the credit to achieve to "an important national goal."[182] The IRS may have also realized that this goal "depended on enlisting private funds in the preservation movement."[183] But in 2010, by challenging a rehabilitation partnership between a tax-exempt entity and a private investor, the IRS threatened to freeze historic rehabilitation in its tracks and thereby frustrate Congress's express intent.

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175 Primoli, *supra* note 170, at ¶ 34.

176 *See, e.g.*, *id.*

177 WILLIAM REEVES & SHERRIE L.W. RHINE, OFF. OF THE COMPTROLLER OF THE CURRENCY, CMTY. DEV. INSIGHTS, HISTORIC TAX CREDITS: BRINGING NEW LIFE TO OLDER COMMUNITIES 2 (2015).

178 *Id.*

179 NPS, FEDERAL TAX INCENTIVES REPORT FOR 2009, *supra* note 16.

180 *See generally* Historic Boardwalk Hall, LLC v. Comm'r, 694 F.3d 425, 446, 447–49, 461 (3d Cir. 2012), *rev'g*, 136 T.C. No. 1 (2011).

181 Alperin, *supra* note 167, at 34 ("[T]here has apparently not been a substantial amount of audit activity recently with regard to Historic Rehabilitation Credit transactions . . . .").

182 CONG. RESEARCH SERV., S. PRT. 111-58, TAX EXPENDITURES, COMPENDIUM OF BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS 391 (2010).

183 *Id.*

A. *The Rehabilitation of Atlantic City's Historic East Hall*

Historic East Hall was built in 1929 and is considered an icon along the Atlantic City Boardwalk.[184] Upon its construction, it boasted the largest clear span space in the country, which earned its claim as an "architectural marvel."[185] The Hall was a "popular event space," and it hosted Lyndon B. Johnson's nomination at the 1964 Democratic Convention, the first indoor college football game in 1930, and the Miss America Pageant for over 40 years.[186] Since 1987, the Hall has been listed on the United States Register of Historic Places as a National Historic Landmark.[187]

However, in 1992, East Hall had become "run down."[188] In order to continue drawing the crowds and events that made East Hall famous, it needed renovations.[189] Recognizing this, the New Jersey legislature made plans for the Hall to be "substantially rehabilitated" into a mixed-use space.[190]

To facilitate the rehabilitation, the New Jersey state legislature passed a resolution for the redevelopment of the Atlantic City Boardwalk.[191] New Jersey appointed the New Jersey Sports and Exposition Authority ("NJSEA") with the task of overseeing the Hall's rehabilitation.[192] Funds for the rehabilitation project were procured through the issuance of state bonds and contributions from the New Jersey Casino Authority.[193] In other words, the project was to be wholly funded by state tax dollars.[194]

Since the Hall was registered as a National Historic Landmark, expenses incurred in restoring it were eligible for the Historic Rehabilitation Tax Credit.[195] As NJSEA is a tax-exempt state entity, it had no use for these credits.[196] However, there was no requirement that these credits go unused.[197] In 1998, a consulting firm approached NJSEA and informed them of a "market"

184 *Arena History*, BOARDWALK HALL, http://www.boardwalkhall.com/arena-information/arena-history (last visited Jan. 5, 2017).

185 *Id. See also* Historic Boardwalk Hall, LLC v. Comm'r, 136 T.C. 1, 4 (2011).

186 *Historic Boardwalk Hall*, 136 T.C. at 4; *Arena History*, *supra* note 184.

187 *Arena History*, *supra* note 184.

188 *Historic Boardwalk Hall*, 136 T.C. at 4.

189 *Id.*

190 *Id.*

191 *Id.*

192 *Id.*

193 *Id.* at 5.

194 Historic Boardwalk Hall v. Comm'r, 136 T.C. 1, 5 (2011).

195 *Id.* at 3.

196 *Id.* at 2; Jacobs, *supra* note 21 at 17.

197 Jacobs, *supra* note 21 at 17.

amongst corporate investors for Historic Rehabilitation Tax Credits.[198] In return, NJSEA would receive capital contributions to put towards its East Hall project.[199]

Shortly after, NJSEA created Historic Boardwalk Hall, LLC ("HBH"), and subleased its entire interest in the East Hall to the partnership.[200] At the time of its creation, NJSEA was the only member of HBH.[201] With the assistance of the consulting firm, NJSEA reached out to private investors interested in co-ownership of the Hall.[202] Private investors would be required to contribute a capital amount to the rehabilitation project; in return, they would receive the Historic Rehabilitation Tax Credits that would otherwise go unused.[203] Ultimately, rehabilitation of the Hall would be achieved at a lower cost to New Jersey taxpayers.[204]

In forming the partnership, NJSEA arranged to serve as the "managing" member, while the private partner would serve as the "investor" member.[205] The partnership agreement also allocated 99% of its profit and loss to the investor partner.[206] Finally, to make investment more attractive to private investors, investor partners were insulated from certain kinds of risks within the project through a series of guaranties provided by the partnership.[207] Crucially, in order to acquire a private investor, NJSEA guaranteed the cash value of any earned credits should any part of the rehabilitation be challenged by the IRS ("Tax Benefit Guaranty").[208]

In 2000, Pitney Bowes entered the partnership as HBH's investor partner.[209] Problematically, this partnership was solicited through an offering memorandum that referred to the potential transaction as a "sale" of credits.[210] However, the ultimate partnership agreement's terms never referred to a sale, and instead referred to both NJSEA and Pitney Bowes as "members" of HBH.[211] As the investor partner, Pitney Bowes agreed to both make capital contributions and lend funds to HBH for the restoration of East Hall.[212] Contributions were first used to pay the principal on the acquisition of the hall,

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198 *Historic Boardwalk Hall*, 136 T.C. at 5.
199 *Id*. at 8.
200 *Id.*
201 *Id.* at 3, 6.
202 *Id*. at 6.
203 *Id*.
204 Historic Boardwalk Hall v. Comm'r, 136 T.C. 1, 24 (2011).
205 *Id.* at 7.
206 *Id.*
207 *Id.* at 14–15.
208 *Id.* at 15.
209 *Id.* at 7.
210 Historic Boardwalk Hall v. Comm'r, 136 T.C. 1, 6 (2011).
211 *Id.* at 6–7.
212 *Id.* at 8.

then on a construction note, with the remainder advanced to HBH for miscellaneous payments, including a developer's fee to NJSEA for the management of the Hall.[213] In exchange for this fee, NJSEA agreed to "obtain all required Government approvals for the rehabilitation and oversee the completion of the rehabilitation."[214] Payment of the fee to NJSEA was contingent on the completion of the East Hall restoration.[215] Ultimately, Pitney Bowes contributed over $18,000,000 of capital to a project that was projected to cost $90,600,000.[216]

After years of phased rehabilitation, the East Hall renovation was a success.[217] Upon the Hall's unveiling, HBH's restoration received nine architectural and engineering awards, including the National Preservation Award for 2003.[218] Pitney Bowes remained a partner in HBH when the IRS challenged its claim for the rehabilitation credits.[219]

In 2001, after claiming the credits for its capital investment in the completed East Hall rehabilitation, HBH received a Notice of Final Partnership Administrative Adjustment ("FPAA") from the IRS reallocating the claimed credits from Pitney Bowes to NJSEA—a tax exempt organization that ultimately could not claim them.[220] Applying the economic substance doctrine, the IRS claimed that Pitney Bowes and NJSEA had not actually created a partnership, and that, in substance, the parties had actually arranged a sale of historic tax credits.[221]

Notably, as this transaction occurred prior to March 1, 2010, it was subject to scrutiny under the judicial version of the economic substance doctrine, not the codified statutory version.[222] However, under Section 7701(o)'s terms, *Historic Boardwalk Hall*'s holding would be incorporated as a precedential means of evaluating economic substance in future tax preferences.[223]

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213 *Id.* at 9.
214 *Id.* at 10.
215 *Id*.
216 Historic Boardwalk Hall v. Comm'r, 136 T.C. 1, 8 (2011).
217 *Id.* at 16.
218 *Arena History*, *supra* note 184.
219 *Historic Boardwalk Hall*, 136 T.C. at 14.
220 *Id.* at 17.
221 *Id.*
222 *Id.* at 19–20.
223 *See* 26 U.S.C. § 7701(o)(5)(C) (2012).

B. *The IRS's Challenge*

In its response to HBH's appeal of the IRS's FPAA, the IRS insisted on applying the economic substance doctrine to the claim of tax-preferred Historic Rehabilitation Tax Credits.[224] Relying on the economic substance doctrine, the IRS focused on the individual partners to attack HBH as a "sham" partnership.[225] Essentially, the IRS argued that HBH was not an investment in the East Hall restoration, but rather a sale of Historic Rehabilitation Tax Credits from NJSEA to Pitney Bowes.[226]

The IRS characterized the objective prong of the economic substance doctrine as requiring a "material, appreciable economic effect (other than reducing taxes)."[227] Ultimately, the IRS argued that HBH lacked economic substance because no outcome of the rehabilitation "would appreciably affect Pitney Bowes' economic position other than through a reduction of its tax liabilities."[228]

The IRS conceded that if a taxpayer is motivated solely by tax avoidance, that motivation is "not fatal to a transaction" if tax avoidance is within the contemplation of Congressional intent.[229] However, it argued that HBH "served no subjective business purpose because it was intended solely to facilitate NJSEA's sale of rehabilitation tax credits and other favorable tax attributes to Pitney Bowes."[230] To support its claim under the subjective prong, the IRS turned to the risk assumed by Pitney Bowes as evidence of the parties' intent in forming HBH.[231] Principally, the IRS argued that the lack of "meaningful stake" undertaken by Pitney Bowes in the success or failure of the restoration was evidence that the parties did not have an actual business purpose in forming HBH.[232]

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224 *Historic Boardwalk Hall*, 136 T.C. at 19; Brief for Respondent at 46, Historic Boardwalk Hall, LLC v. Comm'r, 136 T.C. 1 (2009) (No.11273-07), 2009 WL 7400927, at *31.

225 Brief for Respondent, *supra* note 224, at *12.

226 *Id.* at *11.

227 *Id.* at *30 (citing Knetsch v. United States, 364 U.S. 361, 366 (1960); In re CM Holdings, 301 F.3d 96, 103–05 (3d Cir. 2002); Merryman v. Comm'r, 873 F.2d 879, 881 (5th Cir. 1989); Weller v. Comm'r, 270 F.2d 294, 297 (3d Cir. 1959)).

228 *Historic Boardwalk Hall*, 136 T.C. at 20.

229 Brief for Respondent, *supra* note 224, at *35 .

230 *Historic Boardwalk Hall*, 136 T.C. at 21.

231 Brief for Respondent, *supra* note 224, at *37–38.

232 *Id.* at *36–38.

C. *A Comprehensive Evaluation at the Tax Court*

Despite the IRS's narrow challenge of the partnership formation, the Tax Court considered the investment in terms of the entire rehabilitation project.[233]

First, the Tax Court faulted the IRS for defying the *Sacks* precedent where the investment clearly involved a tax preference.[234] The IRS argued that anticipated Historic Rehabilitation Tax Credits should "never [] be taken into account" in evaluating the objective economic substance of Pitney Bowes's partnership in HBH.[235] However, the Tax Court reiterated *Sacks*'s position that a transaction "'[does] not become a sham just because its profitability was based on after-tax instead of pre-tax projections.'"[236]

The court also noted that by challenging the credits intended by Congress, the IRS was superseding legislative power as an executive agency.[237] The court refused to allow the executive branch to punish taxpayers by using the very reason that the legislature created the credits—a lack of non-tax business outcome—as a challenge to the claim of the credits.[238] Since Pitney Bowes would receive Historic Rehabilitation Tax Credits at the completion of the rehabilitation project, in addition to a 3% preferred profit return, the Tax Court determined that its investment in East Hall did have objective economic substance.[239]

The Tax Court also stated that by challenging the partnership formation, the IRS "overlook[ed] the impact that Pitney Bowes had on the rehabilitation . . . ."[240] Regardless of the East Hall's funding situation at the time Pitney Bowes entered the partnership, their contribution ultimately reduced the cost of the rehabilitation project to taxpayers.[241]

Turning to the subjective prong, the Tax Court criticized the IRS for characterizing the partnership as a "sale" of credits.[242] Employing the substance-over-form doctrine, the Court disregarded the problematic term, "sale," which NJSEA had used in its offering memorandum and instead

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233 *Historic Boardwalk Hall*, 136 T.C. at 20 ("Respondent asks that we look to the individual partners to determine the economic substance of the transaction."); *id.* at 24 ("*Viewed as a whole*, the Historic Boardwalk Hall and the East Hall transactions did have economic substance.") (emphasis added).

234 *See* Sacks v. Comm'r, 69 F.3d 982, 991 (9th Cir. 1995). ("Absence of pre-tax profitability does not show 'whether the transaction had economic substance beyond the creation of tax benefits' where Congress has purposely used tax incentives to change investor's' conduct.") (citation omitted).

235 *Historic Boardwalk Hall*, 136 T.C. at 21.

236 *Id.* at 23 (quoting *Sacks*, 69 F.3d at 991).

237 *Id.* (quoting *Sacks*, 69 F.3d at 992).

238 *Id.*

239 *Id.* at 24.

240 *Id.*

241 Historic Boardwalk Hall v. Comm'r, 136 T.C. 1, 24 (2011).

242 *Id.* at 29.

looked to the partnership agreement's ultimate substance and outcome.[243] NJSEA created HBH to attract a private investor to engage in the rehabilitation of Historic East Hall;[244] Pitney Bowes contributed capital to achieve this rehabilitation in exchange for the otherwise unusable credits.[245] The parties' intent in joining the partnership was tax motivated, but in a sense that had been approved as a "syndication" to achieve joint goals and the ultimate purpose of Section 47.[246]

Additionally, the Tax Court was unconvinced that Pitney Bowes entered a risk-free partnership, as the IRS argued. Considering the entire investment, the Tax Court pointed out several potential risks in the course of a large-scale historic rehabilitation project.[247] First, Pitney Bowes was exposed to environmental risks that had been expressly warned against during construction.[248] Ultimately, there was the risk that the project would not be completed.[249] The Tax Court actually turned to the very guaranties that the IRS presented as evidence of insufficient risk to show that the parties had assumed ample risk in entering into the partnership, and were subsequently protecting themselves from encountering any more.[250] It also acknowledged that, given the nature of historic rehabilitation projects, these types of guaranties were necessary to attract an investor.[251]

Finally, through Pitney Bowes's capital contribution, HBH successfully rehabilitated and placed into service a revenue-raising concert hall.[252] The Tax Court noted the dual benefits accrued by each partner due to the success of the restoration: Pitney Bowes earned an economic benefit through its preferred return and Historic Rehabilitation Tax Credit claims, and NJSEA could anticipate "higher revenues . . . if the East Hall was a successful loss leader and began attracting large crowds after the rehabilitation was completed."[253] The Tax Court concluded that Pitney Bowes had responded to Congress's incentives to join NJSEA in achieving a common goal: the restoration of the East Hall.[254]

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243 *Id.* ("Although the confidential offering memorandum used the term 'sale', it was used in the context of describing an investment transaction. The . . . memorandum accurately described the substance of the transaction: an investment in the East Hall's rehabilitation.").

244 *Id.* at 3.

245 *Id.* at 29.

246 *Id.* at 26–27. *See also* Primoli, *supra* note 170, at ¶ 45.

247 Historic Boardwalk Hall v. Comm'r, 136 T.C. 1, 25 (2011).

248 *Id*.

249 *Id*.

250 *Id.* at 26.

251 *Id.* at 25.

252 *Id.* at 27.

253 Historic Boardwalk Hall v. Comm'r, 136 T.C. 1, 27 (2011).

254 *Id.* at 26.

Ultimately, the Tax Court reemphasized the importance of legislative history when determining whether tax preferences are being used in a legitimate or abusive manner.[255] Where the parties are acting within the intent of the tax-preferred statute, they should not be faulted for acting in a tax-motivated manner—because that is exactly what the statute asks them to do.[256] Through HBH, NJSEA presented credits and guaranties to attract a private investor to a project it otherwise would never be interested in—a risky one that would likely operate at a deficit.[257] In line with Congress's intent, which made the credits available, Pitney Bowes provided HBH with capital contributions for the restoration of East Hall.[258] In a division opinion, the Court reversed the IRS's FPAA and held that the credits should remain with Pitney Bowes.[259]

D. *The Third Circuit's Reversal*

The IRS appealed the Tax Court's opinion, again focusing on the partnership transaction between Pitney Bowes and NJSEA.[260] This time, the court agreed with the IRS's argument that a completed tax-preferred investment could be challenged in terms of specific transaction characteristics.[261] Specifically, the Third Circuit evaluated HBH in terms of the risk assumed by each partner and concluded that Pitney Bowes lacked the subjective intent to be, in substance, a bona fide partner in the restoration of the East Hall.[262]

First, the Third Circuit acknowledged that the Historic Rehabilitation Tax Credit is "a deliberate decision to skew the neutrality of the tax system" to incentivize private investment in historic rehabilitation.[263] Then, citing the recently codified economic substance doctrine, the court opined that "it is not intended that a tax credit . . . be disallowed in a transaction pursuant to which, *in form and substance*, a taxpayer makes the type of investment or undertakes

255 *Id* at 26–27 (citing Friendship Dairies, Inc. v. Comm'r, 90 T.C. 1054 (1988)).

256 *Id.* at 37.

257 *Id.* at 26.

258 *Id.*

259 Historic Boardwalk Hall v. Comm'r, 136 T.C. 1, 37 (2011).

260 Historic Boardwalk Hall v. Comm'r, 694 F.3d 425, 445 (3d. Cir. 2012), *rev'g*, 136 T.C. 1 (2011) (stating the IRS's argument that "PB's claimed partnership interest in HBH was not, based on the totality of the circumstances, a bona fide partnership participation because PB had no meaningful stake in the success or failure of HBH").

261 *Id.* at 448 n.50 ("[W]e focus our analysis on whether PB is as a bona fide partner in HBH."). In footnote 50, the Third Circuit claimed to not consider "economic substance" in its decision. *Id*. The court uses "economic substance" in a loose sense, referring only to the objective prong of the doctrine. As explained below, the focus of the Third Circuit's opinion is the subjective prong, or business purpose, of Pitney Bowes and NJSEA in forming HBH.

262 *Id.* at 448–49.

263 *Id.* at 432.

the type of activity that the credit was intended to encourage."[264] Despite this declaration, the Third Circuit went on to apply the economic substance doctrine to the HBH partnership.

Aside from recounting the Tax Court's opinion, the Third Circuit did not consider the objective prong of the economic substance doctrine as applied to HBH.[265] Thus, the Tax Court's *Sacks*-based interpretation of including both potential profit and expected tax credits in the consideration of objective economic substance was undisturbed on appeal.[266] Instead, the Third Circuit focused on the subjective inquiry, concentrating on the parties' business purposes in forming HBH.[267]

As to the subjective inquiry, the IRS argued that Pitney Bowes and NJSEA did not "[intend] to join together in the present conduct of the enterprise" of restoring East Hall.[268] As evidence of this claim, the IRS argued that Pitney Bowes "did not have any meaningful downside risk or any meaningful upside potential in [Historic Boardwalk Hall]."[269] Ultimately, the IRS claimed, Pitney Bowes assumed insufficient "'entrepreneurial risks of partnership operations,'" and was therefore more akin to a purchaser of Historic Rehabilitation Tax Credits than an investor in the East Hall restoration project.[270]

Apparently convinced by the IRS's focused claims, the court considered only the partnership agreement, the Tax Benefit Guaranty and the schedule of payments from Pitney Bowes to HBH in its decision.[271] The court also determined that Pitney Bowes's contribution was not "necessary" to the restoration, noting that the project had been fully funded by state dollars before HBH was formed.[272] For this reason, it was unconvinced by the Tax Court's finding of the risk that the East Hall restoration would not be completed.[273] Based on these arrangements, the court concluded that Pitney Bowes lacked "meaningful downside risk" to have intended to join as a partner in the restoration.[274]

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264 *Id.* (citing STAFF OF THE J. COMM. ON TAXATION, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT" 152 n. 344 (Comm. Print 2010)).

265 *Id.* at 448–49 n.50 (acknowledging that the Commissioner continued to argue that HBH was a "sham" partnership under the objective inquiry, but instead focusing primarily on the argument that Pitney Bowes was not a partner).

266 Historic Boardwalk Hall v. Comm'r, 694 F.3d 425, 448–49 n.50 (2012) ("Specifically, we do not opine on the parties' dispute as to whether, under [*Sacks*], we can consider HRTCs in evaluating whether a transaction has economic substance." (citation omitted)).

267 *Id.*

268 *Id.* at 454 (quoting Culbertson v. Comm'r, 337 U.S. 773, 742 (1949)).

269 *Id.* at 455.

270 *Id.* at 452 (citation omitted).

271 *Id.* at 455–57.

272 Historic Boardwalk Hall v. Comm'r, 694 F.3d 424, 457 (3d. Cir. 2012).

273 *Id.*

274 *Id.* at 455.

The Third Circuit ultimately held that Pitney Bowes and NJSEA, "in substance, did not join together in HBH's stated business purpose—to rehabilitate and operate the East Hall [but] [r]ather, the parties' focus from the very beginning was to effect a sale and purchase of [Historic Rehabilitation Tax Credits]."[275] Based on this conclusion, it reversed the Tax Court's decision, allowing the IRS to reallocate the Rehabilitation Credits generated by the East Hall restoration to NJSEA, who could never claim them.[276]

E. *The* Golsen[277] *Rule: The Precedential Effect of a Reversed Division Opinion*

Matters before the Tax Court have a unique precedential effect if appealed. The Tax Court is a National Court.[278] Issues that are heard before it and decided as "division opinions" create a national precedent.[279] That is, any tax case heard in any state is bound by the decision of the Tax Court's division opinion precedent.[280] If a Tax Court case is appealed to a federal court of appeals, the decision in the court of appeals is only precedent for those Tax Court cases that could be appealed to that court.[281] Forthcoming Tax Court cases appealable in any other circuit would be subject to the persuasive authority of both the federal appellate decision and Tax Court precedent.[282] In this sense, Tax Court division opinions that are appealed and reversed effectively create a circuit split.[283] This effective split, called the *Golsen* effect,[284] will likely lead to uncertainty around tax-preferred investments in the wake of the Third Circuit's *Historic Boardwalk Hall* reversal.

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275 *Id.* at 458.

276 *Id.* at 463.

277 8 INTERNAL REVENUE MANUAL, ch. 6, § 8.6.4.1.6 (2015), https://www.irs.gov/irm/ (referring to Golsen v. Comm'r, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), noting that the Tax Court "would follow the rule of law laid down by the Court of Appeal to which an appeal in the case before it would lie").

278 Mary Ann Cohen, *How to Read Tax Court Opinions,* 1 HOUS. BUS. & TAX L.J. 1, 6 (2001).

279 *Id.*

280 *See id.*; Andy Grewel, *The Un-Precedented Tax Court: Memo Opinions*, PROCEDURALLY TAXING (May 14, 2015), http://www.procedurallytaxing.com/the-un-precedented-tax-court-memo-opinions/.

281 Cohen, *supra* note 278, at 6.

282 *Id.*

283 Lawrence v. Comm'r, 27 T.C. 713, 716–17 (1957), *rev'd on other grounds*, 258 F.2d 562 (1958) (stating that, upon reversal, the Tax Court "must thoroughly reconsider the problem in the light of the reasoning of the reversing appellate court and, if convinced thereby, the obvious procedure is to follow the higher court. But if still of the opinion that its original result was right, a court of national jurisdiction to avoid confusion should follow its own honest beliefs until the Supreme Court decides the point." (footnote omitted)).

284 8 INTERNAL REVENUE MANUAL, *supra* note 277.

F. *The IRS's Solution: A "Safe Harbor" Revenue Ruling*

The IRS responded to outcry by attorneys, taxpayers, and community organizations regarding the uncertainty of historic rehabilitation projects following *Historic Boardwalk Hall* by issuing a Revenue Procedure.[285] However, this "Safe Harbor" ruling does little more than provide a checklist to ensure that partnerships formed to claim Historic Rehabilitation Tax Credits will not be challenged.[286] Essentially, as long as a historic credit partnership does not include the specific guaranties that NJSEA relied upon to attract a private investor, a Section 47-motivated partnership may go unchallenged by the IRS.[287]

Truly, the safe harbor ruling is little more than a restatement of the Third Circuit's *Historic Boardwalk Hall* decision. It does not specify what the IRS will take into consideration in determining whether the "transaction" of a tax-preferred investment is eligible to be challenged under the economic substance doctrine, and the IRS has stated it does not intend to issue any further guidance on the matter.[288] Additionally, given the *Golsen* effect of the Third Circuit's reversal of the Tax Court decision, only time will tell whether courts will recognize narrower challenges to tax-preferred partnerships, or instead evaluate investments in their entirety, creating even more uncertainty around the interpretation of the Historical Rehabilitation Tax Credit.

VI. A "SUBSTANTIAL REHABILITATION" OF CONGRESS'S INTENT

The disparity between the Tax Court's and the Third Circuit's decisions leaves unanswered which criteria will be considered when evaluating the subjective economic substance of tax-preferred transactions. By considering solely the level of risk assumed by each partner in the formation of HBH, the Third Circuit conducted an incomplete analysis of the partnership's investment. Specifically, the Third Circuit allowed the allocation of risk, an inappropriate factor in evaluating tax preferences, to overcome the purposes of the Historic Rehabilitation Tax Credit.

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285 Rev. Proc. 2014-12, Bulletin No. 2014-3 I.R.B 394, 415 (Jan. 13, 2014).

286 *Id.* ("The Service will not challenge a Partnership's allocations of validly claimed § 47 rehabilitation credits if the Partnership and its partners satisfy the Safe Harbor.").

287 *Id.* at 415–17 (providing minimum partnership interests and impermissible guarantees to avoid audit under § 47 and *Historic Boardwalk Hall*'s precedent).

288 Rev. Proc. 2015-3, Bulletin No. 2015-1 I.R.B 1, 129–31, 136 (Jan. 2, 2015) (listing both § 47 and "[w]hether the economic substance doctrine is relevant to any transaction or whether any transaction complies with the requirements of §7701(o)" as "[a]reas in which rulings or determination letters will not be issued").

The Third Circuit's decision goes beyond Historic Rehabilitation Tax Credits and creates an opportunity for the IRS to challenge other tax-preferred investments at unpredictable levels. Under the Third Circuit's decision, investors will need to consider each level of investment and may even need to force or artificially create risk to avoid IRS challenges. Ultimately, this will reduce the level of private investment in tax credit transactions, which is expressly counter to Congress' intent in passing tax credit statutes.[289] To preserve Congress's intent in providing the Historic Rehabilitation Tax Credit to private investors in order to promote rehabilitation, courts should follow the Tax Court's comprehensive scrutiny of private investment in tax-preferred projects.

A. *Interpreting the Revenue Code: Why "One Should Consult the Statute Only if The Legislative History is Unclear"*[290]

Modern statutory interpretation scholars debate the primary source of statutory meaning. Advocates of textualist theories argue that courts, as interpreters of the law and not its history, have authority only to apply the letter of the law.[291] However, it is apparent that strict textualism authorizes tax shelters.[292] For this reason, the IRS has promulgated regulations mandating that tax statutes "be interpreted consistent 'with the intent of [the statutes.]'"[293] These regulations help to guarantee that courts will uphold those tax shelters that match Congress's intent, and disregard those that undermine it.

Even the strictest textualist would likely concede that the nature of the Revenue Code supports the court's reliance on legislative history. The Revenue Code's words cannot anticipate each activity that may or may not fall within its tax structure. Thus, while a tax statute's text may not be ambiguous on its face, it can become ambiguous when applied to factual situations.[294] Just as judicial doctrines allow courts to be reactive where Congress cannot, the use of legislative history allows Congress to anticipate behavior where the statute's text cannot.[295]

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289 Jacobs, *supra* note 21, at 16.

290 Lawrence Zelenak, *The Court and the Code: A Response to* The Warp and Woof of Statutory Interpretation, 58 DUKE L.J 1783, 1784 (2009).

291 Noel B. Cunningham & James Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1, 2 (2004) (citing Antonin Scalia, *Common Law Courts in a Civil-Law System: The Role of United States Federal Courts in Interpreting the Constitution and Laws*, *in* A MATTER OF INTERPRETATION 3, 17 (Amy Gutmann ed., 1997)).

292 *Id.*

293 *Id.* at 5 (quoting Treas. Reg. § 1.701-2 (1995)).

294 *Id.* at 15.

295 Comm'r v. Morgan's, Inc., 293 U.S. 121, 126 (1934) ("[T]he true meaning of a single section of a statute in a setting as complex as that of the revenue acts, however precise its language, cannot be ascertained if . . . isolated from the history of the income tax legislation of which it is an integral part.").

Congress's intent is especially important in tax preferences. This is because Congress "rarely consider[s] statutory language when discussing a tax bill," and instead discusses proposals and their estimated revenue effect conceptually.[296] Often, the true intent of Congress does not translate into the ultimate statutory text, but a cursory review of the committee or expenditure report will make the tax preference's purpose clear. This is because the committee reports "convey the essence of what Congress thought it was accomplishing when it enacted the statutes."[297]

Reliance on legislative history endorses the application of judicial doctrines when interpreting statutes, as well. Judicial doctrines were developed to distinguish legitimate tax shelters from abusive ones by evaluating whether the claimed tax benefits were actually earned as Congress imagined they would be.[298] Indeed, the need for doctrines arose from the vulnerability of the Revenue Code to exploitation via strict textual interpretations.[299]

Moreover, Section 7701(o)'s committee report explicitly calls on courts to consider Congress's intent when deciding whether a taxpayer is legitimately claiming tax benefits: "If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed."[300] Since the economic substance doctrine was developed to protect Congress's intent, it should not be applied to override it.

B. *The Intent and "Substance" of the Historic Rehabilitation Tax Credit*

Tax preferences are unique provisions within the Revenue Code. In fact, tax preferences are better characterized as spending provisions rather than revenue provisions; they are included in the Revenue Code for the purpose of promoting policy.[301] For this reason, any evaluation that solely scrutinizes the economic aspects of a tax-preferred transaction is incomplete. The Tax Court realized this when it declared that NJSEA and Pitney Bowes formed HBH for the purpose of restoring East Hall, rather than accepting a challenge

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See also Cunningham & Repetti, *supra* note 291, at 13 (explaining how the Supreme Court used a temporal element of a statute's legislative history to develop an "overnight rule" for deductions of meal expenses where the statute itself seemed to only address a geographic requirement (citing United States v. Correll, 389 U.S. 299 (1967))).

296 Michael Livingston, *Congress, the Courts, and the Code: Legislative History and the Interpretation of Tax Statutes*, 69 TEX. L. REV. 819, 833 (1991).

297 Cunningham & Repetti, *supra* note 291, at 20.

298 *See* SCHWARZ & LATHROPE, *supra* note 81, at 12.

299 *See* August, *supra* note 82, at 8 ("[T]extualism has sponsored the growth and economic magnitude of tax sheltered investments . . . .").

300 CONG. EXPLANATION OF TAX LEGIS. IN 111TH CONGRESS, *supra* note 62, at 378 n.1034 (referring to Treas. Reg. § 1.269-2).

301 *Id*.

of HBH's partnership formation solely for the amount of risk each partner assumed in doing so.[302] By evaluating the HBH and the East Hall restoration entirely, the Tax Court recognized and preserved the three goals of the Historic Rehabilitation Tax Credit. Truly, these purposes are the "substance" of the Section 47: each was achieved by the East Hall restoration, with the help of Pitney Bowes's capital contributions to HBH.

1. Achieving the National Goal of Historic Preservation

The Historic Rehabilitation Tax Credit was passed by Congress to achieve the "important national goal" of preserving historic structures and neighborhoods.[303] In assessing the Credit, Congress has cited "the value to society at large from preserving social and aesthetic assets."[304] In focusing only on HBH's partnership formation, the Third Circuit overlooked the public policy objectives that the East Hall restoration ultimately achieved.

Public policy benefits are a legitimate consideration in awarding claimed tax benefits.[305] As the Supreme Court has explained, "tax exemptions for certain institutions thought beneficial to the social order of the country as a whole, or to a particular community, are deeply rooted in our history . . . ."[306] Congress has expressly declared that this is true of historic rehabilitation.[307] And, HBH's restoration of the East Hall did achieve multiple benefits to the "social order" for both New Jersey and the nation. As noted by the Tax Court, through Pitney Bowes's capital contributions, HBH completed a successful multi-purpose facility that will attract tourists and produce additional revenue for an otherwise economically-ailing city.[308] By restoring the East Hall, HBH also preserved a site that has hosted numerous events central to American history.[309] Therefore, the award of the credit to Pitney Bowes benefitted taxpayers nationwide, as well as those in New Jersey.

These public policy effects could not possibly have been considered by evaluating risk alone. However, Section 47's express purpose reveals that

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302 Historic Boardwalk Hall, LLC v. Comm'r, 136 T.C. 1, 24 (2011), *rev'd*, 694 F.3d 425 (3d Cir. 2012).

303 CONG. RESEARCH SERV., S. PRT. 113-32, *supra* note 55, at 381–85.

304 *Id.* at 385.

305 *See, e.g.*, Bob Jones University v. United States, 461 U.S. 574, 586–88 (1983) (holding that although a university fell within the plain language of a 501(c) charitable organization, and therefore qualified to receive tax-deductible contributions under 26 U.S.C. § 170, it could not be considered "charitable" within the meaning of the tax code if it exercised discriminatory beliefs counter to public policy).

306 *Id.* at 588.

307 CONG. RESEARCH SERV., S. PRT. 113-32, *supra* note 55, at 384.

308 Historic Boardwalk Hall, LLC v. Comm'r, 136 T.C. 1, 14, 16 (2011). *See also* Tracey Samuelson, *The Rise and Fall... and Rise and Fall of Atlantic City*, MARKETPLACE (Sep. 8, 2014), https://www.marketplace.org/2014/09/08/economy/rise-and-fall-and-rise-and-fall-atlantic-city.

309 *Arena History*, *supra* note 184.

such public policy effects are one of the principal goals the Historic Rehabilitation Tax Credit was designed to promote.

2. Reducing Costs to Taxpayers

Congress also passed the credit in order to "reduce[] the taxpayer's cost of restoring historic buildings."[310] In the case of Historic Boardwalk Hall, Pitney Bowes's contribution of private capital ultimately reduced the New Jersey taxpayers' cost of restoring the East Hall. It is true that, at the time of Pitney Bowes' investment, the rehabilitation was fully funded by state bonds and the New Jersey Casino Authority.[311] However, thanks to Pitney Bowes's $18-million-dollar contribution, $18 million of those allocated state tax dollars were reserved for use elsewhere. This reduced the financial burden not only of the NJSEA, but each taxpayer in the state of New Jersey.

The Third Circuit's isolation of the partnership formation transaction disregarded the fact that East Hall's restoration was ultimately achieved in accordance within Congress's intent, because Pitney Bowes's contribution reduced expense to New Jersey taxpayers. Private investors should not be punished for claiming tax credits where their investment actually contributes to the completion of an otherwise state-funded historic rehabilitation project, especially one that reduces the financial burden of such a rehabilitation on taxpayers.

3. Encouraging Private Investment

Congress passed Section 47 to facilitate the goals it expressed in the National Preservation Act, recognizing that historic rehabilitation could not be achieved without private investment.[312] However, rehabilitation projects may not be profitable without the Historic Rehabilitation Tax Credit, and private investors often "fail to consider the positive externalities from renovating historic buildings . . . ."[313] By providing the Historic Rehabilitation Tax Credit, Congress intended to counteract private market forces to prioritize rehabilitation of historic sites. By evaluating the HBH partnership only in terms of financial risk, the Third Circuit defied Congress's purpose and created a new force against historic rehabilitation.

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310 CONG. RESEARCH SERV., S. PRT. 113-32, *supra* note 55, at 383.

311 *Historic Boardwalk Hall*, 136 T.C. at 5.

312 *See* TAX REFORM ACT EXPLANATION, *supra* note 10, at 643 ("Congress believes that the achievement of this goal is largely dependent upon whether private funds can be enlisted in the preservation movement.").

313 CONG. RESEARCH SERV., S. PRT. 113-32, *supra* note 55, at 385.

Even as Congress has repealed other investment credits, it continues to recognize historic rehabilitation as an important public policy objective, which requires private support.[314] The IRS also apparently recognized the benefit of private investment in historic rehabilitation. In its own publications, the IRS advocated "syndication" between private investors and public organizations.[315] Until *Historic Boardwalk Hall*, this encouragement from both Congress and the IRS allowed private investors to join with tax-exempt organizations to accomplish historic rehabilitation.[316]

After *Historic Boardwalk Hall*, in addition to lack of market profitability, investors in rehabilitation projects must consider the possibility of litigation expenses to defend challenged Historic Rehabilitation Tax Credits. Alternatively, to insulate the Historic Rehabilitation Tax Credits against IRS challenge, private investors must now ensure that they have assumed enough risk at each level of the partnership to avoid HBH-style liability. Neither are attractive business proposals. And, under the codified economic substance doctrine, private investors face the additional threat of strict liability if a court upholds a challenge to their investment under the economic substance doctrine. Thus, by employing an exclusively economic analysis of the tax-preferred investment, the courts undermine the very policy goals Congress sought to promote through the Historic Rehabilitation Tax Credit.

C. *Why Risk is Wrong*

As stated, an exclusively economic analysis of a tax-preferred investment is incomplete, given the substance of Section 47. Moreover, analysis that considers only the risk assumed by each partner to determine business purpose in a tax preference is especially egregious.

Risk is often used to evaluate the reality of tax transactions. In *Historic Boardwalk Hall*, the IRS relied on precedent in which the court rejected a claimed partnership between two foreign banks, citing the fact that "'they had no meaningful stake in the success or failure of the partnership,'" and therefore lacked a business purpose.[317] Although the Third Circuit considered *Castle Harbour v. United States*[318] a "guidepost" in its decision to reject the HBH partnership,[319] the Castle Harbour partnership is distinguishable from a partnership formed to complete a tax-preferred investment.

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314 *See* discussion *supra* Part III.

315 *E.g.*, Primoli, *supra* note 170, at ¶ 45.

316 Jacobs, *supra* note 21, at 17.

317 Historic Boardwalk Hall, LLC v. Comm'r, 694 F.3d 425, 450 (3d Cir. 2012) (quoting TIFD III-E, Inc. v. United States, 459 F.3d 220, 224 (2d Cir. 2006) (referring to *TIFD III-E* as "*Castle Harbour*" throughout the opinion)).

318 459 F.3d 220 (2d Cir. 2006).

319 *Historic Boardwalk Hall*, 694 F.3d at 449–51.

In *Castle Harbour*, a company that owned and leased airplanes formed a partnership with two Dutch banks, which contributed capital to finance the aircraft in exchange for a guaranteed reimbursement plus an annual return.[320] *Castle Harbour* characterized the banks as "equity partners," but since the banks had no meaningful risk or possibility of being paid anything more or less than the reimbursement of their investment "at the Applicable Rate of return," the court re-characterized the foreign bank "partners" as lenders, precluding any tax benefits claimed through the partnership.[321]

In other words, the banks contributed a one-time lump sum to the partnership, and, like a loan, the only thing they had to lose in the venture was the possibility that the airplane company would be unable to pay them back.[322] Distinctly, as recognized by the Tax Court, an investment in an historic rehabilitation project is inherently subject to additional risks.[323]

1. Guaranteed Risk in Historic Rehabilitation

Tax preferences are often created because a socially positive investment is financially risky. As Professor Steven A. Dean puts it, "the rehabilitation credit statute relies on market frictions," including "high transaction costs, adverse financial accounting, [and] unappealing regulatory treatment" "to limit monetization transaction and other potential abuses."[324] Professor Dean claims that these "frictions" are "eroding" as a result of market innovations. [325] However, the fact that Congress continues to provide a credit for historic rehabilitation, even as it has repealed other credits, shows two things: not only does historic rehabilitation remain an important national goal, but it also is one that continues to require additional incentives for private investment.[326]

As late as 2014, Congress expressed a desire to bolster historic rehabilitation by private investors.[327] In codifying the economic substance doctrine, Congress recognized the additional risk that the doctrine's application to tax

320 *TIFD III-E*, 459 F.3d at 225–27.

321 *Id.* at 226, 231-32, 240.

322 *Id.* at 240.

323 Historic Boardwalk Hall, LLC v. Comm'r, 136 T.C. 1, 25 (2011).

324 Steven A. Dean, *Space Madness: Subsidies and Economic Substance*, 99 CORNELL L. REV. ONLINE 151, 158 (2014) (quoting David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1315 (2001)).

325 *Id.*

326 *Id.*; STAFF ON THE J. COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 [Pub. L. No. 99-514] 149 (Comm. Print 1987).

327 CONG. RESEARCH SERV., S. PRT. 113-32, *supra* note 55, 383–85.

preferences could impose for private investors, mentioning historic rehabilitation specifically.[328] Surely, Congress did not intend the IRS to contribute to the historic rehabilitation challenges it was trying to overcome. Rather, the role of the IRS with regard to the credit was to ensure it would be awarded where projects were completed in accordance with Congress's established terms. The history of Section 47 shows that Congress recognized the risk inherent in historic rehabilitation, and that Congress intended that Historic Rehabilitation Tax Credits be awarded and honored by the IRS, so long as the rehabilitation project was completed according to the terms of Section 47.

Given the amount of administrative oversight afforded the Historic Rehabilitation Tax Credit, there is inherent risk not only in the completion of the project, but also in the ultimate award of the credits.[329] Most other tax expenditures rely on spending caps or phase-outs to limit abusive claims.[330] For the Historic Rehabilitation Tax Credit, abuse is prevented by the credit's own terms and requirements.[331] By its text, Section 47 ensures, through a number of conditions, that Historic Rehabilitation Tax Credits will only be earned by deserving parties.[332] Prior to claiming a credit under Section 47, a rehabilitation project's site and plan must be approved by the National Park Service, both at the beginning of the restoration, and upon its completion.[333] Under Section 47, credits cannot be claimed until the restoration is complete and the building is "placed in service."[334] Even after that period, credits are also subject to a 5-year "recapture period," whereby an investor who leaves the project within the five years following its completion must return his credits to the IRS.[335] By providing its own abuse management system, Congress precluded courts from creating additional risk requirements.[336]

Because of these requirements, it is not enough to simply contribute capital to a rehabilitation project. Investors must dedicate themselves to the project through time and ownership interests. As noted by the Tax Court, an investment that relies on a pay-off subject to such extensive prerequisites is

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328 STAFF OF THE J. COMM. ON TAXATION, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," AS AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT" 152 n.344 (Comm. Print 2010).

329 CONG. RESEARCH SERV., S. PRT. 113-32, *supra* note 55, 385.

330 Dean*, supra* note 324, at 158.

331 *Id.*

332 *See generally* 26 U.S.C. § 47 (2012).

333 CONG. RESEARCH SERV., S. PRT. 113-32, *supra* note 55, at 385.

334 26 U.S.C. § 47(b)(1) (2012).

335 Treas. Reg. § 1.48-12(e)(3), (f)(3) (2012). *See also* Primoli, *supra* note 170, at ¶ 39 ("The rehabilitation credits are subject to recapture if the building is sold or ceases to be business use property.").

336 *See* William N. Eskridge, Jr., *Norms, Empiricism, and Canons in Statutory Interpretation*, 66 U. CHI. L. REV. 671, 674, 676–77, 684 (1999) (explaining the *inclusio unius* interpretive canon of legislation).

risky in its own right.[337] Based on the nature of the Historic Rehabilitation Tax Credit alone, it is unreasonable to fault a private investor for failing to take on additional risk when contributing to a historic rehabilitation project.

2. Re-characterizing Risk Guaranties in Historic Rehabilitation

Given the requirements of Section 47 and the nature of historic rehabilitation projects, risk guaranties are the types of assurance that are necessary to attract a private investor.[338] Additionally, these guaranties fall within Congress's intent of promoting rehabilitation. While by their text they guarantee that the private investor will receive cash value for the credits if they are challenged, in practice they ensure that the tax-exempt partner will work to complete the project in line with the Section 47 requirements to avoid additional costs. Therefore, the guaranty creates a reciprocal motivation for the tax-exempt entity—the dollar "stick"—that the credit provides for a private investor—the dollar "carrot."[339]

In this sense, the guaranties also serve as evidence that the partners do share a common business purpose of restoring the site. Tax-exempt organizations do not want to lose money on the project, especially if only to pay off a private investor. Therefore, the guaranty motivates them to complete the project, so that Historic Rehabilitation Tax Credits will be awarded and granted to the private investor, rather than the tax-exempt partner becoming personally liable for their value. In this sense, guaranties create more risk for the tax-exempt partner, which ultimately motivates actual completion of the project.

When evaluating business purpose under the economic substance doctrine, courts must find context in the purpose of the statute that the benefits are claimed under. Focusing on financial characteristics alone blinds the court from the partnership's full intent and accomplishments. Because Congress creates tax preferences to compensate for existing market risks that it has deemed are outweighed by public benefits, risk is a particularly faulty context under which to evaluate tax preferences. Instead, Courts must consider tax-preferred investments as a whole, because tax preferences are policy tools with broad purposes.

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337 Historic Boardwalk Hall, LLC v. Comm'r, 136 T.C. 1, 25, 28–30 (2011).

338 *E.g.*, *id.* at 26.

339 *See* Jacobs, *supra* note 21, at 17 ("Congress enacted the federal tax credits to stimulate outside investment with the historic credits as the proverbial 'carrot.'").

D. *The Effect of Uncertainty in Light of 7701(o)*

As Section 7701(o) incorporates all precedent applications of the economic substance doctrine, both the Tax Court and the Third Circuit opinions will be incorporated under the codified economic substance doctrine.[340] This existing uncertainty will be especially dangerous given the strict liability applied to taxpayers in held in violation of Section 7701(o).[341] If the IRS is permitted to isolate transactions within the investment, investors will need to examine each step for economic substance. This will only further the chilling effect on tax-preferred transactions that has occurred since HBH was decided.

CONCLUSION

Congress's intent in preventing tax shelters has been to "eliminate shelters without eliminating the preferences on which they are based."[342] The Historic Rehabilitation Tax Credit was not passed to regulate tax shelters; it was passed to incentivize completion of historic rehabilitation projects. It is not up to the IRS to impose additional requirements that will ultimately frustrate intent of this national goal.

In the wake of the Third Circuit's "upend[ing] of expectation of taxpayers and advisors" following *Historic Boardwalk Hall*, attorneys and scholars alike have been left searching for remaining certainty in historic rehabilitation projects.[343] The decision has imposed a chilling effect on a program that has been continually praised and preserved by Congress and has generated billions of dollars of private investment and economic revitalization.[344] To reverse this effect and sustain the credit, courts should evaluate business purpose in terms of the entire investment, as prescribed by the Tax Court, and as intended by Congress.

Historic Rehabilitation Tax Credits have restored vibrancy to historically important cities like Roanoke, Virginia and Atlantic City, New Jersey. As Congress continues to encourage rehabilitation, it is up to courts to preserve this intent, and ultimately the nation's history.

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340 26 U.S.C. § 7701(o)(5) (2012). *See also* the discussion of The *Golsen* Rule, *supra* Section IV.E.

341 26 U.S.C. § 7701(o); LARGE BUS. & INT'L DIV., IRS, LB&I-4-0711-015, GUIDANCE FOR EXAMINERS AND MANAGERS ON THE CODIFIED ECONOMIC SUBSTANCE DOCTRINE AND RELATED PENALTIES (2011).

342 Zelenak, *Good Preferences*, *supra* note 44, at 501.

343 Dean*, supra* note 324, at 155.

344 Jacobs, *supra* note 21, at 16.