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REAL ESTATE

Found Money Or Lost Opportunity? Still Too Few Take Advantage of the Federal Historic Tax Credits Program

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Part 1: Program Background and Basics

This is the first of a two-part series on the Federal Rehabilitation Tax Credit Program that allows developers and owners to attract cash investments for their historic properties redevelopment projects. Part 1 explains the background and basic parameters of the program and describes recent changes in the law. Part 2 describes more detailed aspects of the RTC program and application to typical development projects.

Introduction

Since the 1970s, the federal Rehabilitation Tax Credits (RTC) program has spurred the redevelopment of more than 35,000 historic buildings in the United States. More than $50 billion in construction funds have been associated with these projects, providing approximately $10 billion in tax credits for investors. In 2008 alone, $5.6 billion in private investment was placed, and more than 67,000 new jobs were created in connection with this tax incentive.

Still, there are approximately 300,000 additional structures in the United States that are potential renovation candidates for RTC credits (and potential candidates for investor cash infusions into these projects), with thousands more added to the list of eligible candidates every year. And every year, developers (and lenders in possession of foreclosed properties) pass up clear opportunities for millions of dollars in investment cash for their building rehabilitation projects.

Why are so many leaving so much money on the table? The reasons are complicated, but many owners that could utilize the credits are either unaware of the program or are discouraged from involvement because of (sometimes inaccurate) perceptions regarding the program's complexity or misperceptions regarding historic landmarks designation and its impacts.

With the Housing Recovery Act of 2008 (P.L. 110-289, the Act) the program's scope has been widened—with changes that have largely flown under the radar in the development world. Yet with the right project in the right set of circumstances, the RTC-related cash investments can make the difference between a project that is economically viable and one that will not work. As the economy slowly recovers, the RTC program could add a significant boost to projects that include the redevelopment of historic structures.

This article summarizes the basics of the Rehabilitation Tax Credits program, gives an overview of which redevelopment projects are eligible, describes how developers can take advantage of the program, outlines recurring legal and tax challenges involved in using the credits, and provides an overview of recent changes in the law that expand the availability of the credits.

The Federal Rehabilitation Tax Credit Program: Background

With the wave of urban renewal projects and other large scale developments of the 1960s and 1970s, cities and towns across the country saw the demolition of thousands of historically significant buildings (and entire neighborhoods). This contributed to a growing historic preservation movement, which led to a series of legislative initiatives. Beginning with the Tax Reform Act of 1976 (P.L. 94-455) and especially with the Tax Reform Act of 1986 (P.L. 99-514), a system of tax credits was established to encourage the adaptive reuse of structures through tax incentives. Since then, the Federal Historic Preservation Tax Incentives Program has quietly played a major role in real estate development involving historic landmark properties. The IRS Code, at sections 38 and 47, includes provisions for the rehabilitation tax credit, which can be utilized in connection with "qualified rehabilitation expenses" for renovations of "certified historic structures" and other buildings constructed before 1936.

I have been associated with a series of historic preservation collaborations over the past 20 years, representing the wide range of development projects that can benefit from the program. Traditionally, this program has been seen as applicable only to large rehabilitation projects. And while larger projects will generally be more efficient and attract a higher investment price in exchange for the allocation of credits, there is a growing market for smaller projects in tax credit investment circles. Our rehabilitation projects have included the following, all of which generated substantial cash investments due to the RTC program:

? The Arctic Club Hotel, an iconic Seattle historic landmark redevelopment project. This development included more than $25 million in qualified expenses, generating the potential for approximately $5 million in historic rehabilitation credits.

? The Holley Mason Building, in downtown Spokane, a historically significant industrial building converted to office use, including approximately $5 million in qualified expenses, with $1 million in credits.

? The General Automotive Building, in Portland's Pearl District, a "Non-Historic" building rehabilitation using the little-known (and little-utilized) 10 percent tax credit, involving $7 million in qualified expenses, generating $700,000 in tax credits.

? The "Five & Dime"—an adaptive reuse of a National Register-listed Woolworth's store in the historic Mississippi delta town of Clarksdale. This building was converted to commercial and residential uses, with approximately $1.2 million in qualified expenses and a total of more than $200,000 in federal tax credits, in addition to Mississippi state historic credits. This is an example of a smaller tax credit project—part of a growing segment in the investor market.

In spite of thousands of success stories like these across the United States, the RTC program has not reached its full potential. Part of this is explained by the fact that the tax credits rules and process can be complicated. The documentation can be extensive, and the program is not well-suited to every project or development scenario. But a major reason for lack of use is that few understand the program—and many are unaware that it exists at all.

It is true that there are many traps for the unwary that must be avoided if Rehabilitation Tax Credits are to be fully realized for a project. Still, this particular tax credit program is relatively straightforward (especially compared to the intricacies of such programs as the New Markets Tax Program). And the RTC program presents one of the few significant tax credit advantages that remain available to real estate developers after the 1986 code changes eliminated most tax credits for real estate investors.

Basic Parameters of the RTC Program

What Is the Rehabilitation Tax Credits Program?

This program, administered jointly by the U.S. Department of the Interior (through the National Park Service) and by the Department of the Treasury (through the IRS), makes tax credits available to developers that rehabilitate qualified buildings. There are actually two federal credit programs: one for historic structures and a lesser credit available for "non-historic" structures that were built prior to 1936.

The Internal Revenue Code (IRC) section 47(c)(3)(A) stipulates that in order to qualify for the "historic" credit, qualifying buildings must be "certified historic structures" defined as: (a) buildings listed on the National Register of Historic Places; or (b) buildings that contribute to a National Register Historic District or another qualifying local historic district. Treas. Reg. section 1.48-12(d). For the historic properties, a tax credit equal to 20 percent of the "qualified expenditures" in the renovation of certified historic structures may be allocated to the developer entity. So if an owner spends $5 million on qualified expenditures for a rehabilitation of a certified historic structure, there could be $1 million in tax credits available to directly offset income taxes owed by that entity or one or more of its members/partners. There is a lower credit (10 percent) available for the rehabilitation of nonhistoric structures built before 1936.

Who Uses the Tax Credits? Recent Changes Expand the Pool

Typical Tax Credit Investors. The Rehabilitation Tax Credits are used by owners (or long-term lessees) of certified historic structures (for the 20 percent credit) and "non-historic" structures built before 1936 (for the 10 percent credit). Rehabilitation Tax Credit utilization by individuals is limited, due in large measure to the passive activity loss provisions introduced in the

Tax Reform Act of 1986. *See* IRC section 469 regarding passive activity provisions and phaseout of credits. Historically, the typical structure has involved bringing a corporate tax credit investor entity into the development group as a member of the owner entity—or as a member of long-term lessee—and allocate the tax credits to that investor, in exchange for cash investment in the project.

The tax credit investors contribute anywhere from 60 cents to 95 cents on the dollar of each credit, in exchange for allocation of the tax credits. The investment "price" depends upon such variables as the size of the project, the local market, project parameters, and so forth. This arrangement can be extremely positive for the developer: the tax credit investor comes into the project early and contributes cash at a crucial point in the project. In exchange, the credits (which are typically not as useful for the developer) are allocated to the investor entity. Affiliates of lending institutions are common users of the credits, although (as an example) one of the most active investors involved with investing in Rehabilitation Tax Credits development projects is Chevron Texaco.

Alternative Minimum Tax Revisions. The pool of potential tax credit users has been broadened somewhat by the recent (2008) changes in the Code, based on provisions in the Housing Recovery Act, although more could be done in this regard. For example, the Act expands the use of the rehabilitation credit by providing a new exemption from the alternative minimum tax for tax credit investors. In the past, the application of the alternative minimum tax provisions had practically eliminated the benefits of the credit for individuals.

For qualified rehabilitation credits properly taken into account for periods after December 31, 2007, the IRS treats the minimum tax as zero with respect to the rehabilitation tax credit. This allows an individual taxpayer to use the rehabilitation tax credit to offset regular tax liability—broadening the pool of potential tax credit investors and effectively expanding the number of historic properties that can utilize the RTC to include smaller projects that in previous years might have been considered too small in scope to be attractive candidates.

Leasing to Nonprofit Entities. The Act also expands the pool of investors and qualifying projects by relaxing the restrictions on leasing rehabilitated buildings to nonprofit and tax-exempt entities. Previously, taxpayers could not take full advantage of the RTC program where more than 35 percent of the building was leased to tax exempt entities. With new changes as a result of the Act, investors can qualify for the full amount of the credit provided that less than 50 percent of the building is leased to tax exempt entities.

What Is a "Certified Rehabilitation" of a Historic Structure?

As a prerequisite to utilizing the 20 percent historic tax credits, the proposed rehabilitation work must be certified by the Secretary of the Interior as being in conformance with the Secretary of the Interior's standards for rehabilitation. *See* IRS section 47 (c)(2)(B) & (C); Treas. Reg. section 1.48-12(d). This certification and review process is administered through the National Park Service (NPS), in conjunction with the State Historic

Preservation Officer (SHPO) in each state. Application for certification of a rehabilitation is made to the NPS through the SHPO. The SHPO reviews the applications for certification and forwards its comments and recommendations to the NPS for final approvals. In general, in order to be certified, the rehabilitation must be consistent with the historic character of the structure or the applicable historic district. The defining historic features and character of the structure must be maintained and not destroyed or compromised by the rehabilitation work.

Part II of this article will explain specific aspects of the RTC program in greater detail, including an explanation of development restrictions that must be considered if taking advantage of these tax credits.

Stephen J. Day is both an architect and attorney. He has collaborated with a variety of clients and colleagues in real estate development projects over the past 20 years, focusing on the redevelopment of landmark historic properties. For more information on the tax credit projects he has been associated with, go to www.StephenDayArchitecture.com and www.rp-lawgroup.com. Stephen can be reached at **(206) 625-1511** .

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