# FEDERAL REHABILITATION TAX CREDITS AND RELATED STATE CREDITS

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## INTRODUCTION

- Focus is on preservation of historic structures and revitalization of aging or declining communities.
- Financial incentives give developers the cash they need to make their projects economically feasible, and often very lucrative.

## OVERVIEW

- Federal Rehabilitation Tax Credit (“Federal Credit”)
- South Carolina Historic Rehabilitation Tax Credit (“State Credit”)
- South Carolina Textiles Communities Revitalization Act (“Mill Credit”)
- South Carolina Retail Facilities Revitalization Act (“Shopping Center Credit”)

## HOW CAN TAX CREDITS HELP FINANCE YOUR PROJECT?

- Tax credit investors will provide substantial cash equity investments in your project in exchange for an allocation of the tax credits.
- These investors are often large corporations that can easily use the credits without having to worry about passive activity loss or other tax limitations.
- Investors only want limited partner status and have little desire to meddle in the management of the project, so long as it runs smoothly.

## VALUE OF CREDITS

- Historic Rehabilitation Credits (Federal and State) are available on *Qualified Rehabilitation Expenditures* ("QRE's").
  - Federal Historic Rehabilitation – 20% of QRE's
  - State Historic Credit – 10% of QRE's
- Mill Credit and Shopping Center Credits are available on *Rehabilitation Expenses* (more expansive definition than QRE's).
  - Mill Credit - 25% of rehab expenses
  - Shopping Center Credit – 10% of rehab expenses (25% when used against property tax)

## VALUE OF CREDITS (CONTINUED)

- Depending on market conditions, investors will generally pay:
  - Federal - \$0.80 to \$1.10 per \$1.00 of credit
  - State - \$0.50 to \$0.65 per \$1.00 of credit (includes State Historic, Mill, and Shopping Center credits)
- Combination of various credits can accumulate to provide a substantial portion of the needed equity for your project.
- Mill Credits and Shopping Center Credits can also be used to reduce the property taxes on the Project over the first eight years.

## QUALIFIED REHABILITATION EXPENDITURES (QRE'S)

- QRE's are defined to include amounts:
  - properly chargeable to capital account and
  - incurred for property that
    - is depreciable under IRC Section 168 and
    - is, generally, commercial real property, residential rental property, or an addition or improvement to such property types.
- QRE's generally do not include acquisition costs, enlargement costs, demolition, or site work, among other things.

## QUALIFICATIONS FOR THE 20% FEDERAL REHABILITATION CREDIT

- Certified Historic Structures may be eligible for a 20% Credit.
- A Certified Historic Structure is any building which:
  - is listed on the National Register, or
  - is located in a registered historic district and is certified as being of historic significance to the district.

## QUALIFICATIONS FOR THE 10% FEDERAL REHABILITATION CREDIT

- Structures other than Certified Historic Structures may be eligible for a 10% Credit.
- In order to be eligible, a structure must:
  - Be first placed in service before 1936.
  - Be a “Qualified Rehabilitated Building”.

## WHAT IS A QUALIFIED REHABILITATED BUILDING?

- As defined under IRC Section 47(c)(1)(A), any building (and its structural components):
  - on which depreciation or amortization is allowable (i.e. income producing);
  - which has been substantially rehabilitated; and
  - which was placed in service before the beginning of the rehabilitation.

## STANDARDS OF REHABILITATION

- Rehabilitation plans for Certified Historic Structures must be reviewed and approved by State and Federal authorities in order to be eligible for the Federal credit.
- This process is intended to ensure the rehabilitation will be consistent with the historical character of the building.

## QUALIFICATIONS FOR THE STATE CREDIT

- In order to qualify for the State Credit:
  - The taxpayer must be eligible for the 20% Federal Credit for Certified Historic Structures.
  - The property must be located within South Carolina.

## QUALIFICATIONS FOR THE MILL CREDIT

- A taxpayer who rehabilitates a textile mill site in South Carolina is eligible for the Mill Credit.
- An "textile mill site" is defined as:
  - The textile mill together with the land and other improvements on it which were used directly for textile manufacturing operations or ancillary uses.
  - The area of the site is limited to the land located within the boundaries where the textile manufacturing, dying, or finishing facility structure is located and does not include land located outside the boundaries of the structure or devoted to ancillary uses.
  - Ancillary uses are sales, distribution, storage, water runoff, wastewater treatment and detention, pollution control, landfill, personnel offices, security offices, employee parking, dining and recreation areas, and internal roadways or driveways directly associated with such uses.

## QUALIFICATIONS FOR THE SHOPPING CENTER CREDIT

- A taxpayer who improves, renovates, or redevelops an eligible site is eligible for the Shopping Center Credit.
- An "eligible site" is:
  - a shopping center, mall, or free standing site whose primary use was as a retail sales facility with at least one tenant or occupant located in a forty thousand square foot or larger building or structure.
  - The site must be "abandoned", which means at least 80% of the eligible site's facilities have been continuously closed or otherwise nonoperational for at least one year prior to the rehabilitation.

## TIMING OF CREDITS

- Federal Credits are earned and delivered in the year the building is placed in service.
- State Credits, Mill Credits, and Shopping Center Credits are earned when the building is placed in service, but are delivered over a period of five years, with 20% of the credits being delivered each year.

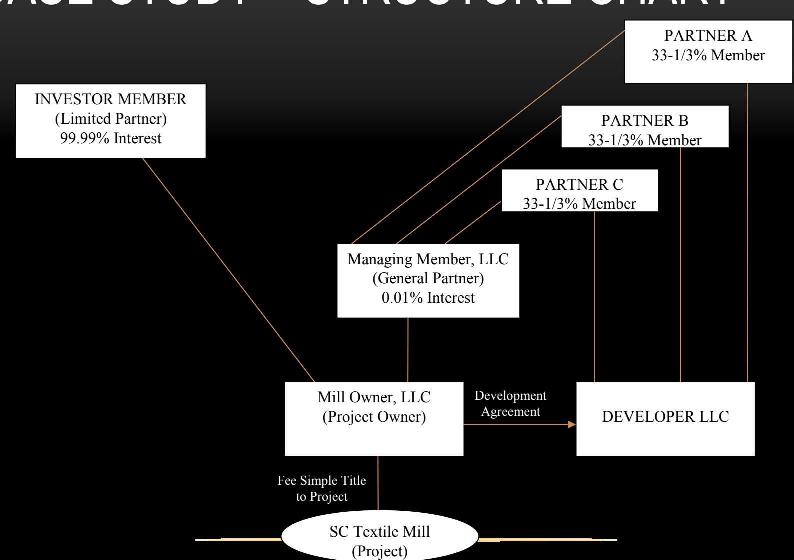
## RECAPTURE

- Federal Credits are subject to recapture if the project, or any portion of it, is transferred within five years after the date the building is placed in service.
- The percentage of recapture is reduced by 20% each year for five years.
  - For example, if the owner sells the entire structure in year 3 after placed in service date, 60% of the Federal Credit will be recaptured.
  - Also applies to transfer of ownership interest in entity that owns the project (2/3 ownership interest safe harbor).

## CASE STUDY – ASSUMPTIONS

- Abandoned textile mill in South Carolina rehabilitated into upscale loft apartments.
- Mill is listed on the National Register of Historic Places.
- Project is eligible for the 20% Federal Credit, the 10% State Credit, and the 25% Mill Credit.
- Total QREs are approximately $20 million (includes a 20% development fee).
- Acquisition cost is $1.5 million.

## CASE STUDY – STRUCTURE CHART



## CASE STUDY – CREDIT VALUE

- Available tax credits:
  - Federal:  $4,000,000
  - State:  $2,000,000
  - Mill:  $5,000,000
- Price per dollar paid by tax credit investor:
  - Federal:  $0.98
  - State and Mill:  $0.60

## CASE STUDY – CAPITAL STRUCTURE

- Equity from tax credit investor:
  - Federal:  $3,920,000
  - State:  $1,200,000
  - Mill:  $3,000,000
  - Total Investor Equity:  $8,120,000
- Construction/Permanent Loan:  $11,157,778

## CASE STUDY – OTHER TERMS

- Investor receives an asset management fee equal to $5,000 per year and a priority return of 2% of their equity per year until they are bought out after recapture period ends.
- $20,000,000 in QRE's includes a $3,333,333 development fee, which equals 20% of QRE's excluding development fee.
  - Assume $2,222,222 of development fee is deferred and paid to the Developer out of net cash flows from the project.
  - Assume $1,111,111 is paid at closing with investor out of tax credit equity.
  - Development fee is included in QRE's.

## SOURCES AND USES OF FUNDS

| | |
|---|---|
| Sources: | |
| Tax Credit Equity | $8,120,000 |
| Mortgage Loan | $11,157,778 |
| Deferred Developer Fee | $2,222,222 |
| Total | $21,500,000 |
| Uses: | |
| QRE's (not including Development Fee) | $16,666,667 |
| Development Fee Paid at Closing | $1,111,111 |
| Deferred Development Fee | $2,222,222 |
| Acquisition Cost | $1,500,000 |
| Total | $21,500,000 |

## CASE STUDY – EXIT STRATEGY

- Reciprocal put/call option agreements between Investor and Developer provide terms for Developer to buyout Investor's interest.
- Can be triggered by either party after 5 year recapture period is over.
- Terms call for buyout price equal to greater of 15% of federal equity ($588,000) or Investor's exit tax liability.
- Pricing usually must be tied to Fair Market Value of Investor's Membership Interest, which is subject to various valuation discounts and is based on the performance of the project.

## CASE STUDY – CONCLUSION

- Developer is able to finance a large portion of his/her project with equity, making a loan for the remaining portion easier to obtain.
- At the end of the project, Developer can use Developer Fee to buy out Investor and end up with complete ownership and control of project.

## ROBERT B. LEWIS

- Has completed many historic rehabilitation projects in Columbia and other areas of SC.
- Most notable project: 701 Whaley Street.
- Consulting services on development aspects / application process for utilizing historic tax credits and Bailey Bill property tax abatement.

## MORE INFORMATION

- http://www.nps.gov/history/hps/tps/tax/index.htm
- http://www.irs.gov/businesses/small/industries/article/0,,id=97599,00.html
- http://scdah.sc.gov/
- http://www.novoco.com/related_program/historic_tax_credit/index.php
- http://www.reznickgroup.com/index.php
- http://www.sctaxcreditblog.com

# QUESTIONS

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