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Restoring Historic Landmarks While Saving on Taxes

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Boardwalk Hall, known today also as the Historic Atlantic City Convention Hall, opened in Atlantic City, New Jersey, in 1929. Famous for having hosted the Miss America Pageant, the Hall was added to the National Register of Historic Places as a National Historic Landmark in 1987. The Hall has become even more famous in the tax law world as the site of a long-running battle over historic rehabilitation tax credits, ultimately won by the Internal Revenue Service when the Third Circuit Court of Appeals disallowed the claimed tax credits. Tax credits, contrary to popular belief, cannot be sold; in practice, the developer will admit a tax credit investor into the partnership or LLC that owns or leases the property, in order to allow an allocation of tax credits to the investor. In the typical case, the tax credit investor's economic benefits are almost entirely derived from the tax credits it is receiving. The Third Circuit's decision on August 27, 2012 in the Boardwalk Hall case contained broad language about looking to the substance of the transaction and how the tax credit investor was not a partner for federal income tax purposes. This holding paralyzed the tax credit industry, which became unsure of how to structure a tax credit investment.

To address this confusion, the Internal Revenue Service (IRS) issued Revenue Procedure 2014-12 earlier this year, which creates a safe harbor that allows the historic rehabilitation tax credit for partnerships or LLCs that meet all of the safe harbor requirements.[1] The Revenue Procedure can be best understood against the factual background of the Hall. This article reviews the safe harbors and how they would not have been met by the Hall's rehabilitation.

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The Revenue Procedure

In 1992, the Hall's local government owner, the Atlantic County Improvement Authority, leased the Hall to the New Jersey Sports and Exposition Authority (NJSEA) for 35 years (later extended to 95 years), in order for NJSEA to renovate the Hall at a cost of $91 million. NJSEA was initially able to raise all of the required funds from bond issuances and from other government agencies.

A few months before the beginning of the Hall renovations, a tax consulting firm informed NJSEA that the Hall's renovation could also generate significant federal income tax credits. The historic rehabilitation tax credit in Internal Revenue Code section 47 generally allows the owner of a certified historic building to claim a federal income tax credit equal to 20% of the renovation costs to the property. NJSEA as a tax-exempt government entity would have no use of the tax credits, which are not transferable, but the consultants informed NJSEA that the credits could nevertheless be "sold" to Fortune 500 corporations with substantial federal income tax liabilities, for approximately $0.80 to $0.90 per dollar of tax credit allocated to the corporate investor.

Generally the tax credit investor would contribute cash (equal to the agreed "purchase price" for the credits) to acquire substantially all of the interests in an entity that owns the property, which would generate credits to allocate to the tax credit investor, while options and other special arrangements would minimize the investor's exposure to the economic benefits and risks associated with the property.

NJSEA prepared a confidential memorandum that was sent to 19 potential investors in the tax credits, of which postage meter manufacturer Pitney-Bowes Inc. (PB) was the ultimate investor. The total renovation costs were increased to $107 million, with the difference between the $107 million and the original $91 million renovation cost paid as a "development fee" to NJSEA and for other minor expenses. The memorandum candidly stated that the $16 million difference was the additional "proceeds from the sale of the historic tax credits." The development fee violated the IRS safe harbor's requirement that the value of the investor's interest in a property may not be reduced through fees and other arrangements that are unreasonable as compared to non-tax-credit projects.

PB agreed to contribute $18 million in exchange for a 99.9 percent membership interest in Historic Boardwalk LLC, the entity that owned the Hall and was treated as a partnership for federal income tax purposes. PB received an annual preferred return equal to three percent of its contributed capital, and it was supposed to receive 99.9 percent of any available cash flow during the life of its investment. However, NJSEA projected that the Hall would not generate any positive cash flow

before 2042, because NJSEA would make significant loans to the LLC that would have to be repaid first.

Under the IRS safe harbor, the sponsor (such as NJSEA) must have a minimum one percent interest in each material item of the LLC at all times. Furthermore, the safe harbor requires the investor's LLC interest to be a bona fide equity investment with a reasonably anticipated value commensurate with the investor's overall percentage interest, separate from any federal, state, and local tax deductions and credits allocated to the investor. The investment is a bona fide equity investment only if that reasonably anticipated value is (1) contingent upon the LLC's net income and loss, (2) is not substantially fixed in amount, and (3) is not substantially protected from losses. The investor must participate in the LLC's profits in a manner that is not limited to a preferred return.

PB was not expected to receive any operating cash flow from the Hall. While PB would technically receive 99.9 percent of the net proceeds from a sale of the Hall, PB's potential for gain or loss was eliminated through options. NJSEA had a call option to purchase PB's interest after five years, and PB has a put option to sell its interest to NJESA after seven years, in each case for an amount equal to the fair market value of PB's interest or, if greater, PB's investment with a 3% return. But if NJSEA desired to take certain actions without the consent of PB, NJSEA had a further option, called the consent option, to buy out PB's interest in the Hall in an amount equal to the present value of any yet-to-be realized projected tax benefits and cash distributions due to PB. The combination of options effectively allowed NJSEA to acquire PB's interest in the Hall by paying PB's investment plus a three percent return, regardless of the economic value of such interest.

Under the IRS safe harbor, the sponsor and the LLC cannot have a call option to acquire the investor's interest at a future date, such as NJSEA's call option or the Consent Option. The investor cannot have a put option to sell its interest in the LLC, unless the put option's strike price is equal to the fair market value of the interest at the time of exercise. Furthermore, the investor cannot acquire its LLC interest with the "intent" of simply abandoning the interest after all the credits are generated.

Other Tax Credit Structures

Other tax credit deal structures use a 'flip' structure instead of a combination of options to minimize the investor's economic exposure. In a flip, the LLC allocates its income, losses, and credits 99.9 percent to the investor and 0.1 percent to the sponsor while the property is generating credits, for example. Once credits are no longer generated, the LLC's interest allocations 'flip' so that income and losses are allocated 0.1 percent to the investor and 99.9 percent to the sponsor, who is able to keep substantially all of the economic benefit with respect to the property.

Under the IRS safe harbor, flips are restricted by the requirement that the investor must have a minimum interest in each material LLC tax item equal to at least five percent of the investor's percentage interest in each such item for the year for which the investor's percentage interest is largest. Accordingly, an investor who initially owns 99 percent of the LLC may be subject to a "flip" that reduces the investor's interest to no less than 4.95 percent of the LLC's income and losses.

With respect to PB's investment in the Hall, a tax benefits guaranty agreement provided that NJSEA would pay to PB an amount equal to PB's loss of tax credits and any additional tax liability, interest, and penalties as a result of any IRS challenge. Under the IRS safe harbor, the sponsor may only guarantee the performance of any acts necessary to claim the tax credit, as well as the avoidance of any acts (or omissions) that would cause the credits to fail or to be recaptured, as long as no money is set aside to fund the guarantee. The sponsor cannot guarantee the investor's ability to claim the credits, nor can the sponsor indemnify the investor's costs against any credit-related IRS challenges.

Under the IRS safe harbor, the sponsor and the LLC cannot lend to the investor any funds to acquire the investor's interest in the LLC. It does not appear that PB borrowed any such funds to acquire its interest in the LLC.

PB made an initial contribution of $4 million to the LLC in 2000, and it made further capital contributions only when NJSEA had verified that it had achieved enough renovation progress to generate sufficient tax credits equal to PB's contribution to date. Under the IRS safe harbor, the investor must contribute a minimum unconditional amount of at least 20 percent of its total expected capital contributions to the LLC before the building is placed in service. The contribution cannot be in form of promissory notes or other obligations of the investor. Furthermore, at least 75 percent of the investor's total capital contributions must be fixed in amount before the building is placed in service.

No Safe Harbor

Based on the above facts, PB's investment in the Hall would not have qualified for the safe harbor in Revenue Procedure 2014-12. The development fee was unreasonably large, the sponsor NJSEA did not retain a minimum 1% interest in the Hall, the investor's tax credits were guaranteed by NJSEA, the investor's economic participation was effectively limited to a preferred return, and the options did not comply with the safe harbor's requirements. In the actual case, the Third Circuit Court of Appeals noted that PB bore no meaningful risk in joining the LLC and acquiring the interest in the Hall. PB could not benefit from any economic gain above its 3% preferred return due to the Consent Option and the Hall's lack of cash flow. Based on this analysis, the court concluded that PB was not a partner or economic owner of the Hall, and should not be entitled to any credits from the property.

Conclusion

The factors noted by the Third Circuit are present to some extent in any deal structure where investors contribute capital to a partnership or LLC mostly for the benefit of obtaining tax credits. Accordingly, the safe harbor in Revenue Procedure 2014-12 is vital guidance in this area. Although some of the safe harbor's requirements are not entirely clear, it is highly desirable for rehabilitation-tax-credit-driven deal structures to try to meet all of the requirements of the IRS's safe harbor.

[1] The Revenue Procedure applies the same rules to both partnerships and LLCs treated as partnerships for income tax purposes. The Revenue Procedure does not apply to other tax credits, such as the low income housing tax credit in Internal Revenue Code section 42.

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