THOMPSON HINE

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Are There NMTC Take-Aways From Rev. Proc. 2014-12?*

By Francesco Ferrante, Thompson Hine LLP

Revenue Procedure 2014-12 (both in its original format and as revised and reissued) provides a safe harbor that avoids an IRS challenge regarding partnership allocations of Section 47 rehabilitation tax credits (HTCs). The substantive issue that the safe harbor addresses is whether the investor is a partner for tax purposes to whom allocations can be made. Rev. Proc. 2014-12 states that it has no application to federal income tax credits other than the HTC.

Solely for speculation purposes, many have wondered if the HTC safe harbor components might shed any light on Section 45D new markets tax credit (NMTC) arrangements. Some components of the safe harbor are limited to HTC arrangements and have no factual application to NMTC arrangements (e.g., principal and investor's minimum partnership interest, investor's minimum unconditional contribution, arrangements to reduce the value of the investor's partnership interest). Other components of the safe harbor are closer to relevant issues in both an HTC and NMTC arrangements, even though they have no direct application to NMTC arrangements. Simply put, the conclusion is that the HTC safe harbor components do not provide insight on issues relating to NMTC arrangements and will likely not change any structuring aspects of NMTC arrangements. Accordingly, the following discussion is for theoretical purposes only on how some of the components required by the HTC safe harbor can arise in NMTC arrangements and how such components should be examined, even though the new safe harbor has no application to NMTC arrangements.

As an initial point, the arrangement and main issue under review in the HTC safe harbor is very different than the relevant issues in NMTC arrangements. In HTC arrangements, the issue addressed by the safe harbor relates to whether the investor can be treated as a partner for tax purposes and it arises from the fact that credit is claimed at the level of the partnership/LLC that holds the building and which generates the credit. The focus is whether the investor has sufficient burdens and benefits (upside and downside) to be respected as a partner for tax purposes to whom the partnership/LLC tax credits can be allocated.

In contrast, the tax credit in a NMTC arrangement is taken at the investor level based on the cash contribution (the qualified equity investment (QEI) as defined in Section 45D(b)) made by the investor to the qualified community development entity (the CDE) as defined in Section 45D(c)). The NMTC is not claimed at the level of the partnership/LLC that holds the building or other property to which the investor's contribution will be applied. The determination of whether the investor is a partner for tax purposes is typically not a critical inquiry in NMTC arrangements. This is because the investor's interest in a NMTC arrangement is as the sole owner of an entity (the CDE) whose sole asset(s) consists of debt receivable(s) payable by the entity that owns the building or other property. The upside and downside aspects have less of a role in a NMTC arrangement because the investor has complete ownership of all of the interests in the CDE and the CDE's sole asset(s) consists of debt receivables with a fixed interest rate and principal receivable. The debt receivables held by the CDE commonly have a low interest rate, and as with any debt obligation a value decrease could be triggered by an increase in market interest rates. Also, as with any debt obligation, an additional downside is the credit risk.

Although the issue addressed in the HTC safe harbor relates to a structure that differs from NMTC arrangements, consideration could be given to whether the HTC safe harbor guidance sheds any light that could impact the investor's status as the true owner of the "qualified equity investment" for NMTC purposes based on the investor's protections and exit strategies or on the status of the qualified low-income community investment (QLICI) loans (defined in Section 45D(d)) in NMTC arrangements as true debt, but, as will be discussed below, even this seems tenuous.

The following discussion reviews some components of the HTC safe harbor guidance and their non-application to NMTC arrangements as well as how they could arise in a NMTC context.

Bona Fide Equity Investment

Section 4.02(2)(b) of the HTC safe harbor states:

> "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, <u>*separate from*</u> any federal, state, and local tax deductions, allowances, <u>*credits,*</u> and other tax attributes to be allocated by the Partnership to the Investor. 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." *(emphasis added)*

One indication that the Rev. Proc. 2014-12 guidelines do not apply to NMTC transaction is the statement that the investor's interest cannot be substantially fixed in amount. In a NMTC transaction, the investor's interest is in a CDE that holds a debt instrument(s) which has a fixed return.

Although the HTC safe harbor requires that the investor's equity investment be valued without regard to tax credits, it would seem that tax credits are important to the valuation of an interest in HTC arrangements in determining the amount to invest. Likewise, the investor's tax credits in a NMTC transaction (taking into account the leveraged loan) are critical to the calculation of the amount that investors contribute in NMTC arrangements. In an NMTC arrangement, the investor typically contributes cash that is equal to approximately 80 percent of the federal tax credit available (taking into account the leveraged loan). In NMTC arrangements, there is a direct correlation between the cash invested and the NMTC available. Besides the NMTC, the investor's return is also based on a repayment of the qualified equity investment plus an additional amount equal to the interest payable on the QLICI loan amount that matches the QEI amount. The interest payable is typically a low rate consistent with the Community Development Financial Institutions (CDFI) Fund mandate to use better-than-market loan terms that CDEs pass on to qualified active low-income community businesses (QALICBs) defined in Section 45D(d)(2).

The following are observations that illustrate that the HTC safe harbor "bona fide investment" test is inapplicable to and was drafted without consideration of NMTC arrangements:

- Ignoring tax credits, the value of the NMTC investor's interest would be the present value of the qualified equity investment repayment taking into account the small amount of positive cash flow stemming from the low interest payable by the QALICB. Depending on the discount rate used, the present value of the investor's cash flow (ignoring NMTCs) might represent 60% of the investor's cash investment. This would mean that the investor's cash investments in NMTC arrangements exceed the anticipated present value of the possible return if tax credits are ignored, which would be contrary to the HTC safe harbor.

- The Revenue Procedure states that the investor's participation cannot be limited to a preferred return that is in the nature of payment for capital. The NMTC rules have a similar prohibition in requiring that the investor's qualified equity investment in a corporate CDE cannot be "nonqualified preferred stock." Applying the HTC safe harbor to NMTC arrangements would seem to extend the prohibition against "nonqualified preferred stock" to interests in CDE partnership contexts.

Guarantees

Section 4.05 of the HTC safe harbor provides for permissible and impermissible guarantees. In NMTC arrangements, an application of the HTC safe harbor guarantees would conflict with what are commonly accepted NMTC provisions. The following illustrates that certain factual guarantee aspects of NMTC arrangements could overlap with certain provisions of HTC arrangements. In some situations, NMTC guarantees would fit within the limitations established in the HTC guidelines. However, the terms of other aspects of NMTC guarantees might not fit within the HTC safe harbor guidelines. In any event, the HTC safe harbor guarantee provisions are inapplicable and confirms that such limitations were drafted without NMTC arrangements in mind.

- ***Impermissible Guarantees.*** The HTC safe harbor states, "*No person* involved in any part of the rehabilitation transaction *may directly or indirectly* guarantee or otherwise insure the *Investor's* ability to claim the § 47 rehabilitation credits, the cash equivalent of the credits, or the repayment of any portion of the Investor's contribution due to inability to claim the § 47 rehabilitation credits in the event the Service challenges all or a portion of the transactional structure of the Partnership."

- ***Permissible Guarantees.*** The HTC safe harbor states, "Guarantees for the performance of any acts necessary to claim the § 47 rehabilitation credits; Guarantees for the avoidance of any act (or omissions) that would cause the Partnership to fail to qualify for the § 47 rehabilitation credits or that would result in a recapture of the § 47 rehabilitation credits."

Impermissible guarantees seem to be limited to unconditional guarantees assuring that investors receive the HTC. In contrast, Rev. Proc. 2014-12 permits guarantees that assure that actions necessary for the availability of the HTC be taken or actions that would defeat the HTC not be taken. In NMTC arrangements, the QALICB (and related parties) generally guarantee that if certain actions or inactions are taken that would defeat the NMTC, the damages are measured by the credit that would otherwise be available. It seems that such a provision would be permissible in an HTC context. A damage provision that is measured by the tax credit available in the event that a party to the transaction takes certain actions or fails to take certain actions affecting the availability of the credit does not seem to be the type of unconditional guarantee (directly or indirectly) on the investor's ability to claim the credit that would violate the HTC safe harbor.

Sometimes a tax credit guarantee is written such that the investor is, in effect, insured against a loss of NMTCs for any reason, including the structure of the transaction. This could also arise if the investor is protected against a loss of NMTCs based on the application of the Treas. Reg. 1.45D-1(g)(1) anti-avoidance regulation . If the impermissible guarantees referenced in the HTC safe harbor were ever extended to a NMTC context, these sort of provisions would seem to conflict with the requirements of that safe harbor because such provisions indirectly protect the investor's ability to claim the credits without conditions.

A second component of the HTC safe harbor guarantee prohibition is that no person involved in the transaction can insure "the repayment of any portion of the Investor's contribution due to inability to claim the § 47 rehabilitation credits in the event the Service challenges all or a portion of the transactional structure of the Partnership." In the context of QLICI loan agreements that are part of NMTC arrangements, a loan covenant between the QALICB and the CDE might provide that the loans maintain their status as QLICIs or that the anti-avoidance regulation not be applied. In such context, a violation of the QLICI loan covenant could result in an accelerated repayment of the debt by the QALICB under the QLICI loan agreement. In limited instances, an accelerated repayment of the QLICI loans could trigger a repayment to the investor. If the HTC safe harbor were extended to NMTC arrangements, these sorts of provisions would need to be evaluated because they could result in a repayment of the investor's contribution.

A third component of the HTC safe harbor guarantee prohibition is that completion guarantees, operating deficit guarantees, environmental guarantees, and financial covenants are permitted but only if they are unfunded – meaning that no money is set aside. Certain investors require that certain guarantees be backed up with cash deposits or letters of credit. This form of protection from persons involved with the transaction would not qualify under the HTC safe harbor. If investors receive such protection solely from persons who are not involved with the transaction, such protection seems permissible. However, that exception might not apply if the investor procures the protection from a party not involved in the transaction but the fees related to such insurance are paid by a participant in the transaction. Again, in the NMTC context, consideration to this limitation would have to be given only if components of the HTC safe harbor were ever extended to NMTC arrangements.

A fourth component of the safe harbor guarantee prohibition is that, "No person involved in any part of the rehabilitation transaction may pay the Investor's costs or indemnify the Investor for the Investor's costs if the Service challenges the Investor's claim of the § 47 rehabilitation credits." This aspect of the safe harbor seems to be saying that a party to the transaction cannot defend nor pay the investor's costs against an IRS challenge. This prohibition seems to be applied even if the party to the transaction defends actions that it guaranteed and that are permissible guarantees under the HTC safe harbor. Once again, consideration of this limitation would have to be given if components of the HTC safe harbor were ever extended in some way to NMTC arrangements.

Loans

Section 4.05(3) of the HTC safe harbor states:

> "A Developer Partnership, a Master Tenant Partnership, or the Principal of either the Developer Partnership or the Master Tenant Partnership may not lend any Investor the funds to acquire any part of the Investor's interest in the Partnership or guarantee or otherwise insure any indebtedness incurred or created in connection with the Investor's acquisition of its Partnership interest."

If this HTC safe harbor limitation were applied to NMTC arrangements, this safe harbor limitation would be violated in many arrangements. First, in those instances where a party to the transaction (or related party) provides the leveraged loan funds that allows the investor to increase its Section 45D(b) qualified equity investment consistent with existing NMTC rulings, such arrangement would not be permitted by the safe harbor. Second, having a party to the transaction (or a related party) guarantee payment of the QLICI loans in a NMTC transaction would seem to prevent the availability of the safe harbor. The expansion of the HTC rules to pick up related parties is found in Section 4.08 of the HTC safe harbor.

Purchase and Sale Rights

- ***Purchase Rights.*** The HTC safe harbor (Section 4.06(1)) does not allow a party to the transaction (or related party) to have a call option with respect to the investor's interest, even if the price is set at the fair market value on exercise. In contrast, the Section 45 energy production tax credit safe harbor provided by Rev. Proc. 2007-65 allows certain fair market value purchase call options.
- ***Sale Rights.*** Section 4.06(2) of the HTC safe harbor seems to permit the investor to have a put option at a nominal amount, but that point seems to be negated by the limitation on abandonment of the investor's interest, discussed below. In contrast, the Section 45 energy production tax credit safe harbor in Rev. Proc. 2007-65 does not allow the investor to have any put rights.

If a safe harbor were ever developed with respect to NMTC arrangements, consideration would have to be given to which and whether any of these limitations on purchase and sale rights should be applicable.

Abandonment of Investor's Interest

Section 4.06(5) of the HTC safe harbor states:

> "An Investor may not acquire its interest in the Partnership with the intent of abandoning the interest after the Partnership completes the qualified rehabilitation. If an Investor abandons its interest in the Partnership at any time, the Investor

will be presumed to have acquired its interest with the intent of later abandoning, unless the facts and circumstances clearly establish that the Investor did not acquire its interest with the intent of later abandoning it."

The HTC safe harbor creates a high threshold for the investor to overcome the abandonment presumption that requires clear facts and circumstances that there was no initial intent to abandon the acquired interest. Under this test, the mere presence of a put option at a nominal price (while permissible pursuant to the sale rights provision) could defeat the investor's ability to overcome the abandonment presumption.

A few observations regarding the abandonment limitation of the HTC safe harbor:

- If an abandonment of the investor's interest occurs after the HTC tax credit recapture period (described in Section 50), how would the abandonment limitation of the HTC safe harbor be applied to the tax credit claimed in the early years prior to an abandonment of the invertor's interest when there might be little or no risk of abandonment?
- In NMTC arrangements, the status of QLICI loans as bona fide debt is a critical aspect. Normally, upfront contemporaneous evidence, a prearranged feature, or an economic compulsion that the debt will be forgiven might need to be present to challenge the bona fide aspect of QLICI loans. If the abandonment component of the HTC safe harbor were ever extended to NMTC arrangements, the abandonment presumption rule goes beyond the accepted tests and completely leaves open how the IRS will apply the facts and circumstances test in those situations where an abandonment does occur. Accordingly, the HTC safe harbor limitation regarding abandonment does not shed any additional light in the NMTC context on the issue that the QLICI loans must be bona fide debt. Further, any safe harbor abandonment component would merely be one of the prerequisites to fit within the safe harbor and not necessarily be reflective of any rule of law.

Conclusion

As this summary illustrates, the new HTC safe harbor does not shed any light on NMTC transactions. In short, the Revenue Procedure guidelines do not apply to NMTC arrangements because (1) the guidelines only apply to the issue of whether partnership allocations of the tax credits should be respected and whether the investor should be treated as a true partner, which is a different scenario than arises in NMTC arrangements and (2) the Revenue Procedure states that it does not apply outside the HTC area. Some components of the HTC safe harbor can arise in NMTC transactions, but the Revenue Procedure guidance is not expected to change any structuring aspects of NMTC arrangements.

Note that one aspect of NMTC arrangements not analyzed in this summary with respect to the HTC limitations is to assure that the second minority partner/member in CDEs is respected for tax purposes where the CDE is structured as a partnership/LLC.

** A shorter version of this article can be found at Novogradac Journal of Tax Credits.*

FOR MORE INFORMATION

For more information, please contact:

Francesco A. Ferrante
Thompson Hine LLP
Phone: 937.443.6740
Mobile: 937.470.0598
Francesco.Ferrante@ThompsonHine.com

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