



## Post Rev. Proc. 2014-12 Trend Emerges: Developer Fee Reasonableness Opinions

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**T**he U.S. Department of the Treasury issued Revenue Procedure 2014-12 Dec. 30, 2013.

It establishes a “safe harbor” for historic tax credit (HTC) investments made within a single tier or through a master tenant structure. The guidance was issued in response to the effect of the decision in *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425 (3d Cir. 2012), cert. denied, US No. 12-90, May 28, 2013 (HBH), in which the Third Circuit held that a purported investor in a single-tier structure 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 guidance was issued to resolve a chilling effect on the tax credit equity market regarding the application of the HBH decision. Rev. Proc. 2014-12 does not establish substantive law, but rather creates a “safe harbor” for structuring transactions which, if followed, will be respected by the IRS.

Among the items addressed in Rev. Proc. 2014-12 is the topic of arrangements to reduce the value of the investor’s partnership interest. The guidance states,

“the value of the investor’s partnership interest may not be reduced through fees [including developer, management and incentive fees], lease terms, or other arrangements that are unreasonable as compared to fees, lease terms, or other arrangements for a real estate development project that does not qualify for Section 47 rehabilitation credits, and may not be reduced by disproportionate rights to distributions or by issuances of interests in the partnership [or rights to acquire interests in the partnership] for less than fair market value consideration.”

This portion of Rev. Proc. 2014-12 has led many investors, developers, and industry players to contemplate what are reasonable fees in HTC transactions. Specifically, many HTC professionals have come up with various ways to determine reasonableness of a developer fee in HTC transactions.

Novogradac Consulting LLP prepares reasonableness reports to aid investors and tax counsel in determining if a related-party fee is reasonable. We are most often asked to provide a determination regarding whether the developer fee is reasonable and market-oriented.

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The following discussion reviews the methodologies that could be used in determining the reasonableness of a developer fee within HTC transactions.

Novogradac's research indicates that typical developer fees vary based upon a number of factors. Considering that the question centers upon a fee for service, the assumption is that the developer retains no equity in the transaction and is simply performing assigned tasks for an agreed-upon fee.

The interviewees commonly indicate that a number of characteristics influence the determined developer fee for a project, including:

- level of effort anticipated, the different responsibilities could include:
  - ◊ financial structuring,
  - ◊ debt acquisition, and
  - ◊ managing environmental remediation
- complexity of the real estate
- new construction versus adaptive reuse
- overall size and cost of a given development
- infill sites versus greenfield sites
- timing of fee payments
- whether the developer fee is at risk
- incentive payments
- degree of competition within the development environment

To test the market-orientation of the developer fee, we complete a review of the development services agreement (DSA) to determine the authorities and obligations of the developer. Typically the DSA includes several items that would not otherwise be present for a non-HTC funded development. Developers and advisors indicate that the amount of documentation that is required is significantly higher in the subject-type development versus a straight market-rate development. Many requirements are considered onerous and often require unique procedures and policies to implement.

These additional obligations result in increased efforts from the developer in order to reach project completion and ultimate payment of the developer fee.

Novogradac examines key features of the particular subject property that would impact the analysis, including but not limited to adaptive reuse, urban infill location and real estate type. The developer will provide developer fee data points for their prior undertakings. If the prior data points pertain to credit-enhanced transactions, we will not rely on the data points.

For each reasonableness report, Novogradac conducts numerous interviews with developers and real estate professionals from the local market and surrounding metropolitan areas in addition to interviews with development professionals particular to the subject real estate type. We supplement this information with developer fee data from various industries.

Often, the developer fee will be partially deferred. Developers in market transactions view this payment option less favorably, as it places at risk their compensation and the value of a dollar is less tomorrow than today. However, most clients ask this question in light of what is a qualified expense. We understand from various legal counsels that it is important to analyze the fee as if it were paid in full upon completion as is typical in a market transaction. Therefore, while the developer fee may be partially deferred, which would argue for a higher developer fee to compensate for the time value of money and the added risk of payment, Novogradac typically assumes all is paid at closing for our analysis.

Generally, market participants indicate that for real estate developments with limited complexity, developer fees paid typically fall below 10 percent, with most fees being in the low to mid-single digits as a percentage of costs less acquisition, reserves and the developer fee itself.

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Market participants report that elevated developer fees are typically a result of more complex projects, including those that involve the reuse of historic structures. Further, developers of HTC transactions are obligated to perform tasks that are not generally present for non-historic real estate projects. This includes coordinating with various agencies such as the state historic preservation office (SHPO) and managing various submittals in addition to coordinating with historic consultants.

The discussion above illustrates the complexities of determining the reasonableness of the developer fee under Rev. Proc. 2014-12. Developers contemplating or developing HTC projects should become familiar with the guidance and consult with attorneys and other HTC professionals to determine the best methodology for determining reasonableness of developer fees and all other related-party fees. ❖

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*This article first appeared in the March 2016 issue of the Novogradac Journal of Tax Credits.*

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ISSN 2152-646X

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