MEMORANDUM

From: Steven P. Berman

Date: January 8, 2014

Re: IRS Guidance on Historic Tax Credit Transactions

On December 30, 2013, the Internal Revenue Service (the "IRS") released Revenue Procedure 2014-12, establishing certain "safe harbor" requirements for historic tax credit transactions under which the IRS will not challenge the allocation of the tax credits to the tax credit investor partner (the "Investor"). The Rev. Proc. 2014-12 was a response to the concern that the market for the syndication of historic tax credits had stopped functioning in the aftermath of the decision of the United States Court of Appeals for the Third Circuit in the case of Historic Boardwalk Hall, LLC vs. Commissioner in August 2012. The tax credit industry had been following the Historic Boardwalk case as it worked through the courts (where the Tax Court held in favor of the taxpayer) and the decision of the Third Circuit on appeal was anxiously awaited. When the Third Circuit reversed the Tax Court and held in favor of the IRS, the initial reaction was relatively calm. However, by the beginning of 2013 it became clear that tax credit investors were having a difficult time deciding just how broadly Historic Boardwalk would be applied to historic tax credit transactions with different facts and how aggressively the IRS would examine other historic tax credit transactions. The anxiety was increased by the release of a memorandum originally dated August 30, 2012 by the IRS Office of Chief Counsel (FAA 20124002F) which addressed a fact pattern less egregious than the facts in Historic Boardwalk. As a result, some tax credit investors decided not to make further investments until the IRS clarified its views in published guidance, while other tax credit investors proceeded cautiously in continuing to make investments, but with some changes to the deal structure in an effort to anticipate how the IRS wanted to see these transactions structured.

By the summer of 2013 it was widely expected that the IRS would issue a Revenue Procedure that would set forth a safe harbor structure under which the IRS would agree not to contest the validity of the allocation of historic tax credits to an investor. The model for such a Revenue Procedure would be Revenue Procedure 2007-65 that was promulgated by the IRS to deal with a similar situation with respect to the wind energy tax credits under Code Section 45, and Rev. Proc. 2014-12 is quite similar to Rev. Proc. 2007-65. It was expected, or at least hoped, that the Revenue Procedure would be published sooner than it was and the delay created anxiety within the historic tax credit industry both because of the difficulty of deferring investments and because the delay suggested that there were significant technical issues with which the IRS was struggling.

Rev. Proc. 2014-12, as expected, makes it clear that the "safe harbor" requirements are not intended to provide substantive rules and have no application to transactions outside of the safe harbor. Rev. Proc. 2014-12 also makes it clear that the safe harbor requirements have no application to tax credits other than historic tax credits and within the historic tax credit realm do not have any application to the allocation or transfer of state tax credits by a partnership, which

30 North 41st Street, Suite 450, Philadelphia, PA 19104 T: (215) 825-9730 F: (267) 507-9102 www.bermanindictor.com

was the issue considered by the Court of Appeals for the Fourth Circuit in Virginia Historic Tax Credit Fund 2001 LP vs. Commissioner in March 2011.

It is likely that virtually all historic tax transactions will be structured to fit within the safe harbor requirements. Rev. Proc. 2014-12 applies to allocations of historic tax credits made by a partnership on or after December 30, 2013, but will also be honored by the IRS with respect to buildings placed in service before December 30, 2013 if all of the safe harbor requirements were satisfied at the time that the building was placed in service. Transactions that have already closed but with respect to which the building has not yet been placed in service and, therefore, the historic tax credits have not been allocated, presumably can now be modified to fit within the safe harbor requirements. Transactions where the historic tax credits were allocated before December 30, 2013 and which do not fit within the safe harbor requirements will not receive the benefit of Revenue Procedure 2014-12. The extent to which those transactions will be vulnerable to an IRS audit is not clear.

Revenue Procedure 2014-12 has prompted two fairly simple questions: (1) will the tax credit industry find the safe harbor requirements to be workable; and (2) how do the safe harbor requirements differ from the standard structure of historic tax credit transactions prior to Historic Boardwalk? It is probably premature to try to answer the first question, although it can be said that the IRS certainly intended and hoped that the safe harbor requirements would be workable and that the historic tax credit syndication business would function under the new safe harbor requirements. Whether the historic tax credit industry will find the safe harbor requirements workable will depend, to a large extent, on the answer to the second question about what will be different under the safe harbor requirements. These requirements fall into several categories which will be discussed briefly below.

Investor Minimum Contribution. The Investor must make a capital contribution of at least 20% of its total expected capital contribution before the building is placed in service. In addition, at least 75% of the Investor's total expected capital contribution must be fixed in amount before the building is placed in service. The point of these requirements is to ensure that the Investor's obligation to make capital contributions is not deferred until after all of the development risk with respect to the project has already been eliminated by the completion of the project and its placement in service.

Guarantees. The developer or general partner (the "Developer") will no longer be able to guarantee to the Investor the delivery of the historic tax credits. However, the Developer may provide guarantees to the Investor that it will take any steps necessary for the project to eligible to claim the historic tax credit and that it will not engage in any act that will negatively impact the eligibility to claim the historic tax credit or that would result in the recapture of the historic tax credit. The Developer may still provide a completion guaranty and an operating deficit guaranty with respect to the project, but those guarantees may not be "funded" and the guarantor may not be required to maintain a minimum net worth in connection with the guarantee. At first blush, this change would appear to be quite significant, but upon further reflection perhaps it is not as big a change as it appears. The tax credit risk that cannot be guaranteed is what we would refer to as "structure" risk and given that Rev. Proc. 2014-12 now provides a safe harbor, it would appear that the "structure" risk is being eliminated from these transactions and, therefore,

the need for a guarantee to the Investor has been significantly reduced, if not eliminated. Further, the fact that other guarantees may not be "funded" probably isn't a major change because most guarantees were not funded to begin with. The Court in Historic Boardwalk focused on the fact that the guarantor was a government agency with unlimited resources, but that type of guarantee is not typical of historic tax credit transactions. Further, while a covenant to maintain a sufficient net worth can no longer be required, Rev. Proc. 2014-12 does not appear to limit the ability of the Investor to underwrite the creditworthiness of the guarantor before deciding to make an investment.

Exit Strategy. The Developer and the partnership may not have a call option to acquire the interest of the Investor at a future date, even if that call option would have been at the fair market value of the interest of the Investor at the time the option is exercised. The Investor may not have a right to require any person involved in the transaction to purchase its interest (a "put option") at a future date at a price that is more than the fair market value of the interest determined at the time of exercise of the right to sell. This rule is then further modified by a requirement that an Investor may not acquire its interest with the intent of abandoning it after the project is completed. These requirements warrant some further discussion. First, the typical put option for an Investor was at a fixed price that was either nominal or was a percentage, such as 20%, of the total capital contributions made by the Investor. The requirement would appear to allow the Investor to have a put option at a price that is less than or equal to the fair market value of the interest, but how could one know with certainty that the fixed price that is selected will not be more than the fair market value? One possibility is that the put price would be set at the lesser of fair market value or a fixed price that is selected. If the put price is low or nominal might the prohibition on the Investor abandoning its interest apply? The IRS seemed to be concerned only with an abandonment that would result in an ordinary loss, not with a sale at a low price that would result in a capital loss. At worst, this uncertainty over the permissible structure of a put option might result in Developers and Investors deciding that the Investor should not have a put option at all, which would leave the Developer and the Investor in the position of negotiating at arms-length a fair market value sale of the Investor's interest after the expiration of the five-year tax credit recapture period. From the standpoint of the Developer not having a call right at fair market value ought not to be a major detriment because it is free to negotiate a fair market value purchase with the Investor any time it would like. Fair market value is the price that would be agreed to by a willing buyer and a willing seller and the Investor presumably will be a willing seller after the expiration of the five-year recapture period. From the standpoint of the Developer the absence of a put option in favor of the Investor ought not to be a significant business issue because there never was any assurance that the Investor would exercise the put option at a price less than the fair market value of its interest. The uncertainty over what the future fair market value of the Investor's interest will be likely will lead to problems in determining the appropriate pricing for the investment. The Investor will be reluctant to make an additional capital contribution in the expectation of a contingent sale price after the five-year tax credit recapture period and the Developer will be reluctant to give up a substantial economic interest in the project if the Investor is not willing to pay for it. This problem will be most severe with respect to properties with high economic value (the opposite of a Historic Boardwalk-type fact pattern).

Economic Structure. Rev. Proc. 2014-12 clearly recognizes the master lease structure that has become so common over the past decade and in the case of a transaction utilizing the master lease structure makes it clear that the requirements apply to the investment by the Investor at the master tenant level. Rev. Proc. 2014-12 also legitimizes a flip of the percentage interest of the Investor in the master tenant after the five-year tax credit recapture period and establishes a minimum percentage interest of 5% that the Investor would have to hold after the flip. The value of the Investor's interest if and when it is purchased after the five-year tax credit recapture period would be based upon a full 5% share of the value of the master tenant, which does not necessarily reflect 5% of the equity of the partnership that owns the real estate. Rev. Proc. 2014-12 makes it clear that the interest of the Investor cannot be diluted by various fees or a sublease of the project that would deprive the Investor of its full participation in cash flow as a partner in the master tenant. Rev. Proc. 2014-12 also recognizes the possibility that the master tenant will own a partnership interest in the property owner, but does not require such a structure or provide any insights into how the IRS views such an arrangement in determining whether the property owner and master tenant are landlord and tenant for Federal income tax purposes.

There are three other observations that jump out at me from Rev. Proc. 2014-12 and the process of the IRS went through in promulgating it. First, the IRS was very reluctant to set forth a different set of tax principles that would apply to the historic tax credit industry. The IRS wanted to come up with a workable set of standards that held the historic tax credit industry to the same standards that applied to other types of partnership and real estate transactions. Second, the IRS seems skeptical that a preferred equity interest would allow a partner to be treated as such for Federal income tax purposes. The Rev. Proc. 2014-12 takes the position that a partner must have a full participation in the economic upside of a development and a substantial capital contribution that entitles the partner to a preferred, but limited, return is not sufficient. Third, while blessing the lease pass-through structure, the Rev. Proc. 2014-12 never quite comes to grips with the fundamental inconsistency of insisting that the Investor have a full economic participation in the development while allowing the Investor to participate through an entity that, by definition, will not be the owner for Federal income tax purposes and instead will have economic rights that are more limited as a lessee of the development.