



## Memo

DATE: DECEMBER 5, 2018

TO: MILWAUKEE COUNTY

FROM: NATIONAL TRUST FOR HISTORIC PRESERVATION

CC: MILWAUKEE PRESERVATION ALLIANCE

RE: USAGE OF HISTORIC TAX CREDITS AT MITCHELL PARK DOMES

The attached Memorandum from Nixon Peabody LLP examines the feasibility of utilizing federal rehabilitation tax credits (HTCs) as a funding source for rehabilitation of the Mitchell Park Horticultural Conservatory (the Domes).

Nixon Peabody is a global law firm with a Community Development Finance practice that is one of the largest and foremost legal authorities in transactions involving tax credit financing. They prepared this Memorandum at the request of the National Trust for Historic Preservation as part of the Trust's National Treasure advocacy campaign in support of a preservation solution for the Domes.

Key takeaways from Nixon Peabody's memo and their potential impact on the Domes are summarized below.

### **It may be possible to utilize federal HTCs to help fund rehabilitation of the Domes.**

- If the project is structured correctly and with the guidance of experienced tax credit attorneys, rehabilitation of the Domes may be eligible for federal HTCs. Federal HTCs provide a tax credit of 20% of qualified rehabilitation expenditures (QREs). The rules governing the HTC set out circumstances under which such projects are and are not eligible.
- Federal HTCs may be combined with other financing or tax incentives, including debt financing from private and public sources, federal new markets tax credits for projects in certified low-income communities, and Wisconsin state historic tax credits. Wisconsin HTCs also provide a 20% tax credit of QREs for rehabilitating certified historic structures. Further analysis on the feasibility of utilizing Wisconsin HTCs and/or federal New Markets Tax Credits is needed; this Memorandum does not analyze the applicability of these funding sources. However, it should be noted that the Domes are located in an eligible census tract for federal New Markets Tax Credits.

**There are many examples of government-owned properties around the country that have successfully utilized Historic Tax Credits to support large rehabilitation projects.**

- One recent example is the \$228 million rehabilitation of Cincinnati's Union Terminal, which utilized Federal and State HTCs. Union Terminal is owned by Hamilton County and the City of Cincinnati, and operated by the Cincinnati Museum Center, a multi-museum complex including the Cincinnati History Museum, the Cincinnati History Library and Archives, the Duke Energy Children's Museum, the Museum of Natural History & Science and the Robert D. Lindner Family OMNIMAX® Theater.
- In addition to federal and state HTCs, the rehabilitation of Union Terminal also utilized \$175 million from a voter-approved five-year quarter-cent sales tax increase in Hamilton County, along with significant private philanthropy.

**Federal HTCs could provide several million dollars of project equity, depending upon the total rehabilitation cost.**

- HTCs provide a tax credit of 20% of QREs for rehabilitating certified historic structures. For instance, if QREs are around \$20-\$30 million (based upon Domes Task Force Phase 1 Feasibility Study cost estimates for addressing deferred maintenance issues), usage of federal HTCs could provide \$4-\$6 million in project equity. Eligible costs include almost all work to the inside and the outside of the historic building except movable equipment, and also include soft costs like architectural and engineering fees. Other ineligible costs include landscaping, paving, and new additions.
- Since 1976, federal tax incentives for historic rehabilitation have been used for thousands of projects, raising billions of dollars in equity for such projects.

**Federal HTCs would likely not be available if one or more Domes are demolished, partially demolished, or rebuilt.**

- To utilize the credits, the Domes would need to be listed in the National Register of Historic Places, maintained by the National Park Service (NPS). The Wisconsin State Historic Preservation Office (SHPO) has already determined that the Domes are eligible for listing. National Register listing is primarily an honorary designation. In and of itself, National Register listing would not prevent demolition of the Domes now or in the future.
- To be eligible for HTCs, rehabilitation work must be "certified" by the NPS, meaning that the project would need to respect the Domes' "character-defining features" and follow the Secretary of the Interior's Standards for the Rehabilitation of Historic Properties. Project architects would work closely with the SHPO and NPS to ensure the rehabilitation design meets these standards.
- Demolition of one or more Domes would likely render the Domes ineligible for

listing on the National Register and thus ineligible for federal HTC. Complete reconstruction of one or more Domes would also not be eligible for federal HTCs. Any work on the Domes Annex (Greenhouse) would not be eligible, since that structure is not historic.

- If the HTCs were used, there is a 60-month recapture period during which changes to the Domes that violate these historic preservation standards could trigger a recapture of any HTCs claimed.

**Public-private partnerships would be necessary in order for the County to take advantage of the Federal HTCs.**

- The Domes would likely not be eligible for HTCs if Milwaukee County undertakes the rehabilitation itself, because government-owned property is generally not eligible.
- However, if the County leased the Domes to another entity, HTCs could be available if the lease is structured correctly. The lease would generally need to be long-term (generally, at least 55 years) and pass the burdens and benefits of ownership. The actual lessee would need to be a for-profit entity in order to take full advantage of the HTC, but the for-profit could be a subsidiary of a non-profit entity if certain conditions are met. Whether the County itself (versus other nonprofits) could form such a subsidiary is a question that requires further research.
- For example, the County could lease the Domes to an unrelated non-profit organization, which would then create a for-profit subsidiary to undertake the rehabilitation and operate the rehabbed Domes facility. In order to utilize the HTCs, the for-profit subsidiary would need to make a “Section 168(h) election,” meaning that net income and gain from the project (if any) received by the non-profit parent entity would be subject to federal income tax.
- This type of arrangement is regularly done on rehabilitation projects. Legal counsel experienced with HTCs would advise on how to ensure the project is structured properly in accordance with all applicable rules.
- In order to successfully structure an HTC transaction, project funding must ultimately be received by the for-profit lessee referenced above, generally as cash equity, other capital contributions, or loans. Grants or forgivable loans generally cannot be made directly to the for-profit entity. Again, this is commonly done on tax credit projects including low-income housing tax credit projects (LIHTC).
- In order to “monetize” federal HTCs as a source of construction finance, the credits can be syndicated to an HTC investor. Typically, the investor would provide a cash equity contribution, which can be used to pay for construction, in exchange for HTCs and other project economics. These HTC leasing and syndication structures can typically be unwound after the end of the 60-month recapture period, with the agreement of the HTC investor.



## MEMORANDUM

**TO:** National Trust for Historic Preservation      **FROM:** Andrew S. Potts  
**RE:** Milwaukee Domes HTC Questions      **DATE:** December 5, 2018

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### Summary

At your request, we reviewed certain questions bearing on the feasibility of utilizing the federal rehabilitation tax credit (the “HTCs”)<sup>1</sup> provided for under Section 47 of the Internal Revenue Code (the “Code”) in connection with a possible future substantial rehabilitation (the “Project”) of the structures known as the Mitchell Park Horticulture Conservatory Domes (the “Domes”). The Domes are located at 524 South Layton Boulevard in the city of Milwaukee, County of Milwaukee, Wisconsin. We understand that the Domes and the land on which they are situated (collectively, the “Property”) are currently owned by Milwaukee County (the “County”), a political subdivision of the State of Wisconsin. We have assumed for purposes of this Memorandum that fee simple state law title to the Domes and the Project will remain with the County.

As with many federal tax incentives, the HTC is governed by a multi-tiered set of rules. This memorandum does not seek to address all issues that may be relevant under these rules. Rather, this Memorandum is focused on the basic question of whether the ownership and potential future use of the Domes by a tax-exempt entity like the County, in and of itself,

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<sup>1</sup> The term “Historic Tax Credit” is actually not used in the Code. The Code refers to this credit as the Rehabilitation Credit, sometimes shortened to “RTC”. This credit is nonetheless commonly referred to as the federal Historic Tax Credit or HTC, and this memorandum follows that custom.

precludes utilizing the HTC in connection with the Project. Specifically, this Memorandum addresses the following questions:

1. If the County were to undertake the Project itself (that is, be the owner of the rehabilitation for federal tax purposes), would the Project be eligible for HTCs? We conclude that the answer is “no” because government owned-property is generally not eligible for the HTC.
2. If the county were to lease the Domes to another entity, which undertook the Project, could the lessee be eligible for HTCs in connection with the Project? We conclude that while lessees of government-owned property are also generally not eligible to claim HTCs, HTCs can be available if the purported lease passes all the “benefits and burdens” of ownership to the named lessee such that the lease is required to be re-characterized as a sale of property for federal income tax purposes.
3. If the County, as lessor, were to lease the Domes pursuant to a lease that passed all the burdens and benefits of ownership as described in Question 2, could the County be a direct or indirect owner or manager of this lessee? While the County could not be the lessee under such a lease, if the lessee were a “pass-through entity” such as a partnership, the County could hold a minority ownership interest (including a managing member interest) in such a lessee but this would reduce the amount of HTCs otherwise available by the proportionate share of the County’s interest.
4. Is there a way for the County (or any other unit of government or instrumentality thereof) to be an indirect owner of the lessee without reducing the amount of HTCs otherwise available? While the Code does provide a means for certain tax-exempt entities to indirectly hold interests in entities such as the lessee described above without reducing the amount of HTCs otherwise available, it is not clear if this option is available to governmental units like the County. This question would require further research.
5. Same question as Question 4, but instead of the County, could a tax-exempt entity that is not deemed a governmental unit (or instrumentality thereof) hold an

ownership interest in such a lessee without reducing the amount of HTC's otherwise available? Yes, particularly if the tax-exempt entity held its interest through a for-profit affiliate that properly made a Section 168(h)(6) Election. If those requirements are met, it could be possible for such a tax-exempt entity to indirectly own an interest in the County's lessee.

6. If the County, as lessor, were to lease the Domes as described in Question 2, and that lessee rehabilitated and operated the Domes, could the County sublease back the rehabilitated Domes from the lessee without reducing the amount of HTC's otherwise available? Any sublease by the County (or any other unit of state or local government or instrumentality thereof) would likely be a disqualified lease under the Code and that would reduce the HTC's available but only if that sublease (together with any other so-called disqualified leases) collectively demised more than 50% of the relevant net rentable square footage. The County could sublease less than this amount without reducing the HTC's.

It is worth noting at the outset that, while the issues presented can be complex, they are not novel, and that transferees of government-owned buildings regularly utilize the HTC as part of historic rehabilitation projects.

### **Factual Background**

We understand that the County is the original user of the Domes. The land on which the Domes are situated was previously owned by the City of Milwaukee. In conjunction with the consolidation of parks in 1937, the relevant land was transferred from the City of Milwaukee to the County. A deed restriction in favor of the City provides that the land must forever be used as a park. Construction of the Domes by the County began in 1957 and was completed in 1967.<sup>2</sup> The Domes consist of a series of conoidal domes or "egg-shaped" domes. The domes are 85

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<sup>2</sup> Some HTC tests must be applied separately to each physical building, as that term is defined by the Internal Revenue Service. The IRS definition of what constitutes a building may differ from that of the National Park Service. At this juncture, Nixon Peabody has not analyzed whether the Domes would be viewed by the IRS as constituting one or more buildings.

feet high and 140 feet wide. By letter dated April 16, 2016, the Wisconsin Historical Society indicated its belief that the Domes may be eligible for listing on the National Register of Historical Places.<sup>3</sup>

The Domes are currently operated by the County as part of the Mitchell Park Horticulture Conservatory. The County is finalizing an agreement with Grandview Management (Catering and Events) for an initial term of 10 years for a new operating agreement. The County also has an agreement with the Winter Farmers Market operated by the Fondy Food Center for a farmer's market at the Domes for the winter season for 2018/2019. Finally, Friends of the Domes, a nonprofit support group, sells memberships which allows free admission to the Domes. The Friends of the Domes group operates the gift shop and has offices in the Domes building. In 2017, the County's revenue from the Domes was \$873,300, including \$750,700 from admissions with the balance from restaurant, space rental, commissions and donations. Expenses were \$1,753,800 with the difference (\$880,550) coming from County funds.

### **Rehabilitation Tax Credit Overview**

The HTC is one of the investment tax credits provided for in section 38 and 50 of the Internal Revenue Code ("Code"). HTC-specific rules are set out in section 47 of the Code. In general, these rules provide for an income tax credit (that is, the HTC) equal to 20% of the "qualified rehabilitation expenditures" ("QREs") incurred in connection with the "substantial rehabilitation" of a "certified historic structure." QREs are generally defined as the development costs incurred in connection with the rehabilitation of an eligible project that are properly includible in computing the basis of real property, less certain statutorily excluded

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<sup>3</sup> We understand that construction of a new 65,000-square-foot new County Greenhouse complex has been completed (located on the South/Southeast side of the complex) The 65,000-square-foot complex features seven greenhouses and are connected via a door next to the Tropical Dome. We have assumed for purposes of this memo that the County Greenhouse complex is not a part of the certified historic structure.

costs.<sup>4</sup> QREs can include both “hard” costs and “soft” costs like architectural and engineering fees.

In addition to the requirement that the building be a certified historic structure, in order to be eligible for HTCs the rehabilitation of the building must be certified by the Secretary of the Interior (acting through the National Park Service) as being consistent with the historic character of the building. The relevant property must meet the Code’s definition of “section 38 property.”<sup>5</sup> Several aspects of this test are relevant to the questions presented in this Memorandum and are discussed in greater detail below.

Congress designed the HTCs to stimulate capital investment in income-producing historic and older buildings and the revitalization of communities. The HTC is subject to a 60-month recapture period during which time certain “dispositions” can cause the IRS to take HTC away from the partner who has claimed them. The IRS may also “disallow” HTCs if they were claimed in a manner that does not comport with tax requirements.

Project sponsors often wish to “monetize” the HTC as a source of construction finance. HTCs cannot be sold but they may be syndicated. Syndication typically involves holding ownership of the rehabilitated property in a pass-through entity (i.e., a partnership or limited liability company [LLC]); admitting an investor (the “HTC Investor”) to that entity; and allocating to that investor all or most of the HTCs as well as project economics in exchange for a cash equity contribution.<sup>6</sup> This cash equity is sized with reference to the value of the HTC, cash and other benefits passed through to the investor. Most of this cash is typically available to pay for construction. The HTC rules provide that an investor is allocated HTCs according to its profits interest in the entity that incurs the QREs. Thus, in the basic form of syndication

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<sup>4</sup> Examples of excluded costs are costs of acquisition and enlargements to the historic building. See Treasury Regulation 1.48-12(c)(7). Expenditure for “facilities related to a building” like sidewalks, parking lots and landscaping are expressly not treated as QREs. 1.48-12(c)(5).

<sup>5</sup> This includes the requirement that the portion of the basis which is attributable to QREs be property with respect to which depreciation (or amortization in lieu of depreciation) is allowable to the taxpayer.

<sup>6</sup> Key aspects of HTC syndication were addressed extensively by the IRS in Revenue Procedure 2014-12 which created a “safe harbor” for qualifying HTC syndication transactions.



transactions, investors typically acquire a 99% interest in the entity that owns (or is deemed to own) the property with the project sponsor/developer having management control and a 1% interest.

Section 50(d) of the Code includes a commonly-used provision that makes possible an alternate approach to HTC syndication known as the “credit pass-through lease” structure. Under this structure, an owner entity amasses construction sources, hires the general contractor and undertakes the rehabilitation of the structure (just as above). Rather than operating the building itself, this entity then enters into a lease (commonly known as a “Master Lease”) of the rehabilitated building with another limited liability company (the “Master Tenant”). The term of the Master Lease is governed by the Code, which generally requires a length of at least 32 years (although other periods are possible). The owner entity makes a one-time election permitted under the Code to pass-through to the Master Tenant the benefit of any HTCs it has earned. The HTC Investor becomes a member of the Master Tenant and shares in the HTCs and project economics at that level.

In this approach to syndication, the Master Tenant will operate the building, including entering into any operator/management agreements and leases with end-user lessees of the rehabilitated building (e.g. a restaurant tenant). It is typically responsible for paying operating costs. Some reserves may be held at this level and the Master Tenant will have other assets like rent receivables from end-user tenants. The annual rent under the Master Lease moves most of the projected net income of the project from Master Tenant to the Owner entity (less fees and certain other amounts paid at the Master Tenant level).

The HTC Investor and the project sponsor often enter into a Put Option Agreement pursuant to which the Investor has the right to “put” (that is, require a counter-party to purchase) its interest in the project and exit the transaction at a later date (typically upon the elapse of the 60-month recapture period).

## Questions Presented and Analysis

*Question 1: If the County were to undertake the Project itself (that is, be the owner of the rehabilitation for federal tax purposes), would the Project be eligible for HTC's?*

*Answer: We conclude that the answer is “no” because government-owned property is generally not eligible for the HTC.*

HTCs can only be claimed by the entity that owns the QREs (or is treated as owning the QREs). This would typically be the entity that has the ultimate obligation for paying for the QREs. Generally, it is this “owner” entity that hires the general contractor, the architect and other professionals (although sometimes this entity enters into a development agreement with another entity that contracts for these services and then is reimbursed by the relevant owner). The Internal Revenue Code and the accompanying Treasury Regulations contains a comprehensive set of rules designed to limit the extent to which HTCs can be claimed on property that is owned or used by a “tax-exempt entity.” For purposes of these rules, the term “tax-exempt entity” generally includes, among other things, U.S. and State political subdivisions, agencies and instrumentalities as well as tax-exempt organizations (e.g. nonprofits like so-called “501(c)(3) corporations”), although in some cases the rules applicable to political subdivisions differ from those applicable to other types of tax-exempt entities.

Of particular note is Treasury Regulation 1.48-1(k) (the “1964 Regulation”) which relates to the definition of section 38 property. In general, to be a QRE (that is, property on which HTCs can be claimed), property must meet the definition of Section 38 property. The regulation, adopted in 1964,<sup>7</sup> provides that Section 38 property “does not include property used by the United States, any State (including the District of Columbia) or political subdivision thereof,” (*emphasis added*). It further provides that the term “property used by the United States, etc.” means property “owned by any such governmental unit ...”.

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<sup>7</sup> The Treasury Regulations in question were adopted in 1964, T.D. 6731, 29 FR 6073, May 8, 1964.

Almost 20 years after the IRS adopted Treasury Regulation 1.48-1(k), language now found in Section 50(b)(4) of the Code (and formerly found in Section 48(a)(5)) was added to the Code. This law expressly provides that no Historic Tax Credit is available with respect to any property “used (i) by ... any State or political subdivision thereof, ... , or any agency or instrumentality of any of the foregoing, ...” This Code section appears to codify aspects of the 1964 Regulation.

*Question 2: If the county were to lease the Domes to another entity, which undertook the Project, could the lessee be eligible for HTCs in connection with the Project?*

*Answer: We conclude that while lessees of government-owned property are also generally not eligible to claim HTCs, HTCs can be available if the purported lease passes all the “benefits and burdens” of ownership to the named lessee such that the lease is required to be re-characterized as a sale of property for federal income tax purposes.*

Treasury Regulation 1.48-1(k), discussed above, states that Section 38 property does not include property owned by governmental units. What about property leased from units of government? The Regulation actually goes on to expressly address this question:

The term “property used by the United States, etc.” means (1) property owned by any such governmental unit (whether or not leased to another person), and (2) property leased to any such governmental unit. ... Property leased by another person to any such governmental unit or leased by such governmental unit to another person is not section 38 property to either the lessor or the lessee, ...

Thus, the clear import of the 1964 Regulation is that expenditures made to property owned or used by units of government, including leased property, is not eligible for the HTC.

As noted above, Code Section 50(b)(4) – adopted almost 20 years after the IRS adopted Treasury Regulation 1.48-1(k) – contains a prohibition similar to that found in the Regulation. However, Section 50(b)(4)(C) goes on to provide an exception not found in the 1964

Regulation. This exception applies if "any qualified rehabilitated building is leased to a governmental unit . . . ." (*emphasis added*). Notwithstanding the 1964 Regulation, this exception would appear to allow a taxable entity to claim HTC's on property it rehabilitates even if that property is then leased to a governmental unit.

Because the Code's exemption language addresses only leases to the government,<sup>8</sup> Section 50(b)(4), read in combination with Treasury Regulation 1.48-1, has been understood to mean that property leased from units of government remains ineligible for the HTC.<sup>9</sup> As a result, it seems likely that were the County to lease the Domes to another party (within the IRS's definition of a lease), as with the County itself, rehabilitation work undertaken by the lessee would not be eligible for HTC's.

This analysis does not end the inquiry however because certain leases are not respected as such and must be re-characterized as a sale for federal income tax purposes. In these cases, an agreement labeled as a lease, and treated as leases for state law purposes (and even other federal purposes), is not treated as such for federal income tax purposes. Such a lease is sometimes referred to as a "lease that passes tax ownership." If the "lease" in question passes tax ownership then the transaction will be characterized as a sale for tax purposes, in which case

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<sup>8</sup> The language of Section 50(b)(4) relating to government leases, should be contrasted with the language used in Section 50(b)(3), which applies to property used by certain tax exempt organizations (other than governmental units). The section 50(b)(3) limitation is worded differently from the one in 50(b)(4). It permits the credit to be claimed where the QREs are "used by the tax exempt organization pursuant to a lease." (*emphasis added*). It is widely perceived that the governmental exception, with its specific reference to property leased "to a government," is not as favorable an exception as the tax-exempt exception with its reference to "property used ... pursuant to a lease."

<sup>9</sup> More general rules found elsewhere in the Code govern when a lessee may claim HTC's on its leasehold improvements. Specifically, Section 47(c)(2)(B)(vi) of the Internal Revenue Code provides that a lessee is entitled to claim HTC's on QREs that the lessee incurs in connection with leasehold improvements if the remaining term of the lessee's lease (determined without regard to renewal periods) is greater than the property's recovery period for depreciation (i.e., 27.5 years for residential rental property and 39 years for nonresidential real property under current law). See also Section 1.48-12(c)(7)(v) of the Treasury Regulations. Even where a lease meets these requirements, Section 50(b)(4) would seem to bar HTC's where the lessor is a governmental unit.

the lease prohibitions discussed above do not come into play, and the QREs may be eligible for the HTC.

### Leases That Pass Tax Ownership

It should be noted that the IRS interpretation of these rules has not been as clear as we might hope. The issue of a lease from a governmental landlord to a tenant seeking to claim HTC on leasehold improvements was, however, directly addressed in a Private Letter Ruling issued by the IRS in 1986.

In Private Letter Ruling 8641024 (the “PLR”), the IRS ruled that where property was owned by a municipality and leased to a limited partnership for a term, with “two renewal options” that was “substantially in excess” of the useful life of the property, the lessee could claim the HTC on its QREs. It should be noted that the IRS analysis is a bit muddier than that; it notes at one point that the lease term was longer than 19 years, which was the depreciable recovery period for real estate at the time, and it also discusses the legislative history related to use by tax-exempt entities in its analysis. In particular, the IRS noted that the legislative history of the Tax Reform Act of 1984 reflected the intent of Congress that improvements constructed by taxable lessees qualify for the investment tax credit notwithstanding the tax exempt status of the lessor. The committee reports at the time of such tax legislation state that: "Tax exempt use property does not include improvements constructed by a taxable entity on underlying land or other property leased from a tax exempt entity merely because the tax exempt entity is the owner of the land or other property." H. Rep. No. 98 432, Part 2, 98th Cong., 2d Sess. 1147(1984); S.Prt. No. 98 169, 98th Cong., 2d Sess. 132 (1984).

Of course, a private letter ruling is directed only to the taxpayer who requested it and may not be used or cited as precedent by other taxpayers. Taxpayers who intend to rely on the rationale of this ruling should attempt to structure their transaction in a manner which matches the fact situation described in the ruling to the greatest extent possible. With that in mind, the tax credit community has focused on the statement in the PLR that the term of the lease was “substantially in excess” of the useful life of the property. While “substantially in excess” is

not defined in the PLR or in other case law, tax advisors have found this phrase to be consistent with lease terms of 50 years and more, or even 75 years, so that they can conclude that the transaction called a “lease” for local law purposes is more properly characterized as a sale for federal income tax purposes, and not even subject to this leasing analysis.

### What is Required for Lease to Pass Tax Ownership?

Private Letter Ruling 8641024 must be read in context with a long line of cases and rulings over the years addressing which entities will be treated as the owner of real estate for federal income tax purposes. Most of the reported authority concerning tax ownership has involved leasing transactions, the re-characterization of sale-leaseback transactions as disguised financing arrangements and “timing” cases (where the issue is not whether a change in ownership has occurred but when such change occurred). These precedents have generally established that where a party is viewed as bearing all of the benefits and burdens associated with ownership of the improvements, then (notwithstanding the characterization of the party’s interest for local law purposes as that of a lessee under a lease), for federal income tax purposes, that entity will be viewed as the owner of improvements (rather than as a lessee of such improvements). This is what is meant by a lease that passes tax ownership.

As the PLR indicates, a key issue as to whether a lease will be viewed as passing tax ownership (i.e. re-characterized as a sale) is the term of the lease. While there is no “bright line” test for determining when a taxpayer will be deemed to own real estate for federal income tax purposes, in one revenue ruling, Rev. Rul. 70-607, 1970-2 CB 9, the IRS adopted a 75-year period as consistent with a lease of a building and land being a sale of the building and a lease of only the land for federal income tax purposes. Accordingly, there is generally consensus among the tax bar that a term of more than 75 years exceeds the useful economic lives for the improvements, so that the lessee can claim the HTC associated with its QREs, even where the lessor is the government. And, for the reasons discussed above, leases as short as 55 years, while subject to greater scrutiny, have also been viewed as acceptable.

Lease term is not, however, the only relevant factor. The reported decisions have articulated a number of tests for determining tax ownership of real estate, including (i) whether, under state law, title or “equitable title” has passed to the purchaser, (ii) whether the facts and circumstances indicate that the parties intended the transaction to be treated as a sale, (iii) whether the purported buyer of real estate is unconditionally obligated to pay the purchase price in a deferred payment transaction, (iv) whether sufficient benefits and burdens of ownership have passed from the seller to the buyer, (v) whether, based on an analysis of all “relevant factors,” the buyer has acquired sufficient characteristics of tax ownership, and (vi) whether either title or the benefits and burdens of ownership has passed. See, e.g., Dettmers v. Commissioner, 430 F.2d 1019 (6th Cir. 1970). An example of a common leasing provision that implicates these issues is the allocation of proceeds as between the landlord and the tenant in the event of a casualty or condemnation.

*Question 3: If the County, as lessor, were to lease the Domes pursuant to a lease that passed all the burdens and benefits of ownership as described in Question 2, could the County be a direct or indirect owner or manager of this lessee?*

*Answer: While the County could not be the lessee under such a lease, if the lessee were a “pass-through entity” such as a partnership, the County could hold a minority ownership interest (including a managing member interest) in such a lessee but this would reduce the amount of HTC’s otherwise available by the proportionate share of the County’s interest.*

As the foregoing discussion points out, HTC’s can be available with respect to property leased from the government if the purported lease passes all the “benefits and burdens” of ownership to the named lessee. Even then, though, the deemed owner (that is, the lessee) must itself also be the kind of entity eligible to own property on which HTC’s are allowed. The simplest case is where the lessee is an individual or a for-profit corporation owned by individuals. Often, however, the government unit that is the lessor will also want to have an ownership interest in the lessee. It is the lessee that will typically undertake the rehabilitation and also manage and operate the rehabilitated property.

A unit of government such as the County may not be the named lessee under such a lease any more than it could have been the lessor. If the lessee were a “pass-through entity” such as a partnership, however, the County could hold a minority ownership interest (including a managing member interest) in such a lessee. In other words, the County could be a minority partner in the partnership that acts as the lessee under the lease passing tax ownership given by the County to the partnership.

Note, however, that the direct presence of the County in the lessee-partnership would reduce the amount of HTC's otherwise available by the proportionate share of the County's interest in such a partnership. This result is dictated by a special rule provided for in Code Section 50(b)(4)(D). This provision applies rules found in Section 168(h)(5) and (6) to the restrictions of Section 50 discussed above, with the result being that the Section 50 restrictions are made to apply not only to properties used by tax-exempt entities but also to properties used by pass-through entities like partnerships that have both tax-exempt partners and partners that are not tax-exempt.<sup>10</sup>

This interplay of Section 50 and Section 168(h) works as follows: Section 168(h) creates the concept of “tax exempt use property,” and you cannot claim HTC's on tax exempt use property. Section 168(h)(5) defines when property leased by a partnership which has both tax-exempt and non-tax-exempt partners will be considered “tax exempt use property.” In general, if any property that is not otherwise treated as tax exempt use property is owned by a partnership that has both tax exempt and taxable partners, the “proportionate share” of the property allocated to the tax exempt partners will be treated as tax exempt use property unless the allocations of partnership items to the tax-exempt partner constitute “qualified allocations”<sup>11</sup> or unless such portion of the property is predominantly used by the tax exempt partner or partners, through the partnership, in an unrelated trade or business the income from which is

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<sup>10</sup> The Provision, entitled “Special Rules for Partnerships, Etc.,” states that “[f]or purposes of [the rules disallowing HTC's on property used by Tax-Exempt Organizations and Governmental Units], rules similar to the rules of paragraphs (5) and (6) of section 168(h) shall apply.”

<sup>11</sup> For reasons which are beyond the scope of this Memorandum, there is some uncertainty as to whether and how to achieve qualified allocations.



subject to taxation under Section 511 of the Code. Any portion of the partnership's property that is determined to be tax-exempt use property under these rules will not be eligible for the HTC.

The foregoing provisions are not technically triggered by a lease that passes tax ownership since such an instrument is treated as a sale and not a lease for tax purposes. However, the import of Section 50(b)(4)(D) is that property that would be defined as tax exempt use property were Section 168(h) to apply will -- to a similar extent -- be precluded from HTCs by Section 50(b). Thus, while it is possible for the County (or any other tax-exempt entity) to directly own an interest in the lessee, that arrangement would result in a reduction in the overall amount of HTCs that otherwise would be available.

*Question 4: Is there a way for the County (or any other unit of government or instrumentality thereof) to be an indirect owner of the lessee without reducing the amount of HTCs otherwise available?*

*Answer: While the Code does provide a means for certain tax-exempt entities to indirectly hold interests in entities such as the lessee described above without reducing the amount of HTCs otherwise available, it is not clear if this option is available to governmental units like the County. This question would require further research.*

Section 168(h)(6) does provide an option for certain tax-exempts to own interests indirectly in entities participating in HTC transactions (including entities like a lessee of the County under a lease that passed all the burdens and benefits of ownership) without reducing the amount of HTCs otherwise available, but it is not clear if this option is available to governmental units like the County. This question would require further research.

To take advantage of the opportunity afforded by Section 168(h)(6), the entity trying to use the HTC must be a pass-through entity like a partnership. Second, the tax-exempt entity seeking to own an interest in this lessee/pass-through would need to form a taxable corporation and own its interest in the pass-through via this corporation. Such a corporation is referred to as

a "tax exempt controlled entity" in the Code.<sup>12</sup> Finally, the corporation (i.e. the tax exempt controlled entity) must make the special election provided for in Section 168(h)(6)(F)(ii) of the Code.<sup>13</sup> This is sometimes referred to as a "Section 168(h) election." Where a partner that is a tax exempt controlled entity makes a valid Section 168(h)(6) election, the partner will not be treated as a tax-exempt entity, its proportionate share of partnership property will not be treated as tax exempt use property, and Section 50(b)(4) will not disallow the relevant HTCs. If such an election is made, however, any gain recognized by a tax exempt entity shareholder of such tax-exempt controlled entity upon the disposition of the stock in the corporation, and any dividends (to the extent not already subject to tax) or interest received by the tax exempt shareholder from the controlled corporation, will forever be treated as unrelated business taxable income to the shareholder and will be subject to tax under Section 511 of the Code.

There is a question, though, about whether a corporation owned by a political subdivision is eligible to make a Section 168(h)(6) election. A section 168(h)(6) election can only be made by an entity which is not otherwise itself a tax-exempt entity. A different provision of Section 168(h) states that instrumentalities or agencies of any State or political subdivision are themselves considered tax-exempt entities. The effect of this language may be to categorically preclude an instrumentality of a political subdivision from making this election, unless it qualifies for the exception discussed below.<sup>14</sup>

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<sup>12</sup> Specifically, a "tax exempt controlled entity" is defined as any corporation (which does not otherwise constitute a tax exempt entity) if 50% or more (in value) of the stock in that corporation is held by one or more tax exempt entities (other than a foreign person or entity).

<sup>13</sup> Just interposing a for-profit corporation between the tax exempt entity and the partnership, alone, is not enough to avoid a loss of HTCs. Unless the election described above is made, Section 168(h)(6)(F) subjects partnerships to the tax-exempt use property penalty even where the tax exempt's partnership interest is owned via a taxable corporation (i.e. a tax-exempt controlled entity).

<sup>14</sup> We have assumed a corporation formed by the County to own an interest in such a lessee would likely be considered an instrumentality of government but this would benefit from further research.

Section 168(h)(a)(2)(D) entitled “Treatment of certain taxable instrumentalities” provides that a corporation shall not be treated as an instrumentality of any State or political subdivision thereof if—

(i) all of the activities of such corporation are subject to tax under this chapter, and

(ii) a majority of the board of directors of such corporation is not selected by the United States or any State or political subdivision thereof.

Establishing whether an instrumentality of the County could meet the foregoing tests (an especially whether all of its activities could be said to be subject to tax) would require further research.

*Question 5: Same question as Question 4, but instead of the County, could a tax-exempt entity that is not deemed a governmental unit (or instrumentality thereof) hold an ownership interest in such a lessee without reducing the amount of HTC's otherwise available?*

*Answer: Yes, particularly if the tax-exempt entity held its interest through a for-profit affiliate that properly made a Section 168(h)(6) Election. If those requirements are met, it could be possible for such a tax-exempt entity to indirectly own an interest in the County's lessee.*

*Question 6: If the County, as lessor, were to lease the Domes as described in Question 2, and that lessee rehabilitated and operated the Domes, could the County sublease back the rehabilitated Domes from the lessee without reducing the amount of HTC's otherwise available?*

*Answer: Any sublease by the County (or any other unit of state or local government or instrumentality thereof) would likely be a disqualified lease under the Code and that would reduce the HTC's available but only if that sublease (together with any other so-called disqualified leases) collectively demised more than 50% of the relevant net rentable square footage. The County could sublease less than this amount without reducing the HTC's.*

Code Section 168 contains an additional set of rules designed to limit the extent to which “tax-exempt entities” can own or use an HTC project, including as a tenant. Under these rules, property that is leased to a tax-exempt entity (or partnership with tax-exempt partners) is treated as “tax-exempt use property” and may be ineligible for HTCs, but only if the leases are “disqualified.” If the property is subject to disqualified leases (and doesn’t fit in the safe harbor discussed below), then the portion of the property so leased is “tax-exempt use property” and the rehabilitation expenditures allocable to that space are not eligible for the HTC.

Generally a disqualified lease is any lease that falls within one of the following four categories: (I) the property is leased to a tax-exempt entity that is financed (directly or indirectly) by tax-exempt bonds and the tax-exempt entity or a related entity participated in the financing, (II) under the lease, the property has a fixed or determinable purchase price or sale option exercisable by the tax-exempt entity, (III) the lease to the tax-exempt entity has a term in excess of twenty years, or (IV) the lease occurs after a sale (or other transfer) of the property from such entity and such property has been used by such entity (or a related entity) before such sale, transfer, or lease.

Most relevant to the Domes may be the last of these four (Section 168(h)(1)(b)(ii)(IV)) which says a lease is disqualified if the lease occurs after a sale (or other transfer) of the property by such entity (or a related entity) and such property has been used by such entity (or a related entity) before such sale (or other transfer) or lease. In the case of the Domes, a lease that passes all the “benefits and burdens” of ownership to the named lessee would likely constitute a sale or other transfer of the property by the County. Thus, assuming the County has previously used the Domes (as seems to be the case), a subsequent sublease of the rehabilitated Domes from the County’s lessee back to the County runs the risk of being characterized as a disqualified lease under this rule (IV).<sup>15</sup>

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<sup>15</sup> It is worth noting that similar issues may be implicated if certain management/operating agreements were back to the County or its affiliates by the for-profit lessee. Under Code Section 7701(e), certain management agreements must be treated as if they were a lease for tax purposes. Whether a management arrangement will be respected for tax purposes or instead re-characterized as a lease (and hence possibly a disqualified lease), is a fact-driven analysis based on considerations such as the following: (i) whether the service recipient is in physical possession of the

This characterization would also likely be triggered by a sublease back to any other unit of Wisconsin state or local government or any agency or instrumentality thereof. This is because Section 168(h) expressly provides that a governmental unit will be treated as if it is “related to each other such unit, agency, or instrumentality which directly or indirectly derives its powers, rights, and duties in whole or in part from the same sovereign authority.”

Importantly, however, the disqualified lease rules contain a safe harbor that allows up to 50% of the net rentable square footage of a building (or in some cases, a project) to be leased pursuant to disqualified leases. Only if disqualified leasing exceeds this threshold is the property considered tax-exempt use property, ineligible for HTCs.<sup>16</sup> Thus, so long as the aggregate of all disqualified leases of the relevant property (including any sublease to the County in the case of the Domes) demise less than 50% of the relevant space, the tax-exempt use property penalty would not be triggered.

Also, note that the particular problem addressed in this Question 6 arises from the fact that the County is both a tax exempt entity and a prior user of the property. Other tax-exempt organizations that were not prior users could lease up to 100% of the rehabilitated Domes without reducing the available HTCs so long as those leases were not otherwise disqualified under one of the other three prongs of the definition of a disqualified lease discussed above.

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property, (ii) whether the service recipient controls the property, (iii) whether the service recipient has a significant economic or possessory interest in the property, (iv) whether the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures resulting from nonperformance, (v) whether the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and (vi) whether the total contract price does not substantially exceed the rental value of the property for the contract period.

<sup>16</sup> The law used to provide only a 35% safe harbor but Congress changed the rule in 2008.