

Combining the New Market Tax Credit with Rehabilitation Tax Credit and the Energy Tax Credits

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The federal historic tax credit program

- Established in 1976, the federal historic tax credit program is the nation's key program for encouraging investment in the renovation of historic buildings
- Diverse uses of the subsidy, including retail uses, theaters, apartments, hotels and office
- Program is based on a partnership among the federal government, state governments and the private sector
- Over 1,000 projects approved in 2008
- Over one million buildings are listed in or contribute to historic districts in the National Register of Historic Places

What is the federal historic tax credit?

- A federal income tax credit for renovation of historic buildings equal to 20 percent of qualified rehabilitation expenditures incurred with respect to a certified historic structure. See § 47 of the Internal Revenue Code (IRC)
- The credit is a dollar-for-dollar offset against the building owner's federal tax credit liability.
- Generally, the historic tax credit is allowed in the year in which the renovated building is first placed back in service.
- Buildings first placed in service before 1936, which are not certified historic structures, may still receive a 10% historic tax credit.

Basic requirements for the historic tax credit

- A qualified project that the Secretary of the Interior designates as a “certified rehabilitation” of a “certified historic structure.”
- “Certified historic structure” is a building that either:
 - is individually listed in the National Register of Historic Places or;
 - is located in a registered historic district and certified by the Secretary as being of historic significance to the district.
- The state historic preservation office plays a key role in the certification process.
- There is a three part certification process:
 - Part 1 – with respect to buildings that are not listed in the National Register of Historic Places, evaluate the historic significance of the building to the historic district in which it is located
 - Part 2 – approval of the scope of the renovation work
 - Part 3 – certification of completion of the renovation work

Basic requirements for the historic tax credit

- A “certified rehabilitation” is a rehabilitation that has been certified by the Secretary as being consistent with the historic character of the building or the district in which it is located.
- The building must be “substantially rehabilitated.” In general, this requires that the qualified rehabilitation expenditures during the 24-month period selected by the taxpayer exceed the adjusted basis of the building, including its structural components.
- The requirements for the historic tax credit can be satisfied in a manner that allows for a “rolling rehabilitation” of a building (i.e. one in phases).

What are “qualified rehabilitation expenditures?”

- Qualified rehabilitation expenditures generally are costs incurred for the renovation of a building that would be depreciable under IRC Section 168 (e.g. construction costs, architect’s fees, engineering fees and related costs of carry). See IRC § 47(c)(1)(A)
- Reasonable developer fees do generate historic tax credits.
- Qualified rehabilitation expenditures do not include:
 - Land costs
 - Costs of acquiring the building
 - Costs of enlarging the building
 - Costs of related facilities, such as sidewalks, parking lots and landscaping
- Personal property, such as appliances, cabinets and furniture do not generate historic tax credits.

Recapture of historic tax credits

- Historic tax credits are subject to “recapture,” which results in a federal income tax liability to the person who had claimed the credit.
- The recapture period is the five-year period commencing on the date the renovated building was placed in service.
- Recapture occurs if:
 - the building is sold or ceases to be used for business purposes during the recapture period;
 - with respect to any partner, if the partner sells 2/3rds or more of its interest in the owner of the renovated building; in this case, recapture is pro rata based on the amount sold in excess of 2/3rds; or
 - a project ceases to be a certified historic structure, whether because of casualty, owner renovations that change the historic character of the building or otherwise.
See IRC § 50(a).
- The recapture amount is 100 percent during the first one year period following the placed in service date, 80 percent the next year, etc. until the recapture period terminates on the fifth anniversary of the placed in service date.
- Because of recapture tax liability, the owner must plan on having a minimum five year holding period for the project.

Use of historic tax credits by lessee

- Subject to certain requirements, an owner can make an election to “pass-through” the historic tax credits to its tenant, See IRC § Section 50(d)(5).
- The pass-through election structure is common in historic tax credit transactions.
- To receive the maximum allowable amount of historic tax credits in connection with a pass-through lease transaction, either (A) the lease term must be at least 80 percent of class life of the renovated building (e.g. for a non-residential building, the minimum lease term would be 31.2 years [80 percent of 39 years]), or (B) the lease must be a “net lease.”
- One of the primary benefits to the pass-through structure is that it does not require the owner to reduce its depreciable basis by the amount of qualified rehabilitation expenditures. Instead, the master tenant must recognize income ratably over the shortest cost recovery period for the rehabilitation expenditures.

Additional tax considerations

- Except in connection with the pass-through lease structure (described above), the owner's basis is reduced by the amount of the historic tax credits allowed.
- As a result of the Housing and Economic Recovery Act of 2008, the historic tax credit can be used to offset a taxpayer's liability for alternative minimum tax.
- The allocation of historic tax credits must follow general profits. This requirement constrains how the tax credit may be allocated among the parties to a transaction.
- Historic tax credits are subject to the "at-risk" rules, including a rule that not more than 80 percent of a project's credit basis can be financed with non-recourse debt.

Additional tax considerations

- Special tax exempt use rules restrict the leasing of more than 50% of a historic tax credit building to governmental entities or other tax exempt entities.
- Additional tax rules restrict ownership of historic tax credit buildings by governmental entities or other tax exempt entities.
- There are structuring techniques to manage the problems raised by ownership or use of a project by a tax-exempt entity.
- Historic tax credits are subject to passive loss rules, which generally make the historic tax credits unavailable to individual taxpayers.

Market Conditions for Historic Tax Credits

- A small, but active effective, market exists for investments in historic tax credits. Because of the passive loss limitations, historic tax credits are primarily purchased by profitable, widely held C-corporations.
- An historic tax credit investment involves a mix of tax investment and economic return – the tax credits cannot be sold without an economic return to the investor.
- Tax credit prices generally range from \$0.90 to over \$1.00 per credit depending on many factors, including timing of equity investments, the required economic return to the historic tax credit investor, structure of tax credit investment and perceived tax risk.
- This market has held up relatively well because (a) the historic tax credit is an investment credit that is 100% allowed the year the improvements are placed in service, and (b) the recapture/investment holding period is only 5 years.

Other Business Considerations

- Usually, the historic tax credit investor demands a cash-on-cash return of 2% to 3% on its investment.
- Typically, the historic tax credit investor has the option to put its investment to the deal sponsor at a pre-determined price after the recapture period.
- In addition, the sponsor often has a call option to purchase the interest of the historic tax credit investor for the fair market value of the interest of the historic tax credit investor.
- The client must evaluate the economic implications of these provisions as well as tax consequences to the sponsor from entering into the HTC transaction.

Market Conditions for NMTCs

- Pricing for the NMTCs in the \$.60 to \$.70 range (net) and likely falling
- Leveraged loans are tough to find
- Banks are the predominant leveraged lender and investors
- Real estate underwriting standards are becoming tougher
- Deals in highly distressed areas are favored by many CDEs
- CDE fees and transaction costs can cut deeply into the proceeds to the owner
- Deals with lots of subsidy in addition to the NMTC are favored

Combining with NMTCs

- The historic tax credit can be “twinned” with the new market tax credit.
- The twinned structure can increase the net proceeds from the historic tax credit investment by 20 to 25%
- While there are numerous ways to structure the new market tax credit investment with the historic tax credit equity, a single equity investment by a CDE is often the most efficient.

Energy Tax Credits under IRC Section 48

- An investment tax credit under IRC Section 48 for investment in “energy property”
- A 30% credit is available for:
 - Solar technology used to generate electricity (if placed in service by end of 2016)
 - Solar equipment to heat or cool a structure building or to provide hot water (but no swimming pools allowed) (if placed in service by end of 2016)
 - Equipment for fiber-optic distributed sunlight (if placed in service by end of 2016)
 - Qualified fuel cell property
 - Qualified small wind energy property

10% Energy Property

- A 10% credit is available for:
 - Equipment used to produce, distribute or use energy from a geothermal deposit
 - Qualified microturbine property (if in service by end of 2016)
 - Combined heat and power system equipment
 - Equipment that uses the ground or ground water as a thermal energy source (heating) or a thermal energy sink (cooling)

Rules for Energy Credits

- Rules generally match the rules for the historic tax credit and other investment credits, including recapture, pass-through election of leased property, governmental use and tax-exempt use property
- Can combine with NMTCs
- Can not claim historic tax credit and Section 48 tax credit on same property – no double dipping
- Except in connection with pass-through election, Section 48 tax credit reduces basis by 50% of the credit amount

Rules for Section 48 Energy Credits

- Energy property that is financed with tax-exempt bonds or other subsidized financing receives a reduced amount of Section 48 credits
- Property must meet performance and quality standards, if any, prescribed by the IRS based on consultation with the U.S. Department of Energy

Grants in Lieu of Credit

- Housing and Economic Recovery Act of 2009 allows for grants in lieu of tax credits for 100% of the amount of the credit that would have been allowed
- This program is available only for property placed in service during 2009 or 2010, or property under construction during 2009 or 2010
- The taxpayer must apply to the Secretary of the Treasury for the grant in lieu of credit and comply with program requirements
- Grants are also subject to recapture rules