



Historic Tax Credit Alert

Developments in historic tax credit law

A publication of Nixon Peabody LLP

JULY 28, 2008

New housing bill includes significant changes that affect the Historic Tax Credit

By Forrest David Milder and Andrew S. Potts

On July 26, 2008, the U.S. Senate gave final congressional approval to H.R. 3221, the massive Housing and Economic Recovery Act of 2008 (the “2008 Act”), which makes sweeping changes to the nation’s housing laws. Tucked into the 2008 Act’s nearly 700 pages are three provisions that bear directly on the Historic Tax Credit (HTC). These provisions reflect the first substantive changes to the HTC enacted by Congress in more than 20 years.

The HTC is set out in Section 47 of the Internal Revenue Code, which provides for a 20% income tax credit for “qualified rehabilitation expenditures” incurred in connection with the “substantial rehabilitation” of a “certified historic structure.” Section 47 also provides for a 10% credit for expenditures incurred in the rehabilitation of older, nonhistoric buildings built before 1936. The HTC is commonly used to help finance both commercial (including tax-exempt projects, such as museums and theaters) and rental housing projects, whereas the 10% credit is available only for nonresidential buildings.

For some time, HTC stakeholders have been looking for ways to improve the HTC. In 2005, these efforts resulted in the introduction of the Community Restoration and Revitalization Act (CRRA), which included several proposed enhancements to the HTC. The CRRA has been reintroduced each year since 2005, most recently by Representatives Stephanie Tubbs Jones (D-OH) and Phil English (R-PA). Nixon Peabody drafted much of the CRRA in its capacity as pro bono counsel to the National Trust for Historic Preservation.

Although the CRRA has not yet become law, two of its provisions are now included in the 2008 Act. One liberalizes the so-called tax-exempt use rules of Section 168 of the Code as they apply to HTC projects. The other directs states to take into account the historic nature of buildings when allocating Low-Income Housing Tax Credits (LIHTCs). The final HTC change made by the 2008 Act (not in the CRRA) exempts HTCs from the Alternative Minimum Tax (AMT). The tax-exempt use and AMT changes also apply to the 10% credit.

Tax-exempt use liberalization

Section 168(h) of the Code provides that property leased to tax-exempt entities in a “disqualified lease” may be deemed “tax-exempt use property”. A special rule in Section 47 provides that HTCs cannot be claimed on rehabilitation expenditures attributable to tax-exempt use property. Section 168(h) defines four types of disqualified leases, including so-called sale leasebacks, leases with a term in excess of 20 years, certain leases with a sales option, and leases with tax-exempt entities that participated in tax-exempt financing for the rehabilitation. A safe harbor provision in existing law exempts properties from these rules where 35% or less of a building is subject disqualified leases.

Section 3025 of the 2008 Act amends Section 47 to raise the safe harbor from 35% to 50%. The provision modifies Section 47 only, but makes no change to Section 168 itself, so that the modification only applies to historic tax credit transactions. Unfortunately, a related portion of CRRA, which would have eliminated three of the four categories of disqualified lease, was not incorporated into the 2008 Act. The new tax exempt use provision applies to expenditures placed in service after December 31, 2007.

Historic buildings and the allocation of LIHTCs

A second CRRA-inspired provision of the 2008 Act relates to the manner in which LIHTCs are allocated. By federal law, each state must have a “Qualified Allocation Plan” (QAP) for allocating its LIHTCs, and QAPs must include certain allocation criteria. Section 3004(d) of the 2008 Act adds two additional criteria that states must use in allocating LIHTCs among potential low-income housing projects. The additional criteria are the “energy efficiency of the project” and “the historic nature of the project.” An explanation prepared by the Joint Tax Committee clarifies that “historic nature” relates to “encouraging rehabilitation [of] certified historic structures (sec. 47(c)(3))”. This provision is effective for allocations made after December 31, 2008.

Some believe current law discourages adaptive reuse of historic buildings for affordable housing by requiring a downward adjustment of LIHTC basis by the amount of HTCs claimed. If adopted, CRRA would have increased by 125% the applicable percentage used to calculate LIHTCs for buildings eligible for both LIHTCs and HTCs in order to restore dollar for dollar the LIHTCs lost by reason of the HTC basis adjustment rule. Although the 2008 Act does not address this basis issue as CRRA would have, it is hoped that the new QAP provision will nonetheless aid historic projects in competing for LIHTC allocation.

Moreover, another new provision of the 2008 Act allows housing credit agencies the discretion to increase by up to 30% the LIHTCs available to a building. The Joint Tax report states that credit agencies are expected to set standards in their QAP for determining which projects will receive this boost. This provision would have roughly the same effect on an HTC/LIHTC project as the CRRA basis add-back provision would have had. Advocates hope to use the enhanced status of historic rehabilitation projects under QAPs to enable these projects to win discretionary 30% boosts as well.

The Alternative Minimum Tax

Finally, the 2008 Act contains an important change in the application of the Alternative Minimum Tax to HTC transactions. This provision has no analogue in CRRA.

Like the individual AMT, the corporate AMT limits a taxpayer's ability to avoid taxes by expanding the kinds of income items subject to tax and by limiting the taxpayer's ability to use certain deductions to reduce its taxable income and most tax credits to reduce tax liability. Typically, a taxpayer's alternative minimum taxable income is larger than its "regular" taxable income, because several items (e.g., tax-exempt interest) are added to the normal calculation of taxable income, and other items (e.g., depreciation) are calculated less favorably. This influence results in a larger "base" on which the tax is computed.

For corporations, this larger base is then multiplied by a fixed rate of 20%. Finally, this "tentative minimum tax" is compared to the taxpayer's regular tax liability. If the tentative AMT is higher, then the taxpayer must pay the excess, in addition to its conventional tax liability. And, here's the part that is important in the syndication world: tax credits are generally ineligible to reduce this liability.

Obviously, this repercussion can have a significant chilling effect on investments in projects that generate tax credits. If a taxpayer knows that it will owe alternative minimum tax, then tax credits may be worth significantly less to it, if anything. This outcome will reduce the market for credits, and therefore, the amount that can be raised from the sale of credits.

Now, in the 2008 Act, HTCs and LIHTCs have been added to the list of credits that can be used to reduce the AMT. The effect of the new rules should be to greatly expand the marketplace for LIHTCs to include taxpayers who previously stayed out because of the AMT (HTC investors have not traditionally been at AMT). Inclusion of HTCs will ensure that HTC/LIHTC deals are not disadvantaged and may help attract new HTC investors as well. Importantly, the provision is effective for qualified rehabilitation expenditures "properly taken into account for periods after December 31, 2007." So, projects being rehabilitated in 2008 should at least partially qualify for the benefit of the new law.

For further information, please contact Forrest Milder, Esq., of Nixon Peabody LLP—617-345-1055 or fmilder@nixonpeabody.com—or Andrew Potts, Esq., of Nixon Peabody LLP—202-585-8337 or apotts@nixonpeabody.com.