Tax Attorneys Work on Framework for Revised Historic Tax Credit Deal Structures

After weeks of conference calls and meetings among themselves and with accountants and investors about the impact of the *Historic Boardwalk Hall* decision by the U.S. Court of Appeals for the Third Circuit, tax attorneys are beginning to arrive at a general framework for necessary modifications to the structure of new federal historic rehabilitation tax credit transactions to give them comfort to issue should-level tax opinions. But there is no uniform set of standards yet and the situation is still evolving, said several practitioners.

Meanwhile, the taxpayer in *Historic Boardwalk Hall* filed a petition on October 10 asking the Third Circuit to rehear the case. *(Text: http://tinyurl.com/9t4n8xc)*

The tax credit industry was thrown into a tizzy on August 27th when the Third Circuit overturned a U.S. Tax Court decision, holding that Pitney Bowes was not a bona fide partner in a partnership formed to own, renovate, and operate the historic former Atlantic City convention center. The court said Pitney Bowes – the historic tax credit investor – lacked a meaningful stake in the success or failure of the business venture because it had no meaningful risk of investment loss and no potential for meaningful upside beyond the tax credits and a preferred return. It thereby supported a reallocation of the historic tax credits from the investor to the partnership. *(For details, see* Tax Credit Advisor*, October 2012, p. 8.)*

Transactions Moving Forward

The historic tax credit community has struggled since the decision because the Third Circuit didn't provide guidance on the specific minimum levels of risk and potential upside that it would consider sufficient to treat an investor as a bona fide partner in a partnership and thereby respect a transaction for federal income tax purposes.

The decision prompted a temporary postponement of closings for new historic tax credit transactions, though Boston tax attorney Forrest Milder, a partner at Nixon Peabody LLP, said some transactions have closed recently and many others are on track to close.

Milder and Washington, D.C. tax attorney Jerry Breed, a partner at Bryan Cave, LLP, reported that tax practitioners have made progress towards consensus on some of the revisions that should be made to historic tax credit deal structures to pass muster under *Historic Boardwalk Hall*. However, individual law firms are coming up with their own standards regarding investor capital contribution schedules, appropriate levels of guarantees from developers to investors, etc.

The overall anticipated structural changes are designed to make sure that historic credit investors have significant levels of investment risk and of potential financial gain beyond the tax credits and preferred turn.

"The tax credit community is coalescing towards an approach to the case that will permit historic rehab transactions to close," Breed said. "As the case looked at the totality of the circumstances, so post-Historic Boardwalk tax opinions will also examine the totality of the circumstances in the transactions. So people can adjust one or more general factors up or down depending upon the particular goals and sensitivities of investors and developers to the issues that arise in trying to close these transactions. The focus is primarily on creating and making certain that there is a downside risk, or a risk of loss, to the investors that is not fully protected. And, on the flip side, an upside potential [to investors] that is not limited to a preferred return. Different factors can be used to create that risk or to create that upside potential."

Breed said his firm has settled on an approach and set of factors to consider in reviewing new historic tax credit transactions for purposes of writing an opinion – an approach and set of factors reflected in should-level tax opinions it has circulated for some historic credit transactions that will close soon.

Milder is recommending a "three-bucket approach," comprised of "must have, must not have, and nice to have" features in a transaction. This is not a lengthy list of specific features. Rather, Milder cites a few examples in each category as illustrations.

As an example of a "must have," to increase risk to investors, Milder cited investor capital coming into deals earlier – a change Breed mentioned as well.

"Most advisers are requiring that investors contribute capital during the construction process and generally at closing," said Breed. "But it could be done in

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installments through the construction process. And that that capital is at risk in the deal. So that if the deal would unravel, the investor wouldn't necessarily get all of that capital back. The amount of the capital may change from investor to investor, and change on the facts in the deal. Most people are looking at something in the range of 20%."

The two attorneys said investor risk could also be bumped up by scaling back the guarantees developers typically provide to limited partners so that investors are not fully protected. Breed expected a reduction in tax credit guarantees so investors wouldn't recoup their full investment amount if there is a shortfall in credit delivery. He also felt that project operating deficit guarantees will be reduced in some fashion, which he noted could be done in different ways (e.g., shorter time period, absolute dollar amount cap). Breed didn't expect changes to construction completion guarantees.

Both Breed and Milder felt that a "must not have" for transactions going forward is the use of guaranteed investment contracts (GICs) or letters of credit to guarantee developer payment obligations to investors, such as of a preferred return or a call purchase price.

On the flip side, the pair expected changes to provide investors the opportunity for additional financial benefits above the tax credits and a preferred return, such as allocating investors a decent share of a project's excess cash flow or net operating income. This wouldn't be guaranteed so such payment and the size would depend on the degree of success of the project.

Breed also felt that preferred returns will be modified and that the share of residual benefits to investors will be increased.

Again, he felt there will be variations in standards applied across the industry.

"Different firms, different participants in the process, are going to come out with different percentages and different approaches as to how to structure these thing, with different amounts of upside and how that is measured and structured in the transaction," Breed noted.

Milder observed that these kinds of features, as well as other more subjective ones like market studies, make up his third bucket of "nice to haves," which he said should vary from deal to deal depending on which fit the particular transaction. TCA