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# Tax Group Client Alert:

## Revenue Procedure 2014-12 : IRS Follow-Up to *Historic Boardwalk*[1]

On December 30, 2013, the Internal Revenue Service (the "IRS") released Revenue Procedure 2014-12 (the "Revenue Procedure"), describing a "safe harbor" for the allocation among partners of rehabilitation credits under section 47 of the Internal Revenue Code of 1986, as amended (the "Code"). A copy of the Revenue Procedure can be found here. If the requirements of the safe harbor are met, the IRS will not challenge a partnership's allocation of rehabilitation credits.

### BACKGROUND

The impetus for the Revenue Procedure was Historic Boardwalk Hall, LLC. v. Commissioner,[2] in which the Third Circuit determined that an investor was not a "bona fide partner" in a partnership that incurred qualifying rehabilitation expenditures and, accordingly, was denied the rehabilitation credits allocated to it under the partnership agreement. The key factors underlying the Third Circuit's opinion in Historic Boardwalk included that the developer partner guaranteed that the investor partner would receive the allocated rehabilitation credits and a preferred return. The court determined that the investor partner lacked a "meaningful stake in either the success or failure of [the partnership]" and as result was not a "bona fide partner."

The IRS expressly limited the Revenue Procedure to transactions involving rehabilitation credits, which are credits for rehabilitating certain buildings and structures. Notwithstanding this express limitation, the Revenue Procedure may provide some insight into the positions the IRS might take when analyzing the allocation of other types of tax credits, including the investment tax credit under Code

[1] Historic Boardwalk Hall, LLC. v. Commissioner, 694 F.3d 425 (3d Cir. 2012), cert. denied, U.S., No. 12-901, May 28, 2013.

[2] Id.

section 48 for certain renewable energy property, Code section 48A for qualifying advanced coal projects, and Code section 48B for qualifying gasification projects, as well as the production tax credit under Code section 45. This, however, may be wishful thinking as the rationale for some of the requirements set forth in the Revenue Procedure is unclear. Further, although the Revenue Procedure seems to borrow from some of the requirements and the analysis in a previously published Revenue Procedure that sets forth the widely-followed safe harbor for "flip partnership" investments in wind energy facilities ("Revenue Procedure 2007-65"),[3] at least with respect to one material feature of these transactions, the Revenue Procedure states a position that is contrary to and in direct conflict with the position set forth in Revenue Procedure 2007-65.[4] Consequently, the value of the Revenue Procedure in connection with analyzing partnership investments in other asset classes is unclear.

## THE SAFE HARBOR

As an initial matter, in order to satisfy the safe harbor criteria, allocations under the partnership agreement must satisfy the requirements of Code section 704(b) and the Treasury Regulations thereunder, and the rehabilitation credit must be allocated in accordance with Treasury Regulations section 1.704-1(b)(4)(ii). Generally speaking, this means that the rehabilitation credit must be allocated to the partners in the same ratio that the partners share the general profits of the partnership, or more specifically, the taxable income of the partnership described in Code section 702(a)(8). The other requirements of the safe harbor are described below.

For purposes of this description, the "Partnership" is the entity claiming the credits. References to the "Developer Partnership" and to the "Master Tenant Partnership" are relevant in the case of an inverted lease (or "pass-through lease") transaction in which the Developer Partnership owns and is rehabilitating the building and will claim applicable depreciation and amortization deductions consistent with ownership and the Master Tenant Partnership is leasing the building and will claim the applicable tax credit pursuant to an election provided for under the Code.

The Revenue Procedure addresses Partnerships comprised of one or more "Investors" and one or more "Principals." A Principal is a partner authorized to act as a manager for the Partnership and an Investor is a partner, other than a Principal, whose investment satisfies the requirements of the Revenue Procedure. An Investor may be an initial partner or may be a person who later purchases a Partnership interest.

[3] 2006-42 I.R.B. 686.

[4] *See* the discussion of "purchase and sale rights" below.

References in the Revenue Procedure to Principal, Investor or Partnership include “related persons” within the meaning of Code section 267(b) or Code section 707(b)(1).

### DOUBLE DIPPING

An inverted lease transaction will be outside the safe harbor if the Investor holds an interest in both the Master Tenant Partnership and the Developer Partnership, unless the interest in the Developer Partnership is held indirectly by reason of the Master Tenant Partnership holding an interest in the Developer Partnership. The prohibition does not apply to a separately negotiated, distinct economic arrangement (e.g., a separate arm’s length investment in the Developer Partnership to share in allocations of federal new markets tax credits or low income housing credits). The scope of these exceptions is unclear. For example, it is unclear whether the exception is violated by a separate arm’s length investment in a Developer Partnership that allows the Investor to share in other tax attributes (e.g., net losses attributable to accelerated depreciation). It is also unclear why an indirect participation in the tax attributes resulting from the Master Tenant Partnership holding an interest in the Developer Partnership does not present the same opportunities for whatever abuse the prohibition is intended to preclude.

### MINIMUM PARTNERSHIP INTERESTS

As in the case of Revenue Procedure 2007-65, the Principal must have a minimum one percent interest in each material item of Partnership income, gain, loss, deduction, and credit at all times during the existence of the Partnership. Similarly, the Investor must have, at all times during the period it owns an interest in the Partnership, a minimum interest in each material item of Partnership income, gain, loss, deduction and credit equal to at least five percent of the Investor’s percentage interest in each such item for the taxable year for which the Investor's percentage share of that item is the largest (as adjusted for sales, redemptions or dilution of the Investor’s interest).

### BONA FIDE EQUITY INVESTMENT

The Revenue Procedure contains the following prescription:

> *The Investor’s Partnership interest must constitute a bona fide equity investment with a reasonably anticipated value commensurate with the Investor’s overall percentage interest in the Partnership, separate from any federal,*

> *state, and local tax deductions, allowances, credits, and other tax attributes to be allocated by the Partnership to the Investor.*[5]

Once again, the intent of this requirement is unclear. Although it could be read as saying that the amount of the Investor's investment or the purchase price paid for its partnership interest must be determined without regard to tax attributes, that would appear to go too far. The Revenue Procedure goes on to say:

> *An Investor's Partnership interest is a bona fide equity investment only if that reasonably anticipated value is contingent upon the Partnership's net income, gain, and loss, and is not substantially fixed in amount. Likewise, the Investor must not be substantially protected from losses from the Partnership's activities. The Investor must participate in the profits from the Partnership's activities in a manner that is not limited to a preferred return that is in the nature of a payment for capital.*[6]

Assuming these requirements are satisfied, we presume the general requirement first quoted above in this section will be treated as satisfied. Note that the payment of preferred returns, fees, and tax distributions are permitted, but such amounts will not be determinative of whether an Investor has a bona fide equity investment.

### NO OFF-MARKET OTHER ARRANGEMENTS

Compliance with the safe harbor requires that the value of the Investor's Partnership interest not be reduced through arrangements (e.g., fees or lease terms) that are unreasonable as compared to similar arrangements in real estate development projects that do not qualify for rehabilitation credits, and also may not be reduced by disproportionate rights to distributions or by issuances of interests in the Partnership (or rights to acquire interests in the Partnership) for less than fair market value consideration. Section 4.06(2)(c) of the Revenue Procedure contains certain limitations on subleasing that are presumably related to the concept, discussed below, that the Investor must bear risk of loss and possibility of gain beyond a fixed return. In particular, in the case of an inverted lease, a sublease to any person will be deemed unreasonable if the duration of the sublease is as long or longer than the duration of the head lease.

[5] Revenue Procedure § 4.02(2)(b).

[6] Id.

### INVESTOR'S MINIMUM UNCONDITIONAL CONTRIBUTION

Before the date that the rehabilitated building is placed in service, the Investor must make an unconditional contribution to the Partnership in an amount equal to at least 20% of the Investor's total expected capital contributions (the "Investor Minimum Contribution"). The Investor must maintain the Investor Minimum Contribution throughout the duration of its investment in the Partnership and, except for the permissible guarantees described below, the Investor Minimum Contribution must not be protected against loss through any arrangement, directly or indirectly, by any person involved with the rehabilitation. Contributions of promissory notes or other obligations for which the Investor is the maker are not included in determining whether the Investor satisfies the Investor Minimum Contribution.

### CONTINGENT CONSIDERATION

At least 75% of the Investor's total expected capital contributions must be fixed in amount before the date the building is placed in service. The Investor also must reasonably expect to meet its funding obligations as they arise.

### GUARANTEES AND LOANS

The Revenue Procedure provides that no person involved in any part of the rehabilitation transaction may offer a guarantee that is not an unfunded permissible guarantee. A guarantee is unfunded if (i) no money or property (other than certain limited operating reserves) is set aside to fund any portion of the guarantee and (ii) there is no minimum net worth requirement imposed in connection with the guarantee. Permissible unfunded guarantees include: (i) completion guarantees, (ii) operating deficit guarantees, (iii) environmental indemnities and (iv) financial covenants. Specifically prohibited by the Revenue Procedure are guarantees (or insurance) to insure the Investor's ability to claim the rehabilitation credits, the cash equivalent thereof, or the repayment of any portion of the Investor's contribution due to inability to claim the rehabilitation credits. Also prohibited are indemnities that cover the Investor's costs if the IRS challenges the Investor's claim of the rehabilitation credits. Note that the guarantee (and insurance) prohibitions do not prevent the Investor from procuring insurance from persons not involved with the rehabilitation transaction or the Partnership. In addition to the foregoing, the Revenue Procedure requires that neither the Partnership nor the Principal lend funds to the Investor or guarantee any indebtedness incurred to acquire any part of the Investor's interest in the Partnership.

## PURCHASE AND SALE RIGHTS

Under the Revenue Procedure, neither the Principal nor the Partnership may have a call option or other contractual right or agreement to purchase or redeem the Investor's interest at a future date (other than a contractual right or agreement for a present sale). Further, the Investor may not have a contractual right or other agreement to require any person involved in any part of the rehabilitation transaction to purchase or liquidate the Investor's interest in the Partnership at a future date at a price that is more than its fair market value determined at the time of exercise of the contractual right to sell. Implicit in this limitation is that a "put" at a price less than the then-determined fair market value is permissible. Note that the IRS took a contrary and conflicting position in Revenue Procedure 2007-65.

In addition to the foregoing, to meet the safe harbor, an Investor may not acquire its interest in the Partnership with the intent of abandoning the interest after the Partnership completes the qualified rehabilitation. An intent to abandon is rebuttably presumed if the Investor abandons its interest at any time.

## CONCLUSION

The Revenue Procedure should alleviate some of the uncertainty caused by Historic Boardwalk in the context of partnerships claiming rehabilitation credits. However, the extent to which the IRS will apply the same principles to partnerships investing in other asset classes is unclear.

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