Section on Taxation

Inside Basis

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Remarks of the 2013 Recipient of the Kenneth H. Liles Award: John A. DiCicco, Former Principal Deputy Assistant Attorney General, U.S. Department of Justice, Tax Division

John A. DiCicco is the 2013 recipient of the Kenneth H. Liles Award for Distinguished Service from the FBA Section on Taxation. The Kenneth H. Liles award is presented by the Section on Taxation annually to recognize individuals for outstanding service and dedication to tax policy and administration, as well as their contributions to the bar and the legal profession. John A. DiCicco was recognized for his more than 30 years of service in the U.S. Department of Justice, Tax Division, and his steady stewardship of the tax division as principal deputy assistant attorney general and acting assistant attorney general for over two years. The following are his remarks at the Kenneth H. Liles Award ceremony that took place in March 2013.

Thanks to all of you. Those who selected me for this wonderful award, and those who put this ceremony together. I am very humbled to receive this Liles award, especially when I look at the distinguished previous recipients. Quite an august group.

Now, if anyone is expecting a scholarly discourse on tax law, or some profound thoughts from me, you will be sadly disappointed—and probably don't know me well. I will, however, be short.

I have talked to people about what I might say today, and some suggested I offer what advice I can, especially to young lawyers. I thought a lot about that— to see if I could come up with some deep thoughts to pass on to younger lawyers—unfortunately, I couldn't come up with much.

John A. DiCicco

The best I could think of was to advise you to retire early and often. That's true. When I retired, people said nice things about me. I wasn't used to that. So, my recommendation is to retire a lot of times. The same is true of awards. Try and get a lot of them, even if you have to cheat. People say nice things about you at award events, too. They have to.

Another piece of advice is don't get fired. I guess what I had always felt was

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Message from the Chair

Fred Murray

I hope you enjoy this issue of *Inside Basis*. This issue includes John A. DiCicco's brief remarks upon receiving the 2013 Kenneth H. Liles Award, the first and second place entries in the 2013 Donald C. Alexander Writing Competition, and updates on our section's recent past and upcoming activities. Many thanks to our editors, Christine Hooks and Alan Williams, for their work on our publications including this newsletter, which I hope you will find to be not only informative but also an invitation to further participate in our activities. I am grateful, too, that the Federal Bar Association Newsletter Awards Committee has recognized their efforts in awarding the section the FBA Meritorious Newsletter Award for 2013.

We have had a very successful year due in no small part to the efforts of many of our members. On March 1,

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2013, we hosted the 37th Annual Tax Law Conference at the Ronald Reagan Building and International Trade Center in Washington, D.C. Featured speakers at the conference included Tamara W. Ashford, deputy assistant attorney general for Appellate & Review, Tax Division, U.S. Department of Justice; Mark J. Mazur, assistant secretary (tax policy) at the U.S. Treasury Department; and William J. Wilkins, chief counsel for the Internal Revenue Service. Immediately following the conference we presented the Section's 2013 Liles Award for Distinguished Service to John DiCicco, former acting assistant attorney general at the Tax Division. Next year's co-chairs, Ryan Kelly of Baker & McKenzie LLP, and William Alexander of the Office of Chief Counsel, Internal Revenue Service, are already hard at work on putting together another very good conference.

Also this year, we hosted the section's Twelfth Biennial Invitational Conference on Tax Administration and the Legislative Process (f/k/a The FBA Airlie House Conference). The conference was held on February 20, 2013, in the Cannon Caucus Room, Cannon House Office Building, in Washington, D.C. Invitees included current and former congressional staff, administration officials, academics, and tax practitioners. As with our previous conferences, the objective of this conference was to promote a wide-ranging discussion of topics related to tax administration and the legislation on which it is based, with a view to lessons learned and best approaches, as well as possible improvements. By all accounts received, it was very successful in that regard.

Last and certainly not the least, the section, in conjunction with the Office of Chief Counsel, Internal Revenue Service, presented the 25th Annual FBA Insurance Tax Seminar on May 30–31, 2013, at the J.W. Marriott in Washington, D.C. The co-chairs this year of that very well-known and respected conference program were Lori J. Jones of Scribner, Hall & Thompson LLP and Nancy Vozar Knapp of the Office of Chief Counsel, Internal Revenue Service.

The section also hosted a number of other exciting programs this year, including our very popular "Women in Tax Law" series, our annual careers in tax law lunch for summer interns, and a "Beyond the Beltway" event in New York.

Further, we are very proud that the Young Tax Lawyers Group has expanded the section on taxation's membership base this year by hosting bi-monthly networking events and substantive panel discussions, including one with several judges from the U.S. Tax Court and the U.S. Court of Federal Claims. These events were well-attended by attorneys from the public and private sectors, accountants, law clerks, tax L.L.M. candidates, and D.C.-area law students. Future young tax lawyers events are being planned and will be announced soon.

Finally, we launched a new committee within the section, the Tax Practice and Procedure Committee. Led by Stuart Bassin of Baker & Hostetler LLP, Starling Marshall of the DOJ Tax Division, Christine Lane of Hogan Lovells LLP, and Mary Prosser of Miller & Chevalier, Chartered, the committee has created a **Practice and Procedure Discussion Group**. The new committee has conducted recurring hour-long conference calls on various hot topics in the realm of federal tax practice and procedure. All members across the country are welcome to dial in and join the discussion, or simply place the phone on mute and listen. We have now held a number of these calls and many of you have remarked to me about the quality of the discussions. Make sure your current email address is in the section's membership records to receive future monthly invitations!

We welcome in October, Andrew Strelka of the Tax Division at the U.S. Department of Justice as our new chair, Lori Jones of Scribner, Hall & Thompson LLP as treasurer, and Starling Marshall of the Tax Division at the U.S. Department of Justice as secretary. I have appreciated the opportunity to serve again this year as section chair. It has again been a great experience to work with so many fine tax attorneys within both the government and the private sector. The section relies on volunteers, and I am impressed by the energy and enthusiasm of our section members who have developed programs, monitored our budget, and guided the section. The FBA staff, and in particular Sherwin Valerio and Kate Koch, have been a tremendous help as well. I have been privileged to work with our fine Steering Committee members this year and look forward to another exciting schedule for 2014.

Lastly, I thank you for your participation. If you would like to become more involved in the section, or have ideas for a program, or just want to let us know how we are doing, please feel free to contact me or Andy. Also, please visit our website (www.fedbar.org/Sections/Section-on-Taxation.aspx) for announcements regarding section programs or to be added to our email distribution list. Thank you for your continued support of the FBA and of the Section on Taxation.

In closing, we know these are trying times for those in public service, particularly for those serving us at the Internal Revenue Service. As we as a nation work through the issues that confront us, our section wants you to know that we stand with you and appreciate the work that you do, day in and day out, to serve us. Do not lose heart or lose sight of the important cause that brought you to public service in the first place. ⌘

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my greatest achievement, was not getting fired. I take pride in the fact I worked for nine different assistant attorney generals, and none of them got rid of me.

Slightly more seriously, the advice I would offer is, in short, to try to find a situation where you can enjoy what you are working on; where you like and respect who you are working with, and where you believe what you do has value. Also, remember to listen to people who know more than you, and be open to suggestions/change.

It helps a lot if, when you go to work every day, you like what you are doing. I was fortunate to always have challenging and interesting work. I never intended to make the tax division a career, but it was the work, and the people I worked with, and the opportunity to do different things—trying cases, supervising litigation, reviewing major settlements and ultimately being acting assistant attorney general—that kept me there. Along with that I have had the opportunity to work with the highest caliber attorneys in the country. Not only were they superbly talented, but they were extremely hard working and dedicated. We all had the same goal—ensuring the full and fair enforcement of the tax laws. In addition, there was always a willingness to share information and ideas in a truly collegial atmosphere. That provided for a lot of professional growth and satisfaction.

Also, I felt good about the work I did. I believe there is much that government can and should do for its citizens, and it takes money to accomplish those things—money that has to be raised through an honest, effective tax system.

Perhaps my greatest strength has been to recognize when someone knew more about something than I did, and to listen and accept advice when it was appropriate to do so. It is the people I worked with in the tax division, the department, the IRS Office of Chief Counsel, and the IRS who are largely responsible for any successes I have had.

Looking back on my years in the division, I think we have had some notable remarkable successes. Especially in a few areas—abusive tax shelters, abusive scheme promoters, fraudulent tax return preparers, and undisclosed bank accounts. All of these are, in my view, a plague on the tax system.

While the tax shelter wars are not over, and given human nature, maybe they never will be, as new schemes seem to continually pop up, we have won many significant battles. We have really curtailed the spread of abusive corporate shelters, putting a stop to the BOSS, SOB, LILOs and SILOs and other schemes which would have bled billions from the Treasury. My hope is that in the future, tax professionals will take a harder look at these schemes, before going along with them.

Our injunction and return preparer work has also been hugely successful. Not only have we stopped schemers, we have alerted the public about illegal schemes and we have shown the public that those who would cheat our system will be caught and punished, either criminally, or civilly or both.

In addition, working together with the IRS we have made a huge dent in bank secrecy, uncovering the identities of tens of thousands of undisclosed foreign bank account holders, and sending a clear message that no matter where a taxpayer might hide, he will be discovered and held accountable. Our efforts in the foreign non-compliance area have had a huge impact on tax enforcement—a benefit that will continue well into the future. Would-be cheaters have been deterred, and actual cheaters have been discovered.

In closing, I have found tax litigation offers a great opportunity to do very interesting, varied, and worthwhile work. Litigation itself presents difficult intellectual challenges—the chance to develop and discover complex facts, and to deal with highly complex issues. Our tax litigation cases involve all of those challenges. I think that our cases are among the most sophisticated litigation in the federal courts. So I am very grateful for having had the opportunity to be part of that litigation process. Thank you all again for this wonderful award and ceremony. ⌘

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Historic Boardwalk Hall and the Substance-Over-Form Doctrine

by William Halliday

Introduction

On August 27, 2012, the U.S. Court of Appeals for the Third Circuit decided *Historic Boardwalk Hall, LLC v. Commissioner of Internal Revenue*,[1] a case that has caused a good deal of agitation in the historic rehabilitation tax credit community. Indeed, after the case was decided, one annual conference on historic rehabilitation tax credits ominously titled itself "The Future of Historic Tax Credits."[2] Even before the Third Circuit handed down its decision, commentators were concerned about the impact of an IRS victory in the case.[3] This paper will analyze the Third Circuit's decision and its implications for historic preservation.

This paper is divided into four parts. Part I will provide an overview of historic rehabilitation tax credits (HRTCs or rehabilitation credits). This part will focus on a key aspect of HRTCs, namely the inability to transfer them. In sum, rehabilitation credits can be used only by the person or entity that "holds title to the property."[4] That presents a problem for owners who are tax-exempt organizations or entities that produce little taxable income. Without sufficient taxable income to generate federal income tax liability, the value of the tax credits would be diminished or even worthless. Only by transferring the tax credits to an entity that could use them would tax-exempts be able to extract any value from the tax credits. While the prohibition against transferring HRTCs may come as a surprise to supporters of historic rehabilitation, Part I will explain why it is required by the terms of the statute and how it is consistent with general tax policy.

The prohibition against selling HRTCs presents only a minor obstacle for the creative lawyer. Part II will examine how tax-exempt entities have taken advantage of rehabilitation credits, notwithstanding the prohibition against their direct transfer. The primary method has been to form a partnership between the tax-exempt entity and a taxable entity, where the partnership allocates all or nearly all of the tax credits to the taxable entity. The partnership in *Historic Boardwalk Hall* is an example of this partnership arrangement.

Part III will examine the substance-over-form doctrine used by the Third Circuit in *Historic Boardwalk Hall* to invalidate the partnership at issue in the case. The substance-over-form doctrine, as its name implies, authorizes a court to look to the underlying reality of a transaction rather than follow its legal form. Should the underlying reality differ from the legal form used, a court will recharacterize the transaction to comport with its economic reality. This part will discuss the partnership structure used in *Historic Boardwalk Hall* and how the Third Circuit reached its conclusion that Pitney Bowes, the taxable entity that joined the partnership to take advantage of the tax credits, was not a bona-fide partner.

Part IV will delve into the policy rationale behind the Third Circuit's decision. This paper will argue that from a tax policy perspective, the court's decision is the correct one. Until *Historic Boardwalk Hall*, the prohibition against selling HRTCs was unenforced. Tax-exempt entities used partnership arrangements to do indirectly what they could not do directly, namely sell historic rehabilitation tax credits. Yet, such an arrangement runs counter to the express terms of the statute, and the substance-over-form doctrine is a valuable tool for policing these types of arrangements.

An Overview of the Historic Rehabilitation Tax Credit

The historic rehabilitation tax credit permits a taxpayer to offset his federal income tax liability dollar-for-dollar by the amount of the credit generated.[5] The rehabilitation credit is divided into two tiers: (i) a 10% credit for "qualified rehabilitation expenditures" on historic buildings that do not qualify as a "certified historic structure" and (ii) a 20% credit for "qualified rehabilitation expenditures" on any certified historic structure.[6] To be deemed a "certified historic structure," and therefore gain access to the more lucrative tax credit, a building must be either (i) listed on the National Register of Historic Places or (ii) located in a registered historic district and certified by the Secretary of the Interior "as being of historic significance to the district."[7]

Importantly, rehabilitation tax credits can be used only by the person or entity that "holds title to the property."[8] In other words, these tax credits cannot be bought or sold. That presents a limitation on a property owner's ability to use the tax credits generated by a historic rehabilitation. If the property owner has insufficient taxable income (*e.g.* income that would generate a small tax liability), the credits may be diminished in value or even go unused. This is the situation that arose in *Historic Boardwalk Hall*.

At this point, friends of historic preservation may ask why Congress would authorize a tax credit to incentivize historic rehabilitation, yet limit who can use it. It may strike them as being unfair to non-profit entities or taxpayers with little taxable income. Yet the limitation is consistent with nearly every other tax benefit provided by the Internal Revenue Code.[9] A quick examination of the deduction for casualty losses helps illustrate this point.

Under §165 of the Internal Revenue Code, a taxpayer may take a deduction for any uncompensated loss that arises from "fire, storm, shipwreck, or other casualty, or from theft."[10] The deduction generated by a casualty loss is not transferable.[11] Thus, to the extent a taxpayer does not generate taxable income in the year the loss is sustained, the deduction will go unused.[12] Such an outcome seems counterintuitive. Those taxpayers generating taxable income are the most likely to be able to absorb casualty losses; conversely, those without taxable income are least able to absorb such losses. Yet, such an outcome illustrates the limited nature of subsidies provided through the Internal Revenue Code. There are several ways,

however, that Congress could expand the subsidy to capture those who fail to generate taxable income, which will be discussed later in this paper. The key point thus far is that most tax benefits provide little value to persons who do not generate taxable income.

While the above analysis represents the current state of federal income tax law, one can question whether it is sound policy. In questioning the prohibition against alienating tax benefits, there are two ways to view these tax benefits. First, tax benefits can be viewed as a structural component of the tax code, in that they are a necessary aspect of calculating a "proper" or "correct" tax.[13] Second, tax benefits can be viewed simply as subsidies.[14] The differing viewpoints have implications for transferability. If a tax benefit is viewed as a means to reduce tax liability, then it "should be no more transferable than the deduction for any other expense incurred in the conduct of a taxpayer's business."[15] As a result, tax-exempt entities should not be able to utilize the benefit because they "are already effectively exempt."[16]

On the other hand, if a tax benefit is viewed as a subsidy, *i.e.* a method of incentivizing certain behavior, then "the principle of competitive neutrality supports extending these subsidies to loss companies…."[17] Without the ability to transfer the tax credits, tax-exempt entities would operate at a disadvantage in their efforts to rehabilitate historic properties. A simple way to ameliorate this disparity would be to permit the transfer of historic rehabilitation tax credits:

> Unbundling the tax benefits is required to ensure a level playing field among different providers of the desired service. The absence of [transferability] would shift production away from potentially efficient nonprofit developers and for-profit developers with little or no tax liability. In short, the [transferable] nature of the credits undoes the bias toward providers with taxable income.[18]

If the subsidy view is accepted, the direct sale of tax benefits is not the only way to "level the playing field" between tax-exempt entities and those taxpayers generating taxable income. Indeed, Congress has experimented with all of the following methods of providing subsidies to taxable and tax-exempt entities alike.[19] First, the HRTC could be made a refundable tax credit, commonly referred to as a "negative tax credit." Generating taxable income is not necessary in order to utilize a refundable tax credit because the IRS issues a refund to the taxpayer in the event that the credit exceeds tax liability. A well-known example of a refundable credit is the earned income tax credit.[20] Second, Congress could provide direct subsidies to entities involved in historic preservation, rather than the indirect subsidy provided by the tax code. Third, the tax-exempt entity could enter into a nominal sale-leaseback arrangement, but ensure that the "seller" retained economic ownership of the property.[21] As a result, the purchaser of the property "would be entitled to the associated tax benefits of ownership even though it were to possess none of the benefits or burdens of ownership."[22] Through any of these methods, Congress can provide a subsidy for historic rehabilitation to taxable and tax-exempt entities alike.

Unfortunately for historic preservation, its advocates were able to obtain only a limited subsidy in the form of a non-transferable tax credit. A more complete legislative victory would have included one of the several methods for transferring HRTCs, such that taxable and tax-exempt entities would operate on a level playing field. The restriction on alienation, however, is by no means the end of the matter. As Part II will demonstrate, the prohibition against transfer is a minor obstacle to the creative lawyer.

Partnership Structures Before *Historic Boardwalk Hall*

Notwithstanding the prohibition against transferring historic rehabilitation tax credits, a tax-exempt property owner may still extract value from the credit. The owner could transfer the property into a partnership, sell a partnership interest to a taxpaying entity, and then allocate the tax credits to such partner.[23] Indeed, the Internal Revenue Service contemplated exactly this scenario for tax-exempt entities looking to take advantage of the tax credit:

> The rehabilitation tax credit would be of no use to a tax exempt entity. However, in many instances, tax exempt entities are involved in rehabilitation projects by forming a limited partnership and maintaining a minority ownership interest as a general partner. In these situations, the limited partners would be entitled to the rehabilitation tax credit and the tax exempt entity is able to ensure that their organizational goals are being met.[24]

Yet, this simple statement belies the complexity involved in forming a partnership to rehabilitate a historic property. The goals of the tax-exempt property owner are two-fold: (i) to capture the value of the tax credits generated by the historic rehabilitation and (ii) to retain as much economic ownership of the underlying project as possible.[25] This Part will examine how partnerships were structured to satisfy those two goals prior to *Historic Boardwalk Hall*, which represents the first time a court has utilized the substance-over-form doctrine to invalidate a tax credit partnership. As such, this Part defers analysis of any substance-over-form issues until later in this paper.

Under the partnership provisions of the Internal Revenue Code, tax credits must be allocated "in accordance with the profits interests of the partners."[26] This presents a problem for the tax-exempt owner of a historic property, whose goal is to take advantage of the tax credits yet nevertheless retain the full economic benefits of the project.[27] For example, if

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a tax-exempt entity owns a historic property that generates rehabilitation tax credits, it must allocate 100% of the profits from the project to the taxpaying entity if it wants to utilize 100% of the tax credits generated by the project. Yet, such an allocation undermines the developer's second goal of retaining the economic benefits of the project. There are, however, various methods that can be used to make the same allocation, *i.e.* 100% of profits to the taxpaying entity (the investor), yet actually divert all or nearly all of the profits to the tax-exempt entity (the developer).[28]

First, the partnership could master lease the property to an entity controlled by the developer, who would then lease the property to tenants and earn the spread between the rents paid by the tenants and the rent paid to the partnership.[29] Second, the partnership could pay the developer a development fee or management fee that can "soak up" the earnings of the partnership.[30] Under the latter scenario, the investor—while nominally 100% owner of the partnership—would receive little (if any) of the project's economic benefits. As such, the investor would be unwilling to accept any of the risks associated with actual property ownership. To alleviate the concerns of the investor, the developer (who is the true economic owner) will typically provide a number of guaranties to shift the risks of the project back to itself.[31] Thus, a developer will typically guarantee, for the benefit of the investor, (i) that the project will be completed, (ii) that the investor's contribution will be refunded to the extent that tax credits are not forthcoming, and (iii) that the developer will cover any operating deficits of the partnership.[32]

Yet another obstacle awaits in structuring a partnership that allows a tax-exempt entity to take advantage of the tax credits without giving up any real economic interest in the project: how to get the investor out of the project once the tax benefits have been captured.[33] The partnership could have a series of put and call options "which are designed to enable the developer to buy out the investor at a price acceptable to both of them at a future date."[34] The price must be based on the fair market value of the investor's partnership interest at the time the option is exercised.[35] The investor's interest is unlikely to have any value at all, since all of the tax credits have been captured and the investor is not receiving any of the economic benefits from the underlying project.[36]

With this type of partnership structure, the parties have come very close to recreating the purchase and sale of tax credits. Indeed, one commentator referred to these partnership structures as the purchase and sale of tax credits.[37] As of 2005, the IRS was apparently comfortable with the use of these tactics in claiming historic rehabilitation tax credits.[38] Thus far, the creative lawyer has been able to overcome the limitation on buying and selling rehabilitation credits. One of several doctrines the IRS could use to clamp down on these arrangements is the substance-over-form doctrine.

The Substance-over-Form Doctrine

Introduction. The substance-over-form doctrine is a foundational principle in tax law that authorizes a court to look through the form of a transaction to its underlying reality.[39] One subset of that principle is the bona fide partnership doctrine, which resolves whether a person claiming to be a partner will be recognized as such for federal income tax purposes.[40] Unfortunately, the Internal Revenue Code provides little guidance on whether a person is indeed a partner. It defines a partnership as including "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on…."[41] It unhelpfully defines a partner as including "a member in such a syndicate, group, pool, joint venture or organization."[42] The IRS regulations prove more helpful, in that they require a profit motive in carrying on a "trade, business, financial operation, or venture."[43] The courts have helped fill the gap, and in *Commissioner of Internal Revenue v. Tower*[44] the Supreme Court defined a partnership as follows:

> A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is a community of interest in the profits and losses. When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both.[45]

Three years later in *Commissioner of Internal Revenue v. Culbertson*,[46] the Supreme Court expanded on the bona fide partnership test, pointing to a number of factors that indicate whether "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."[47] A focus on the intent of the parties, as deduced from the listed criteria, is how a court shall determine whether partners will be respected for federal income tax purposes.[48] While *Culbertson* provided guidance on the factors to consider, the bona fide partner inquiry nevertheless remains a totality-of-the-circumstances test.[49]

The Historic Boardwalk Hall Decision. The case arose from the rehabilitation of the Historic Boardwalk Hall (East Hall), a convention center located in Atlantic City, New Jersey. Built in 1929, the East Hall is famous for hosting the Miss America pageant for nearly a quarter of a century, the 1964 Democratic National Convention that selected Lyndon Johnson for the Democratic ticket, and a variety of other events, including the first indoor college football game.[50] As a result of its storied

history, it was named a National Historic Landmark in 1987.[51] From 1998 to 2001 the New Jersey Sports and Exposition Authority (NJSEA), a state agency, spearheaded the rehabilitation of the East Hall.[52] As a state instrumentality, NJSEA is exempt from federal income taxation.[53] In order for NJSEA to take advantage of the tax credits generated by the rehabilitation, it would have to find a taxable partner.

NJSEA implemented a partnership arrangement typical of the period, as discussed previously in Part II. Indeed, the partnership in *Historic Boardwalk Hall* was described as a "conservatively structured" and "traditional" HRTC partnership.[54] Understanding how the partnership in *Historic Boardwalk Hall* was structured is critical to understanding the outcome of the case.

NJSEA formed Historic Boardwalk Hall, LLC (HBH) in June 2000 and admitted Pitney Bowes, a Fortune 500 company, as a member in September 2000.[55] Pitney Bowes contributed $20,198,460 to HBH in return for a 99.9% ownership interest in the partnership.[56] NJSEA retained a 0.1% ownership interest as the managing member of the project.[57] While NJSEA held a small ownership interest in the project, it provided the lion's share of the financing for the historic rehabilitation through two loans to HBH: (i) an Acquisition Loan of $53,621,405, which reflected the total expenditures made by NJSEA prior to Pitney Bowes joining HBH and (ii) a Construction Loan of $57,215,733, which reflected the estimated expenditures needed to complete the rehabilitation.[58] Ultimately, the project claimed $108,999,998 in qualified rehabilitation expenditures, which generated $21,799,999.60 in tax credits.[59] Because Pitney Bowes held a 99.9% interest in the profits and losses of HBH, it would be allocated 99.9% of the tax credits generated by the project.[60]

Like the partnership arrangements previously discussed, NJSEA faced the dilemma of giving up a large ownership interest in the project (in order to capture the tax credits) yet retain full economic interest in the profits and losses of the underlying project. To accomplish both goals, HBH would have to divert some or all of the earnings back to NJSEA. The two loans provided by NJSEA were a simple but effective way to "soak up" the profits generated by the underlying project. Before Pitney Bowes would be entitled to 99.9% of any profits generated by the project, HBH would have to pay the substantial debt service payments under the two loans.[61]

An examination of the "cash flow waterfall" helps illustrate how any potential profits or losses could be diverted away from Pitney Bowes. Pursuant to HBH's Operating Agreement, cash would be distributed according to the following schedule:

1. Debt service payments on Pitney Bowes' Investor Loan;
2. *Annual* payments in accordance with each party's membership interests until Pitney Bowes received its current and any accrued but unpaid Preferred Return;[62]
3. Payments to Pitney Bowes to offset any income tax liability arising from income allocated to Pitney Bowes;
4. Current and accrued but unpaid debt service payments on NJSEA's Acquisition Loan and Construction Loan;
5. Payments on any loans made by NJSEA to HBH under the Operating Deficit Guaranty; and
6. The balance to NJSEA and Pitney Bowes in accordance with their membership interests (0.1% and 99.9%, respectively).[63]

The last step in the waterfall distributes cash flow in accordance with each party's ownership interest. The court questioned whether such an allocation would ever occur. In order to make that determination, the court looked to the financial projections of the project.

In September 1999 Spectacor, the third-party operator of the East Hall, created five-year financial projections that estimated operating losses of $1.7 million each year between 2002 (the first full year of operations) and 2006.[64] Five years of substantial operating losses was not good news to Sovereign Capital Resources (Sovereign), the consulting firm charged with the task of securing an equity investor. Sovereign drafted a memo to Spectacor noting that in order to attract an equity partner, the partnership "should be able to reasonably show that it is a going concern."[65] By March 2000, when Sovereign produced the prospectus that was sent to potential investors, the financial projections showed positive net operating income in each of the ten years of its projections.[66] Such projections presented cash flows sufficient "to pay a portion of the Preferred Return [step 2 in the cash flow waterfall] on an annual basis."[67] The projections were increased again prior to closing the partnership with Pitney Bowes, such that HBH, LLC was able to generate $1,715,867 of net operating income in 2002 and satisfy half of step 4 of the cash flow waterfall by 2040.[68] Thus, while formally the parties had provided for a 0.1% and 99.9% bifurcation of cash flows from the underlying project (step 6 of the waterfall), such an allocation was unlikely to occur. In effect, steps one through five of the waterfall "soaked up" the cash flow from the project before it could be divided according to the partners' ownership interests.

NJSEA also agreed to provide a series of guarantees and indemnities in favor of Pitney Bowes. First, NJSEA assured Pitney Bowes that it would receive the tax benefits, or in the case of a successful IRS challenge, the cash equivalent of the tax benefits.[69] Second, NJSEA agreed to pay for any cost overruns on the rehabilitation.[70] Third, NJSEA agreed to fund all operating deficits of the partnership through interest-free loans to HBH.[71] Fourth, NJSEA agreed to indemnify and insure Pitney Bowes against any environmental contamination.[72]

The parties agreed to a series of put and call options, allowing (or requiring) NJSEA to purchase Pitney Bowes' partnership interest. Importantly, there were no options allowing (or requiring) Pitney Bowes to purchase NJSEA's partnership interest.[73] Under two of the option agreements, the value was tied to the present value of any unrealized tax benefits and five years' worth of Pitney Bowes' Preferred Return.[74] Under the other two option agreements, the value was tied to the greater of (i) the FMV of Pitney Bowes' partnership interest or (ii) any accrued but unpaid Preferred Return.[75] The latter two options could be triggered only after the five-year tax credit recapture period had ended.[76] Thus, under all four of the options, the price was tied to

the value of the tax benefits and the Preferred Return.[77]

The Internal Revenue Service challenged the partnership on three fronts: (1) under the economic substance doctrine, which asks if a transaction has any real purpose beyond its tax advantages,[78] (2) under the substance-over-form doctrine, and (3) under the theory that NJSEA failed to transfer the benefits and burdens of ownership to HBH.[79] The Third Circuit assumed, without deciding, that the partnership had an underlying business purpose, allowing the Court to focus its analysis on the substance-over-form inquiry.[80] While the parties characterized themselves as partners, the Commissioner questioned whether that characterization comported with economic reality. To resolve the issue, the court looked to two recent "guideposts" in its efforts to apply the facts of the HBH partnership to the rule outlined in *Tower* and *Culbertson*.[81]

Virginia Historic. In *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner of Internal Revenue*,[82] a case decided by the Fourth Circuit in 2011, the tax credits at stake were Virginia historic rehabilitation tax credits (Virginia HRTCs), which can be used in conjunction with federal HRTCs. In order to claim Virginia HRTCs, the developer must receive approval from the Virginia Department of Historic Resources (the DHR).[83] Like the federal program, Virginia HRTCs cannot be sold or transferred.[84] Instead, the parties can form a partnership and allocate the tax credits "either in proportion to their ownership interest or as the partners or shareholders mutually agree."[85]

The partnerships in *Virginia Historic* (the fund or funds) would raise money from investors and then contribute the money to developers working on historic rehabilitation projects (the operating partnerships).[86] At the fund level, each investor "was promised a certain amount of tax credits and a limited partnership interest."[87] The investor's limited partnership interest was something of a formality; most investors were given a 0.01% interest in the partnership and expressly warned that they should expect no "material amounts of partnership income or loss."[88] At the Operating Partnership level, the Funds themselves would take a 0.01% partnership interest.[89] Importantly, Virginia's tax code is not as restrictive as the Internal Revenue Code in limiting the ability of partnerships to allocate income and tax credits among the partners.[90] Thus, even with a 0.01% ownership interest, the Operating Partnerships could allocate all of the tax credits to the Funds.[91] Similarly, even though the investors only held a combined 1.0% ownership interest in the Funds,[92] they could be allocated nearly all of the tax credits. Indeed, the Virginia Department of Taxation confirmed that the allocation would be upheld for Virginia income tax purposes, notwithstanding the federal tax treatment, noting:

> [T]he IRS action based upon a deemed purchase of state tax credits, which by its terms is limited to the calculation of federal income tax, does not require the Virginia agencies administering the credit to similarly ignore actions otherwise valid under Virginia law and revoke the credit because of the deemed purchase.[93]

It should be noted that the partnership arrangements in *Virginia Historic* were designed to fulfill the same goals common to all tax-exempt entities leading a historic rehabilitation. As previously mentioned, those goals are two-fold: (i) to utilize the tax credits generated by the project and (ii) to retain all of its economic interest in the project. Under Virginia law, accomplishing both goals is relatively easy. The tax-exempt can allocate 100% of the tax credits to the taxable partner, who may only have a 0.01% interest in the profits and losses of the partnership. Thus, the tax-exempt can utilize the tax credits, yet give up only a tiny fraction of its economic ownership in the project. This arrangement, however, would not satisfy federal income tax law, which mandates that tax credits by allocated "in accordance with the profits interests of the partners."[94]

Like the partnership arrangements previously discussed, the Funds offered a number of guaranties to their investor-partners. First, the funds would invest only in completed projects, *i.e.* those that the DHR had certified as constituting a "qualified rehabilitation" and confirmed "the amount of qualified rehabilitation expenditures paid or incurred by the operating partnership."[95] Second, if the tax credits could not be delivered, the partnership promised to refund the investor's contribution.[96] The funds also faced the obstacle of getting the investors out of the partnership once the tax credits had been captured. The funds utilized a purchase option.[97] The price paid for the investors' partnership interests, while nominally set at fair market value, was "unilaterally set by [the general partner] at [0.1%] of the investor contribution."[98] The funds exercised its options in May 2002, paying each investor 0.1% of their original contribution at a total cost of $7,000.[99]

Ultimately, the funds contributed $5.1 million to the operating partnerships, which allocated $9.2 million of tax credits to the funds.[100] The funds, however, managed to raise $6.99 million from investors.[101] In effect, the funds paid $0.55 per dollar of allocated tax credit and sold each dollar of tax credit for $0.76 to the investors.[102] The spread—$0.21—was kept by the general partner, who orchestrated the arrangement.[103] It is also the amount that the IRS deemed to be taxable income from the sale of the tax credits (and therefore taxable to the funds).[104]

The commissioner challenged the partnership arrangement on two grounds, arguing that: (1) under the substance-over-form doctrine, the investors were not bona fide partners in the Funds and (2) even if the investors were bona fide partners in the funds, the transactions were "disguised sales" under I.R.C. § 707.[105] After the Fourth Circuit assumed, without deciding, that a bona fide partnership existed, it analyzed the transaction as a disguised sale.[106]

Under §707 a sale occurs when "based on all the facts and circumstances (i) the transfer of money or other consideration would not have been made *but for* the transfer of property; and (ii) in cases in which the transfers are not made simultaneously, the subsequent transfer is *not dependent on the entrepreneurial risks of partnership operations*."[107] The court noted several factors—the fixed rate of return received by investors,

the explicit warning that they would not receive allocations of profits or losses, the promise of a refund if the tax credits were not forthcoming, and the fact that the Funds invested exclusively in completed projects—in reaching the conclusion that "there was no true entrepreneurial risk faced by investors."[108] Moreover, the court was obligated to apply a presumption that the transfers were sales simply because the transfers occurred within two years of each other.[109] All of these factors convinced the Fourth Circuit that the allocation of the tax credits was a disguised sale.[110]

Castle Harbour. In *TIFD III-E, Inc. v. U.S.*[111] General Electric Capital Corporation (GECC), ING Bank and Rabo Bank (the latter two are referred to collectively as the banks or foreign banks) formed Castle Harbour, LLC (Castle Harbour). GECC owned commercial aircraft, which it leased to airlines.[112] Once the aircraft had been fully depreciated, making ownership of such aircraft "less remunerative," GECC looked to refinance the aircraft by forming a partnership with the foreign banks.[113] Importantly for this case and the structure of the partnership, neither of the foreign banks was subject to U.S. income taxation.[114]

GECC contributed to the partnership aircraft with a net value of $272 million, rents receivable with a value of $22 million, and $296 million in cash for a total investment of $590 million.[115] The foreign banks contributed $117.5 million in cash to the partnership.[116] While GECC contributed the lion's share of capital, the partnership allocated 98% of "operating income" to the foreign banks.[117] Yet, operating income did not constitute all of the upside or downside potential of owning and leasing these aircraft. In particular, Operating Income excluded amounts earned by aircraft transferred to Castle Harbour Leasing, Inc. (CHLI), a subsidiary of Castle Harbour (such income and losses referred to as disposition gains or disposition losses," respectively).[118] GECC controlled which assets would be transferred to the subsidiary and when the transfer would occur.[119] The allocation of disposition gains and losses differed from the allocation of operating income, with GECC receiving a much more favorable share of disposition gains and losses.[120]

One can begin to understand the tax benefits of the transaction by following the lifecycle of an airplane through the partnership. As the airplane earned rental income, it would be allocated 98% to the foreign banks and 2% to GECC. Such income, however, did not reflect the actual cash flow through the partnership because operating income was reduced by depreciation deductions that were not respected for tax purposes. Thus, the foreign banks received 98% of book income (an artificially small number), but they also received 98% of taxable income (a much higher number).[121] Thus, the tax bill that would have accrued entirely to GECC was dampened by this partnership structure. Moreover, GECC would still be entitled to retain the upside potential of an improved market for commercial aircraft. Upon sale of an aircraft, GECC would be allocated the bulk of any disposition gain.[122]

The partnership was "self-liquidating," meaning that over the eight year life of the partnership "the Dutch banks' ownership interest was to be almost entirely bought out with the income of the partnership."[123] This purchase would occur via annual cash payments in amounts calculated to provide the foreign banks with an internal rate of return of 9.03587% over the life of the partnership (the applicable rate).[124] Both GECC and the foreign banks could terminate the partnership unilaterally. In the event of nonpayment, the foreign banks could force dissolution and receive an amount that would provide for reimbursement at the applicable rate.[125] Similarly, GECC could pay a premium of $150,000 [over and above the applicable rate] and "terminate the banks' interest in the partnership and thereby prevent allocation of earnings to the banks."[126] The effect of both options was to guarantee that the foreign banks would receive the applicable rate of return.[127]

Moreover, the foreign banks' receipt of the applicable rate was "elaborately protected."[128] The partnership had to maintain "core financial assets" in an amount equal to 110% of the "amount that the banks would receive upon dissolution of the partnership."[129] Additionally, the partnership had to maintain substantial amounts of casualty-loss insurance in favor of the foreign banks.[130] Lastly, GECC provided its personal guaranty to ensure the foreign banks received the applicable rate of return.[131]

The Internal Revenue Service challenged the partnership on several grounds, including (1) that Castle Harbour lacked a non-tax business purpose, (2) that, even assuming the partnership had a business purpose, the Dutch banks were not bona fide partners, and (3) even if the Dutch banks were bona fide partners, the allocation of income violated the "overall tax effect" rule of §704(b).[132] The Court found it unnecessary to address issues one and three and focused its efforts on whether the foreign banks were indeed bona fide equity partners in Castle Harbour.[133]

The court analyzed the banks interests under the *Culbertson* rubric, an analysis that simplified into whether the foreign banks' interests were more akin to equity or debt. The difference, according to the court, depends on whether "the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business."[134] The court concluded that the foreign banks' interests were more akin to debt than equity because the foreign banks were limited to earning the applicable rate of return.[135] Should earnings of the partnership exceed the applicable rate, GECC could cut off excessive distributions to the foreign banks in two ways: (i) by electing to transfer the assets into CHLI (which treats such earnings as disposition gains and, hence, more favorably allocated to GECC) or (ii) by electing to terminate the partnership for a small premium payment. On the other hand, if earnings fell short of the applicable rate, the foreign banks were assured of nevertheless receiving the applicable rate of return. The elaborate protections discussed above weighed heavily in the determination that the foreign banks were unlikely to receive less than the applicable rate.[136]

Application to Historic Boardwalk Hall. Relying on these two "guideposts," the Third Circuit in *Historic Boardwalk Hall* asked whether Pitney Bowes faced "any meaningful down-

side risk or any meaningful upside potential in HBH."[137] The answer turns on Pitney Bowes' risk participation.[138] Key to the court's decision were the mechanics of the cash flow waterfall, the guarantees and indemnities provided by NJSEA to Pitney Bowes, and the price of the put and call options available to buy out Pitney Bowes' membership interest.

In regards to the cash flow waterfall, the court was skeptical that Pitney Bowes would receive any cash apart from the tax benefits and the preferred return. The court remarked, "Even HBH's own rosy financial projections from 2000 to 2042, which (at least through 2007) had proven fantastically inaccurate, forecasted no residual cash flow available for distribution."[139] In other words, even if the projections had proven accurate there was still insufficient cash flow to distribute to Pitney Bowes. The emphasis on HBH's cash flow waterfall illustrates how a court will look through the formality of a partnership to its underlying economic substance.[140] Once the court followed the cash (or lack thereof) down the waterfall, it understood that the form of the transaction was quite different from its reality.

Second, as a result of the protections offered by NJSEA to Pitney Bowes—including the completion guaranty, the operating deficit guaranty, the environmental indemnity, and the promise to compensate Pitney Bowes should the tax credits not be available—the court concluded that Pitney Bowes "bore no meaningful risk in joining HBH."[141]

Third, in regards to the purchase options, the court noted that the exercise price was fixed in advance, rather than being based on fair market value.[142] Although the parties created a complicated set of put and call options, the price under all of the options was based on the present value of any unrealized tax benefits and at least five years' worth of Pitney Bowes' Preferred Return.[143] Indeed, Pitney Bowes' partnership interest likely had no value apart from the value of the tax credits and the Preferred Return.[144] Even if Pitney Bowes' partnership interest did have a fair market value that exceeded the value of the tax credits and the Preferred Return, NJSEA could cut off the excess value by exercising one of its options for the previously set price.[145] Thus, no matter how much Pitney Bowes' partnership interest was actually worth, Pitney Bowes was guaranteed to eventually receive a fixed return consisting of the tax benefits and Preferred Return.[146] The court also emphasized that there was little risk that NJSEA would not have the money to exercise any of the purchase options. Indeed, the exercise price was secured by a Guaranteed Investment Contract, a requirement that had been incorporated into HBH's operating agreement.[147] The court's ultimate conclusion was that NJSEA and Pitney Bowes had not entered into a partnership but had simply effectuated the direct sale of HRTCs.[148]

Implications of Historic Boardwalk Hall for HRTC Transactions

At a fundamental level, what the bona fide partner doctrine demands – as interpreted by the Third Circuit in *Historic Boardwalk Hall* – is that the investor take on some project-level risk. It requires the investor to be exposed to the "upside potential" and "downside risk" of the project. Moreover, the project level risk assumed by a partner cannot be completely hedged through guaranties or fixed returns. This requirement is not limited to partnerships seeking to take advantage of rehabilitation tax credits. Because the decision is predicated on a doctrine applicable to all partnerships (the bona fide partner doctrine), its impact could be felt much more broadly. Even if the decision is limited to tax credit transactions, its impact may be substantial. Indeed, one commentator has noted that "there is a lot at stake" on the outcome of the appeal because it will impact "all similar credit transactions," such as the low-income housing tax credit (LIHTC), the new markets tax credit and the renewable energy tax credits.[149]

The implications for LIHTC transactions could be especially pronounced. Unlike the partnership structure in *Historic Boardwalk Hall*, which provided for a small return that at least theoretically originated with the underlying project (the Preferred Return), LIHTC partnerships have historically compensated equity investors exclusively in tax benefits.[150] One commentator described the typical LIHTC partnership as follows:

> The developer acquires equity financing for the project from investors in return for tax benefits… which generally constitute the sole component of the investor's return. Thus the recipients of the LIHTCs are neither the providers, nor the consumers and beneficiaries of the projects being subsidized, and typically… have no real interest in the projects beyond the tax benefits.[151]

Historic Boardwalk Hall has the potential to change how investors view investing in these types of tax credit transactions. Rather than looking exclusively to the tax benefits, investors will need to invest in the underlying project and—as an incentive to make that investment more attractive—they will receive the tax benefits generated by the project. Thus, the holding in *Historic Boardwalk Hall* helps to transform investments in tax credit transactions from financial arrangements with a fixed return (akin to a well-secured loan or bond) to an investment predicated on the project's underlying operations.

How much exposure to project-level cash flow will be sufficient to satisfy the bona fide partnership test? Unfortunately, the level of participation in the underlying project required by the doctrine is difficult to pin down. The Third Circuit admitted as much when it stated:

> Where the line lies between a defensible distribution of risk and reward in a partnership on the one hand and a form-over-substance violation of the tax laws on the other is not for us to say in the abstract.[152]

In other words, the bona fide partner inquiry remains a totality-of-the-circumstances test that cannot be simplified

into a formulaic rule.

It is unlikely that the partnership structure used by the parties in *Historic Boardwalk Hall* is completely discredited. Rather, the case serves to caution tax-exempt entities leading historic rehabilitation projects from excessively limiting or mitigating the risk of its investor-partners. The only certain lesson that can be drawn from the case is that HBH fell on the wrong side of the line differentiating true partnerships from a device to sell nontransferable tax benefits. This paper argues that drawing such a line in HRTC transactions effectuates Congressional intent in passing §47.

Without drawing a line between true partnerships and substance-over-form violations, the prohibition against transferring HRTCs would be meaningless. As Part II discussed, there are a number of ways to make HRTCs transferable so that all entities—taxable and tax-exempt alike— would be able to use them. For example, Congress opted to make the Earned Income Tax Credit a "refundable" credit, which means that a person need not produce taxable income in order to utilize the credit. Unfortunately for historic preservation, Congress opted to treat HRTCs differently. Put simply, Congress made the generation of taxable income a requirement in utilizing the historic rehabilitation tax credit.

As this paper has illustrated, the prohibition against transferring tax benefits is far from being an insurmountable hurdle. Indeed, HBH was a sophisticated effort at overcoming this restriction. Yet, the bona fide partner doctrine remains a key tool available to the courts to police violations of the prohibition against transferring HRTCs. If the doctrine were not applied, then a nontransferable tax credit would be treated no differently than a transferable credit.

Nevertheless, certain commentators have argued that the substance-over-form doctrine is inapplicable to HRTC transactions. The following argument is typical of such an approach:

> The Tax Court got it right when it concluded that the executive branch of government should not be able to take away tax benefits that the legislative branch had tried to bestow in the context of transactions that further Congress's purpose. The Service is certainly free to contend that a transaction should not be respected when it is contrary to Congress's purpose, but how can the IRS attack a transaction which is doing exactly what Congress wanted? Historic Boardwalk Hall is a case that the government should never have litigated.[153]

Another commentator put it similarly:

> The appeal by the IRS… represents a misguided effort to apply doctrines that are intended to combat transactions that are engineered solely to produce tax benefits without any business purpose or economic substance to a transaction that was structured to achieve the very result Congress intended when it enacted the historic tax credit.[154]

For these commentators, the end result is dispositive. If a historic property is rehabilitated, then it should fall within the ambit of §47. Their arguments place a heavy emphasis on Congressional intent in support of historic rehabilitation. Yet, such an argument disregards the normal method of determining Congressional intent – through the express terms of the statute. Congress, it is correctly asserted, cares about historic preservation, as evidenced by the passage of §47. Yet, its support for historic rehabilitation is limited. Had Congress favored historic preservation more, it would have opted to make the tax credit available to tax-exempt entities and others with little taxable income.[155] Instead, it decided to limit its use to entities with federal income tax liability. If the substance-over-form doctrine was deemed inapplicable to HRTC transactions, then historic rehabilitation advocates would have achieved judicially what they could not achieve legislatively, namely the transferability of HRTCs. The substance-over-form doctrine is a critical tool to enforce the nontransferability of rehabilitation tax credits.[156]

Ultimately, the weakness of the argument against applying the substance-over-form doctrine is attributable to an inability to identify which tax benefits should be exempted from its grasp. Should the same treatment be afforded to partnerships seeking to take advantage of accelerated depreciation deductions?[157] One commentator framed the issue well:

> Depreciation deductions, of course, have a 'structural' aspect insofar as allowable depreciation deductions match economic depreciation. Accelerated depreciation deductions, on the other hand, include a 'subsidy' component….[158]

In other words, Congress attempted to stimulate capital investment by offering accelerated depreciation deductions, which often do not match economic depreciation. If a person who owned an asset subject to accelerated depreciation deductions could not use them due to a lack of taxable income, could it sell (via a partnership) those deductions to a taxpaying entity?[159] The same question could be asked about casualty loss deductions, charitable contribution deductions, mortgage interest deductions, and nearly every other subsidy provided by the Internal Revenue Code. How these commentators could differentiate these tax benefits from historic rehabilitation tax credits is unclear.

Conclusion

The prohibition against transferring historic rehabilitation tax credits has had a major impact on how historic rehabilitation projects are structured. Owners of historic properties who cannot utilize the tax credits have entered into partnership arrangements in an effort to get around that restriction. In many respects, HBH was a very typical example of those partnership structures. Indeed, there were several features

in HBH that could be found in any number of partnership arrangements from that period.

First, HBH allocated 99.9% of the profits and losses to Pitney Bowes in order to take advantage of nearly all of the tax credits generated by the rehabilitation of the East Hall. Second, HBH's Operating Agreement placed several hurdles in the cash flow waterfall to "soak up" cash flow from the project before it would be allocated to Pitney Bowes in accordance with its 99.9% partnership interest. Third, NJSEA provided a number of guarantees and indemnities that insulated Pitney Bowes from any project-level risk. Fourth, the Operating Agreement provided for a mechanism to purchase Pitney Bowes' interest in the partnership after the tax credit recapture period had expired. These aspects of the transaction were critical to the court's conclusion that Pitney Bowes "did not bear a meaningful risk in joining HBH" and therefore was not a bona fide partner.

The outcome of this case comports with Congressional intent as deduced from the express terms of the statute. If it were possible to transfer tax credits through a partnership structure like HBH, then the prohibition against transferring credits would ring hollow. The substance-over-form doctrine is a key tool in enforcing that prohibition. ⌘

Endnotes

[1]694 F.3d 425(3d Cir. 2012).

[2]Nixon Peabody's annual tax credit conference occurred on October 11, 2012.

[3]John Leith-Tetrault, *The IRS' Appeal of Boardwalk Hall v. Commissioner Raises Concerns in the HTC Industry*, Novogradac Journal of Tax Credits, Dec. 2011, at 1.

[4]Mark Primoli, *Tax Aspects of Historic Preservation*, Internal Revenue Service 1, 1 (Oct. 2000).

[5] I.R.C. §38(a).

[6]I.R.C. §47(a).

[7]I.R.C. §47(c)(3)(A).

[8]*See* Mark Primoli, *supra* note 4.

[9]Tax benefits include both credits and deductions.

[10]I.R.C. §165(a), (c).

[11]*See generally* I.R.C. §165.

[12]Some degree of solace is provided in the form of loss carryovers, which effectively permit the deduction to be used in a year where the taxpayer produces more taxable income.

[13]Thomas W. Giegerich, *The Monetization of Business Tax Credits*, 12 Fla. Tax Rev. 709, 709 (2012).

[14] *Id.*

[15] *Id.* at 735, n.100.

[16] *Id.* at n.100.

[17] *Id.* at n.100.

[18]*Id.* at 750.

[19]*See generally*, *id.*

[20]I.R.C. §32.

[21] *Id.* at 731.

[22]*Id.* ("Such an arrangement would undoubtedly "flunk the modern 'economic substance' standard of section 7701(o).").

[23]Another option would be to sell the historic property outright to a taxpayer with tax liability, who would be willing to pay a 20% premium for the parcel of property.

[24]Mark Primoli, *supra* note 4, at 1.

[25]Kenneth A. Alperin, *What You Should Know About the Historic Rehabilitation Tax Credit*, 19 No. 2 Prac. Tax Law. 31, 35 (2005)

[26]*Id.*; *see also* William F. Machen, *The Virginia Historic Tax Credit Funds Case and the Uncertain Federal Income Tax Treatment of State Tax Credits*, William & Mary Annual Tax Conference 1, 1 (2009) ("For example, in the case of a partnership that owns an historic building, federal historic rehabilitation tax credits arising from the rehabilitation of the building must be allocated to and among the members or partners of the Owner in accordance with their respective shares of "bottom line" profits."). If tax credits are allocated differently, they will fail the "economic effects" test of §704. *See also supra* at 71.

[27]Alperin, *supra* note 25, at 35 ("Because the developer of an historic project typically desires to use the Historic Rehabilitation Credit as a source of financing for the Project, the Developer would like to "sell" the Credit to an investor while retaining all of the economic benefits from the Project.").

[28]*Id.* at 35 ("Although 99 percent of the profits must be allocated to the Investor, transactions are structured in such a way that the profits earned by the Partnership are reduced by diverting the earnings of the Partnership to the Developer in other forms.")

[29]*Id.*

[30] *Id.*

[31]*Id.* at 35-36.

[32]*Id.*

[33]The tax credits are fully vested after five years, when they are no longer subject to recapture. I.R.C. §50(a).

[34]Alperin, *supra* note 25, at 36.

[35]*Id.* at 36.

[36]Machen, *supra* note 26, at 2.

[37]Alperin, *supra* note 25, at 36 ("Most of the current *purchasers* of Historic Rehabilitation Credit transactions are financial services companies….") (emphasis added); ("These capital contributions are typically based upon the amount of Historic Rehabilitation Credits anticipated to be available, with *current prices* equal to approximately $.90 per dollar of Credit.") (emphasis added).

[38]*Id.* at 34-35 ("Although there has apparently not been a substantial amount of audit activity recently with regard to Historic Rehabilitation Credit transactions, there is an IRS audit guide which covers the audit procedures for such transactions which can be reviewed by taxpayers and their professional advisors.").

[39]James W. Hahn, *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner: Virginia is for Partners?*, 64 Tax Law. 975, 979 (2011) (citing *U.S. v. Phellis*, 257 U.S. 156, 168 (1921) ("We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder.")).

[40]*Comm'r of Internal Revenue v. Culbertson*, 337 U.S. 733, 752 (Frankfurter, J., concurring) ("Men may put on the habiliments of a partnership whenever it advantages them to be treated as partners underneath, although in fact it may be

a case of 'The King has no clothes on' to the sharp eyes of the law.").

[41]I.R.C. §761(a).

[42]I.R.C. §7701(a)(2).

[43]Treas. Reg. 301.7701-1(a)(2).

[44]327 U.S. 280 (1946).

[45] *Id.* at 286-87.

[46]337 U.S. 733 (1949).

[47]*Id.* at 742. The factors include "the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on the true intent." *Id.*

[48]*Id.* at 748.

[49]Id. at 742.

[50]The Atlantic City Convention Center, *The History of Boardwalk Hall*, http://www.boardwalkhall.com/history.asp (last visited January 7, 2013).

[51]*Historic Boardwalk Hall, LLC v. Comm'r of Internal Revenue*, 694 F.3d 525, 432 (3d Cir. 2012).

[52]*Id.* at 432.

[53]*Id.* at 433.

[54] Leith-Tetrault, *supra* note 3, at 1 (2011).

[55]*Historic Boardwalk Hall*, 694 F.3d at 437. While HBH is a limited liability company under New Jersey law, it is a partnership for federal income tax purposes. Because HBH did not elect to be treated as a corporation, it was deemed to be a partnership under the check-the-box regulations. *Id.* at n.1; Treas. Reg. §301.7701-3(a)-(c). Like the Third Circuit, this paper will refer to HBH according to its federal tax characterization, *i.e.* HBH as a "partnership" and its members as "partners."

[56]*Historic Boardwalk Hall*, 694 F.3d at 436, 443. Pitney Bowes also made a $1,218,000 Investor Loan to HBH, LLC. *Id.* at 443.

[57]*Id.* at 436.

[58]*Id.* at 440.

[59]*Id.* at 444-45.

[60]*See* Alperin, *supra* note 25 at 35; *see also id.* at 33 ("Even when partners are admitted to a partnership after a portion of the rehabilitation work has occurred, Treas. Reg. §1.46-3(f) provides that partners admitted to a partnership before the date on which the property it owns is placed in service will be entitled to an allocation of their share of the Historic Rehabilitation Credit with respect to the that property.").

[61]If HBH did not have sufficient cash flow to make the debt service payments, then the "shortfall would accrue without interest and be added to the next annual installment." *Historic Boardwalk Hall*, 694 F.3d at 440. In order to protect Pitney Bowes from any personal liability should repayment prove difficult, both loans were made nonrecourse to Pitney Bowes. *Historic Boardwalk Hall, LLC v. Comm'r of Internal Revenue*, 136 T.C. 1, 21 (2011).

[62]This "Preferred Return" equaled 3% of Pitney Bowes' investment. *Historic Boardwalk Hall*, 694 F.3d at 435, 458; *see also* Giegerich, *supra* note 13 at 771 ("Anecdotal evidence suggests that historic rehabilitation tax credit transactions generally call for an annual cash distribution (3-percent cash-on-cash apparently is common) and include a schedule showing an anticipated return of investment over the life of the project.").

[63]*Historic Boardwalk Hall*, 694 F.3d at 438.

[64] *Id.* at 434-35.

[65]*Id.*

[66]*Id.* at 435-36.

[67]*Id.* at 436.

[68]*Id.* at 436-37.

[69]*Id.* at 456 ("the Tax Benefits Guaranty eliminated any risk that, due to a successful IRS challenge in disallowing any HRTCs, PB would not receive at least the cash equivalent of the bargained-for tax credits").

[70]*Id.* at 438.

[71]*Id.* Repayment of the operating deficit loan is step five of the cash flow waterfall.

[72]*Id.*

[73]*Id.* at 438-39, 441.

[74]*Id.* at 438-39.

[75]*Id.* at 441.

[76]*Id.*

[77]*Id.* at 438-39, 441.

[78]The economic substance doctrine was codified by Congress after these transactions occurred. I.R.C. §7701(o)(5)(A) ("The term 'economic substance doctrine' means the common law doctrine under which tax benefits under Subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.").

[79] The Third Circuit did not address this last contention. *Historic Boardwalk Hall*, 694 F.3d at n.44.

[80]*Id.* at n.50.

[81]*Id.* at 449-453.

[82]639 F.3d 129 (4th Cir. 2011).

[83]*Id.* at 132.

[84]*Id.* at 132-33.

[85]Va. Code Ann. § 58.1-339.2.A.

[86]*Virginia Historic Tax Credit Fund 2001 LP*, 639 F.3d at 134.

[87]*Id.*

[88]*Id.*

[89]*Id.*

[90]*See supra,* note 26. Giegerich, *supra* note 13 at 712 ("[I]t seems readily apparent that an attempt to allocate federal tax credits in the manner used by the parties in Virginia Historic Tax Credit to allocate the Virginia tax credit would be impermissible under section 704 and would not be given effect.").

[91]*See* Machen, *supra* note 26 at 1 ("[T]he state credit investor typically is allocated 100% of the state tax credits but only a very small percentage of cash flow and federal tax items (usually between 0.01% and 1%).").

[92] *Virginia Historic Tax Credit Fund 2001 LP*, 639 F.3d at n.5.

[93]Giegerich, *supra* note 26 at n.6 (citing VA DEP'T OF TAXATION, RULINGS OF THE TAX COMMISSIONER, No. 07-82 (May 25, 2007)).

[94]Alperin, *supra* note 25 at 35.

[95]*Virginia Historic Tax Credit Fund 2001 LP*, 639 F.3d at 143.

[96]*Id.* at 134. This guaranty was further protected by requiring the Operating Partnerships to "reimburse the Funds in the event that any of their credits could not be delivered or were later revoked by the state." Indeed, the contributions by investors "simply sat in escrow earning interest because [they] were protected by a money-back guarantee." Hahn, *supra* note 39 at 985.

[97] *Id.* at 135; *see also* Machen, *supra* note 26 at 2 ("Call options must be priced at fair market value but such value may be quite low due to the nominal interest of the state investor in profits, losses, and operating cash flow, the lack of a market for the state investor's interest, the inability of the state investor to participate in the management and operation of the business, and the inability of the state investor to compel a liquidation of the Owner and the return of its capital.").

[98]Hahn, *supra* note 39 at 980.

[99]*Virginia Historic Tax Credit Fund 2001 LP*, 639 F.3d at 135.

[100]*Id.*

[101]*Id.*

[102]Hahn, *supra* note 39 at 975. Whether the investor purchases a tax credit or is allocated a tax credit affects the value of the credit. If the tax credit is allocated, the IRS disallows a deduction under §164 for every dollar of tax credit used to offset state and local income tax liability. If purchased, §164 remains available to the investor. *See* Machen, *supra* note 26 at 2.

[103]Hahn, *supra* note 39 at 975.

[104]*Id.* Had the Tax Court ruling been allowed to stand, there would be a perverse incentive for states to make their HRTCs nontransferable. If the tax credits were transferable, they would be taxed upon disposition; under a partnership arrangement, however, the same transfer could be made tax-free. *See* Hahn, *supra* note 39 at 987.

[105]*Virginia Historic Tax Credit Fund 2001 LP*, 639 F.3d at 137.

[106]*Id.*

[107]Treas. Reg. §1.707-3 (emphasis added).

[108]*Virginia Historic Tax Credit Fund 2001 LP*, 639 F.3d at 145.

[109]*Id.* at 143; *see also* Treas. Reg. §1.707-3(c) ("unless the facts and circumstances clearly establish that the transfers do not constitute a sale.").

[110]*Virginia Historic Tax Credit Fund 2001 LP*, 639 F.3d at 146.

[111]459 F.3d 220 (2d Cir. 2006).

[112]*TIFD III-E Inc. v. U.S.*, 342 F.Supp.2d 94, 96 (D. Conn. 2004). Airlines prefer to lease aircraft because, unlike entities such as GECC, they are insufficiently profitable to utilize the substantial depreciation deductions generated by commercial aircraft. In other words, full use of the depreciation deductions allowed GECC to charge the airlines less for the use of the planes than it would cost the airlines to own the aircraft directly. *Id.*

[113]*TIFD III-E Inc.*, 459 F.3d at 225.

[114]*Id.* at 223.

[115]*Id.* at 225.

[116]*Id.*

[117]*Id.* at 226.

[118]*Id.* at 228.

[119]*Id.* at 228-29.

[120]*Id.* at 228-29. The foreign banks received 90% of Disposition Gains until they had been allocated $2,854,493, with higher amounts allocated 99% to GECC and 1% to the foreign banks.

[121]*Id.* at 222 ("Operating Income, calculated for tax purposes, however, vastly exceeded the amounts the banks would actually receive.").

[122]*Id.* at 229.

[123]*TIFD III-E Inc.*, 342 F.Supp.2d at 98.

[124]*Id.* at 99. The partnership maintained both a Capital Account and an Investment Account for the foreign banks. The Investment Account was a theoretical account, based on the Applicable Rate. The Capital Account reflected the actual returns generated by the partnership. *TIFD III-E Inc.*, 459 F.3d at 227-28.

[125]*TIFD III-E Inc.*, 459 F.3d at 227.

[126]*Id.* at 229.

[127]*Id.* at 237-238.

[128]*Id.* at 228.

[129]*Historic Boardwalk Hall*, 694 F.3d at 450. "Core Financial Assets" consisted of high-grade commercial paper and cash. *Id.*

[130]*TIFD III-E Inc.*, 459 F.3d at 228.

[131] *Id.*

[132]*Id.* at 224, n.1, and n.11.

[133]*Id.* at 224.

[134]*Id.* at 233 (citing *Gilbert v. Commissioner*, 248 F.2d 399, 406 (2d Cir. 1957)).

[135]*Id.* at 222; *see also id.* at 231 ("In sum, the banks' interest was overwhelmingly in the nature of a secured lender's interest, which would neither be harmed by poor performance of the partnership nor significantly enhanced by extraordinary profits.").

[136]*Id.* at 228.

[137]*Historic Boardwalk Hall*, 694 F.3d at 455; *see also id.* at 449 ("In essence, to be a bona fide partner for tax purposes, a party must have a "meaningful stake in the success or failure" of the enterprise.").

[138]*Id.* at 455; *see also id.* at n.57 ("The relevant question, here, however, is not the factual one of whether there was risk; it is the purely the legal question of how the parties agreed to divide that risk, or, in other words, whether a party to the transactions bore any legally significant risk under the governing documents.").

[139]*Id.* at 459-60. The Court benefitted from seeing several years of actual results. While HBH had projected $9.9 million of net operating income between 2003 and 2007, it instead suffered a net operating loss of $10.5 million. Moreover, by the end of 2007, the Operating Deficit Loan had an outstanding balance of more than $28 million. *Id.* at 444 and n.63.

[140]Mark Leeds and Diana Davis, *Tax Credits: 'Historic Boardwalk Hall v. Commissioner': IRS Dissolves a Partnership Between Pitney Bowes and N.J. Agency*, BNA Insights (2012).

[141]*Historic Boardwalk Hall*, 694 F.3d at 457.

[142] *Id.* at 460.

[143]*See supra* note 77 and accompanying text.

[144]*Historic Boardwalk Hall*, 694 F.3d at n.63 ("Despite the smoke and mirrors of the financial projections, the parties' behind-the-scenes statements reveal that they never anticipated that the fair market value of [Pitney Bowes'] interest would exceed [Pitney Bowes'] accrued but unpaid Preferred Return."); *see also*, Machen *supra* note 26 at 2.

[145]*Historic Boardwalk Hall*, 694 F.3d at 460 ("Even if there were an upside, however, NJSEA could exercise its Consent Option, and cut PB out by paying a purchase price unrelated to any fair market value.").

[146]*Id.* at 459 ("[Pitney Bowes] was assured of receiving the value of the HRTCs and its Preferred Return regardless of the success or failure of the rehabilitation of the East Hall and HBH's subsequent operations.").

[147]*Id.* at 439.

[148]*Id.* at 458 ("[Pitney Bowes] and NJSEA, in substance, did not join together in HBH's stated business purpose—to rehabilitate and operate the East Hall. Rather, the parties' focus from the very beginning was to effect a sale and purchase of HRTCs.").

[149]John Leith-Tetrault, *supra* note 3 at 4.

[150]Giegerich, *supra* note 11 at 745.

[151]*Id.*

[152]*Historic Boardwalk Hall*, 694 F.3d at 463.

[153]Richard M. Lipton, *IRS Challenge to Rehabilitation Tax Credit Partnership Ends Up Under the Boardwalk*, 114 J. Tax'n 294, 299 (May 2011).

[154]John Leith-Tetrault, *supra* note 3 at 4 (citing William Machen); *see also* Giegerich, *supra* note 13 at 791 ("In fact, the notion that the tax law requires that the investor extract more in the way of non-tax economic benefits from the sponsor/developer that is the "natural" beneficiary of the subsidy in order for the subsidy to operate appears to be a perversion of applicable non-tax policy goals. The goal of the system should be the efficient delivery of the government subsidy to the intended beneficiary.").

[155]Assuredly, Congress was not unaware of the increased cost of a transferable historic rehabilitation tax credit program over a nontransferable program.

[156]Indeed, the Court recognized as much when it noted that "[i]t is the prohibited sale of tax credits, not the tax credit provision itself, that the IRS has challenged." *Historic Boardwalk Hall*, 694 F.3d at 462-63.

[157]Giegerich, *supra* note 13 at n.427.

[158]*Id.*

[159]*Id.*

Close The Loophole: The Marketplace Fairness Act and its Likely Passage

by Bryan J. Soukup

Introduction

When a consumer makes a purchase at a local book or clothing store, she is required to pay all applicable state sales tax as a matter of course. However, when the same item is purchased from an online retailer, such as Amazon.com or Zappos.com, frequently no state sales taxes are paid. In this stagnant economy, brick and mortar retailers (brick and mortars) are voicing increasingly strong objections to the current state of online tax collection considering they must always collect state sales tax. Due in part to this uneven playing field, brick and mortars lose thousands of dollars a day in sales to online retailers. States, too, are losing revenue in the form of unpaid use taxes and, like the brick and mortars, are proponents of legislation allowing states to require online retailers to collect sales tax from their customers. Proponents of federal legislation on this issue point to the fact that sales tax revenues currently amount to approximately $150 billion annually and constitute about one-third of state revenues, making federal action a matter of fiscal responsibility.[1] Conversely, opponents temper these numbers by citing data that the sales tax due for all consumer e-commerce is only 0.5% of total state and local tax revenue.[2]

To understand this controversy it is imperative to understand the similarities and differences between sales and use taxes. A use tax is a "substitute for sales tax. All states which have a sales tax also impose a use tax… The use tax rate is the same as the sales tax rate."[3] Usually a use tax is assessed when an individual purchases an item without paying his or her home state's sales tax (*e.g.*, the individual purchases the item online without being charged sales tax) and the item is consumed or used in the home state. As a result, a use tax is an indirect tax, while a sales tax is a direct tax.

Sales and use taxes in the United States date back to the early nineteenth century.[4] The sales tax blossomed during the Depression era, with Kentucky being the first state to create a tax exclusively directed at retailers.[5] The last state to impose a sales tax was Vermont in 1969. Presently, Alaska, Delaware, New Hampshire, Montana and Oregon are the only states without a sales tax.[6] One benefit of a use tax, as compared to a sales tax, is that it is easier to impose on out-of-state transactions. As the Supreme Court has held, "[h]owever fatal to a direct [sales] tax a 'showing that particular transactions are dissociated from the local business [is,]' such dissociation does not bar the imposition of the use-tax-collection duty."[7]

Of the 50 states in the union, approximately 12 have enacted legislation, discussed in detail below, mandating the collection of state sales tax on online purchases.[8] These states, and a variety of online retailers both large and small, are crying foul over the lack of guidance provided by the federal government to force others to comply. States want the law changed so that they can collect much needed revenue. Online retailers that already collect these taxes want the law changed to prevent their competitors from escaping their obligation to do so.

In response, in 2011 Congress acted by introducing a bipartisan solution to the issue, *The Marketplace Fairness Act* (the Act). This paper will study the events leading up to the Act, review the legal hurdles the Act will face before its potential passage, analyze current tax laws and loopholes relating to sales tax on online purchases, and examine the policy concerns surrounding the Act. In the end, while the Act will face significant challenges, these challenges will not be enough to prevent its passage during the 113th Congress.

The Necessity of Federal Legislation

The need for federal legislation traces its roots to the "dormant Commerce Clause." While the Commerce Clause grants Congress the right to regulate interstate commerce, the dormant Commerce Clause implies the converse; a negative right that prohibits states from passing legislation that discriminates against or excessively burdens interstate commerce.[9] This principle has been cited in two seminal Supreme Court decisions as the basis for precluding states from imposing sales taxes on retailers that do not have a physical presence in the state where the product is sold.[10] Clearly, federal legislation is necessary to allow states to require online retailers to collect sales tax.

State taxation of remote retailers was first addressed in *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois*.[11] Bellas Hess, Inc. was a national mail order catalogue company with its principal place of business in North Kansas City, Missouri.[12] In 1967, the State of Illinois, a state in which Bellas Hess "maintained no office, had no agents or solicitors, owned no property, and had no telephone listing" sought to force Bellas Hess to collect sales taxes from Illinois consumers purchasing its products.[13] The U.S. Supreme Court found in favor of Bellas Hess and refused to allow Illinois to collect a use tax on these sales. In its decision, the Supreme Court observed that it "has never held that a State may impose the duty of use tax collection and payment upon a seller whose only connection with customers in the State is by common carrier or the U.S. mail."[14] Justice Stewart, writing for the majority, also analyzed the crushing burden collecting these taxes would impose on Bellas Hess, Inc. and the negative impact on the free flow of interstate commerce writing, "[t]he many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National [Bellas Hess'] interstate business."[15] Therefore, the Court held that a **physical presence** in the state is required in order to mandate tax collection by the business.[16]

Twenty-five years later, the Supreme Court again broached this issue in *Quill Corp. v. North Dakota*.[17] Quill Corp. was an office supply distributor incorporated in Delaware with warehouses in Illinois, Georgia, and California.[18] The State of North Dakota sought to collect owed use taxes from the company. Akin to the facts of *Bellas Hess*, "none of [Quill Corp.'s] employees work[ed] or reside[d] in North Dakota, and its ownership of tangible property in that State is either insignificant or nonexistent."[19] Upholding *Bellas Hess* on a Commerce Clause analysis, the Court held that although Quill Corp. satisfied the *International Shoe* minimum contacts rule, because Quill's business did not have a "substantial nexus" with North Dakota, North Dakota's attempt to force Quill to collect sales taxes violated the Commerce Clause. Using the Commerce Clause, the Court reasoned, would better avoid the undue burden on entities that *Bellas Hess* forbids.[20] The Supreme Court's examination found continued "value" in the bright-line, physical presence rule established in *Bellas Hess*.[21]

However, Justice Stevens, writing for the majority, explicitly left the door open for Congressional action stating, "the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve."[22] Because the fundamental basis for the Court's reasoning was the Commerce Clause and because the Court held that North Dakota's statute did not violate the Due Process Clause of the Constitution, Stevens postulated that Congress should have the final say in whether or not these states could collect these taxes. Hence, while states are currently precluded from collecting sales and use taxes from out-of-state retailers, Congress has the ability to pass legislation-giving states the authority to do so.

The Main Street Fairness Act. In July of 2011 Congress finally heeded the Supreme Court's clear advice and moved forward with legislation to close the loophole formed by *Quill* with Senator Dick Durbin's (D-Ill.) introduction of the Main Street Fairness Act (Main Street). Main Street would allow states to require large Internet and mail-order retailers to collect state and local sales taxes, provided certain conditions have been met.[23] Although enactment of the bill would remove the nexus requirement established in *Bellas Hess* and *Quill*, in order to ease the potential undue burden on interstate commerce, Main Street would require all states that wish to take part in the legislation to fully adopt the Streamlined Sales and Use Tax Agreement (SSUTA).[24]

The SSUTA is a voluntary agreement created by the Streamlined Sales Tax Project (a group composed of members of the National Governors Association and the National Conference of State Legislatures) that simplifies tax collection procedures through the implementation of tax law reorganization, more efficient administrative procedures, and emerging technologies.[25] According to the SSUTA, execution of these procedures minimizes costs and administrative burdens on retailers that collect sales tax, particularly retailers operating in multiple states.[26]

Senate Republicans and other opponents of Main Street cited the amorphous term of "large" businesses coupled with the lack of a defined exemption for small businesses as reasons for their opposition. Republicans argue that small businesses, much like the online marketplace in its infancy, deserve some sort of protection, as they do not have the large infrastructure and resources that large corporations do to comply with collecting these taxes. Consequently, by early fall, support for Main Street had mostly disappeared.[27]

The Marketplace Equity Act. Nonetheless, in October 2011, a similar Bill called the Marketplace Equity Act (Equity) was introduced by Reps. Speier (D-Ca.) and Womack (R-Ar.). Like Main Street, Equity would enable states to require online companies that do not have a physical presence in the state to collect and remit state sales taxes.[28] However, unlike Main Street, Equity established a specific small business exemption that would excuse remote sellers with annual U.S. gross revenues of $1 Million or less, or in-state revenues of $100,000 or less.[29] Equity also does not require participation in the SSUTA. It only provides that a state must, "implement a simplified system for administration of sales and use tax collection with respect to remote sellers."[30] However, Equity was criticized for being crafted too hastily in order to collect Republican support and for abandoning too many of the protections for remote retailers prescribed in *Quill*, and the bill ultimately failed.[31]

The Marketplace Fairness Act. Finally, in November of 2011, the Marketplace Fairness Act (the Act) was introduced in the Senate by a bipartisan army consisting of such-heavy hitters as Lamar Alexander (R-Tn.) and Dick Durbin. The Act is an amalgamation of the two previous proposals. Like Main Street, the Act gives a state the option to participate in the SSUTA in order to remedy any undue burden posed by collection of sales taxes across jurisdictions.[32] However, the Act also allows states to adopt a detailed list of stringent procedures short of entering the SSUTA,[33] much like those proposed in Equity.[34] The Act also provides an exemption for small businesses whose gross annual revenue is less than $500,000 nationally. Those states that choose not to ratify the SSUTA must implement the following procedural safeguards to streamline tax collection: (1) a single state level collection agency; (2) a single audit for all state and local taxing jurisdictions within the state; (3) a single sales and use tax return to be used by remote sellers to be filed with the state-level agency; (4) a uniform sales and use tax base among the state and its local taxing jurisdictions; (5) adequate software and services to remote sellers that identifies the state and local sales tax rate to be applied on sales sourced to the state; (6) certification procedures which include an agreement to hold providers harmless for any errors or omissions as a result of relying on state provided information; and (7) 30 days notice to remote sellers and single and consolidated providers of local tax rate changes.[35]

The Act has collected, by far, the most positive attention from officials and pundits on both sides, blessed by some of America's most staunch anti-tax advocates, including Governors

Mitch Daniels (R-In.), Paul LePage (R-Me.), and Haley Barbour (R-Ms.). Rarely, in this political environment, has a bill achieved such bipartisan backing, especially one that deals with the divisive topic of taxation. Though the Act has found the most traction of the three bills and has the greatest likelihood of earning bipartisan support in both chambers, it has been tabled in committee until the 113th Congress. Of the approximately 8,000 bills that go to committee each year, only 10% of them make it out for consideration on the chamber floors.[36]

Legal Challenges to New Legislation

Those opposed to the Act are asserting a variety of legal challenges to the proposed legislation. This section will deal with the two major challenges and explain why each is based on an inaccurate interpretation of the law.

Challenge #1: The Marketplace Fairness Act Will Create a New Unconstitutional Tax. Opponents claim that by allowing states to force remote online retailers to collect sales tax, the Act will, in effect, create a federally based online sales tax. Because each state and locality has different sales and use tax rate, [37] opponents say such a federally mandated tax would be in violation of Article 8, Section 1 of the 16th Amendment, which requires uniform imposition of taxes. Specifically, this section states, "[t]he Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States."[38]

This argument is not persuasive because the Act is not a new federally mandated "national sales tax"; it is a bill that provides a structure and procedure for states to collect a direct sales tax (that is already due) rather than an inefficient indirect use tax.[39] Presently, 23 states provide for use tax reporting on their individual income tax return form while seven more states provide informational booklets on how to report use taxes.[40] Each state that has sales and use tax (even those that do not have a state income tax and, therefore, no state income tax return) provide some sort of method for what is in theory and in law, mandatory use tax reporting.[41]

Rather than rely on customers reporting a use tax on their tax returns, as they are required to do by law as of right now, the Act would simply require online retailers to collect, directly, sales tax.[42] Under the Act, no item will be subject to more or less tax under the law, and any state without sales and use taxes will be exempt from the legislation.[43] Moreover, any state that does not wish to collect these owed taxes may opt out altogether.[44]

According to the Tenth Amendment to the Constitution, "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."[45] Thus, states have taken the constitutionally protected initiative to levy sales and use taxes in order to generate revenue.

Other than *Quill* and *Bellas Hess*, discussed above, the Supreme Court has provided only limited restriction on a state's right and ability to collect sales and use tax. For example, in 1940, the Court emphatically declared that, "[t]his Court has uniformly sustained a tax imposed by the state on the buyer upon a sale of goods".[46] Considering this precedent, and the Court's suggestion in *Quill* that Congress may enact legislation that will allow states to collect sales tax from online retailers, it is doubtful that the Act would be found to be unconstitutional.

Challenge #2: Even if the Act does not create a new tax, it will impose an unconstitutional undue burden on interstate commerce. Opponents point to the Court's opinion in *Quill* in arguing that the Act will impose an undue burden on interstate commerce. The *Quill* Court examined the nearly 6,000 taxing jurisdictions in the United States and concluded that requiring a company to comply with the tax law and rates of each of those states and localities would impose an unconstitutional undue burden on interstate commerce.[47] *Quill* observed that the purpose of the physical presence nexus requirement is to "limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce."[48] Challengers of the Act have claimed that even with the SSUTA, interstate commerce will be unduly burdened.[49]

This is incorrect. First, the Supreme Court in *Quill* did not delineate any specific requirements for how to limit the burden on interstate commerce.[50] Second, the SSUTA has already proven to be an effective simplifier of tax codes. As of 2010, there are 20 full member SSUTA states and three associate member states.[51] These states have complied with rate simplification by creating one general state rate per state, allowing a single local rate per jurisdiction, establishing uniform sourcing codes for goods and services that are destination based, uniform treatment of bank holidays, and uniform rules for sales tax holidays.[52] All SSUTA full member states have put into place a central registration system, simplified electronic tax return systems, and a uniform rounding rule.[53] The Act's requirement of states that wish to take part in the legislation to adopt all the provisions of the SSUTA or to enact provisions (detailed in the text of the Act and listed above) that are similar to the SSUTA in depth and breadth, ensures that the imposition of a sales tax will not constitute an "undue burden" on interstate commerce.[54, 55]

In addition, the Supreme Court has provided detailed guidance on what constitutes an undue burden on interstate commerce—standards that the Act clearly does not violate. According to the Court in *Complete Auto Transit, Inc. v. Brady*, the state has a right to tax interstate commerce if a four-prong test is satisfied.[56] The state may impose such a tax if: (1) it is applied to an activity with substantial nexus with the taxing state; (2) it is fairly apportioned; (3) it does not discriminate against interstate commerce; and (4) it is fairly related to the services provided by the state.[57]

The Act passes the *Complete Auto* test. Prongs two and four are relatively self-explanatory. Prong two is met because

the tax will be apportioned equally throughout each jurisdiction according to each state's already established, constitutional, sales tax. As to the fourth prong, *Quill* stated, "there is no question that Quill has purposefully directed its activities at North Dakota residents . . . . [T]he use tax is related to the benefits Quill receives from access to the State."[58] Like Quill Corp., online retailers direct their products towards consumers in all U.S. jurisdictions. Therefore, the tax will be related to the benefits the company receives from the state.

As for prong one, the Act would eliminate the "physical presence" rule as it relates to the substantial nexus test and would declare such actions as nondiscriminatory. The Court in Quill specifically acknowledged the possibility such action.[59]

Regarding prong three, the *Quill* Court held that it prohibits "taxes that pass an unfair share of the tax burden onto interstate commerce."[60] As the consumer already owes these taxes in states with sales and use tax should he or she choose to purchase the item instate at a Brick and Mortar retailer or online, the Act will not discriminate against interstate commerce. The Act will not force collection in states where no sales or use tax exists.[61]

Based on the Congressional discretion acknowledged by the Court to Congress in *Quill* and the Court's analysis of the prongs of the *Complete Auto* test, it is unlikely that the Act will be found to create any undue burden on interstate commerce in violation of the Commerce Clause.

Current Tax Law and Loopholes

State Response. While *Quill* has prevented states from directly taxing remote retailers, states have employed a variety of tactics to work within its frame. As will be detailed below, states have done this, largely, in two ways. First, states have lured corporations into their borders by exempting them from collecting sales taxes for purchases made online by state residents. In return, such corporations have generated revenue for those states by bringing jobs, thereby personally taxing the new residents seeking those jobs, and through state corporate income tax. Second, in order to work within the confines of the *Quill* decision, states have tried to find physical nexuses through corporate affiliates (defined below). These two methods have had mixed results.

The Legality of Exemption as Incentive. Many states have weighed the benefits and detriments of how to tax out-of-state-based corporations. A long-standing conundrum has existed between the two predominant modern political and economic ideologies in America on how to increase revenue: (1) increase taxes on corporations and businesses and produce immediate revenue or (2) decrease taxes to attract businesses, increase the tax base and bring more jobs into the state (something of particular urgency in today's economy).

Since *Quill* severely limits states' ability to tax online retailers, rather than try to tax these retailers, some states have focused on providing the retailers with incentives to locate their physical operations in the state. In 2010, Tennessee struck a deal with Amazon for a $139 million project that will reportedly bring between 1,400 and 2,000 new jobs to the state.[62] The deal will also bring two order-fulfillment centers in East Tennessee establishing a physical presence nexus in the state.[63]

As a result of the unique nature of the Tennessee tax code, Tennessee had to provide Amazon with adequate incentive to locate these centers in Tennessee. Tennessee has no state income tax and, instead, has a comparatively high sales tax on products purchased within the state. As a result of the high sales and use tax, a large segment of the state population shops online for large or expensive purchases. A 2009 University of Tennessee study calculated that Tennessee lost approximately $7.7 billion in e-commerce sales tax revenue due to the *Quill* exemptions in 2008. These numbers play heavily on Amazon's and other online retailers' calculus of where to open physical facilities because establishing a nexus in a state with a large population of residents who deliberately purchase products online would likely force these online companies to collect taxes from those online purchasers in that state. Doing this would diminish the likelihood that citizens in that state would make online purchases. Amazon would normally not quash a dependable revenue stream from Tennessee without any incentive.

"[T]o lure [Amazon] to Tennessee, the state gave Amazon an economic-incentive package [including a provision that] the company would not have to collect sales taxes -- even on sales made within the state borders."[64] In striking this deal, Tennessee learned from Texas Governor Rick Perry, who made the mistake of "present[ing] [Amazon] with a $269 million bill for uncollected sales taxes" which resulted in the company "clos[ing] a suburban Dallas distribution center and scrapp[ing] expansion plans."[65] Consequently, Tennessee, in essence, granted tax collection amnesty to Amazon.

In October 2011, however, Tennessee's Attorney General Cooper, a Democrat, reversed course on the state's position. Mr. Cooper, taking from both the holding in *Quill* and the state's *Retailers' Sales Act*, found that a corporation, with a physical nexus, could not be exempt from collecting and remitting state sales and uses taxes in the state of Tennessee.[66] He went on to make a more stringent distinction not addressed in *Quill* stating, "if the in-state distributing house or warehouse is owned by a retailer's subsidiary, instead of the retailer directly, nexus is established only if the subsidiary's in-state activities are significantly associated with the retailer's ability to establish and maintain a market in Tennessee for its sales."[67] In closing, the Attorney General wrote, "[a]s a general rule, the State of Tennessee cannot contractually waive a taxpayer's obligation to pay sales taxes" because of Tennessee's *Retailers' Sales Act* which requires all companies with a physical presence in the state to collect and remit sales taxes.[68] To soften this hard position, the Attorney General granted some discretion to the Tennessee Commissioner of Revenue, in the case of online retailers, by allowing the Commissioner to assess the constitutionality of taxing such entities.[69]

Since the Attorney General handed down his opinion and Congress has moved to legislate on the issue (as discussed above), Republican Governor Bill Haslam, perhaps seeing the

writing on the wall, took the initiative and reached a tentative agreement with Amazon to begin collecting state sales tax on January 1, 2014. Despite the imposition of sales tax, Amazon accepted the deal because it will give the company an almost two-year tax holiday should any Congressional action take hold during this year.

In Virginia, where Amazon operates a warehouse in Sterling and a data center at an undisclosed location within the state, the online retailer was also granted a tax collection exemption in return for the company bringing two new distribution centers that would generate approximately 1,300 jobs in the state.[70] According to a 2007 Virginia Department of Taxation decision, Amazon is exempt from collecting and remitting sales taxes in the state because its facilities in Virginia do not handle sales.[71] However, bowing to bipartisan political pressure, Governor McDonnell, Amazon, the Virginia House of Delegates and Senate recently reached a deal to require Amazon to start collecting sales tax on September 1, 2013.[72] Sponsored by Senator Wagner (R–Virginia Beach) the "state legislation also creates a legal presumption that other out-of-state online businesses with a physical presence in Virginia such as distribution centers must collect sales taxes."[73] This legislation mirrors Tennessee's *Retailers' Sales Act*. A similar scenario is unfolding in South Carolina, Arizona, and Nevada.[74]

In states where there is no equivalent to Tennessee's *Retailers' Sales Act*, the practice of contractually exempting companies from collecting sales taxes to draw them to the state, even when they have a physical presence, is currently not illegal under state law or the holding in *Quill*.

The Amazon Tax Laws. Amazon.com, one of the nation's largest online retailers, collects sales or use taxes in only five US states.[75] Generally, these states are where Amazon has a strong physical presence, like a corporate headquarters. Additionally, five other US states don't have statewide sales taxes; thus, Amazon does not collect taxes in 40 states.[76] Seventeen states have taken matters into their own hands by passing "Amazon Tax" laws through their state legislatures. These laws are designed to compel Amazon and other online and remote retailers to collect and remit local sales and use taxes from customers.

In order to collect online sales taxes from these remote retailers, most states target remote retailers' "affiliates" that have an actual physical presence in the state.[77] These Amazon "affiliates" are usually bloggers who link to Amazon products on their blog or website.[78] Since they are registered and monitored by Amazon, they are officially associated with the company. Moreover, since many of these affiliates are individual bloggers, Amazon often has thousands of affiliates in each state thus creating an in-state physical nexus to satisfy the legal requirements of *Quill*. Consequently, Michigan's tax law, for example, "impute[s] [a] nexus to remote sellers that compensate in-state affiliates for sales made on a "click-through basis" from the affiliates' websites."[79] Similar laws have also taken this approach by creating, "a rebuttable presumption that an Internet retailer has a nexus with the applicable state if the seller enters into an agreement with an in-state resident or person to refer potential customers, directly or indirectly, through a link on a website or otherwise."[80]

These laws, as will be detailed in the section (c) below, have varied in their success.

Policy Concerns

The Government's Role in tax "fairness." Just viewing the names of the three proposed pieces of legislation, The Main Street *Fairness* Act, The Marketplace *Equity* Act, and The Marketplace *Fairness* Act, one can easily see that the overriding message sent by Congress is one of equality and fairness. Yet we live in a society that has built a strong economy on principles of competition, laissez faire principals, and survival of the fittest. How can one ensure fairness in a capitalist economy, including the tax regime governing such an economy? Why fairness is a question that both proponents and opponents of the Act have raised.

Is fairness at the heart of the issue; or is it simply a matter of allowing states to enforce their own tax laws? Every American citizen, except those who live within the borders of the five non-sales tax states, is required to report the tax owed on e-commerce interstate purchases by way of use taxes on their individual tax returns or other similar means. Despite this legal requirement, many (or most) consumers do not do it. This lack of compliance has cost states, most of which are struggling in the current economic downturn, an estimated $23 billion for the year 2012 alone.[81] In context, the fifty states, in total, collected an estimated $150 billion in general sales tax in 2011.[82]

The U.S. government should not be in the business of picking winners and losers, be it the auto industry or the online retailers. Right now our laws pick online retailers as the winners, giving them special security not enjoyed by their Brick and Mortar counterparts. Perhaps when e-commerce was in its infancy (about the time *Quill* was decided) it made sense to pad protections to ensure its early survival. Twenty years later we know that e-commerce is a force here to stay. We know it will survive even if it has to play by the same rules as its Brick and Mortar counter parts. If enforcing the laws that are already in place regarding sales and use taxes of online products hurts some online retailers, it is commensurate with the perils of the free market. The best product in the best forum always wins. The online retail business is robust, and making it play by the same rules that the brick and mortars play by is unlikely to dramatically decrease the appeal of shopping, with ease, from the comfort of your living room. In a free market society, the only role of the government is to ensure that each individual and each business entity has the *opportunity* to enter into the market and try its hand at success. This Act does nothing more and nothing less.

Will the Act harm an already weak economy? The first bill dealing with this issue was titled "The Main Street Fairness Act." While this title came across as a bit hackneyed by

outwardly appealing to the most sentimental parts within us, the principle behind it was sound. The online tax loophole is hurting Brick and Mortar retailers. These retailers are part of the fabric of our economy and support a significant part of our work force, employing an estimated fourteen million people in approximately one million retail outlets.[83] To compare, Amazon.com only employs 56,200 employees worldwide.[84] Furthermore, eBay only employs 27,000 workers worldwide.[85] While pumping money into the economy with online retail purchases is an effective way to help jumpstart our struggling economy, protecting the millions of Americans who work at and own brick and mortar retailers is even more important.

Many supporters of the Act also tout its ability to simplify our archaic and chaotic tax structure and, perhaps, lower our overall tax rates in each state. State implementation of the SSUTA and/or other prescribed tax simplification procedures will streamline our complicated state and national tax scheme, cutting down on the time, effort, and money required to comply with the tax code. Al Cardenas, a renowned Republican strategist and conservative anti-tax advocate sees the Act as a way to lower taxes across the board. Cardenas writes that the Act "should — allow for commensurate reductions in sales tax rates. For instance, if Internet sales tax revenues will add 10 percent in revenue to a governing body's coffers, then, at a minimum, a corresponding overall reduction in rates should apply."[86]

Moreover, regardless of the impact the Act may have on online retailers, it will not **negatively** affect our economy since, whether online or in a physical store, Americans still will purchase the products that they desire or require. While the sales volume might trend more favorably towards brick and mortar retailers after the Act passes, Americans will keep this economy moving by continuing their consumerism.[87]

Would a state solution work better? For a number of years states have tried crafting their own solution to this problem with little positive result. As discussed above, states that have attempted imposing "Amazon Laws" have run into a buzz saw wielded by online retailers. One tactic of the large retailers has been to remove or cut ties with their affiliates, as we have seen in California and other states. On the day California's Amazon Law was passed, Amazon sent e-mails to its affiliates stating, "[u]nfortunately, Governor Brown has signed into law the bill that we e-mailed you about earlier today. As a result of this, contracts with all California residents participating in the Amazon Associates Program are terminated effective today…"[88] This process has repeated itself in states across the country that have installed Amazon Laws.

Amazon Laws are also running into legal trouble. In New York State, for instance, Amazon and Overstock.com filed claims against the State asserting that New York's Amazon Law was "invalid, illegal, and unconstitutional" based on a *Quill* analysis.[89] Although the action was dismissed by the trial court, it was reinstated on appeal in a ruling by the state appellate court that the previous dismissal was premature.[90]

Other solutions have also faltered. Some states have tried constructing "cooperative agreements between states" involving "each state [agreeing] that if an out-of-state buyer makes a purchase from a vendor within their state, the vendor will collect and remit the applicable use-tax to the state where the buyer has the purchase delivered."[91] This has been largely ineffective since purchasers can get around these agreements by having the goods delivered to a family member or friend outside of the agreeing jurisdiction.[92]

Since states do not have the ability to enforce taxation of online sales, a federal solution is necessary.

Conclusion

While there is no silver bullet for fixing the budgetary crises our states are currently confronting, there are ways to close tax loopholes that allow citizens to escape their duty to pay taxes currently owed. As shown, the debate over the *Marketplace Fairness Act* should not revolve around a traditional Republican-Democrat theorem on taxes and tax structure, but rather, around the fundamental premise of abiding by the law. The Act is not a new tax, it is not prohibited by the Constitution, and it will not create an undue burden on private retailers or interstate commerce. It is, in essence, a net positive for all. For states, it will bring new revenue that, under current law, it is entitled to. For citizens, it will streamline paying taxes for purchases, as they are currently legally obligated to do, and will simplify chaotic and onerous tax codes across the country. For the online retailer, it will make their duty to collect taxes easier and more straightforward. For the brick and mortar retailer, it will level a playing field that has been uneven, in violation of the laws concerning use taxes, for nearly 20 years.

This Act will be mutually beneficial to everyone involved and will pass constitutional muster, and, for those reasons, it is anticipated that Congress will ultimately vote in its favor; though, as of the end of the 2012 calendar year, a vote on the bill has been postponed until the 113th Congress.[93] Senators Alexander and Durbin will be members of the 113th Congress and Senator Durbin has already stated he is committed to championing this cause in the next legislative session. ⌘

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[17]*Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[18]*Id.*

[19]*Id.*

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Section on Taxation Upcoming Events

Beyond the Beltway
By Brian C. Power

The FBA's Section on Taxation has an upcoming event scheduled for Beyond the Beltway. The event is on October 17 in conjunction with the FBA Southern District of New York chapter. Brian Power will present along with Liz McGee, an associate at Shearman & Sterling. This event will be something of an update to the CLE the Section put on in April in conjunction with the NYU School of Law. Again, CLE credit should be available.

Upcoming FBA Events

Webinar: Cyber Security for Lawyers & Recent Ethics Opinions About Cloud Computing
Wednesday, October 16, 2013 // 1-2pm EDT

Webinar: Emergence of the Mid-Size Law Firm
Wednesday, November 6, 2013 // 1-2pm EDT

D.C. Indian Law Conference
November 15, 2013 // Washington, D.C.

Tax Law Seminar
February 28, 2014 // Washington, D.C.

Midyear Meeting
March 29, 2014 // Arlington, Va.

Indian Law Conference
April 10-11, 2014 // Santa Fe, NM

Insurance Tax Seminar
May 29-30, 2014 // Washington, D.C.

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