Certainty at Last

Safe Harbor Guidance Issued for Historic Tax Credit Transactions

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On January 8, 2014, the U.S. Treasury and IRS issued a revised Revenue Procedure 2014-12 ("Guidance") establishing a "safe harbor" for federal historic tax credit (HTC) investments made within a single tier or through a master tenant structure. This responded to the decision in *Historic Boardwalk Hall, LLC v. Commissioner*[1], in which the U.S. Circuit Court of Appeals for the Third Circuit held that the purported investor was not a partner in the partnership that owned the rehabilitated project because it possessed neither a meaningful upside potential nor a meaningful downside risk. The *HBH* decision created uncertainty that produced a substantial dislocation in the equity market.

The new guidance does not establish substantive tax law. Rather it creates a "safe harbor" for structuring HTC transactions. Compliance with the terms of the guidance provides certainty that the HTC generated by a project will be treated as allocated to the investor and that the investor will be respected by the IRS as a partner in the allocating partnership for federal tax law purposes.

The guidance does not address other types of federal or state credits or transactions combining federal historic tax credits with federal low-income housing or new markets tax credits.

Structuring historic tax credit transactions to comply with the guidance will necessitate significant changes in underwriting and review practices, but we are optimistic that the guidance successfully establishes a structure that will permit both developers and investors to achieve their goals in these deals.

Cash Distributions, Flips

The guidance makes clear that there is no minimum amount of cash that must be distributed by the partnership to the investor. As a result, "community benefit" projects (e.g., museums, community theaters) that do not generate substantial cash returns can satisfy the upside return requirement of the guidance even if the aggregate cash generated by the investment will not exceed the amount of the investor's capital contribution.

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The investor must receive a reasonably anticipated value, exclusive of tax benefits, commensurate with its percentage interest in the partnership. IRS and Treasury have informally indicated in a public conference that the investor does not need to receive an interest in current cash flow from operations of the project equal to its percentage interest in the partnership and that a portion of the reasonably anticipated value may be derived from its interest in the residual value of the project. The economic value of the investor's interest may not be reduced through fees, lease terms, or other arrangements that are "unreasonable" compared to the terms found in real estate development projects that do not qualify for the HTC. Specifically, subleases of the project to an entity affiliated with the developer or the partnership are a type of agreement that will be deemed to be "unreasonable" if not mandated by a third party. Similarly, subleases are deemed "unreasonable" if their term is not shorter than that of the master lease.

The guidance authorizes "flips" in the partnership interests of the developer and the investor after the end of the five-year tax credit recapture period. The developer's interest at all times must be at least 1% and the investor's interest at least 5%. To the extent that current cash is deferred, the post-flip percentage held by the investor should be increased over the 5% minimum.

Example 1 in the guidance shows a flip in the developer/investor interests, respectively, of 1%/99% at the beginning of the transaction to 95%/5% later.

Preferred returns to investors are permitted. However, the reasonably expected value of the investor's interest must be contingent upon the success or failure of the activities of the partnership and the investor must have a reasonable possibility of receiving meaningful cash in excess of any preferential return.

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[1] 694 F.3d 425 (3d Cir. 2012), cert. denied, US No. 12-90, May 28, 2013

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Allowable Risk Protections, Put Options

The guidance provides for meaningful downside risk in part by requiring that at least 20% of the investor's total expected capital contribution be contributed before the project is placed in service and maintained for as long as the investor owns an interest in the partnership. Moreover, at least 75% of the investor's expected capital contribution must be fixed before placement in service. This provision effectively limits timing and delivery tax credit adjusters to 25% of the expected investor capital contribution. The contribution of the "fixed" portion of the investor's investment may be subject to the satisfaction of contingencies such as placement in service or stabilization of the project or the receipt of a Part 3 approval from the National Park Service.

To further ensure that the investor bears some risk of loss, the guidance prohibits funded guaranties and a clearly defined range of "impermissible" guaranties. The definition of "funded" guaranties curiously includes any guaranty for which the guarantor agrees to maintain a minimum net worth. Impermissible guaranties include any guaranty of partnership distributions or other economic return, and any guaranty of tax structural risk or other disallowance or recapture events not due to an act or omission of the developer.

No person involved in the rehabilitation transaction may pay the investor's costs or indemnify the investor for expenses incurred in connection with an IRS challenge of the HTCs. The guidance confirms that the investor may require a guaranty with respect to damages it has incurred as a result of the developer's actions or inactions, including a breach of a representation, warrant, or covenant that involves actions or omissions of the developer. While the guidance does not specifically address casualty losses that

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Industry Welcomes Guidance, Expects Renewed Equity Flow

Historic tax credit industry participants have welcomed and praised the new IRS safe harbor guidance and are optimistic that it will eventually restore a healthy flow of equity investment capital for new projects. But they suggested it will be a number of weeks before the spigot turns on fully because of ambiguous or challenging parts of the guidance that need to be clarified or addressed and until investors, developers, and practitioners come to consensus on acceptable features of partnership structures for new deals.

One thing is certain: The structures of future historic tax credit transactions will be significantly different from those in the past, shifting greater risk to investors while also providing them greater potential upside.

The industry has experienced a fiscal "chill" since the *Historic Boardwalk Hall* decision in August 2012. The decision created uncertainty about whether typical federal historic rehabilitation tax credit deals would be respected by the IRS for federal tax law purposes, prompting a number of major traditional investors to stop or cut back on fresh equity investment commitments for new projects. Some historic credit deals have closed since the decision but with some revisions to partnership structures compared to pre-*HBH* deals.

New IRS Revenue Procedure 2014-12 is the end product of a lengthy dialogue between historic credit industry participants and IRS/Treasury officials that began April 2013 when the industry requested formal guidance on allowable historic tax credit partnership structures to provide certainty and comfort to investors and thereby enable new projects to move forward. *(Revised Rev. Proc. 2014-12: http://tinyurl.com/kjf98uf)*

New Guidance Lauded


John Leith-Tetrault

"The overall reaction is relief, and a belief, based on conversations we've had over the last couple of weeks, that this is going to restore the flow of capital to the historic tax credit business," said John Leith-Tetrault, chairman of the Historic Tax Credit Coalition and president of the National Trust Community Investment Corporation, a syndicator of historic and new markets tax credits. "We're getting a lot of positive reaction from developers, investors, accountants, and lawyers and feel like the consultative process that we had with the IRS and Treasury really worked."

"I think Treasury and IRS did a very good job in trying to create a safe harbor and a road map for the industry to move forward after *Historic Boardwalk*," said Washington, D.C. tax attorney Jerry Breed, a partner at Bryan Cave LLP.

Several major corporate investors in historic tax credit transactions welcomed the new guidance.

"We have a pipeline of historic deals that we're really excited to

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result in recapture, IRS and Treasury have indicated that the risk of casualty loss must be borne by the investor. There is no prohibition against an investor procuring third-party insurance covering risk associated with "impermissible" guaranties, including loss of credit due to a casualty. Except for "impermissible" guaranties, unfunded guaranties may cover 100% of environmental liabilities and the amount of the HTC or the capital contributed to the partnership with respect to the HTC due to the developer's failure to complete the project. The investor may also be protected by an operating deficit reserve equal to no more than 12 months of project operating expenses and an operating deficit guaranty, which may be unlimited.

A developer may not hold an option to acquire the investor's partnership interest. However, the investor may hold an option to put its partnership interest to the developer for an amount not exceeding its fair market value. While a put of the investor's interest at a nominal price below fair market value is permissible, an investor may not abandon its interest. Investors doing so will be deemed to have acquired the interest with the intention of abandoning it, unless the facts clearly establish that the interest is worthless.

While the standards set forth in the guidance provide considerable clarity to the industry, questions remain for taxpayers and practitioners.

Conservative Approaches Expected

Because the guidance shifts 100% of the tax structure risk to the investor, we expect that investors will impose rigorous standards to ensure compliance with the guidance, to try to minimize or eliminate this risk. Investors will likely underwrite the guarantors more stringently at the outset of the transaction, including requiring principals rather than entities to provide the guaranties (since the guidance bars ongoing financial covenants). During the period between *HBH* and the new guidance, some investors in historic transactions used capped recapture guaranties as a way to establish risk of loss, but such caps are no longer necessary after the issuance of the guidance. Since the guidance does not require such a cap on guaranties (apart from effective cap on timing and basis adjusters), it is unlikely that investors will continue using such an approach going forward.

When structuring new transactions, developers will also need to consider the increased scrutiny on fees, lease terms, and any other arrangements that reduce cash flow to the investor, to assure that the investor receives a reasonably anticipated value commensurate with its percentage interest in the partnership, separate from any tax benefits, that is not substantially fixed in amount.

While the standards set forth in the guidance provide considerable clarity to the industry, questions remain for taxpayers and practitioners. The guidance is not precise in defining "unreasonable" fees, lease terms, and other arrangements. Thus, compliance with the safe harbor will depend upon a comparative analysis of the terms of similar non-HTC real estate development projects. For most industry participants, this requirement will necessitate an additional layer of underwriting and review that will not lend itself to "bright-line" interpretations. Investors may consider obtaining a third party "fairness" opinion with respect to fees, rent payments and "other arrangements" paid to affiliates of the developer to establish the reasonableness of such payments. Even with this material issue remaining, we believe that, taxpayers, using the standards established in the guidance, will be able to create deal structures for new historic transactions that will be acceptable to both the IRS and to the parties participating in transactions.

Effective Date

The guidance is effective for projects that are placed in service on or after December 30, 2013. Transactions closed but not yet placed in service may be amended to be consistent with the terms of the guidance. Taxpayers should consider conforming such transactions to the safe harbor requirements. Transactions placed in service prior to December 30, 2013 that meet the requirements of the guidance will not be challenged by the IRS. However, such transactions are unlikely given the specifics of the guidance. TCA

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move forward with now that we have a safe harbor," said senior executive David Leopold of Bank of America Merrill Lynch, who said BofAML in 2013 closed six transactions utilizing historic tax credits, far fewer than the bank's normal annual volume prior to *HBH* and the recession. "We intend to operate in line with the safe harbor guidance and execute on that pipeline and build it," he said.

Executive Matt Philpott of U.S. Bancorp Community Development Corporation, in a statement, said: "Last year we experienced significant uncertainty in the industry, and we believe that this guidance will be useful in getting this important tax credit back into the service of helping fill financing gaps in historic property rehabilitation. The clarification to certain features under the safe harbor is helpful and appreciated. We expect to work with the guidance immediately as applicable in our tax credit equity investments."

Areas of Certainty, Uncertainty

Some sources believed that virtually all new historic tax credit partnerships and projects will be structured to meet all requirements to qualify for reliance on the safe harbor. A partnership structured to satisfy the safe harbor requirements will be respected by the IRS for federal tax law purposes and not challenged. Still, the guidance provides that partnerships not fully meeting the safe harbor requirements won't automatically be deemed as suspect.

Sources said some objective standards in the guidance should be easy to satisfy in structuring new deals. Examples include the requirements that the developer/general partner have at least a 1% interest in the partnership and that the investor/limited partner contribute at least 20% of their anticipated total capital contribution before the project is placed in service, according to Boston tax attorney Forrest Milder, a partner at Nixon Peabody LLP.

Photo courtesy of Nixon Peabody LLP

Forrest Milder

Still, some areas of uncertainty need to be resolved.

"We've certainly taken a major step with the guidance," said Boston attorney William Machen, a partner at Holland & Knight, "but there's still some clarifications and stuff like that that we're going to need to make this thing really work."

Some of the biggest challenges, tax attorneys said, are getting clarification of some definitions and formulating acceptable procedures to verify that certain traits of proposed historic tax credit transactions are comparable to those in conventional, non-HTC real estate projects. For instance, the guidance provides that the value of an investor's partnership interest "may not be reduced through fees (including developer, management, and incentive fees) that are unreasonable as compared to fees, lease terms, or other arrangements" for a non-HTC real estate project.

The guidance doesn't define "unreasonable" nor conversely shed light on what would be considered reasonable. Accordingly, for example, practitioners will have to make judgments as to the allowable types and size of fees that reduce the amount of project cash flow available for distribution to the investor.

Machen felt it will probably be necessary to hire a third-party expert with good credentials, such as an appraiser or market analyst, "to come in and confirm that the terms of your deal are consistent with those of non-credit transactions."

The attorneys also said some features of typical past historic tax credit projects differ from those of conventional commercial real estate projects, making comparisons difficult.

In addition, the guidance doesn't allow for net worth and liquidity requirements to be imposed on providers of various permitted guarantees, such as on the general partner, even though these are common in conventional real estate transactions and in past historic tax credit deals. However, several attorneys suggested a possible workaround might be to "piggyback" on the net worth requirements imposed by lenders, which aren't barred.

Current Projects, Pricing Impact

While the safe harbor guidance is intended to provide certainty for future historic tax credit deals, several sources anticipated reviewing the terms of existing historic tax credit deals in the pipeline and projects that have closed but not yet been placed in service to determine whether to make modifications to comply with the safe harbor.

The other big unknown is what impact if any the revised deal structures will have on the price investors are willing to pay developers for federal historic tax credits. While new deals structured under the safe harbor will require investors to bear greater risk than on typical historic deals of the past, their likely share of the partnership before any flip will be slightly smaller (99% vs. 99.99%) and any preferential return can't be guaranteed. But they will have the opportunity for greater economic gain if a project is very successful.

Despite all the remaining certainties, sources are generally optimistic that the new guidance will put the historic tax credit industry back in a healthy place.

"I think people will figure out how to do it," says Milder. "And that will improve the marketplace terrifically." TCA