Health Care REFORM
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Historic Rehabilitation Tax Credit and Other Tax Credit Incentive Structures in Limbo Awaiting IRS Guidance

By J. Leigh Griffith, JD, CPA

The tax credit industry, particularly the historic rehabilitation tax credit and perhaps the new markets tax credit, are in somewhat of a state of limbo at the current time. The traditional methods for structuring these projects and obtaining investors that can utilize the credits, but do not want real estate risk, are now suspect.

In the Code Section 47 rehabilitation tax credit arena ("47 Credit"), the IRS is moving forward to provide a safe harbor revenue procedure that hopefully the industry can live with and Congressional intent be achieved. Until the revenue procedure is released, there is great uncertainty and danger for the promoters and developers seeking to do projects that are consistent with Congressional intent and for investors only interested in the 47 Credit to invest. The issue of who is a “partner” for federal tax purposes has re-emerged in this setting.

The genesis of the current situation starts with the fact the 47 Credit is not a transferable credit. It cannot simply be sold and used. The historically common structures admit investors into a partnership (either an LLC or a limited partnership) which either owns or leases the property with the investors receiving almost all of the credit and a minimal fixed economic return. The developer is generally an affiliate of the promoter, and there are guarantees that either the credit will be obtained or that all efforts necessary to obtain the credit will be timely and successfully completed. There are generally guarantees as to cost overruns and some manner of shifting the risk of operations away from the investors to the affiliates of the promoter. There is generally a put and call feature for the investors after the recapture period has passed.

In Historic Boardwalk Hall, LLC v. Commissioner, the Tax Court upheld Pitney Bowes ("PB") receipt of the 47 Credit via a partnership with the New Jersey State Exposition Authority (NJSEA) that purported to rehabilitate a building owned by NJSEA and leased to the partnership. Per the documents, PB obtained a 99.9 percent membership interest and was entitled to 99.9 percent of the tax credits and 99.9 percent of the cash flows (after various fees). The only “unusual aspects” of this transaction were the direct involvement of the New Jersey governmental entity, perhaps the timing of PB’s capital contribution and perhaps the call right at other FMV.

The IRS appealed the case to the 3rd Circuit on various theories. The 3rd Circuit held against PB on the ground that PB was not a bona fide partner and did not have a meaningful share of the risks/benefits. • Risk Elimination. PB’s investment risk was eliminated because PB was not obligated to make a contribution until NJSEA generated enough credits equal to PB’s investment, audit risk was eliminated through a tax benefits guaranty and project risk was eliminated because the project was fully funded and construction had neared completion before PB entered the transaction.

• No Meaningful Upside. The cash flow entitlement was deemed illusory as even the best projections forecasted no residual cash flow due to fees to NJSEA. In addition, NJSEA could cut off the PB’s upside by exercising a purchase option not based on the FMV of PB’s interest.

The 47 Credit industry attempted to limit Historic Boardwalk Hall, LLC’s ramifications to the unusual nature of the strength of the various guarantees (government agency backing vs. individual and mere corporate guarantees), the timing of the contributions and admission of PB and the fact that PB’s money was not needed to complete the construction. Historic Boardwalk Hall, LLC was marketed as a “sale of credits.” Unfortunately, with the release of CCA 20124002F, it became clear that Historic Boardwalk Hall, LLC was, in the view of the IRS, not so limited and that the IRS would challenge more traditional 47 Credit structures.

CCA 20124002F’s 47 Credit transaction involved an investment fund which was entitled to the historic tax credits and a set preferred return and B, an affiliate of the promoter, as the other partner. As is common, B provided a tax benefit guaranty. The fund had an option to put the interest to B whose performance was guaranteed by affiliates of B.

The put option price was equal to any unpaid preferred return. B had a call option equal to the FMV of the fund’s interest (after the recapture period) with FMV taking into account lack of marketability, liquidity, etc. The fund was not obligated to put up additional capital (all debt was nonrecourse to the fund) and B was responsible for all excess development costs. In short, a traditional 47 Credit transaction took place.

The CCA concluded the fund was not a bona fide partner and not eligible to receive the 47 Credit as (A) it did not have downside risk given (i) tax benefit guaranty, (ii) preferred return and put, (iii) no risk beyond contributed capital, and (iv) the guaranteed sum certain (preferred return and tax benefit) and (B) it did not have a meaningful upside based on (i) an illusory cash flow entitlement because of the management/development fees and debt service (including related party debt) netted out cash flow, and (ii) the FMV on the call was illusory because of the illusory of cash flow and “under the terms it was unlikely the FMV would exceed the residual percentage of the membership interest.”

The CCA took analysis of TIFD III-E, Inc. (commonly known as “Castle Harbour”) which was a joint venture between two foreign banks and a subsidiary of GE in which the court found the foreign banks were not partners even though there was economic substance to the transaction.

Going beyond Historic Boardwalk Hall, LLC, the CCA also took the position the partnership was a sham, as there was no alleged joint undertaking for profit and loss (ignoring the tax credit as an economic benefit that came about from renovating the property). The IRS found there was no legitimate business purpose for the use of the partnership form, and the partnership served no purpose other than to effect an indirect sale of the rehabilitation tax credit.

In Sacks v. Commissioner, the 9th Circuit held that the energy credit was considered in determining a profit motive was distinguished because there was risk and reward to the partners in the underlying business. Of potential importance in Tennessee is the IRS’ reliance on American Electric Power, in which the 6th...
Circuit refused to evaluate the profitability of a corporate-owned life insurance plan on an after tax basis in accordance with “the Sacks court’s dictum.” The IRS acknowledged that other courts have found that the transaction was “the thing which the statute intended” but stated “…there is no authority that supports the notion that Congress intended to allow a third party to claim tax credits for a rehabilitation activity in which it did not participate, either by contributing to its cost or by assuming some portion of its risk.”

Finally, the CCA took the position that the partnership was not the owner of the historic property for federal tax purposes. The developer and its affiliates developed the project and bore all of the properties operational and rehabilitative burdens and essentially continued to do so after the partnership through a circular flow of contracts. The rent and loan payments as well as the development and management fees were designed to ensure profits from operations did not go to the partnership.

The IRS has stated that expected guidance is well along, but the IRS maintains that the recipient of the credits must be a partner under Culbertson - a joint undertaking of parties with a business purpose in the conduct of a business enterprise. In September 2013 at the fall ABA Section of Taxation Meeting, Craig Gerson, attorney adviser Treasury Office of Tax Legislative Counsel indicated that the guidance will take into account that the credit is a significant component of the return. However, the guidance will also be looking for entrepreneurial upside potential beyond the credit as well as the possibility - although because of the nature of the deals, somewhat slim - of downside potential. There would be some focus on permissible types of guarantees to that end. There was consideration being given to allowing “put rights” at FMV but no call rights. In the context of a discussion over a 1 percent threshold for a partner’s minimum partnership interest as found in Rev. Proc. 2007-65, Gerson stated to the extent there are already lines in Rev. Proc. 2007-65 (which people can debate as to what they mean), the Treasury intends to stay with them.

Howard E. Abrams of Harvard Law School summed up his view as “What’s the nonsense about who is a partner? They put money in and it’s being dissipated in a venture that Congress recognized might very well not be done otherwise … The idea that you’re looking as to who’s economically sharing in profits in an investment, that we agree without the tax credit wouldn’t be profitable, seems to me to be chasing your tail.”

It is anticipated that the guidance will provide a safe-harbor for 47 Credit transactions, and that the IRS will not issue private letter rulings on such transactions in the future.

Until such guidance is issued, tax advisers to developers and investors should be very cautious and make sure the investor is economically in the operation results and potential appreciation of the real estate and clearly a partner in the full sense. The previously common guarantee that the investor will receive the credit or a refund of the investment with costs may be dangerous, although a guarantee that development and actions necessary to qualify for the credit may well be acceptable. At this time there is much uncertainty as to what is required to be a partner in a non-economic investment supported by tax credits - stay tuned.

Endnotes
2 459 F.3d 220 (2nd Cir. 2006)
3 69 F.3d 982 (9th Cir. 1995)
4 326 F.3d 737 (6th Cir. 2003)
5 CM Holdings, Inc., 301 F.3d 96 (3d Cir. 2002).
6 Since the investor was putting up cash equal to 90% of the credit, it is unclear to the author as to why the investor was not providing funds for the rehabilitation of the property.
7 Commissioner v. Culbertson, 337 U.S. 733 (1942)
8 Comment of Clifford Warren, senior counsel, IRS Office of Associate Chief Counsel (Pass-throughs and Special Industries), September 20, 2013 at ABA Tax Section Meeting.

About the Author:
J. Leigh Griffith, JD, CPA, is an attorney with Waller. He can be reached at leigh.griffith@wallerlaw.com.