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By Jerry Breed and Scott DeMartino

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This article describes recommended practices for closing historic rehabilitation tax credit transactions intended to satisfy the requirements of Rev. Proc. 2014-12 that have been developed by the Historic Tax Credit Coalition, a trade association that provided input to Treasury while it was drafting the revenue procedure.

On January 8, 2014, Treasury and the IRS issued Rev. Proc. 2014-12, 2014-3 IRB 415, establishing a safe harbor for federal historic tax credit (HTC) investments made within a single tier or through a master lease passthrough structure. The guidance was issued in response to the Third Circuit's decision in *Historic Boardwalk Hall LLC v. Commissioner*.[1] The court held that a purported investor was not a partner in the partnership that owned a rehabilitated project because the investor possessed neither meaningful upside potential nor meaningful downside risk. *Historic Boardwalk* created uncertainty that produced a substantial dislocation in the HTC equity market.

Rev. Proc. 2014-12 does not establish substantive tax law, but creates a safe harbor for structuring HTC-advantaged transactions. The revenue procedure's intent is to establish a structure in which an investor in a historic project will share both the upside potential and the downside risk of loss, the essential elements of the ownership of a true equity interest in a real estate project. Compliance with the revenue procedure provides certainty that the IRS will respect an investor as a partner in the allocating partnership for federal tax law purposes and that the HTCs generated by a project will be treated as allocated to the investor.

The revenue procedure does not address other types of federal or state credits or transactions combining HTCs with federal low-income housing or federal new markets tax credits. This article will not discuss the issues raised by combining, or "twinning," HTCs with other credits. Further, this article does not address true debt questions, qualified rehabilitation expenditure issues, the at-risk rules, the passive loss rules, or other federal and state tax issues that should be analyzed in light of the particular facts in each HTC-advantaged transaction.

Structuring HTC transactions to comply with Rev. Proc. 2014-12 generally requires significant changes in an investor's underwriting and review practices, but the revenue procedure successfully established a workable tax structure that allows principals and investors to achieve substantially all of their goals in structuring and closing these deals. To qualify for the safe harbor, participants must comply with all requirements of the revenue procedure.

This article discusses practices recommended by the Historic Tax Credit Coalition (HTCC) to structure HTC transactions so that they satisfy the requirements of the revenue procedure and qualify for the safe harbor. The HTCC is a group of historic tax credit industry representatives who have come together to develop a consensus on the most effective ways to structure HTC transactions. Its members are tax credit syndicators, investors, tax attorneys, accountants, preservation consultants, and real estate principals involved in the business of using the HTC as a financing tool to promote economic development through the rehabilitation of historic properties. The HTCC researches the economic effect of the HTC; develops legislative and regulatory proposals to promote the simplification and greater use of the HTC; and fosters communication between the National Park Service, the IRS, and the HTC industry.

The Investor's Partnership Interest

The investor's interest in the master tenant or owner entity must be a bona fide equity investment that has an anticipated value equal to the investor's overall percentage interest in the partnership separate from its tax attributes. To be bona fide, the nontax economic return on the investor's partnership interest generally must vary with the success or failure of the partnership's activity and must not

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[1] *Historic Boardwalk Hall LLC v. Commissioner*, 694 F.3d 425 (3d Cir. 2012), *cert. denied*, U.S. No. 12-90 (May 28, 2013).

be substantially fixed in amount. The investor's return must not be limited to a preferred return in the nature of a payment for the use of capital. Rev. Proc. 2014-12 does not require that the overall percentage interest received by the investor be proportional to its capital contribution. However, to ensure that the anticipated value of the investor's interest is equal to its overall percentage interest, the revenue procedure requires that fees, distributions, lease payments, and "other arrangements" (which are broadly construed) must be reasonable and comparable to non-HTC-advantaged investment arrangements.

Fees

Section 4.02(2)(c) of Rev. Proc. 2014-12, which deals with arrangements to reduce the value of the investor's partnership interest, provides that:

> 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.

To satisfy the requirement that fees, lease terms, and other arrangements are not unreasonable (reasonableness test), fees must not be "unreasonable as compared to fees . . . for a real estate development project that does not qualify for section 47 rehabilitation credits." Generally, fees should be reviewed carefully in the context of the particular facts of and the specific services rendered in the transaction. To buttress the reasonableness analysis, one should obtain a third-party opinion to substantiate the reasonableness of fees, lease terms, and any other arrangements involving affiliates of the principal that have the effect of reducing the investor's share of cash flow.

While the revenue procedure does not explicitly require a third-party opinion, Treasury and IRS officials have indicated that that is the best way to demonstrate that fees and other arrangements do not unreasonably reduce the value of the investor's interest. As a result, reasonableness opinions should (i) address fees, lease terms, and other arrangements using direct comparables, if available; and (ii) include a reasoned discussion that applies direct/indirect comparables from non-tax-credit-advantaged transactions to the particular facts of the transaction, including an analysis of low, high, median, and average ranges for those comparable fees (based on appropriate measurement units such as per unit and per square foot). The content and analytical approaches used in reasonableness opinions continue to evolve.

Advisers should consider whether an independent firm that is not otherwise involved in the transaction should provide the reasonableness opinion: At a minimum, a division of a firm engaged to render an opinion should be separate and apart from any other division that is engaged to provide financial modeling or is otherwise involved in the transaction.

Except in unusual circumstances, "incentive management fees" paid by either a developer partnership or a master tenant partnership should be avoided. From a technical standpoint, such a fee might not present a problem under Rev. Proc. 2014-12, if paid by the developer partnership in a master lease transaction in which the master tenant partnership has no interest in the developer partnership. Alternatively, a reasonable supplemental or incentive rent (in an amount supported by a reasonableness opinion and meeting the reasonableness test) could be paid under the master lease, if the rent payment is subject to achieving specific benchmarks (for example, obtaining signed leases for $X over projected square footage rents). Such incentive or contingent rents are common in non-tax-credit transactions.

Development fees are similarly subject to the reasonableness test and should be supported by a reasonableness opinion. Generally, development fees, including any deferred portion, should be treated as earned and recognized by the developer in the year the rehabilitation improvements are placed in service and the associated HTCs are available to be claimed. Shorter payment terms that are comparable to those in non-tax-credit-advantaged transactions are recommended over longer payment terms in all events.

While the revenue procedure does not address the development fee issue, more than a de minimis cash flow (that is, 10 to 20 percent) should remain for distribution annually after payment of the deferred portion of the development fee. The reasonableness opinion should address the amount of any development fee and the possible deferral of development fee payments. Deferred development fees are an area of concern for the IRS. If the transaction includes a fee for providing any required guarantees or a fee paid to an affiliate of the managing member of the partnership, the reasonableness opinion should address the fee amounts and payment terms.

All sources of payments and distributions to a principal or a principal's affiliate must be analyzed under the reasonableness test. The scope of the term ''other arrangements'' — or as it has been described, the ''no funny business rule'' — is extremely broad and encompasses special distributions, returns of capital, priority returns, and all other payments to principals and their affiliates.

Lease Terms

To comply with the reasonableness test, lease terms must not be unreasonable compared with those in a non-HTC project. This requirement should be read broadly to preclude comparison with federal low-income housing, new markets, renewable energy projects, or any other tax-credit-advantaged project. For a master lease arrangement between the developer partnership and the master tenant partnership, the reasonableness opinion should (i) identify any available actual master leases from directly comparable (or at least similar) transactions; (ii) summarize (perhaps in a matrix format) the key terms of those comparable leases; and (iii) compare the proposed master lease terms with the comparable data. The opinion should reach a conclusion on the reasonableness of the master lease terms in consideration of the projected ''leakage'' between gross income generated at the master tenant partnership level over payments due under the master lease. Again, this analysis and the pool of available comparables continues to evolve; our recommendations in this area are somewhat aspirational.

For subleases by the master tenant partnership, section 4.02(c) of Rev. Proc. 2014-12 provides that a ''sublease of the Building from the Master Tenant Partnership back to the Developer Partnership or to the Principal of either the Developer Partnership or Master Tenant Partnership will be deemed unreasonable unless the sublease is mandated by a third party unrelated to the Principal.'' Further, section 4.02(2)(b) provides that the investor's return must be contingent on the results of the partnership's operations and cannot be ''substantially fixed in amount,'' nor can the investor be ''substantially protected from losses from the partnership's activities.'' The reasonableness opinion should address transactions in which a lender, regulatory authority, or other entity unrelated to the principal[2] that is involved in the transaction (such as a hotel franchisor) legitimately requires a sublease arrangement, and in which the sublease provides for some form of variable or participating rent. Further, financial projections should reflect variability in sublease rents received rather than sublease rents that are relatively fixed in amount. That said, Treasury and the IRS have expressed concerns over those sublease arrangements, and they will generally be subject to close scrutiny. In the absence of robust comparable data, there is no established clear method to determine reasonableness. Therefore, taxpayers should exercise their best judgment to assess reasonableness.

Disproportionate Distributions

Section 4.02(e) of Rev. Proc. 2014-12 provides that the value of the investor's interest may not be diluted by ''disproportionate rights to distributions'' (disproportionate distribution test). There is no qualifier stating that such disproportionate distributions be ''unreasonable.'' The revenue procedure clarifies that there is no minimum amount of cash that must be distributed by the partnership to the investor. Thus, community benefit projects (for example, museums and community theaters) that do not generate substantial cash returns can satisfy the upside return requirement of the revenue procedure even if the aggregate cash generated by the investment is modest compared with the amount of the investor's capital contribution. The investor must receive a reasonably anticipated value, exclusive of tax benefits, commensurate with its percentage interest in the partnership. The IRS and Treasury have informally indicated in public conferences that the investor does not need to receive current cash flow from operations of the project and may derive a portion of the reasonably anticipated value from its interest in the project's residual value. However, as discussed above, the economic value of the investor's interest may not be reduced through fees, lease terms, or other arrangements that are unreasonable compared with the terms found in real estate development projects that do not qualify for the HTC.

Preferred returns and special tax distributions to investors are permitted and, if not paid currently, may accrue. However, the reasonable expected value of the investor's interest must remain contingent on the success or failure of the activities of the partnership, and the investor must have a reasonable possibility of receiving meaningful cash in excess of any preferential return. Subject to scrutiny of fees or other arrangements in the transaction, the recommended practice permits preferred returns as a fixed percentage of contributed capital if there remains some meaningful amount of variable cash distributions generated by the partnership after payment of the preferred returns when compared with the amount of the preferred distributions. Neither preferred returns nor special tax distribution amounts may be guaranteed (but presumably will be valued when valuing the investor's membership interest).

[2]Applying the related-party rules in sections 267(b) and 707(b)(1).

The IRS has indicated that the disproportionate distribution test would apply at the developer partnership level if a master tenant partnership acquires an equity interest in the developer partnership. In those transactions, fees and distribution provisions at the developer partnership level should be carefully scrutinized to ensure that they do not reduce the value of the master tenant's equity interest in the developer partnership or indirectly dilute the value of the investor's interest in the master tenant partnership resulting from a diminution in the value of the master tenant partnership's interest in the developer partnership. Similarly, the value of the master tenant partnership's interest in the developer partnership should be dependent on the operations of the developer partnership and should not be ''substantially fixed in amount.''

Investor's Capital Contributions

Section 4.03 of Rev. Proc. 2014-12 establishes a meaningful level of downside risk by requiring that an investor contribute at least 20 percent of its anticipated capital ''before the date the *Building* is placed in service'' and that such investment be maintained for as long as the investor owns an interest in the partnership (emphasis added). Section 4.03 goes on to provide that the investor minimum contribution ''must not be protected against loss through any arrangement, directly or indirectly, by any person involved with the rehabilitation except as permitted under Section 4.05(1) of this revenue procedure'' (which deals with permissible guarantees, as discussed below). Moreover, section 4.04 provides that at least 75 percent of the investor's expected capital contribution must be fixed and satisfied ''before the date the Building is placed in service.'' As a result, the recommended practice is to limit timing and delivery tax credit adjusters to 25 percent of the expected investor capital contribution, and not to tie those adjusters to structure risk. The recommended practice is to avoid ''pay as you go'' arrangements for equity contributions, which would condition subsequent capital contributions on the continued availability of the HTC.

Section 4.04 of Rev. Proc. 2014-12 also states that the investor must ''reasonably expect to meet its funding obligations.'' Thus, while the contribution of the fixed portion of the investor's investment may be subject to the satisfaction of contingencies — such as placement in service or stabilization of the project (for example, a debt service coverage ratio), or the receipt of a Part 3 approval from the National Park Service — the fixed portion should be contributed before the final year of the five-year HTC recapture period, even if the contingencies have not been satisfied. In short, future capital contributions may be deferred and contingent but must be expected to be made, and to avoid characterization as a funded guarantee of a put price, they should not become due so close to the expiration of the compliance period.

Many larger projects involve more than one building or, in some cases, contemplate the rehabilitation of a single building in separate and distinct phases over a period of several years. In multibuilding or multiphase projects, the 20 percent investor minimum contribution condition should be satisfied on a building-by-building, phase-by-phase basis. Practitioners do not recommend applying the 20 percent investor minimum contribution on a phase-by-phase basis if only one building is involved.

Flips

Like Rev. Proc. 2007-65, 2007-45 IRB 967, which enacted a safe harbor for wind production tax credit investments (wind procedure), Rev. Proc. 2014-12 authorizes ''flips'' in the partnership interests of the principal affiliate and the investor after the end of the five-year HTC recapture period. At all times, the principal's interest must be at least 1 percent of each material item of partnership income, gain, loss, deduction, and credit; and the investor's interest in such must be at least 5 percent of its largest investment percentage of such material items in the tax year for which the investor's percentage interest is the largest (presumably 99 percent, resulting in 4.95 percent minimum interest). To the extent that current cash distributions are deferred through disproportionate or preferential distribution, payment of fees, or other arrangements, it is recommended that the post-flip percentage held by the investor be increased over the 5 percent minimum. Any such arrangement, including the exit strategy, should be carefully considered and structured to make certain that it meets the requirements of Rev. Proc. 2014-12. This recommended practice supports the conclusion that transactions complying with the revenue procedure are exempt from the codified economic substance test of section 7701(o).

Guarantees

Section 4.05 of Rev. Proc. 2014-12 describes various permissible and impermissible guarantees that may be provided to the investor.

Section 4.05(1) lists several permissible guarantees tied to the performance of acts or omissions that are necessary to obtain the HTCs and to avoid recapture, including 100 percent completion guarantees, 100 percent operating deficit guarantees, and 100 percent environmental guarantees. Those guarantees need not be limited in duration. The investor also may be protected by an operating deficit reserve equal to not more than 12 months' worth of project operating expenses (including debt service and master lease payments). Importantly, the list of permissible guarantees includes the relatively broad category of ''guarantees that are not described as impermissible guarantees under Section 4.05(2) of this revenue procedure.'' To be impermissible under Rev. Proc. 2014-12, section 4.05(2), a guarantee must (i) cover tax structure risk; (ii) indemnify or reimburse the investor for its expenses incurred in connection with an IRS challenge of the investor's rights to claim the HTCs; or (iii) be a ''funded'' guarantee. The definition of funded guarantees includes any guarantee for which the guarantor agrees to maintain a minimum net worth. The recommended practice is to treat liquidity covenants by guarantors as impermissible. (Many advisers believe that such net worth and liquidity covenants could be added as triggers to general partner or managing member removal provisions in appropriate cases when the removed managing member retains its economic interest in the partnership.) Impermissible guarantees include any guarantee of partnership distributions or other economic return, and any guarantee of tax structure risk or other disallowance or recapture events not attributable to an act or omission of the principal or its affiliates.

The definition of permissible guarantees in section 4.05(1) of Rev. Proc. 2014-12 generally refers to guarantees regarding ''acts or omissions.'' The revenue procedure confirms that an investor may require a guarantee concerning damages it has incurred as a result of the principal's (or its affiliates') actions or inactions, including a breach of a representation, warrant, or covenant that involves actions or omissions of the principal. While the revenue procedure does not specifically address casualty losses that result in recapture, the IRS and Treasury have indicated that the risk of casualty loss must be borne by the investor. However, there is no prohibition against an investor procuring third-party insurance covering risks associated with ''impermissible'' guarantees, including loss of the HTCs because of a casualty loss affecting the building or a condemnation proceeding.

Thus, adjusters and other indemnities or guarantees should be operative only if the loss arises from some act or omission of the general partner or managing member of the partnership or its affiliates. The act or omission requirement does not imply prudence or a reasonableness, negligence, or fault standard. For example, if the general partner or managing member breaches a covenant to obtain and maintain insurance on the building, any resulting casualty loss (including a recapture of HTCs) could be covered by the guarantee. Failure to obtain necessary governmental approvals, such as appropriate zoning or National Park Service approval, should be treated as an act or omission. Inevitably, there will be situations in which it is not clear whether a loss actually arises from an act or omission; in those cases, the parties may consider including some form of dispute resolution mechanism.

As noted above, permissible guarantees cover everything that is not impermissible under section 4.05(2) of Rev. Proc. 2014-12 or otherwise prohibited under section 4.05(1). The second sentence of section 4.05(2)(a) provides that ''no person involved in any part of the rehabilitation transaction'' may guarantee that the investor will receive ''partnership distributions or consideration in exchange for its partnership interest (except for a fair market value sale right described in section 4.06(2)).'' Because any type of yield guarantee presumably would include projected cash distributions, and because the investor's return cannot be substantially fixed in amount, the second sentence of section 4.05(2)(a) should prohibit a specific reference to yield or lost cash distributions in the computation of damages. This would be the case even in a non-transactional structure challenge situation. Section 4.05(2)(a) also would preclude any guarantee (whether or not ''unfunded'') of priority returns or special tax distributions due to the investor. However, section 4.06(4) specifically permits the payment of any accrued but unpaid fees, preferred returns, or tax distributions at the time of the exercise of a permitted put option, if the aggregate put price does not exceed the fair market value of the investor's interest.

Section 4.06(2) of Rev. Proc. 2014-12 explicitly permits a put option at below fair market value, and that right presumably may be guaranteed as long as the guarantee is ''unfunded.'' A traditional repurchase obligation, which contemplates a return of the investor's equity under specific circumstances, would have to conform to the put option conditions in section 4.06(2), which would limit the purchase price to fair market value. This limitation would nullify most repurchase obligations because the event that would trigger the repurchase obligation also would significantly reduce the fair market value of the investor's interest. Therefore, the repurchase obligation should be limited to acts or omissions of the managing member and its affiliates and determining the amount of the obligation by reference to the payment of damages to the investor.

Options

Unlike the wind procedure, Rev. Proc. 2014-12, section 4.06 prohibits call options but permits put options at a price that does not exceed the fair market value of the investor's interest at the time of exercise of the option. While a put of the investor's interest at a nominal price below fair market value is permissible, an investor may not abandon its interest in the partnership and claim an ordinary loss. Investors doing so will be deemed to have acquired the interest with the intention of abandoning it, unless the facts clearly establish that the interest is worthless.

To ensure compliance with the safe harbor, the purchase price under a put option should be set at the lesser of (i) a stated amount (which could be yield based); or (ii) the fair market value of the investor's interest on the exercise date, as determined by an independent qualified appraiser, taking into account the provisions of Rev. Proc. 2014-12, section 4.06(3). The payment of the put option price may be guaranteed under the terms of an unfunded guarantee. As discussed above, accrued but unpaid fees, priority returns, and tax distributions should become due at the time of the exercise of a put option, and may be guaranteed through an unfunded guarantee if the aggregate put price does not exceed the fair market value of the investor's partnership interest.

Scope of Application

Rev. Proc. 2014-12 restricts the activities of ''persons involved'' with the underlying transaction in several ways, but does not identify who is deemed to be a person involved. Whether the reference is to a person ''involved with the transaction'' (as in Rev. Proc. 2014-12, section 4.03), or a person ''involved in any part of the rehabilitation transaction'' (as in sections 4.05(2)(a), (b), and (c) and section 4.06(2)), or a person ''involved in any part of the rehabilitation'' (as in section 5.01(1)(v)), we can assume that for any given transaction, the same persons are being referred to in each section. The wind procedure states: ''In addition to the Project Company, the Developer, and the Investors, wind energy transactions typically involve lenders, land owners, a turbine supplier, a construction contractor, power purchasers, and a project operator.''

HTC transactions do not have exact analogues to those persons involved in a wind energy transaction, but we can assume that the IRS intended a similarly broad scope when it referred to ''persons involved in the rehabilitation transaction.'' Moreover, the requirements and restrictions of both revenue procedures encompass named and related parties. Thus, ''persons involved'' should include:

- the principal;
- the managers or managing members for the partnership (that is, ''principals'');
- any lenders;
- the land owners;
- any major tenant[3] (or major subtenant in the case of a master tenant partnership);
- the syndicator;[4]
- the principal partnership; and
- if applicable, the master tenant partnership itself.

A person providing insurance to the investor, as long as that insurer is not a related party to any of the persons listed above, generally should not be considered a ''party involved in the transaction.''

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[3]Generally thought to include any tenant who accounts for 25 percent or more of the projected rents in the rehabilitated project.

[4]To the extent such a party is involved; is separate from the principal, the principals, and their affiliates and is involved in raising the equity capital from the investors that is used in the rehabilitation; and is compensated for its efforts.