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IRS Explains Sandwich Lease Prohibition in Rehab Tax Credit Safe Harbor.

The prohibition on so-called sandwich leases contained in the safe harbor revenue procedure for section 47 historic rehabilitation tax credit deals applies even when the leaseback is for less than all of the building, Joseph Worst, branch 3 attorney, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), said March 20.

Section 4.02(2)(c) of Rev. Proc. 2014-12 provides that "a sublease agreement of the building from the master tenant partnership back to the developer partnership or to the principal . . . will be deemed unreasonable unless the sublease is mandated by a third party unrelated to the principal." The guidance adds that "the terms of a sublease agreement of the building by the master tenant partnership to any person will be deemed unreasonable unless the duration of the sublease is shorter than the duration of the head lease." (The revised Rev. Proc. 2014-12, 2014-3 IRB 1 was issued January 8. The original Rev. Proc. 2014-12, 2014-3 IRB 415 was issued December 30.)

Speaking on his own behalf at an Institute for Professional and Executive Development conference in Washington cosponsored by Nixon Peabody LLP and CohnReznick LLP, Worst said the government tried to draw a bright line in the guidance where sandwich leases were concerned. "Even if the lease of the building is of less than half the building . . . you can't do that, whether it's all of the building or less than all of the building," he said. "That being said, I would say that if the partners can show that there are actual economics to the deal, you might not be in the safe harbor, but I don't think Exam would try to audit that kind of a case as long as there are economics."

The revenue procedure came about because the decision against the taxpayer in the *Historic Boardwalk Hall* case scared investors off of deals involving the section 47 historic rehab tax credit. (*Historic Boardwalk Hall LLC v. Commissioner*, No. 11-1832 (3d Cir. 2012).)

Forrest Milder of Nixon Peabody said the facts in *Historic Boardwalk* were worse for the taxpayer because the investor didn't care if the deal went well or not. The investor was entitled to get a certain amount of cash and tax credits no matter how successful or unsuccessful the project.

The Third Circuit determined that the investor in Historic Boardwalk wasn't a bona fide partner. "*Historic Boardwalk Hall* bears a lot of resemblance to the transactions that we typically do. It's just that this one was really, really locked up," Milder said.

In a February 14 letter responding to an inquiry from Connecticut Gov. Dan Malloy (D), Mark Mazur, Treasury assistant secretary for tax policy, wrote that Treasury officials "are confident that the safe harbor described in the revenue procedure will facilitate the resumption of" projects that utilize the section 47 historic rehabilitation tax credit.

Milder wasn't as optimistic about the impact of the guidance. "There are pending audits right now. Many of the large investors have one or more audits pending," he said. "Notwithstanding that there is a safe harbor, it can be hard to go to your boss and say, 'We should do more of these.'"

Craig Gerson, attorney-adviser in the Treasury Office of Tax Legislative Counsel, speaking on his own behalf, said that the historic rehabilitation industry "has a leg up now because they have a safe harbor set of rules that they can look to." He added, "I don't know what to tell investors in this area aside from this is just the world that we occupy. When you do deals that have a tax element, there's a level of subjective risk involved, and your deals have less subjective risk than most, which should make you more likely to do the deals."

Separate Agreements

Milder explained that probably 95 percent of section 47 historic rehab tax credit deals involve an element called a lease passthrough structure, in which the tax credit gets passed to the master tenant while the depreciation deductions stay with the property owner.Section 4.01 of the safe harbor provides that an investor can't invest in both the master tenant partnership and the developer partnership "other than through an indirect interest" unless there's "a separately negotiated, distinct economic arrangement."

Milder said that there's been a lot of discussion about how this provision affects the new markets tax credit world, where investors typically make both investments — one on the historic master tenant side and one ultimately on the developer/landlord side — together. "How can they demonstrate that there were two separate arm's-length investments?" he asked. "People are very interested in this whole separateness concept."

"What the rev. proc. requires is simply that they are two separate economic deals," Gerson said. While the parties may see the project as a dual investment opportunity, "we want the investment for each component of it to be separately determined." He likened the requirement to an individual trading in his old car for a new car. The government wants the sale of the old car to be a separate negotiation from the purchase of the new car.

Investor's Partnership Interest

The rehab tax credit safe harbor requires a minimum partner interest of 1 percent for the principal and 5 percent for the investor. It also states — albeit in a convoluted way — that the investor's interest can't flip to less than 5 percent of what it was in its highest year, Milder said.Section 4.02(2)(b) of the guidance provides that the investor's interest "must constitute a bona fide equity investment with a reasonably anticipated value commensurate with the investor's overall percentage interest in the partnership, separate from any federal, state, and local tax deductions, allowances, credits, and other tax attributes to be allocated by the partnership to the investor."

Milder said that when practitioners first read this they were concerned that the government was requiring that the investor show profit motive because the value of the interest didn't take into account tax benefits.

"We understand that the credits and other tax attributes are a key part of the deal and that partners may not have a profit potential without taking them into account," Gerson said. "What we're really after there is that we don't want [the value of the investor's interest] to be winnowed down through the use of unreasonable fees or lease terms orany of the myriad other artificialities that we saw at use in, for example, *Historic Boardwalk*."

Gerson added that the requirement in section 4.02(2)(b) couples with the requirement in section 4.02(2)(c), which provides that "the value of the investor's partnership interest may not be reduced through fees, . . . lease terms, or other arrangements that are unreasonable . . . and may not be reduced by disproportionate rights to distributions or by issuances of interests in the partnership . . .

for less than fair market value consideration."

"If you comply with (2)(c), you should generally get to (2)(b) in a fairly natural way," Gerson said.

Milder said most people who do historic rehab tax credit transactions are used to the notion of a cash-on-cash return where — if it's 3 percent on an investment of $1 million, the investor would get back $30,000 per year. He said such a return has the potential to look like interest.

"I would not say that a 3 percent preferred yield could not be within the parameters of the safe harbor," Gerson said. "But the 3 percent yield in *Historic Boardwalk* was not contingent upon the partnership's net income, gain, or loss. It was, in fact, substantially fixed in amount. So the preferred yield should be contingent upon income — the performance of the partnership. And if I'm sitting in your shoes, the safer route is probably what I would call a common interest rather than a preference."

Worst said that the Service didn't include a bright-line rule providing that — for example — the investor receive a 3 percent return on its investment because "there's a myriad of different kinds of investments out there, and some may be able to get 3 percent and some may not. And I don't think we wanted to exclude those deals that could not."

"A lot of people have taken the safe harbor as a wonderful thing perhaps for poorer projects," Milder said, given that the revenue procedure doesn't have a profit motive requirement.

Gerson said the lack of a profit motive requirement was by design because the government wanted the safe harbor to be as objective as possible. "Pinning our safe harbor on something as subjective as taxpayer intent does not make for easy living for either taxpayers or examiners," he said. "We've tried to structure a safe harbor in which we require that people are all acting at arm's-length with each other, and I think that the profit motive will take care of itself through there."

Milder said Faith Colson, branch 1 senior counsel, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), refers to the requirement in section 4.02(2)(c) as the "no monkey business" test. Milder said a cottage industry has sprung up in the marketplace to produce reports establishing that development and other fees are reasonable.

"Those of us rendering tax opinions read these reports and are not quite sure what to make of them" given that, among other things, it's hard to find comparables, Milder said.

Gerson said taxpayers that commission such reports aren't necessarily any better off than taxpayers that don't. "Your ability to rely on the safe harbor is as good as the strength of your report," he said. "At the end of the day, people will have to make their own determinations on this." Gerson said that the most useful guidepost is to ask whether the fee strips out the upside or downside potential of the deal.

by Amy S. Elliott