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The Internal Revenue Service (IRS) issued guidance explaining the circumstances in which it will not challenge partnership allocations to its partners under §47, rehabilitation tax credits. Rev. Proc. 2014-12, 2014-3 I.R.B. 415, establishes the requirements of a "safe harbor." According to the Rev. Proc., if the partnership follows the guidelines of the safe harbor, the IRS will not challenge the allocations of the §47 credit.

Under §47, the owner of a qualified rehabilitated building is entitled to claim a tax credit of 10% of the qualified rehabilitation expenditures starting in the year in which the property is placed in service. The amount of the credit increases to 20% of the qualified rehabilitation expenditures made with respect to a certified historic structure.

The IRS issued the Rev. Proc. in response to the decision rendered by the Third Circuit Court of Appeals in the case *Historic Boardwalk Hall LLC v. Commissioner*, 694 F.3d 425 (3d Cir. 2012), *rev'g* 136 T.C. 1 (2011), in which the Third Circuit reversed the decision by the Tax Court, and held that the sole investor's interest in the LLC was lacking a meaningful stake in either the success or failure of the partnership, and the investor was not a bona fide partner. This ruling resulted in the disallowance of the partnership's allocation of the rehabilitation tax credits.

In this case, the New Jersey Sports and Exposition Authority (NJSEA) had undertaken to restore "Historic Boardwalk Hall," the property in which NJSEA held a leasehold interest. Since the building was a certified historic structure, the tax credits would be 20% of the qualified rehabilitation costs as properly allocated under the partnership agreement and in accordance with applicable tax regulations.

NJSEA formed a New Jersey LLC and sold a 99% interest to an investor member, who was a wholly owned subsidiary of Pitney-Bowes (PB). Through the agreement for PB to invest in Historic Boardwalk Hall, PB would receive 99% of the §47 rehabilitation credits and a preferred return of 3%. Additionally, the structure of the deal was designed to minimize as much risk as possible to PB. This was through various contractual provisions. The provisions were as follows: a construction completion guaranty, operating deficit guaranty, preferred return, and a tax benefit guaranty. Basically, the agreements set in place negated any possible risk for PB, and any cash that was invested into the LLC was essentially certain to be recouped by the rehabilitation tax credits or their cash equivalent.

The IRS audited and reviewed the allocation of the tax credits. The IRS determined that in substance, PB was not a bona fide partner for federal income tax purposes due to the contractual provisions and agreements set in place. This determination led Historic Boardwalk Hall to file a petition with the Tax Court challenging the IRS's position – where Historic Boardwalk Hall succeeded. The IRS Commissioner then appealed to the Third Circuit. The Third Circuit Court of Appeals concluded that PB did not have a meaningful stake in either the success or the failure of Historic Boardwalk Hall, and therefore was not a bona fide partner.

To provide partnerships and well as tax professionals with more predictability as well as clarity in determining the partnership allocations of the rehabilitation tax credits, the IRS issued Rev. Proc. 2014-12, which established a safe harbor under which it will not challenge partnership allocations of the credits.

Below is a brief summary of the safe harbor requirements included in the Rev. Proc. For a more detailed description, see Rev. Proc. 2014-12, §4.

Investors Defined. This section details the definition of partnership investors, as well as the relationship allowed between master tenant partnerships and developer partnerships.

Partners' Partnership Interests.

- Principal's minimum partnership interest. The Principal must have a minimum of 1% interest during the existence of the partnership.
- Investor's Partnership Interest. The investor must have a minimum of 5% or more interest in each material item of Partnership tax item during each taxable year.
- Requirements regarding the investor's partnership interest. The investor's partnership interest must constitute a bona fide equity investment with a reasonably anticipated value.
- Arrangements to reduce the value of the Investor's Partnership interest. The value of the investor's interest may not be reduced through fees, lease payments, or other arrangements that are not reflective of fees for a real estate development project that does not qualify for §47 rehabilitation credits.

Investor's Minimum Unconditional Contribution. The Investor Minimum Unconditional Contribution must equal 20% of the Investor's total expected capital contributions required under the agreements relating to the Partnership as of the date the Building is placed in service. The Investor must maintain the Investor Minimum Contribution throughout the duration of its ownership of its Partnership interest.

Contingent Consideration: At least 75% of the Investor's total expected capital contributions must be fixed in amount before the date the Building is placed in service.

Guarantees and Loans.

- Permissible guarantees. The following unfunded guarantees may be provided to the Investor:
  - Guarantees for the performance of any acts necessary to claim the credits;
  - Guarantees for the avoidance of any act (or omissions) that would cause the Partnership to fail to qualify for the rehabilitation credits or that would result in a recapture of the credits; and
  - Guarantees that are not described as impermissible guarantees under the revenue procedure.

Examples of unfunded guarantees permitted under this section include completion guarantees, operating deficit guarantees, environmental indemnities, and financial covenants.

Impermissible guarantees. No person involved in any part of the rehabilitation transaction may:

- Directly or indirectly guarantee or otherwise insure the ability to claim the credits, the cash equivalent of the credits, or the repayment of any portion of the Investor's contribution due to inability to claim credits in the event the IRS disallows the credits.
- Guarantee that the Investor will receive Partnership distributions or consideration in exchange for its Partnership interest except for a fair market value sale right described in the Rev. Proc.
- Pay the Investor's costs or indemnify the Investor for the Investor's costs if the Service challenges the Investor's claim of the credits.
- Offer a guarantee that is not an unfunded guarantee described in the Rev. Proc.

Loans. The Partnership or a person involved in the transaction 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.

Purchase Rights and Sale Rights. Neither the Principal nor the Partnership may have a call option or right to purchase or redeem the Investor's interest at a future date (other than a contractual right or agreement for a present sale), and the Investor may not have a contractual right to require any person involved in the rehabilitation transaction to purchase or liquidate its interest in the Partnership at a future date at a price that is more than its fair market value determined at the time of exercise of the contractual right to sell.

The guidance is effective for allocations of §47 rehabilitation tax credits after December 29, 2013. However, if a building was placed in service before December 30, 2013, and the Partnership and its' partners satisfied all the requirements for safe harbor were met, the Rev. Proc. states the IRS will not challenge the Partnership's allocations of the §47 rehabilitation tax credits.

For more information, in the Tax Management Portfolios, see Sloan and Sullivan, 712 T.M., Partnerships — Taxable Income; Allocation of Distributive Shares; Capital Accounts, *and in Tax Practice Series, see ¶3140, Investment Tax Credit.*

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