IRS Issues Long-Awaited Guidance Regarding the Allocation of Federal Rehabilitation Tax Credits

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The Internal Revenue Service ("IRS") recently issued guidance in Rev. Proc. 2014-12, providing a safe harbor for the allocation of IRC Sec. 47 rehabilitation tax credits in tax credit partnerships under IRC Sec. 704(b). The IRS indicated that the safe harbor is intended to provide partners and partnerships with increased predictability in IRC Sec. 47 rehabilitation tax credit allocations following the decision in *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425 (3rd Cir. 2012).

Historic Boardwalk Decision

The issuance of the *Historic Boardwalk* decision in August 2012 created significant uncertainty in the rehabilitation tax credit arena. The United States Court of Appeals for the Third Circuit found that a private sector investor in a rehabilitation tax credit partnership had no meaningful stake in the partnership and was not a bona fide partner for federal income tax purposes. Accordingly, the Third Circuit disallowed all historic rehabilitation tax credits previously allocated to the investor. Following this decision, tax practitioners and real estate development professionals sought guidance from the IRS regarding the conditions under which rehabilitation tax credit allocations would be respected.

Safe Harbor

The Revenue Procedure outlines several requirements that must be met for IRC Sec. 47 rehabilitation tax credit allocations to be respected.

Historic Tax Credit Partnership Investors

An investor can be an initial partner or may subsequently purchase its partnership interest in either a developer partnership, the partnership that owns and restores the historic building, or a master tenant partnership, a partnership that leases the building from the developer partnership and is treated as having acquired the building solely for IRC Sec. 47 purposes pursuant to a Treas. Reg. Sec. 1.48-

4(a)(1) election. Other than in a separately negotiated and economically distinct arrangement (e.g., an allocation of New Markets Tax Credits), an investor who receives an allocation of IRC Sec. 47 rehabilitation tax credits from a master tenant partnership cannot also invest in the developer partnership.

Minimum Partnership Interest

The safe harbor requires that the principal, the manager authorized to act for the partnership, must have at all times at least a 1% interest in each material item of partnership income, loss, deduction, and credit. An investor, any partner other than a principal, must maintain a minimum interest in each material item of partnership income, loss, deduction, and credit that is equal to 5% 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. Further, the investor’s partnership interest must constitute a “bona fide equity investment” with a reasonably anticipated value equivalent to the investor’s overall interest in the partnership, separate and apart from any tax deductions, allowances, credits or other tax attributes to be allocated to the investor. The “bona fide equity investment” cannot be substantially fixed in amount and must be contingent upon the partnership’s net income, gain, and loss. The investor must also participate in the profits of partnership activities in a manner that is more than a preferred return.

The value of the investor’s partnership interest cannot be reduced through fees, lease terms or other arrangements that are unreasonable compared to a real estate development project that does not qualify for IRC Sec. 47 rehabilitation tax credits. The value also may not be reduced by disproportionate rights to distributions or additional issuances of partnership interests for less than fair market value.

Investor Contributions

The investor must contribute an unconditional amount to the partnership of at least 20% of the investor’s total expected capital contributions before the date that the building is placed in service. This contribution must be maintained throughout the period in which the investor holds its ownership in the partnership. Contributions of investor-created obligations, including promissory notes, are disregarded in determining whether the investor minimum contribution is sufficient.

In addition, at least 75% of the investor’s total expected capital contributions must be fixed in amount before the building is placed in service.

Guarantees and Loans

The safe harbor outlines guarantees and loans that are permissible as among the investor, the partnership, and other partners. Permissible guarantees include the following unfunded guarantees: completion guarantees, operating deficit guarantees, environmental indemnities, and financial covenants.

While a principal may provide an unfunded guarantee to the investor that both the partnership and the principal will undertake any acts necessary for the partnership to claim the IRC Sec. 47 rehabilitation credit, impermissible guarantees include direct or indirect guarantees to insure the investor’s ability to claim the IRC Sec. 47 rehabilitation tax credits, the cash equivalent of the credits or the repayment of any portion of investor's contribution due to an inability to claim the IRC Sec. 47 credits. Moreover, no individual involved in the rehabilitation transaction can guarantee that the investor will receive partnership distributions or consideration in exchange for its partnership interest, other than a fair market sale right. No person involved in the rehabilitation transaction can pay the investor's costs or indemnify the investor for its costs if the IRS challenges the investor's claim of the IRC Sec. 47 rehabilitation tax credits.

Neither the principal of a tax credit partnership nor the partnership itself may lend the investor funds or guarantee any indebtedness created to facilitate the acquisition of its interest in the partnership.

Notably, the IRS will permit an investor to procure insurance to protect itself from losses incurred in a IRC Sec. 47 rehabilitation tax credit transaction, provided, however, that the insurer is not involved with the rehabilitation or the partnership.

Call and Put Options

The partnership or the partnership's principal may not have a contractual agreement to purchase or redeem the investor's interest. In addition, the investor may not have a contractual right to require any person involved in the rehabilitation transaction to purchase its partnership interest at a price in excess of its fair market value at the time of the exercise of this right.

The investor also may not acquire its partnership interest with the intention of abandoning the interest after the completion of the qualified rehabilitation. A presumption that the investor acquired the interest with the intent to abandon is created when the investor abandons at any time, unless the facts and circumstances indicate otherwise.

Effective Date

The safe harbor guidance is effective for tax credit allocations made after December 29, 2013. However, if a building was placed in service before December 30, 2013 and at the time it was placed in service the safe harbor requirements were met, then the IRS will not challenge the related allocations.

Conclusion

In the wake of *Historic Boardwalk*, this highly anticipated guidance will provide helpful parameters for properly and effectively structuring rehabilitation tax credit transactions and allocating the associated tax credits among partners. Further, the increased predictability stemming from the safe harbor may result in a revitalization of the stalled historic rehabilitation tax credit industry. Williams Mullen and its Business Tax Group will continue to evaluate the developments impacting historic rehabilitation tax credits. For further questions about this Revenue Procedure, please contact one of the authors of this tax alert or a member of our firm's Business Tax group.

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