



Federal Tax Credit Law Alert

Winthrop & Weinstine Summary of Revenue Procedure 2014-12

Scope of the Guidance & General Information¹

1. Application of the Guidance is limited to allocations of HTC from Buildings that are placed in service on or after December 30, 2013.²
2. This means the Guidance does not address allocations of other federal tax credits or state tax credits other than HTC, federal HTC matters not specifically addressed by the safe harbor, or state tax credit transactions.
3. The Guidance is only a safe harbor and is not intended to provide substantive rules. We expect that Investors will require satisfaction of all components of the safe harbor outlined below.
4. No private letter rulings will be issued by the IRS on the issue of allocation of HTC (i.e., the IRS intends the Guidance to be the final official word from the IRS on this issue).

Safe Harbor Requirements

The Guidance provides that ALL of the following conditions must be met in order to satisfy the safe harbor:

1. Minimum Interests of Principals. Principals must maintain at least a 1% interest in each material item of Partnership income, gain, loss, or credits at all times.
2. Minimum Interests of Investors. It is expected that an Investor will almost always initially acquire a 99% interest in each material item of Partnership income, gain, loss, or credits. The Guidance allows the parties to “flip” the allocation of some or all of such Partnership items at some point; provided, however, that an Investor must maintain a percentage interest in each of such items at all times equal to at least 5% of the Investor’s percentage interest for such item for the taxable year in which the Investor’s percentage interest in such item is the largest (i.e., assuming an Investor begins with a 99% share of all items, the minimum percentage would be 4.95% (99% x 5%)).
3. Bona Fide Equity Investment. An Investor must make a “bona fide equity investment” in exchange for its interest, which requires each of the following requirements to be satisfied:
 - a. The reasonably anticipated value must be commensurate with the Investor’s overall percentage interest in the Partnership’s cash flow and residual, exclusive of other tax benefits. IRS officials stated that means that the Investor must be allocated an amount equal to its percentage interest of whatever economics are generated from the Building – it does not require any sort of “cash on cash” analysis or minimum return.
 - b. The reasonably anticipated value of an Investor’s interest must be contingent upon the Partnership’s cash flow and residual interests and is not *substantially fixed*³ in amount.
 - c. An Investor must not be *substantially protected*⁴ from losses from Partnership activities.

¹ Capitalized terms are those used within the Guidance; for the readers' convenience, they are also defined at the end of this summary.

² Projects that have closed but that have not yet been placed in service should be evaluated as to compliance with the safe harbor requirements with the Guidance. However, this leaves in limbo projects previously placed in service that do not comply with the safe harbor. Once a project has been placed in service, a subsequent modification to the investment terms is not likely to help a taxpayer’s position in an audit, since the determination of whether an Investor is a partner is made on that day.

³ The term “substantially fixed” is not defined, but the assumption is that the Investor’s return must not be limited to a set fee(s) or an annual preferred return.

- d. An Investor's participation in profits cannot be limited to an annual preferred return of capital.
 - e. The Investor's contribution cannot be obtained from (i) funds loaned to Investor by a Developer Partnership, Master Tenant Partnership, or Principal of either, or (ii) indebtedness created in whole or in part to acquire Investor's interest if such indebtedness is guaranteed or insured by any such party.
4. No Unreasonable Reduction in Investors' Interests. The value of the Investor's interest may not be reduced through fees (including developer, management, and incentive fees), lease terms, or other arrangements that are *unreasonable* compared to fees, lease terms or other arrangements for a project that doesn't qualify for HTC. Except for the following specific examples actions or arrangements that are deemed to be unreasonable, the Guidance is silent as to how "unreasonable"⁵ will be determined:
- a. Master subleases will be deemed unreasonable under the following circumstances: (i) a sublease back to the Developer Partnership or Principal, unless mandated by a third party unrelated to the Principal; and (ii) the term of a sublease to any person is shorter than the term of the Head Lease.
 - b. Master Tenant Partnership may not terminate Head Lease during the period the Investor is a partner in the Developer Partnership.
5. No Disproportionate Distributions. An Investor's interest may not be reduced by disproportionate rights to cash flow or residual distributions or by issuances of interests (or for option rights to acquire interests) for less than fair market value. IRS officials stated that distributions straying from the stated percentage interest of an Investor will not in and of themselves cause this requirement to not be satisfied, but the Principal and Investor should have commercially reasonable reasons for doing so.
6. Investor's Capital Contribution Requirements.
- a. An Investor must contribute an amount equal to at least 20% of its total expected capital contribution as of the date the Building is placed in service. Be aware that 20% at the closing of financing may not be equal to 20% at the date a Building is placed into service if the amount of qualified rehabilitation expenditures increases during construction.⁶ An Investor's contribution of a note or other obligation to actually pay later will not count towards meeting this minimum investment.
 - b. At least 75% of the Investor's total expected capital contributions must be fixed in amount before the date the Building is placed in service.⁷ This does not require that 75% be contributed by the date the Building is placed in service. The example contained in the Guidance provides that mutually agreed upon milestones can be set for terms of contribution of capital over the minimum amount.
7. Permitted Guarantees.
- a. The Guidance permits guarantees of damages from an act or omission that would cause the Partnership to fail to qualify for the HTC or that would result in recapture of HTC. The Guidance explicitly cites the following as examples of permitted guarantees: completion guarantees, operating deficit guarantees,⁸ environmental indemnities, financial covenants, and the payment of an agreed-upon put price that complies with the requirements set forth under Number 9 below, although IRS representatives cautioned that guarantees must be tied to an "act" and allow recovery for damages resulting therefrom, but guarantees should not be structured as guaranteeing the HTC itself or a loss of the HTC not caused by an act or omission of a Principal (e.g., a casualty resulting in recapture).

⁴ The term "substantially protected" is not defined, but it is assumed that permitted guarantees (discussed under Number 7 below) should not cause an Investor to be deemed substantially protected from losses.

⁵ This is often one of the most key structuring issues in HTC projects in order to make sure cash flow and residual interests are allocated where the parties intend. The determination of whether a fee or lease arrangement is "unreasonable" will likely be a fact-specific determination that will need to be supported by outside facts and/or third-party reports.

⁶ Investors will likely require a cushion to be built into the initial capital contribution to ensure that the 20% minimum contribution is met and/or a mechanism for making an additional contribution just prior to construction completion may be needed in order to satisfy such requirement.

⁷ Investors will likely wait to set such fixed amount until just before a Building is placed in service and not at the initial closing.

⁸ IRS representatives at the IPED Conference stated that unlimited operating deficit guarantees are not prohibited under the Guidance, but that appears to be contrary to the official position taken by the IRS in the *HBH* case and in numerous other contexts. Accordingly, pending further official confirmation from the IRS on this issue, parties should be cautioned against relying on such statement alone.

- b. Any other unfunded guarantees not falling under the definition of impermissible guarantees are assumed to be permitted.
- c. All guarantees must be “unfunded,” which means that (i) no money or property is set aside to fund all or any portion of a guarantee, and (ii) no guarantor or affiliate thereof agrees to maintain a minimum net worth.⁹ However, the Guidance provides that reserves up to an amount equal to twelve (12) months’ operating expenses will not constitute property set aside to fund a guarantee. The Guidance is not clear as to whether a requirement that such operating reserve be replenished out of first available cash flow will be permitted.
- d. The Guidance allows Investors to obtain insurance for impermissible guarantees and/or obtain guarantees from persons not involved in any part of the rehabilitation transaction.

8. Impermissible Guarantees.

- a. The Guidance prohibits direct or indirect guarantees of the Investor’s ability to claim the HTC, the cash equivalent of the HTC, or the repayment of any portion of the Investor’s contribution due to inability to claim HTC in the event the IRS challenges the transactional structure of the Partnership.
- b. An Investor may not require guarantees that it will receive any consideration or distribution of its interest, except for a guaranty of a put price that complies with the provisions described under Number 9 below.
- c. Guarantees of an Investor’s costs or losses if the IRS challenges an Investor’s claim of HTC are also prohibited.

9. Exit Rights.

- a. No call options to purchase Investor’s interest are allowed.
- b. A put right cannot be for an amount that is *more* than its “fair market value” at the time of the sale, but IRS representatives stated that a put option for a set price at *below* fair market value is allowable.¹⁰
- c. An Investor may not acquire its interest with the intent of abandoning it later. If abandoned later, the IRS will assume it was initially intended to be abandoned unless facts and circumstances clearly establish that Investor didn’t do so. The IRS officials indicated that if an Investor is selling its interest for less than fair market value, but it is not trying to claim an ordinary loss under Internal Revenue Code Section 165(g) for worthless securities, the IRS will not consider a put option for a set price at below fair market value to be an abandonment.
- d. The elimination of call option rights may be a concern for some developers because they would not have the unilateral right to cause an Investor to exit the Partnership. To mitigate that concern, developers are advised to seek only Investors they feel they can trust and/or who are likely to have a vested interest in continuing to invest in HTC transactions going forward.

Contact

If you have any questions about any topics in this Alert, or any other concerns that arise as a result of the Guidance, please do not hesitate to contact any of the attorneys from Winthrop & Weinstine’s federal tax credit practice group.

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⁹ Although unclear, the consensus among those in the industry is that liquidity covenant would also be prohibited. It does appear that negative covenants prohibiting disposition of assets should be permitted, which will give Investors comfort. Additionally, Investors will be able to place some reliance on net worth covenants required by lenders, although the IRS representatives at the IPED Conference stated that arrangement would likely be scrutinized if the Investor and lender are related parties.

¹⁰ Although not explicitly required by the Guidance, it would be prudent to have documented reason(s) for exercising a put below fair market value (e.g., clearing certain assets from books, other accounting considerations, etc.).

Defined Terms Used in the Guidance

“Building” means a qualified rehabilitation building or a certified historic structure.

“Developer Partnership” means a Partnership that owns and restores a Building.

“Head Lease” means a lease of a Building from a Developer Partnership to a Master Tenant Partnership.

“Investor Minimum Contribution” means the minimum unconditional amount an Investor must contribute to the Partnership before the date that the Building is placed in service.

“Investors” means Partnership partners other than Principals that hold an interest in the Partnership.

“Master Tenant Partnership” means a Partnership that leases a Building from a Developer Partnership pursuant to a Head Lease and for which an election is made pursuant to § 1.48-4(a)(1) to treat the Master Tenant Partnership as having acquired the Building solely for purposes of the § 47 rehabilitation credit.

“Partnership” means a partnership that validly claims the §47 rehabilitation credit.

“Principals” means one or more managers authorized to act for the Partnership.

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