<u>Wisconsin Historic Credit Basics</u>

- Credit is allowed when project is placed in service (issuance of certificate of occupancy) to project owner on placed in service date
- Credit can be claimed against individual or corporate franchise or income tax
- Credit can be carried forward 15 years
- Credit is not subject to passive activity loss limitations for individuals and closely held corporations
- Credit can offset Wisconsin alternative minimum tax
- Credit can be allocated to partners/members as provided in written agreement (special allocations permitted)
- Credit can be sold (certificated) by project owner or partner/member of project owner to any person or entity who can use it (WDOR must certify the transfer)
- Credit not included in income for Wisconsin purposes
- Credit claimed reduces Wisconsin adjusted basis of project and Wisconsin adjusted basis of partner/member interests

Structure Choices

- Project almost always will be owned by an LLC or partnership that is a partnership for tax purposes (Partnership)
- Smaller projects: Partnership owned by developer group (along with family/friendly investors) and credit claimed by developer group
- Smaller projects: Partnership owned by developer group (along with family/friendly investors) and credit sold by Partnership to third party with Wisconsin tax liability
- Partnership owned by developer group, federal historic credit investor and special purpose state credit member which is specially allocated the state credit (or any income from a "deemed sale" of the credit)
- Partnership owned by developer group and federal historic credit investor with state credit specially allocated to a developer group entity which includes a special state credit member
- Partnership owned by developer group and state credit member and "master leased" to a special purpose master tenant LLC with the federal historic investor – the master tenant claims the federal historic tax credit and operates the project – lease payments to the owner cover debt service plus profit. Federal historic equity either contributed to Partnership as equity capital (in which case the master tenant LLC owns an interest in the Partnership) or advanced as a subordinated loan

After-Tax Value of Credits Allocated to Partners/Members

- The allocated credit reduces the claimant's deduction for state taxes on its federal income tax return
- Assuming a 35% federal income tax rate, $100 of credit allocated to/claimed by a partner/member is worth a net of $65 after taking into account federal tax effects
- As a result, the tax equity that could be raised by allocating the credit to a partner/member is 52-58% of the tax credit amount (i.e., 80-90% of the $65 net benefit)
- Even a nominally "allocated" credit can be treated as a "sale" of state credits by the IRS – sale treatment is almost certain for special "state credit partners"
- Net tax effect of "sale treatment" is not much different from allocation treatment for the partner claiming the credit. Assume a state credit partner contributes $58 of equity capital and is allocated a $100 credit. The IRS treats the transaction as a "sale":
  - Special allocation of STCG on credit sale to state credit partner = 58 x .35 = 20.30 federal tax
  - State credit partner is treated as paying $58 of state tax
  - Lost state tax DED (or STCG) = $42 x .35 = $14.70
  - Total federal tax cost is $35
- In either case, the state credit partner has a $58 tax basis and capital account for its partnership interest

After-Tax Consequences of Certificated Credit

- Project Partnership/LLC (or a partner/member who is allocated the credit) can transfer/sell the credit to a third party who is not a partner for roughly 90% of the credit amount
- Credit purchaser is treated as paying $90 of state taxes on its federal income tax return and loses only $3.50 of net federal benefit
- Project Partnership/LLC has federal STCG of $90 ($31.50 of federal tax liability at 35%) – total federal tax hit is $35
- IRS wants its $35/100 of state credit, one way or the other, but the developer would like to keep $90/100 – if the state credit is $1 million, the difference in equity to the project would be about $300,000 if the federal tax liability can be avoided on the credit certificate sale price
- Allocate income from sale of credit certificate to a "loss partner" with net operating losses
- Allocate income from sale of credit certificate to a tax-exempt entity
- "Donate" credit to a historic preservation 501(c)(3) and obtain subordinate loan from nonprofit after sale of the certificate by the nonprofit
- Significant federal tax issues for all three approaches: (a) Will the special tax allocation withstand IRS scrutiny? (b) Is the allocation recipient a partner? (c) Does the allocation have an adverse impact on the federal historic credit allocation? (d) Does allocation to a tax-exempt entity create tax-exempt use property and eliminate the federal historic credit? (e) Should the donation of the tax credit and loan from the nonprofit be given tax effect?
- The federal credit investor will make sure these tax risks are borne contractually by the developer group
- Significant economic issue for all approaches: State credit investor has a large tax capital account which, under the contracts, it must be allowed to keep if there is any chance of the tax planning surviving an IRS audit

Recapture/Disallowance of State Credit

- WDOR has four years to recapture credits after notice from SHPO that rehabilitation expenditures don't qualify under SHPO cost certification standards – this is the only recapture provision in the Wisconsin Statutes
- Not clear whether WDOR has the authority to do its own audit of qualified rehabilitation expenditures
- Unlikely that WDOR has any authority to reallocate the credit among partners or to otherwise assert "structure related" challenges
- If SHPO were to disallow expenditures and the credit has been transferred, only the project owner (and not the transferee) is liable to repay the credit
- Federal historic credit recapture provisions should not be applicable to state credit
- No "recapture risk" needs to be priced into a certificate sale

Putting the Deal Together

- Need to identify and cut deal with state credit investor at the outset – state credit equity is an important funding source that lenders and federal investors will need to see in place before closing
- Don't expect to get the state tax equity until completion and issuance of NPS Part 3 (may need bridge financing)
- Developers frequently use national state credit brokers to find state credit investors
- Need to clear the state credit structure with the federal credit investors at the outset
- The credit can be combined with the federal historic credit, the federal new markets tax credit or the federal low-income housing tax credit – in most cases, the federal credit investor(s) do not use the state credit
- Where state and federal historic credits are combined in a single project, the federal credit is typically "passed through" to a separate master tenant entity (the state credit cannot be "passed through") – in this structure, the "landlord" is owned by the state credit investor and the developer group and the "master tenant" is owned by the federal credit investor and the developer group
- Federal historic tax credit investors are now coming to grips with Revenue Procedure 2014-12 – IRS "safe harbor" for structuring federal historic tax credit investments
- Key features of Rev Proc 2014-12 include:
  - Developer guarantees limited to events within their control (federal tax equity investor must bear "structure risk")
  - Investor must contribute 20% of equity before rehab is complete
  - At least 75% of investor's required capital contribution must be "fixed" before building is completed
  - For 5 years, the tax investor must get same percentage of net cash flow as historic credits (<u>i.e.</u>, 99%)
  - After 5 years, tax investor's percentage interest can "flip down" to 5%
  - No artificial arrangements to reduce the amount of investor's 99% interest in net cash flow are permitted