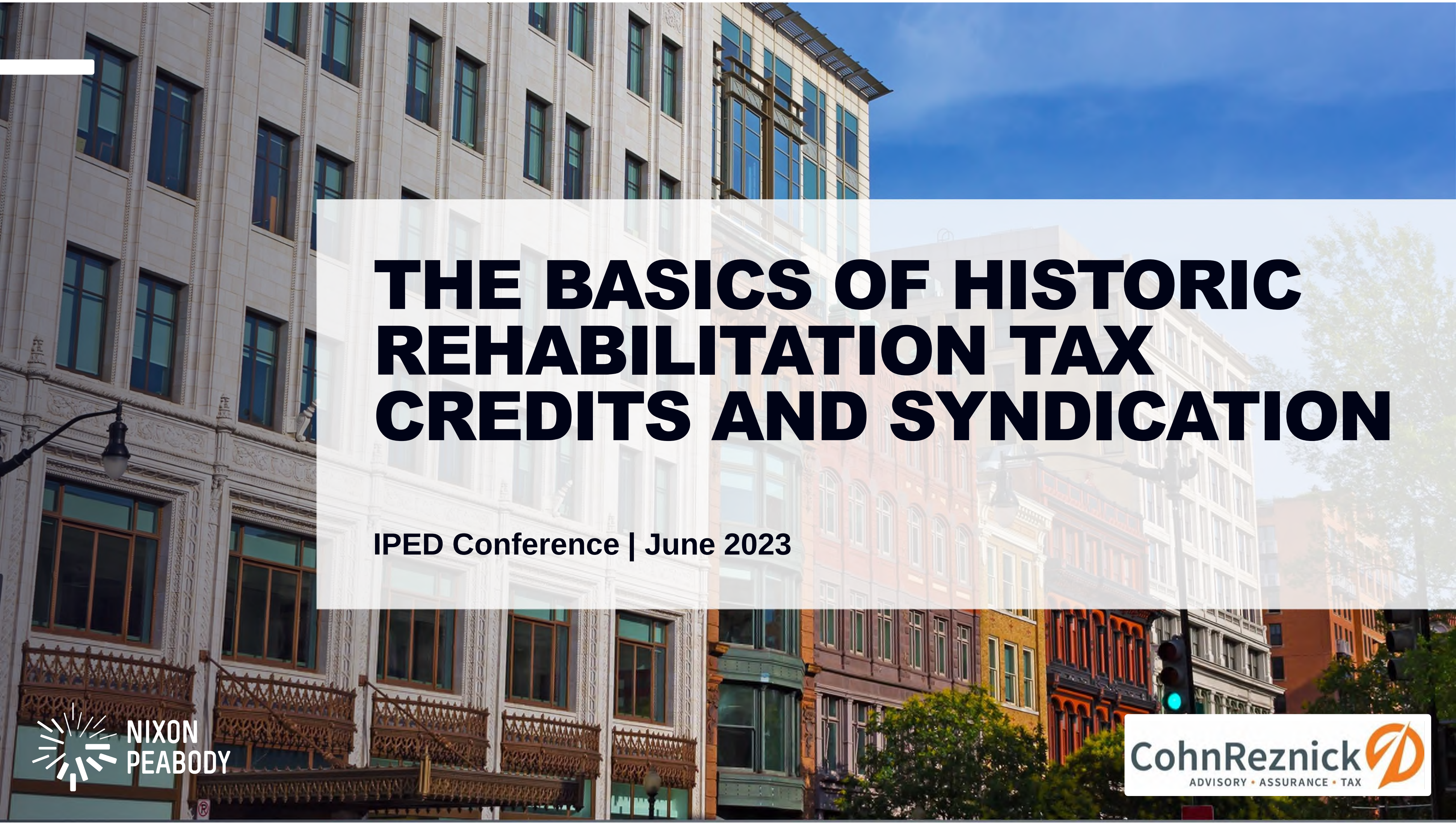

THE BASICS OF HISTORIC REHABILITATION TAX CREDITS AND SYNDICATION

IPED Conference | June 2023

NIXON PEABODY

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ADVISORY • ASSURANCE • TAX

FEDERAL HISTORIC REHABILITATION TAX CREDIT

- 20% Credit against Federal Income Tax liability
- Calculated on Qualified Rehabilitation expenditures
- Incentive to preserve and rehabilitate – NOT acquire
- Credits are utilized easily by large corporate investors
- Sophisticated market of investors for the credits
- Real Estate developers / owners partner with corporate investors to monetize
- Preservation aspects jointly administered by NPS and State Historic Pres. Offices (SHPOs)
- Tax aspects administered by the IRS
- Tax Credits = dollar-for-dollar reduction in tax liability (contrast to deduction)
- RTC is the most important (in dollar volume) federal preservation program
- Available in all 50 states, the Virgin Islands and Puerto Rico

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"I have an Old Building and someone told me I can get a tax credit, please call me back…"

QUALIFYING BUILDINGS

- National Register Properties – individual or in district
- Generally, at least 50 Years Old
- Architecturally or historically significant
- Role of the National Park Service
- Three Part Process
- Since 1977, more than 48,000 projects with over $122.90B in investments*
- In 2022, 858 proposed projects were approved by NPS; estimated rehab costs $6.56B
- In FY 2022, top 4 states were New York (116), Virginia (80), Pennsylvania (66), and Ohio (64)
- Over half used state historic tax credits*

*Source: Annual Report for Fiscal Year 2022: Federal Tax Incentives for Rehabilitating Historic Buildings National Park Service

QUALIFYING FOR THE REHAB CREDIT

Option #1

/ Building is listed in the National Register of Historic Places

Option #2

/ Building is located in a registered historic district and certified as being of historic significance contributing to the district

- Must be a "building"
- Building is defined as a structure or edifice enclosing a space within its wall and usually covered by a roof
- Building must be depreciable

QUALIFYING FOR THE REHAB CREDIT

Substantial Rehabilitation Test

- 24 Month Test
- 60 Month Test—Phased

Standard Rehabilitation Test

- Look back from placed in service date to basis in building 24 months prior or beginning of project, whichever is later
- QREs must exceed prior basis or $5,000, whichever is greater
- Rolling 24-month window

Phased Rehabilitation Test

- Must have plans and specifications showing two or more phases prior to beginning construction
- 60-month window
- Otherwise similar rules

“The first thing we are going to do is update the windows…”

THE NATIONAL PARK SERVICE RULES

Part 1

Evaluation of Significance

Part 2

Description of Rehabilitation

Part 3

Request for Certification of Completed Work

DEVELOPER PERSPECTIVE

NPS Part 1/Part 2 Timing

Part 1: Historic Preservation Certification application

Part 2: Approval/Conditional Approval/Denial

Rehabilitation is consistent with the historic character of the property and, where applicable, with the district in which it is located

- Rehabilitation will meet the Secretary of the Interior's standards for rehabilitation if conditions are met
- Rehabilitation is not consistent with the historic character of the property or district and the project does not meet the Secretary's standards for rehabilitation

“Someone told me that the IRS will pay for the cost of construction…”

CREDITS VS. DEDUCTIONS

	Deduction	Credit
Income	$1000	$1000
Less: Deductions	-200	0
Taxable Income	800	1000
Tax @ 20%	160	200
Less: Credits	0	-200
Net Tax Due	**$160**	**$0**

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CALCULATING THE CREDIT

Qualified Rehabilitation Expenditures	$4,900,000
Credit Rate:	20%
Credits:	$ 980,000

Calculate the equity amount:
$0.80 per credit multiplied by $980,000 credits = **$784,000**

COMBINING HTC WITH OTHER CREDITS AND FINANCING SOURCES

Financing Source	Amount
Construction Loan	$19,000,000
LIHTC Equity	$9,000,000
HTC Equity	$4,500,000
State LIHTC	$3,000,000
State HTC Loan	$2,000,000
Subordinate Debt	$4,500,000

With regard to multifamily residential developments, no affordability restrictions are required for rehabilitation credits, although it is common for rehabilitation credits to be combined with LIHTC and loan programs imposing affordability restrictions

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"A friend of mine sold his credits to an investor…"

HTC INVESTOR

- Investor makes capital contribution in ownership entity in exchange for 99% ownership interest
- Capital contribution equal to set amount per each $1.00 of HTC
- **Old Rule:** Full amount of the rehabilitation tax credit is claimed in the year in which the QREs are placed in service
- **New Rule:** Rehabilitation credit claimed during a 5-year period beginning in the taxable year in which the QREs are placed in service
- Important to reconcile equity installments with projected costs/schedules

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“I added up my construction costs and multiplied by 20% to calculate my credits…”

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QUALIFIED REHABILITATION EXPENDITURES

Includes costs related to:

- Walls, partitions, floors ceilings
- Permanent coverings such as paneling or tiling
- Windows and doors
- Air conditioning or heating systems, plumbing and plumbing fixtures
- Chimneys, stairs, elevators, sprinkling systems, fire escapes
- Construction period interest and taxes
- Architect fees, engineering fees, constructions management costs
- Reasonable developer fees

Does NOT Include costs related to:

- Land and interest carry on land
- Building acquisition and interest carry on acquisition
- Acquisition-related costs
- Site improvements and landscaping
- Enlargements and demolition
- Personal property
- Tax-exempt use property

“We just finished construction and we are ready to sell our credits…”

WHO CAN CLAIM THE CREDIT?

Historic credits are shared among owners based on the PROFITS allocation:

- ‘Profits’ are considered to include the owner’s share of:
  - Taxable Income
  - Operating Cash Flow
- These allocations must remain the same throughout the recapture period
- Unused credits can carryback 1 year or carryforward 20 years

WHO CAN CLAIM THE CREDIT?

Timing of Ownership is Absolutely Critical:

- If you own the project throughout the rehab but sell it prior to it being placed in service, you CANNOT claim the credit
- If you bought into ownership just ***prior*** to, and owned it the day it was placed in service, you CAN claim the credit
- If you bought into ownership ***after*** it was placed in service, you CANNOT claim the credit

“Our partner wants to sell the building within two years of completing the rehab…”

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COMPLIANCE PERIOD

- HTCs are subject to a 60-month compliance period, known as the Recapture Period
- Dispositions during Recapture Period trigger claw back of HTCs, subject to vesting rules
- Disposition includes any sale, transfer, gift or casualty
- New work that does not comply with the secretary's standards can trigger recapture

“I heard that some of the rules for the credits have changed…”

TAX CUTS AND JOB ACT UPDATES TO THE HTC

Old Rules

- 20% federal historic tax credit available for the taxable year in which the qualified rehabilitations expenditure are placed in service
- 10% tax credit available for pre-1936 buildings

New Rules

- 20% federal historic tax credit is taken into account for any taxable year during a 5-year period beginning in the taxable year in which the qualified building is placed in service.
  The credit is an amount equal to the ratable share, 20% of QRE, for each year.
- Qualified Building
  - Listed in the National Register of Historic Places
  - Located in a registered historic district and certified by the Sec of the Interior as being of historic significance to the district
- 10% tax credit is eliminated

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NEW RULE: RECOGNITION OF HISTORIC TAX CREDIT

Year	Old Rule Historic Tax Credit		New Rule: Tax Cuts & Jobs Act Historic Tax Credit	
2018	$	1,000,000	$	200,000
2019				200,000
2020				200,000
2021				200,000
2022				200,000
Total	$	1,000,000	$	1,000,000

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TRANSITION RULES

- Old rules apply to cost paid or incurred on or before December 31, 2017
- New rules apply to cost amounts paid or incurred AFTER December 31, 2017
  - (2) TRANSITION RULE—In the case of qualified rehabilitation expenditures with respect to any building— (A) owned or leased by the taxpayer during the entirety of the period after December 31, 2017, and (B) with respect to which the 24-month period selected by the taxpayer under clause (i) of section 47(c)(1)(B) of the Internal Revenue Code (as amended by subsection (b)), or the 60-month period applicable under clause (ii) of such section, begins not later than 180 days after the date of the enactment of this Act, the amendments made by this section shall apply to such expenditures paid or incurred after the end of the taxable year in which the 24-month period, or the 60-month period, referred to in subparagraph (B) ends

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TAX CUTS AND JOBS ACT: CAP ON BUSINESS INTEREST

- Caps business interest at 30% of its adjusted taxable income
- Applies to tax years after 2017
- There are 3 exceptions to avoid the cap
  - Gross receipts for a 3 year tax period ending with the previous tax period do not exceed $25 Million **DOES NOT APPLY TO TAX SHELTERS**
  - Real property trades or businesses
  - Specific electrical energy, water, sewage, gas, and steam transactions
- Historic tax credit transactions can elect the real property trades or business in order to avoid the 30% business interest limitation

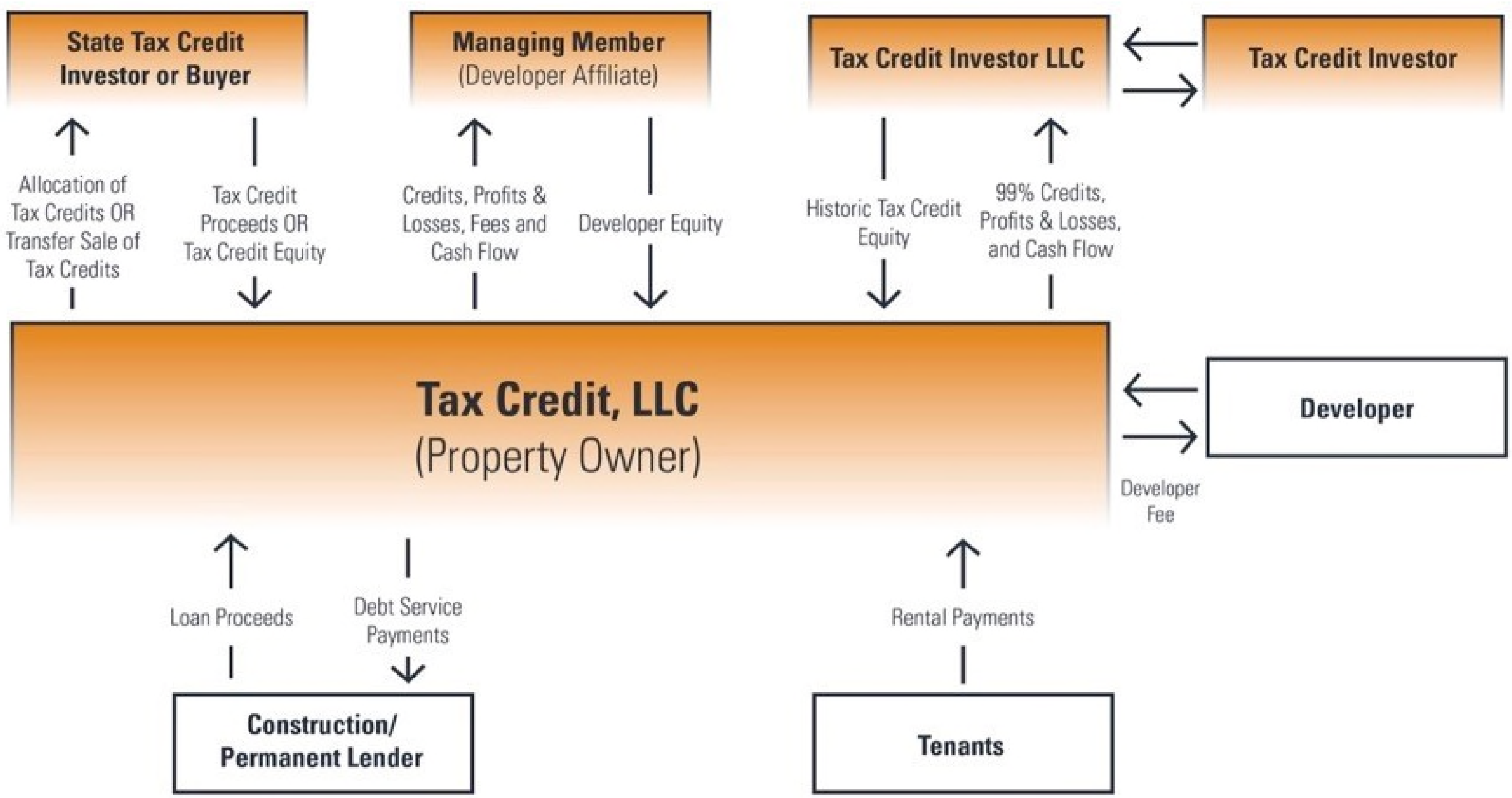
TAX CUTS AND JOBS ACT: CAP ON BUSINESS INTEREST (CONT'D)

/ If the real property trades or business election under Section162(j)(7)(B) the following occurs

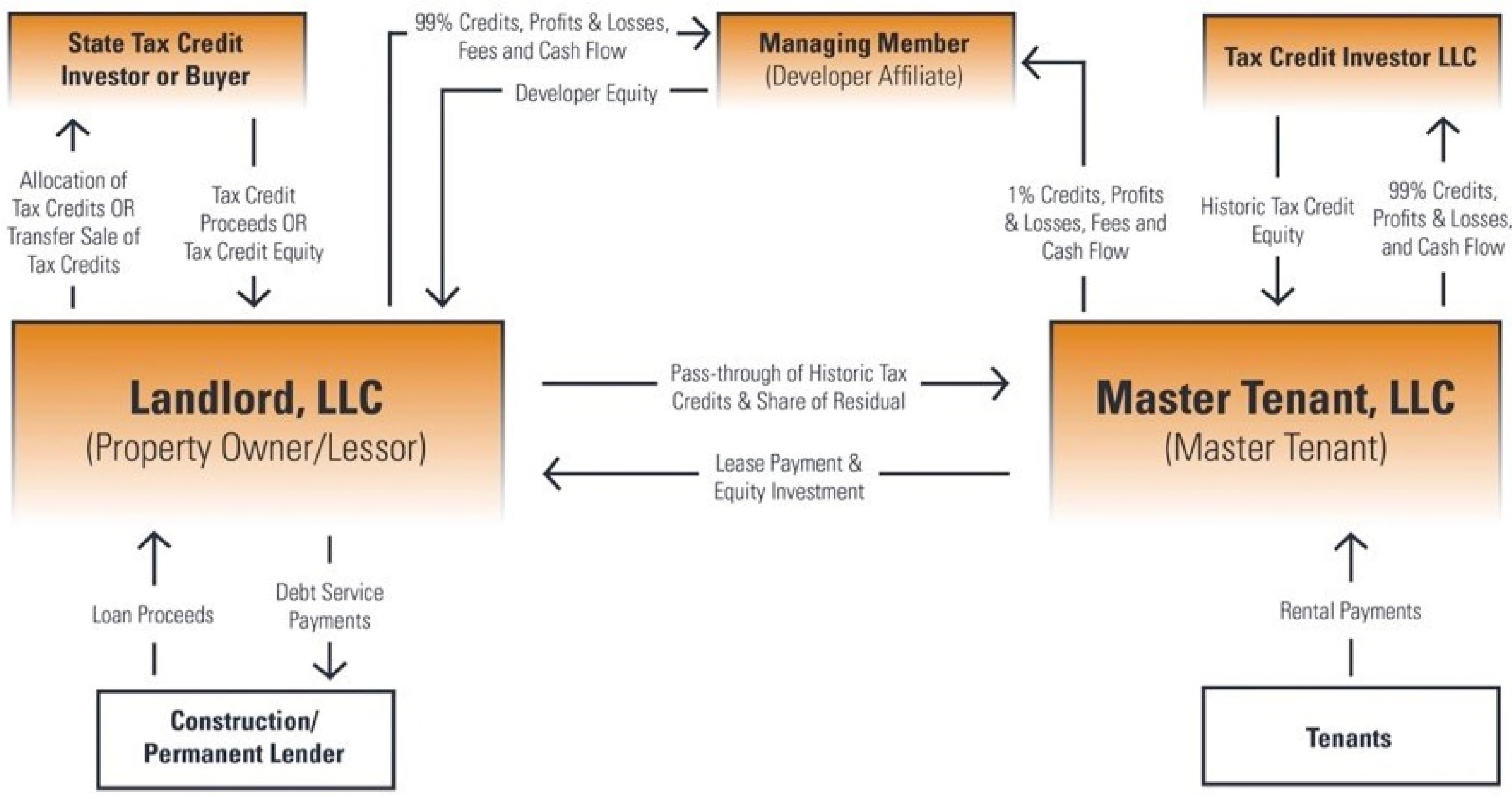
- Alternative Depreciation System:
  - Residential rental property = 30 years (NEW)
  - Nonresidential real property = 40 years
  - **Qualified improvement property = 40 years**
  - **Personal property and site improvements may still utilize MACRS and bonus depreciation**

"I just want to sell my credits to an investor, that's all…"

SINGLE TIER STRUCTURE



LEASE PASS THROUGH STRUCTURE (MASTER LEASE)



IMPLICATIONS OF THE TAX CUTS AND JOBS ACT

- Lower Pricing
- ADS Depreciation
- But stay tuned: if the corporate tax rate increases, investor appetite for credits may increase as well
- Transition rule deal activity is now tapering off due to timing

THE PROJECTIONS

Purpose of a good set of projections:

- Analyze Cash flow
- Depreciation allocation (Lease Pass-Through)
- Estimate QRE and Credits
- Used for underwriting by investors
- Used by working group to refine transaction structure
- Blueprint for the preparation of the legal documents
- Attached to the Partnership/Operating Agreement as an Exhibit

SOURCE AND USE OF FUNDS

Description	Total		Acquisition Basis	Qualified Rehabilitation Expenditures (QREs)	Site Improvements	Personal Property	Funded Expense	Other
SOURCES								
Federal Investor Member Equity	2,042,146	12%						
State Investor Member Equity	1,831,153	11%						
Permanent Loan	9,312,000	54%						
Managing Member Equity	2,544,500	15%						
Deferred Developer Fee	1,417,730	8%						
Total Sources:	17,147,528	100%						
USES								
Acquisition	1,240,000		1,052,500	-	-	-	-	187,500
Construction Hard Costs	12,528,995		325,555	11,637,260	466,180	100,000	-	-
Total Hard Costs	13,768,995		1,378,055	11,637,260	466,180	100,000	-	187,500
Soft Costs								
Design Fees	339,000		-	339,000	-	-	-	-
Legal & Accounting	200,000		-	66,667	-	-	66,667	66,667
Permits	27,432		-	27,432	-	-	-	-
Property Taxes	5,000		-	5,000	-	-	-	-
Environmental, Market Studies, & Appraisals	47,828		-	47,828	-	-	-	-
HTC Fees including Heritage Consulting Group	40,000		-	40,000	-	-	-	-
Marketing	25,000		-	-	-	-	25,000	-
Construction Loan Closing Fee	93,120		-	12,844	-	-	80,276	-
Construction Loan Interest	256,164		-	96,853	-	-	159,310	-
Bridge Loan Closing Fee	59,792		-	59,792	-	-	-	-
Bridge Loan Interest	127,685		-	96,305	-	-	31,380	-
Predevelopment Mezz Debt Interest	174,000		-	-	-	-	174,000	-
Operating Reserve	257,000		-	-	-	-	-	257,000
Insurance	52,702		-	52,702	-	-	-	-
Soft Cost Contingency	98,555		-	49,277	-	-	49,277	-
Total Soft Costs	1,803,277			893,700	-	-	585,910	323,667
Development Fee	1,575,255		-	1,575,255	-	-	-	-
Total Uses:	17,147,528		1,378,055	14,106,215	466,180	100,000	585,910	511,167

“What other subsidies can I access…”

STATE HISTORIC TAX CREDITS

State credit laws vary in many respects from state-to-state

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OTHER ISSUES

Development Fee

- Amount must be reasonable
- Payment Timing

Fees paid to a related party

- Example—property management fee subject to reasonableness

Tax Exempt-Use Property

- Check the tenants!!!

Investor requirements:

- Cost Certification
- Annual audited financials required? Tax or GAAP basis?

Refinance

- During the Compliance Period
- Cash Waterfall Planning

Reserve requirements

Contingency requirements

Tax priority payments

- Is 50(d) income and losses from the partnership considered when calculating these payments?

THANK YOU!

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