



Tough Times for Historic Credit Deals Clock Ticking As Equity Dries Up

“It’s extremely alarming,” says Hal Fairbanks, Vice President of Acquisitions at New Orleans-based HRI Properties, a company that specializes in developing real estate projects using the federal historic rehabilitation tax credit. “We have a couple of large, 500,000-square-foot-plus buildings under contract – the clock is ticking on our due diligence. And in many cases we’re already hard on our deposits. And we can’t find someone who will issue an historic credit term sheet.”

The historic tax credit industry has been roiled by a sharp curtailment in closings of historic tax credit transactions and the availability of new equity commitments from major investors for new projects, as investors, tax attorneys, accountants, and others mull the tax structures of deals for possible modifications before resuming business as usual.

“Because of events of the last six months or so, a number of investors have – at least temporarily – pulled out of the market,” says Eric Darling, a partner at Boston-based Carlisle Tax Credit Advisors. “And the reason is the uncertainty as to what type of deal could be approvable by the IRS.”

As of mid-April, at least one traditional major investor was not making new investments in historic credit projects and at least one was said to have paused on closing deals. This is an industry with few major investors: Bank of America Merrill Lynch; Chevron; PNC; Sherwin Williams;

and U.S. Bancorp Community Development Corporation.

Hardest hit are “standalone” projects planning to use only federal historic tax credits. But some “twinned” projects combining federal historic and new markets tax credits have also been affected. Industry officials said projects combining federal low-income housing and historic tax credits generally haven’t been affected. Federal tax rules provide that sponsors of LIHTC don’t need to have a profit motive, and the amount of housing credits in twinned deals usually dwarfs the historic credits.

Series of Stunners

The quaking in the historic credit industry began in earnest in August 2012 when a federal appeals court, in the *Historic Boardwalk Hall* case, overturned a U.S. Tax Court decision and upheld the IRS’ disallowance of historic credits allocated to the investor on the grounds that it was not a true partner in the partnership for federal tax law purposes because it lacked any “meaningful” upside or downside in the transaction. In January 2013, a federal court, in the *Consolidated Edison* case, sided with the IRS in a “lease in/lease out” transaction that stirred concerns about the use of put options in federal historic and new markets tax credit transactions. The angst intensified again in late March with a newly released IRS Chief Counsel Memorandum (No. 20124002F). This

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focused on a specific historic tax credit transaction under IRS scrutiny and cast a shadow on some deal structure characteristics that were common in many historic tax credit transactions prior to the *Historic Boardwalk* decision.

These events rattled an industry already nervous about a number of pending IRS audits of historic tax credit transactions.



Jeff Huggett

"The industry is slowing down substantially because there's a lot of unknowns out there," says developer Jeff Huggett, a partner at Dominionium, a Minneapolis-based company that frequently uses historic tax credits. "There's large investors that won't write commitments right now because they want to understand what's an acceptable structure and what's not."

St. Louis CPA Bryan Keller, of RubinBrown LLP, echoed, "Unfortunately I think the dust has got to settle again before we're going to see people back in the market."



Bryan Keller

In *Historic Boardwalk*, the court didn't provide any guidance on what would be considered meaningful upside or downside for an investor. In *Consolidated Edison*, the court didn't say how put options might be structured to satisfy federal tax rules.



Jerry Breed

Washington, D.C. attorney Jerry Breed, a partner at Bryan Cave LLP, indicated that there is no consensus so far among tax attorneys on exactly how the structure of historic tax credit deals should be modified to make attorneys, investors, accountants, and developers

comfortable that a transaction will likely be safe from IRS audit.

Formal Guidance Sought

The industry, meanwhile, has taken action to try to resolve the present situation. Members of the Historic Tax Credit Coalition, an industry group, met April 9 with U.S. Treasury and IRS officials to discuss the industry's concerns, get reaction to examples of hypothetical deal structures, and ask for formal guidance on acceptable tax structures for historic tax credit deals.

"It was an amicable meeting," said one industry

attendee. "They were certainly listening to us."

Federal officials did not commit to anything. However, one possibility might be to place a guidance project on the IRS' forthcoming Priority Guidance Plan, which will list rulemaking and tax guidance projects that the Service intends to initiate or complete during the one-year period beginning this July 1. Industry officials also asked, though, if something could be issued sooner, such as interim guidance. The next step and the timing of any guidance is unclear.

Some industry officials hoped for something like an IRS revenue procedure issued in the 2000s that provided a safe harbor for wind energy tax credit deals.

Sources said historic tax credit deal structures have been modified since the *Historic Boardwalk* decision and continue to evolve, but there is still no uniformity.

"What investors are trying to do now," said Michael Bernier of Ernst & Young LLP, "is float some of these new structures out before they go too far into it, to try one or two on a test case and see how developers like it and see where there's the most pushback."



Michael Bernier

Structures for new historic credit transactions have been modified since *Historic Boardwalk* to increase the risk and financial return to the investor and to reduce the risk and return to the developer. This has been done by limiting or reducing various guarantees by the developer to the investor, making the investor contribute more capital earlier, giving the investor a larger preferred return that isn't guaranteed, and giving the investor a bigger share of a project's operating profits. Put options have also been modified or eliminated.

"At the end of the day it benefits both parties," says Springfield, Mo. attorney Shawn Whitney, a partner at Husch Blackwell LLP. "The developer is not having to be the only one on the hook on these deals anymore. And the investor, what they're losing in risk mitigation, they're gaining in the upside share of the profits of the project."

Some historic tax credit deals – those in the pipeline that already had equity commitments from major investors – are still closing. But some closings have been postponed. The biggest dilemma is for new projects without investor commitments.

David Leopold of Bank of America Merrill Lynch said the bank is moving forward with all of the historic tax credit deals and was "getting more calls" that he anti-

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pates will result in a growth in its pipeline.

"We've worked very closely with the leading law firms in the industry to tweak our deal structure to conform with *Historic Boardwalk Hall, Con Ed*, and everything else that's been put out there," he said. "We've made those changes and we're still closing deals."



David Leopold

He said the structure has not been uniform from deal to deal, and that the bank has changed the structure of puts in transactions that have them.

"We do not think, and all of the attorneys and accountants with whom we've spoken do not think, that there is one thing to do on every historic deal and you're good," says Leopold. "We think that it's about the overall structure and are you conforming to the letter and the intent of the tax code and the reg."

While new equity commitments are harder to come by from major investors, Whitney indicated that some local financial institutions such as state-chartered banks are willing to make equity investments in historic credit

projects. "I'm seeing a shift where developers are reaching out to them," he said. Whitney said these institutions allow a little more flexibility in transactions and, because they often do deals on a one-off basis, may not feel that when they do a transaction that they are setting a precedent for the structure of future deals.

New Markets Impact

The new markets tax credit market has also been affected because many NMTC deals are twinned with historic tax credits. Also, NMTC transactions typically have a put option that is exercised by the investor. In *Consolidated Edison*, the court held that the tax shelter transaction lacked substance due to the "reasonable likelihood" that the purchase option would be exercised.

It's difficult to get a good read on whether the court decisions and IRS memo will affect investors' appetite for new standalone NMTC transaction and the structure of such deals. As of early April there was little if any uncommitted NMTC allocation authority available for new transactions. The picture will quickly change, though, as the CDFI Fund is expected to announce new NMTC allocation awards by the end of April. **TCA**

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