

Converting Tax Incentives into Profitable Historic Rehabilitation Projects

BY GORDON GOLDIE, CPA, AND TIMOTHY A. FRENS, CPA, MBA

SINCE 1976, RESOURCEFUL DEVELOPERS HAVE taken advantage of significant tax incentives to rehabilitate historic properties into profitable development projects. Such incentives have sparked renewed interest in reviving forgotten local landmarks and have enabled developers to successfully tap into an emerging market of commercial and residential tenants who are looking for unique space.

However, according to the National Trust for Historic Preservation, historic tax credits are widely underutilized. So, what tax incentives are available for historic rehabilitation projects and how can a developer take advantage of them? It depends upon the location of the property—in many cases a project may qualify for federal and state historic tax credits and New Markets Tax Credits.

FEDERAL REHABILITATION TAX CREDIT

The Internal Revenue Code (IRC) provides a federal tax credit of either 10 or 20 percent of qualified rehabilitation expenditures (QREs) incurred in connection with the rehabilitation of a qualified building. QREs represent all rehabilitation costs that are capitalized as part of the depreciable cost of the building and its structural components. QREs exclude acquisition costs, land improvements, and personal property. However, they may include capitalized interest and property taxes, as well as reasonable construction man-

agement fees and developer fees paid to related parties. Property owners may claim the credit in the year that the QREs incurred on a project are placed in service. Tax credits are extremely valuable, because they represent a dollar-for-dollar reduction in your federal income tax liability.

About the Author

Gordon Goldie, CPA, focuses on providing tax consulting services to the real estate and construction industries. He specializes in community development tax incentives, including historic tax credits, New Markets Tax Credits and Brownfield redevelopment incentives, and also structuring transactions involving LLCs, partnerships, and S Corporations. ■■■■■

Timothy A. Frens, CPA, MBA, provides accounting and consulting services to a wide variety of institutional and entrepreneurial real estate and construction companies. His industry specialties include: hospitality, homebuilding, self-storage, commercial development, residential and commercial subcontractor, and residential and commercial rental properties. His experience includes hotel acquisition due diligence, financial pro-forma modeling for developers, Historic Tax Credit syndications, financial forecasts for private equity investments, entity and deal structuring, as well as traditional tax and audit compliance engagements. ■■■■■

Both authors work at Plante & Moran, PLLC. Gordon is based in the Auburn Hills, Michigan office and Tim is based in Elgin, Illinois, one of Plante & Moran's Chicagoland offices.

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ELIGIBILITY REQUIREMENTS FOR FEDERAL HISTORIC TAX CREDITS

To be eligible for the 20 percent credit, the following requirements must be met: (1) The building must be individually listed in the National Register of Historic Places or contribute to a historic district that is listed in the National Register, and (2) The rehabilitation must comply with the design and construction principles of the Secretary of Interior's Standards for Rehabilitation. These standards are designed to ensure that the architectural and historic significance of a property will be maintained during the rehabilitation process.

Nonresidential, nonhistoric buildings that were originally placed in service prior to 1936 are eligible for a 10 percent federal credit. The 10 percent credit can also be applied to a mixed-use project (e.g., first floor retail and upper floor loft apartments) as long as the revenue generated by the residential portion of the project is less than 80 percent of the project's total annual gross revenue.

In addition, there are some general restrictions that apply to both credits. For example, to qualify for either the 10 percent or the 20 percent credit, a building must be used in a trade or business. Therefore, personal residences are not eligible. In addition, the availability of the credit may be restricted if the property is owned or used by a tax-exempt entity. The property owner also must select either a 24- or 60-month rehabilitation period and the owner's QRE during that time must exceed the building's adjusted basis at the beginning of the period.

OBTAINING FEDERAL HISTORIC TAX CREDITS

To claim a 20 percent credit, the rehabilitation must be certified by the National Park Service. To obtain certification, taxpayer's must prepare and submit a three-part Historic Preservation Certification Application. The three-part application addresses the following: Part 1 of

the application provides information regarding the historical significance of the building and Part 2 includes a description of the proposed rehabilitation. Part 3 is submitted upon completion of the rehabilitation to request certification. Taxpayers must submit the application to the State Historic Preservation Office (SHPO). Applicants must pay a fee ranging from \$500 to \$2,500 with their application.

There is no certification process required for rehabilitations of buildings eligible for the 10 percent credit and the rehabilitation is not required to meet the Secretary of Interior's Standards for Rehabilitation.

NEW MARKETS TAX CREDITS

Another tax incentive that is quickly gaining favor in the historic rehabilitation area is the New Markets Tax Credit (NMTC). The NMTC program began with the passage of the Community Renewal Tax Relief Act in December of 2000. Under the NMTC program, through 2007, the CDFI (Community Development Financial Institutions) Fund of the Department of Treasury has authority to grant approximately \$6 billion of federal tax credits to taxpayers who make investments in or loans to qualified businesses located in low income communities. This federal tax credit is equal to 39 percent of the amount invested in or loaned to the qualified business. The investor is allowed to claim the credit over a seven year period, beginning with the date of the initial investment.

COMBINING THE HISTORIC TAX CREDIT AND THE NEW MARKETS TAX CREDIT

Not only can the NMTC be combined with the federal historic tax credit, but many of the properties that qualify for historic tax credits are also eligible for NMTCs. The National Trust for Historic Preservation estimates that 58 percent of buildings located in historic districts are located in census tracts that qualify for NMTCs. In addition, to date, a majority of the investments and loans made under the NMTC program have been used to finance real estate development projects, such as historic rehabilitation projects. However, it is important to note that, just like the 10 percent federal rehabilitation tax credit, NMTCs are not available for residential rental real estate. Residential rental real estate is defined as any building where 80 percent or more of the gross rental income from the building

Converting Tax Incentives into Profitable Historic Rehabilitation Projects

is rental income from dwelling units used as living accommodations. Consequently, a mixed use facility can qualify for NMTCs as long as the rental income from the residential portion of the building represents less than 80 percent of the building's gross rent revenue for the year.

OBTAINING NEW MARKETS TAX CREDITS

Access to the NMTC is only possible by routing an investment through a community development entity (CDE) that has directly or indirectly received an allocation of NMTCs from the CDFI Fund of the Department of Treasury. To date, the CDFI Fund has authorized approximately 130 CDEs to award \$2.34 billion of NMTCs. In May 2005, the CDFI Fund is expected to award an additional \$.78 billion of NMTC allocations to CDEs that submitted applications in October 2004. During the application process, each CDE identifies the geographic area where they will utilize their NMTC allocation. While some CDEs have geographic scopes as small as one city or county, many CDEs have a national scope which allows them to use their NMTC allocation in any low income community in the country. In addition, CDEs generally restrict the types of projects to which they are willing to allocate NMTCs (e.g., charter school facilities, nonprofit organizations, etc.). As a result of these restrictions, there may only be a few dozen CDEs that are allowed to allocate NMTCs to a particular historic rehabilitation project. However, many CDEs have specifically targeted historic rehabilitation projects. For example, a subsidiary of the National Trust for Historic Preservation has received an allocation of NMTCs with a national scope, which will be used primarily to benefit projects that are eligible for federal and state historic tax credits.

While historic tax credits can provide significant financial incentives for a rehabilitation project, they do not come without some costs. Failure to recognize such costs is a common pitfall that could easily be avoided.

POTENTIAL BENEFITS OF NEW MARKETS TAX CREDITS TO HISTORIC REHABILITATION PROJECTS

If the owner of a historic building is able to identify a CDE that is willing to assign part of its NTMC allocation to the project, the investor who "purchases" the historic tax credits will also receive NMTCs. Since the investor will receive two tax credits for making one investment, the investor is typically willing to make an investment that is approximately 25 percent higher than they would have made if they had only received historic tax credits. Historic rehabilitation projects can also benefit from the NMTC program by routing debt financing through a CDE. Since the lender's rate of return is essentially subsidized through the NMTCs generated by the CDE's loan to the historic project, the project can effectively borrow money at very favorable terms. For example, the interest rate could be as much as 2 percent to 3 percent below market or the project may not be required to repay the entire loan.

EXAMPLE: TWO SOURCES OF NMTC'S BENEFIT DETROIT HISTORIC REHABILITATION

In Detroit, a historic building was recently rehabilitated into a business incubator for high-tech companies with the help of two different sources of New Markets Tax Credits. The project benefited from a \$5.4 million New Markets Tax Credit enhanced loan which will save the project \$115,000 per year over the seven year term of the loan. In addition, the project's historic tax credit investor agreed to infuse the project with \$920,000 of additional capital after the transaction was restructured to enable the investor to receive New Markets Tax Credits upon making a \$3.6 million capital contribution to "purchase" the federal historic tax credits generated by the project.

STATE TAX INCENTIVES

While the federal government provides a significant financial incentive to encourage the rehabilitation of historic buildings and districts throughout the nation, individual states have also stepped up and formed unique programs involving tax credits, grants and loans to encourage the rehabilitation of historic properties. Such programs are typically coordinated by the SHPO. Twenty-four states currently offer some form of tax credit as an incentive to encourage rehabilitation of historic properties. In addition, twenty-nine states currently offer some form of

Converting Tax Incentives into Profitable Historic Rehabilitation Projects

property tax abatement for owners of historic properties. Many thousands of historic properties have benefited from state tax incentives such as these. The National Trust for Historic Preservation has compiled a list of these incentives. This list, which includes a brief description of each incentive, is available on the National Trust's website at <http://www.nationaltrust.org/help/taxincentives.pdf>.

OVERVIEW OF A TYPICAL STATE HISTORIC TAX CREDIT: MICHIGAN

The State of Michigan offers a state historic tax credit that is similar to credits offered by other states. Like many state historic tax credits, the Michigan credit has different eligibility requirements than that of the federal historic tax credit. For example, Michigan does not require the property to be used in a trade or business. Consequently, personal residences are eligible for Michigan historic tax credits. In addition, Michigan places fewer restrictions on property that is owned or used by tax-exempt entities. To qualify for the Michigan credit, the QREs must exceed 10 percent of the property's State Equalized Value. The process required to obtain the Michigan historic tax credit is essentially identical to that required to obtain the federal 20 percent credit.

The Michigan tax credit equals 25 percent of QREs. However, the Michigan credit must be reduced by the amount of any available federal historic tax credit (which may result in a 5 percent net state credit). The Michigan credit can be used to offset either the Michigan Single Business Tax (SBT) or the Michigan Individual Income Tax. It may be claimed during the year that the completed rehabilitation certificate is issued for the project. Any portion of the credit not used in a tax year may be carried forward for a maximum of 10 years. The credit may be assigned (but not reassigned) to owners of a pass-through entity or to tenants. The state allows developers to assign 100 percent of the credit to a single owner or tenant. An efficient market also exists for the "sale" of these credits. These state tax credits typically "sell" for approximately \$.60 per \$1 of credit. However, the price for these credits can range from \$.50 to over \$1 per dollar of credit, depending upon the federal and state tax position of the "purchaser."

DETAILED EXAMPLE:

The value of tax credits in financing a certified historic rehabilitation project is illustrated in the following exam-

Table 1—Uses and Sources of Funds

Uses of Funds:	
Building and land acquisition cost:	\$1,500,000
Rehabilitation expenditures:	
Qualified rehabilitation expenditures (QREs), includes related party development fee	8,000,000
Land improvements and personal property	<u>500,000</u>
Total uses of funds	<u>\$10,000,000</u>
Sources of Funds:	
Tax credit investor equity:	
Federal historic tax credits (QRE x 20 percent x \$.90)	\$1,440,000
New Markets Tax Credits (\$1,790,000 x 39% x \$.50)	350,000
State historic tax credits (QRE x 5 percent x \$.60)	240,000
Developer equity (including deferred developer fee)	1,000,000
Bank financing	<u>6,970,000</u>
Total sources of funds	<u>\$10,000,000</u>

ple, which assumes that the federal credits are "sold" for \$.90 per \$1 of credit. The example also assumes that the federal historic tax credit investor's capital contributions qualify for New Markets Tax Credits and that the tax credit investor is willing to pay \$.50 per \$1 for the NMTCs. Finally, the example assumes that the project qualifies for a 5 percent state credit that is "sold" for \$.60 per \$1 of credit (Table 1).

As this example demonstrates, tax credits can finance a substantial portion of a project's costs. By combining several incentives, such as New Markets Tax Credits and federal and state historic tax credits, 25 percent or 30 percent

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of the cost of a historic rehabilitation can be funded with tax incentives.

WHAT ARE THE COMMON PITFALLS OF A HISTORIC REHABILITATION PROJECT?

One of the most common mistakes a developer can make is to not adequately plan the project. The success of the project often depends upon the developer's ability to prepare a realistic time budget and financial projection and to obtain SHPO approval of the design plans before beginning construction. The financial projections will be critical in assisting the developer with obtaining financing and in negotiating the "sale" of historic tax credits to an investor.

While historic tax credits can provide significant financial incentives for a rehabilitation project, they do not come without some costs. Failure to recognize such costs is a common pitfall that could easily be avoided. When evaluating the potential benefits associated with historic tax credits, it is important to consider the following:

Construction Costs—Because the 20 percent federal credit requires that the rehabilitation meet the Secretary of Interior's Standards for Rehabilitation, the hard and soft construction costs associated with such projects will be higher. In addition, following these standards may constrain the developer's ability to design the rehabilitation to meet the optimal needs of the building's ultimate occupants. However, the developer may be able to mitigate such design restrictions by seeking input from the SHPO as early in the process as possible.

Reduced depreciation deductions—Taxpayers claiming a federal historic tax credit are required to reduce the depreciable basis of the rehabilitated property by the amount of the credit claimed.

Potential credit recapture—Taxpayers claiming a federal historic tax credit are required to recapture a pro rata portion of the credit if they dispose of their interest in the property within five years of the rehabilitated project being placed in service. Many states historic tax credit programs have similar recapture provisions. In projects that benefit from New Markets Tax Credits, a seven year recapture period applies to the New Markets Tax Credits.

Limitations on use of credits—A taxpayer's ability to use a federal historic tax credit is often limited (due to at-risk, passive activity and alternative minimum tax limitations). Consequently, taxpayers who generate such credits often "sell" the credits to investors who are able to utilize them quicker. Fortunately an efficient market exists that allows developers to "sell" historic tax credits for approximately \$.90 per \$1 of federal credit. The pricing of state credits differs from state to state depending upon the specific provisions applicable to the state's historic tax credit.

Transaction structuring costs—Unfortunately, "selling" tax credits is not as easy as it sounds. The IRS does not permit the direct sale of such credits. To accomplish such a "sale," developers typically enter into a partnership or LLC with the credit "purchaser." Extensive financial projections are typically required to properly structure the transaction. In addition, the tax credit "purchaser" often requires an attorney to issue a tax opinion to give them comfort that the transaction is properly structured. Such complexities obviously increase the cost of the project.

WHAT ARE THE KEYS TO A SUCCESSFUL HISTORIC REHABILITATION PROJECT?

The most important ingredient to a successful historic rehabilitation project is assembling a team of experienced professionals. An integral member of the team will be a historic consultant, whose primary job is to safeguard the tax credit (i.e., review plans and decisions as they are made, always with the credit in mind). It is also critical to the success of the project that the architect, CPA, and attorney all have experience with historic rehabilitation projects and the related tax credits. ■