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Tax Credits Basics & Update--Historic Tax Credits and New Markets Tax Credits (PowerPoint)

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TAX CREDITS BASICS & UPDATE – HISTORIC TAX CREDITS AND NEW MARKETS TAX CREDITS

62nd Annual

WILLIAM & MARY

TAX CONFERENCE

November 10, 2016

Tax Credits Update – Discussion Outline

- Introduction
- Historic Tax Credits
  - Federal Historic Rehabilitation Tax Credits
    - HTC Basics
    - Syndication Structures
    - *Historic Boardwalk* & Rev. Proc. 2014-12
    - Current Developments
  - State Historic Tax Credits
    - State HTC Basics
    - *Virginia Historic*
    - Current Developments
- Q & A

INTRODUCTION

GENERATING TAX CREDITS

- Complicated statutes, with high cost of execution
- HTC has been around since 1981, and has been relatively stable
- NMTCs were introduced in 2000, and many aspects are still being worked out

SYNDICATING TAX CREDITS

- Most owners / developers want subsidy ($$) not credits
- Federal Tax Credits cannot be sold
- Syndication is process of designing a structure so that Tax Credits can be allocated/delivered to Tax Credit Investor

INTRODUCTION

- Developers and Syndicators assumed a "penumbra" of protection for HTC syndications, pointing to, e.g., footnote 344 from JCT report on Section 7701(o)
  - If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed. … Thus, for example, it is not intended that a tax credit (e.g., section 42 (low-income housing credit), section 45 (production tax credit), section 45D (new markets tax credit), section 47 (rehabilitation credit), section 48 (energy credit), etc.) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.

    Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the Reconciliation Act of 2010, p. 152, n344
- SPOILER ALERT – The recent action / developments has been in the syndication of credits NOT the generation or use of credits

FEDERAL HTCS

FEDERAL HTC BASICS

- Section 47 allows a "rehabilitation credit"; more commonly called the "Historic Tax Credit" ("HTC")
- Program administered jointly by IRS and National Park Service (NPS) [thru State Historic Preservation Offices (SHPO)]
- Part of Section 38 Investment Tax Credit ("ITC")
  - Pre 1986 ITC law / regulations / rules are grandfathered
- Use of HTCs are limited by Passive Activity (§469) and At-Risk rules (§49)
  - Under §49, non-recourse financing cannot > 80% of credit base
- After 2008, HTCs are not subject to Alternative Minimum Tax (§55) limitations

FEDERAL HTC BASICS *(cont.)*

- HTC claimed in year when rehabilitation is placed in service
- HTC subject to recapture for 5 years after placed in service
  - HTC recapture burns off 20%/year
  - Recapture from (i) disposition of ownership, (ii) non-complying change to building or (iii) failure to be Section 38 property
- Project tax basis reduced by HTCs claimed

FEDERAL HTC BASICS *(cont.)*

- Certain taxpayers (*e.g.*, tax-exempt and REITs) do not qualify for HTCs
- HTCs can be "twinned" with other credits
  - Low Income Housing Tax Credits (Section 42) – but HTC basis reduction may reduce LIHTC
  - New Market Tax Credits (Section 45D) – but more difficult after Rev. Proc. 2014-12
- HTCs allocated to partners in accordance with share of bottom-line profits at time rehab work is completed/placed in service
  - Treas. Regs. § 1.46-3(f)

Federal HTC Basics / 10% vs. 20%

20% HTC

- Certified Historic Structure
  - Listed on Historic Register
  - Located in Historic District
- Residential or non-residential
- Rehabilitation work certified by NPS as consistent with historic character

10% Credit

- "Old" building (placed in service prior to 1936)
- Only non-residential
- No NPS certification

FEDERAL HTC BASICS / NPS & IRS ROLES

NATIONAL PARK SERVICE

- Three–part certification
- Part 1: Historic Significance
- Part 2: Proposed Work (plans and specs) complies with rehab standards
- Part 3: Certification that rehab completed in accordance with NPS standards

IRS

- Issued regulations and other guidance on availability of HTCs
- Audits HTCs claimed by taxpayers

Qualified Rehabilitation Expenditures

Any amount properly chargeable to capital account with respect to depreciable real property made in connection with the rehabilitation of the building

Items Specifically Excluded	Included Items
– Purchase/acquisition costs – Land costs – Enlargements & Additions – Soft costs allocable to above	– Soft costs –architect, historic consultant and legal fees – Construction period interest – Developer Fee

FEDERAL HTC BASICS / TAX-EXEMPT USE

Capitalized costs of Tax-Exempt Use Property [IRC§168(h)] generally ARE NOT QREs

- Tax-Exempt Partner: ANY Tax-Exempt Use Property arising from having a tax-exempt entity as a partner of owner is not QRE
- Disqualified Leases: More liberal rule for Tax-Exempt Use Property from Disqualified Leases; must be > 50% of rentable space before not QREs
  - For§168(h), more than 35% space leased under Disq. Leases
  - For HTC, more than 50% space leased under Disq. Leases
  - Disqualified Lease = lease to tax-exempt entity PLUS any one of (i) lease term > 20 years, (ii) purchase option, (iii) tax-exempt financing or (iv) prior use by tax-exempt seller

Substantial Rehabilitation Test

- In year rehabilitation is placed in service, QREs must >= adjusted cash basis of building before rehabilitation (and > $5,000)
- Measurement period for "substantial rehabilitation" is 24 months or 60 months for multiple phased project
  - Does not limit QREs to those in measurement period
  - Substantial Rehab test applied on a "rolling" basis, so can claim HTCs in multiple years – i.e., additional work placed in service over time

FEDERAL HTC BASICS/LEASE PASS-THRU

- Project Owner may elect to pass HTCs thru to Tenant under a lease [IRC § 50(d)]
- Neither Project Owner nor Tenant can be a disqualified owner (e.g., tax-exempt or REIT)
- Lease term must be>80% of depreciation life
  - i.e., 32+ yrs nonresidential / 22+ yrs residential
  - can be <80% if lease is "net lease" under former Sections 48(d)(4)(D) and 57(c)(1)(B)
- Owner does not reduce tax basis
  - Tenant must amortize HTC into income over depreciation period (generally 39 years)

SYNDICATING FEDERAL HTCS / BASICS

- *Who / Tax Credit Investors*

  Typically, Banks, Insurance Companies and Large "C" Corporations

  - Not subject to at-risk and passive loss rules
  - VERY THIN MARKET

- *What / Investment*

  $0.80 to $1.10 per HTC delivered

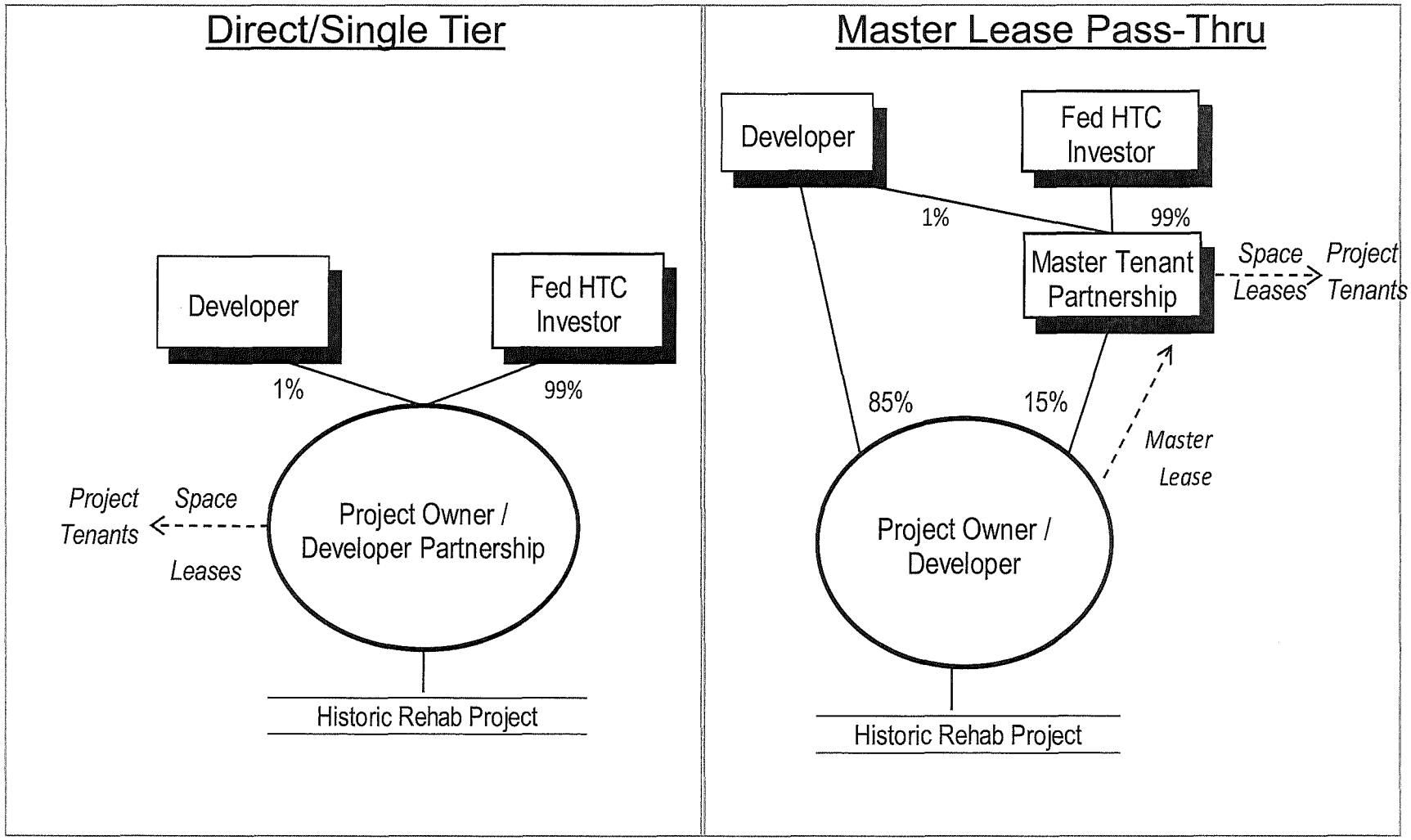
  - Why would a Tax Credit Investor pay more than $1.00 per $1.00 of HTC?

- *How / Tax Credit Delivery Structure*

  Allocation of HTC to Equity Investor

  - Direct (single-tier) investment
  - Master Lease (two-tier) structure

SYNDICATING FEDERAL HTCs / ALTERNATIVE STRUCTURES



SYNDICATING FEDERAL HTCS / ALTERNATIVE STRUCTURES

Direct/Single Tier

- Simpler
- New Treasury Regulations on 50(d) Income should level the playing field as to pricing of HTCs

Master Lease Pass-Thru

- Pass-through isolates HTCs; more efficient
- No recapture on transfer of Property
- No reduction in depreciable basis
- BUT Tax Credit Investor must pick up HTCs over depreciable life (27.5/39 recovery period)

SYNDICATING FEDERAL HTCS / ISSUES ON "UNWIND"

Typically "unwind" is structured as "Put" of Investor's equity interest in Project to Sponsor

- Project Owner suffers forced Basis Step-Down on transfer of Investor's Interest under § 743(b)
- Question as to whether Unamortized 50(d) Income would be accelerated if Master Lease terminates
  - Consider whether this could be deferred by having Affiliate of Sponsor acquire Investor's Interest, and keeping Master Tenant/Master Lease structure in place?
- What if Investor fails to exercise "Put"?
  - Prior to Rev. Proc. 2014-12 Safe Harbor, Developer could Call Investor interest

SYNDICATING FEDERAL HTCS / TYPICAL ELEMENTS
(PRIOR TO REV. PROC. 2014-12)

- Staged / Conditional Capital Contributions
  - Example: 20% At Admission / 60% At Completion-Placed In Service / 10% Upon Part 3 Approval
  - Adjusters based on HTCs delivered – Price per $1.00 HTC
- Investor Returns
  - 2% - 5% annual cash on cash return on equity investment
  - *Projected* return of investment and 5%+ return on sale of Project
  - These address economic substance concern – that Investor must expect a Pre-Tax Profit to be considered a partner
  - Tax make-whole distributions
- Unwind after HTC Recapture Period
  - Investor can Put its interest at 20% - 5% of equity investment
  - Developer can Call interest of Investor at Fair Market Value

SYNDICATING FEDERAL HTCs / TYPICAL ELEMENTS
(PRIOR TO REV. PROC. 2014-12) (CONT.)

- Developer / Sponsor Guarantees
  - Completion Guaranty – Planned Rehabilitation Work will be completed by date certain
  - Environmental Guaranty / Indemnity
  - Operating Deficit Guaranty – Will fund cash shortfalls that may occur, including (before Rev. Proc. 2014-12) minimum return
  - Tax Credit Delivery (before Rev. Proc. 2014-12) – return of capital and yield makewhole if
    - No HTCs generated
    - For any reason, HTCs not delivered to Investor (failure of HTC syndication structure)
    - Recapture of HTCs

SYNDICATING FEDERAL HTCS / HISTORIC BOARDWALK

HISTORIC BOARDWALK HALL V. COM'R, 694 F.34 425 (3d Cir. 2012)

- 3rd Circuit Court of Appeals ruled against taxpayer and overturned Tax Court decision
- Held that Investor – Pitney Bowes, Inc. – was not a bona fide partner of syndication partnership
  - Investor lacked a meaningful stake in either the success or failure of the syndication partnership / project
- Historic Boardwalk had an immediate chilling effect on HTC syndication market
  - IRS promptly used Historic Boardwalk to challenge what appeared to be a "vanilla" HTC syndication – FAA 2012 24 002F
- Example of the maxim – "Bad facts make bad law."

SYNDICATING FEDERAL HTCS / HISTORIC BOARDWALK / BAD FACTS

- Staged / Conditional Capital Contributions
  - Investor made contributions immediately before Project was placed in service – no construction / rehab risk
  - Investor contributions not needed to fund construction costs
- Investor Returns
  - 3% annual cash on cash return PAID OUT OF INVESTOR'S EQUITY (and set aside in separate account)
  - Profit opportunity limited to 3% fixed return
  - Underwriting / projections were overly optimistic and developer made Acquisition Loan that sucked up all possible cash flow

SYNDICATING FEDERAL HTCS / HISTORIC BOARDWALK / BAD FACTS

- Guarantees
  - Owner guaranteed delivery of HTCs to Investor
  - Investor indemnified for any reduction in projected tax benefits as a result of IRS challenge
- Unwind
  - Owner had right to buy out Investor at any time (DURING 5-year recapture period) at purchase price = NPV of tax benefits and 3% preferred return
  - Investor Put Option and Owner Call Option at FMV of Investor's Interest.
  - Payment of purchase price under Buyout Option, Put Option and Call Option all defeased / secured by guaranteed investment contract

SYNDICATING FEDERAL HTCS / HISTORIC BOARDWALK / THE "SHARKEY SPIN"

- Owner is NJ Authority!
  - Beyond everything else, problem with transaction was that the Project was owned by New Jersey Sports and Exposition Authority – a governmental authority.
  - Property owned by a governmental authority or tax-exempt entity cannot generate HTCs.
  - Not just a question of who gets the benefit of HTCs – but whether any HTCs were generated at all.
- PB Ownership Interest was Monkey Business
  - PB was 99% partner of syndication partnership in name only.
  - PB 99% ownership interest had no substance – no $$$ at risk and because of developer fees and related party loans, no opportunity to participate in project economics

SYNDICATING FEDERAL HTCS / REV. PROC. 2014-12 / THE GRAND BARGAIN

- IRS issued Revenue Procedure 2014-12 Jan. 2014
  - "The Service will not challenge a Partnership's allocations of validly claimed § 47 rehabilitation credits if the Partnership and its partners satisfy the Safe Harbor."
- Investor Does not Need Expectation of Pre-Tax Profit to be Recognized as Partner for tax purposes
  - RP 2014-12 based on / follows § 45 wind energy production tax credit safe harbor. Rev. Proc. 2007-65.
- But (i) Investor Must Take On Risk and (ii) No Monkey Business with Investor Partnership Interest
  - "No Monkey Business Rule" – Investor's partnership interest must provide real participation in Project economics – cannot be eroded by unreasonable fees, lease terms, or similar devices to "siphon" "cash flow.

SYNDICATING FEDERAL HTCS / REV. PROC. 2014-12 / THE GRAND BARGAIN *(CONT.)*

- RP 2014-12 Confirms / Affirms Two Syndication Structuring Elements
  - Syndication through Master Lease Pass-Through
  - Investor "Flip" Structure
- RP 2014-12 Safe Harbor expressly does not apply to:
  - Syndication of other Federal tax credits
  - State historic tax credits
  - Whether Partnership is the owner of historic building for income tax purposes
  - Whether expenditures are QREs
  - How tax-exempt use property rules apply
  - How to allocate unamortized HTCs in Master Lease structure

SYNDICATING FEDERAL HTCS / REV. PROC. 2014-12 / DEFINED TERMS

■ *Partnership*	HTC syndication partnership
■ *Developer Partnership*	Project owner; HTC syndication partnership in "single tier" deal
■ *Master Tenant Partnership*	Leases building from Developer Partnership; HTC syndication entity in lease pass-through deal
■ *Principal*	Managers authorized to act for HTC syndication Partnership
■ *Investor*	HTC Equity Investor

SYNDICATING FEDERAL HTCS / REV. PROC. 2014-12 / 9 REQUIREMENTS

1. Investor. If Master Lease pass-thru structure is used, Investor cannot also make a direct equity investment in Developer Partnership.
   - Master Tenant may be partner of Developer Partnership
2. Principal's Minimum Partnership Interest. Minimum 1% interest in each material item of Partnership income, gain, loss, deduction and credit
3. Investor's Partnership Interest (Size of Interest). Minimum interest in each material item each material item of Partnership income, gain, loss, deduction and credit = 5% of greatest interest
   - Partnership "flip"; 99% interest dropping to 5% interest

SYNDICATING FEDERAL HTCs / REV. PROC. 2014-12 / 9 REQUIREMENTS *(CONT.)*

4. Investor's Partnership Interest – No Monkey Business Rule (Quality of Interest). "[B]ona fide equity investment with a reasonably anticipated value commensurate with the Investor's overall percentage interest …"
   - NOTE: NOT REQUIRED THAT VALUE BE COMMENSURATE WITH EQUITY INVESTMENT
   - Anticipated value must be contingent on Partnership's net income, gain and loss. Cannot be substantially fixed in amount
   - Value may not be reduced through fees (developer, management and incentive), lease terms or other arrangements that are unreasonable as compared to fees, lease terms, or other arrangements for a real estate development project that does not qualify for § 47 rehabilitation credits

SYNDICATING FEDERAL HTCS / REV. PROC. 2014-12 / 9 REQUIREMENTS *(CONT.)*

4. Investor's Partnership Interest – No Monkey Business Rule (Quality of Interest).
   - NOTE: Exaggerated Developer Fees (including deferred developer fees) appear to be a principal target
   - Value may not be reduced by disproportionate rights to distributions or by issuances of interests in the Partnership for less than fair market value
   - May not utilize "sandwich leases" – sublease back from Master Tenant to Developer Partnership or Principal (unless "mandated" by an unrelated third party
   - Master Tenant may not terminate Master Lease while Investor is a partner of Master Tenant Partnership

SYNDICATING FEDERAL HTCS / REV. PROC. 2014-12 / 9 REQUIREMENTS *(CONT.)*

5. Investor Minimum Contribution
   - Investor must contribute to Partnership, before Building is placed in service, at least 20% of total expected contributions
6. Investor Unconditional Contribution Obligation
   - At least 75% of Investor's contributions must be fixed before Building is placed in service
7. Allocation of HTCs
   - Allocations under partnership agreement must satisfy § 704(b) regulations.
   - Allocations of HTCs must satisfy § 1.704-1(b)(4)(ii) [in accordance with § 1.46-3(f)]

SYNDICATING FEDERAL HTCS / REV. PROC. 2014-12 / 9 REQUIREMENTS *(CONT.)*

8. Impermissible and Permissible Guarantees

   a) Structural Guarantees are Impermissible . No person involved in any part of the rehabilitation transaction may guarantee Investor's ability to claim §47 rehabilitation credits, the cash equivalent of the credits, or the repayment of any portion of the Investor's contribution due to inability to claim the §47 rehabilitation credits if the Service challenges all or a portion of the transactional structure of the Partnership.

   b) Guaranteed Return is Impermissible . No person involved in any part of the rehabilitation transaction may guarantee that the Investor will receive Partnership distributions or consideration in exchange for its Partnership interest

SYNDICATING FEDERAL HTCS / REV. PROC. 2014-12 / 9 REQUIREMENTS *(CONT.)*

8. Impermissible and Permissible Guarantees *(cont.)*

   c) Indemnities against IRS Challenge are Impermissible. No person involved in the rehabilitation transaction may pay Investor's costs or indemnify Investor for costs if the Service challenges Investor's claim of HTCs.

   d) "Funded" Guarantees are Impermissible. No other guaranty is permissible unless it is "unfunded." Guarantee is funded if:

      – Money or property is set aside to fund all or any portion of the guarantee
      – The Guarantor (or an affiliate) is required to maintain a minimum net worth in connection with the guarantee
      – Partnership sets up unreasonable reserves (more than 12 months of reasonable expected operating expenses)

SYNDICATING FEDERAL HTCS / REV. PROC. 2014-12 / 9 REQUIREMENTS *(CONT.)*

8. Impermissible and Permissible Guarantees *(cont.)*

   e) Examples of Permissible Guarantees. Any of the following guarantees – if unfunded – may be provided to Investor:

   - Guarantees for the performance of any acts necessary to claim HTCs
   - Guarantees for the avoidance of any act (or omissions) that would cause the Partnership to fail to qualify for HTCs or that would result in recapture of HTCs
   - Completion guarantees, operating deficit guarantees, environmental indemnities, and financial covenants
   - Issue with permissible guarantees is finding appropriate measure of damages (without turning permissible guarantee into impermissible)

SYNDICATING FEDERAL HTCS / REV. PROC. 2014-12 / 9 REQUIREMENTS *(CONT.)*

9. Unwind Mechanisms – Investor Put OK; No Call

   a) Put Option. Investor may have option to require the purchase or redemption of Investor's partnership interest

      – No minimum purchase / redemption price

      – Purchase / redemption price cannot be more than FMV of Investor's partnership interest at time of exercise

   b) NO CALL OPTION. No Principal or the Partnership may have a call option to purchase or redeem Investor's partnership interest

      – Not even an FMV call option

      – Preclusion of call option is different from Wind Energy Safe Harbor (Rev. Proc. 2007-65) and tax law generally

SYNDICATING FEDERAL HTCS / WHERE IS THE MARKET?

- Deals are Getting Done
  - BUT all the kinks HAVE NOT been worked out
- Investors Require Deals Comply with Safe Harbor
- More Conservative Positions Taken on Tax Issues
  - Investors no longer receive structural guarantees /protection
  - Internalizing tax risks previously borne by Owner/Developer
  - Examples:
    - Developer Fees getting smaller, paid sooner
    - No assumption of Deferred Devel. Fee by Master Tenant

SYNDICATING FEDERAL HTCS / REV. PROC. 2014-12 / WHERE IS THE MARKET?

- More Investor $$$ Contributed Early On
  - More than 20% to create cushion on minimum contribution
  - Contributed well before Building being placed in service
- Fairness Opinions Required for all Fees and Related Party Economic Arrangements
  - Required for attorneys to give tax opinion – that transaction complies with RP 2014-12
  - In particular, Developer Fees, Master Lease Rents and Intercompany Debt

SYNDICATING FEDERAL HTCS / REV. PROC. 2014-12 / REMAINING ISSUES

- "Twinning" HTC equity investment with NMTC
  - RP 2014-12 precludes Investor from holding an equity investment in Developer Partnership. Typical NMTC twinned structure involves direct and indirect ownership.
- Structuring guarantees
  - What is the appropriate measure of damages, in the face of RP 2014-12 prohibition on guaranteed return?
- What Opinions does Developer Partnership's tax counsel give?
  - Transaction complies with RP 2014-12?
  - Investor will be respected as a partner outside of RP 2014-12?
- Fairness Opinions on Related Party Transactions
  - Who gives, and what do they need to cover/include?

SYNDICATING FEDERAL HTCs / 50(d) INCOME / BACKGROUND

- Prior to 50(d) Regulations in 2016, Master Tenant in Master Lease pass-through structure would (in lieu of basis reduction) amortize HTCs into income over recovery period of property ("50(d) Income")
  - Former IRC Section 48(d)(5)(A)
- Where Master Tenant was itself a partnership, 50(d) Income would be allocated 99% to Tax Credit Investor.
  - Tax Credit Investor did not decrease basis of its partnership interest by HTCs allocated to it
  - Allocation of 50(d) Income would increase Tax Credit Investor's basis in its partnership interest
- Upon "exit" from Master Tenant partnership (presumably, under a put arrangement), (i) exit transaction was structured to avoid accelerating 50(d) Income and (ii) Tax Credit Investor would recognize a loss.

SYNDICATING FEDERAL HTCS / 50(d) INCOME / TEMPORARY REGULATIONS

- On July 22, 2016, the IRS issued temporary Treasury Regulations governing inclusion of 50(d) Income
  - Treas. Regs. §1.150-1T, "Income Inclusion When Lessee Treated as Having Acquired Investment Credit Property"
- New 50(d) Regulations treat 50(d) Income as a partner item recognized outside of the partnership
  - 50(d) Income does not increase Tax Credit Investor's basis in its partnership interest.
  - Tax Credit Investor must pick up 50(d) Income over recovery period for the historic rehab property
- Tax Credit Investor may elect to accelerate unamortized 50(d) Income in the taxable year it disposes of its partnership interest.

SYNDICATING FEDERAL HTCS / 50(d) INCOME / TEMPORARY REGULATIONS / ISSUES

- 50(d) Regulations apply to property placed in service on or after September 19, 2016.
  - 50(d) Regulations do not include express protection/ grandfathering for property placed in service before September19, 2016.
  - Possibility of IRS challenging existing HTC syndication transactions using the Master Lease structure

- 50(d) Regulations do not address whether unamortized 50(d) Income is affected by (accelerated on) termination of Master Lease.

SYNDICATING FEDERAL HTCS / 50(d) INCOME / TEMPORARY REGULATIONS / MARKET EFFECTS

- Issues around extent of Owner/Developer's exposure under tax credit guaranties (deals prior to Rev. Proc. 2014-12).
  - Issue is whether literal language of tax credit guaranty covers inclusion of 50(d) Income under 50(d) Regulations.

- Pricing on HTC syndications has dropped to reflect increased tax cost to Tax Credit Investor
  - *Prior to 50(d) Regulations:* $0.95 to $1.10 per $1.00 HTC
  - *After 50(d) Regulations:* $0.85 to $0.95 per $1.00 HTC

- Consideration being given by Tax Credit Investors whether to structure new transactions using Single Tier (rather than Master Lease) structure
  - 50(d) Regulations effectively eliminated pricing premium for Master Lease structure.

STATE TAX CREDITS

STATE HTCS / BASICS

- Currently, about 37 States have separate State Historic Tax Credit (SHTC) Programs
  - See list on Novogradac website: http://www.novoco.com/historic/htc/state_programs.php
- Each SHTC is unique; will not get into particulars; address here Federal income tax treatment of SHTC
- Much of the recent authority/developments have come out of other State Tax Credits
  - Conservation easement credit
  - Charitable contribution tax credit
  - Venture capital tax credit
  - Brownsfield tax credit

STATE HTCS / BASICS *(CONT.)*

KEY FEATURES / CHARACTERISTICS

- Nontransferable vs. Transferable / Certificated
  - Can SHTCs be transferred by Property Owner that rehabs the building?
  - Some States provide for transferable SHTC certificates
- How are SHTCs allocated to owners in pass-thru?
  - Several programs permit SHTCs to be specially allocated to partners (apart from Federal allocation rules)
  - Special allocations may make SHTCs effectively transferable
- Nonrefundable / Refundable
  - Does SHTC only reduce State tax liability, or can Taxpayer receive cash refund (to extent credit > tax liability)?

STATE HTCS / BASICS / FEDERAL TAX TREATMENT

PROPERTY OWNER / ORIGINAL HOLDER TREATMENT

- Receipt of SHTC is not a taxable event. SHTC is treated as reduction (or potential reduction) in taxpayer's State tax liability, not payment of cash or property. Use of SHTC simply reduces State tax deduction under§164(a).
- Transferability does not change treatment of SHTC as potential reduction to State tax liability.
- Receipt of refundable SHTC generates income, to the extent of excess of (i) SHTC over (ii) current State tax liability and prior State Taxes paid for which not Federal tax benefit received (Tax Benefit Rule).

STATE HTCs / BASICS / FEDERAL TAX TREATMENT *(CONT.)*

PROPERTY OWNER / ORIGINAL HOLDER TREATMENT *(CONT.)*

- Transferable SHTC is not "property" on grant, but becomes "property" both to Property Owner/Seller and to Purchaser on transfer/sale.
- Transfer of SHTC for value is sale of property under§1001. Taxpayer who initially receives SHTC and transfers for value recognizes gain / loss from disposition of property (SHTC).

STATE HTCS / BASICS / FEDERAL TAX TREATMENT (CONT.)

PURCHASER TREATMENT

- Purchase price paid for transferable SHTC is not payment of tax under §164(a). Purchaser has cost basis in purchased property (SHTC).
- Upon use of SHTC to reduce state tax liability:
  - Purchaser recognizes §1001 gain/loss from disposition of property (SHTC) to satisfy state tax liability.
  - Purchaser entitled to§164(a) state tax deduction for payment made (amount of SHTC).

STATE HTCs / BASICS / FEDERAL TAX TREATMENT *(CONT.)*

Partial List of Authorities on Fed. Tax Treatment of State Tax Credits

- Snyder v. U.S., 894 F.2d 1337 (6th Cir. 1990)
- Tempel v. Com'r, 136 T.C. 341 (2011)
- McNeil v. Com'r, T.C. Memo 2011-109
- Maines v. Com'r, 144 T.C. 123 (2015)
- Rev. Rul. 79-315
- CCA 2011-05-010
- CCA 2011-47-024
- IRS Settlement Guide – New York State Qualified Empire Zone Credit (April 4, 2013)
- 2011 Coordinated Issue Paper on State and Local Tax Incentives
- CCA 2001-26-005
- CCA 2002-11-042
- PLR 2003-48-002
- CCA 2004-45-046
- CCA 2007-04-028 & CCA 2007-04-030
- PLR 2009-51-024

STATE HTCs / BASICS / FEDERAL TAX TREATMENT *(CONT.)*

TEMPEL V. COM'R, 136 T.C. 341 (2011), *aff'd Esgar Corp. v. Com'r.*, 744 F3d 648 *(CA10, 3/7/2014)*

- Transferable State Tax Credit from donation of conservation easement.
- State Tax Credit is Capital Asset
- Taxpayer has $0 basis in State Tax Credit
  - Costs of conservation easement capitalized into property, not credit
- Holding Period begins on grant of State Tax Credit

BOTTOM LINE: Taxpayer recognizes short-term capital gain on sale == full sale price of State Tax Credit.

STATE HTCS / BASICS / FEDERAL TAX TREATMENT *(CONT.)*

DAVID J. MAINES V. COM'R, 144 T.C. 123 (2015)

- Various New York State EZ Credits – Real Property Tax Credit, Investment Credit and Wage Credit.
- NY State law treated credits as "overpayments" against Taxpayer's NY income tax (regardless of nature of NY tax)
- EZ Investment Credit and EZ Wage Credit were refundable.
  - Portion that only reduced NY state tax liability was not income
  - Excess (refundable portion) generated taxable income
- EZ Property Tax Credit were also refundable.
  - Portion that only reduced NY state tax liability was not income
  - Refundable portion generated taxable income to the extent previously deducted (under Tax Benefit Rule)

Syndicating State Tax Credits / Overview

1. METHODS FOR DELIVERING STATE TAX CREDIT (State Law)
   a. Outright Sale – Transferable State Tax Credits
   b. Allocation to Tax Credit Investor through partnership structure
      – Could also be an S corporation / shareholder
2. FEDERAL INCOME TAX CHARACTERIZATION

   Sale Tax Credits that are delivered through partnership allocation ***may be treated as sold*** to Tax Credit Investor for Federal Income Tax purposes

Syndicating State Tax Credits / Overview

ALLOCATION

a. Original holder (Partnership) receives non-taxable capital contribution

b. Tax Credit Investor acquires (i) partnership interest and (ii) allocation of State Tax Credits

SALE

a. Original holder (Partnership) sells property and realizes capital gain (typically short term)

b. Purchaser purchases property that is used to satisfy State Tax liability

Syndicating State Tax Credits / Overview / Pricing/Buyer's Perspective *(example)*

		(A) ***Allocated***	(B) ***Purchased***	(C) ***Purchased***
1	Contribution / Purchase Price	($0.55)	($0.55)	($0.84)
2	State Tax Credit	$1.00	$1.00	$1.00
3	Increase to Federal Tax -- (reduction to Section 164 Deduction)	($0.35)	($0.35)	($0.35)
4	Subtotal	$0.10	$0.10	($0.19)
5	Increase to Federal Tax -- Gain on Use of Credit	$0.00	($0.16)	($0.06)
6	Section 164 Deduction	$0.00	$0.35	$0.35
7	Net Benefit to Investor	$0.10	$0.29	$0.10

What about loss on sale of P/S/I? ***???***

Syndicating State Tax Credits / Overview/Pricing/Owner's Perspective *(example)*

		(A)	(B)	(C)
		Allocated	***Purchased***	***Purchased***
1	Contribution / Purchase Price	$0.55	$0.55	$0.84
2	Fed & State Income Taxes (@40%)	$0.00	($0.22)	($0.34)
3	Net Syndication / Sale Proceeds	$0.55	$0.33	$0.50

Background / Syndicating State Credits / Principal Fed. Tax Issues

1. Is Tax Credit Investor a bona fide Partner?
   a) Tension between (i) Tax Credit Investor's objectives – only to "buy" State Tax Credits – and (ii) requirements of being recognized as a partner for federal income tax purposes
   b) This was the issue in *Historic Boardwalk Hall* (but involved Federal historic tax credits)
2. Is syndication transaction properly treated as a disguised sale under Section 707?
   a) Regardless of whether Tax Credit Investor is a partner.
   b) This was the issue in *Virginia Historic*

SYNDICATING STATE HTCS / VIRGINIA HISTORIC

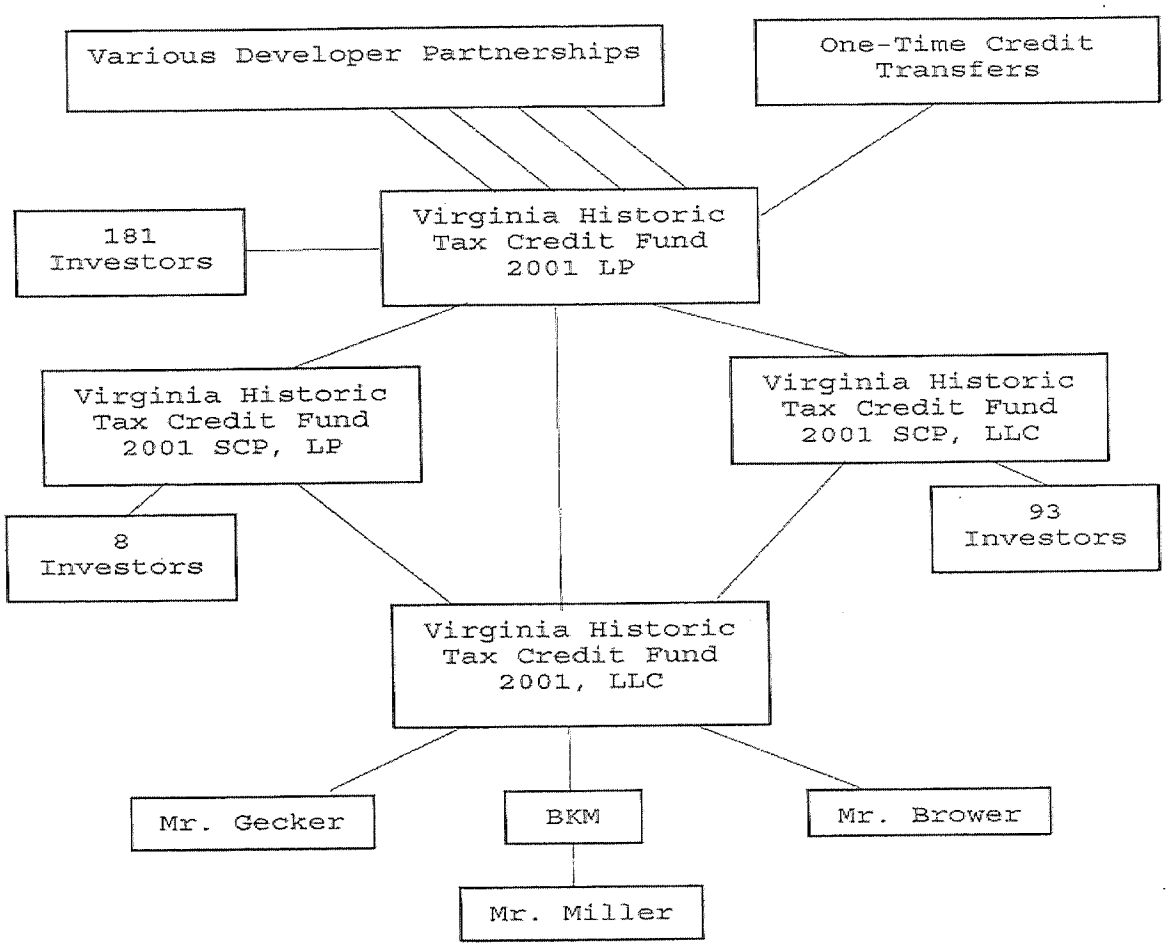
VIRGINIA HISTORIC TAX CREDIT FUND 2001 LP V. COM'R,
639 F.3 129 (4th Cir. 2011)

- 4th Circuit Court of Appeals ruled against taxpayer and overturned Tax Court decision (like Historic Boardwalk)
- Held that syndication structure effected a "disguised sale" of SHTCs to Investors under §707(a)(2)(B)
- Court did not hold that SHTCs were "property"; rather, special allocation of SHTCs to Investors was a "transfer of property" under §707(a)(2)(B)
- Another example of "Bad facts make bad law."

SYNDICATING STATE HTCS / VIRGINIA HISTORIC/ FACTS

- Involved 3 partnerships ("Funds") syndicating Virginia SHTCs to 282 investors
- For every $0.74–$0.80 contribution, Fund promised to deliver Investor $1.00 VA SHTCs; if not delivered, promised refund of capital, "net of expenses"
- Investor received a 0.01% partnership interest in Fund (irrespective of amount of capital contribution)
- Funds made capital contributions to Developer Partnerships, and acquired 0.01% interest with special allocation of VA SHTCs.
- Funds invested only at project completion.

SYNDICATING STATE HTCS / VIRGINIA HISTORIC/ FACTS *(CONT.)*



SYNDICATING STATE HTCS / VIRGINIA HISTORIC/ FACTS *(CONT.)*

- Subscription agreements stated VA SHTCs allocated to Investor "*simultaneously*" with admission.
- Between November 2001 and April 2002, Funds received $6.99 million contributions from Investors.
- In April 2002, Funds issued Schedules K-1 to Investors with promised amount of VA SHTCs.
- Funds exercised option to buy out all Investors, for a total buyout cost (all Investors) of approx. $7,000.
- Funds reported (i) money paid to Developer Partnerships for SHTCs as expenses; (ii) Investors as making nontaxable contributions to capital; and (iii) total of $3.28 million in losses for 2001 and 2002.

SYNDICATING STATE HTCS/VIRGINIA HISTORIC/ ANALYSIS

- 4th Circuit avoided issue of whether Investors were partner of syndication Partnership (Fund).
- Held that special allocations of VA SHTCs in exchange for contributions was disguised sale under§ 707(a)(2)(B) and§ 707 Regulations.
  - Applying §707 Regulation framework, found Investors had "no true entrepreneurial risk"
  - Value of VA SHTCs was disproportionate to 0.1% interest
  - Subscription documents told Investors not to expect any material amounts of partnership items of income, gain, loss or deduction.
  - Investor did not overcome presumption of sale under §707 Regulations (transfer of money and related transfer of property within 2 years presumed a sale).

SYNDICATING STATE HTCS/VIRGINIA HISTORIC/ "TAKE-AWAYS"

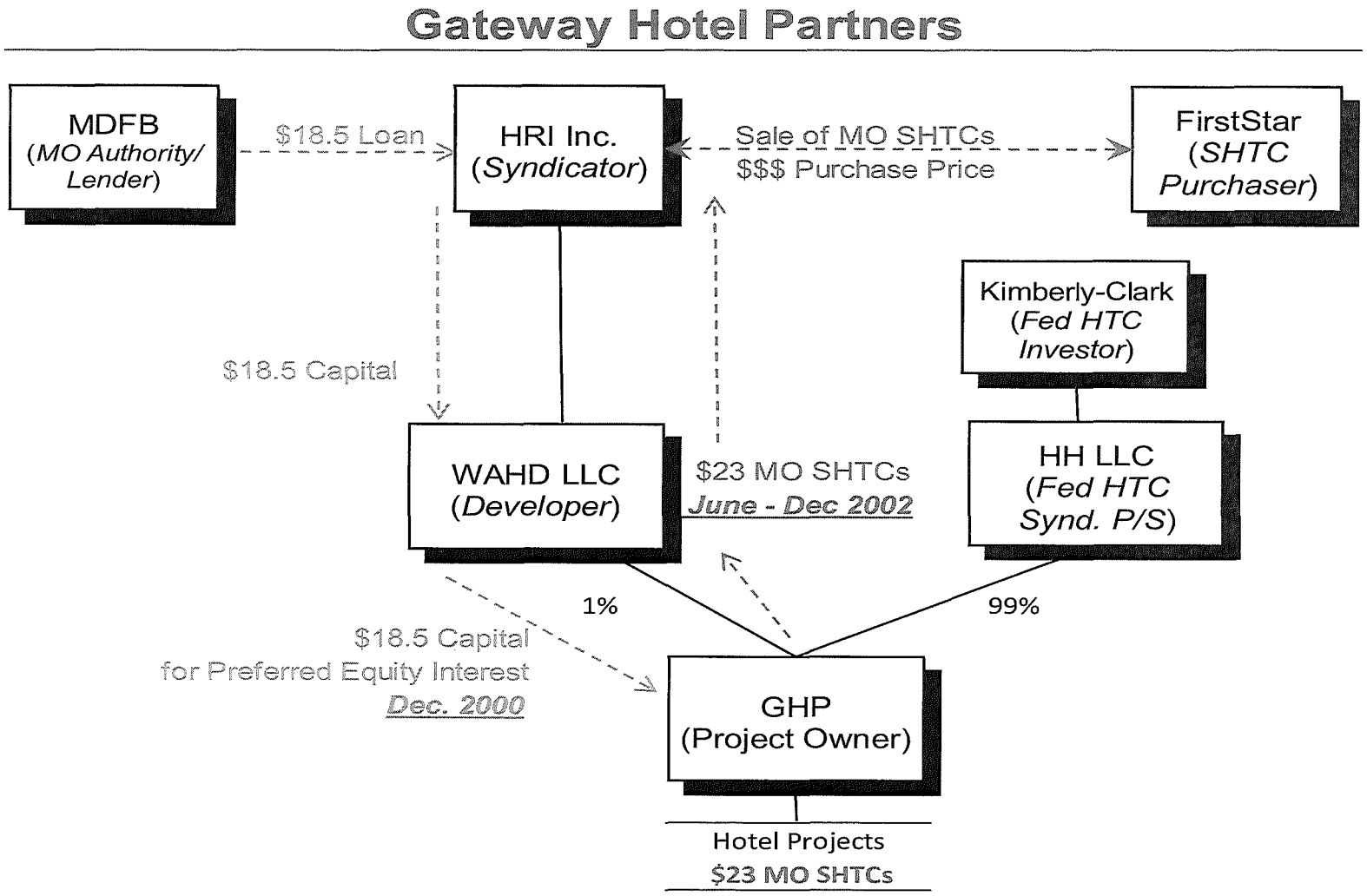
- SIGNIFICANT RISK of disguised sale treatment in ANY transaction where there are special allocations of State Tax Credits.
- Issue becomes how much disproportionality can be tolerated before cross the line on disguised sale?

SYNDICATING STATE HTCS / CURRENT DEVELOPMENTS

GATEWAY HOTEL PARTNERS, LLC V. COM'R, T.C. Memo. 2014-5

- Partnership set up in 2000 to syndicate transferable MO Historic Preservation Tax Credits
- Indirect partner (HRI) borrowed $$$ in 2000, and contributed to direct partner (WAHD), who contributed to Project Owner (GHP) for Preferred Equity
- Investor's Preferred Equity redeemed in 2002 in exchange for MO SHTCs
- Tax Court ruled that two of three transfers of SHTCs did not result in taxable sales
  - Third transfer failed to follow form, and was held taxable

SYNDICATING STATE HTCS / CURRENT DEVELOPMENTS



SYNDICATING STATE HTCs / CURRENT DEVELOPMENTS

GATEWAY HOTEL PARTNERS / LESSONS LEARNED

- Possible to syndicate SHTCs without disguised sale; transfers to Investors treated as nontaxable Partnership distribution under§ 731
- Keys to Tax Court holding
  - Loan to Syndicator entity (HRI) was respected against IRS challenge that it was made, in substance, to Project Owner
  - SHTC Investor retained entrepreneurial risk by contributing $$$ early (2000 contribution vs. 2002 completion/SHTC delivery)
  - Project Owner retained right to redeem Investor preferred equity for either $$$ or MO SHTCs – so no certainty as to either timing or amount of MO SHTCs to be transferred to SHTC Investor
- QUERY: Did HRI report gain on sale of HTCs?

SYNDICATING STATE HTCS / CURRENT DEVELOPMENTS *(CONT.)*

ROUTE 231, LLC V. COM'R, T.C. Memo. 2014-30

- Involved syndication of Virginia conservation easement donation credits to single SHTC Investor.
- In Dec. 2005, (i) JV made charitable donations of easements generating $7.7MM VA SHTCs, (ii) Investor acquired 1% interest in JV and (iii) Investor made $3.8MM contribution to JV in exchange for special allocation of $7.2MM VA SHTCs.

SYNDICATING STATE HTCS / CURRENT DEVELOPMENTS *(CONT.)*

ROUTE 231, LLC V. COM'R, *(Cont.)*

- IRS challenged $3.8MM contribution and special allocation of $7.2MM as disguised sale.
- Tax Court held Virginia Historic "squarely applied" to facts, and upheld IRS determination.
  - Interestingly, SHTC promoter involved in Virginia Historic also had prominent role in Route 231.
- Important because Investor lost even though it did not "grab the tax credits and run".
  - In Virginia Historic, Investors were partners of syndication Funds for only 4 – 5 months.
  - Investor remained partner thru Tax Court decision (8+ years).

SYNDICATING STATE HTCs / CURRENT DEVELOPMENTS *(CONT.)*

SWF REAL ESTATE LLC V. COM'R, T.C. Memo. 2015-63

- Substantially the same facts as in *Route 123*; involved Virginia conservation tax credits allocated to the same investment/syndication fund involved in *Route 123*.
- Tax Court again upheld IRS determination based on Virginia Historic disguised sale analysis.
- The decision also analyzed when the sale of state tax credits occurred – in the year when the credits were earned (2005) or when the State issued/registered the credits (2006). The Tax Court applied a "benefits and burdens" of ownership analysis to conclude the disguised sale occurred in the earlier (2005) year.

SYNDICATING STATE HTCs / WHERE IS THE MARKET?

- Preference to treat syndication of SHTCs as Sale
  - Reduces risk of IRS challenge
  - Higher pricing from Investor because of§ 164(a) deduction
- Search for Techniques to Defer / Deflect Gain from SHTC Sales
  - Developers and tax advisors looking for transaction structures that reduce tax hit from gain on SHTC sale
- Pricing varies by State, Investor type and structure
- Syndications to Individuals replaced by transactions with corporations having large state tax liabilities
  - e.g., banks, insurance companies

STATE HTCs / HELPFUL RESOURCES

1. Harry K. Schwartz, *State Tax Credits for Historic Preservation*, A Policy Report Produced by the National Trust for Historic Preservation (last updated 8/22/2016); available at http://ncshpo.org/State-Tax-Credits-Report%202013.pdf
2. Novogradac & Company, LLP, Historic Tax Credit Resource Center, available at https://www.novoco.com/resource-centers/historic-tax-credits/state-htcs/map-state-htc-programs
3. William F. Machen, *Federal Income Tax Issues Arising in connection with the Allocation, Purchase or Sale of State Tax Credits*, 50th Annual Southern Federal Tax Institute (2015)

NEW MARKETS TAX CREDITS

NMTC / BASICS

- Limited dollar amount of NMTCs
  - National allocation of NMTCs through CDFI Fund
  - $3.5 billion of NMTCs allocated for each year 2010 through 2019
- NMTCs earned for
  - Qualified Equity Investment (QEI)
  - made by taxpayer in Community Development Entity (CDE)
  - if substantially all of the investment is used by the CDE to make a Qualified Low Income Community Investment (QLICI)
  - in Qualified Active Low Income Community Business (QALICB)
- Program (statutory allocation authority) had expired as of 2014. Extended through 2019 by the PATH Act of 2015
- CDFI Fund announced (Notice of Allocation Availability) that it is combining the CY 2015 and the CY 2016 NMTC allocation into a single $7 billion round.

NMTC / BASICS *(CONT.)*

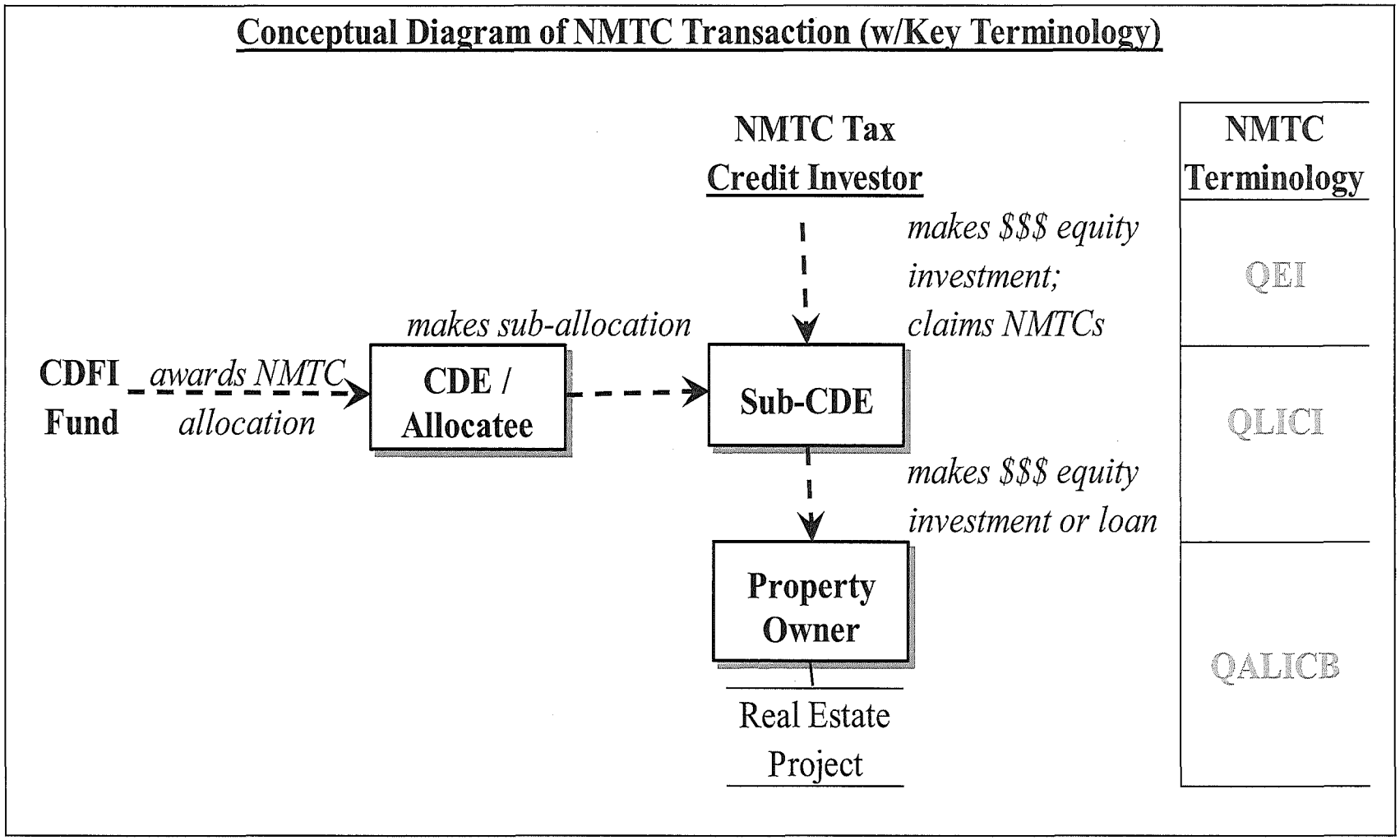
- NMTCs taken over 7 year period
  - Years 1 to 3: NMTCs = 5% of QEI (15% total)
  - Years 4 to 7: NMTCs = 6% of QEI (24% total)
- Investor reduces investment basis by NMTCs
- Recapture if, during 7 year credit period, CDE / QLICI / QALICB fails to qualify
  - 100% tax credit recapture regardless of year 1 or year 6
  - BUT protection under "reasonable expectations" safe harbor
- Use with other Federal tax credits
  - Can use with HTCs (§ 47)
  - CANNOT USE with Low Income Housing Tax Credits (§42)

NMTC / BASICS *(CONT.)*

IDENTIFYING THE PLAYERS

•*Player*	•*Role(s)*
•CDFI Fund	•Awards NMTC allocation to CDE
•CDE / Allocatee	•Receives NMTC allocation •Obtains equity investment from investor •Makes investment in QALICB
•Tax Credit Investor	•Invests $$$ in CDE •Receives NMTCs
•Property Owner / QALICB	•Receives $$$ investment from CDE

NMTC / BASICS *(CONT.)*



NMTC / BASICS *(CONT.)*

Basic NMTC Economics

New Market Tax Credits	39% of Allocation
Investment	$0.80 - $0.85
Attorney Fees	$250,000 – $600,000
Sub Allocation Fees	0 – 5% / CDE, typical deal total 3-5%
Annual Accounting Fees	$10,000 - $15,000 / CDE
Asset Management Fees	0 -.5% / CDE
Exit Fee per CDE	0 - 1%
Lower fees on Investor owned CDEs	
Put	usually $1,000 at Investment Fund
	After put, sponsor / affiliate typically holds own note
Net Benefit to developer	20-25% of Allocation

Representative NMTC Transaction

QEI		$10,000,000
New Markets Tax Credits	39%	3,900,000
Investment	$0.82	3,198,000
Leverage Loan	68%	6,802,000
Initial Attorney Fees		300,000
Sub Allocation Fees		350,000
Exit Fee		50,000
Annual Accounting Fees		15,000
Asset Management Fee	0.5%	50,000
Put		1,000
Net Benefit of Having an Investor (23% of QEI, 73% of Investor Investment)		$2,341,993

NMTC / QALICB Tests for Real Estate

- Test somewhat simplified – no employees
- Property must be located in Low Income Community
  - Poverty Rate of census tract is at least 20%
  - Median family income is 80% or less of statewide or metro area
- Must have substantial improvements; must generate income during first 3 years
- Non-residential rental property
  - Less than 80% of gross income from rental of dwelling units
  - Building by building determination

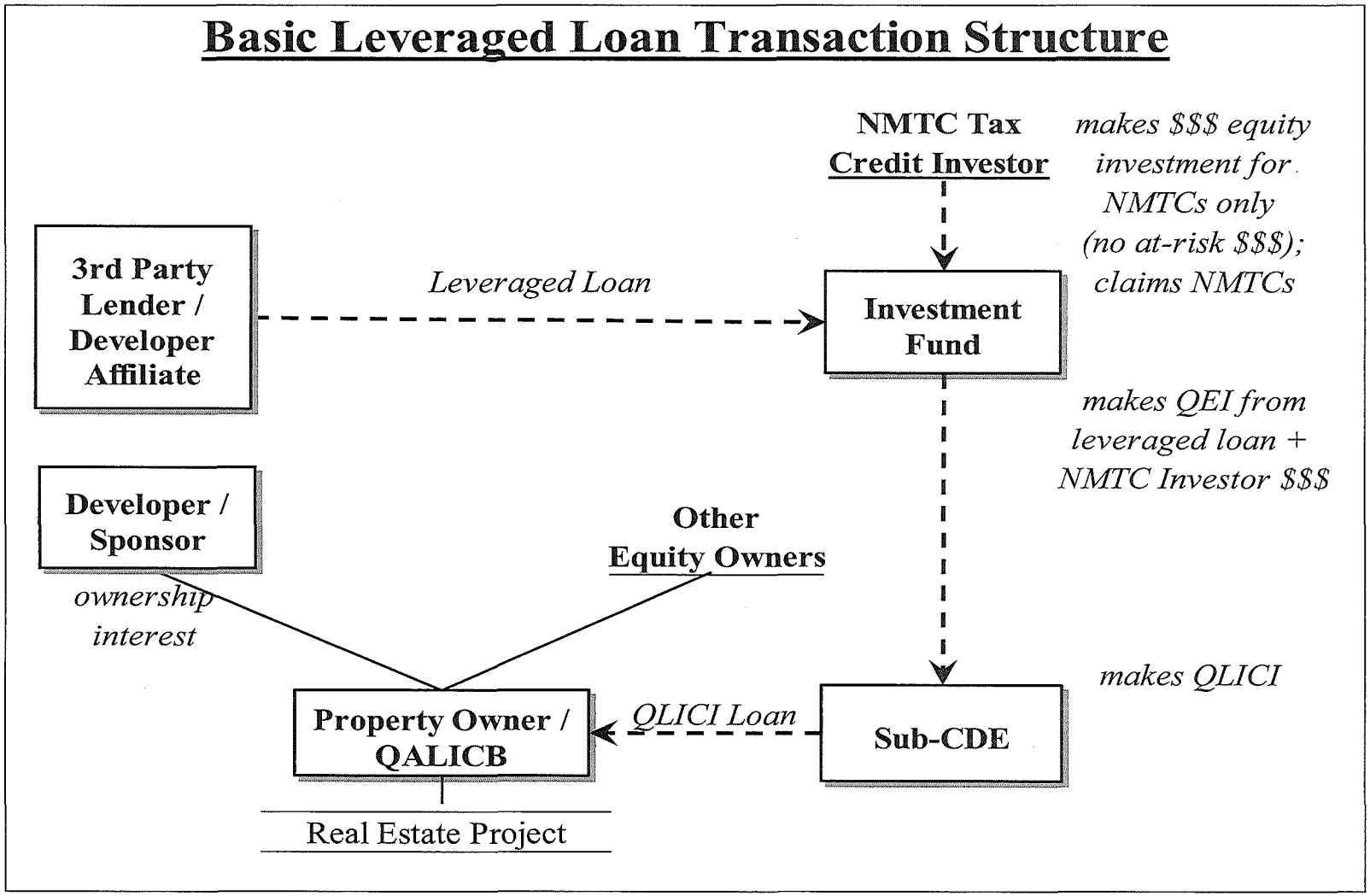
NMTC / QALICB Tests for Real Estate (Cont.)

- Cannot lease (or sublease) to "sin businesses"
  - farming, golf course, country club, massage parlor, hot tub facility, suntan facility, race track or gambling, sale of alcoholic beverages for consumption off premises
- "Active" requirement limits assets that may be owned by QALICB during 7 year period – no "Nonqualified Financial Property"
  - No subsidiary entities / joint ventures
  - Cannot have more than 5% of "nonqualified financial property" – debt, stock, partnership interests, options, futures, etc.; implicitly also includes cash in excess of reasonable working capital

NMTC / STRUCTURING THE QLICI

- Tax structuring is significant driver –deliver additional $$$ to Project Owner without current taxable income
- Equity QLICIs – Subordinated Equity
- Loan QLICIs
  - Reduced Interest Rate
    - Typically used where CDE is affiliate of Investor
    - Delivers long term subsidy, but not up front cash
  - A / B Loan
    - A Loan is "real" / hard loan
    - B Loan represents NMTC subsidy/ "soft" loan
- Leveraged Loan Structure

NMTC / LEVERAGED LOAN STRUCTURE



NMTC / Owner Issues

- Syndication structure makes dispositions during 7-year recapture period difficult
  - Must sell ownership interest in QALICB and leveraged loan
- Tax Credit equity ultimately taken into income either
  - As current accrual or
  - As cancellation of debt (COD) at unwind
- Owner Accounting Treatment – If Leveraged Lender is Affiliate, can Property Owner and Leveraged Lender consolidate? If so,
  - Leveraged Loan and QLICI Loan are eliminated on bal. sheet
  - Interest expense on QLICI Loan offsets interest income on Leveraged Loan
- What if Investor fails to exercise "Put"?