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VIRGINIA HOUSING COMMISSION

AGENDA

Neighborhood Transitions and Residential Land Use Work Group
House Room 1, Capitol Building
June 20, 2011, 1:00 P.M.

Members present: Delegate Rosalyn Dance, Delegate Glenn Oder, Mark Flynn, Barry Merchant, Chip Dicks, David Freeman, Kelly Harris-Braxton, Bill Ernst, Ted McCormack, Ali Farouk

Staff present: Elizabeth Palen, Beth Jamerson

I. Welcome and Call to Order

- Delegate Rosalyn Dance, *Chair*
  - The meeting was called to order at 1:11 P.M.
  - Each member of the work group introduced himself.

II. *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner of Internal Revenue,* 639 F.3d 129 (2011)

- Kathleen S. Kilpatrick; Director, Virginia Department of Historic Resources
  - Kathleen Kilpatrick began the meeting by providing background information about Virginia's Historic Rehabilitation Tax Credit Program:
    - There is both a state and a federal tax credit program, and both are administered in Virginia by the Department of Historic Resources (DHR).
    - The federal program has been in existence since 1977, and was created to provide preservation, economic, and community benefits, ask well as an economic tool for urban revitalization. Accordingly, the key stakeholders have been older cities all over the country.
    - The Rutgers University Edward J. Bloustein School of Planning and Public Policy conducted a study of the economic impact of the Federal Historic Tax Credit. The study found that since 1978, the credit has created nearly two million jobs, and generated $72 billion in labor income (it is important to note that when rehabilitating existing housing stock, most of the cost is for labor since most of the materials are being reused, and the materials that are needed are purchased in the locality). Approximately 37,000 projects have been

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certified, and private investment incentivized through the credits has totaled $59 billion over the life of the program.

- The cost of the federal program has been more than offset by $21 billion in federal taxes realized through the program, including resulting income taxes, and sales taxes on goods and services used for rehabilitation.
- DHR has partnered with the Virginia Commonwealth University Center for Public Policy to quantify the results of the state tax credit program, which came into existence in 1996. The state program was intended to work in unison with the federal program, and was created to incentivize the private sector to provide stewardship through tax credits rather than through regulation.
- Through the state program, 2,000 landmark properties have been rehabilitated, 12,000 jobs have been created, $532 million in labor income has been generated, and $2.6 billion invested privately for a total economic impact of $2 billion in Virginia. As with the federal program, the cost of the program has been more than made up for with $55 million in excess taxes.
- Aside from providing economic benefits, the program preserves landmark buildings, and provides housing benefits by creating a market that draws people to the downtown areas of cities, and businesses subsequently follow the resettlement of the population. The program is also environmentally friendly as fewer materials are required to rehabilitate a building than are required to build one from start to finish. The program benefits Virginia's communities, developers, and historic preservationists.
- In 2008 when developers began having difficulty securing construction loans, lenders were still willing to provide loans to participate in the program because of the tax credits.

- Kathleen Kilpatrick explained that the future of Virginia's Historic Rehabilitation Tax Credit Program and its ability to provide developers with an economically viable approach to rehabilitation has recently been threatened.
    - In 1996 DHR and the Tax Department created a system to deliver the credits through a partnership or limited liability company (LLC) when the taxpayer could not use the credit to offset his personal income taxes. The partnership system ensures that a developer-owner will be able to attract a capital investment to make the rehabilitation of a building economically feasible. The credit is not immediately transferrable; the developer must form a partnership or LLC, receive a capital contribution from his investors, and then the credit is assigned to the investors through the partnership structure.
    - Several years ago the Internal Revenue Service (IRS) questioned the validity of the program's partnership transactions and whether they were in fact partnerships. The IRS has asserted that the partnership structures are a disguised sale. Categorizing the credits as income

greatly impairs the program's ability to attract investors and rehabilitate landmark buildings.

- Initially, the IRS lost its case challenging the partnership structure in tax court, and appealed the decision to the 4th Circuit Court of Appeals. The 4th Circuit reversed the tax court's decision. The 4th Circuits decision leaves the fate of Virginia's Historic Rehabilitation Tax Credit Program uncertain. The court provided no guidance for a safe harbor, nor what would constitute an appropriate structure.
- A chilling effect on building rehabilitation has extended beyond developers to banks and accounting firms, who are uncertain whether the court's decision applies to all tax credits issued through a partnership structure. The majority of economic activity stimulated by tax credits is done through a similar partnership structure. While there are homeowners and small developers who are able to use the credits to offset their own personal income taxes, they make up the smallest percentage of the overall economic benefit.
- DHR is working with the Historic Tax Credit Coalition and the National Trust for Historic Preservation, and has asked the Treasury Department to define a safe harbor as well.
- If the 4th Circuit decision stands without correction or further explanation, Virginia will lose 40.5% of the equity from rehabilitation deals with developers. The decision could have impact beyond Virginia as 31 states have tax credit programs, many of which are built on a partnership delivery system. When over 40% of the equity in a project is removed, it will be more difficult for developers to obtain a loan, less money will be available to invest in the buildings, and fewer projects will be completed. The result for landmark buildings is that, absent the program's standards, they will be insensitively rehabilitated or will be left to crumble. Jobs will no longer be created, and places for people to live, work, and play in the urban center will not be generated.
- Many of the program's projects result in low-cost housing because the historic tax credits can be combined with other tax credits, including the Low-Income Housing Tax Credit, Enterprise Zone Tax Credits, and New Market Tax Credits. Around Richmond the results of the program are evident in market and low-cost housing, the revitalized Miller and Rhoads building, The National theater, many other projects in Church Hill and Shockoe Bottom, and over 100 projects in Petersburg focused on housing.

- Delegate Dance assured Kathleen Kilpatrick that the group recognized the importance of the program and understood the issues it is facing. She asked Ms. Kilpatrick what they could do to help ensure the continuity of the program.
- Kathleen Kilpatrick asked the work group to support the Historic Tax Credit Coalition's request to the Treasury Department to provide a safe harbor

definition for the future. However, there is still cause for concern because if the court's decision stands, the IRS will be able to reclaim taxes from projects that have already been completed as far back as six years ago. If those developers were to be audited and compelled to pay taxes on the credits from those projects, many of them would be forced to put their buildings into foreclosure and file for bankruptcy. Therefore, a solution at the congressional level is required. Finally, DHR needs the Tax Department to uphold its rulings from 1996 honoring the partnership structure. The then-Tax Commissioner, Janie Bowen, issued a ruling that stood behind the partnership structure, and that ruling needs to be renewed. DHR is also trying to meet with United States Senator Mark Warner, who has expressed interest in this issue, as well as United States Representative Eric Cantor, whose district has benefitted enormously from historic tax credits.

- Delegate Dance suggested the Housing Commission write a letter supporting the tax credit program and a resolution as well.
- Delegate Oder agreed that the Commission could write a letter, and suggested they encourage Governor Bob McDonnell to do the same. A resolution cannot be issued because the regular session has ended, and the Rules Committee is not currently meeting.
- Delegate Dance asked the other members of the work group to offer their thoughts on the issue.
- Chip Dicks, of FutureLaw, pointed out that Virginia is dependent on the federal taxation system. If the court's decision stands, then by law Virginia will automatically recognize the federal position on the tax credits, both going forward and with regard to reclaiming taxes to the statute of limitations period of six years. However, there are statutory exceptions to conformance, and typically that type of legislation would read that the state shall conform in all respects with the federal law except for certain enumerated points. Therefore, this group might consider meeting with the Tax Department or a member of the House or Senate Finance committees to discuss conformance exceptions further. The legislation could exclude Virginia from conforming to the federal position on historic tax credits both going forward and for the statute of limitations period of six years. The program uses a combination of federal and state historic tax credits, and the state income tax credit is an important aspect of some of those rehabilitation deals. The state law can be changed to the extent that it would protect Virginia's Historic Rehabilitation Tax Credit Program. This approach would be stronger than writing a letter or asking for a resolution because the Tax Department will be duty bound to comply with the federal position since Virginia is a conforming tax system under the Code.
- Kathleen Kilpatrick mentioned that in a letter from Janie Bowen, the fact that Virginia is a conforming state is addressed, but that it is not always automatic. The 40.5% of equity that will be lost breaks down so that 35% would be taxable as sale of property income at the federal level. This would increase the basis on which state taxes are computed, resulting in a 5.5%

increase in taxes at the state level. Separating the state and federal taxes would certainly help, however, she feels that ultimately Congress will need to become involved in reaching a solution since the problem extends beyond Virginia.
    - Chip Dicks asked if the case had been appealed.
    - Elizabeth Myers answered that the petition for rehearing before the full appeals court had been denied en banc.
    - Delegate Oder suggested drafting legislation with regard to the conformance exception and presenting it at the next Neighborhood Transitions work group meeting prior to it going before the full Housing Commission. This should happen before the end of the year so the legislation can be considered during the next General Assembly session.
    - Delegate Oder made a motion to proceed as discussed, and it was properly seconded.
    - All were in favor of the motion and the motion carried.

III. Amicus Curiae Brief of the Office of the Attorney General, *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner of Internal Revenue*, 639 F.3d 129 (2011)

- Elizabeth Bushnell Myers; Assistant Attorney General, Financial Law and Government Support Section
    - Elizabeth Myers explained that the Office of the Attorney General filed an amicus brief in this case because it considers the Historic Rehabilitation Tax Credit Program an important program enacted by the General Assembly under strong policy reasons. There were two main issues in the case. First, the court decided whether the transferred credit scheme was a disguised sale, and second, whether the contributions to investors were essentially a purchase price. The 4th Circuit decided affirmatively on both issues.
    - Elizabeth Myers noted that Virginia has a long and rich history that is reflected in the architectural styles of buildings across the Commonwealth. The position of the IRS in this case seriously undermines the effectiveness of the tax credit program.
    - Elizabeth Myers explained that the Office of the Attorney General had two main points in its amicus brief. First, the Historic Rehabilitation Tax Credit Program is of extreme importance to Virginia. Second, a partnership that has harnesses the availability of these tax credits to attract beneficial investment does not lack a valid business purpose; it clearly falls under the definition of a valid business purpose as established by the General Assembly. The partnerships advance strong public policy objectives and as such, should be held to different approximated standards than other ventures. The fact that the partnerships are marketed to partners to reduce tax liability is the exact purpose of the program and how it was statutorily enacted. Furthermore, from a federalism standpoint, ruling against the partnership structure would damage the policy objectives of the Virginia General Assembly.
    - Elizabeth Myers agreed that decoupling taxes for federal and state tax income purposes is essential and should be done very soon. She represents

the Tax Department and can begin speaking with them shortly about potential legislation.

- Mark Flynn, from the Virginia Municipal League, asked Ms. Myers whether or not the case affects other tax credit programs are affected by analogy.
- Elizabeth Myers answered that all tax credit programs that use the partnership system are affected. In Virginia every tax credit program, including the Low Income Housing Tax Credit Program, uses the partnership structure except the Land Preservation Tax Credit Program, which is the only freely transferable credit in the state.
- Mark Flynn asked whether Ms. Myers knew the specific dollar amount involved in the case.
- Chip Dicks answered in Part I, Section C of the opinion it lists $1.53 million as being owed in taxes.
- Barry Merchant, with the Virginia Housing Development Authority (VHDA), pointed out that the partnership structure exists in nearly every tax credit program, and the IRS has been administering the federal law for tax credit programs for decades, which means they seemingly understood and approved of the partnership structure. He asked Ms. Myers why the IRS was challenging the structure now, and whether there was any distinction with this particular case.
- Elizabeth Myers responded that she did not know why the IRS decided to challenge the partnership structure.
- Delegate Dance suggested a transition within the IRS or an audit may have caused the agency to develop a different impression of the partnership structure.
- Elizabeth Myers agreed, and reiterated that the decision was narrowly tailored to the partnership system involved in the Historic Rehabilitation Tax Credit, and it is not clear how far the decision will reach.
- Delegate Dance asked Ms. Myers if she agreed with the earlier motion that was voted on and passed.
- Elizabeth Myers answered that if the Virginia General Assembly wants its portion of the tax credit to continue as it has in the past, something must be done.
- Chip Dicks noted that his law firm has structured several of these partnerships in the Richmond area. He offered a hypothetical, where A and B are partners in a renovation that costs $10 million, and $4.5 million of that amount comes from state and federal tax credits. If company C then buys the $4.5 million of credits, the IRS position is that out of the $10 million deal, where A and B are partners and C is a partner for $4.5 million, then C is not actually a partner, but a buyer of tax credits and not at risk in the $10 million deal. This does raise questions about all other similarly structured tax credit programs, and he suggested asking the United States Treasury for a revenue ruling. In another scenario, company C buys the tax credits, but it actually does have some risk the deal will fail. Under the current ownership of these partnerships, more than 45% of the income and losses can be assigned to company C. With tax credit deals, the losses and income are

assigned to the partnership at a different ratio than the investor. He suggested asking for a revenue ruling, setting out several different factual scenarios that can then be relied upon for a safe harbor.

- Elizabeth Myers agreed, but warned that the risk in asking for a revenue ruling is that they could take the decision farther than the IRS had even intended.
- Delegate Dance asked Mr. Dicks if he was making a recommendation for Ms. Myers to take back to the Attorney General's Office.
- Chip Dicks replied that the Attorney General's Office should at least discuss asking for a ruling. Without a revenue ruling, lenders are forced to rely on this case and that puts tax credit deals in jeopardy. Underwriting requirements are tight as it is, and no lender will lend on any tax credit deal as long as this uncertainty exists. There is an additional issue regarding whether the lender treats the taxes owed from up to six years ago as a default under the loan agreement. They would either need to require the parties to provide additional equity or treat the loan as a default. This opinion cannot stand long without clarification.
- Mark Flynn added that this may affect agencies and the business community, certainly VHDA is affected. It may be appropriate for a task force to delve deeper into the issue.
- Delegate Dance summarized the options the work group discussed, including letters from the Housing Commission and Governor, and recommendations for the Attorney General's Office.
- Chip Dicks suggested that the group would do better to work on state tax legislation as a substitute for the letters. Also, the group needs to decide whether to recommend the Attorney General's Office have an internal discussion for a request for a revenue ruling to provide some level of certainty for investors.
- Elizabeth Myers noted that it is important to realize at this point that this case is only currently applicable to this particular partnership with this particular tax credit. Until the opinion is applied to other credits, there is no way to know how far it will reach.
- Kathleen Kilpatrick agreed that they need to be careful about what questions are asked. The very notion that a credit is property is problematic on its face; for example, credits cannot be inherited. The situation is difficult because the court said the ruling applies only to the facts of the case, but at the same time made broad, sweeping statements. She indicated the only solution would have to be done through legislation, most likely at the congressional level.
- Mark Flynn again suggested setting up a task force rather than having several different groups approach the issue from different directions. It should include tax attorneys, the Attorney General's office, etc., because this ruling is a massive attack on issues of interest to the Housing Commission.
- Bill Ernst, from Department of Housing and Community Development (DHCD), agreed that attacking the opinion at a statutory level makes sense

if it would structure a safe harbor in Virginia. This is a small case nationally, but it poses such a threat that the decision cannot remain ambiguous. He agreed with involving staff from the Attorney General's Office, the Tax Department, and Legislative Services as well.

- Kelly Harris-Braxton, with Virginia First Cities, asked Ms. Myers if the facts of this case differ from a typical tax credit case.
- Elizabeth Myers answered these facts are extremely typical. The credit was created to be used by these partnerships because it is the only way to obtain investors and make the project economically desirable.
- Ted McCormack, with Virginia Association of Counties (VACO), asked Ms. Kilpatrick what she planned to do if congressional action fails and whether they were working on two tracks.
- Kathleen Kilpatrick answered that they were working on two tracks.
- David Freeman, with the City of Norfolk, asked whether they were tracking what other states were doing about this issue.
- Kathleen Kilpatrick replied that other states have joined in the industry amicus as well as the request to the Treasury Department to dialogue with regard to a safe harbor. She mentioned that they were coordinating closely with the National Trust for Historic Preservation, which is looking to the states in the 4th Circuit, particularly Virginia, to take the lead on this issue.
- Delegate Dance reminded the work group that the legislation had already been voted on in the previous motion. The group has been discussing pieces that will be incorporated into the legislation and who should be advising them as the legislation is drafted. She asked the group if the letters were still necessary.
- Delegate Oder suggested that the group needs to do something immediately. Legislatively, nothing can be done until 2012, and it may not be necessary to act upon the advice just given by Chip Dicks.
- Delegate Dance told the group that a letter from the Housing Commission will be drafted to United States Representatives as well as the governor. She asked the group if everyone agreed the letters should be drafted.
- Delegate Oder moved to take the course of action the chair just discussed, and it was properly seconded.
- All were in favor of the motion and the motion carried.

IV. Update on SB 1312; Repair of Derelict Buildings (McEachin, 2011)

- Chip Dicks; Manager, FutureLaw, LLC
- Mark Flynn; Director of Legal Services, Virginia Municipal League
    - Delegate Dance noted that at the previous receivership sub-work group meeting, Mr. Dicks and Mr. Flynn were asked to work on this legislation and report back when they were ready to present their proposal. Mr. Dicks and Mr. Flynn have not yet finished the proposal. Accordingly, this piece of the agenda will be bypassed until the next meeting.

V. Public Comment

- There was no public comment.

VI. Adjourn

- The meeting was adjourned at 2:06 P.M.