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New Guidance on Historical Rehabilitation Credits May Indicate Tougher Safe Harbors for Other Investment Tax Credits in the Future

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On December 30, 2013, the Internal Revenue Service (the "IRS") released Revenue Procedure 2014-12, which sets out a new "safe harbor" for allocations of the historical rehabilitation credit (the "HRC") among partners in a partnership or members in an LLC (for purposes of this notice, "Members" of a "Project Company"). The new safe harbor is intended to provide a degree of assurance regarding allocations of the HRC for investors in developer and lease pass-through (*i.e.*, inverted lease) partnerships and LLC structures, including those using a "partnership flip" model.

Revenue Procedure 2014-12 was released in response to the Third Circuit's decision in Historic Boardwalk Hall, LLC v. Commissioner, 694 F.3d 425 (3d Cir. 2012), cert. denied, U.S., No. 12-901, May 28, 2013. The Historic Boardwalk Hall decision concerned a partnership investment structure in which the investor's right to a return on its investment was substantially protected such that the investor did not have either a significant downside risk or the possibility of participation in partnership income over and above its preferred return. Accordingly, the Third Circuit held that the investor was not a bona fide partner in the partnership and was not entitled to allocations of HRCs. Revenue Procedure 2014-12 should, therefore, be read as the IRS's attempt to set parameters for structuring partnerships and LLCs that will claim HRCs.

The Revenue Procedure expressly (and repeatedly) states that it applies only to allocations of HRCs and does not set forth rules regarding any other type of federal income tax credit or the determination of whether a person is a partner of a partnership for general federal income tax purposes. Specifically, Revenue Procedure 2014-12 states that the "Treasury Department and the [IRS] do not intend the inclusion of any particular criterion in the Safe Harbor to be an indication either of our views of the significance of that criterion with respect to any other federal or state tax credit transactions, or of whether a Partnership has the requisite benefits and burdens of ownership of a Building." Nonetheless, HRC transactions are similar in many respects to transactions involving other types of investment tax credits, including investments in alternative energy projects. Thus, it is reasonable to assume that the IRS's interpretation of the rules governing those other credits may be to some degree influenced by the provisions of Revenue Procedure 2014-12.

Transaction Structures and Participants

Revenue Procedure 2014-12 discusses allocations of HRCs to Members of a Project Company that either rehabilitates an historical property (a "Developer Partnership") or leases the rehabilitated property from a Developer Partnership (a "Master Tenant Partnership"). Thus, Revenue Procedure 2014-12 provides guidance to both development and lease pass-through (also known as an inverted lease) structures. In addition, the safe harbor expressly

allows a "partnership flip" structure, which allows the developer and the investor to change their allocation percentages after the five-year recapture period expires, provided that certain minimum and maximum percentage and minimum investment requirements are met, as discussed below. Also, the Revenue Procedure expressly permits an Investor to join the Project Company as an initial partner or purchase an interest in the Project Company at some time prior to placement in service of a rehabilitated building.

Revenue Procedure 2014-12 separately provides rules for partners who act as the manager in a partnership ("Principals") and partners who do not act in that capacity ("Investors"). For example, if an Investor receives an allocation of HRCs from a Master Tenant Partnership, then it may not also be, for purposes of the rehabilitation credit, a partner of the Developer Partnership that leases the Project to the Master Tenant Partnership unless the agreement to invest in the Developer Partnership is "separately negotiated" and "distinct." It is not clear how such a separate interest should be structured in order to be deemed "distinct." Other restrictions that specifically apply to Investors and Principals are discussed below.

Substance Requirements

As noted above, the IRS's primary argument in the Historic Boardwalk Hall decision was that the Investor was not actually a member of the Project Company. Thus, it is not surprising that the safe harbor includes provisions concerning this issue. Unfortunately, several of the provisions are rather vague and could create significant risk depending on how the IRS interprets them. Specifically, the Revenue Procedure states that an Investor's interest in the Project Company be a "bona fide equity investment with a reasonably anticipated value commensurate with the Investor's overall percentage interest in the Partnership" without regard to any federal, state, or local tax deductions, allowances, credits, or other tax attributes that will be allocated to the Investor. Furthermore, the value must not be substantially fixed in amount and must also be contingent on the partnership's net income, gain, and loss. Similarly, the Investor's allocations of partnership profit must not be limited to a preferred return that is "in the nature of a payment for capital." It is not entirely clear how these statements should be applied, but they could be read to exclude tax attributes in determining the value of the Investor's interest in the Project Company.

Finally, the Investor must also not have any intent to abandon its interest in the Project Company and is presumed to have intent if it, in fact, abandons its interest at any time, unless the facts and circumstances clearly establish otherwise.

Minimum Investment in the Project Company

Consistent with other published guidance concerning incentive tax credits, including Revenue Procedure 2007-43, which concerns the production tax credit, the Members of a Project Company must maintain a minimum investment. The manager or general partner of the Project Company (that is, the Principal) must have an interest equal to at least 1% in each material item of the Project Company's "income, gain, loss, deduction, and credit at all times during the existence of the [Project Company]." The Investor must, at all times that the Investor is a Member of the Project Company, maintain an interest in each material item of the Project Company's income, gain, loss, deduction, and credit equal to at least 5% of the Investor's percentage interest in each such item during the taxable year in which its percentage share of that item is the largest.

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In addition, the Investor must make a 20% minimum unconditional investment before placement in service and must maintain that minimum at all times that it is a Member of the Project Company. Unlike the minimum unconditional investment restriction in Revenue Procedure 2007-43, the restriction in Revenue Procedure 2014-12 apparently may not be reduced for any reason, including distributions of cash flow. Also unlike Revenue Procedure 2007-43, Revenue Procedure 2014-12 expressly states that the Investor's minimum unconditional investment may not be funded with any note or other obligation made by the Investor.

Furthermore, at least 75% of the Investor's total capital commitment must be fixed before the project is placed in service, and the Investor must have a reasonable expectation that it will completely fund its commitment as it is called.

Restrictions on Directly or Indirectly Impacting the Investor's Return on Investment

Revenue Procedure 2014-12 states that the Investor generally must not be "substantially protected from losses from the Partnership's activities," and lists several specific restrictions to ensure that will not occur. Most of the listed restrictions concern the Principal's ability to provide guarantees to the Investor in respect of the HRC or to protect the Investor from loss. (The Investor is permitted to obtain insurance from a party that is not related[1] to the Principal or the Project Company.) While these restrictions initially appear to be similar to those in Revenue Procedure 2007-43, the restrictions in Revenue Procedure 2014-12 are more extensive and significantly more detailed. The restrictions include the following:

1. None of the Principal, parties related to the Principal, or any other person "involved in any part of the rehabilitation transaction"[2] may insure or guarantee that the Investor will be able to: claim HRCs or its cash equivalent; receive distributions from the Project Company or consideration for its interest in the Project Company (other than the fair market value of such interest); or obtain repayment of any portion of its contribution as a result of the unavailability of HRCs if the IRS challenges any aspect of the transaction structure.
2. None of the Developer Partnership, Master Tenant Partnership, the Principal of either entity, or any person related to either entity or the Principal of either entity may make a loan to the Investor for the Investor to acquire an interest in the Project Company. In addition, none of the listed parties may guarantee or otherwise insure any indebtedness incurred or created in connection with the Investor's acquisition of an interest in the Project Company.
3. No person "involved in any part of the rehabilitation transaction" may pay the Investor's costs or indemnify it for costs if the IRS challenges the Investor's claim of the HRC.

[1] For purposes of Revenue Procedure 2014-12, a person may be related to a Project Company or the Investor by common ownership of the Project Company and certain other types of entities, certain family relationships, or interests in other entities, including trusts, estates, and corporations.

[2] It is not clear who is a person that is "involved in any part of the rehabilitation transaction." In a similar context in Revenue Procedure 2007-43, the Treasury expressly lists several parties that are conceivably related to a wind energy project, including the developer and investors in the project, equipment suppliers, power purchasers, and parties related to them. Presumably, in the context of a rehabilitation transaction, the people involved would include at least the Principal, the Investors, any contractors providing services, and equipment suppliers. It is not clear whether the category would also include a lessee of the property or any federal, state, or local government agency.

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4. The value of the Investor's interest in the Project Company may not be reduced by the Project Company issuing to any person any interests in the Project Company or rights to acquire any interests in the Project Company for less than fair market value.
5. The value of the Investor's interest in the Project Company may not be reduced by granting any partner in the Project Company a disproportionate right to distributions.
6. Allocations to the Members of the HRC must be made in the same ratio as the allocations of general profits to the Members as of the day that the rehabilitated building is placed in service.
7. No person "involved in any part of the rehabilitation transaction" may provide a funded guarantee of any kind to the Investor.

Notwithstanding the above, certain types of warranties, guarantees, and reserves are permitted. Specifically, the Project Company may fund a reserve to cover up to 12 months of its reasonably projected operating expenses. Certain unfunded guarantees may also be made to the Investor, including guarantees that any act necessary to claim the HRC will be performed and that no act or omission will occur that will cause the Project Company to fail to qualify for the HRC or cause the HRC to be recaptured. In addition, unfunded completion and operating deficit guarantees, environmental indemnities, and financial covenants are permitted.

Certain additional restrictions designed to ensure that the value of the Investor's interest in the Project Company is not reduced impact how the Project Company may operate or be structured. Specifically, fees (including developer, management, and incentive fees), lease terms, and other arrangements of the Project Company may not be unreasonable as compared to those offered in real estate developments that do not qualify for the HRC. In addition, if the Developer Partnership leases the building to a Master Tenant Partnership, then the Master Tenant Partnership may not sublease the building back to the Developer Partnership, the Principal of either the Developer Partnership or the Master Tenant Partnership, or a party related to any of the forgoing, unless the sublease is mandated by a third party that is unrelated to the Principal. In addition, any sublease must be for a shorter term than the head lease.

Put and Call Rights

The put and call right restrictions in Revenue Procedure 2014-12 concern the Investor's ability to transfer its interest in the Project Company.[3] Specifically, neither the Principal nor the Project Company may have a right to purchase the Investor's interest. The Investor may have a right to sell its interest to the Principal or the Project Company, but only for a purchase price equal to fair market value (at the time of exercise) or less. For this purpose, fair market value is calculated only by reference to contracts and other arrangements entered into in the ordinary course of the Project Company's business with parties that are not related to the Project Company or the Investor. Thus, while Revenue Procedure 2014-12 does not expressly prohibit the Project Company from entering into contracts with a related party for property management, leasing, or similar purposes, the definition of fair market value restricts the Investor's ability to profit from those contracts.

[3] In comparison, Revenue Procedure 2007-43 concerns a project company's ability to sell a wind energy project.

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For additional information about how Revenue Procedure 2014-12 may impact your planned development project or investment, please contact one of the K&L Gates attorneys listed below.

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