New Markets Tax Credits and Other Tax Incentives for Real Estate Development

Qualifying, Applying for and Using Tax Credits to Structure Real Estate Projects

TUESDAY, JULY 31, 2012

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What is the Federal New Markets Tax Credit Program?

1. The federal NMTC program was enacted in 2000 as an incentive to generate and provide private investment capital (in the form of either debt or equity) to businesses and nonprofits located in qualifying urban and rural low-income communities that otherwise cannot obtain traditional financing in the marketplace.

2. NMTC financing can be used for real estate projects and business and nonprofit operations.

3. The program is facilitated by the Community Development Financial Institutions Fund (the “CDFI Fund”) which is administered by the US Treasury Department.

4. Each NMTC financing covers a minimum 7-year compliance period.

5. NMTCs are a 39% tax credit based on the amount invested by private investors, which is recognized by such investor over 7 years: 5% over the first 3 years and 6% over the remaining 4 years.

6. Financing is facilitated by "qualified community development entities" ("CDEs"), which apply to the CDFI Fund for an allocation of allocation authority each year.

7. CDEs are typically banks, municipalities and nonprofits, but can be public and private organizations.

8. CDEs have national, multi-state, state, local and multi-local services areas.
What is a New Markets Tax Credit Allocation?

1. An allocation is not an award of money or tax credits to the applying CDE itself.

2. It is a "permission slip" to the winning CDE that authorizes such CDE to designate an investor’s investment in such CDE as a qualified equity investment (a "QEI") upon which the NMTCs are calculated.

3. Such CDE uses such investment to then provide financing to borrowers and nonprofits for financing real estate or operations thereof (i.e., the CDE uses none of its own funds).

4. For example, an allocation award of $10,000,000 authorizes the CDE to designate $10,000,000 as a qualified investment that entitles the applicable investor a 39% NMTC (i.e., $3.9 million, which is recognized over a 7-year period).
## Current and Prior Allocations

<table>
<thead>
<tr>
<th>Year</th>
<th>Qualified Equity Investments</th>
<th>New Markets Tax Credits</th>
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</thead>
<tbody>
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<td>$1.0 billion</td>
<td>$390 million</td>
</tr>
<tr>
<td>2002</td>
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<td>$585 million</td>
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<tr>
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<td>[$1.365 billion]</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>$36.5 billion</strong></td>
<td><strong>$14.235 billion</strong></td>
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Program Definitions

1. **Community Development Entities ("CDEs")** must use...

2. **Substantially All** of the proceeds from...

3. **Qualified Equity Investments ("QEIs")** to make...

4. **Qualified Low-Income Community Investments ("QLICIs")** in...

5. **Qualified Active Low-Income Community Businesses ("QALICBs")** located in...

6. **Low-Income Communities ("LICs")** or otherwise benefit Targeted Populations.
Strafford Webinar:
New Markets Tax Credits for Real Estate Developments

July 31, 2012

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General Overview: New Markets

- NMTC were a bipartisan idea enacted near end of the Clinton administration.
- Designed to encourage investment in low-income communities, but with market discipline of private investment review.
- Flexible subsidy; very few limitations on use.
- Basic rule is use must be primarily in “low-income community” (but this is a gross generalization).
General Overview: New Markets

• Basic rule: Tax credits are given to taxpayers who make “Qualified Equity Investments” (QEIs) in “Community Development Entities” (CDEs) that make qualified investments (QLICIs) in qualified businesses located in low-income communities (LICs)
A. **Qualified Equity Investment (“QEI”).** A “qualified equity investment” is the purchase of stock or capital interest in a CDE that must remain invested in the same CDE for at least 7 years. The CDE must invest “substantially all” of the QEI in a QLICI (see below) within 12 months after receipt.

B. **Qualified Low-Income Community Investment (“QLICI”).** There are 4 ways for a CDE to invest the QEIs, but for our purposes we only care about one: An equity investment in, or loan to, a Qualified Active Low-Income Community Business (“QALICB”).
General Overview (cont.)

• Tax credit amount equals 39% of equity investment, but tax credits are available over 7-year period
• 5% during first 3 years after QEI (15%) and 6% during next 4 years (24%)
• Unlike the historic tax credits or low-income housing tax credits, NMTCs is not a permanent credit. In December 2010, Congress extended the program for two years, providing allocation of $3.5 billion for each of 2010 and 2011. Program has not yet been re-authorized for 2012 but is expected to be.
Non-Leveraged Structure

CDE: Community Development Entity
CDFI: Community Development Financial Institution
QALICB: Qualified Active Low-Income Community Business
QLICI: Qualified Low-Income Community Investment
QEI: Qualified Equity Investment

CDFI Fund of Dept. of Treasury

Allocates NMTCs to Qualified CDEs

Tax Credit Investor

$10M equity investment

$3.9M in tax credits over 7 years

Tax Credit Allocatee ("CDE")

$10M in loans or equity investment ("QLICI")

Borrower/Developer ("QALICB")
The Players

CDFI Fund
The Community Development Financial Institutions Fund of the Department of Treasury performs the following functions:

• Certifies the “Qualified Community Development Entities” (CDEs)
• Allocates the New Markets Tax Credits among applying CDEs
• Monitors CDEs on an ongoing basis
**The Players**

**CDEs**—Community Development Entities

- Must be certified by the CDFI Fund
- Must apply for NMTC allocations for each annual round
- Investors wishing to receive NMTCs must make equity investment in CDEs that have received an allocation
- CDEs, in turn, use substantially all of the proceeds to make investments (debt or equity) in QALICBs
- Many national banks have CDEs, as well as national nonprofit entities such as LISC and Enterprise
Tax Credit Investors

- **Investors** make Qualified **Equity** Investments in CDEs (not debt, must be cash)
- Investors need confidence that CDE will manage the investments in compliance with the NMTC program to avoid recapture of the credits
- Most investors are CDC affiliates of national banks (e.g., US Bank, Wells Fargo, Bank of America)
- Banks generally pay more for tax credits because they get “credit” for such purchases against their CRA (Community Reinvestment Act) requirements
- Presently pricing for federal NMTCs ranges from $.75-77 per dollar of credit
QALICBs (Qualified Active Low Income Community Businesses)

- These are the entities that may receive loans or equity contributions from CDEs
- For most of you, these will be your clients
QALICB Qualifications

• At least 50% of the total gross income is from the active conduct of a qualified business in Low-Income Communities;
• At least 40% of the use of tangible property of the business is within LICs; and
• At least 40% of the services performed by the business’s employees are performed in LICs; and
• Gross income test is deemed to be met if either the tangible property or the services test is met at 50% or higher.
• If a business has no employees, it can meet both the services and gross income tests if it meets the tangible property test at 85% or higher.
“Portion of Business”

• *Portion of the Business.* A company that has a discrete portion of its business that would qualify as a QALICB if it were separately incorporated may qualify by maintaining separate books for the qualifying “portion of the business.”

• This makes the previous three tests (gross income, tangible property and services performed) relatively easy to meet for most real estate developments located in a LIC.

• E.g. a QALICB could be a third-party developer who acquires and builds a facility to lease to an operating company, or that operating company could create a division to serve the same purpose and that division could be the QALICB.
Low-Income Communities (LICs)

• Census tracts with **at least 20%** poverty rate

  OR

• Census tracts where the median family income is at or **below 80%** of the area median family income (or state median income for non-metro areas) [**85%** if the census tract has experienced greater than 10% population out-migration over the last two decades]
QALICB Restrictions

- Less than 5% of the average of the aggregate unadjusted bases of the property is attributable to collectibles (e.g., art and antiques), other than those held for sale in the ordinary course of business (e.g., inventory).
- Less than 5% of the average of the aggregate unadjusted bases of the QALICB’s property is attributable to nonqualified financial property (e.g., cash, stock, or debt instruments with a term in excess of 18 months).
- Nonprofits can be QALICBs (but exercise caution where there are endowments because of previous rule), but governmental entities cannot.
Restrictions (cont.)

• Prohibited uses: country clubs, golf courses, massage parlors, hot tub facilities, suntan facilities, gambling facilities, liquor stores, banks, and farms with over $500,000 in assets

• Rental of residential real property (defined as building that receives over 80% of income from rental of dwelling units) is not eligible, nor is rental of vacant land

• But rental of improved commercial real estate in a LIC is a qualifying trade or business
Targeted Populations

• Besides satisfying the five criteria set forth above, businesses may qualify as QALICBs if they serve “targeted populations,” which generally are defined as persons earning 80% or less than the applicable median income. To qualify, the business must:

  – be at least 40% **owned** by targeted populations,
  – have at least 40% of its **employees** be targeted populations as of the date of hire, or
  – receive at least 40% of its **gross income** from targeted populations
Does Project Qualify

First Step is Finding Out Whether Your Project Qualifies

- There are websites that allow you to determine whether a particular site is in a Low-Income Community (e.g. novoco.com; reznickgroup.com; cdfifund.gov)
- For a limited period, these areas are based on the 2000 Census data
- Recently the CDFI Fund released FAQs on the Census Data transition, which are included in your materials
- These FAQs show how to determine whether your project will qualify under the new census data
Finding Allocation

Second Step is Finding a CDE with Allocation for your Project

• There are websites that list the CDEs that have received allocations (e.g. novoco.com; reznickgroup.com; cdfifund.gov)

• There are also many consultants, accountants and brokers who will help find allocation

• If your client has a relationship with a bank, it should ask its relationship banker whether the bank has its own allocation
Finding Allocation

CDEs want to finance projects with Community Impact

• CDEs must apply annually for future allocation from the CDFI Fund
• This is a competitive process and CDEs want to show all the great things they have done with previous allocations
• Community Impact can be economic development, job creation and/or retention (depending on the situation), and blight removal, etc. Community service centers or facilities that directly serve low-income persons and/or neighborhoods are becoming more prevalent as QALICBs.
Finding Allocation

CDEs want to finance projects in “Higher Distress Areas” and Non-Metropolitan Areas

- CDEs have committed with the CDFI Fund to make a very high percentage of their QLICIs in areas of higher distress
- For each allocation round, there is a distinct list of criteria that make a census tract an area of higher distress
- Websites can help determine this, but some factors are only known on a local level
- In addition, projects located in “non-metropolitan” areas are generally more in demand by CDEs
Finding Allocation

CDEs applications for 2012 Round are due September 2012

- CDE applications for NMTC allocations describe projects that CDEs intend to finance (i.e. their “pipeline” of projects)
- This is a great time to get your project in front of CDEs
- Industry insiders believe allocation awards could be made in February or March 2013 (assuming Congress reauthorizes the program before year end), but this could be later if the amount reauthorized is different than CDFI Fund expects
Structuring Your Project

Leverage Loan Model

• Approved by IRS in Rev. Ruling 2003-20
• Increases the amount of tax credits available to a project
• Minimizes the tax credit investor’s risks, which allows for higher prices for the tax credits
Non-Leveraged Structure

CDE: Community Development Entity
CDFI: Community Development Financial Institution
QALICB: Qualified Active Low-Income Community Business
QLICI: Qualified Low-Income Community Investment
QEI: Qualified Equity Investment
$30M equity

$11.7M of tax credits (39% of $30M) = $8.2M of equity based on “purchase” of tax credits at $.70 per credit

$21.8M loan

$7M* Loan Benefit to Project*

$21.8M loan

$11.7M of tax credits (39% of $30M)

$30M equity

* Size will vary depending on CDE fees.
Leverage Loan considerations

- Identity of Leverage Lender

- No principal repayment during 7-year compliance period (Investor can receive return on investment, but not return of investment during 7 years after QEI is made)

- Tax Credit Investors insist on Leverage Lenders forbearing from exercising remedies during 7-year period (some carve outs usually can be negotiated but investors are reluctant to do so)
“Day Loan”

- Many developers have incurred substantial pre-development expenses before closing
- As with traditional debt, these expenses can be financed at closing with the NMTC debt
- But to have these pre-paid expenses generate additional tax credits, tax credit investor needs additional funds to increase its QEI
Exit Strategy

• Typical scenario provides for a Put/Call Option Agreement at the end of the 7-year period
• Investor may “put” its interest in the CDE (and/or the loan) to the developer, usually for a below-market amount (exit tax, agreed amount)
• Developer also has a “call” option (at FMV)
• These transfers will generally result in Cancellation of Debt income to the developer/borrower assuming that it or an affiliate acquires the Investor’s interest
• For tax reasons the “put” cannot be a certainty
State NMTC Programs

• The following states have a NMTC program for state credits:
  – Alabama
  – Connecticut
  – Florida
  – Illinois
  – Kentucky
  – Louisiana
  – Maine
  – Mississippi
  – Missouri
  – Nebraska
  – Ohio
  – Oklahoma
  – Oregon
  – Texas
State NMTC Programs

• The following states have legislation pending or proposed:
  – California
  – Hawaii
  – Indiana
  – New Mexico
  – North Carolina
  – Wisconsin
Takeaways

• Is your real estate development in a Low-Income Community (or serve “Targeted Populations”)?
• Does your development have substantial Community Impact (e.g. job retention/creation, economic development, community services, etc.)?
• NMTCs effectively can provide equivalent of interest-free 7-year forgivable loan equal to 18-22% of the project’s total development cost (but no certainty that loan will be forgiven, i.e. no certainty investor will exit after year 7)
Historic Tax Credits
Recent Developments

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Outline

• Background
• Federal Historic Tax Credit (HTC) requirements
  • *Virginia Historic Tax Credit Fund 2001*
  • *Historic Boardwalk Hall*
• Conclusion
History of Federal Historic Tax Credits

• 1986 Tax Reform Act enacted current federal tax credits
• Goals:
  – Reduce demolitions of historic structures
  – Decrease cost of renovation below value of building
  – Make rehabilitation competitive with new construction

Photo: Wikimedia Commons/Local Hero

Book-Cadillac Hotel, Detroit, MI
Amount of Federal Historic Tax Credits

- **20% credit** for qualified rehabilitation expenditures (“QRE”) of a certified historic structure

- If the building was placed in service before 1936 – **10% credit** for QRE

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Photo: Wikimedia Commons/Andrew Jameson

Capitol Park, Detroit
Requirements to Obtain HTC

- Rehabilitation must be substantial
- Building must have been in service before rehabilitation
- Renovations must be consistent with historic character of the building

Photo: Wikimedia Commons/Local Hero

Broderick Tower, Detroit
Basic Qualification

Although the National Park Service ("NPS") formally has to approve the rehabilitation plan, approval generally is delegated to the State Historic Preservation Office ("SHPO").
Basic Qualification (cont’d)

Application process:
• Evaluation of significance by the NPS (“Part 1”)
• Establishment of a rehabilitation plan, prepared by an architect versed in historic rehabilitations, and reviewed by the SHPO (“Part 2”), and
• Request for certification of completion from SHPO (“Part 3”)
Pre-1936 Buildings

Buildings erected before 1936 that do not meet historic criteria may qualify for a federal credit of 10% of QRE.

The pre-1936 buildings must keep intact 50% of the external walls, use 75% of the external walls as either interior or exterior walls, and retain 75% of the existing framework.
The credit is based on the amount of QRE.

In general, the qualified expenditures must exceed the building’s adjusted basis at the start of the testing period or $5,000.00.

The testing period is a 24-month period selected by the developer.

Expenditures for personal property, acquisition costs, or enlargement costs are not QRE.
Recapture

- For five years, original owner must own building and continue its historic features. If not:
  - Full or partial recapture of credit
  - Recapture period
    - Starts: Building placed in service
    - Ends: Five years following
  - Decreases credit by 20 percent each year of period
Structuring Credit Deal

Equity Investment Structure
- Investor must be member of ownership entity (usually LLC) before building is placed in service
- Most common:
  - Investor receives 99.9 percent interest in entity and proportionate credit allocation

Master Tenant Structure
- The investor owns all, or substantially all, of the master tenant
  - Master tenant subleases projects to end users
- Frequently, the developer group is the manager of the master tenant and is responsible for leasing to the ultimate tenants
Frequent Issues in HTC Cases

- Tax Commissioner challenges HTC projects with partnerships where:
  - Transaction lacks economic substance
  - Transaction’s substance does not match its form
  - Disguised sales
  - Investors not actually partners or partnership is a sham

Photo: Wikimedia Commons/Andrew Jameson
John Harvey House (Inn on Winder), Detroit
Recent Developments: Virginia Historic Tax Credit Fund LP 2001

- Investors pooled funds in partnership that financed historic redevelopment in exchange for allocation of state historic tax credits

- Tax credits allocated to partners proportionately

- General partner could exercise option to buy investors’ interest out

- Promoters would refund investors if partnership did not obtain tax credits
Virginia Historic Tax Credit Fund LP 2001: IRS Arguments

• The IRS challenged the partnership’s tax return and argued
  – that the investors were not partners and their investment
    was a sale of state tax credits; or
  – even if the investors were partners, the contribution was a
disguised sale of state credits
Virginia Historic Tax Credit Fund LP 2001: Tax Court

- The Tax Court rejected both of the IRS’s arguments and found that
  - the investors were partners
  - there was no disguised sale
- The IRS appealed and the Fourth Circuit overturned the Tax Court
Virginia Historic Tax Credit Fund LP 2001: Fourth Circuit Court of Appeals

- The Court of Appeals found that even if the partnership was a true partnership, the transactions were disguised sales.

- Disguised sales because the tax credits were like property and:
  - The investors lacked entrepreneurial risk
  - The transaction was like “an advanced purchaser who pays for an item with a promise of later delivery”
Recent Developments: *Historic Boardwalk Hall*

- The municipal owner of the Hall formed a partnership with an investor to renovate a convention center and obtain historic tax credits.
- Hall transferred to partnership.
- The investor was a 99.9 percent member of the partnership.
- The investor was entitled to a three percent preferred return.
- Agreement provided put and call options for the members of the partnership.
- Agreement provided tax benefits guarantee contract where the municipal owner agreed to pay investor if partnership did not obtain tax credits.

Photo: Library of Congress, Prints & Photographs Division, NJ,1-ATCI,18-11

Boardwalk Hall, Atlantic City, New Jersey
Historic Boardwalk Hall Structure

PB LLC ("investment member")

NJSEA

Historic Boardwalk Hall ("HBH"), LLC (P'ship for tax)

Title & Insurance

Interest Payments on PB's investor loan

99.9% *
(up to 3% preferred return)
-Profits
-Losses
-Tax Credits
-Cash Flow

Capital Contributions**

Tax Benefits Guarantee K

Vested Put

Vested Call

K1: Sublease East Hall ("sale & purchase" for tax)

K2: Construction loan K

GIC K

Acquisition Note = $53m

Loan $57 m

K1

K2

Current & accrued but unpaid debt service on notes

.1% Remaining Cash flow

Income Taxes

99.9% Remaining Cash flow

Totaling $18m and an investor loan of $1.1m

- Contributions to pay down acquisition note
- Same amt. to be drawn on K loan (increasing balance) and dist’d to HBH
- Part used by NJSEA to purchase GIC
- Part used by HBH to pay NJSEA development fee (w/ associated responsibilities)
Historic Boardwalk Hall: Tax Court IRS Arguments

- The IRS challenged the partnership by arguing:
  - The transaction lacked economic substance,
  - The investor was not a partner,
  - The owner did not sell or transfer the Hall to the partnership, and
  - The partnership should pay an accuracy penalty
Historic Boardwalk Hall:
Taxpayer Arguments

• The taxpayer argued that:
  – The economic substance doctrine did not apply because Congress intended HTC to spur otherwise unprofitable investments and even if it did, the investor expected a three percent return
  – The taxpayer is a partner because there was partnership agreement that the parties negotiated
  – The transaction documents and the parties’ conduct show that the Hall was actually transferred to the partnership
Historic Boardwalk Hall: Economic Substance Argument

- Found economic substance:
  - Tax Credit
  - Three percent return
  - Partnership could invest more in the renovation because of investor’s contribution
Historic Boardwalk Hall: Partnership Argument

- Rejected because:
  - The investor entered into a transaction to facilitate an investment in exchange for tax credits and a three percent return
  - The investor’s interest was not more like debt than equity
Historic Boardwalk Hall: Hall Transfer

- The court rejected the IRS’s argument that the owner did not transfer the Hall to the partnership because:
  - The documents showed an intent that the Hall transfer
  - It was irrelevant that the Hall would continue to be operated by the former owner
  - The former owner’s purchase option did not destroy the transfer because it was consistent with the operation of the credits
**Historic Boardwalk Hall:**

**Accuracy Penalty Argument**

- The court rejected the IRS’s anti-abuse regulations because:
  - There was a real business purpose to the transaction
  - It was unimportant that the investor’s tax liability was reduced by the transaction because Congress intended the HTC spur investment by doing just that
Historic Boardwalk Hall: Result

- Tax Court upheld the partnership’s 99.9 percent allocation of the HTC to the investor
- IRS appealed the result to the Third Circuit Court of Appeals
Historic Boardwalk Hall: IRS Arguments on Appeal

- The investor was not a partner because it had no entrepreneurial risk or potential for upside gain
- The partnership was a sham
- The partnership was not the owner of the Hall
Historic Boardwalk Hall: Taxpayer’s Arguments on Appeal

- The partnership is a real partnership and both partners are *bona fide*
- The partnership is not a sham
- The Hall was transferred to the partnership
Historic Boardwalk Hall: Court of Appeals

- On June 25, 2012, the Third Circuit Court of Appeals in Philadelphia heard oral arguments on the IRS’s appeal of the Tax Court decision.

- Observers say that the judges strongly questioned if the investor had any risk in the partnership because of the various guarantees and indemnities.

- Decision currently pending.
Conclusion

**Virginia Historic Tax Credit Fund**
- Investors in a partnership that obtains historic tax credits must be subject to some risk of loss from the transaction or the transaction may be challenged as a disguised sale
- It is unclear a court would uphold the partnership
- No risk, no partnership?
- Until Court of Appeals rules, partnerships should be cautious in overly reducing risk to investors when structuring HTC partnerships
Strafford Webinar:
Renewable Energy Tax Credits

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July 31, 2012
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Mr. Kennard has substantial experience in federal, international, state and local tax matters involving corporations and partnerships, innovative investment structures and tax-exempt entities, and focuses on tax credit financing, including new markets tax credits, historic tax credits, low-income housing tax credits and energy tax credits, as well as public finance.

He is a Certified Public Accountant, Certified in Financial Management, a Certified Managerial Accountant, a Certified Internal Auditor and a Certified Fraud Examiner.

Mr. Kennard’s extended bio and Locke Lord LLP’s at http://www.lockelord.com/akennard/.
Production Tax Credits

Production Tax Credits:

- The production of electricity from facilities that generate electricity using renewable resources under Section 45 of the Code (the production tax credits or "PTCs").
- To qualify the electricity must be produced from “qualified energy resources:”
  - wind;
  - closed-loop biomass;
  - open-loop biomass;
  - geothermal;
  - solar (but only if placed in service prior to 1/1/06);
  - marine and hydrokinetic;
Production Tax Credits (cont’d)

- municipal solid waste;
- qualified hydropower production; and
- marine and hydrokinetic renewable energy.

• PTC is based upon the amount of electricity generated and sold currently (for 2012) 2.2 cents per kilowatt hour of electricity produced by the taxpayer and sold to an unrelated person.

• PTCs are claimed over a 10-year period beginning on the date the facility was placed in service.
Investment Tax Credits

Investment Tax Credits:

• The placing in service renewable energy property under Section 48 of the Code (the investment tax credits or "ITCs").
• The ITC is equal to 30% of the cost of the facility, is available to the owner of a qualifying solar facility placed in service before 2017.
• The ITC is taken entirely in the year the project is placed in service.
• The ITC is available to the owner of the property (including regulated utilities), whether or not the owner is engaged in the production of electricity, and regardless of the levels of production of electricity.
Investment Tax Credits (cont’d)

• In addition to the 30% ITC, a 10% ITC is available for geothermal energy property, geothermal heat pumps, combined heat and power (CHP) systems ("co-generation facilities"), qualified microturbine plants, and small commercial wind energy property, in each case placed into service before 2017.

• For purposes of calculating depreciation deductions, the tax basis of property for which the ITC is claimed is reduced by 50% of the amount of the credit (i.e., the depreciable basis is reduced to 85% of original asset cost).

• The ITC may be used to offset the alternative minimum tax.

• Under the 2009 Act, ITC tax basis is not reduced by tax-exempt private activity bond financing or subsidized financing of any kind provided by the federal or any state or local government.

• The ITC is subject to recapture in the event the property is disposed of or ceases to be qualifying property during the 5-year period after the property is placed in service.
Energy Property

• Energy property eligible for the energy credit generally must be new tangible personal property that has an estimated useful life of three years or more.
• The energy property must either be constructed by the taxpayer or acquired by the taxpayer.
• The recovery of the cost of the energy property must be through depreciation (or, in some rare cases, amortization) and must also meet performance and quality standards prescribed by the Secretary of Energy.
• Solar energy property is generally
  – solar property;
  – geothermal property;
  – qualified fuel cell property or stationary microturbine property;
  – combined heat and power system property;
  – qualified small wind energy property; and
  – geothermal heat pump systems.
Energy Property

• Local law does control whether or not property is considered tangible personal property and eligible for the ITC. Property may be considered a fixture or real property under local law but may still qualify as energy property for purposes of the ITC.
• Energy property is generally depreciated under the modified accelerated cost recovery system, or MACRS, over 5 years using the 200% declining balance method.
• Unlike the PTC, the sale of the electricity produced by the energy property to an unrelated third party is not required to claim the ITC.
Disqualifying Uses

- Energy property does not include any property that is part of a facility claiming PTC in the current or any previous taxable year.
- ITCs are generally not available for property that is used outside the United States; property used by certain tax-exempt organizations; property used by governmental units or foreign persons and entities; or for property used predominantly for lodging.
Placed in Service

• The energy credit is available on the date the qualifying energy property is placed-in-service.
• The term “Placed-in-service date” is not defined in the IRC.
• Generally, the placed-in-service date is defined under the depreciation regulations as the date at which the asset is “placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business in the production of income, in a tax-exempt activity or in a personal activity.
• The placed-in-service date is crucial because it determines the date that 100% of the ITCs are earned by the taxpayer that owns the energy property on such date.
• A taxpayer may elect to claim the ITC on qualified progress expenditures if the taxpayer can reasonably estimate that the construction of the asset will take at least two years and that the useful life of that asset will be seven years or longer.
Basis Reduction

• In connection with the ITC, the basis of the energy property and the basis of the owner’s interest in energy property is reduced by half of the amount of the ITCs claimed when it is placed in service and before any depreciation deductions are taken.

• Since the depreciable basis is reduced by half of the ITC, a taxpayer may only depreciate 85% (in the case of a 30% ITC, (100% of qualify energy property basis less one-half of 30% ITC claimed,) or 95% (in the case of a 10% ITC, 100% of qualifying energy property basis less one-half of 10% ITC claimed) of the qualifying energy property.
Basis Reduction

• The reduction in basis is not taken into consideration for purposes of depreciation recapture.
• For energy property owned by a partnership or other flow-through entity, the reduction in depreciable basis of the energy property also triggers a corresponding reduction in the partner capital accounts or shareholder basis.
Forbearance

• Recapture of the ITC is triggered by a change in ownership of the energy property.
• Foreclosure on the energy property would trigger ITC recapture.
• To mitigate this additional recapture risk, some taxpayers in leveraged ITC transactions have negotiated forbearance agreements with lenders.
Development Service Fees

• It is customary to pay development fees to a developer for performing oversight functions related to the overall development of a project.
• The term “developer fee” is not specifically defined in the IRC, and no specific mention is made of whether developer fees are includable in ITC basis.
• As it relates to developer fees’ the IRS’s overall approach to determining how much of the developer fee is includable in basis for the ITC is to look through to each specific developer service rather than to look to the overall developer fee.
Development Service Fees

- The fee for each specific service that the developer is to perform should be assigned a value or price.
- However, this rarely occurs in practice.
- The overall fee is subject to scrutiny for reasonableness.
- Generally, expenditures are recognized only as reasonable in amount if the fee correlates to the fair market value of those services in an arms-length transaction.
Construction Period Interest and Taxes

- Generally, interest on any debt to purchase, transport and install energy property, taxes and other carrying charges incurred during the construction period are capitalizable and includable in ITC basis as long as the taxpayer files an election to do so.
- The construction period ends on the placed-in-service date.
- Similar to the historic tax credit and the low-income housing tax credit capitalizing similar costs to the basis of the building is permitted.
- It is important to note the different treatment as IRC Section 266 for ITC requires the taxpayer to file an election to capitalize interest, taxes and other carrying costs while IRC Section 263A for other types of credits does not.
Tax-Exempt Use Property

• The tax-exempt use rules can cause problems for ITC transactions. The IRC provides that no ITC will be allowed on energy property used by a tax-exempt organization.

• For purposes of the tax-exempt use rules, the IRC defines a “tax-exempt entity” as being any of the following:
  1. the government of the United States and any state or local government agency or any political subdivision thereof;
  2. any organization (other than a cooperative) that is exempt from income taxes under the IRC;
  3. any foreign person or entity; or
  4. any Indian tribal government.
Tax-Exempt Use Property

• There are specific rules applicable to property other than nonresidential real property (i.e. personal property) that provide for an allocable portion of the property to be treated as tax-exempt use property.

• What qualifies as tax-exempt use property per IRC Section 168(h) is relatively straightforward for property other than nonresidential real property (i.e., for personal property). For personal property, tax-exempt use property generally is “that portion of any tangible property (other than nonresidential real property) leased to a tax-exempt entity.”

• For personal property, this proportional exclusion rule also applies to ownership of the property.

• Additional special rules apply to partnerships with tax-exempt partners if the partnership agreement provides for allocations of partnership items that are not considered a “qualified allocation.”
Tax-Exempt Use Property

- For partnerships containing both tax-exempt and taxable partners, any allocation of partnership income, loss, credit or basis must be a qualified allocation.¹
- The portion of the energy property or amount of the expenditures that are deemed to be tax-exempt use property is equal to the highest allocable share of income, gain, loss, deduction, credit or basis.
- For example, Partnership A has a solar installation with total costs of $10,000,000. The expenditures are placed in service in year one. The partnership agreement of Partnership A calls for allocation of 99.99% of income to a tax-exempt partner in one year, with an allocation of 0.01% of losses to the same partner in the next year. Therefore, the tax-exempt entity's highest share of income is 99.99%, and this portion of the expenditures is deemed to be tax-exempt use property and ineligible for the ITC. Hence, only $1,000 of costs would be eligible for the ITC.

¹ Refer to the source for detailed allocation rules and exceptions.
Power Purchase Agreements

• A power purchase agreement (PPA) is a contractual agreement that provides for one entity (the host) to purchase electricity from another entity that produces electricity (the energy provider).

• In ITC transactions, generally, the energy provider owns the energy property that is installed at a host’s site.

• As the energy property produces electricity, the energy provider sells that electricity to the host pursuant to the terms of PPA.

• PPAs can vary in length and usually provide for a set price per kilowatt hour of electricity that is increased annually by a negotiated escalation rate.
Leases

• Some ITC transactions opt to use an operating lease in lieu of a PPA.
• In ITC lease transactions, the lessor owns the energy property that is installed at a host’s (the lessee) site.
• Instead of buying the electricity under a PPA, the host or lessee makes lease payments to the lessor for the rights to use the electricity generated by the energy property.
Service Contracts

- A service contract is considered a property lease under IRC Section 7701(e) if certain requirements hold. The 6 criteria are:
  1. if the service recipient is in physical possession of the property,
  2. if the service recipient controls the property,
  3. if the service recipient has a “significant” economic interest in the property,
  4. if the service provider has no economic risk in the contract,
  5. if the service provider does not provide services to a third party, and
  6. if the contract price does not “substantially” exceed the rental value of the property

- It is important to note that all relevant factors, including the above factors, will be considered in determining whether the service contract should be considered a lease.
How Can an Investor Purchase Renewable Energy Tax Credits?

- "stand alone" structure.
- "sale-leaseback" structure, which cannot be used in wind transactions because the PTCs are not available to a non-operator owner.
- "flip partnership" structure, which originated in wind energy transactions and adapted for solar energy.
- "lease pass-through/inverted lease structure " structure, originated in HTC transactions (known as a “sandwich lease structure”) and adapted for solar energy.
Partnership Flip

- **Fund General Partner**: 1%
- **Tax Credit Equity Investor**: 99%
- **Solar 1, LLC**, **Solar 2, LLC**, **Solar 3, LLC**, **Solar 4, LLC**
- **System Integrator/Installer**: 1%
- **Solar Installation Host #1**, **Solar Installation Host #2**, **Solar Installation Host #3**, **Solar Installation Host #4**

Graph: 
- **Investment Fund**: 1% incoming from Fund General Partner, 99% incoming from Tax Credit Equity Investor.
- **Developer**: connects to Investment Fund.
- **Solar 1, LLC**, **Solar 2, LLC**, **Solar 3, LLC**, **Solar 4, LLC** connect to System Integrator/Installer.
Sale Leaseback Structure

- Solar Developer, LLC
  - Lessee

- Corporate Investor Lessor
  - Lease Agreement
  - Sales Proceeds
  - Energy Procurement and Construction Contract ("EPC")

- Solar 1, LLC
- Solar 2, LLC
- Solar 3, LLC
  - Solar Integration Host #1
  - Solar Integration Host #2
  - Solar Integration Host #3

- System Integrator/Installer
  - PPA/Lease Agreements
Lease Pass Through

Manufacturer → Developer/Installer → Lessor Solar LP (PV System Owner) → Lessor Solar LP (General Partner) → Lender

State Incentive Programs → Capital Contribution → Capital Contribution

Sale of PV Panels

$ → $

Pass-through Election → Lease → Capital Contribution

99% Limited Partner (Corporate Investor) → Cash, Capital Loss → 1% General Partner (Developer) → P/L and Credits

Lease Payments

General Partner 51%-99% partnership interest

Debt Service Payments

P/L Payments

1% General Partner (Developer)
Exit Strategies

• Once you have gotten the investors IN, you need a way to get them OUT:
  1. Flip – reduces the investor’s ownership percentage to make it cheaper to buy it out.
  2. Put – investor can exercise option requiring developer to make a small payment to buyout investor; not as common in energy deals as in other transactions because of Rev. Proc. 2007-65.
  3. Call – developer can exercise option to buy out the investor for fair market value of partnership interest.
  4. Purchase option or early buy out option.
Exit Strategies for Partnership and Lease – Pass Through Structures

• Investors generally want out of the transactions at the end of year 6 – Put/Call option.
• Most common exit is through a flip:
• Investor ownership interest flips from 99% to 5%; and
• Developer/GP exercises call option to buy out investor for greater of FMV of ownership interest or amount required to achieve agreed-upon IRR.
Advantages of a Lease Structure

• Sale/leaseback transaction can be closed up to 90 days after PIS.
• Partnership transaction must be closed before the facility is PIS.
• Less pressure for Developer to delay placing the facility in service if the investor is not yet in the deal.
• 100% financing available at full value.
Advantages of a Lease Structure (cont’d)

• Investor buys the facility:
  1. generally no investment is necessary from developer; and
  2. in a partnership structure, the Developer may have to leave money in the deal (deferred developer fee) or contribute sponsor equity.

• Fixed rent and ability to stretch out the term of the lease result in the lessee being immediately able to keep the upside if the project generates greater returns than is anticipated.

• In a partnership structure, the principal effect of greater returns is to accelerate the date of the "flip."

• Lessor gets a predictable rent stream.
Disadvantages of a Lease Structure

- Lessee's purchase option is more expensive than in a partnership structure. In a lease, the investor owns all of the residual value of the asset (must be estimated to be at least 20% of initial cost).
- Developer is required to make scheduled rent payments and comply with extensive covenants.
- Developer may not have visibility (transparency) with respect to the tax investor's return.
- Leasing deals have traditionally been document- and time intensive. Lease documents contain extensive representations, warranties, covenants and indemnities; there is typically a complex tax indemnity agreement.
- An appraisal is almost always required for each project. In a partnership structure an appraisal is optional.
Advantages of a Partnership Structure

• Investor does not need a 20% residual value as in a lease. A 5% residual is sufficient.
• Cheaper purchase option at the time it is to be exercised.
• Less default risk than in a lease - there is no fixed rent schedule or covenant package that Developer must comply with.
Disadvantages of a Partnership Structure

- Deal must be closed and investor must have funded before the facility is placed in service.
- Developer has to fund its portion of the partnership/LLC interests.
- Management rights and powers (issues related to who has the power to manage the company and run the projects and what level of consents is needed for what actions) can be difficult to negotiate. (In contrast to leases, which have been used for a long time and with respect to which an accepted practice exists.)
Disadvantages of a Partnership Structure (cont’d)

• Developer does not have the immediate ability to keep for itself all of the upside generated by the project as would be the case in a lease, where rent payments are fixed upfront.

• No clear advantage to one or other structure and both leases and partnerships are common.

• There may be advantages and disadvantages from accounting perspective.