

**HISTORIC
REHABILITATION
TAX CREDIT**

The Tax Basics

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HISTORIC REHABILITATION TAX CREDIT

OUTLINE

I. What Kind of Rehabilitation Qualifies?

Section 47 and Section 38 of the Code provide for a 20% historic rehabilitation tax credit ("Historic Rehabilitation Credit") in the case of the rehabilitation of "certified historic structures."

A. A certified historic structure includes any building which is (1) listed in the National Register of Historic Places or (2) located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to the district. (Part I Approval)

B. The rehabilitation plans (Part II Approval) and work (Part III Approval) must be certified by the Secretary of the Interior as consistent with the historic nature of the building.

C. A qualified rehabilitated building includes any building, together with its structural components, which has been substantially rehabilitated, which was placed in service before the beginning of the rehabilitation, and which retains 75% or more of the existing external walls in place after the rehabilitation has been completed.

D. A building has been substantially rehabilitated for a taxable year if, during any 24-month period selected by the taxpayer ending with or within the taxable year in which the Historic Rehabilitation Credit is claimed, the qualified rehabilitation expenditures for all owners of the building exceed the greater of (1) the adjusted basis of all owners of the building at the beginning of such 24-month period or (2) \$5,000.

E. Qualified rehabilitation expenditures are defined to include any amount properly chargeable to capital account with respect to property which has a 27.5-year or 39-year recovery period and which is made in connection with the rehabilitation of a qualified rehabilitated building.

F. Section 47(c)(2)(B) specifically excludes certain expenditures from the definition of qualified rehabilitation expenditures.

1. The cost of acquiring a building cannot be treated as a qualified rehabilitation expenditure;

2. Any expenditure related to the enlargement of an existing building cannot be treated as a qualified rehabilitation expenditure.

3. Personal property costs and expenditures attributable to work done to related facilities such as sidewalks and parking lots are not treated as qualified rehabilitation expenditures.

G. The basis of property projected to qualify for the Historic Rehabilitation Credit is expected to include essentially all expenditures made in connection with the renovation (as distinguished from new construction) of a project which are properly chargeable to capital account and eligible for depreciation over 27.5 years. The straight-line method of depreciation must be used with respect to expenditures that are to be treated as qualified rehabilitation expenditures, and the basis must be reduced by the amount of the Credit.

1. Treasury Regulation Section 1.48-12(c)(2) provides that the portion of construction period taxes and interest relating to funds borrowed in connection with qualified rehabilitation expenditures, if such interest and taxes are chargeable to capital account and added to the basis of the building, are considered as properly chargeable to capital account for purposes of determining whether they are qualified rehabilitation expenditures.

2. In addition, Treasury Regulation Section 1.48-12(c)(2) specifically provides that architectural and engineering fees, site survey fees, legal expenses, insurance premiums, development fees and other construction related costs are properly chargeable to capital account.

H. Even though a building and the rehabilitation would both meet the requirements above, some types of users of the property may disqualify the property for historic tax credits. Code Section 168(h) provides that in certain circumstances, the leasing of the property to a government or nonprofit entity will disqualify the property for historic tax credits. Specifically, if more than 35% of the property is leased to government or nonprofit entities in cases where the lease term is too long, or where there is a fixed price option at the end, the credits are not allowed. In addition, if the rehabilitation is financed with tax exempt bonds issued by the government or nonprofit entity which leases the property, or if the transaction is a sale/leaseback from the government or nonprofit entity, this would disqualify the property as well. These rules are very complex, and should be reviewed if a nonprofit or governmental entity is involved in the use of the property or as a part of the owning entity.

II. When Can the Credit be Claimed?

A. The Historic Rehabilitation Credit can be claimed only in the year in which the property which is subject to the credit is "placed in service", or, if later, when the building has been substantially rehabilitated. Thus, in some cases, credits may be claimed over multiple years.

1. Even where partners are admitted to a partnership after a portion of the rehabilitation work has occurred, Treasury Regulation Section 1.46-3(f) provides that partners admitted to a partnership prior to the date on which the property which it owns is placed in service will be entitled to an allocation of their share of the Historic Rehabilitation Credit with respect to that property. For partnerships the Credit is allocated in accordance with the partners' interests in profits for tax purposes.

B. Treasury Regulations provide that property is considered to be placed in service on the earlier of:

1. the taxable year in which, under the taxpayer's depreciation practice, the period for depreciation with respect to such property begins, or

2. the taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function.

III. How is a Change in Ownership Treated?

A. Treasury Regulation Section 1.48-12(e)(3)(ii) specifically provides that where rehabilitation expenditures are incurred with respect to a building by one person and a new owner subsequently acquires the building, the new owner is treated as having incurred the rehabilitation expenditures provided that the building as rehabilitated had not already been placed in service and that no other party claims the tax credits with respect to such expenditures.

B. The amount of qualified rehabilitation expenditures which the new owner may claim under these circumstances is limited to the lesser of the amount of expenditures incurred by the original party or the allocable cost of acquisition attributable to such expenditures.

IV. How Much in Credits Can be Taken Each Year?

The Historic Rehabilitation Credit is a direct credit against a taxpayer's Federal income tax liability.

A. The Code limits use of business tax credits, including both Low-Income Housing Credits and Historic Rehabilitation Credits, to the amount of Federal income tax liability that does not exceed \$25,000 in such year plus 75% of any Federal income tax liability in excess of \$25,000.

B. Any excess unused credits disallowed under this rule may be carried back 1 year and forward 20 years.

C. The Historic Rehabilitation Credit cannot be used to reduce liability for the alternative minimum tax.

D. The Historic Rehabilitation Credit is subject to the Passive Activity Rules of Section 469.

E. The Historic Rehabilitation Credit is subject to the at risk rules of Section 49.

V. When is the Credit Recaptured?

If a project or any portion of a project which includes qualified rehabilitation expenditures is sold or otherwise disposed of prior to the expiration of five years from the date it was placed in service, all or a portion of the Historic Rehabilitation Credit will be recaptured.

A. In the event of such a disposition, a taxpayer's tax liability for the year of disposition will be increased by an amount equal to the amount of the Historic Rehabilitation Credit originally allowed multiplied by the "recapture percentage" which will vary depending on the date of disposition. The "recapture percentage" is 100% for a disposition within the first year after property is placed in service and decreases by 20% for dispositions within each of the next five years.

B. For purposes of determining the recapture of Historic Rehabilitation Credit, a disposition is deemed to occur upon any sale, exchange, transfer, distribution, involuntary conversion, gift or lease of a project, or the occurrence of any other event which causes a project to cease to qualify for the Historic Rehabilitation Credit.

C. In addition, a partner may be required to recapture some or all of its Historic Rehabilitation Credit by reason of a reduction of its interest in a partnership, whether caused by a transfer of all or part of its interest, the admission of new partners or a reduction in its share of profits.

1. If a partner's interest in the partnership is reduced by a certain percentage, it will be subject to recapture to the extent of the reduction in its interest.

2. The recapture provisions are not applied until more than one-third of its interest is disposed of. Once there has been recapture by reason of a more than one-third reduction in interest, there is no further recapture until the partner's interest is reduced to less than one-third of its interest at the time the property was placed in service. Thereafter, any reduction in interest will result in further proportionate recapture.

VI. Do Any States Allow for an Historic Tax Credit?

Eleven states currently offer state income tax credits for historic preservation purposes. This is separate from any property tax abatements or special tax assessments covering these properties.