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IRS guidance offers safe harbor in devising tax credit deals

TAXING MATTERS
Josh Gewolb

Federal and state tax credits are a key part of the financing for many development projects in the Greater Rochester area.

For the past several years, there has been uncertainty with respect to the "sale" of these credits to investors because of unfavorable court decisions.

The IRS has now issued guidance that clarifies the rules of the game. While this guidance technically applies only to historic rehabilitation credits, it provides a window into the IRS' thinking. It will have an impact on many types of tax credit transactions, including the low-income housing and brownfields credit transactions widespread in the Rochester region.

The key case leading to the recent developments involved historic Boardwalk Hall in Atlantic City, home of the Miss America Pageant.

The tax credit investor must own at least a 1 percent interest in the partnership.

The project qualified for federal historic rehabilitation tax credits. However, the New Jersey state agency that owned the hall was unable to use the credits, since it was not a federal taxpayer. In a common structure, the state worked to sell the tax credits to the highest bidder and use the proceeds to finance the transaction.

Federal law, however, prohibits the sale of tax credits. Instead of selling credits, a partnership is formed to pursue the project and the "tax credit investor" is made a partner. The credits are then allocated to the tax credit investor by the partnership.

Commonly, these partnerships are structured so that the economic consequences of the allocation are similar to those of "buying" the tax credits. However, for a partnership to be valid for tax purposes, all partners must—to at least some extent—share in the venture's potential for profit and loss. This is something that most tax credit investors do not want; they want to buy credits for cash.

Creative dealmakers have devised many structures to reduce tax credit investors' exposure to partnership business risks while maintaining at least nominal participation in partnership profits and losses.

Sometimes, however, these protections go too far. In the Boardwalk Hall case, the government successfully argued that the investor was not entitled to the tax credit it claimed, given the nature of its economic interest in the partnership. The IRS prevailed in a federal appeals court, which found that investor "lacked a meaningful stake in success or failure" of the project. Last year, the Supreme Court declined to hear the case.

The Boardwalk Hall case and similar cases caused alarm in the tax credit community.

While it has long been clear that tax credits can be syndicated through properly structured transactions, these cases raised questions about many of the protections that are commonly used to mitigate the investor's risks. The case law developments had a chilling effect on the tax credit market.

In December, the IRS issued guidance that provides a great deal of clarification in this area. Though the guidance by its terms applies only to historic rehabilitation credits, it helps to understand the IRS' thinking about tax credit allocations more generally and will accordingly have an impact across the sector.

In the guidance, the IRS states that it will not challenge the allocation of credits in connection with historic rehabilitation projects if they are made in a manner that satisfies a safe harbor designed to ensure meaningful economic participation by the tax credit investor in the venture.

Generally, the guidance states that a tax credit deal will be respected if the following requirements are met:

Ownership: The tax credit investor must own at least a 1 percent interest in the partnership.

Risk: The investor's return or loss must be tied to the performance of the project.

Capital contributions: Investors must invest a specified amount of their equity prior to completion of certain milestones.

Guarantees: Some types of guarantees are permitted, but others are not. Guarantees must be unfunded.

Exit: While the investor can have the right to put its interest in the partnership, the put must be at fair market value. The partnership cannot have the right to call the investor's interest.

The Boardwalk Hall case caused widespread anxiety in the tax credit community and disrupted deal-making. Although the economic participation required by the new safe harbor may not be palatable to some investors, taxpayers that comply with it will at least have certainty that their transactions will be respected. While the application of the new rules beyond historic tax credits remains to be seen, we expect that they will have an impact on many types of tax credit transactions.

In light of the new guidance, organizations that have tax credit deals in process should review them to see if they can be conformed to the safe harbor. Potential players in the market that had been sitting on the sidelines because of the developing case law can now proceed with greater certainty that their structures will be respected.

Josh Gewolb is a tax attorney at Harter Secrest & Emery LLP.

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