Historic Tax Credit Coalition

To:	Historic Tax Credit Coalition Members
From:	IRS Guidance Committee
Authors:	Jerry Breed of Bryan Cave, Bill Machen of Holland and Knight and Forrest Milder of Nixon Peabody
RE:	**IRS Guidance**
Date:	January 10, 2014

On December 30, 2013, and in revised form with two clarifications Janauary 8, 2014, Treasury issued Revenue Procedure 2014-12 ("Guidance") which 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 meetings between representatives of the Historic Tax Credit Coalition, IRS and Treasury to discuss the affect 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 ("Partnership") that owned the rehabilitated project ("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 equity market regarding the application of the HBH decision.

The Guidance does not establish substantive law, but rather creates a "safe harbor" for structuring transactions which, if followed, will be respected by the IRS. The Guidance addresses only HTC transactions and does not address other federal credits, state credits, combined HTC and LIHTC transactions or combined HTC and NMTC transactions. By strictly following the terms of the Guidance and underwriting requirements necessitated thereby, taxpayers can be certain that the HTC generated by an investment will be allocated to the Investor and that the Investor will be respected as a partner in the allocating Partnership. Recognizing that structuring transactions in compliance with the Guidance will necessitate significant changes in underwriting and review practices, we are optimistic that the Guidance successfully establishes a structure that will permit both developers and Investors to achieve their goals in HTC transactions. The highlights of Revenue Procedure 2014-12 are summarized below.

The Guidance makes clear that there is no minimum amount of cash that is required to be distributed to the Investor. As such, "community benefit" projects such as theaters and museums that do not generate substantial cash returns can satisfy the upside return requirement of the Guidance. The Investor must receive a reasonably anticipated value, exclusive of tax benefits, commensurate with the Investor's percentage interest in the Partnership. While the meaning of "commensurate" is not precisely known at this time, cash flow and residual distributions in accordance with the current percentage interest of the Investor clearly would be "commensurate". Accordingly, cash flow equal to 99% of the cash flow of the master tenant during the initial five-year period after placement in service followed by a 5% interest in cash flow and residual in subsequent periods after a flip of partnership interests as described below, subject to Section 704 allocation rules and taking into account capital account balances, would clearly satisfy the "commensurate" standard.

The emphasis of the Guidance is on ensuring that the economic value of the Investor's interest is 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. Thus, compliance with the Guidance is dependent upon a comparative analysis of the terms of 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. The Guidance does provide some bright-lines with respect to types of agreements that will be deemed to be "unreasonable". Specifically, arrangements involving subleases of the Project to an entity affiliated with the Developer or the Partnership are deemed "unreasonable" if they are not mandated by a third party. Similarly, subleases are deemed "unreasonable" if the duration of the sublease is not less than the duration of the Master Lease. While the Guidance is not precise in defining "unreasonable" fees, lease terms and other arrangements, we believe that taxpayers will be able to create structures that will be acceptable both to the IRS and to the parties to the transaction. The revised version of the Guidance issued January 8, 2014 clarified that fair market value of a Partnership interest is determined by taking into account only those contracts and arrangements that are not "unreasonable" under the standard.

We note that the Guidance authorizes "flips" in the Developer and Investor Partnership interests after the end of the recapture period. The minimum interest to be held by the Developer is one percent and the minimum percentage to be held by the Investor is five percent of the

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Investor's largest percentage interest. Example 1 in the Guidance flips the Developer and Investor interests from 1-99 to 95-5 in favor of the Developer. While Investor preferred returns are permitted, the reasonably expected value of the Investor's interest must be contingent and variable based upon the success or failure of the activities of the partnership.

Downside risk is established by the requirement that at least twenty percent of the Investor's total expected capital contribution must be contributed before placement in service and maintained throughout the duration of the Investor's ownership interest in the Partnership and this contribution must not be protected against loss through any arrangement with the Developer (expect permissible guarantees, as discussed below). Moreover, at least seventy-five percent of the Investor's total expected capital contributions must be fixed before placement in service. This provision effectively limits timing and delivery tax credit adjusters to 25 percent of the total expected Investor capital contribution. The "fixed" portion of the Investor's investment may be subject to contingencies such as placement in service, stabilization or receipt of a Part 3 approval from the National Park Service.

To ensure the Investor bears some risk of loss, the Guidance prohibits funded guaranties and a clearly defined range of "impermissible" guaranties. The Guidance curiously includes within the definition of "funded" guaranties 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. Also impermissible is any guaranty of tax structural risk or other disallowance or recapture events that are not due to an act or omission of the Developer.

Similarly, it is impermissible for any person involved in the rehabilitation transaction to pay the Investor's costs or indemnify the Investor for expenses incurred with respect to an IRS challenge of the Investor's claim of the HTCs. 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, thereby seeking to minimize or eliminate the tax structure risk. While the Guidance contains clear standards related to most types of guaranties, it is not clear whether recapture that results from a casualty loss may be included in a Developer guaranty. The Guidance makes clear that there is no prohibition against an Investor procuring insurance covering risk associated with "impermissible" guaranties if such coverage is from persons not involved with the rehabilitation or the partnership. With the exception of the "impermissible" guaranties, unfunded guaranties may cover 100% of the amount of the HTC or the capital contributed to the Partnership with respect to the HTC due to the acts or omissions of the general partner or its affiliates. Unfunded guarantees may cover all of the loss due to failure to complete the Project as well as environmental liabilities. An operating deficit reserve not in excess of 12 months of operating expenses may be established and an operating deficit guarantee capped at 12 months of operating expenses may be provided to the Investor. In the case of a master tenant, operating expenses will include lease payments that inevitably exceed the debt service obligations of the landlord entity.

While a Developer may not hold an option to acquire the Investor's interest, the Investor may hold an option to put its interest to the Developer for an amount that does not exceed fair market value. Abandonment of an investment is not permitted under the Guidance, and an Investor that abandons its interest will be deemed to have acquired its interest with the intention of abandoning it, unless the facts clearly establish that its interest is worthless. Although the Guidance clearly permits a put for less than fair market value, it consistently refers to the Investor's put right as a "fair market value" transfer.

The Guidance is effective for Projects that are placed in service on or after December 30, 2013. Transactions that have closed but have not been placed in service may be amended to be consistent with the terms of the Guidance and taxpayers should consider such amendments. Transactions that were placed in service prior to December 30, 2013 and meet the requirements of the Guidance, which is unlikely given the specificity of the Guidance, will not be challenged by the IRS. Because HTC is generated at placement in service, amendments made after placement in service cannot change the facts that determine compliance with the Guidance on that date and therefore would generally not be effective.