

The Ingredients of an Historic Tax Credit Transaction



Dallas Coffin Company Building (Constructed 1909)



NYLO South Dallas (2012)

Agenda

1. Historic Tax Credits: A Brief History
2. Structuring Primer
3. Parties to an HTC Transaction
4. Economics: Cash Flow Waterfall
5. Structuring Federal HTCs
6. Key HTC Issues (Incl. Equity Markets)
7. Structuring Texas HTCs
8. The Parallel Track: The Eligibility Process
9. Q&A Session



Wilson Building, Dallas



Pressures on the historic built environment

After World War II, a tidal wave of suburbanization and urban renewal swept the nation, decimating the historic built environment.

The National Historic Preservation Act of 1966 was the first policy response. It established:

- National Register of Historic Places
- State Historic Preservation Offices (SHPOs)
- Section 106 Review



Penn Station (1911)

Federal Financial Incentives for Historic Preservation

Tax Reform Act of 1976:

- Ended accelerated depreciation for structures replacing demolished historic buildings
- Established deduction for QREs incurred rehabilitating historic buildings



Revenue Act of 1978:

- Created the Federal Historic Rehabilitation Tax Credit
(an Investment Tax Credit, at first equal to 10% of QREs incurred)



The Healing Center (2010 and 2012)



Federal Financial Incentives for Historic Preservation

Tax Reform Act of 1986:

- Established the current value of the Federal Historic Rehabilitation Tax Credit: 20% of QREs incurred
- Instituted passive activity loss limits



Housing and Economic Act of 2008:

- Allowed filers to apply the HTC against an AMT liability
- Liberalized tax-exempt use rules



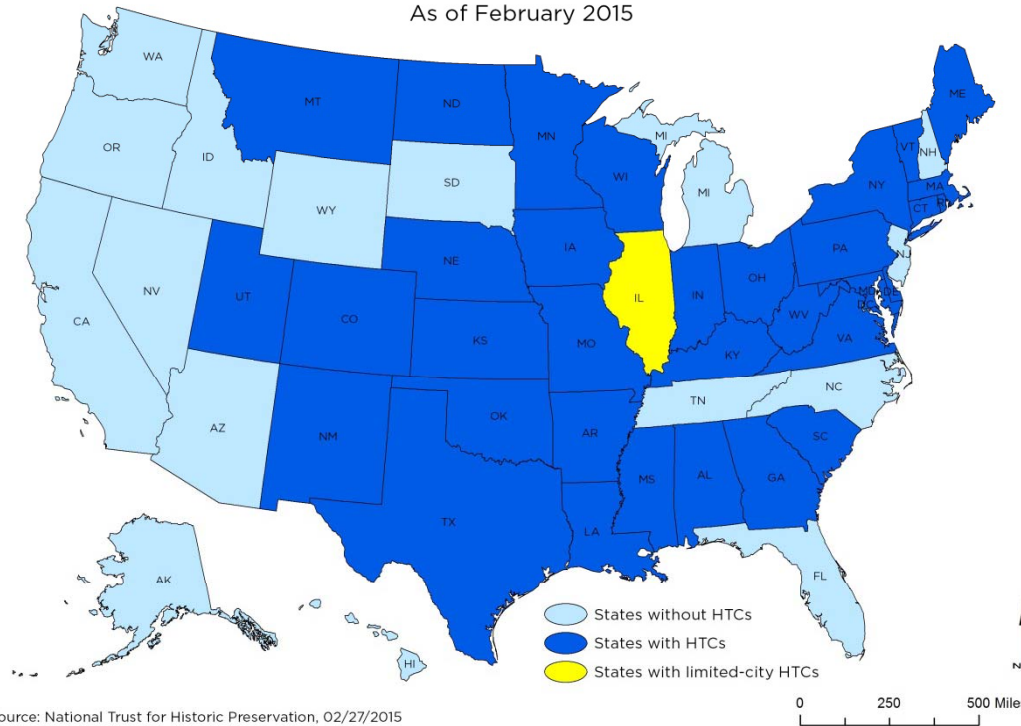
1936-38 Magazine Street (2010 & 2012)



Financial Incentives for Historic Preservation (State Level)

State Historic Tax Credits (HTCs)

As of February 2015



Source: National Trust for Historic Preservation, 02/27/2015

Historic Tax Credits and Structuring

- The Federal Historic Rehabilitation Tax Credit is one of several Investment Tax Credits that may be earned by equity investors to a project
 - The credit is not “bought” or “sold” but is typically passed through to a tax credit investor via a master lease
- The Texas State Historic Tax Credit is transferrable; it can be bought and sold.
 - If sold, the seller incurs a federal income tax liability upon receipt of the sale proceeds
 - If allocated, tax is not owed, but the state tax credit investor must contribute equity to the project
- Numerous structuring challenges include:
 - Subordination, Non-Disturbance and Attornment (“SNDA”) Agreement
 - Cash Flow Distributions to Investor-Owner
 - Tax-exempt use rules (“disqualified lease”)
 - Passive activity rules
 - Revenue Procedure 2014-12 Compliance (Historic Boardwalk Hall)
 - Capital at-risk



Parties to an HTC Transaction

- Developer/Sponsor
- Tax Credit Arranger
 - Acts as historic preservation consultant, securing eligibility for historic tax credits
 - Models the project's financing to incorporate all funding sources
 - Coordinates financial structuring and tax credit monetization
- Legal Team
 - Advises on structure
 - Authors legal opinions needed by investors and lenders
- Tax Credit Investor/Buyer
 - Provides tax credit equity at financial closing, during construction and at completion
 - Purchases historic tax credits at project certification
- Lenders

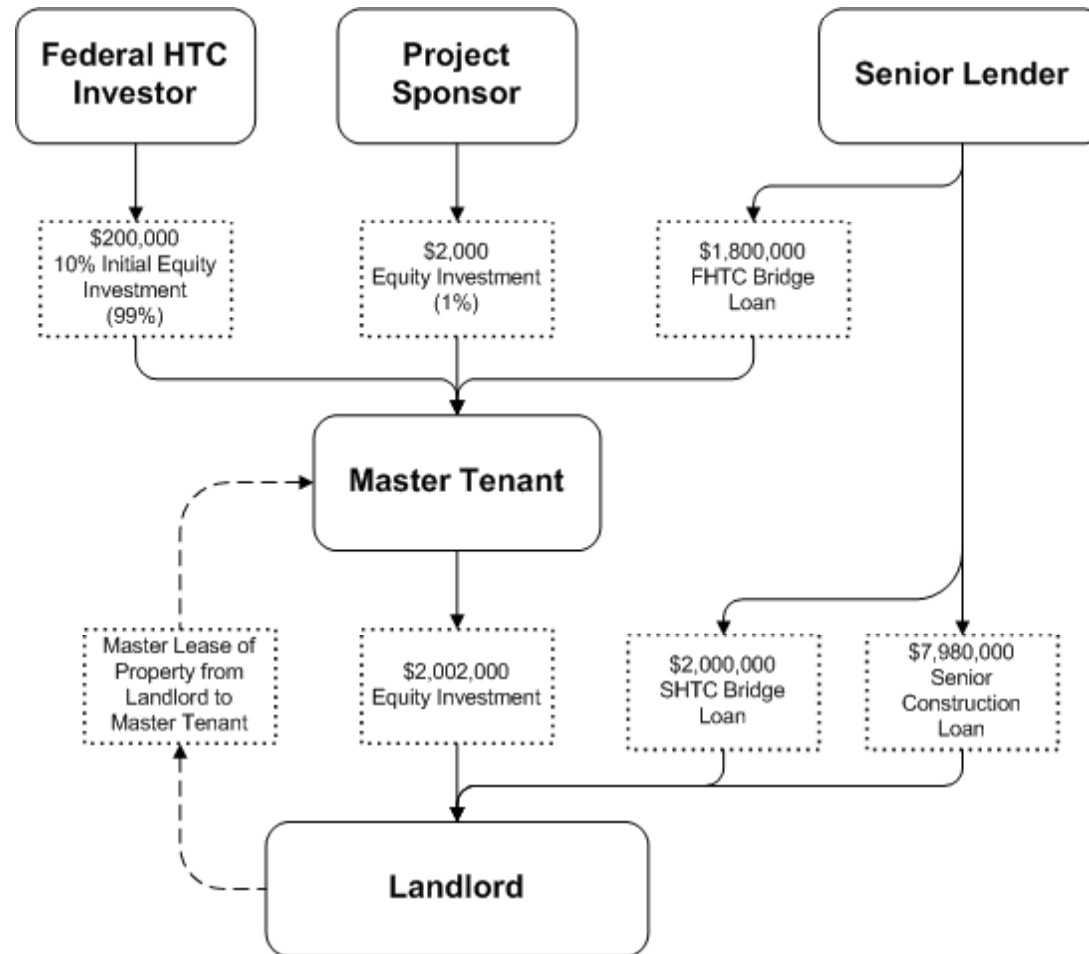


Economics – Cash Flow Waterfall to Project

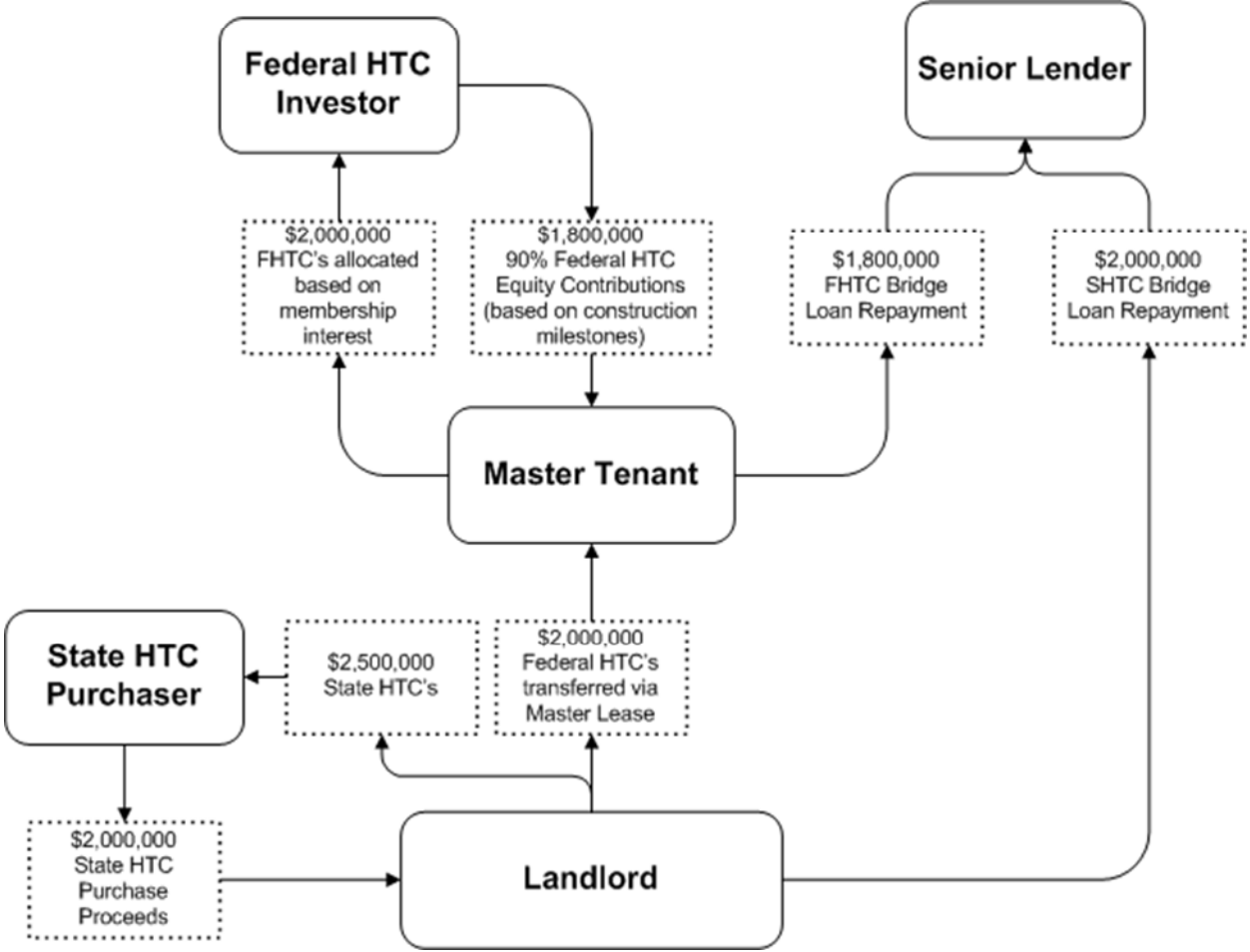
		Federal Historic Tax Credits		State Historic Tax Credits	Combined
Project Size		12,000,000		12,000,000	12,000,000
Eligible Basis (QRE)		10,000,000		10,000,000	10,000,000
Tax Credits	20.0%	2,000,000	25.0%	2,500,000	4,500,000
Equity Price	100.0%	2,000,000			2,000,000
Sales Price			80.0%	2,000,000	2,000,000
Gross Proceeds at Close		2,000,000		2,000,000	4,000,000
Estimated Fees & Closing Costs		(170,000)		(150,000)	(320,000)
Net Proceeds at Close/Certification		1,830,000		1,850,000	3,680,000
Estimated Aggregate Annual Distributions	2.0%	(200,000)			(200,000)
Exit/Put Price	10.0%	(200,000)			(200,000)
Net Benefit (Before Tax)		1,430,000		1,850,000	3,280,000
Income Tax Liability			39.0%	(721,500)	(721,500)
After Tax Net Benefit		1,430,000		1,128,500	2,558,500



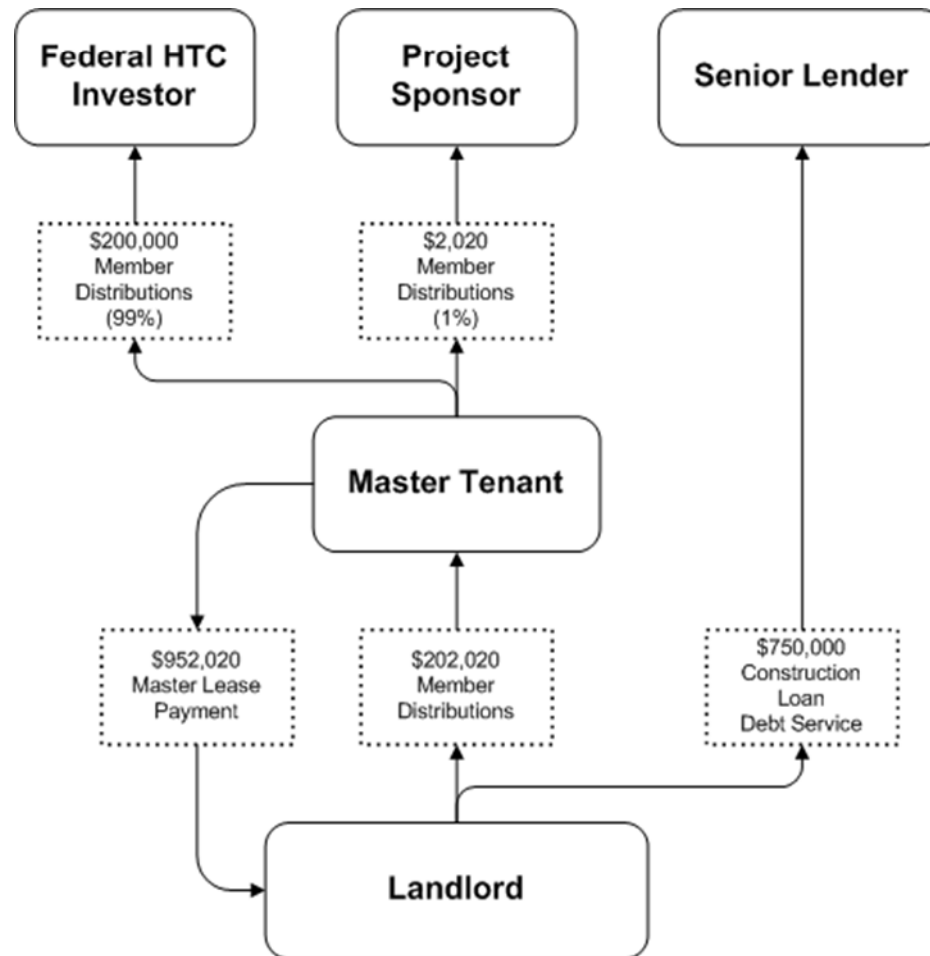
Structuring Federal HTCs - Closing



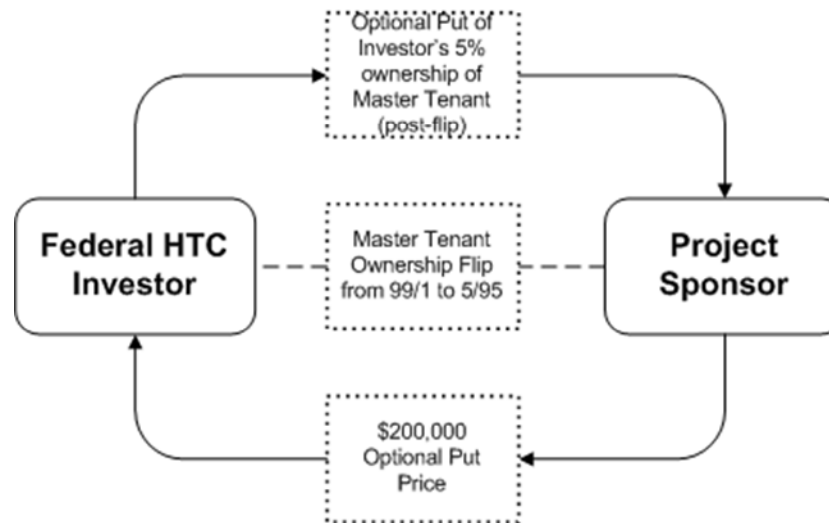
Structuring Federal HTC's - Certification



Structuring Federal HTC's - Compliance



Structuring Federal HTC's - Exit



Key HTC Issues

- Intercreditor / Priority Agreements
- Subordination, Non-Disturbance / Forbearance Agreements
- Bridging Requirements and Lender Priority
- Loan / Equity Funding Timing
- Compliance Period and Exit
- Tax consequences



Impact of Historic Boardwalk Hall: Summary of IRS Revenue Procedure 2014-12

- **Partnership Interest**
 - 99% interest in the Master Tenant flipping to 5% interest as of the Transition Date
 - No minimum required return
 - To the extent that the partnership is generating an economic return, then the investor must receive its stated pro-rata percentage (99%) of such return,
 - Income must be contingent (variable) upon partnership income, and not fixed in nature.
- **Lease, Fees & Other Arrangements**
 - Investor income can't be diluted by any unreasonable fees, disproportionate distributions, lease obligations...
 - Fees and lease obligations are okay if supportable in a non-HTC context
 - Lawyers typically do not make such reasonableness assumptions, but will likely rely on third-party valuation divisions of accounting firms for comparable analysis.
- **Guarantees**
 - Impermissible Guarantees:
 - Ability to claim the credits, Transaction Structure, Distributions
 - Permissible Guarantees:
 - Completion, Operating Deficit, Environmental, Acts or Omissions
- **Exit**
 - No Calls
 - Puts at lower of fixed price of FMV



Accessing the HTC Equity Market: Factors for Competitive Projects

- **Scale**
 - Large investors are looking for \$3MM in tax credits (i.e., \$15MM in QREs)
 - Large investors include certain large corporations, banks and several equity funds
 - Small Deal Funds will evaluate any deal size, but pricing is lower
 - Community and Regional Banks are sometimes active tax credit investors and, where available, can provide competitive terms relative to Small Deal Funds
- **Developer experience**
 - Having a team (developer, architect, general contractor, tax credit arranger, attorneys, accountants, etc.) in place that has historic rehabilitation experience helps sell a deal to the investor community
- **Bridging & Bank Loans**
 - Bridge loans are often used fund project expenditures prior to receipt of the full amount of tax credit equity proceeds
 - Banks providing senior debt alongside of an HTC investment need to be comfortable with restrictions on their remedies in a foreclosure
- **Historic Boardwalk Hall**
 - Put many investors on the sidelines pending additional guidance from the IRS
 - Rev-Proc 2014-12 issued in January 2014 provided Safe Harbor procedures
 - Purpose of the Safe Harbor was to bring investors back into the market – which appears to be happening



Texas Historic Rehabilitation Tax Credit



Texas Capitol Building, Austin, TX

Subchapter S of Chapter 171, Tax Code

Benefit:

- 25% of QREs credit against Texas Franchise Tax with no cap, 5 year carry-forward
- Bifurcated: Can be sold, transferred, assigned, or allocated without limitation; subject to registration with Comptroller
- No recapture period
- Credit is available during tax year when project is placed in service

Eligible Buildings – Same as FHTC and includes (a) Recorded Texas Historic Landmark under Section 442.006 and (b) State archeological landmark under Chapter 191

Effective Date: January 1, 2015 but QREs incurred up to 5 years prior can be included in an application

Regulations: Tex. Admin. Code Title 13, Part II, Chp. 13

LEGISLATIVE UPDATE: HB3230 - Permits tax-exempt entities to incur "eligible costs and expenses". Passed House and Senate; pending Governor approval



Texas SHTCs - Investor Perspective

CHARACTERISTICS OF INVESTMENT CANDIDATES

- Property type - Multi-family, mixed use, special use, hospitality, office, retail
- Developer has site control of property
- Construction and permanent debt has been identified
- NPS Part I completed; Part II submitted
- Experienced HTC architect and contractor

INVESTMENT PREFERENCES

- Development cost > \$1 million
- Development period < than 24 months
- Qualified Rehabilitation Expenditures (QREs) > \$2 million
- Catalyze further redevelopment

PRICING SHTCS

- Very competitive market for Texas SHTCs and pricing can range from \$.83 to \$.88 per credit (net to project after federal income tax of \$.60 to \$.70 per credit, depending on tax rate)
- Credits are most in demand when Franchise Taxes are due to the Comptroller

BRIDGE FINANCING

- Bridge financing for Texas SHTCs is available but can be difficult to structure and pricing varies project to project



Structuring Texas SHTCs

Direct Sale - Project Owner sells the certificated tax credits to a third party purchaser. The sale proceeds are considered investment income subject to capital gains taxes under the Internal Revenue Code to the Project Owner.

Allocation – Project Owner allocates the Texas SHTCs in accordance with capital accounts and each partner utilizes the Texas SHTC or sells them. Allocation is not subject to federal income tax but subsequent sale would be subject to capital gains tax to seller.

Minimizing Capital Gains – Project Owner or allocatee holds Texas SHTCs for a minimum of 13 months to have any gain treated as a long-term capital gain.



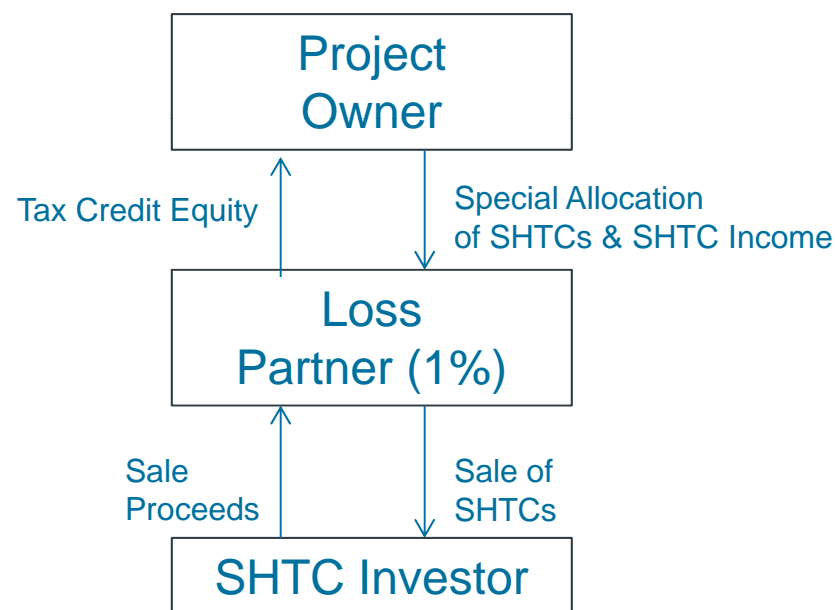
1700 Commerce, Dallas Texas



Structuring Texas SHTCs

Loss Partner Model (Missouri)

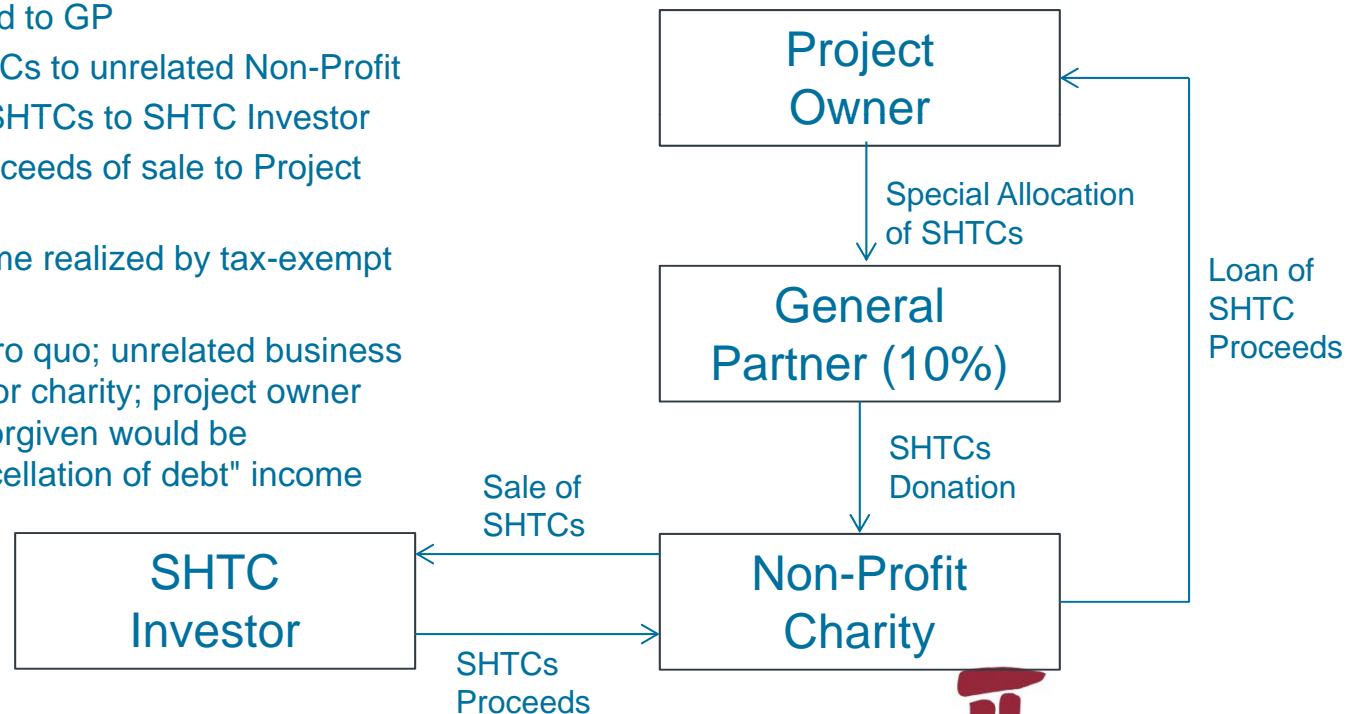
- Corporation with large loss carry-forward admitted as limited partner
- Loss Partner is specially allocated SHTCs
- Loss Partner sells the SHTCs to SHTC Investor
- **Net Effect:** Loss Partner recognizes income from the sale of the SHTCs but does not pay tax because of loss carry-forwards
- **Concern:** Use of a corporation for "tax avoidance purpose"; disproportionate allocation may suggest Loss Partner is not a "partner"



Structuring Texas SHTCs

Non-Profit Model (Massachusetts)

- SHTC is allocated to GP
- GP donates SHTCs to unrelated Non-Profit
- Non-Profit sells SHTCs to SHTC Investor
- Charity loans proceeds of sale to Project Owner
- **Net Effect:** Income realized by tax-exempt organization
- **Concern:** quid pro quo; unrelated business taxable income for charity; project owner has debt that if forgiven would be considered "cancellation of debt" income



Eligibility for Historic Tax Credits

Certified Historic Structure (CHS)

- CHS status must be secured to permit pursuit of historic tax credits
 - Building in question can be found to be a “contributing element” to an historic district
 - Building can be individually listed on the *National Register of Historic Places*



Eligibility for Historic Tax Credits

Historic Preservation Certification Application (HPCA)

- **Part 1/Part A – Evaluation of Significance**
- **Part 2/Part B – Description of Rehabilitation**
- **Part 3/Part C – Request for Certification of Completed Work**

Nomination to National Register of Historic Places (NR)

- **Determine viable listing criterion**
- **Write nomination**
- **Nomination reviewed by state-level committee**
- **Nomination approved by National Park Service**

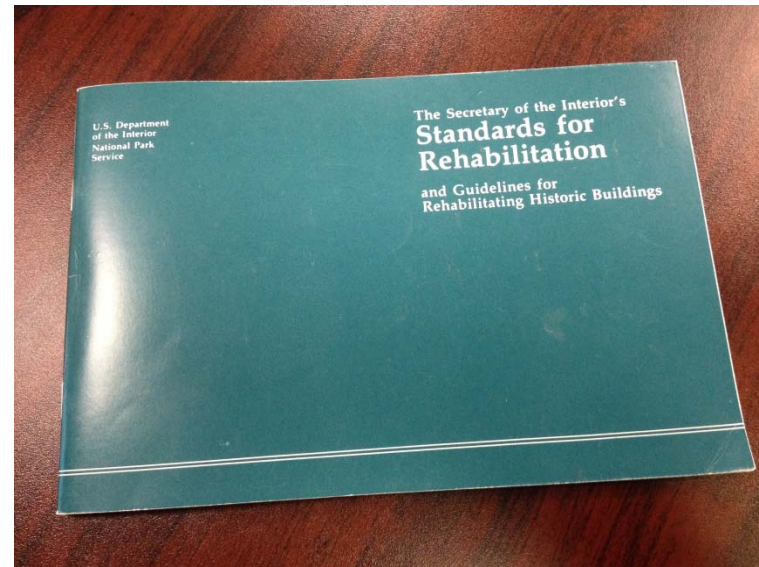
Eligibility for Historic Tax Credits

Part 2/Part B – Description of Rehabilitation

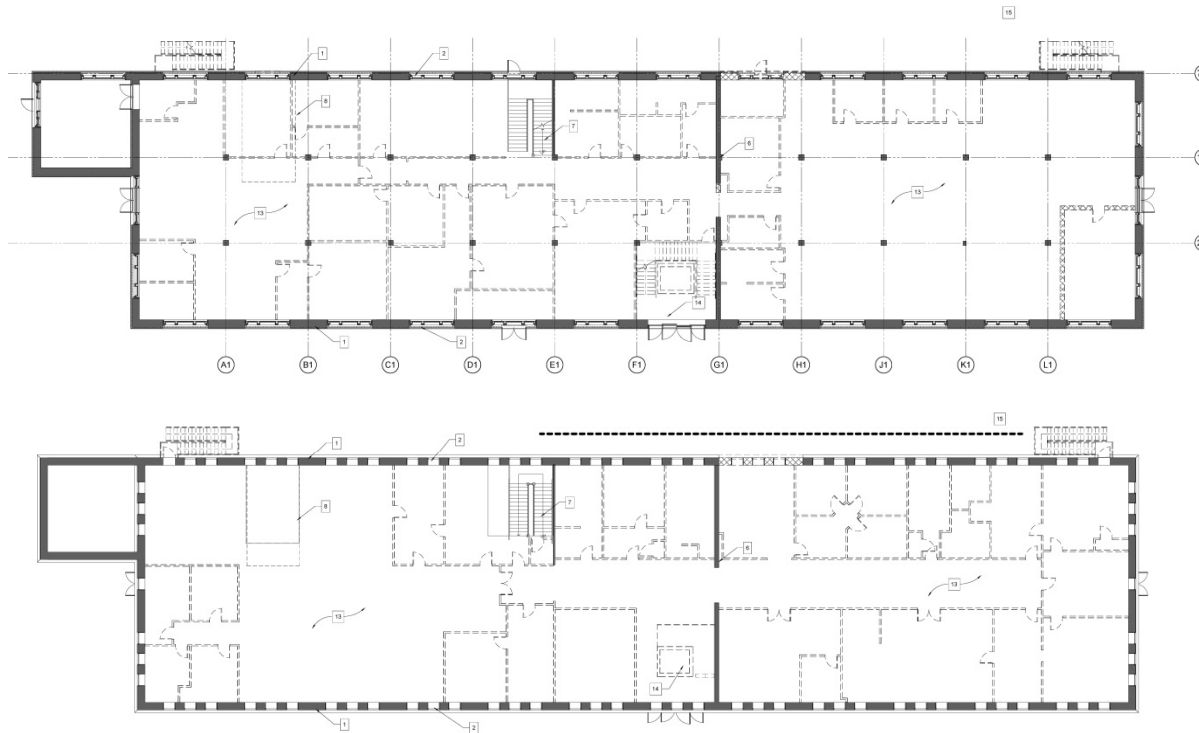
- Historic Tax Credit Arranger authors application, working with THC/NPS and Project Architect to craft a submission in conformance with the Secretary of the Interior's *Standards for Rehabilitation*

Part 3/Part C – Request for Certification of Completed Work

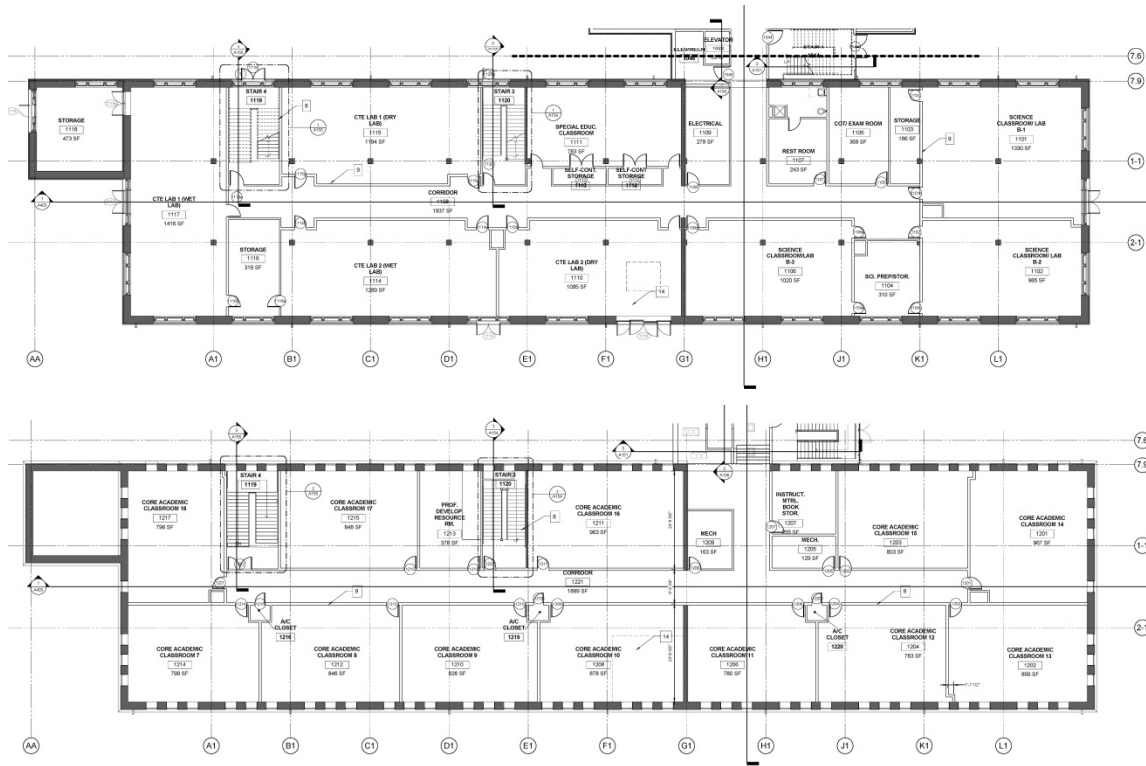
- Historic Tax Credit Arranger documents completed work and submits Part 3 for THC and NPS review. Cost certification report certifies the final total of QREs, the amount claimed in the Part 3/Part C submission



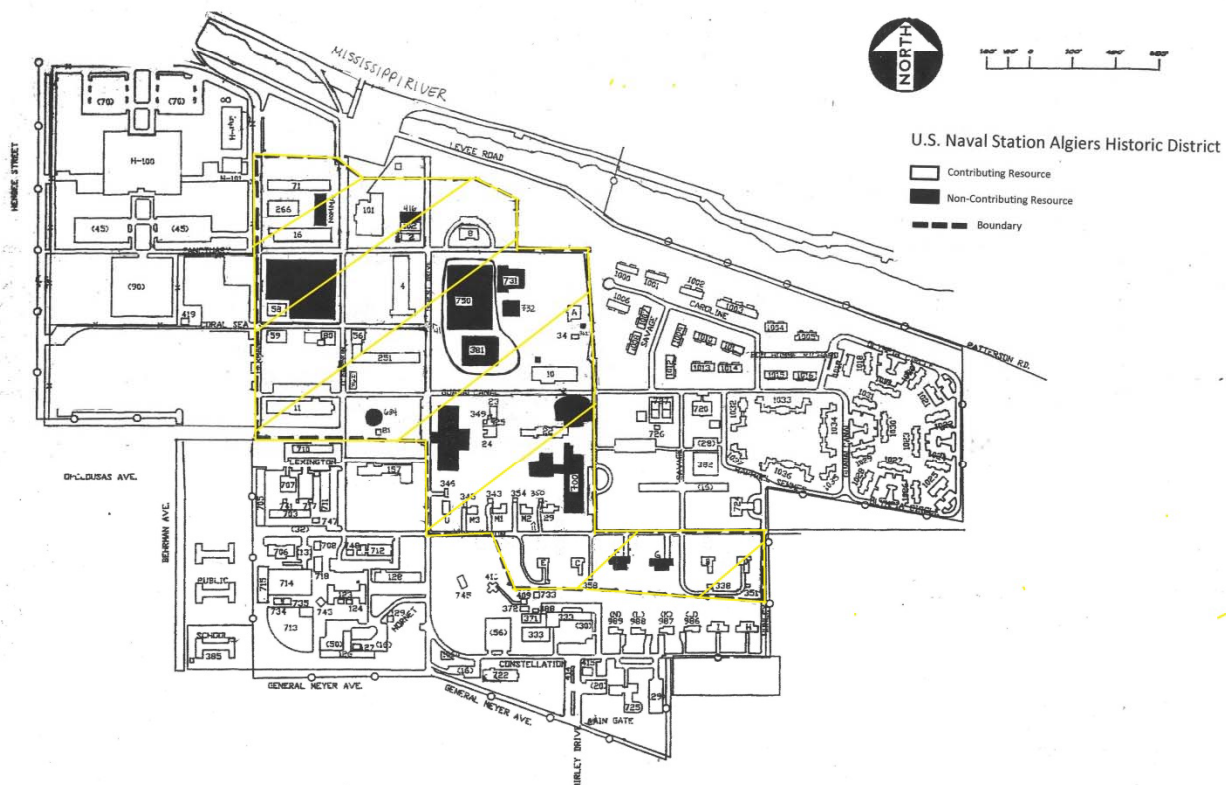
Existing Floor Plans – Bldg 16



Proposed Floor Plans – Bldg 16



CHS Status for the Buildings



Presenters



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