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The New Deal FOR MAIN STREET'S HISTORIC TAX CREDIT PROJECTS...

Tips on how
you can apply
for tax credits.
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SUCCESS

The federal historic tax credit (HTC) is a powerful economic engine. By providing developers of historic properties with a dollar-for-dollar reduction in taxes owed, the HTC gives them a strong incentive to take on historic rehab projects that otherwise would not be financially feasible. These projects transform vacant properties, help revitalize local downtowns, and, collectively, create a vast economic multiplier effect nationwide. Rutgers University, with support from the Historic Tax Credit Coalition, proved the program's economic impact unequivocally in its recent report: over the credit's 30-year history, the HTC has created 1.8 million jobs, attracted \$85 billion in new private investment, and stimulated the local economy to a far greater extent than new construction.

Identification Number

TOTAL \$

Revitalization

Unfortunately, small towns and rural areas do not get their fair share of the federal tax credit's economic benefits. This stems from the relatively small size (less than \$1 million in total development costs) of historic real estate projects in Main Street districts and the fact that the dollar amount of the credit is equal to 20 percent of the project's eligible rehabilitation costs (i.e., a small project yields only a small tax credit amount). As a result, both of the major ways to utilize the historic tax credit are difficult for Main Street developers to pursue:

1 One way to utilize the HTC is for the developer to reduce his or her annual tax bill by filing for the credit after the

historic rehab project is complete. But many Main Street developers and property owners have insufficient tax liability, earn too much annual income (\$250,000 or more), or are limited in their ability to use the credits (per the passive loss limitations of the Internal Revenue Code).

Still others are subject to the Alternate Minimum Tax (AMT), a tax paid by individuals and corporations that would otherwise have enough credits and deductions to zero out their federal tax liability. Until recently, the AMT could not be reduced by the historic tax credit. Furthermore, some developers need the money the tax credit represents while

they are developing the project, not once it is complete. In all these scenarios, the historic tax credit offers little benefit to the developer or owner, prompting many to consider the second option for utilizing the credit.

2 Those who can't fully utilize the credit themselves can transfer the rights to the tax credits to a corporate investor in exchange for cash invested in the project. This cash infusion is often an essential piece of the project financing that enables the project to move forward, while the tax credits can prove highly beneficial to corporate investors with onerous tax burdens. However, the accounting and

legal fees involved in transferring tax credits are high — regardless of the deal size — so if the credit value is relatively low, as is the case with smaller deals, the net benefit of the transaction may not be worth the effort.

Typically, the lack of interest in these small deals by corporate investors or the inability of the property owner to utilize the full value of the credit has prevented many Main Street developers from taking advantage of this powerful incentive.

NEW HOPE FOR THE SMALL DEAL

Fortunately, help has arrived for Main Street building owners and developers. Signed in the waning months of the Bush Administration, the Housing and Economic Recovery Act of 2008 provides a simpler, less costly method of utilizing the federal historic tax credit. The law enables individuals to use the historic tax credit to lower their Alternative Minimum Tax. This effectively makes the credit a true incentive for individual local investors who are subject to the AMT.

What's the bottom line? It's easier than ever to employ the historic tax credit to benefit a Main Street-scale historic rehab project.

HOW IT WORKS

Thanks to the new legislation, if Main Street property owners cannot, for the reasons stated above, use the credits or if they simply want to trade the credits for cash up front, they have the option to convey them to individual “real estate professionals” (REPs) who enjoy a unique exemption from passive loss limitations.

To make this connection happen, the developer can work with a local accounting firm — preferably one that knows a lot of real estate professionals — to identify an individual in the community who could use the credits in exchange for cash. This person should be a high net-worth real estate professional with substantial federal tax liability. If the real estate professional is also subject to AMT, his or her motivation will be especially high. After admitting this individual into a limited partnership or limited liability company, the real estate professional can pay the property owner cash in exchange for the right to use the credits.

An example:

In 2010, the City of Wyandotte, Michigan, (population: 25,000) renovated the 1911 Masonic Temple building into a community arts center and arts incubator. The developer, Dudley Ventures, also a prominent national syndicator of historic and new

markets tax credits, was able to identify a local real estate professional who could benefit from the historic tax credits generated by the \$1.5 million rehab, but only because the credits could be used to offset the investor's Alternative Minimum Tax. The individual invested \$180,525 into the project in exchange for the right to use the tax credits. This key financing made the project financially feasible.

Partnering with a local investor also has the benefit of building a network of support for historic preservation on Main Street. The local investor is more likely to invest any profits from the partnership with the developer locally, unlike a national corporate investor with a distant headquarters and limited connection to the community.

► *The Masonic Temple, in Wyandotte, Michigan, has been transformed into the Wyandotte Regional Arts Center, thanks in part to historic tax credit equity invested by a local real estate professional and made possible by the 2008 legislative changes. The Center offers 12 affordable artist studios; provides performance space and galleries; and hosts poetry readings, lectures and classes.*



**SIGN
HERE
FOR HELP**



WHAT IS A REAL ESTATE PROFESSIONAL?

A Real Estate Professional (REP) is defined as a person who:

- 1** Spends more than 50 percent of his or her time and more than 750 hours per year engaged in real estate activities; and
- 2** Owns at least 5 percent of the real estate business where he or she works.

Qualifying real estate activities include work performed by:

- Real estate developers
- Construction contractors
- Property managers
- Real estate brokers
- Leasing agents
- Architects

Things to consider.

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ROLE OF THE MAIN STREET ORGANIZATION: HOW YOU CAN HELP SEAL THE DEAL

Main Street organizations, armed with the details on how the historic tax credit can be used and by whom, can work with property owners and local developers to better understand how the tax credits function and also help identify real estate professionals. Better information in the hands of property owners about ways to use the credits is essential to achieving greater use of the HTC on Main Street.

One idea is for the Main Street organization to develop and promote a “directory” of local REPs who may be potential investment partners for property owners, as well as a list of developers who do not qualify as REPs.

MORE HELP ON THE WAY?

The National Trust and its for-profit subsidiary, the National Trust Community Investment Corporation (NTCIC), are currently heavily invested in advocating for provisions to the federal historic tax credit that would further simplify the use of tax

credits in small transactions. If adopted by Congress, these provisions would increase the use of the historic tax credit. One major change that would have an immediate impact is to increase the value of the federal credit from 20 to 30 percent for smaller deals.

THE FEDERAL HISTORIC TAX CREDIT: A USER'S GUIDE

If you're still trying to get some bearings on how the HTC operates, some background information is in order.

The federal government created this incentive in 1981 to encourage and increase the financial feasibility of historic building rehab projects. The federal government offers a 20 percent credit (for historic and architecturally significant buildings) and a 10 percent credit (for nonresidential, nonhistoric buildings built before 1936; a mixed-use project, however, can take the 10 percent credit on the commercial portion of the rehab).

While the federal rehab tax credit program has changed several times over the years, most of the program's basic elements have remained the same:

CASE STUDY: Moeszinger/ Marquis Hardware Co., Clinton, Iowa

The Moeszinger-Marquis Hardware Co. project in Clinton, Iowa, demonstrates the significant financial hit a project suffered under the previous legislation — before the 2008 changes. The \$3 million rehab of the upper floors of the building into affordable housing was substantial enough to attract an investor. However, the first-floor office space was created as a separate condominium unit within the building, and could not attract a national tax credit investor because the credits generated were deemed too small to be worthwhile. Without the tax credit payments of approximately \$98,000, the project needed to take on more debt: \$98,000 more to be exact. With a larger bank loan, the project paid \$10,530 more to the bank in a year than it would have if its loan principal was \$98,000 less.



- To be eligible for the 20 percent tax credit, buildings must be listed, or eligible for listing, in the National Register of Historic Places or be “contributing” buildings in a National Register historic district. Property owners file Part 1 of the National Park Service’s Historic Preservation Certification Application to seek property approval for the tax credit.
- To be eligible for the 20 percent credit, the property owner’s building plan must meet certain design and construction standards, as outlined in the *Secretary of the Interior’s Standards for Rehabilitation* (www.nps.gov/hps/tps/standguide/rehab/rehab_index.htm). These standards ensure that the building’s architectural and/or historic significance will not be damaged. Property owners file Part 2 of the Historic Preservation Certification Application to seek approval for their rehabilitation plans.
- The building has to be an income-producing building. Most Main Street commercial buildings are therefore eligible, but private homes are not. However, because it’s income-producing for the property owner, rental housing is eligible for the 20 percent credit.
- The property owner gets a tax credit equal to 20 percent — or 10 percent for the nonhistoric credit — of the total rehabilitation cost, provided the rehabilitation costs are equal to or greater than the “adjusted basis” of the building (adjusted basis is generally defined as the purchase price, minus the cost of the land, plus the value of any capital improvements made since the building acquisition, minus any depreciation of the building since purchase) or \$5,000, whichever is greater.
- The tax credit is applied against tax liability. So, a property owner who has a \$20,000 rehab tax credit and owes \$20,000 in federal income tax can apply the tax credit to the amount of tax owed — and, in this example, not have to pay any tax. The credit can also be divided up and carried back one year and forward 20 years.

There are some other requirements and limitations, of course. For example, individuals who earn more than \$200,000 cannot claim the full value of the credit, and people earning more than \$250,000 cannot use the credit at all. Additional information, including an interactive guide to determine if your project would qualify, is available at www.ntcicfunds.com.



► Built in 1883, the Town Hall Theater in Middlebury, Vermont, was the heart of community life for nearly 75 years. In the 1950s, the town offices relocated, the ornate stage and balcony were ripped out, and exquisite stained-glass windows were covered with brick. Federal historic tax credits helped finance its glorious return to the center of the Middlebury arts and social scene, enabling the project to proceed with no foreclosable debt.

TURNING CREDITS INTO CASH

People and businesses that own property in historic commercial districts have three choices when it comes to using the federal rehabilitation tax credit.

1. They can do a certified rehabilitation project, earn the 20 percent tax credit, and use it to reduce their taxes.
2. If the building was built before 1936 and is neither historic nor residential, they can bypass the National Park Service’s Part 2 certification process, earn a 10 percent tax credit, and use it to reduce their taxes.
3. They can sell the tax credit to an investor.

Who buys tax credits? Banks and other large corporations are the primary buyers of credits generated by large projects. They have lots of tax liability, and the tax credit reduces their taxes while also bringing capital (in the form of the money they pay for the credits) to historic commercial districts and other places that need it. As explained above, the 2008 Housing and Economic Recovery Act also enables individuals and corporations to use the historic tax credit to offset the AMT.

SHOULD YOU USE THE TAX CREDIT? A CHECKLIST FOR PROPERTY OWNERS

For a variety of reasons, a third of the property owners who receive design approval (Part 2 of the tax credit application) from the National Park Service do not proceed to final approval (Part 3) and use of the tax benefits. While no surveys have been conducted, it’s fair to assume that many of these building owners discovered — after they had committed predevelopment time and resources — that it was in their best interests to forgo the credits.

To help property owners in your commercial district avoid this loss of time and money, ask them the following questions at the beginning of the development process:

- **Do you have the right building?** Is your property a contributing structure in a historic district or is it listed or eligible for individual listing in the National Register of Historic Places? Only such properties can take advantage of the 20 percent historic tax credit. A nonhistoric, nonresidential building built before 1936 is eligible for the 10



THE TAX CREDIT TEAM

Assembling an experienced development team is critical to the success of any tax credit transaction. Be sure to include:

- Tax attorney
- Tax accountant
- Preservation consultant
- Experienced architect
- Rehab contractor
- State historic preservation officer

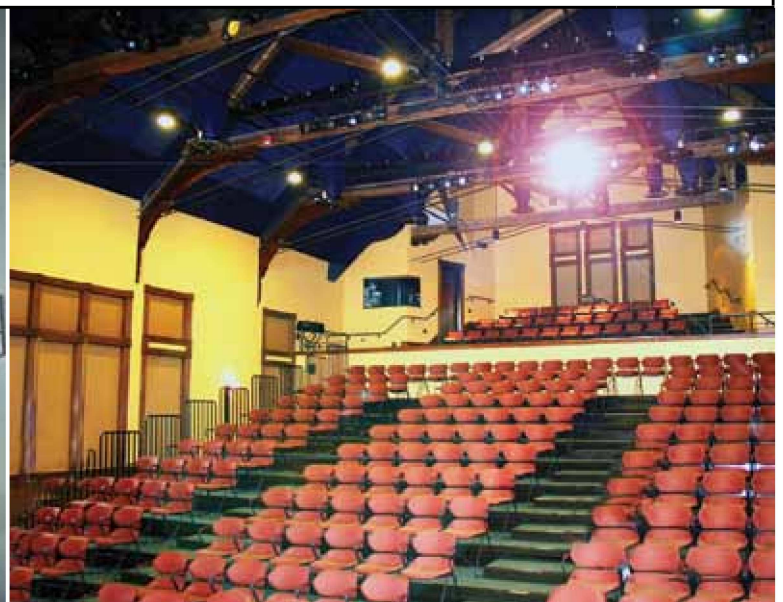
percent credit. Ask your local municipal planning department, preservation commission, or State Historic Preservation Office (SHPO) to help determine the building's eligibility.

- **Can you live with the design constraints?** The State Historic Preservation Office and National Park Service reviewers are not trained to consider practical issues such as retail visibility, parking access, optimum use of floor space, or building code compliance. To avoid less than optimum results for your

business, walk through the property with a state reviewer or a preservation consultant before you submit an application so you will be aware of what is required by the Secretary of the Interior's Standards.

- **Will the net tax credit benefit justify the additional costs?** Historic rehabs cost more than contemporary improvements, and selling the credits to an investor will generate transaction costs you would not incur otherwise. If you sell your credits, the investor will buy one dollar of credits for a discounted price, typically paying between \$0.80 and \$0.90 per \$1.00 of credits. Be sure to factor in these hidden costs before making a decision.
 - **Are you in a tax position to use the HTC or will you need to transfer it to an investor?** Using the credit to offset your own tax liability is the most efficient type of small tax credit transaction. But depending on your tax position, you may be better off selling your credits to an investor. The key difficulty in doing small tax credit projects centers on the sometimes complicated and expensive process of selling the credits. Is it worth it to spend \$25,000 in legal and accounting fees to obtain a \$50,000 credit? The answer may be
- “no,” given the other constraints tax credit use may impose on your business. Be sure to calculate the net tax benefit (the value of the credits less all transaction and additional construction costs) before committing to a project that depends on the sale of tax credits.
- **Do you need the equity to make your financial package work?** You may need the equity provided by the credits to meet lender cash requirements. You may need the HTC to finish the rehab because the project does not qualify for a loan large enough to complete the work. Or you may need the cash to reduce the size of the bank loan. If your financing package works without the equity from federal and state tax credits, make sure the net credit amount is worth it before committing to an HTC transaction.
 - **Do you have access to the right professional expertise?** Your current legal and accounting advisors may not be familiar with the use of tax credits. The contractor and architect you use may have never worked on a rehab that takes advantage of federal and state tax credits. You will have to get your team the advice they need, or find new resources with specialized experience you can rely on.

▶ After a \$5.9 million historic rehabilitation, the 250-seat Town Hall Theater hosts plays, dances, wedding receptions, classes, exhibits, and even a very popular winter farmer's market.



- **Do you have the extra time?** Under the best of circumstances, preparing an application and obtaining approval of Parts 1 and 2 of the application from the SHPO and National Park Service is a 120-day process. If you have to submit an amended application to obtain final approvals, the process could stretch out to four months. You will need to factor this extra time into your schedule.
- **Are there additional benefits, such as state historic tax credits or tax abatement, that go along with federal historic tax credit use?** If your state and locality provide additional benefits for historic rehabs, such as property tax relief, a piggy-back state HTC, or preservation grant programs, be sure to add these extras into your net benefit calculation.

CALCULATING THE VALUE OF THE TAX CREDIT

It is useful to know certain rules of thumb to estimate the value of a HTC benefit before spending time and money in pursuit of the credits. Generally speaking, the federal HTC is 20 percent of the eligible rehab and rehab-related “soft costs.” These rehab-related soft costs include construction loan interest, appraisals, construction lender points, architectural and engineering fees, and environmental evaluations. Excluded items include any expenses related to a permanent loan, such as appraisals, points, and interest; acquisition expenses and related costs; site improvements, furniture, fixtures, and the costs of any additions to the existing building

For a quick and dirty estimate of the federal tax credit’s value, a building owner should calculate the sum of hard construction costs and 95 percent of the total soft costs, then multiply this amount by 20 percent. If the owner plans to sell the federal credits, multiply this sum by \$0.80 for a conservative estimate of value on the market as investors will typically pay between \$0.80 and \$0.90 cents for every dollar of credits. If your state has a historic credit, multiply the percentage of that credit times the same tax credit basis number and, if the owner intends to sell it, multiply by 65 percent for the conservative value of your state’s hard construction costs. Selling the credits will require formation of a limited liability company or limited partnership that will allow the building owner to transfer the credits to a third party investor. Combined tax accounting and tax counsel fees can range from \$15-20,000 if local resources are used.

► This 22,000-square-foot former bank building in downtown Rocky Mount, North Carolina (population: 56,341), was converted into office space for nonprofits and small businesses by the Self Help Ventures Fund at a cost of \$3.5 million.



- The \$5.8 million historic rehabilitation of the Dalton Building, a former bank, created 23,000 square feet of upper-floor apartments and first-floor retail and office space in Rock Hill, South Carolina (population 69,210). The rehabilitation project has helped cement the character of the downtown, while providing first-rate upper-floor housing.



FINDING AN INVESTOR IN A SMALL TOWN

If you estimate that the tax credits for a rehab project are worth less than \$500,000 and the building owner's individual or corporate tax position does not justify keeping the credits, it will be difficult to find a buyer in the national historic tax credit marketplace. Companies such as Chevron and Sherwin Williams, which actively solicit direct tax credit investment opportunities typically buy credits in units of no less than \$2 million.

The market for projects that total less than \$2.5 million in development costs and \$500,000 in credits is your own community. A small community bank with which the Main Street program or the building owner already has a business relationship is one of your best bets. Banks may see the credits as a way to improve the return on a construction or permanent loan.

A local bank with state tax liability may be interested in investing in both the federal and state credits. A utility company or a major local employer might also be potential investors. And of course, as explained previously, a real estate professional, such as a developer, contractor, property manager, appraiser, or architect, is a potential tax credit investor and may be someone the building owner already trusts and does business with. The importance of experienced legal and accounting advisors comes into play most importantly when approaching local investor prospects who may be unfamiliar with the credits.

IDENTIFYING A TAX CREDIT TRANSACTION TEAM

Failing to assemble an experienced development team is the most common mistake made by first-time users of the HTC. But where does a building owner find an architect and contractor with preservation experience and accountants and attorneys who've done a tax credit transaction? Is it necessary to throw away existing relationships with local professionals because they are unfamiliar with the complexities of the HTC? Well, you have a choice.

You can help the owner pull together a new team. The State Historic Preservation Office and your local preservation commission are good places to find people who've helped out on similar projects in your area. Your statewide or local preservation advocacy group can recommend qualified architects. For a list of statewide preservation organizations, consult the National Trust web site at <http://www.preservationnation.org/about-us/partners/statewide-local-partners/>. Contact the American Institute of Architects

at <http://architectfinder.aia.org/> for a qualified preservation architect in your state. Local developers who've done similar projects can also recommend architects, tax accountants, and tax attorneys.

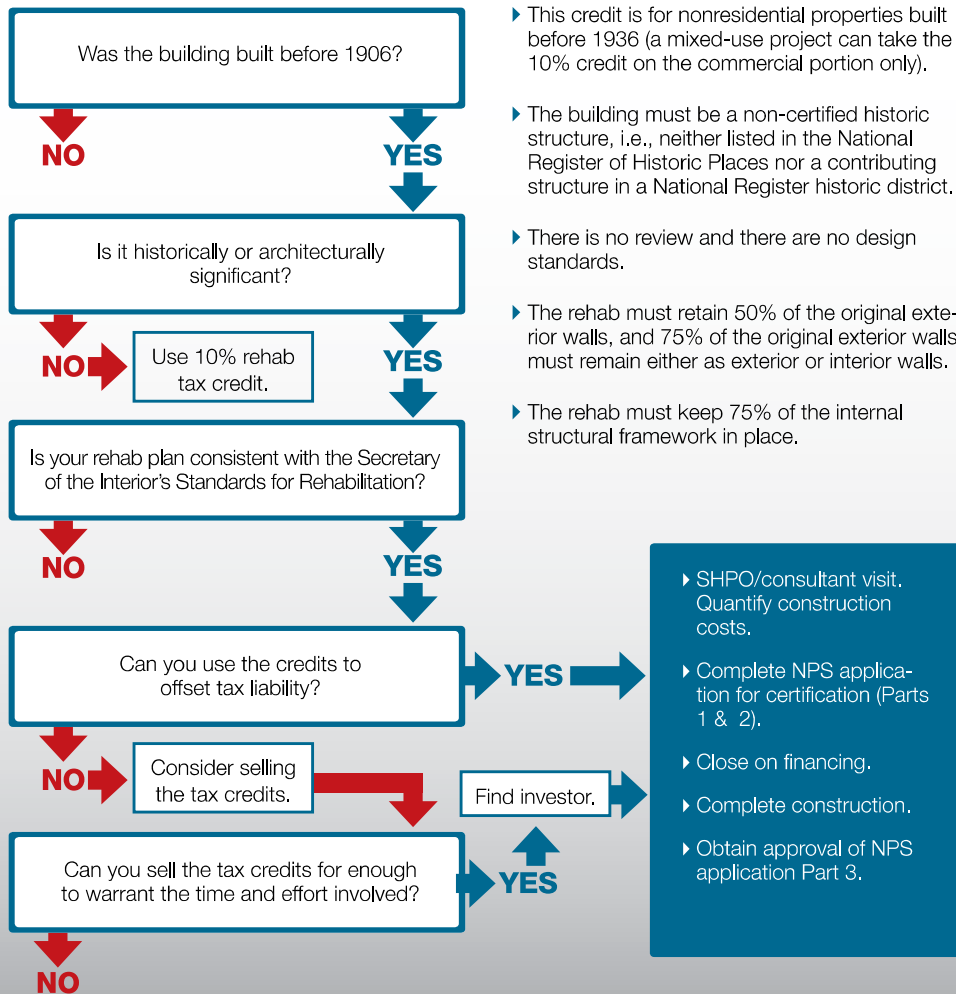
Your second option is to train the real estate team the building owner already has by connecting them with firms and individuals who have tax credit experience. A local tax attorney or accountant can obtain advice from a larger firm that specializes in tax credit work. An architect who hasn't done a historic rehab can be paired with a preservation consultant who can prepare the tax credit applications and provide advice on how to meet the Secretary's Standards. The building owner will spend less money on this second option because it limits the billable time of the higher-priced firms and consultants. Just make sure the experienced resource people ultimately certify the work and recommendations of the local team.

AUTHOR BIOS

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Steps in the Tax Credit Feasibility Process



10% Federal Tax Credit Basics

- ▶ This credit is for nonresidential properties built before 1936 (a mixed-use project can take the 10% credit on the commercial portion only).
- ▶ The building must be a non-certified historic structure, i.e., neither listed in the National Register of Historic Places nor a contributing structure in a National Register historic district.
- ▶ There is no review and there are no design standards.
- ▶ The rehab must retain 50% of the original exterior walls, and 75% of the original exterior walls must remain either as exterior or interior walls.
- ▶ The rehab must keep 75% of the internal structural framework in place.

20% Federal Tax Credit Basics

- ▶ The credit is a dollar-for-dollar reduction of federal tax liability for 20% of eligible costs to rehabilitate a certified historic structure.
- ▶ The property must be listed in or eligible for listing in the National Register of Historic Places or a contributing building in a National Register historic district.
- ▶ The application consists of Parts 1, 2, and 3 and must be submitted to the State Historic Preservation Office, which makes recommendations and submits the application to the National Park Service for final approval.
- ▶ The rehab over a 24-month period must be "substantial," defined as \$5,000 or the building's adjusted tax basis (acquisition cost + cost of improvements – value of land – depreciation taken) whichever is greater.
- ▶ The exterior and interior rehab must meet the Secretary of the Interior's Standards as interpreted by the State Historic Preservation Office and the National Park Service.
- ▶ The credit may only be claimed by building owners after the property is placed in service (generally a certificate of occupancy); an investor may claim the credit only if he or she is admitted to the partnership before the building is placed in service.
- ▶ Transfer of ownership or adverse change to a character-defining feature of the building during the five-year compliance period triggers recapture of the credits (20% recapture for every year left in the compliance period).
- ▶ The credit may be taken by the owner or be transferred to an investor.