COMBINING HISTORIC PRESERVATION AND BROWNFIELD DEVELOPMENT INCENTIVES AND TAX CREDITS: CASE STUDIES IN CREATIVE DEAL MAKING

A PRIMER ON THE HISTORIC REHABILITATION TAX CREDIT

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THE FEDERAL HISTORIC REHABILITATION TAX CREDIT

I. OVERVIEW

The federal rehabilitation tax credit provides an indirect federal subsidy for the rehabilitation of certain older structures.

A. Amount of Credit.

1. **10 Percent Credit**. The credit is equal to 10 percent of the "**qualified rehabilitation expenditures**" incurred with respect to any "**qualified rehabilitated building**" other than a certified historic structure. Section 47(a)(1).[1]

2. **20 Percent Credit**. The credit is equal to 20 percent of the "**qualified rehabilitation expenditures**" incurred with respect to a "**certified historic structure**." Section 47(a)(2).

B. Eligibility.

A "**qualified rehabilitated building"** is any building that:

1. has been "**substantially rehabilitated**;"

2. was placed in service before the beginning of the rehabilitation;

3. is a structure with respect to which depreciation (or amortization in lieu of depreciation) is allowable; and

4. in the case of a building which is not a "certified historic structure," (a) the building was placed in service before 1936, and (b) complies with certain requirements regarding the percentage of walls and internal structural framework retained. Section 47(c).

C. Certified Historic Structure.

A "**certified historic structure**" is any building that is listed in the National Register or that is located in a registered historic district and certified by the Secretary of the Interior (National Park Service) as being of historic significance to the district. Section 47(c)(3).

D. Substantial Rehabilitation.

A building is generally considered to be "**substantially rehabilitated**" only if the "**qualified rehabilitation expenditures**" during the 24-month period selected by the taxpayer in accordance with the applicable Treasury Regulations and ending with or within the taxable year exceed the *greater* of (i) the adjusted basis of the building (including structural components) or

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code, as amended and in effect as of September 1, 2003.

(ii) $5,000. The adjusted basis of the building (including structural components) is determined as of the beginning of the first day of the 24-month period or the holding period of the building, whichever is later. The determination of the beginning of the holding period is made without regard to any reconstruction by the taxpayer in connection with rehabilitation. Section 47(c)(1)(C).

Special 60-Month Rule for Phased Rehabilitation. If the rehabilitation is reasonably expected to be completed in phases set forth in architectural plans and specifications completed *before* the rehabilitation begins, expenditures incurred over a 60-month period (rather than 24 month period) may be taken into account. Section 47(c)(1)(C)(ii).

E. Qualified Rehabilitation Expenditure.

The term "**qualified rehabilitation expenditure**" generally means any amount properly chargeable to capital account: (i) for property which is depreciable for federal income tax purposes and which is (a) nonresidential real property, (b) real property with a class life of more than 12.5 years, *or* (c) an addition or improvement to property in one of the above-described classes, and (ii) in connection with the rehabilitation of the qualified rehabilitated building. Section 47(c)(2).

The term "**qualified rehabilitation expenditure**" does not include the cost of acquiring the building, the cost of any enlargements to the building or, in the case of a certified historic structure, any expense unless the rehabilitation is certified by the Secretary of the Interior (National Park Service) as being consistent with the historic structure of the property. Section 47(c)(2). The term "**qualified rehabilitation expenditure**" also does not include any expenditure in connection with the rehabilitation of a building that is allocable to the portion of the property which is, or may be reasonably expected to be, "**tax-exempt use property**" as defined in Section 168(h) of the Internal Revenue Code. Section 47(c)(2)(B).

Generally, real property may be classified as "**tax-exempt use property**," in whole or in part, if (1) it is leased to a tax-exempt entity pursuant to a "**disqualified lease**" or (2) it is owned by a partnership composed of both taxable and one or more tax-exempt entities and the partnership's tax allocations are not qualified allocations. This issue is discussed further in Part II below.

F. Timing of Credit.

The rehabilitation tax credit can generally be claimed only in the year in which the rehabilitated property is "placed in service." Section 47(b). The credit is based on the sum of the qualified rehabilitation expenditures incurred during the following periods: (1) the 24-month period selected to determine whether the building is considered to have been "substantially" rehabilitated", (2) the period from the beginning of the tax year in which the 24-month period began to the first day of the measuring period; and (3) the period from the end of the 24 month period through the end of the tax year in which the measuring period ended. Treas. Reg. Section 1.48-12(c)(6).

Practice Pointer: If the building is owned by a partnership or entity classified as a partnership for tax purposes (such as a limited liability company), the partners to whom the tax credit will be allocated must be admitted to the partnership prior to the date on which the building is placed in service. The credit cannot be allocated to a partner who is admitted to the partnership after the building has been placed in service even if the partner is admitted to the partnership in the same year the building is placed in service.

Progress Expenditure Election.

If the normal rehabilitation period for a building is two years or more, and it is reasonable to expect that the building will be a qualified rehabilitated building when it is placed in service, a taxpayer may elect to claim the rehabilitation tax credit using the progress expenditure method. Section 47(d).

Generally, if a building is considered to be "self-rehabilitated," the expenditures are taken into account in the year in which they are properly chargeable to capital account under the taxpayer's method of accounting. If a building is not considered to be "self-rehabilitated," the expenditures are taken into account in the year in which they are paid. Section 47(d)(1).

The progress expenditure election must be made on the taxpayer's federal income tax return. The election will apply to that tax year and all subsequent tax years. The election may be revoked only with the consent of the Internal Revenue Service. Section 47(d)(5).

Practice Pointer: In the case of a partnership or S corporation, the progress expenditure election may be made only at the partner/shareholder level and not by the partnership or corporation. Each partner/shareholder may decide independently whether to make to the election. Treas. Reg. 1.46-5(o)(1).

G. Depreciable and Low-Income Housing Tax Credit Eligible Basis Reduced by Amount of Rehabilitation Tax Credit Claimed.

If a taxpayer claims a rehabilitation tax credit with respect to a building, the depreciable basis of the qualified rehabilitation expenditures incurred with respect to the building is reduced by the amount of the rehabilitation tax credit claimed. The eligible basis of the rehabilitation expenditures is also reduced for purposes of determining the low-income housing tax credit based on those expenditures. Section 50(c).

H. Nonqualifying Property.

Generally, the following types of property are not eligible for the rehabilitation tax credit:

1. Property outside the United States;

2. Property used for lodging, unless the property is (a) a certified historic structure, or (b) a hotel or motel and the predominant portion of the accommodations are used on a transient basis;

3. Property used by tax-exempt organizations, unless the property is used predominantly in an unrelated trade or business, the income of which is taxable under Section 511. In the case of property owned by a partnership, the determination of whether the property is "used" by a tax-exempt entity is made under the tax-exempt use property rules applicable to partnerships, which are discussed in Section II.B. below; and

4. Property used by governmental units or foreign persons or entities, provided that buildings *leased* to governmental units or foreign persons or entities are eligible for the credit.

Section 50(b).

I. Recapture.

The rehabilitation tax credit is subject to recapture in the event of early disposition (including destruction from casualty or condemnation) of an historic credit property. If, within five years after the date the building is placed in service, the building is disposed of, the owner's tax for the year will be increased by an amount equal to the amount of the rehabilitation tax credit originally allowed, multiplied by a "**recapture percentage**" determined on the basis of the holding period of the building. Section 50(a).

The "**recapture percentage**" is 100 percent for a disposition within the first year after the building is placed in service and decreased by 20 percent for each full year that elapses thereafter such that no recapture occurs in the event of a sale occurring more than five years after the building is placed in service. For purposes of determining recapture of the rehabilitation tax credit, a disposition is deemed to occur in any sale, exchange, transfer, distribution, involuntary conversion or gift of the building, or the occurrence of any other event which causes the building to cease to qualify for the rehabilitation tax credit.

II. TECHNICAL TAX TRAPS

A. Overview.

This portion of the outline will review three areas in which technical tax rules may adversely effect the amount of tax benefits that a rehabilitation project will generate or that an investor will receive: (i) the passive activity credit limitations; (ii) the alternative minimum tax; (iii) the tax-exempt use property rules, (iv) the nonqualified nonrecourse financing rules, and (iv) the coordination of the rehabilitation credit under Section 47 with the low-income housing tax credit under Section 42.

There are many other tax rules that could also affect the amount of tax benefits to be received by project investors. The rules discussed are highly technical, and their application may

turn on the facts and circumstances of a particular project. This outline is intended merely to highlight and summarize the issues so that project developers and their advisors will be aware of them in structuring transactions.

B. Passive Activity Credit Limitations.

The rehabilitation tax credit is subject to the passive activity credit limitations. Section 469. This limitation significantly limits the ability of most individual investors to use the credit.

Practice Pointer: In light of this limitation, the most likely investors in a historic rehabilitation project are corporate and institutional investors rather than individuals.

C. Alternative Minimum Tax.

The rehabilitation tax credit may not be applied to reduce a taxpayer's alternative minimum tax liability. Section 55.

D. Tax-Exempt Use Property.

1. General Rule - Expenditures Attributable to Tax-Exempt Use Property are Excluded from Basis on which the Rehabilitation Tax Credit is Calculated.

The rehabilitation tax credit is generally based upon a percentage of the "qualified rehabilitation expenditures" incurred with respect to a rehabilitated building. Section 47(a). However, "qualified rehabilitation expenditures" do not include any expenditures incurred in connection with the rehabilitation of a building that are allocable to the portion of the building that is (or may reasonably be expected to be) tax-exempt use property. Section 47(c)(2)(B)(v).

2. Definition of Tax-Exempt Use Property.

Generally, property is considered to be "tax-exempt use property" if it is either (a) leased to a tax-exempt entity in a "disqualified lease" or (b) owned by a partnership that includes both taxable and tax-exempt entities as partners and the partnership tax allocations are not "qualified allocations."[2] Section 168(h).

a. Leases to Tax-Exempt Entities.

In the case of both residential rental property and nonresidential real property, the term "tax-exempt use property" generally means that portion of the property that is leased to a tax-exempt entity in a "disqualified lease." Section 168(h)(1)(B) and (E).

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[2] This outline does not address the tax-exempt use property rules applicable to personal property. See Sections 168(h)(l)(A) and 168(h)(3)

(1) Tax-Exempt Entity.

For purposes of these rules, the term 'tax-exempt entity' means: (i) the United States, any state or political subdivision thereof or any agency or instrumentality of any of the foregoing, (ii) an organization (other than a cooperative described in Section 521) which is exempt from federal income tax and (iii) a foreign person or entity.[3]

A corporation is not treated as an instrumentality of the United States or of any state or local government if all the activities of the corporation are subject to federal income tax and the majority of the board of directors of the corporation is not selected by the United States or a state or local government.

Certain previously tax-exempt organizations are also treated as tax-exempt entities for five years after the date on which they first used the property in question. *See* Section 168(h)(2)(E).

(2) Disqualified Lease.

Generally, a lease to a tax-exempt entity is a "disqualified lease" if any of the following conditions are met:

(a) Tax-Exempt Financing. All or part of the property was financed (directly or indirectly) by an obligation the interest on which is tax-exempt and the entity (or related entity) participated in the financing;

(b) Option. Under the lease, there is a fixed or determinable purchase price or sale option which involves the entity (or related entity) or there is the equivalent of such an option;

(c) Long-Term Lease. The lease has a lease term in excess of twenty years; or

(d) Certain Sale-Leasebacks. The lease occurred after a sale (or other transfer) of the property by, or the lease of the property from, the entity (or a related entity) and the property has been used by the entity (or a related entity) before such sale (or other transfer) or lease. However, this provision does not apply if the property is leased within three months after the date first used by the entity (or a related entity).

Section 168(h)(1)(B).

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[3] Special rules apply if more than 50% of the gross income for the taxable year derived by the foreign person or entity from the use of the property is subject to federal income tax or is included in the gross income of the United States shareholder for the taxable year within which ends the taxable year of the controlled foreign corporation from which income was derived. Section 168(h)(2)(B).

There are a number of exceptions to these rules:

(i) 35% Threshold. Rehabilitated property is considered tax-exempt use property only if the portion of the property leased to tax-exempt entities in disqualified leases is more than 35% of the property.

(ii) Short-Term Leases. Property is not treated as tax-exempt use property merely by reason of a short-term lease, which is generally defined as a lease of less than three years.

(iii) Unrelated Trade or Business. The term "tax-exempt use property" does not include any portion of property that is predominantly used by a tax-exempt entity (directly or through a partnership of which it is a partner) in an unrelated trade or business, the income of which is subject to tax under Section 511.

In the case of property leased to a partnership, the determination of whether any portion of the property is tax-exempt use property is made by treating each tax-exempt entity partner's proportionate share of the property as being leased to that partner. Similar rules apply in the case of any pass-through entity other than a partnership and in the case of tiered partnerships. *See* Section 168(h)(5).

Practice Pointer: In light of the exception for short-term leases, it should generally be possible to structure a lease with an exempt entity in a manner that avoids characterization of the lease as a "disqualified lease" under these rules.

b. Property Owned by Partnerships Composed of Both Taxable and Tax-Exempt Partners.

The tax-exempt use property rules may also be triggered where the property is owned by a partnership composed of both a tax-exempt entity and one or more taxable entities. Generally, if any tax allocation made to the tax-exempt entity of partnership tax items is not a "qualified allocation," then an amount equal to the tax-exempt entity's proportionate share of the property is treated as tax-exempt use property. Section 168(h)(6).

(1) Qualified Allocations. For purposes of these rules, the term "qualified allocation" means any allocation to the tax-exempt entity which is consistent with that entity being allocated the same distributive share of each item of partnership income, gain, loss, deduction, credit and basis throughout the entire period in which the entity is a partner in the partnership and which has substantial economical effect under Section 704(b). For purposes of these rules, tax allocations under Section 704(c) (with respect to property contributed to a partnership) are not taken into account.

If the tax-exempt use property rules are triggered, a tax-exempt entity's proportionate share of property owned by the partnership is determined on the basis of the entity's share of partnership income or gain (excluding gain allocated under Section 704(c)), whichever results in the largest proportionate share. If a tax-exempt entity's share of partnership

items of income or gain (excluding gain allocated under Section 704(c)) may vary during the period in which such entity is a partner, its share shall be the highest share that the entity may receive. Similar rules apply in a case of any pass-through entity other than a partnership and in the case of tiered partnerships.

Practice Pointer: The "qualified allocation" rules do not provide an exception for partnership regulatory allocations required to comply with the substantial economic effect regulations under Section 704(b), such as minimum gain chargeback allocations. Congress's failure to address regulatory allocations under Section 704(b) may be due in part to the fact that the Section 704(b) regulations had not yet been promulgated at the time that the tax-exempt use property rules were enacted. Nonetheless, Congress has failed to address the issue since. Many practitioners believe that any anticipated regulatory allocations under Section 704(b) must be taken into account in determining whether the partnership runs afoul of the qualified allocation rules.

(2) Tax-Exempt Controlled Entities. A "tax-exempt controlled entity" is generally treated as a tax-exempt entity for purposes of these rules. A "tax-exempt controlled entity" is a corporation (which is not a tax-exempt entity) 50% or more of the stock of which (determined by value) is held by one or more tax-exempt entities (other than a foreign person or entity).

In determining the amount of stock held by the tax-exempt entity, the attribution rules under Section 318 (determined without regard to the 50% limitation contained in subsection (a)(2)(C) thereof) apply. However, in the case of a corporation whose stock is publicly traded in an established securities market, stock held by a tax-exempt entity is not taken into account unless the entity holds at least 5% of the corporation's stock (determined by value). For purposes of this provision, related entities are treated as one entity.

(3) Option to Elect Out of Section 168(h). A tax-exempt controlled entity may elect out of the tax-exempt use property rules as they apply to partnerships. Section 168(h)(6)(F). If the tax-exempt controlled entity makes this election, the entity will not be treated as a tax-exempt entity for purposes of these rules and any gain recognized by a tax-exempt entity on any disposition of its interest in the tax-exempt controlled entity and any dividend or interest received or accrued by a tax-exempt entity from the tax-exempt controlled entity will be treated as unrelated business taxable income under Section 511. Any such election by a tax-exempt controlled entity is irrevocable and binding on all tax-exempt entities holding an interest in the tax-exempt controlled entity.

E. Nonrecourse Financing - At Risk Rules.

1. Certain Nonrecourse Financing is Excluded from the Tax Credit Base.

Certain types of nonrecourse financing are excluded from the base on which the rehabilitation tax credit is determined. Section 49(a). If these rules are applicable, the amount of tax credit for which a building is eligible can be substantially reduced. The rules are generally

designed to exclude from the tax credit base seller financing or related-party financing for which the owner of the property is not at risk.

a. The Nonrecourse Financing Rules are Applicable to Taxpayers who are Subject to the At Risk Rules Under Section 465.

Generally, the rules are applicable to individuals and to closely-held corporations where more than fifty percent of the outstanding stock is owned (directly or indirectly) by five or fewer individuals. Section 465(a)(1).

b. Nonqualified Nonrecourse Financing is Excluded from the Tax Credit Base.

Nonqualified nonrecourse financing means any financing other than "**qualified nonrecourse financing**." Section 49(a)(l)(D).

"**Qualified nonrecourse financing**" means financing with respect to the property where:

(1) the property was not acquired by the taxpayer from a related party;

(2) the amount of the nonrecourse financing does not exceed 80% of the tax credit base of the property; and

(3) the financing is borrowed from a "qualified person" or represents a loan from (or a loan guaranteed by) a federal, state or local government. Section 49(a)(1)(D)(ii).

For purposes of these rules, the term "**nonrecourse financing**" includes any amount with respect to which the taxpayer is protected against loss through guarantees, stop-loss agreements, etc. and, generally, any amount borrowed from a person who has an interest in the activity (other than as a creditor) in which the property is used or from a related person to a person (other than the taxpayer) having such an interest. Section 49(a)(1)(D)(iii).

A "**qualified person**" means a person (including an entity):

(1) who is actively and regularly engaged in the business of lending money; and

(2) who is not:

(a) a related person to the taxpayer,

(b) a person from whom the taxpayer acquired the property (or a person related to that person), or

(iii) a person who receives a fee with respect to the taxpayer's investment in the property (or a person related to that person).

Section 49(a)(l)(D)(iv).

2. Application to Partnerships (and Entities Classified as Partnerships for Tax Purposes) and S Corporations.

Generally, the determination of whether a partner's or S corporation shareholder's allocable share of any financing is nonqualified nonrecourse financing is made at the partner or shareholder level. Section 49(a)(l)(E).

Special rules apply to certain financing that is recourse to an S corporation (although not to its shareholders). *See* Section 49(a)(l)(E)(ii).

3. Additional Tax Credit May be Claimed Where, After the Year in Which the Property is Placed in Service, There is a Net Decrease in the Amount of Nonqualified Nonrecourse Financing.

Generally, if, in a year subsequent to the year in which the property has been placed in service, there is a net decrease in the amount of nonqualified nonrecourse financing (due to circumstances other than the surrender or other use of the property), the net decrease is taken into account as an increase in the property's tax credit base. Section 49(a)(2). The taxpayer may claim the tax credit attributable to the increase in the tax credit base in the year in which the decrease in nonqualified nonrecourse financing occurs. Section 49(a)(2)(C). However, for purposes of determining the general limitations on the amount of credit that may be claimed and for purposes of computing tax credit recapture, the credit is deemed to have been claimed in the year in which the property was placed in service. *Id*.

4. Increases in Nonqualified Nonrecourse Financing May Result in Additional Tax.

If, in any year, there is a net increase in the amount of nonqualified nonrecourse financing with respect to the property, then an additional tax is imposed in an amount equal to the aggregate decrease in investment tax credits allowable under Section 38 for all prior taxable years that would have resulted from reducing the tax credit base by the amount of the net increase in nonqualified nonrecourse financing. Section 49(b). For purposes of computing any tax credit recapture on transfer or disposition of the property, the net increase in nonqualified nonrecourse financing is treated as having reduced the property's tax credit base in the year in which the property was placed in service.

For purposes of computing the amount of any net increase in nonqualified nonrecourse financing under this rule, transfers of debt occurring more than one year after the debt was incurred are not taken into account. Section 49(b)(2).

F. Coordination of the Rehabilitation Tax Credit and the Low-Income Housing Tax Credit

The rehabilitation tax credit and the low-income housing tax credit available under Section 42 are often combined. The use of both credits provides a greater return to project investors and therefore permits the project developer to obtain greater equity investment in the project. However, there are a number of potential pitfalls to bear in mind in structuring a project that will use both credits.

1. Basis Reduction.

The property's basis (including the basis upon which the low-income housing tax credit is determined) will be reduced dollar for dollar by the amount of rehabilitation tax credit that is allowable with respect to the property. Section 50(c).

2. Period Over Which Credit is Claimed.

Subject to the rules concerning decreases in nonqualified nonrecourse financing discussed above, the rehabilitation tax credit is a one time credit claimed in the year in which the property is placed in service. The low-income tax credit is generally a ten year credit claimed beginning with the year the property is placed in service or, at the election of the taxpayer, the year thereafter. Section 42(a) and (f).

3. Timing of Ownership.

In order to be eligible for the rehabilitation tax credit, a taxpayer must own the property on the date the property is placed in service. In the case of the low-income housing tax credit, a subsequent owner may "step into the shoes" of the prior owner and claim the remaining credits allowable over the tax credit period. Section 42(d)(7).

4. Partnership Allocations.

Generally, the rehabilitation tax credit is allocated among partners in a partnership in accordance with the ratio in which the partners divide the general profits of the partnership, regardless of whether the partnership has a profit or loss for the taxable year in which the property is placed in service. However, if the ratio in which the partners divide the general profit of the partnership changes during the taxable year, the ratio effective on the date in which the property is placed in service applies. Treas. Reg. §1.46-3(f).

The low-income housing tax credit, on the other hand, is generally allocated among the partners in the same proportion as partnership losses or deductions arising from the expenditures that gave rise to the credit. Treas. Reg. §1.704-l(b)(4)(ii).[4]

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[4] This discussion of partnership tax credit allocations assumes that the allocations of other partnership items are valid and will be respected under Section 704(b).

5. Recapture Rules.

Generally, if property with respect to which rehabilitation tax credit has been claimed is disposed of within five years after the property is placed in service, a portion of the tax credit must be recaptured. Section 50(a). The recaptured portion is generally 20% per year. Thus, if the property is disposed of during the second year after the property was placed in service, the taxpayer must recapture 80% of the credit, and if the property is disposed of during the third year after the property was placed in service, the taxpayer must recapture 60% of the credit.

In the case of the low-income housing tax credit, more complex recapture rules apply. Generally, if there is a decrease in the "qualified basis" of a building during any year of the fifteen-year compliance period (which begins with the first year in which a credit is claimed for the building), a portion of the tax credit that has been claimed with respect to the building is subject to recapture. Section 42(j). A decrease in qualified basis would most likely result from a reduction in the number of units leased to qualified low-income tenants at qualified rents. However, any event that would result in a reduction of qualified basis would trigger recapture. A portion of the low-income housing tax credit is also subject to recapture if the taxpayer disposes of its interest in the building prior to the end of the tax credit compliance period unless the taxpayer posts a bond pursuant to Section 42(j)(6).

6. At Risk Rules.

The at risk rules with respect to nonrecourse financing are slightly different for purposes of determining the low-income tax credit than the rehabilitation tax credit. *Compare* Section 49 with Section 42(k). Generally, the low-income tax credit at risk rules permit, under certain circumstances, nonrecourse financing from a qualified nonprofit organization to be taken into account without regard to whether the organization is actively and regularly engaged in the business of lending money or whether the organization is a "qualified person" within the meaning of Section 49(a)(l)(D)(iv)(II). (Generally, for purposes of this rule, the term "qualified person" means a person other than (i) a person related to the taxpayer (ii) a person from whom the taxpayer acquired the property or (iii) a person who receives a fee with respect to the taxpayer's investment in the property.) Section 42(k)(2).

7. Minimum Amount of Qualifying Expenditures.

In order to qualify for the rehabilitation tax credit, the qualified rehabilitation expenditures during a twenty-four month period must exceed the greater of (i) the adjusted basis of the building or (ii) $5,000. Section 47(c)(l)(C). In the case of the low-income housing tax credit, the qualifying expenditures during a twenty-four month period must equal or exceed the greater of (i) 10% of the adjusted basis of the building or (ii) $3,000 per "low-income unit" in the building. Section 42(e)(3).

There is no requirement that the twenty-four month period used for purposes of the rehabilitation tax credit and the twenty-four month period used for purposes of the low-income housing tax credit be the same.