SQUIRE SANDERS

REVENUE PROCEDURE 2014-12 – THE HISTORIC BOARDWALK SAFE HARBOR

January 2014

On December 30, 2013, the Internal Revenue Service (IRS) issued **Revenue Procedure 2014-12** establishing a safe harbor (Safe Harbor) under which allocations by partnerships to partners of historic rehabilitation tax credits (HTCs) under Section 47 of the Internal Revenue Code of 1986, as amended (the Code) will be respected. Clarifications to the Safe Harbor were published on January 9, 2014.

The Safe Harbor is in direct response to the decision in ***Historic Boardwalk, LLC v. Comm'r***, 694 F.3d. 425 (3rd Cir. 2012), cert. denied 133 S. Ct. 2734 (2013) (*Boardwalk* case), in which the Third Circuit denied HTCs to an investor on the basis that it was not a partner in a partnership entitled to HTCs. The adverse holding of the *Boardwalk* case brought investment in historic projects nearly to a halt; the Safe Harbor was intended to provide investors with the necessary comfort to resume investments in HTC transactions.

Section I of this publication is a summary of the *Boardwalk* case.

Section II summarizes and discusses the Safe Harbor.

Section III provides suggestions for structuring an HTC transaction to satisfy the Safe Harbor. While some of the requirements to meet the Safe Harbor are straightforward, many requirements are subjective or ambiguous, and thus this section attempts to provide suggestions that avoid the ambiguities and subjective standards.

The Safe Harbor is effective for allocations made on or after December 30, 2013, i.e., for projects placed in service after such date. This presents the possibility for parties to revise a transaction that has closed before such date if the project has not yet been placed in service. The Safe Harbor provides that allocations of HTCs made before December 30, 2013 will be respected if the requirements of the Safe Harbor were satisfied at all times on and after placement in service of the project and such allocations were made in accordance with Code Section 704(b); it would be very unlikely that all of the various provisions of the Safe Harbor would have been anticipated.

It is important to stress the very limited scope of the Safe Harbor. It covers only one narrow issue presented by a typical HTC structure in which an investor becomes a partner in a partnership primarily to receive the HTCs: whether such party is respected as a partner in the partnership, and thus entitled to allocation of the HTC. The Safe Harbor does *not* address the myriad other issues commonly encountered in an HTC transaction, including: (1) what expenditures are properly treated as "qualified rehabilitation expenditures" (QREs), including whether all or part of a development fee is included; (2) whether and when the building is "substantially rehabilitated"; (3) the timing of placement in service, and whether the investor has been admitted as a partner before such date; (4) whether the Developer Partnership (as defined in the Safe Harbor and below) is the tax owner of the rehabilitated building – this is principally an issue where the Developer Partnership possesses the building pursuant to a long-term lease; (5) whether the tax-exempt use rules in Code Section 168(h) apply; (6) whether the limitations in Code Sections 50(b)(3) and (4) relating to property used by certain tax-exempt organizations, governmental units or foreign persons apply; (7) whether the at-risk rule in Code Section 49 is satisfied; (8) whether the requirements to pass through the HTC under Code Sections 50(d)(5) and 48(d) (as in effect before repeal by the Revenue Reconciliation Act of 1990) are satisfied, including the special pass through at-risk rules of Code Section 48(d)(6); and (9) how "Section 50(d)" income under Code Section 48(d)(5) is allocated. On the last point, note that the method of allocating Section 50(d) income will not cause a transaction to fail the Safe Harbor if all of its provisions are otherwise satisfied; however, the allocation of Section 50(d) income may still be challenged.

The Safe Harbor applies only to HTC transactions. Despite this limited scope, it seems that application of the Safe Harbor to energy tax credits under Code Section 48 (which are investment tax credits similar to the HTC) might avoid a structural challenge to such transactions.

Section I – Background on the Boardwalk Case

On August 27, 2012, the United States Court of Appeals for the Third Circuit issued their decision in the *Boardwalk* case, in which the court held that a tax credit investor was not a bona fide partner in the project partnership because it "did not have any meaningful downside risk or meaningful upside potential . . . ," and thus was not entitled to claim the HTCs with respect to the rehabilitation. The case reversed a contrary decision of the U.S. Tax Court, which had upheld the allocation of the HTCs.

The *Boardwalk* case involved the rehabilitation of the historic Boardwalk Hall located on the boardwalk in Atlantic City (Hall). The New Jersey Sports and Exposition Authority (NJSEA) undertook the restoration of the Hall in the 1990's at an anticipated cost of $90.6 million; NJSEA had commitments to fully fund the rehabilitation of the Hall between bond issuances and funds to be provided by a state authority.

Just prior to the start of the renovation, NJSEA was approached by a consultant concerning "the sale of the historic rehabilitation tax credits expected to be generated" by the rehabilitation of the Hall. In an offering memorandum prepared by the consultant, it estimated the cost of renovation to be $107 million and attributed the difference in the $90.6 million estimated total construction costs to the payment of a $14 million development fee to NJSEA, legal, accounting and syndication fees and the establishment of a working capital reserve.

NJSEA selected Pitney Bowes, Inc. (PB) as the tax credit investor, and entered into a joint venture called Historic Boardwalk Hall, LLC (LLC). PB made an initial capital contribution of $650,000 to LLC out of total contributions of $20,198,460 (and a loan of $1,218,000) in exchange for a 99.9% ownership interest as the investor member of LLC. NJSEA provided the LLC with two loans: (1) a purchase money obligation representing the amount of QREs incurred by NJSEA prior to PB's investment; and (2) a loan to finance the remainder of the projected QREs.

PB's additional capital contributions were contingent upon the completion of certain project-related events, including the verification of the amount of rehabilitation costs incurred to date that would be classified as QREs. The last phase of the rehabilitation was completed in October 2001. Prior to that time PB had made 38% of its required capital contributions. Proceeds from its capital contributions were used to pay down the principal on the purchase money obligation to NJSEA.

NJSEA provided the following guarantees: (1) to fund all excess development costs through a completion guaranty; (2) to fund operating deficits through interest free loans as an operating deficit guaranty; and (3) to indemnify PB against any loss arising from hazardous materials on the property including remediation costs through an environmental guaranty. In addition, the LLC also agreed to provide PB with a typical tax indemnity covering any recapture of the HTC and audit costs.

Cash flow was distributed first to PB to pay its preferred return and tax distribution, then to NJSEA to repay interest and principal on its loans and amounts advanced pursuant to any operating deficit guaranty, and only then the balance to PB and NJSEA in accordance with their respective percentage interests.

NJSEA and PB entered into "put" and "call" options whereby NJSEA had the right to call PB's membership interest in LLC any time during the 12 month period starting 60 months from the placement in service date. If NJSEA did not exercise its call option, PB had the right to exercise its put option at any time during the 12 month period beginning 84 months from the placement in service date. Both the put and call price was set at the greater of the fair market value of PB's membership interest and any accrued and unpaid preferred return due to PB. In addition to a purchase option and a put option, there was also a "consent option" whereby NJSEA could purchase PB's interest for an amount equal to the net present value of any unrealized tax benefits and expected cash flow through the end of the credit period. PB could compel NJSEA to purchase its interest in the event of an NJSEA default.

NJSEA was required to obtain a guaranteed investment contract (GIC) in an amount reasonably satisfactory to secure the repurchase of PB's interest. The amount of the GIC needed to be sized to repay PB's loan plus accrued but unpaid interest and PB's annual priority distributions.

Prior to the closing of PB's commitment, the LLC engaged an accounting firm with national experience in HTC transactions to prepare financial projections in connection with PB's investment. The projections for the project were changed several times, often without sufficient support, with the ultimate appearance that they were being artificially massaged solely to support the tax position. The initial projections showed a significant net operating loss for the first five years. Those projections were revised by removing utility expenses, which resulted in significant net operating income over the same period. When the accountants pointed out that there was no cash flow to pay the project debt, they were instructed by a consultant to add several new sources of revenue, specifically "naming rights," parking revenue and net concession revenue, apparently without any evidence that such revenue was actually contemplated. The accountants also (without any stated rationale) increased the trending of the income to 3.5%, but left the trending of the expenses at 3%. The final projections estimated net operating income for the first five years of $9.9 million, but in reality there were operating deficits totaling $10.5 million for that period.

The court cited both lack of downside risk and upside potential in its holding. Following are negative factors that presumably contributed to the court's assessment that there was no meaningful downside risk:

- The 3% preferred return was assured because it was the floor for the purchase and put options, which were secured by a GIC purchased with PB's equity;
- PB did not bear any construction risk due to the unlimited completion guaranty and the timing of the investor's capital contributions;
- Operating deficits were guaranteed;
- PB bore no environmental risk due to the environmental guaranty; and
- PB was assured of receiving its capital back in the form of the tax credit or an indemnity payment in lieu thereof, and of receiving its 3% preferred return, whether the project was a success or a failure.

In addition to the limited downside risk assumed by PB, it had virtually no upside potential. The court stated that PB's "avoidance of all meaningful downside risk in [LLC] was accompanied by a dearth of any meaningful upside potential." Following are factors cited for that conclusion:

- PB was entitled to 99.9% of residual cash flow, but as the court noted, the LLC's "own rosy financial projections from 2007 to 2042 … forecasted no residual cash flow available for [residual] distribution." This was because cash flow was first used to pay the investor its preferred return and then to pay debt service and repay the operating deficit loan.
- Although in form PB could receive the fair market value of its interest if either the call option or put option were exercised, there was also a "consent option" whereby NJSEA could purchase PB's interest for an amount equal to the net present value of any unrealized tax benefits and expected cash flow through the end of the credit period.

The court therefore held that PB was not a bona fide partner in the LLC because it had no meaningful downside risk or upside potential.

A fuller summary of the *Boardwalk* case is **available online**.

Section II – Summary and Discussion of Safe Harbor

For purposes of this Section II, terms defined in the Safe Harbor are used, *viz.*, "Investor" refers to a tax credit-motivated investor member in a Developer Partnership or Master Tenant Partnership. A "Developer Partnership" is the entity, customarily a limited liability company that is treated as a partnership for tax purposes, that owns and rehabilitates the building. A "Master Tenant Partnership" is an entity, again customarily organized as a limited liability company, that leases the project pursuant to a long-term master lease from the Developer Partnership, in a transaction in which the Developer Partnership elects to pass through the HTC pursuant to Code Section 50(d)(5). The term "Principal" refers to a managing member in a Developer Partnership and/or a Master Tenant Partnership, which would customarily be the developer or an affiliate of the developer. All of these terms include related parties, as defined in Code Sections 267(b) and 707(b)(1).

1. **Prohibition on Investor investing in Developer Partnership if Investor receives HTC through a Master Tenant Partnership**. If the transaction is structured as a pass through deal, whereby the Investor is a member in the Master Tenant Partnership, the Investor cannot also hold an interest in the Developer Partnership. The Master Tenant Partnership is, however, permitted to hold an interest in the Developer Partnership (and thus the Investor can have an indirect interest in the Developer Partnership). The percentage interest that the Master Tenant Partnership may hold in the Developer Partnership is not specified, but it would be prudent to limit the investment to less than a 50% profits interest.[1]

   It is unclear what potential abuse this prohibition is attempting to foreclose, or why that abuse is not present with the indirect investment allowed, but since dual investments in pass through transactions would be very uncommon, this proscription is unlikely to be of concern.

   The Safe Harbor permits, as an exception, the Investor to invest in both the Master Tenant Partnership and the Developer Partnership pursuant to a separately negotiated arrangement, with "twinned" investments in New Markets Tax Credit or Low-Income Housing Tax Credit transactions mentioned as examples, although no further guidance on this point is given.

2. **Member's Minimum Interests in Developer Partnership and/or Master Tenant Partnership; Flip Permitted**.

   a. **Minimum 1% interest for Principal**. The Principal must have a minimum 1% interest in each material item of the partnership's income, gain, loss, deduction, and credit during the existence of the partnership.

   b. **Minimum 5% interest for Investor**. The Investor must have a minimum interest in each material item of the partnership's income, gain, loss, deduction, and credit during the period it owns an interest equal to 5% of its largest percentage interest for any taxable year (which presumably would be 99%, resulting in a 4.95% minimum interest).

   c. **Flip Permitted**. A flip of the Investor's interest from 99% down to 4.95% immediately or shortly following the end of the HTC recapture period is specifically approved. Although not prohibited by the Safe Harbor, a flip (of any amount) prior to the end of the recapture period should be avoided. See PLR 8931001.

   This is one of two extremely beneficent provisions of the Safe Harbor (the other being the absence of minimum cash or economic returns to the Investor, as discussed below), and the feature that makes the Safe Harbor a viable option for structuring HTC transactions. Even though a similar flip was permitted in the Wind Safe Harbor, Rev. Proc. 2007-65, 2007-2 C.B. 967, as amended by Ann. 2009-69, 2009-2 C.B. 475, there was no assurance it would be permitted for an HTC transaction, and existing law concerning a flip and its timing and minimum percentage interest is ambiguous.

3. **Investor's partnership interest must be a bona fide investment with value "commensurate" with overall percentage interest**. The heart of the Safe Harbor is the requirement that the Investor's partnership interest must constitute a "bona fide equity investment with a reasonable 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." An Investor's interest is bona fide only if its anticipated value is contingent upon the partnership's net income, gain and loss and is not substantially fixed in amount. The investment cannot be substantially protected from losses and the Investor must participate in profits in a manner that is not limited to a preferred return that is in the nature of a payment for capital.

   a. **Commensurate with overall percentage interest**. The most important requirement of the Safe Harbor is perhaps also its most obscure, i.e., the requirement that the value of the Investor's interest be "commensurate" with its overall percentage interest. According to public comments by the Treasury and IRS following the publication of the Safe Harbor, this does not require that the Investor's capital contribution be sized to the non-credit economics; to the contrary, all parties including the IRS recognize that the amount of the Investor's capital contribution will continue to be determined principally by reference to the amount of the HTC anticipated. Instead, this requires that the Investor receives the cash and other economic benefits of the partnership (whatever they are), on an overall but not necessarily an item-by-item basis, equal to its percentage interest at the time, be it 99% or 4.95%.

   b. **No minimum cash or economics required**. The second extremely beneficent provision of the Safe Harbor (in addition to the approval of flips, as discussed above) is the absence of any minimum economic thresholds. Rather, the Investor must instead receive its share of whatever is available, even if that should be minimal. This will avoid the need for a minimum preferred return for tax purposes (the Investor may still require a preferred return from a business perspective) and the "cash on cash" rule of thumb used in many HTC transactions will no longer be relevant.[2]

   Since a put right (as discussed below) cannot be for an amount greater than the fair market value of the Investor's interest, it

[1] Note that one of the reasons that traditionally required an investment by the Master Tenant Partnership in the Developer Partnership – using gains on a hypothetical sale of the project to achieve a specified cash on cash return – is no longer required by the Safe Harbor; however, the indirect investment will still be required as a mechanism to get the Investor's equity contribution to the Developer Partnership where it is needed, and to permit the allocation of depreciation deductions to the Investor.

[2] Note that attempting to achieve a cash on cash return, of 3% or some other amount, would probably not be possible in any event with a flip of the Investor's interest down to 4.95% following the end of the recapture period.

is clear that the Investor is not required to recover its entire capital account on exit.

c. **Cash flow not required to be distributed pro rata but advisable to do so**. The requirement that the value of the Investor's interest be commensurate with its "overall" percentage interest leaves open the possibility that one or more items, such as distributions of cash flow, be distributed or allocated differently. Caution should be exercised in taking advantage of this opening: if cash flow were disproportionately distributed to the Principal, there would need to be a corresponding increase in the Investor's residual interest to satisfy the "overall" requirement. This might be the case in a liquidation scenario where distributions are made in accordance with capital account balances, but probably would not be the case in a sale of the Investor's interest pursuant to a put right or otherwise. What would seem more supportable would be to distribute sales and refinancing proceeds to the Principal to the extent its capital account balance exceeds 1% of the total capital – this is a common provision in many joint venture agreements for projects that do not involve an HTC.

d. **Prohibition on arrangements to reduce the value of Investor's partnership interest**. The value of the Investor's partnership interest may not be reduced through fees (including developer, management, and incentive fees), lease terms or other arrangements that are unreasonable compared to comparable non-HTC real estate development projects. The value 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. Note that this last provision does not prohibit all disproportionate rights to distributions, but only those that reduce the overall value of the Investor's interest – as noted in the previous paragraph, caution is in order if making disproportionate distributions.

   This requirement may be the most problematic – and subjective – requirement in the Safe Harbor. Property management fees in the range of 3% to 6% of revenues should be fairly easy to support, whereas "incentive management" fees up to 95% of available cash flow would seem unsupportable.

   Developer fees present a particularly difficult challenge. The actual development services provided for an HTC transaction can be substantial, sometimes occurring over a multi-year period. Often, the services are much greater than similar services for new construction and can include an obligation to fund cost overruns. Developer fees are also not routinely seen in non-HTC real estate development projects. To eliminate developer fees due to these concerns seems unjustified, and likely would not be acceptable to the developer who had expended considerable efforts and may be required to assume significant obligations. On the other hand, using the old rule of thumb of charging a developer fee equal to 20% of other development costs would be permissible only if the parties could support a fee of that amount under the particular circumstances of the project. It is tempting to defer to negotiation between the developer and the Investor to determine the amount of the fee, but unfortunately this would not likely be a true arm's length negotiation, since the Investor would not generally contemplate receiving the cash otherwise used to pay the developer fee, and a larger developer fee would actually increase the amount of QRE's and thus the amount of the HTC. A possible solution would be to pay a developer fee equal to the actual costs incurred by the developer, including out-of-pocket expenses and a reasonable charge for the actual time devoted to development activities. This would place a burden on the developer to document such time and expenses, but if it were able to do so the rationale seems unassailable. The timing of payment of the developer fee could also raise an issue. Ideally, the fee would be paid entirely from development sources, but if these were insufficient, it would seem better to pay the fee as quickly as possible, as opposed to stretching out the payment, certainly if that would take repayment beyond the flip date.

   The requirement that "lease terms" be comparable to those in non-HTC transactions has particular relevance to a master lease in a pass through transaction. Master leases always have rentals that allow the lessor to pay its debt service and anticipated expenses. Increasing the rentals above this amount reduces the cash pool at Master Tenant Partnership in which the Investor could otherwise share. Therefore, to rebut a potential challenge that the rentals are excessive, it would seem that an appraisal or other third-party support (such as a letter from a commercial real estate broker) should be obtained to evidence that the rentals are at market.

e. **Limitations on "sandwich" leases in Master Tenant Partnership structures**. Subleases by the Master Tenant Partnership back to the Developer Partnership or to the Principal are deemed to be unreasonable unless mandated by a third party unrelated to the Principal. In such cases, the term of the sublease must be shorter than the term of the master lease. A lender may require a sandwich lease structure (and often does to assure that the developer, its "borrower," is on the hook for performance of the project). In cases where the lender does not otherwise require this, it seems inadvisable to invite such requirement. Although such arrangements may appear to be clever in planning, such provisions stick out in retrospect, and there is always a paper trail that discloses the true genesis. Although the Investor would technically be a "third party unrelated to the Principal" (even after application of the related party rules of section 4.08 of the Safe Harbor), it would not be supportable for the Investor to require a sandwich lease. This limitation on "sandwich leases" may require the parties to forego compliance with the Safe Harbor or use of the pass through structure where the Principal or its affiliates intends to occupy the property.

   The master lease in a pass through transaction may not be terminated while the Investor is a partner of the Master Tenant Partnership.

4. **Investor must make minimum capital contributions.**

   a. **20% minimum capital contribution**. The Investor must contribute at least 20% of its total expected capital contributions to the Developer Partnership or the Master Tenant Partnership, as the case may be, prior to the date the project is placed in service (and not at the closing of the transaction, which would be earlier, and in some cases could be months or even years before placement in service). Contributions of

promissory notes or other obligations on which the Investor is the maker do not count for this purpose, apparently even if the note is negotiable or would otherwise be included in the Investor's capital account under Treas. Reg. §1.704-1(b)(2)(iv)(d)(2). The Investor must maintain the minimal level of investment the entire time it owns the partnership interest. It is not clear how this requirement would be determined. Since the requirement concerns the Investor's capital contribution, as opposed to it capital account, presumably the amount would be reduced only by a distribution of capital proceeds, such as sale or refinancing proceeds, that decreased the Investor's capital contribution below the minimum threshold. Since such distributions would be uncommon in a typical HTC transaction, lack of clarity on this point is not likely to be problematic. The minimum capital contribution cannot be protected against loss through any arrangement, directly or indirectly, except pursuant to permissible guarantees, as discussed below.

b. **75% of capital contribution must be fixed in amount**. At least 75% of the Investor's total expected capital contributions at the time the project is placed in service must be fixed in amount. The effect of this provision is that typical adjusters based on the actual amount of QRE's (compared to the estimated amount of such expenditures) and adjusters based on the timing of placement in service cannot reduce the Investor's capital commitment by more than 25%. The contribution of the Investor's capital in excess of the 20% minimum, including the 75% that must be fixed in amount, can be contingent on achieving certain customary benchmarks, such as placement in service, stabilization, obtaining a cost certification or a part 3 approval from the National Park Service. There is no prohibition on delaying the contribution of capital in excess of the 20% minimum to dates agreed upon by the developer and the Investor, although it would seem imprudent to delay a contribution beyond the end of the HTC recapture period.

   The Investor must reasonably expect to meet its funding obligations as they arise. This does not require that the Investor prove that it will be financially capable of contributing the required capital into the future, but effectively prohibits oral agreements or understandings between the developer and the Investor that the Investor will not be required to fund its fixed contribution amount, other than due to acceptable contingencies contained in the documents.

5. **Impermissible and permissible guarantees**. Certain guarantees listed in the Safe Harbor are impermissible, and will cause a transaction to fall outside the Safe Harbor. Other guarantees are permissible if unfunded.

   a. **Impermissible guarantees**. Guarantees for the benefit of the Investor are impermissible if:

      i. Any person involved in any part of the HTC transaction directly or indirectly guarantees the Investor's ability to claim the HTC, the cash equivalent of the credits, or the repayment of the Investor's capital contribution due to its inability to claim the HTC in the event the IRS challenges the transaction structure;

      ii. Any person involved in any part of the transaction guarantees that the Investor will receive distributions or consideration in exchange for its interest (except for a sale right as discussed below); or

      iii. Any person involved in any part of the HTC transaction agrees to pay the Investor's costs or indemnity the Investor for its costs if the IRS challenges the Investor's claim of the HTC.

   b. **Insurance**. The preceding requirements do not prohibit the Investor from obtaining insurance from persons not involved with the HTC transaction or partnership. Strict observance of this requirement would prevent a third party insurer from acquiring even a *de minimis* interest in the Developer Partnership or Master Tenant Partnership (or related entities). It is not clear if an insurer would require rights to recover against the developer, or if such rights would be permissible under the Safe Harbor.

   c. **Permissible guarantees**. Guarantees for the benefit of the Investor *not* described as impermissible guarantees are permitted if unfunded. Examples of permissible guarantees are the following:

      i. guarantees for the performance of any acts necessary to claim the HTC;

      ii. guarantees for the avoidance of any act or omission that would cause the Developer Partnership or Master Tenant Partnership to fail to qualify for the HTC or that would result in the recapture of the HTC; and

      iii. completion guarantees, operating deficit guarantees, environmental indemnities and financial covenants, without limitation on amount or duration.

   d. **Guarantees for performance or non-performance**. The parties would have flexibility in defining the acts or failures to act that could result in loss of the HTC, and thus for which the developer could provide a guarantee or indemnity. The controlling factor in this determination should be commercial reasonableness; for example, it would certainly be reasonable to require the developer to take whatever actions were required to obtain a part 3 approval from the National Park Service (including making any required modifications to the rehabilitation), but it may not be reasonable to require the developer to "act" to cause the amount of QRE's to equal or exceed an amount estimated at the start of the rehabilitation.

   e. **Operating deficit guarantees**. An operating deficit guarantee at the Master Tenant Partnership level could presumably cover rent under the master lease as well as all other operating expenses. An operating deficit guarantee at the Developer Partnership level could presumably cover debt service payments and other expenses at that level.

   f. **Definition of unfunded; limited reserves permitted**. A guarantee is considered unfunded if no money or property is set aside to fund the guarantee. Neither the guarantor nor any person under the guarantor's control may agree to maintain a

minimum net worth in connection with the guarantee. Since the section of the Safe Harbor that contains this prohibition is otherwise dealing with guarantees provided to the Investor, it would appear that a guarantor could agree to maintain a minimum net worth if required by another party, such as a lender (as long as not at the request of the Investor).

Reserves in an amount equal to or less than the Developer Partnership's or the Master Tenant Partnership's reasonably projected operating expenses for a 12-month period will not constitute an amount set aside to fund a guarantee. For this purpose, operating expenses should include rent payable under a master lease and the interest paid on indebtedness. There is no prohibition on requiring the developer to replenish a reserve if used.

Reserves other than for operating expenses, e.g., typical replacement reserves, are not addressed in the Safe Harbor. Even though these reserves would provide an indirect benefit to the Investor as an owner of the project, they do not support a guarantee to the Investor, and thus should be permissible under the Safe Harbor.

g. **Certain loans to Investor are impermissible**. A Developer Partnership, Master Tenant Partnership or Principal of either may not (i) lend the Investor funds to acquire its partnership interest or (ii) guarantee any indebtedness incurred by the Investor with respect to the acquisition of its interest. Such loans or guarantees would be unusual in the typical HTC transaction, but could be encountered in a "twinned" HTC/NMTC transaction, where it is not uncommon to require a developer guarantee of the leverage loan.

6. **Limitations on purchase and sale rights on exit**.

   a. **Prohibition on "call" rights**. Neither the Principal nor the Developer Partnership or Master Tenant Partnership may have a contractual right to purchase or redeem the Investor's interest at a future date. This does not prohibit the parties from negotiating a sale at some time in the future, as long as it was not pre-arranged. This is directly contrary to what was permitted under the Wind Safe Harbor, referenced above.

   b. **"Puts" up to fair market value are permissible**. The Investor may have a contractual right to require a person involved in the HTC transaction to purchase or liquidate its interest in the Developer Partnership or the Master Tenant Partnership at a future date for not more than fair market value as determined at the time of exercise. For this purpose, fair market value of the Investor's interest may take into account only those contracts or other arrangements that are on an arm's length basis and that would be permitted under section 4.02(2)(c) of the Safe Harbor, i.e., management fees, etc., that would be expected in a non-HTC real estate transaction. The fair market value can be determined by reference to the Investor's flipped down interest at the time the put is exercised. The limitation on the amount of the put price to fair market value was meant to prevent payment through the "back door" of impermissible indemnities or guarantees on exit. No minimum put price is required, and thus a put at a nominal price would be permitted.

   c. **Payment of preferred returns, accrued but unpaid fees and tax distributions to Investor are permissible**. Preferred returns are permitted, as long as the Investor's sole potential economic return is not limited to the preferred return. Tax funding distributions, typically payable to an Investor to the extent it realizes taxable income from its investment, are also permitted. However, unpaid preferred returns should not accrue and be paid as part of the exit payment. It is unclear whether other unpaid and accrued fees including unpaid tax funding distributions could be paid to the Investor on exit if this caused the total payment to exceed the fair market value of the interest.

   d. **An Investor may not intend to abandon its interest in the Developer Partnership or the Master Tenant Partnership after the completion of the rehabilitation**. If an Investor abandons its interest in the Developer Partnership or the Master Tenant Partnership at any time, the Investor will be presumed to have acquired its interest with the intent of later abandoning it unless the facts and circumstances clearly establish otherwise. Although superficially this provision would seem to prohibit puts at a nominal price, based on comments by the Treasury and IRS it is only intended to prevent the Investor from claiming an ordinary loss (as opposed to a capital loss) on its exit from the partnership, pursuant to Rev. Rul. 93-80, 1993-2 C.B. 239.

7. **Allocations of HTC must have "substantial economic effect" under Code Section 704(b)**. This would require that the Developer Partnership and the Master Tenant Partnership follow one of the capital account safe harbors in Treas. Reg. § 1.704-1(b)(2)(iv). This would require, in turn, that capital accounts be maintained for each partner and that liquidating distributions follow capital account balances, and other requirements. The credit would have to be allocated pursuant to Treas. Reg. §§ 1.704(b)(4)(ii) and 1.46-3(f), which would require an allocation of the credit in accordance with the allocation of "bottom line" profits under Code Section 702(a)(8) for the year in which the project was placed in service.

Section III – Suggestions for Structuring HTC Transactions

The following outlines are meant to present a possible structure for each of a Developer Partnership (single tier transaction) and a Master Tenant Partnership (pass through transaction) that would have a high degree of certainty of being within the Safe Harbor. Ambiguities and subjective standards in the Safe Harbor are resolved by retreating to a conservative position in each case. Therefore, transaction structures that are less conservative on these points may also satisfy the requirements of the Safe Harbor.

Single Tier Transaction

1. **Percentage Interests**
   a. Investor contributes at least $10,000 to Developer Partnership at closing for a 99% profits interest.
   b. Principal contributes property (including intangible property), past and future services and/or cash for a 1% profits interest.
   c. Profits interests automatically "flip" to 95.05% for the Principal and 4.95% for the Investor at the end of the 63rd month following placement in service.
2. **Capital**
   a. Investor contributes capital equal to 20% of its total capital commitment (if not contributed at closing) prior to placement in service.
   b. Typical adjusters (including timing adjusters) cannot reduce the capital commitment by more than 25%.
   c. Remaining capital contributions are contingent on completion of construction, stabilization, completion of the cost certification and obtaining part 3 from the National Park Service.
   d. The dates for contributing the remaining capital are as agreed by the parties, but no later than five years after placement in service.
3. **Distributions of Cash/Preferred Return**
   a. Cash flow from operations distributed in accordance with percentage interests.
   b. If projected cash flow is significant, Investor receives preferred return (which is not cumulative) equal to 75% of projected cash flow (expressed as annual dollar amount, not as percentage of Investor's capital).
   c. Distributions of sale and refinancing proceeds distributed first to Principal until its capital account is reduced to 1% of the total capital and then pro rata to the members.
4. **Fees**
   a. Principal or its affiliate paid market property management fee.
   b. Principal or its affiliate paid a developer fee equal to actual out-of-pocket expenses incurred by the developer and a reasonable value for time devoted to development activities.
5. **Exit**

   Investor has option beginning 66 months following placement in service and continuing for six months to put its interest in Developer Partnership for $10,000 plus accrued and unpaid fees other than the preferred return (or fair market value of the interest if less).

Pass Through Transaction

1. **Percentage Interests**
   a. Investor contributes at least $10,000 to Master Tenant Partnership at closing for a 99% profits interest.
   b. Principal contributes property (including intangible property), past and future services and/or cash for a 1% profits interest.
   c. Profits interests automatically "flip" to 95.05% for the Principal and 4.95% for the Investor at the end of the 63rd month following placement in service.
   d. Master Tenant Partnership acquires profits interest in Developer Partnership of up to 49%.
2. **Capital**
   a. Investor contributes capital equal to 20% of its total capital commitment (if not contributed at closing) prior to placement in service.
   b. Typical adjusters (including timing adjusters) cannot reduce the capital commitment by more than 25%.
   c. Remaining capital contributions are contingent on completion of construction, stabilization, completion of the cost certification and obtaining part 3 from the National Park Service.
   d. The dates for contributing the remaining capital are as agreed by the parties, but no later than five years after placement in service.
3. **Distributions of Cash/Preferred Return**
   a. Cash flow from operations distributed in accordance with percentage interests.
   b. If projected cash flow is significant, Investor receives preferred return (which is not cumulative) equal to 75% of projected cash flow (expressed as annual dollar amount, not as percentage of Investor's capital).
   c. Distributions of sale and refinancing proceeds distributed first to the Principal until its capital account is reduced to 1% of the total capital and then pro rata to the members.
4. **Fees and Lease Terms**
   a. Principal or its affiliate paid market property management fee.
   b. Principal or its affiliate paid a developer fee equal to actual out-of-pocket expenses incurred by the developer and a reasonable value for time devoted to development activities.
   c. Master lease rentals at greater of market rate or amount needed to pay lessor debt service plus projected out-of-pocket

costs, but in all events less than projected subrentals less projected operating expenses of Master Tenant Partnership.

5. **Exit**

Investor has option beginning 66 months following placement in service and continuing for six months to put its interest in Developer Partnership for $10,000 plus accrued and unpaid fees other than the preferred return (or fair market value of the interest if less).

If you have any questions or comments, please contact one of the Squire Sanders Columbus office partners listed in this publication.

Contacts

Steven F. Mount
T +1 614 365 2727
E steven.mount@squiresanders.com

Michael D. Saad
T +1 614 365 2735
E michael.saad@squiresanders.com

Holly H. Heer
T +1 614 365 2716
E holly.heer@squiresanders.com

The contents of this update are not intended to serve as legal advice related to individual situations or as legal opinions concerning such situations nor should they be considered a substitute for taking legal advice.

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