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On the Subject

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On December 30, 2013, the Internal Revenue Service issued much anticipated guidance, in the form of Revenue Procedure 2014-12, providing a safe harbor under which it will not challenge a partnership's allocations of rehabilitation tax credits to its partners. Because Revenue Procedure 2014-12 is similar to Revenue Procedure 2007-65, which established a safe harbor for the allocation of production tax credits by wind partnerships, the two revenue procedures are compared below.

Safe Harbors for Rehabilitation Tax Credits

On December 30, 2013, the Internal Revenue Service (IRS) issued Revenue Procedure 2014-12, which provides the requirements under which the IRS will not challenge a partnership's allocations of Internal Revenue Code (Code) Section 47 rehabilitation tax credits to its partners (Safe Harbor) for all allocations made by a partnership on or after December 30, 2013 (or made prior to December 30, 2013 for those existing partnerships already satisfying the Safe Harbor). The Safe Harbor is a response to the U.S. Court of Appeals for the 3rd Circuit decision in *Historic Boardwalk Hall, LLC v. Comm'r*, 694 F.3d 425 (3d Cir. 2012)(*Historic Boardwalk*). As discussed below, in *Historic Boardwalk*, the Third Circuit disallowed a partnership's allocation of rehabilitation tax credits because the purported partner did not have a meaningful stake in the economic realities of the partnership. In light of this decision, investors in rehabilitation tax credit eligible projects and other tax credit eligible projects have asked the U.S. Department of the Treasury and the IRS for clarifying guidance; the IRS responded with the Safe Harbor discussed below and available at http://www.irs.gov/pub/irs-drop/rp-14-12.pdf.

While the Safe Harbor expressly applies only to partnerships allocating the rehabilitation tax credit, it may provide some guidance and points to consider in the context of other federal tax credits, such as the investment tax credit, low-income tax housing credit, and new market tax credit. While the Safe Harbor is a response to *Historic Boardwalk*, it addresses general partnership tax credit allocation issues not unique to the rehabilitation tax credit.

Background

Code Section 47 provides a rehabilitation tax credit for a portion of the expenditures made in rehabilitating a qualified building. The rehabilitation credit for any taxable year is the sum of 10 percent of the qualified rehabilitation expenditures with respect to any qualified rehabilitated building other than a certified historic structure and 20 percent of the qualified rehabilitation expenditures with respect to any certified historic structure. Treasury Regulation Section 1.46-3(f)(2)(i) generally requires that a partner's share of the rehabilitation credit be determined by the ratio by which the partners divide the general profits of the partnership.

In many transactions, third-party investors help fund the rehabilitation of historic buildings, in part, to receive a share of the rehabilitation credit. In *Historic Boardwalk*, the Third Circuit denied the rehabilitation credit to one such investor when the investor was deemed not to have sufficient economic risk or upside in the rehabilitation project to be a partner for federal income tax purposes. There, the New Jersey Sports and Exposition Authority (NJSEA), a state instrumentality, was rehabilitating a convention center and had originally obtained funding for the rehabilitation through grants from government agencies and the issuance of government bonds. After construction had begun, NJSEA was approached about partnering with an investor in order for the investor to take advantage of the rehabilitation credit. NJSEA agreed and formed a partnership with the investor pursuant to which the investor would be allocated rehabilitation credits.

Under the partnership agreement between NJSEA and the investor, the investor was allocated 99.9 percent of all partnership items, including the rehabilitation credit. In addition, the NJSEA and the investor entered into a put/call arrangement, which generally assured that the investor would get its expected return and no more or no less. The parties also entered into a series of guarantees that guaranteed the value of the rehabilitation credits, provided for the funding of operating deficits and excess construction costs and generally protected the investor from downside risk. The Third Circuit found that the parties did not actually intend to conduct business together because the investor "did not have any meaningful downside risk or any meaningful upside potential" in the partnership. Thus, the investor was not a bona fide partner in the partnership and was, therefore, not entitled to an allocation of rehabilitation credits.

As a result of the holding in *Historic Boardwalk*, the rehabilitation credit community and others requested guidance on rehabilitation tax credit allocations from the IRS, which led to Revenue Procedure 2014-12.

In addition to this Safe Harbor, the IRS previously released Revenue Procedure 2007-65, which established a safe harbor for wind partnerships allocating the production tax credit pursuant to Code Section 45 (Wind Safe Harbor). Revenue Procedure 2007-65 can be found at http://www.irs.gov/irb/2007-45_IRB/ar18.html. In the summary of the Safe Harbor below, we compare the requirements of the Wind Safe Harbor to those of the rehabilitation credit Safe Harbor, recognizing that the applicable revenue procedures are intended to apply to different tax credits. The Wind Safe Harbor and Safe Harbor are, nevertheless, relevant to each other, as each addresses partnership credit allocation issues generally.

Revenue Procedure 2014-12

Through the Safe Harbor established by Revenue Procedure 2014-12, the Treasury and the IRS intend "to provide partnerships and partners with more predictability regarding the allocation of § 47 rehabilitation credits to partners of partnerships that rehabilitate certified historic structures and other qualified rehabilitated buildings." The Safe Harbor makes clear that it applies only to rehabilitation credits and not to other federal tax credits or state credits. It also provides that it does not indicate the IRS's views as to whether a partnership has the requisite benefits and burdens of ownership of the relevant building or whether an expenditure is a qualified rehabilitation expenditure for purposes of the credit. Recently, the IRS made additional changes to the revenue procedure to clarify that it does not address how partnerships are required to allocate the income inclusion required by Code Section 50(d)(5), which, pursuant to its reference to former Code Section 48, requires lessees to include in gross income an amount equal to 50 percent of the amount of the credit allowable with respect to the property. The IRS also states in the revenue procedure that it will not provide private letter rulings to individual taxpayers regarding the allocation of rehabilitation credits.

The Safe Harbor addresses two types of rehabilitation credit transaction structures—the first is the "Developer Partnership" that owns and restores the applicable building, and the second is a "Master Tenant Partnership" that leases the building from the Developer Partnership (Head Lease) and is entitled to the rehabilitation credit pursuant to an election available under the Code to treat the lessee as having acquired the building for purposes of the credit. The Safe Harbor provides that, if an investor receives an allocation of rehabilitation credits from a Master Tenant Partnership, the investor cannot also invest in the Developer Partnership other than through an indirect interest in the Developer Partnership held through the Master Tenant Partnership. This prohibition does not apply to an investment pursuant to a separately negotiated, distinct economic arrangement, such as an investment into the Developer Partnership to share in allocation of federal new market tax credits or low-income housing tax credits.

The following is a summary of the requirements that must be met with respect to the Developer Partnership and Master Tenant Partnership structures in order to qualify for the Safe Harbor:

Minimum Partnership Interests of Principal and Investor

Under the Safe Harbor, the managing partner (referred to in the Safe Harbor as the Principal) must have, at all times during the period it owns an interest in the partnership, at least a one-percent interest in each material item of partnership income, gain, loss, deduction and credit throughout the existence of the partnership. The investor partner (Investor) must have an interest equal to at least a five-percent interest in each material item of the partnership for the taxable year in which the Investor's percentage share of that item is the largest.

The Wind Safe Harbor under Revenue Procedure 2007-65 contains virtually identical ownership interest requirements. These requirements are, therefore, not surprising to those who invest in renewable energy projects eligible for production tax credits or to renewable energy investors generally.

Investor's Bona Fide Equity Investment Requirement

The Safe Harbor requires that the Investor's partnership interest be a "bona fide equity investment with a reasonably anticipated value commensurate with the Investor's overall percentage interest in the [p]artnership, separate from any federal, state and local tax deductions, allowances, credits, and other tax attributes to be allocated by the [p]artnership to the Investor." The Investor also cannot be "substantially protected from losses from the [p]artnership's activities." The Safe Harbor specifies that an Investor's interest is a bona fide equity investment only if the reasonably anticipated value of its interest is contingent upon the partnership's net income, gain and loss and is not substantially fixed in amount. Moreover, the Investor "must participate in the profits from the partnership's activities in a manner that is not limited to a preferred return that is in the nature of a payment for capital."

This requirement and the requirement immediately below are perhaps the most significant of the Safe Harbor because they are less objective, bright-line tests than the other requirements. Revenue Procedure 2007-65 does not contain these bona fide investment requirements.

Arrangements to Reduce the Value of the Investor's Partnership Interest

The value of the Investor's interest cannot be reduced through fees, lease terms or other arrangements that are unreasonable as compared to other such arrangements for a real estate development project that does not qualify for the rehabilitation credit. In addition, the Investor's interest may not be reduced by "disproportionate rights to distributions or by issuances of interests in the [p]artnership (or rights to acquire interests in the [p]artnership) for less than fair market value consideration."

The Wind Safe Harbor does not contain this requirement, and its reach is uncertain. One unanswered question, for example, is whether the requirement relating to disproportionate rights to distributions is requiring that an Investor's percentage of partnership items must match its percentage of cash distributions. We understand that requiring this matching was not the intent of this provision, and that the intent was to insure that the partnership does not use these arrangements to significantly reduce the value of the Investor's residual interest. However, it is clear that having cash distribution percentages that match profit and loss allocation percentages would fall squarely within this part of the Safe Harbor, and it is not yet as clear what other arrangements also would be acceptable.

The Safe Harbor also addresses Master Tenant Partnerships with respect to this requirement. Subleases of the building back to the Developer Partnership or the Principal are deemed unreasonable unless the sublease is mandated by an unrelated third party. If a building is subleased to any person by the Master Tenant Partnership, such sublease is deemed unreasonable unless the duration of the sublease is shorter than the duration of the Head Lease. However, the Safe Harbor does not indicate how much longer the term of the Head Lease must be than the sublease to satisfy this requirement. Would one day suffice? In addition, the Safe Harbor provides that the Master Tenant Partnership may not terminate its lease of the building from the Developer Partnership during the period in which the Investor remains a partner in the Master Tenant Partnership.

Investor's Minimum Unconditional Contribution and Contingent Consideration Requirements

Before the date the rehabilitated building is placed in service, the Investor must contribute at least 20 percent of the Investor's total expected capital contribution (Minimum Contribution), and at least 75 percent of the investor's total amount of expected capital contributions must be fixed. The Investor must maintain the Minimum Contribution throughout the Investor's ownership of its partnership interest and the Investor cannot be protected from loss, except pursuant to a "permissible guarantee" (discussed below). The determination of whether the Investor has met the Minimum Contribution requirement disregards investments made in the form of promissory notes or other obligations of the Investor.

The Minimum Contribution requirement is required to be met before the applicable project is placed in service. The Wind Safe Harbor contains a similar Minimum Contribution requirement but specifically provides that the Minimum Contribution must be made on or before either the date the wind farm is placed in service or the date the Investor acquires its interest in the applicable project company, whichever is later. The Wind Safe Harbor also clarifies that the Investor's Minimum Contribution is permitted to be reduced by distributions of cash flow from the project company's operation of the wind farm.

Guarantees and Loans

The Safe Harbor provides that the following "unfunded" guarantees may be provided to the Investor: guarantees for the performance of any acts necessary to claim the rehabilitation credit, guarantees for the avoidance or omission of any act that would cause the partnership to fail to qualify for such credits or that would result in recapture of such credits and any guarantees that are not "impermissible guarantees" described below. Such permissible guarantees include, for example, completion guarantees, operating deficit guarantees, environmental indemnities and financial covenants. The Safe Harbor provides that guarantees are "unfunded" if no money or property is set aside to all or any portion of the guarantee and if neither the guarantor nor its affiliates agrees to maintain a minimum net worth in conjunction with the guarantee. However, requiring reserves in an amount less than or equal to the partnership's reasonably projected operating expenses for a twelve-month period will not constitute an amount set aside to fund a guarantee.

Impermissible guarantees are defined by the Safe Harbor as a direct or indirect guarantee of the Investor's ability to claim the rehabilitations credits, the cash equivalent of the credits or the repayment of any portion of the Investor's contribution due to inability to claim the rehabilitation credits in the event the IRS challenges all or a portion of the transactional structure of the partnership. Additionally, no person involved in the transaction may guarantee that the Investor receives partnership distributions or consideration in exchange for its partnership interest except for a fair market value sale right (described below). No person involved in the transaction can pay the Investor's costs or provide an indemnity for the Investor's costs if the IRS challenges the Investor's claim of rehabilitation credits. The Safe Harbor provides, however, that these requirements do no prohibit the Investor from procuring insurance from parties unrelated to the partnership or the rehabilitation project.

Lastly, neither the Developer Partnership, Master Tenant Partnership nor the Principal may lend any Investor the funds to acquire any part of the Investor's interest in the partnership or guarantee or otherwise insure any indebtedness incurred or created in connection with Investor's acquisition of its interest.

These requirements expand upon similar requirements in the Wind Safe Harbor and seem to be tailored to addressing the set of guarantees in place in *Historic Boardwalk*. The Wind Safe Harbor did not specifically preclude the developer party from indemnifying the Investor against an IRS denial related to the transactional structure, although it did provide that no person may guarantee or insure the allocation of production tax credits to the Investor. The Safe Harbor requirement that permissible guarantees be "unfunded" was not in the Wind Safe Harbor.

Purchase and Sale Rights

Under the Safe Harbor, neither the Principal nor the partnership is permitted to have a call option or other right or agreement to purchase or redeem the Investor's interest at a future date. However, the Investor may have a put right, exercisable at a future date if the exercise price is no greater than fair market value at the time of exercise.

This requirement of the Safe Harbor conflicts with the purchase and sale right requirements in the Wind Safe Harbor. In the Wind Safe Harbor, call options are permitted, but put options are not. Call options under the Wind Safe Harbor are permitted if the purchase price for the project is not less than the fair market value of the project determined at the time of exercise or, if the purchase price is determined prior to exercise, is a price that the parties reasonably believe, based on all facts and circumstances at the time the price is determined, will not be less than the fair market value of the project at the time the right may be exercised, pursuant to IRS Announcement 2009-69. Query which of these requirements (if any) should be met by partnerships claiming credits other than the rehabilitation tax credit or the production tax credit.

The Safe Harbor also provides that an Investor may not acquire its interest in the partnership with the intent of abandoning the interest after the rehabilitation has been completed. If an Investor abandons its interest at any time, the investor will be presumed to have acquired the interest with the intent of abandoning it, unless the facts and circumstances clearly establish that the Investor did not acquire its interest with such intent. Presumably, this requirement indicates that the IRS does not want rehabilitation credit investors to take an ordinary loss upon the disposition of the partnership interest.

Satisfaction of Code Section 704(b)

Finally, the Safe Harbor requires that allocations under the partnership agreement satisfy the requirements of Code Section 704(b) and the regulations thereunder. Solely for purposes of determining whether this requirement is satisfied, allocations of the Code Section 50(d)(5) lessee income inclusion are not taken into account.

Effective Date

The Safe Harbor applies to allocations of rehabilitation tax credits by a partnership to its partners on or after December 30, 2013, and the IRS will not challenge such allocations. In addition, if a rehabilitated historic building was placed in service prior to December 30, 2013, the IRS also will not challenge a partnership's allocation of rehabilitation tax credits, provided the allocations satisfied the Safe Harbor at the time the building was placed in service and thereafter.

Conclusion

The Safe Harbor expands upon and adds some requirements to rehabilitation credit transactions that were not previously applicable under the Wind Safe Harbor for production tax credits. Despite the fact that these safe harbors expressly apply only to the rehabilitation credit and production credit, they address issues not specific to either credit. Thus, investors in other credit projects may have to consider the impact of the Safe Harbor and whether its requirements (or those of the Wind Safe Harbor, where the requirements conflict) should be met.

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