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Revenue Procedure 2014-12 – The Historic Boardwalk Safe Harbor

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Historic Boardwalk LLC v. Commissioner
Summary

- New Jersey Sports and Exposition Authority ("NJSEA") formed Historic Boardwalk Hall, LLC, ("HBH") later admitting Pitney Bowes ("PB") as a partner
- PB benefited from the majority of the historic rehabilitation tax credits ("HRTC") generated by the rehabilitation of the Historic Boardwalk Hall in Atlantic City New Jersey

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Historic Boardwalk LLC v. Commissioner Summary *(cont.)*

- IRS argued that, in substance, NJSEA sold the HRTCs to PB
  - HBH is a sham and PB was never a partner
  - NJSEA never transferred ownership of the East Hall to HBH
- HBH argued that the transactions were supported by Congress and are not shams
- The Tax Court held for HBH
- Third Circuit reversed the Tax Court's opinion

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Historic Boardwalk LLC v. Commissioner Summary *(cont.)*

- Background:
  - Pitney Bowes (PB) entered into a “tax equity partnership” with a state agency (NJSEA)
  - PB received a 99.9% ownership interest that allowed it to obtain historic rehabilitation tax credits generated by the partnership
  - The Tax Court previously held that the partnership could allocate PB the tax credits
- Tax Court (2011):
  1. HBH was not a sham and did not lack economic substance
  2. PB was a partner in HBH
  3. NJSEA did transfer ownership of the East Hall to HBH
  4. Partnership anti-abuse regulations did not apply
- Third Circuit: Was PB a bona fide partner for federal income tax purposes that could be allocated historic rehabilitation tax credits under the partnership agreement?

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Historic Boardwalk LLC v. Commissioner Summary *(cont.)*

Conclusion:

- PB was not a bona fide partner because it had no meaningful downside risk or upside potential in the partnership
  - There was no meaningful downside risk due to the following:
    - PB made its capital contribution in phases and was not required to contribute to the partnership until NJSEA had verified the amount of credit-eligible expenditures had been made by the partnership
    - Tax benefits guarantee eliminated the risk PB would fail to receive the tax credits (or at least their cash equivalent)
    - Project was fully funded before PB agreed to make contributions
  - There was no meaningful upside potential due to the following:
    - The partnership was unlikely to generate any residual cash flow available for distribution criticizing overly optimistic projections
    - Consent Option provided means for NJSEA to keep residual cash flow by paying amount unrelated to FMV
- Tax credits were reallocated to NJSEA, the only other partner

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Historic Boardwalk LLC v. Commissioner
Summary *(cont.)*

Key Take Aways:

1. Avoid capital contributions tied directly to the generation of tax credits
2. Capital contributions should be necessary to fund the project (i.e., “gap financing”)
3. Tax benefit guarantees significantly reduce a tax equity investor’s downside risk especially if guarantor is financially strong
4. The risk of not receiving a preferred return that is effectively guaranteed through the use of options and other agreements is not downside risk
5. Providing an investor with a large share of residual cash distributions (99.9%) is not participation in upside potential when it is unlikely that the partnership will have much, if any, residual cash flow
6. If the partnership should ultimately earn residual positive cash flow the parties’ agreements should not provide an avenue by with which the equity investor can be deprived of their upside potential
7. Parties should be careful to document and support realistic financial projections
8. Greater care should be given to the documentation avoiding characterization as a “sale” of tax credits

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Rev. Proc. 2014-12

- Issued on December 30, 2013 for tax equity transactions involving tax credits for rehabilitating old buildings
- Guidelines are a mix of bright lines and general principles issued in wake of *Historic Boardwalk*
- Companies involved in syndicating tax credits for renovating historic buildings complained that the decision cast cloud over tax equity deals under section 47
  – Guidelines are an attempt to create a "safe harbor" in which historic tax credit market can function

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Rev. Proc. 2014-12 *(cont.)*

- IRS went out of its way to say that just because a deal strays from the safe harbor does not mean it is invalid and warned against trying to read too much into the new guidelines for the broader tax equity market
  - "The Treasury and the Service do not intend the inclusion of any particular criterion in the Safe Harbor to be an indication of our views of the significance of that criterion with respect to any other federal or state tax credit transactions"

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Rev. Proc. 2014-12 *(cont.)*

- In partnership flip and inverted lease transactions involving historic tax credits, tax equity deals will have to comply with the following:
  - TE investor must put at least 20% of its anticipated total investment in at inception
  - Rest can be paid over time, but at least 75% of the expected total investment must be fixed in amount
  - TE Investor must be expected to be able to meet the fixed portion of its funding obligations as they arise
  - TE Investor share of partnership income, gain, loss, deduction and credits cannot be less than 5% of its highest allocation percentage over the life of the deal

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Rev. Proc. 2014-12 *(cont.)*

- TE Investor’s partnership interest must have “a reasonably anticipated value commensurate with the Investor’s overall percentage interest” apart from tax benefits
- Value should not be fixed
  - It should move with the income or loss in the underlying partnership business
- The TE Investor cannot be substantially protected from losses from its exposure to the underlying business
  - It should not receive merely a preferred return including tax benefits on its investment

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Rev. Proc. 2014-12 *(cont.)*

- Sponsor can’t strip out cash through developer, management or other incentive fees that are above what a third party would be paid for the same services in a non-tax credit deal
  - Cannot be distributed a disproportionate amount of cash -- for example, it cannot receive all the cash above preferred cash distributions to the TE investor
- Sponsor can take some traditional business risks
  - Guarantees cannot be "funded," meaning the sponsor cannot set aside money or property to ensure payment on the guarantee

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Rev. Proc. 2014-12 *(cont.)*

- Sponsor can’t indemnify TE investor against loss of credits or guarantee "cash equivalent of tax credits" if IRS challenges the transaction structure
- Can’t agree to make capital contributions to pship to ensure the pship will have enough cash to make distributions to TE investor
- Sponsor cannot pay the TE investor's "costs" or indemnify for its "costs" if IRS challenges credits
- Neither the sponsor nor pship can have a call option to repurchase TE Investor's interest in future
  - TE Investor can have "put" to force sponsor repurchase of interest if not above FMV when exercised

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RP 2014-12 vs. RP 2007-65 Matrix

See Handout

Provision	Treatment in Safe Harbors
Minimum Partnership Interests	Same
Bona Fide Equity Investment	Only Rev. Proc. 2014-12
Off-Market Arrangements	Only Rev. Proc. 2014-12
Investor Minimum Contribution	Similar
Contingent Consideration	Same
Guarantees and Loans	More strict in Rev. Proc. 2014-12
Purchase and Sale Rights	Opposite

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Conclusion

Effect on structuring transactions

- Partnership flips
- Lease transactions

Application of Safe Harbors to solar, wind and other technologies

- Rev. Proc. 2014-12 expressly applies to the rehabilitation credit, a type of ITC
- Rev. Proc. 2007-65 expressly applies to the PTC for wind
- Should both safe harbors be taken into account for other ITCs and PTCs?

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