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Historic Tax Credit

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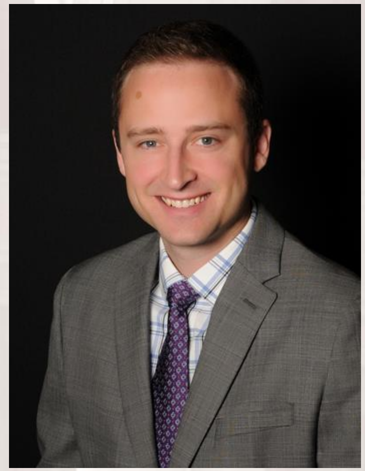

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A developer in Iowa can qualify for two types of historic tax credits

- Federal – Rehabilitation Tax Credit – Internal Revenue Code Chapter 47
- State – Historical Preservation and Cultural and Entertainment District Tax Credit – Iowa Code Chapter 404a

Federal Tax Credit Requirements

There are two credits available

- a 20% tax credit for the certified rehabilitation of certified historic structures and is available for:
  - Commercial
  - Industrial
  - Agricultural
  - Rental residential
- a 10% tax credit for the rehabilitation of non-historic, non-residential buildings built before 1936, rental housing does not qualify, but hotels do

The two credits are mutually exclusive; only one applies in a given project and the two cannot be combined to be used on the same project.

Federal Tax Credit Requirements

Qualifying buildings must be “certified historic structures” defined as:

(A) buildings listed on the National Register of Historic Places; or

(B) buildings that contribute to a National Register Historic District or another qualifying local historic district.

Example

If a developer entity spends $5 million on qualified expenditures for a project, there could be $1 million in tax credits available to directly offset income taxes owed by the developer

Historic Tax Credit Requirements Substantial Rehabilitation

In order to get a project into the Historic Tax Credit arena, the project must be "substantial."

"Substantial rehabilitation" includes projects that involve qualified costs in excess of the larger of:

(a) the adjusted basis of all owners of the building;

(b) $5,000

Federal Tax Credit Requirements

A tax credit equal to 20 percent of the "qualified expenditures" in the renovation of certified historic structures may be allocated to the developer.

The credit is claimed when the building is placed in service.

Historic Tax Credit Requirements
Qualified Expenditures

Qualified Expenditures can include a wide range of hard and soft costs associated with the buildings work.

Qualified Expenditures:

- costs of construction
- certain developer fees
- consultant

Unqualified expenditures:

- property acquisition costs
- new additions to the historic structure or other new buildings
- parking and landscaping costs

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Claiming the Credit

Claimed in the taxable year that the rehabilitated building is "placed in service" or the date that the project work is completed.

Any excess credit can be carried forward for up to 20 years and carried back 1 year.

Historic Tax Credit Application Process for the 20% Tax Credit

- 2- or 3-part process.
- Each part requires “certification” by the National Park Service (NPS), but reviewed by both NPS and State Historic Preservation Office (SHPO)
- NPS approves projects for the Federal tax credit.
- Both the NPS and the IRS strongly encourage owners to apply before they start work.

SHPO and NPS
Part 1

Buildings listed on the National Register of Historic Places automatically qualify under Part I

The NPS bases its decision on the Secretary of the Interior's Standards for Evaluating Significance within Registered Historic Districts.

Part 2

Description of Rehabilitation Work

The owner submits the application to the SHPO

The SHPO provides technical assistance and literature on appropriate rehabilitation treatments, advises owners on their applications, makes site visits when possible, and forwards the application to the NPS, with a recommendation.

Part 2 (cont'd)

The NPS reviews the description of the proposed rehabilitation for conformance with the Secretary of the Interior's Standards for Rehabilitation.

If the proposed work meets the Standards, the NPS issues a preliminary decision approving the work.

Work must be completed in accordance with Part 2 to receive tax credit

Bank should not lend until Part 2 Application approved

Part 3

Request for Certification of Completed Work

After the rehabilitation work is completed, the owner must submit application form requesting final approval of the completed work.

The NPS evaluates the completed project and compares it with the work proposed in the Part 2 application form.

Iowa Historic Tax Credits

The Program provides an income tax credit of 25% of qualified rehabilitation costs. Another 20% is available if the property is income-producing and qualifies for the Federal Rehabilitation Investment Tax.

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Iowa Historic Tax Credit Eligibility Requirements

Several types of properties are eligible for the state tax credit:

1. The building is listed on the National Register of Historic Places, or determined by the staff of the State Historic Preservation Office to be eligible for listing.
2. The building is contributing to the significance of a historic district that is listed, or eligible to be listed, on the National Register.
3. The building is designated as local landmarks by city or county ordinance.
4. Barns constructed prior to 1937 and barns listed in or eligible for listing in the National Register.

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Iowa Historic Tax Credit

For commercial buildings, qualified rehabilitation expenditures must equal at least 50% of the assessed value of the building (excluding the land) before rehabilitation, or $50,000, whichever is less.

For non-commercial buildings (residences or barns), qualified rehabilitation expenditures must equal at least 25% of the assessed value of the building (excluding the land) before rehabilitation, or $25,000, whichever is less.

Iowa Historic Tax Credit

Qualified Rehab Costs Include:

- Architectural and engineering fees
- Site survey fees
- Legal expenses
- Insurance premiums
- Development fees
- Other construction-related costs

Costs of sidewalks, parking lots, and landscaping do not constitute qualified rehabilitation costs.

Work must meet the Secretary of the Interior's Standards for Rehabilitation and Guidelines for Rehabilitating Historic Buildings.

Iowa Historical Tax Credit Concerns

All Applications approved on or before July 1, 2014 are subject to an Allocation Agreement and new Administrative Rules.

This has caused uncertainty and Iowa legislature has been lobbied to make changes in light of the fact that the Allocation Agreement "form" has not been finalized and existing drafts contain provisions that are problematic from the lender's perspective.

STAY TUNED

All IHTC projects are subject to audit respecting verification of qualified rehabilitation expenses which is causing delays in payment.

$45 million annual cap on IHTC awards.

Pending Legislation – HF2412

- Administrative oversight transferred to the IDEA
- Add flexibility in regards to application of IHTC to income tax liability v. refund

Utilizing Tax Credit

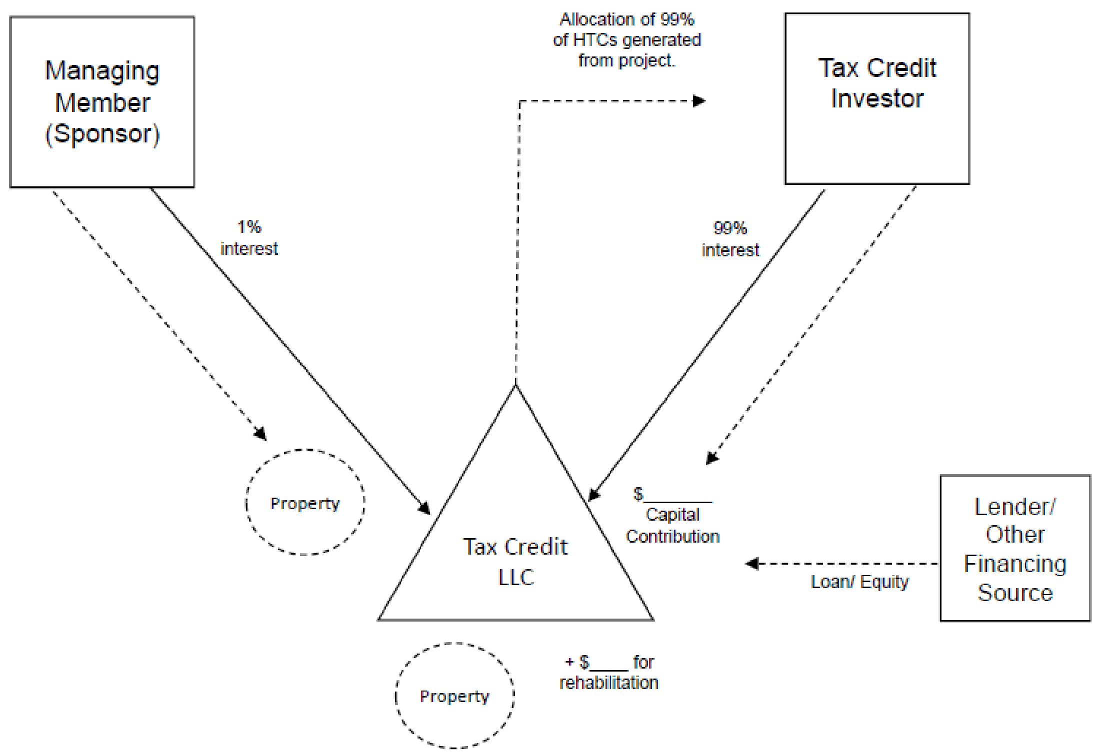
- Timing – Credits generated with QREs are "placed-in-service."
- Who Can Use the Tax Credits?
  - Sponsor OR Investor

Initial Steps

Assume a sponsor looking to monetize the credits and raise equity for its project.

- Typical Steps:
  - Form new entity such as an LLC
  - Sponsor contributes or otherwise transfers property to LLC
    - Takes back a managing member interest
  - Admit tax credit investor into LLC in exchange for its cash equity contributions
    - Receives a non-managing member interest

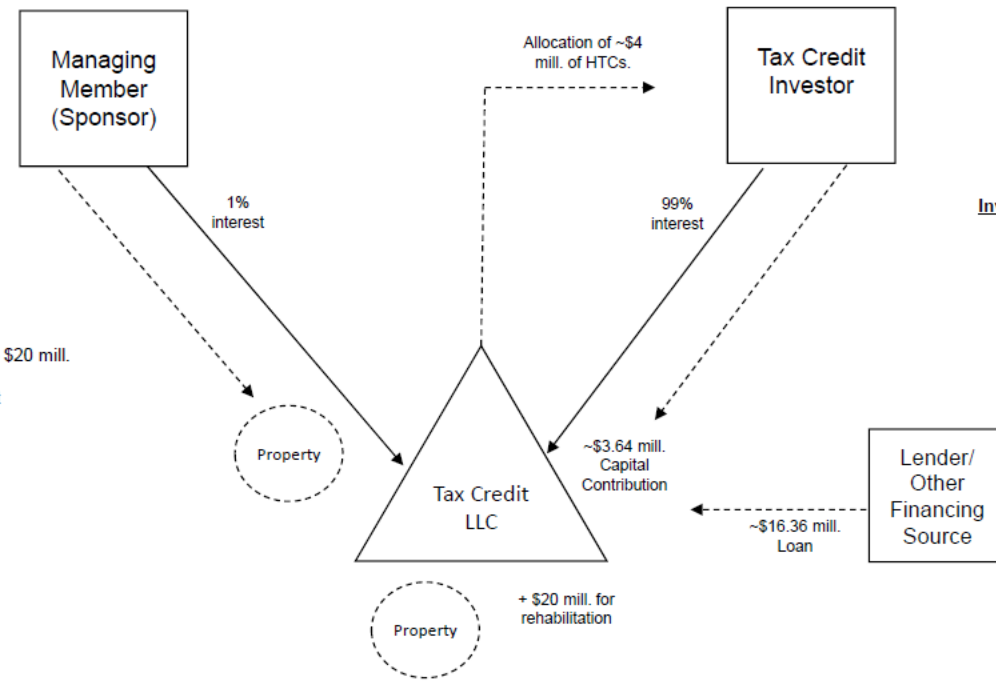
Typical Direct Investment Structure



Example Structure

Example Deal:

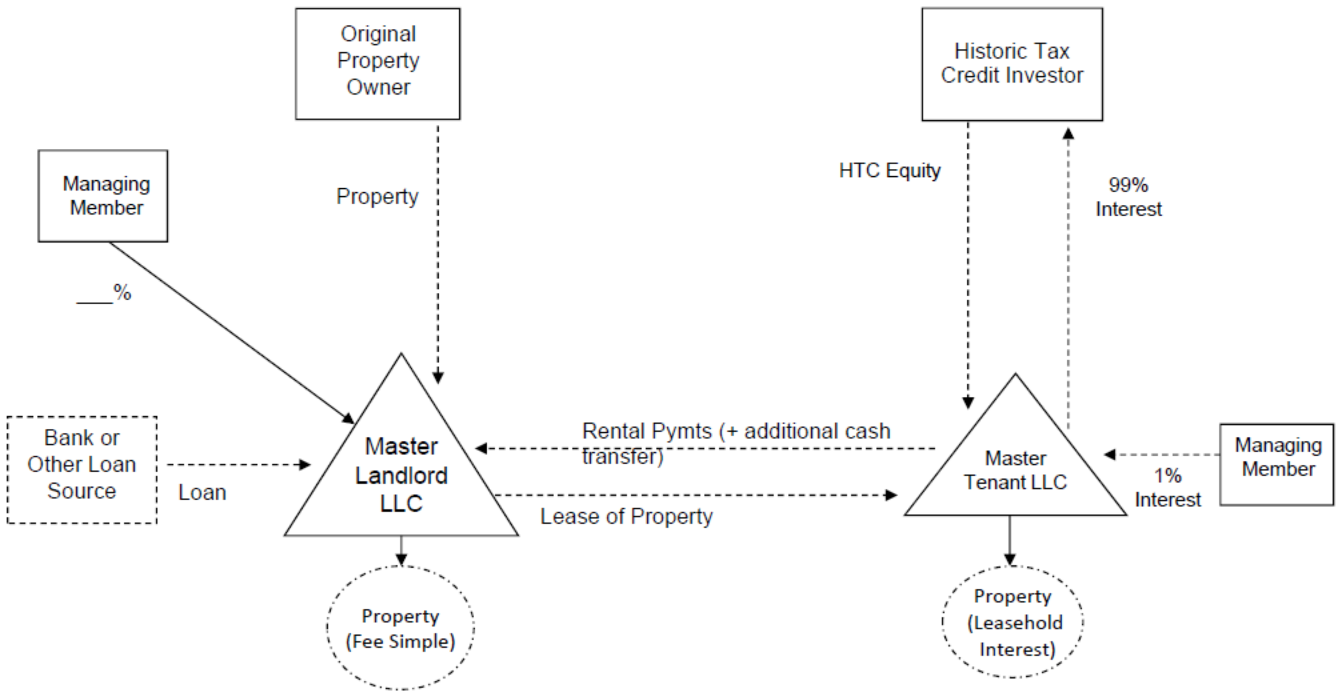
- **Total Rehab Costs** – $20 mill.
- **QREs** – $20 mill.
- **Pricing** – $0.92/ credit



Investor Equity:

$20,000,000
20%
99%
$0.92
$3,643,200

Lease Pass-Through Model



Lease Pass-Through Model (Pros and Cons)

- Pros
  - Tax benefits to Investor such as increased capital losses
  - Could result in increased pricing for credits
- Cons
  - More complex transaction
  - Additional structuring challenges
- Tax benefits to sponsor such as investor keeping cash flow, potential tax losses and no reduction in tax basis for master landlord

Tax Credit Recapture

Recapture Events – Within 5 years of credits generated:

- Building is disposed of.
- Building ceases to qualify as "investment credit property."
- Partner's interest in Tax Credit Entity is reduced to less than 2/3 of what it was when HTCs were claimed.

Revenue Procedure 2014-12

(Federal Historic Tax Credit Safe Harbor Guidance)

Background (HBH) *Historic Boardwalk Hall, LLC v. Comm'r*

Lack of Downside Risk

- Timing of Capital Contribution/Completion Guaranty
- Tax Benefit Guaranty
- Put Right (*Price fully funded at closing*)
- Fully-Funded Project

Lack of Upside Potential

- Receipt of Distributions (after 3% preferred return) was highly unlikely
- Call Right

Revenue Procedure 2014-12
Safe Harbor

Partnership Interest Rev. Proc. 2014-12: Safe Harbor

- Minimum Partnership Interests
  - Principal: Minimum 1% interest in each material item of Partnership income, gain, loss, deduction and credit.
  - Investor: Interest in each material item of Partnership income, gain, loss, deduction and credit must be equal to <u>at least 5%</u> of the Investor’s largest interest in such item.
    - *Example Application:* “Flip” Structures

Rev. Proc. 2014-12: The Safe Harbor

- Bona Fide Equity Investment
  - Upside Potential – Share in profits not limited to preferred return.
  - Downside Risk – Cannot be “substantially” protected from losses.
  - Interest Value – Commensurate with Investor’s overall percentage interest in Partnership, separate from tax benefits; cannot be “substantially” fixed.

Rev. Proc. 2014-12: The Safe Harbor

- Value Reduction Agreements
  - Value of Investor's interest cannot be reduced by arrangements that would be "unreasonable" in a non-HTC real estate development deal.
  - Example
    - Unreasonable developer/management fees

Contributions Rev. Proc. 2014-12: The Safe Harbor

- Minimum Unconditional Contribution – At least 20% of the Investor's total expected capital contribution must be contributed before the building is placed in service.
- Contingent Consideration – At least 75% of the Investor's total expected capital contribution must be fixed in amount before the building is placed in service.
  - Example Application – "Adjusters"
- Loans – Neither the Partnership nor the Principal can: (i) loan the Investor funds to purchase its interest; or (ii) guarantee any debt incurred by Investor to purchase interest.

Guarantees
Rev. Proc. 2014-12: The Safe Harbor

- Impermissible Guarantees – Following guarantees are specifically <u>prohibited</u>:
  - Ability of Investor to claim the federal HTC
  - Cash equivalent of the federal HTC
  - Repayment of Investor's capital contribution in the event of an IRS challenge to "transaction structure" (or Investor's costs associated therewith)
  - Cash distributions
  - Purchase price for partnership interest
    - Exception – FMV put right

Rev. Proc. 2014-12: The Safe Harbor

- Permissible Guarantees
  - General Rule – Guarantees that are not specifically prohibited as long as they are "unfunded."
  - Examples
    - Performance/avoidance of acts in order to claim the federal HTC
    - Completion guarantee
    - Operating Deficit Guarantee
    - Environmental indemnity
  - "Unfunded" – No money set aside; no minimum net worth requirements
    - Exception – Operating expenses for 12-month period

Rev. Proc. 2014-12: The Safe Harbor

- Credit Allocation
  - The allocation of the federal HTC under the Partnership agreement must be made in accordance with the Section 704(b) regulations.
  - Revised version of Rev. Proc. (issued Jan. 8, 2014) contains a special exception to this rule for the allocation of Section 50(d)(5) income under a "lease pass-through" structure.

Rev. Proc. 2014-12: The Safe Harbor

- Effective Date – Allocations made on or after Dec. 30, 2013.
- Applicability to Non-Safe Harbor Transactions
  - Not a pronouncement of substantive law.
  - No inference for transactions that do not meet all safe harbor requirements.
- Applicability to Past Deals – Safe harbor applies if all requirements happen to be met.

Historic Tax Credit Advantages for Lenders

- Tax investor can provide additional confidence for lenders as the investor will do its own due diligence on the transaction.
- Certification by the NPS and the SHPO will provide further oversight.

The tax investor's involvement:

- Keeps the project going
- Tax investor's funds must stay in the project for at least five years
- Helps reduce LTV

Key Risks for HTC Lending

- Compliance with Part II requirements
- Recapture

Methods to Reduce Risk

- Control over construction process
- Experienced partners
- Insurance and bonding
- Good documentation

Three Typical Lending Structures

- Lender as Tax Credit Investor
- Lender as Bridge Loan Lender
- Lender as Construction Lender

Typical Bridge Lender Documents

ASSIGNMENT OF TAX CREDIT PURCHASE AGREEMENT

- Security interest in and assignment under the Tax Credit Purchase Agreement to receive the Net Tax Credit Proceeds and the Tax Credits and any other credits under the Tax Credit Purchase Agreement.
- Assignor will direct the purchaser of the Tax Credits to deposit the Net Tax Credit Proceeds directly into an account held with the Lender.

ASSIGNMENT OF CAPITAL CONTRIBUTIONS AND DEPOSIT ACCOUNT

- Assignment of its rights under the Operating Agreement to receive and enforce payment of all installments of capital contributions of the investor member.
- The capital contributions shall be deposited into the pledge account held at the bank, to be applied to the repayment of the loan with the bank.
- If no separate assignment of the pledged account is necessary, recommend also inserting language in the assignment document as to the assignment and transfer of the pledged account to the bank and any and all rights of the assignor with respect thereto and the proceeds therefrom, including the interest thereon.

PLEDGED ACCOUNT CONTROL AGREEMENT

- If tax credit proceeds deposited in account not held by Lender, all HTC Lending requires a pledge of membership interests

All HTC Lending Requires Pledge of Membership Interests

COLLATERAL ASSIGNMENT OF MEMBERSHIP INTEREST

- Security interest in all of the right, title and interest he/it has in and to (i) Assignor’s membership interest in Managing Member whether now owned or hereafter acquired (“Membership Interest”), and (ii) any and all proceeds or avails of the foregoing, including, without limitation, all distributions of Managing Member (whether in cash or in kind) which are allocable to the holder of the Membership Interest.

Master-Lease Structure Issues

- The relationship between the tax investor and lender will be governed by an SNDA
- Primary effect is to subordinate the master lease to the lien of the mortgage in exchange for the lender's agreement not to terminate the lease following a foreclosure
- The tax investor will often insist that the lender agree not to terminate the master lease even if the master lessee is in default under the master lease
- With an HTC master lessee, there is not real change of the master lessee committing a material default since the master lessee is merely a pass through entity for the property's real economics
- The lender, in any event, will be able to foreclose on the developer's pledge of the managing member interest in the master lessee and thereby cause the master lessee's compliance with the master lease
- The lender should insist on the right to terminate the master lease once the recapture period has expired

Foreclosure Termination Issue

- The tax investor will want to prohibit the transfer of the property through foreclosure to a disqualified transferee. Such a transfer could result in a recapture event of loss of credit
- The lender will want the freedom to foreclose and to further transfer the property
- A compromise is to permit the lender to foreclose in exchange for an agreement that any subsequent offer to purchase the property made by a disqualified transferee will trigger a right of first refusal for the tax investor
- The lender needs to obtain a release from any liability for the developer's obligations to the tax investor should the lender foreclosure on the developer's pledge

Removal of Developer

If the tax investor insists on its right to remove the developer as managing partner of the master lessee;

The lender should limit such replacements to cases involving:

- willful misconduct,
- fraud, or
- other malfeasance

Plus require the tax investor to supply a replacement managing partner with the requisite operating experience

Questions?

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