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Guidance Issued on Historic Tax Credit Transaction Structures

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On December 30, the Internal Revenue Service released long-awaited guidance concerning the monetization of rehabilitation tax credits (commonly referred to as historic tax credits). This guidance provides certainty that should thaw the market for these tax credits, providing new opportunities to owners and developers of historic buildings.

Historic Tax Credit Background. A federal income tax credit is available to taxpayers who rehabilitate historic structures; the credit can be equal to as much as 20% of the cost of the rehabilitation. Since many taxpayers involved in the redevelopment of historic buildings do not have sufficient federal income tax liability to utilize this credit, building owners and developers often enter into partnerships with investors who can utilize the credit. The core economic expectation behind these partnerships is that the investor will achieve a targeted rate of return (driven, in large part, by the investor taking the bulk of the available historic tax credits); in exchange, the investor puts money into the redevelopment project, reducing the amount of money the building owner or developer has to raise or borrow. In this way, the building owner or developer can derive value from the tax credits, without utilizing them directly.

Uncertainty in the Market. Over time, developers of, and investors in, these historic tax credit-eligible projects grew more and more creative in designing transaction structures that limited the investors' downside tax and economic risk and upside economic potential. One of these historic tax credit-eligible projects was the restoration of "East Hall," or "Historic Boardwalk Hall," which is located on the boardwalk in Atlantic City, New Jersey (and is the original home of the Miss America Pageant). The IRS challenged the allocation of historic tax credits to the investor in that project; ultimately, in August 2012, the Third Circuit Court of Appeals sided with the IRS, finding that the investor's downside risk and upside potential was so limited that the investor was not a "partner" in the limited liability company that owned the project. Since the court agreed that the investor was not a "partner," the allocation of historic tax credits to the investor was ineffective.

Unfortunately, the Third Circuit's ruling was hard for owners and developers of, and investors in, historic tax credit-eligible projects to interpret, as the court did little to identify precisely which features of the Historic Boardwalk Hall structure it found problematic. As a result, participants in the historic tax credit market were left to guess which transaction features were to be avoided, and which were to be embraced—an uncertainty that significantly chilled the market during the last year and a half. In recognition of the impact the ruling had on the market, the IRS, following the Supreme Court's decision in May of this year to not hear an appeal of the Third Circuit's ruling, promised to issue guidance laying out a "safe" transaction structure for the monetization of historic tax credits.

Historic Tax Credit Safe Harbor. Revenue Procedure 2014-12 is that guidance. In the Revenue Procedure, the IRS details a partnership transaction structure under which historic tax credits can be allocated to a tax credit investor without fear of IRS challenge. While a discussion of all the nuances of the transaction structure is beyond the scope of this Alert, here are some significant features of the structure:

- As it has in the renewable energy tax credit context, the IRS has embraced a "partnership flip" structure. Under this type of transaction structure, the tax credit investor initially has a very high (99%) equity interest in the partnership; then, once the recapture period for the historic tax credits runs, the investor's equity interest "flips" to a much lower percentage (around 5%). This "flip" allows the owner/developer of the building to enjoy the lion's share of the long-term economic rewards of the building, and also facilitates the owner's/developer's acquisition of the tax credit investor's equity in the project once the tax credits have been exhausted.

- Perhaps most importantly, the tax credit investor's equity interest in the partnership must be a "bona fide equity investment," with a value that is contingent on the investor's percentage interest in the partnership's net income, gain and loss, irrespective of any federal, state or local tax attributes. This value must be allowed to rise and fall over time; it cannot be substantially fixed in amount, and it cannot be limited to a preferred return.

- The tax credit investor must put in a substantial portion (at least 20%) of its equity investment before the historic tax credit-eligible project is placed in service. Moreover, at least 75% of the investor's total expected capital contributions must be fixed in amount by this time, and the investor must reasonably expect to make these capital contributions as they become due.

- The building owner or developer may <u>not</u> guarantee the investor's ability to claim the historic tax credits, the cash equivalent of the credits, or the repayment of any portion of the investor's capital contributions due to an inability to claim the historic tax credits. The building owner or developer <u>may</u>, though, guarantee the performance of any acts necessary to claim the credits, and the avoidance of any act that would cause the project to fail to qualify for the credits, so long as those guarantees are unfunded.

- The building owner or developer may <u>not</u> have any right to acquire the investor's equity interest in the project in the future. The investor, though, <u>may</u> have the right to <u>sell</u> its equity interest to the building owner or developer in the future, at its then fair market value (and remember that the investor's equity position in the project would likely be close to 5% when this right would be exercised).

Thanks to the Revenue Procedure, participants in the historic tax credit market now have certainty regarding how to structure these transactions. This certainty, along with recent enhancements to Wisconsin's state income tax credit for the redevelopment of historic properties, should lead to new (or reopened) opportunities for owners and developers of these properties.

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