
IRS Issues Long-Promised Guidance Following *Historic Boardwalk* Decision

By Thomas D. Morton

To welcome in the new year, the Internal Revenue Service (the “IRS”) issued Rev. Proc. 2014-12, 2014-3 I.R.B. 415, to provide administrative guidance to the federal historic tax credit industry in the aftermath of the Third Circuit’s decision in Historic Boardwalk Hall, LLC v. Commissioner, 694 F.3d 425 (3d Cir. 2012), cert. denied, 133 S.Ct. 2734 (2013). Rev. Proc. 2014-12 includes a safe harbor (the “Safe Harbor”) pursuant to which the IRS will not challenge the allocation of rehabilitation tax credits (“Historic Credits”) under Section 47 of the Internal Revenue Code of 1986, as amended (the “Code”), among partners in a partnership. Overall, the guidance is a good faith and useful attempt by the IRS to set reasonable Safe Harbor parameters while addressing its concerns with the deal structure in the Historic Boardwalk case. Unfortunately, it does also include some puzzling elements.

I. Background – The *Historic Boardwalk* Case

In the *Historic Boardwalk* case, the Third Circuit addressed whether an equity investor in a partnership which completed the rehabilitation of a historic building in a manner which qualified for Historic Credits should be regarded as a partner in the partnership for federal income tax purposes. In this case, the New Jersey Sports and Exposition Authority (the “NJSEA”) was the lessee and operator of a historic structure which required substantial renovation. To complete the rehabilitation, NJSEA created *Historic Boardwalk Hall, LLC* (“HBH”), in which it served as the managing member. A subsidiary of Pitney Bowes (“PB”) was admitted to HBH as the investor member. The building was subleased by NJSEA to HBH for a term of 87 years.

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Under the terms of the operating agreement for HBH, PB had a 99.9% interest in HBH's profits, losses, Historic Credits and cash flow, and was entitled to an annual priority return equal to 3% of its capital contributions. Only a small portion of PB's capital was contributed prior to placement in service, with the balance dependent upon, and calculated with reference to, the amount of Historic Credits actually allocated to PB. NJSEA provided PB with a construction completion guaranty, an unlimited operating deficit guaranty, a guaranty against environmental liability and a guaranty of PB's projected federal income tax benefits (including indemnification against any loss of such benefits following an audit by the IRS). In certain circumstances, NJSEA had the right to purchase PB's interest in HBH for an amount equal to the present value of unrealized federal income tax benefits and cash flow projected to be realized by PB during the 5-year Historic Credit recapture period. Following the recapture period, NJSEA had the right to acquire PB's interest in HBH for a formula price equal to the greater of (i) the fair market value of its interest or (ii) PB's unpaid priority return. PB also had the right to put its interest in HBH to NJSEA for the same formula price. NJSEA's obligation to pay the purchase price under the foregoing options was secured by a Guaranteed Investment Contract ("GIC") equal to the anticipated cumulative priority return.

At the trial court level, the Tax Court held that PB was a bona fide partner in HBH. The Third Circuit reversed, finding that PB had no meaningful interest in either the success or failure of HBH's activities. The court determined that there was no meaningful potential for economic upside from PB's investment, finding that the financial projections had been manipulated to create the impression of a pre-tax economic motive for PB's investment by using unsupported and overly optimistic assumptions. Thus, it concluded that the only possible economic benefit to PB, apart from federal income tax benefits, was its 3% priority return, the payment of which was guaranteed by NJSEA through the put and call options, and which was fully secured by the GIC. The court further noted that PB bore no risk that it would not receive the anticipated Historic Credit (or its cash equivalent), and had contributed little capital until the rehabilitation was completed and the amount of Historic Credits had been determined. The court was also swayed by the fact that (i) NJSEA provided construction completion, cost overrun and operating deficit guaranties, (ii) the sources of financing available to HBH were sufficient to fund the rehabilitation without PB's capital, with the original budget being revised to add a development fee payable to NJSEA and most of PB's capital being used to pay it.

Although the *Historic Boardwalk* case had some very bad facts for the taxpayer, the overall structure and scope of investor protections were not far afield from those in typical Historic Credit transactions being done at the time. Due to the turmoil the *Historic Boardwalk* decision caused in the industry and the adverse impact on the willingness of investors to invest in Historic Credit properties, the IRS announced it would issue guidance providing a safe harbor for Historic Credit investments. Rev. Proc. 2014-12 is that promised guidance.

II. The Rev. Proc. 2014-12 Historic Credit Safe Harbor

Rev. Proc. 2014-12 makes clear that the Safe Harbor is not intended to provide substantive legal rules, such that (in theory, at least) no inference is intended with respect to a transaction that does not satisfy the Safe Harbor requirements. The Rev. Proc. also states that the determination of whether an expenditure is a qualified rehabilitation expenditure, or whether a partnership is the owner of a building for purposes of claiming the Historic Credit, are outside the scope of the guidance. Nevertheless, following the uncertainty engendered by the *Historic Boardwalk* decision, it is useful to have an indication of the IRS's position on the issues addressed. While a number of the elements in the Safe Harbor have precedent in previous guidance released by the IRS in other areas, certain aspects of the Safe Harbor do seem somewhat surprising, and only time will tell how the industry ultimately reacts to them.

The key provisions of the Safe Harbor are described below. As becomes clear, the Safe Harbor departs from the manner in which Historic Credit transactions have typically been structured in a number of respects, with some departures seemingly benefiting investors and others benefiting developers. Stated simply, the Safe Harbor requires investors to sacrifice certain customary protections while requiring developers to cede pre-tax economics to investors.

The discussion adopts the nomenclature of the Safe Harbor, which defines the manager of the partnership in question (the “**Partnership**”) as the “**Principal**”, the equity investor as the “**Investor**”, and the partnership that owns the building and performs the rehabilitation as the “**Developer Partnership**.” If the deal is structured as a lease pass-through, the master lease is referred to as the “**Head Lease**” and the lessee as the “**Master Tenant Partnership**”.

“Investor” Defined. The Safe Harbor defines each partner that is not a Principal in the Partnership as an Investor. In a lease pass-through structure, it is typically the case that the Investor will hold a 99 percent (or greater) interest in the Master Tenant Partnership, and that the Master Tenant Partnership will own an interest in the Developer Partnership. The Safe Harbor expressly permits the Investor to hold such an indirect interest in the Developer Partnership through the Master Tenant Partnership. Curiously, however, it prohibits the Investor from holding an interest in the Developer Partnership directly unless acquired pursuant to “a separately negotiated, distinct economic arrangement” (such as if the Developer Partnership is also entitled to low-income housing tax credits (“**LIHTC**”) or new markets tax credits)¹.

Partners’ Partnership Interests. The Safe Harbor requires the Principal to have a minimum interest of one percent in each material item of Partnership income, gain, deduction, loss and credit throughout the term of the Partnership. This is not surprising, as the IRS has long believed that a general partner of a limited partnership should have a minimum interest of one percent.²

The Safe Harbor further requires that the Investor must have a minimum interest in each material item of Partnership income, gain, deduction, loss and credit equal to five percent of the Investor’s greatest percentage interest in such Partnership items (as adjusted to account for redemptions, sales and dilutions of Partnership interests). This five percent requirement has precedent in the Wind Safe Harbor, but it is nonetheless welcome news that the IRS did not choose to adopt a greater minimum percentage interest for the Safe Harbor.

In elaborating on the nature of the Investor’s Partnership interest, the Safe Harbor states that the interest must be a “bona fide equity investment with a reasonably anticipated value commensurate with the Investor’s overall percentage interest in the Partnership” determined without regard to any tax benefits attributable to the investment. An equity investment will only be considered bona fide if (i) the reasonably anticipated value is contingent upon the Partnership’s net income or loss, (ii) the Investor is not substantially protected from Partnership losses and (iii) the Investor’s interest in profits is not limited to a preferred return in the nature of a payment for capital. The foregoing does not appear to require that the Investor’s percentage interest in the Partnership be ratable based upon the capital contributions of all partners – in fact, the Safe Harbor’s express contemplation of a flip in percentage interests suggests that

¹ Given that the Safe Harbor explicitly permits an Investor in the Master Tenant Partnership to hold an indirect equity interest in the Developer Partnership, the potential for abuse that the IRS is apparently attempting to address by prohibiting the Investor from acquiring the interest directly is not readily apparent.

² For example, prior to the check-the-box rules for entity classification, Rev. Proc. 89-12, 1989-1 C.B. 798, contained such a requirement as a condition of receiving a favorable partnership classification ruling (subject to a limited exception for partnerships having more than \$50,000,000 of capital contributions). The minimum 1 percent requirement is also found in the safe harbor for the Code section 45 wind energy production tax credits contained in Rev. Proc. 2007-65, 2007-2 C.B. 967 (the “**Wind Safe Harbor**”).

no such requirement was intended – but it does make clear that, whatever the Investor’s stated percentage interest might be, that percentage interest must represent an uncapped share of the Partnership’s pre-tax economic profits and/or losses.

For purposes of the foregoing, Section 4.02(2)(c) of the Safe Harbor states prohibits a reduction in the value of the Investor’s Partnership interest through fees, lease terms or other arrangements that are “unreasonable” in relation to those of real estate development projects that do not qualify for the Historic Credit. Disproportionate rights to distributions, or the right to admit additional partners other than on fair market value terms, are similarly prohibited. In addition, in the case of a lease pass-through structure, a sublease of the project from the Master Tenant Partnership to the Developer Partnership or to a Principal (including any related person) is deemed to be unreasonable unless compelled by an unrelated third party (such as a mortgage lender). Further, the duration of any sublease must be shorter than the Head Lease term, and the Head Lease may not be terminated by the Master Tenant Partnership while the Investor remains a partner.

The above conditions potentially depart from commercial reality and applicable Treasury Regulations in certain respects. First, given the Safe Harbor’s emphasis that the Investor must share in all of the Partnership’s economics, and not just tax benefits, it is understandable that the IRS would not want this to be undercut by unreasonable fees and disproportionate distributions. However, the reality is that, in most instances, a rehabilitation project that qualifies for the Historic Credit is a much more complex task than a conventional rehabilitation, and the fees payable to the developer should reflect that complexity. If the IRS interprets “unreasonable” as allowing fees to reflect the difficulty of a Historic Credit rehabilitation (whether by means of a higher development fee or payment of a separate ‘historic services’ fee), the Safe Harbor should be clearer on that point. If the intent is to treat any fee in excess of that payable in a conventional rehabilitation as unreasonable, however, that position is clearly problematic.

Second, it is unclear why the IRS requires, in a lease pass-through structure, that the Head Lease exceed the term of any subleases. It is certainly a legitimate concern that a Head Lease coupled with a pre-arranged and coterminous sublease back to the Principal may lack economic substance. However, this issue seems to be addressed by the prohibition of a sublease to the Developer Partnership or a Principal. If a Master Tenant Partnership arranges one or more subleases on market terms that run the full duration of the Head Lease, why is this a problem?

Finally, Treasury Regulation section 1.704-1(b)(4)(ii) states that allocations of tax credits do not have economic effect but, in the case of investment tax credits (such as the Historic Credit), allocations of such credits in accordance with the manner in which the partners share basis in the property giving rise to the credit are deemed to be in accordance with the partners’ interests in the partnership. Treasury Regulation section 1.46-3(f)(2) provides the general rule that partners share basis in investment credit property in the same ratio as bottom line taxable income under Code section 702(a)(9) “regardless of whether the partnership has a profit or a loss for its taxable year”³ For this purpose, it would appear irrelevant that the partnership may distribute cash flow in a different manner if the partnership satisfies Code section 704(b) requirements. However, in TAM 8931001 (March 15, 1989), the IRS departed from this notion in a circumstance in which profits during the taxable year in which investment tax credit property was placed in service were allocated 90 percent to the limited partners, reduced to 60 percent for the next five years, and further reduced thereafter to 33 percent.⁴ The general partner was entitled to a guaranteed payment of 10 percent of gross revenues and an incentive fee of up to 35 percent of remaining cash flow. The partnership

³ Code section 702(a)(9) referenced in the foregoing Treasury Regulation is current Code section 702(a)(8).

⁴ All percentages are approximate.

was projected to recognize losses in all years in question, with no expectation of distributable cash prior to the reduction in the limited partners' interests to 60 percent. The IRS disallowed the allocation of 90 percent of tax credits to the limited partners on the basis that, under Treasury Regulation section 1.46-3(f)(2), the stated allocation of bottom line profits was inconsistent with the partners' actual sharing of the partnership's economics. The IRS further found, in the alternative, that because the partnership was projected as only having losses, the first year allocation of 90 percent of the partnership's profits lacked substantiality under Treasury Regulation section 1.704-1(b)(2)(iii). The IRS continues this movement away from the language of Treasury Regulation section 1.46-3(f)(2) with the Safe Harbor's focus on the Partnership's fee structure and the Investor's investment having "a reasonably anticipated value commensurate with the Investor's overall percentage interest in the Partnership"⁵

Minimum Unconditional Contribution. Consistent with the Wind Safe Harbor, the Safe Harbor requires that (i) the Investor make a minimum capital contribution to the Partnership of 20 percent of its aggregate expected capital contributions prior to the property's placement in service, (ii) the Investor maintain this minimum investment in the Partnership at all times it is a partner, and (iii) a minimum of 75 percent of the Investor's expected capital contributions be fixed prior to placement in service.

Guaranties. The Safe Harbor only permits "unfunded" guaranties to be provided to the Investor and, with respect to the availability of Historic Credits, may only be an "acts or omissions" guaranty; i.e., the guaranty may only protect the Investor for a loss or recapture of Historic Credits attributable to the performance of acts or the failure to act that would cause the Partnership to fail to qualify for, or cause a recapture of, the Historic Credit. The Safe Harbor also permits unfunded construction completion guaranties, operating deficit guaranties, environmental indemnifications and financial covenants. For this purpose, a guaranty is "unfunded" if no money or property is set aside to fund the guaranty, and neither the guarantor nor any person under the control of the guarantor is required to maintain a minimum net worth with respect to the guaranty.⁶ While Investors may be troubled by these restrictions (potentially negatively impacting pricing), the Safe Harbor does helpfully permit the Partnership to maintain reserves of up to 12 months of reasonably expected operating expenses without the reserves being treated as amounts "set aside" to fund guaranties.

Section 4.05(2) of the Safe Harbor expressly prohibits any person involved in the rehabilitation transaction from guarantying (i) the tax structuring risk of the deal for the benefit of the Investor (including paying the Investor's costs in connection with a challenge by the IRS), (ii) distributions from the Partnership to the Investor or (iii) any amount of consideration to be paid in exchange for the Investor's Partnership interest (other than in connection with the exercise of a put option on the terms described below). The Safe Harbor does permit the Investor to obtain insurance against the tax structuring risk from one who is not otherwise involved in the transaction.⁷

Loans. The Safe Harbor prohibits the Developer Partnership, the Master Tenant Partnership, or a Principal from lending any funds to the Investor to acquire an interest in the Partnership (or guaranty any loan made to the Investor for the purpose of such an investment).



⁵ It should be noted that the Safe Harbor does expressly require that (i) the Partnership's allocations be in compliance with Code section 704(b) and (ii) allocations of the Historic Credit be in compliance with Treasury Regulation section 1.704-1(b)(4)(ii).

⁶ Query what the IRS intends by permitting financial covenants but prohibiting a minimum net worth covenant.

⁷ Although such third party insurance is not a violation of the Safe Harbor, the terms of any such insurance must nevertheless be such that under general federal income tax principles the Investor remains the tax owner of the Partnership interest.

Purchase, Sale and Abandonment Rights. The Investor may not have the right to cause any person involved in the rehabilitation transaction to purchase, or cause the Partnership to liquidate, the Investor's interest in the Partnership for an amount greater than then-current fair market value. Further, neither the Partnership nor a Principal may have a call option or contractual right to acquire or redeem the Investor's interest in the Partnership at a future date.

This is a very curious turn of events, as the IRS historically has had a greater concern with the impact of put options on tax ownership than call options. For example, when the IRS first published its ruling guidelines for leasing transactions in Rev. Proc. 75-21, 1975-1 C.B. 715, the lessee was permitted to have a call option to acquire the leased equipment at its fair market value determined at the time of exercise.⁸ The lessor, however, was required to represent that it had neither the contractual right to require any person to purchase the leased property nor the intent of acquiring any such right. Similarly, the Wind Safe Harbor prohibits the investor from having the right to require any person to purchase its interest in the project company, whereas both the developer and the investor are permitted to have a call option to acquire the wind farm or an interest in the project company for not less than its then-determined fair market value.⁹ The Safe Harbor takes the opposite approach – the Investor may have a put option that obligates a Principal to purchase its Partnership interest for an amount that does not exceed fair market value, but a Principal is prohibited from having a call option, under any terms, to purchase the Investor's interest. It is not clear what concern the IRS is addressing here (and why, in doing so, it is reversing its previous position) – if the option price to acquire the Investor's Partnership interest is then-determined fair market value, there should be no adverse impact on tax ownership of a bona fide equity interest in the Partnership regardless of whether the option is a put or a call.

A related and somewhat inexplicable feature of the Safe Harbor is that it prohibits the Investor from acquiring its interest in the Partnership with the intent to abandon it at any time after the rehabilitation has been completed. The Safe Harbor expressly permits the Investor to put its interest to a Principal for a price that does not exceed the fair market value of the interest. Accordingly, it appears perfectly permissible for the Investor to have a put option with a price of one dollar, whereas it is impermissible for the Investor to have the right to convey its interest for nothing.¹⁰ It is difficult to discern the policy behind this.

This Section of the Safe Harbor also provides that it is not intended to prohibit the payment of accrued fees, preferred returns or tax distributions to the Investor. Given that the payment of preferred returns and tax distributions to equity investors were common prior to the *Historic Boardwalk* case, it is a helpful clarification that the IRS does not intend to impede this practice. By permitting the parties the flexibility to structure a transaction in which the Investor is entitled to a priority on distributions that could exceed its percentage interest in the Partnership, it is also arguably consistent with the notion that the parties are afforded the flexibility to assign percentage interests in the Partnership that are not necessarily ratable in accordance with the parties' respective capital contributions.¹¹

⁸ In fact, the IRS has approved a purchase option involving real property where the lessee was entitled to acquire the leased property for the lesser of the property's fair market value or a specified formula price. See PLR 8530093 (April 30, 1985).

⁹ The Wind Safe Harbor prohibits the developer from exercising a contractual right to purchase the wind farm or an interest in the project company prior to five years following placement in service.

¹⁰ It is unlikely that this is driven by a loss characterization concern. Typically, the Partnership will have some amount of permanent financing secured by the project. If any portion of the Partnership's debt is allocated to the Investor, an abandonment of the Investor's interest will be treated as a sale or exchange with an amount realized equal to the Investor's share of the Partnership's debt. This would ordinarily be true even in the case of a lease pass-through structure, assuming the Master Tenant Partnership is a partner in the Developer Partnership.


¹¹ As previously discussed, the Safe Harbor requires that the Investor's Partnership interest must have "a reasonably anticipated value commensurate with the Investor's overall percentage interest in the Partnership", but it does not specify any

Illustrative Examples. The Safe Harbor contains two examples to illustrate its provisions, the first involving only a Developer Partnership and the second, utilizing similar facts, with a Head Lease to a Master Tenant Partnership. Although the examples do not stray beyond the confines established in the Safe Harbor, the second example clarifies that, in applying the provisions of the Safe Harbor to a lease pass-through deal, the term “Partnership” refers solely to the Master Tenant Partnership. While this does suggest the availability of flexibility in negotiating the structure of the Developer Partnership in such a case, the Safe Harbor makes clear that this remains within the context of a Head Lease that must reflect market terms in comparison to leases that do not involve Historic Credit properties.

Possible Implications for LIHTC Transactions. The Safe Harbor is expressly intended to apply solely to projects qualifying for the Historic Credit, with no implications for other transactions such as those qualifying for the LIHTC. To a large extent, that is appropriate – LIHTC transactions are distinguishable in many ways from Historic Credit transactions, such that (with the possible exception of LIHTC transactions featuring a minimum yield guaranty) the *Historic Boardwalk* case ultimately had little impact on the LIHTC market, and the Safe Harbor will likely meet a similar fate. Certain features of the Safe Harbor, however, may very well have relevance to issues that sometimes arise in LIHTC transactions. For example, the Safe Harbor underscores the fact that the IRS does not regard a partner’s interest in “profits” as being limited to “book” profits as determined for capital account purposes or taxable income under Code section 702(a)(8), but as also including a partner’s interest in partnership fees and cash distributions.¹² Accordingly, for LIHTC transactions in which a tax-exempt entity or a tax-exempt controlled entity is a partner, the Safe Harbor suggests that the IRS will look at the fees payable to such an entity in determining the extent to which the partnership’s property should be treated under Code section 168(h)(6) as tax-exempt use property. A similar analysis will apply to the related party rule in determining whether a partnership purchasing an existing property can qualify for LIHTC with respect to the acquisition cost where there is some amount of common ownership between the selling partnership and the purchasing partnership.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the author below.

Thomas D. Morton [\(bio\)](#)
Washington, DC
+1.202.663.8317
thomas.morton@pillsburylaw.com

 required relationship between that overall percentage interest and the Investor’s capital contributions in comparison to the aggregate contributions of all partners.

¹² In fact, Proposed Regulation section 1.752-3(a)(3) takes yet another approach, defining a partner’s interest in profits as that percentage corresponding to the partner’s share of the liquidation value of the partnership.

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