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Historic Tax Credits: Federal Tax Issues for Investors and Developers

Navigating IRS Qualifications, Structuring Deals After
Historic Boardwalk Hall, and Pairing With Other Tax Credits

TUESDAY, NOVEMBER 27, 2012

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Strafford CLE/CPE Webinar
November 27, 2012

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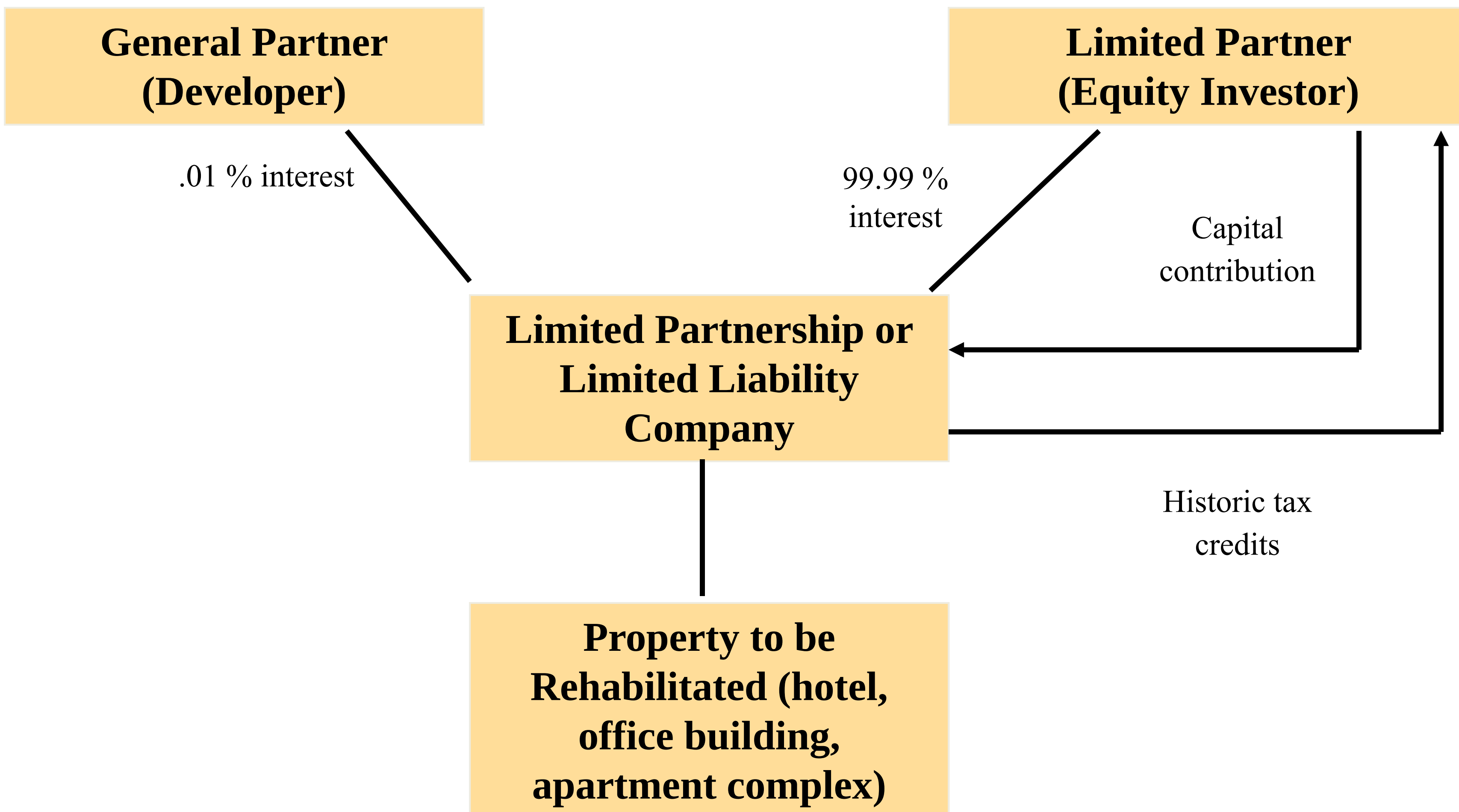
Historic Rehabilitation Tax Credits
Section 47 of Internal Revenue Code (“IRC”)
Transaction Diagram



Example

➢ Purchase price of building	$2 million
➢ Cost of qualified rehabilitation expenditures	$8 million
➢ Tax credit of 20% of qualified rehabilitation expenditures (.20 x $8 million)	$1.6 million
➢ Equity contribution of $1.05 per $1 of credit ($1.05 x $1.6 million)	$1.68 million

- There are often multiple components of equity price (tax credit, priority return, payment at exit) that may result in credit pricing in excess of $1.00

Rehabilitation Tax Credit Basics

- Two Types of Credit: (i) 10% credit for non-historic, non-residential buildings first placed in service prior to 1936; and (ii) 20% credit for rehabilitation of “certified historic structures” (application submitted to State Historic Preservation Office/National Park Service (Parts 1, 2, 3)).

- One-time credit earned in full in the year the rehabilitated property is “placed in service” for federal tax purposes.

- Available only to the tax owner of the property at the time rehabilitation expenditures are placed in service. Investor must be admitted to the limited partnership as a partner before the rehabilitation expenditures are placed-in-service.

- No competitive process similar to Low-Income Housing Tax Credits.

- No requirement that a building eligible for the rehabilitation tax credit be maintained or operated in any special way other that it continue to be used in a trade or business.

- Basis of property reduced by full amount of credit claimed. This results in reduced depreciation deductions.

- Excluded expenditures: (i) acquisition costs, (ii) enlargements, (iii) tax-exempt use property, and (iv) lessee expenditures.

Overview of Definitions

- Certified Historic Structure: A building which is either listed in the National Register, or is located in a "registered historic district" and is certified by the Secretary of the Interior as being of historic significance to the district.

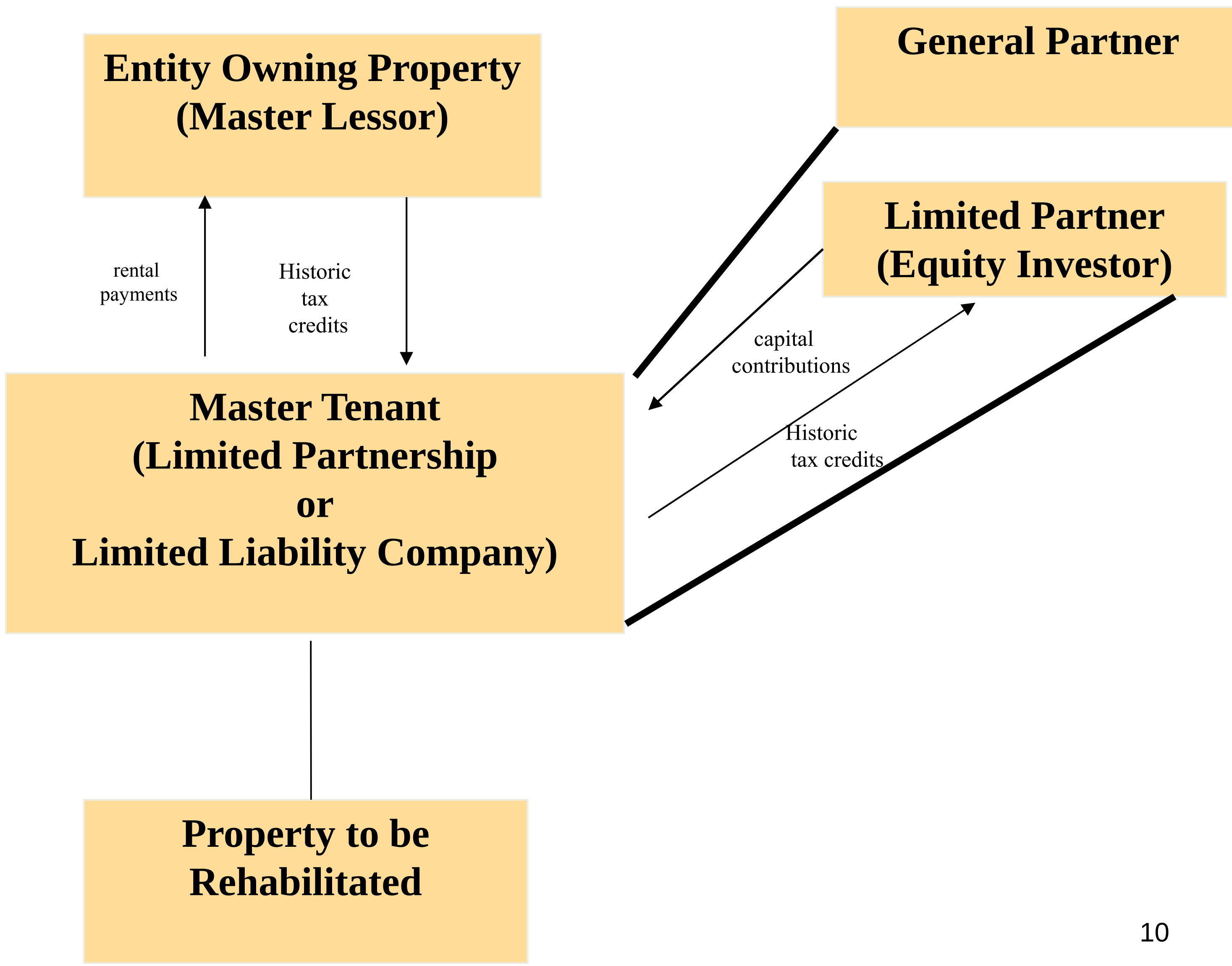
- Qualified Rehabilitation Expenditure: Any amount incurred by the taxpayer after December 31, 1981 that is properly chargeable to capital account for property for which depreciation is allowable under IRC §168 and which is real property, and made in connection with the rehabilitation of a "qualified rehabilitated building".

- Qualified Rehabilitated Building: Any building (and its structural components) on which depreciation (or amortization) is allowable, which has been "substantially rehabilitated", and which was placed in service before the beginning of the rehabilitation.

- Substantially Rehabilitated: Qualified rehabilitation expenditures during the 24-month period selected by the taxpayer and ending with or within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), and (2) $5,000. The 24-month period may be extended to 60 months for certain phased rehabilitations.

- The minimum rehabilitation expenditures must be incurred during the 24-month period that is selected by the taxpayer, but the rehabilitation expenditures for the building can be incurred both before the 24-month period and after the 24-month period but before the end of the calendar year in which the 24-month period ends.

Lease Passthrough Election Transaction Diagram



Lease Passthrough Election

- The owner of a property that is being rehabilitated ("Master Lessor") may elect to pass the rehabilitation tax credit through to a tenant. The entire rehabilitated property is master leased to a newly formed partnership or limited liability company ("Master Tenant"). An affiliate of the owner/developer is the general partner and the historic tax credit investor will be admitted as the limited partner.

- An election is filed to pass all of the historic tax credit through to the Master Tenant and the Master Tenant allocates 99.99% of the historic tax credit to the tax credit investor.

- "Short Term Lease Rules" under Code Section 48(d) (still currently applicable pursuant to Code Section 50(d)) limit the amount of the credit passed through to the lessee to the portion of the credit which the period of the lease bears to the class life of the property.

Lease Passthrough Election

- Exception to short-term lease rules if the lease term is at least 80% of the property's class life for depreciation purposes. So, if real property has a class life of 40 years, the lease term should be at least 32 years so that the short-term lease rules will not apply and 100% of the historic rehabilitation tax credits can be passed through to the lessee. Even with this long lease term, lease pass-through transactions generally contain put/call rights so that the tax credit investor may exit the deal after the 5-year recapture period has expired.

- Master Lessor is owner of building and rehabilitation expenditures for federal income tax purposes and will be entitled to depreciation deductions. Master Lessor is not obligated to reduce its tax basis in the building by the amount of the credit passed through to Master Tenant. The ability of the Master Lessor to avoid a reduction in tax basis may be particularly valuable when the rehabilitation tax credit is combined with other tax credits such as the low-income housing tax credit.

- Instead of reducing the depreciation deductions available to the Master Lessor, an offsetting item of "phantom income" must be recognized by the Master Tenant.

Lease Passthrough Election

- Under the lease pass-through structure, the tax credit investor will make its capital contribution to the Master Tenant; however, it is the Master Lessor that is incurring the rehabilitation and other development costs with respect to the project.

  - The tax credit investor's equity contribution may be spent by the Master Tenant if the Master Tenant is incurring sufficient expenditures (examples: furniture, fixtures and equipment and/or other costs that are not otherwise included in basis for purposes of calculating the rehabilitation tax credit).

  - The Master Tenant can transfer the funds to the Master Lessor as a prepayment of rent under the Master Lease. The tax consequences of the prepaid rent will be determined under Section 467 of the Code.

  - The Master Tenant can make a loan to the Master Lessor. The loan can be repaid upon a later sale or disposition of the project by the Master Lessor.

  - The Master Tenant can become a partner in the Master Lessor holding a relatively small percentage interest (e.g., 10%) and could transfer the funds to the Master Lessor in the form of a capital contribution.

Tax-Exempt Entity Leasing Rules

- Tax-exempt use property (as defined in Code Section 168(h)) is not eligible for the rehabilitation tax credit.

- Tax-exempt use property is defined with respect to two different roles that a tax-exempt entity may play in a rehabilitation tax credit transaction:

  - If the owner of the property is a tax-exempt entity or a partnership or limited liability company of which the tax-exempt entity is a partner or member, all or part of the property may be treated as tax-exempt use property. In the case of a partnership or limited liability company having a tax-exempt partner or member, if the allocations of tax items among the partners or members are "qualified allocations" the existence of the tax- exempt partner or member will be disregarded. "Qualified allocations" are allocations in which each tax item for the life of the partnership is allocated in the same percentages, thereby avoiding the potential abuse of disproportionately allocating income items to the tax-exempt partner and loss or tax credit items to the taxable partner.

  - If the rehabilitated property is leased to a tax-exempt entity in a "disqualified lease" that portion of the property will be tax-exempt use property and not eligible for the rehabilitation tax credit. A "disqualified lease" includes leases that are of long duration or provide to the tax-exempt lessee rights to acquire the underlying property (i.e., situations in which the tax-exempt entity has rights that resemble ownership.)

Tax Credit Recapture

- Recapture (or partial recapture) of credit will occur if property is transferred after it is placed in service, but before 5 years have elapsed, and new owner may not claim or revive any portion of the credit.

- The amount of recapture is reduced by 20% for each full year that elapses after the property is placed in service (100% recapture if disposition occurs during year 1, 80% during year 2, 60% during year 3, 40% during year 4, 20% during year 5 and no recapture if disposition occurs after year 5).

- Casualty losses are dispositions under the recapture provisions; however, there will not be recapture if damaged property is being repaired or restored over a reasonable period of time.

- If property is owned by a partnership, a partner's disposition of its partnership interest (or even a portion of such interest under certain circumstances) will trigger recapture.

- With regard to the recapture of historic rehabilitation tax credits passed through under a lease, the IRS ruled in PLR 8943074 that if the lease terminated after five full years from the last date on which any portion of the qualified rehabilitation expenditures subject to the lease were placed in service, there would be no recapture of the tax credits passed through to the lessee.

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Historic Boardwalk Hall: Facts of the Case

- Case Citation: Historic Boardwalk Hall, LLC v. Commissioner, No. 11-1832 (3rd Cir., August 27, 2012)
- The transaction at the center of the case is the rehabilitation of the historic convention center known as East Hall in Atlantic City, NJ.
- The New Jersey Sports and Exposition Authority ("NJSEA") was originally tasked with the restoration of East Hall.
- NJSEA had a commitment of sufficient funds to complete the project before a syndication of historic tax credits ("HTC") was ever contemplated.

Historic Boardwalk Hall: Facts of the Case

- A consultant learned of the project and contacted NJSEA to discuss how they could "sell" the Federal historic tax credits generated by the proposed rehabilitation.

- NJSEA agreed to the proposal, and East Hall was transferred to Historic Boardwalk Hall, LLC ("HBH"). Pitney Bowes ("PB") was identified as the historic investor and took a 99.9% membership interest in HBH.

Historic Boardwalk Hall: Facts of the Case

- Deal Structure in Boardwalk:
  - Single Tier Deal Structure (no lease-pass-through)
  - PB was only obligated to contribute 10% of its total equity to HBH prior to construction completion.
  - PB was supposed to get a 3% preferred return and 99.9% of available cash flow, but the projections showed NO cash flow would be available for distribution during the first 42 years of operations.
  - PB was also to receive 99.9% of the residual proceeds, but a pre-closing memo indicated that, because of the nature of the transaction, the fair market value of PB's interest in HBH would be insignificant.
  - The initial projections showed that HBH could not support the level of debt proposed, and various expenses (utilities) were moved off of HBH's books and back to NJSEA in subsequent projections.

Historic Boardwalk Hall: Facts of the Case

- Use of the proceeds:
  - The proceeds of the syndication of the credits were used almost exclusively to pay NJSEA a developer fee.
  - No such fee was contemplated prior to the decision to syndicate the credits, and NJSEA had already performed most of the work before the development agreement was put in place.

Historic Boardwalk Hall: Facts of the Case

- Guaranty Provisions:

- NJSEA provided broad guaranties to PB, including guaranties to cover completion, operating deficits, environmental liability, and a tax benefits guaranty.
- These guaranties effectively removed all downside risk (NJSEA had access to a seemingly endless flow of cash due to luxury taxes and other taxes collected).

Historic Boardwalk Hall: Facts of the Case

- Put Option/Call Option/Consent Option:
  - There was a put and a call exercisable after the end of the recapture period – the exercise price under each was the greater of (i) the fair market value of PB’s membership interest in HBH, or (ii) any accrued and unpaid preferred return to PB.
  - A GIC was established to ensure the funding of the preferred return if the put/call were ever exercised.
  - NJSEA held a consent option enabling it to buy PB’s membership interest without PB’s consent if NJSEA wanted to take certain actions that were prohibited under HBH’s operating agreement or which required PB’s consent. The purchase price was the then-present value of any unrealized projected tax benefits and cash distributions due to PB through the end of the 5-year recapture period.

Historic Boardwalk Hall: Timeline and Results

- In the initial audit, the IRS concluded that all credits should be reallocated from PB to NJSEA based on (i) the sham transaction doctrine, and (ii) the conclusion that PB was not a *bona fide* partner in HBH because it had no meaningful stake in the success or failure of HBH.
- The taxpayer appealed, and in January, 2011, the Tax Court found that the transaction was not a sham transaction and that PB should be respected as a partner in HBH.
- The IRS appealed, and based on all of the factors listed above, the 3rd Circuit reversed the Tax Court and concluded that PB was not a member (partner) of HBH, and therefore was not entitled to an allocation of Federal historic tax credits.

HBH Decision: Conclusions

- The appeals court decision was primarily decided on the investor not being a partner in the transaction
- The decision did **NOT** provide any "bright line" guidance to restructure transactions, nor did it spell out any tests or actions that could be taken by an investor to be deemed a partner
- It is possible to draw some preliminary conclusions and/or recommendations based on the decision, but the tax credit industry is still in flux 3 months later
- Post HBH, historic tax credit deal structuring is being changed to maximize the potential for the investor being a partner in the transaction with a focus on downside risk and upside potential.
- Is it possible to give a HTC tax opinion post HBH?

Current Transaction Structuring after HBH

- Downside Risk:
  - More Risk =Partner?
    - What type of guarantees can be provided to the Investor? Should there be limitations on total amounts guaranteed?
    - When should the Investor make its initial investment in the project? How much should such initial investment be?
    - What can the investor require as a condition for further investment?

Current Transaction Structuring after HBH

- Upside Potential:
  - More Financial Upside = Partner?
    - What kind of upside potential will a potential investor see?
    - Greater than 3% cash on cash return?
    - Managing cash flow after HBH: what happens if the project hits a home run?
- Dealing with the exit: Put Options/Call Options

HBH: Next Steps

- Due to HBH, an already limited investor market has become smaller
- HTC transactions are still closing, but with more concern placed on downside risk and upside potential, in various combinations
- No “one size fits all” approach
- Difficult to structure “pay as you go” transactions due to lack of downside risk
- Difficult to structure “sandwich lease” transactions due to lack of upside potential
- Potential investment pricing considerations:
  - More risk = lower tax credit equity

Combining the Rehabilitation Tax Credit

Facade Easement Donation:

- An easement given in perpetuity to a historic preservation society or similar tax-exempt organization which limits alterations that can be made to a building's facade.

- A charitable contribution deduction is available based on the value of the easement as determined by an appraisal measuring the difference between the value of the property prior to the donation and the value of the property after the easement is given (the amount of the deduction allowed is reduced to take into account rehabilitation tax credits allowed to the taxpayer for the building over the 5 preceding taxable years; recapture of credit may also occur if donation occurs within the 5-year holding period). Generally it will make sense to donate the facade easement after the 5-year tax credit recapture period.

- Note that designation of a property in the National Register does not otherwise obligate the owner to maintain the historic nature of the property and, therefore, in valuing the easement, the fact that the property is in the National Register or that rehabilitation tax credits were previously claimed, should not adversely affect the calculation of the diminution in value of the property created by the easement.

Low-Income Housing Tax Credit:

- The basis reduction required under the rehabilitation tax credit rules may have an impact on the amount of low-income housing tax credits available to the project; however, the net tax benefits achievable by combining the two credits can still exceed the benefits of using either of the credits alone.

- The use of the lease pass-through structure potentially avoids the basis reduction that would reduce the amount of the low-income housing tax credit. To support the separation between the historic tax credit and the low-income housing tax credit, the investor at the Master Tenant level that will claim the historic tax credit is not the same as the investor at the Master Lessor level that will claim the low-income housing tax credits.

- Note also that in many low-income housing tax credit transactions that receive an allocation of 9% credit, the allocation does not fully utilize all of the available basis and a reduction in basis in the amount of the historic tax credit may not reduce the tax basis below the amount needed to utilize the low-income housing tax credit allocation that the owner has received.

New Markets Tax Credit:

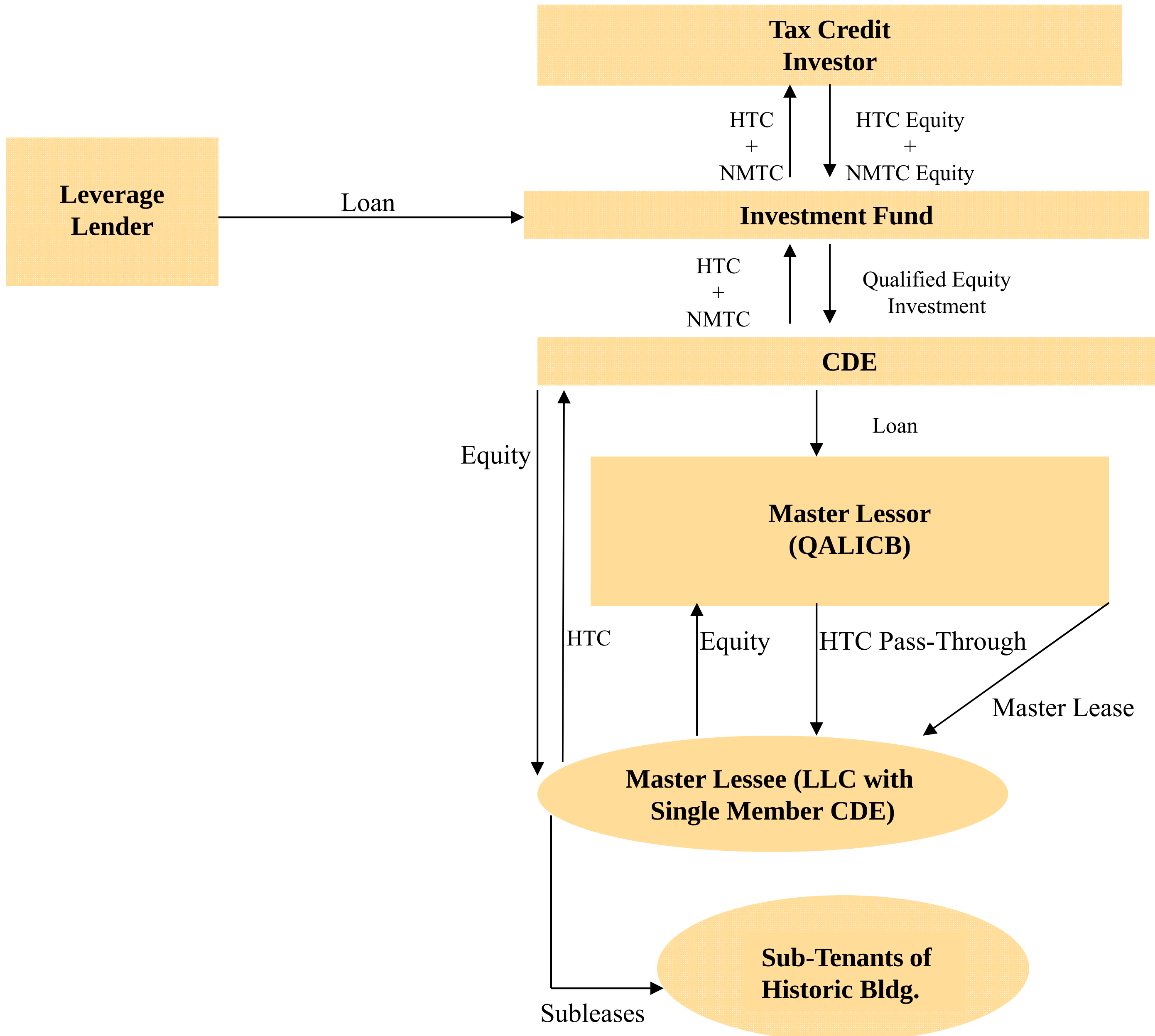
- The rehabilitation tax credit can be combined with the Federal New Markets Tax Credit that is available for investments in Qualified Active Low-Income Community Businesses ("QALICB").

- In certain transactions, the equity contributed by the historic tax credit investor may flow through the NMTC structure, with the effect that an aggregate 39% NMTC can be generated with respect to the historic tax credit equity, thereby increasing the overall amount of NMTC for which the development would be eligible.

- Using a master lease structure within the NMTC structure allows the Community Development Entity ("CDE") to make an equity investment in the Master Tenant (this helps the CDE meet a requirement that it not have a significant ownership interest in the QALICB (i.e., the Master Lessor)).

- Historic tax credit equity may also be contributed into the Master Tenant directly and may flow through the NMTC structure as part of the leverage loan made by the owner of the project to the NMTC Investment Fund (or such equity may not flow through the NMTC structure at all if there is not enough NMTC allocation available).

NMTC and HTC


Tax Credit Investor
HTC + NMTC
HTC Equity + NMTC Equity
Leverage Lender
Loan
Investment Fund
HTC + NMTC
Qualified Equity Investment
CDE
Equity
HTC
Loan
Master Lessor (QALICB)
Equity
HTC Pass-Through
Master Lease
Master Lessee (LLC with Single Member CDE)
Subleases
Sub-Tenants of Historic Bldg.

HBH: LIHTC/NMTC Structure

- LIHTCs are structured quite differently from HTCs, and therefore it is possible to distinguish an investment in a LIHTC project partnership from the type of investment at issue in Historic Boardwalk.
  - LIHTCs are not awarded “as of right,” so financial feasibility requirements should prevent a LIHTC project from being over sourced in the way HBH was.
  - LIHTC investors are in the transaction for longer periods of time, typically the 15 year compliance period
  - Most investors in LIHTC deals contribute a substantial amount of equity prior to construction completion, and even if they do not, the compliance obligations (and resulting recapture risk) are much greater with LIHTC projects than with HTC projects.
  - Most guarantors in LIHTC projects do not have the kind of unlimited sources that NJSEA had at its disposal to fund calls on the guaranty.

HBH: LIHTC/NMTC Structure

- NMTC transactions typically do not rely on partnership allocations to direct the tax credits
- CDEs typically make qualified investments in a qualified business through a loan structure, not an equity structure
- Twinned transactions (NMTC/HTC) have the potential to be problematic post-HBH, depending on the structure of the HTC portion of the transactions

Thank You

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