Federal Historic Rehabilitation Tax Credits

Cameron N. Cosby, Partner
Hunton & Williams LLP

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Overview of Federal HTCs

- **Amount and timing of credit**
  - Credit equals 20% of the “qualified rehabilitation expenditures” for “certified historic structures”
  - Credit is claimed when the building is placed in service

- **Definition of qualified rehabilitation expenditure**
  - Amount properly chargeable to capital account in connection with rehabilitation of a “qualified rehabilitated building” for which depreciation is allowed and which is real property
  - Acquisition cost excluded
  - Enlargement expenditures excluded
  - Certified rehabilitation – see “Application and Review Process”
  - Not tax-exempt use property – see below

- **Definition of qualified rehabilitated building**
  - Substantially rehabilitated -- qualified rehabilitation expenditures during the 24-month period selected by the taxpayer exceed the greater of the adjusted basis of the building or $5,000
  - Placed in service before the rehabilitation
  - Depreciation is allowable
Overview of Federal HTCs

• Definition of qualified historic structure
  • Listed on the National Register or
  • Located in a registered historic district and certified as being of historic significance to the district

• Limitations on use of credit
  • Credit only reduces 75% of tax liability in excess of $25,000
  • Passive activity rules
  • At-risk rules

• Unused credits can be carried back one year and carried forward 20 years

• Pass-through election by lessor
  • Certain lessors ineligible
  • Lease term generally must be 80% or greater than depreciable life
Overview of Federal HTCs

• Basis of property reduced by amount of credit
  • However, in pass-through structure, no basis reduction
  • In lieu of basis reduction, lessee recognizes amount of credit as income over useful life of the property

• Recapture of credit
  • 5 years after building was placed in service
  • Decreasing by 20% each year
Overview of Federal HTCs

Single-Entity Federal HTC Structure

- Sponsor
- 1% Managing Member
- Federal HTC Investor
- 99% Investor Member
- Lender
- Loan
- Real Estate Entity
- Leases
- Space Tenants

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Overview of Federal HTCs

Pass-Through Federal HTC Structure

- **Lender**
  - Loan
  - Real Estate Entity
    - 80% Managing Member
    - 20% Investor Member
    - 1% Managing Member
  - Sponsor
    - 99% Investor Member
    - 1% Managing Member
  - Master Tenant Entity
    - 32-yr Lease
- **Federal HTC Investor**
- **Space Tenants**
  - Leases
Application and Review Process

- To claim 20% credit, owner must apply for certification that:
  - Property is a historic structure, and
  - Rehabilitation complies with Secretary of Interior’s “Standards for Rehabilitation”

- Part 1 – Evaluation of Significance
  - Not required for properties individually listed on National Register

- Part 2 – Description of Rehabilitation

- Part 3 – Request for Certification of Completed Work

- Applications first sent to state historic preservation office

- Application fees
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Special Rules for Tax-Exempt Entities

- General rule for tax-exempt use property
  - Portion of property leased to tax-exempt entity in a “disqualified lease”
  - Disqualified lease is lease of property to tax-exempt entity if:
    - Property financed with tax-exempt debt
    - Purchase or sale option in lease
    - Lease term in excess of 20 years
    - Sale-leaseback
  - 50% exception – if the portion of the property leased to tax-exempt entities in disqualified leases is no more than 50% of the property, the property is not tax-exempt use property
- Exception for short-term leases
- Exception for UBTI

- Property leased to a partnership
- Property owned by a partnership
- “Tax-exempt controlled entity” is treated as tax-exempt entity, unless a special election is made
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Sale of Properties

• 5-year recapture period
  ▪ In single-entity structure, sale of property (including foreclosure) causes recapture
  ▪ In pass-thru structure, recapture is caused by:
    o Termination of master lease
    o Sale of property (include foreclosure) to certain entities that would cause at-risk or tax-exempt use property issues – “disqualified transferee”

• Disqualified transferee includes:
  ▪ Tax-exempt organization, unless subject to U.S. tax
  ▪ United States agency
  ▪ Foreign person, unless subject to U.S. tax
  ▪ Mutual savings bank, cooperative bank or domestic building and loan association
  ▪ RIC or REIT, but not a “taxable REIT subsidiary”
  ▪ Cooperative organization
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- Pass-thru structure can create complexities for debt financing
  - Master lease must be respected as true lease for tax
  - “Leakage” to master tenant
  - Lender may prefer sublease to affiliate of borrower
  - Nondisturbance of master tenant
    - Standard SNDA
    - “Enhanced” SNDA during 5-year recapture period
      - Master lease cannot be terminated
      - Property cannot be transferred to disqualified transferee

- At-risk rules
  - Applicable when individuals or closely-held C corps own landlord or master tenant
  - Exception for nonrecourse financing if
    - Property not acquired from related person
    - Amount of financing does not exceed 80% of “credit base” of the property
    - Financing borrowed from “qualified person” or federal, state or local government
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Unwind of Tax Credit Structure

• Put option on investor’s equity interest
  ▪ Exercise period
  ▪ Exercise price

• Call option on investor’s equity interest
  ▪ Exercise period
  ▪ Exercise price

• Termination of master lease in connection with sale of property
Topics

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Historic Boardwalk Case

- Summary of case
  - Lack of meaningful downside risk
    - “Investment risk” – risk that tax investor would not receive tax credits in an amount that was at least equal to installments made to date
    - “Audit risk” – risk that, if challenged by IRS, tax investor would not receive at least cash equivalent of tax credits
    - “Project risk” – risk that tax investor would not receive tax credits due to a failure of rehabilitation to be completed
  - Lack of meaningful upside potential
  - “Consent” option
  - Guaranteed investment contract
• Impact on federal historic tax credit transactions
  - Significant slowdown in equity transactions
  - Waiting for IRS “safe harbor” guidance
    - Timing of capital contributions and adjustors
    - “Flip” structure
    - FMV call option
    - No put option
    - What risks will investor have to take?
    - How much cash flow/residual will investor have?
    - Will sublease be addressed?