

Legislative Summary: Proposed Changes to the Federal Rehabilitation Tax Credit

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Enabling Smaller Rehabilitation Projects (Modified From Section 4 of the Previous Bill)

Amendment to Section 47 of the Tax Code that would increase the historic tax credit from 20 to 30 percent for “small projects” with \$5 million or less in qualified rehabilitation expenditures.

The historic tax credit is difficult for individuals and small businesses to use. Transaction costs make the available tax credit from smaller projects too shallow to meet the minimum threshold for effective syndication to institutional investors and the public companies that invest in historic tax credit rehabilitations. Allowing a deeper credit of 30 percent for historic rehabilitation projects of \$5 million or less in total development costs would ensure enough equity to make the historic credit work for smaller projects. Many of these businesses provide essential Main Street, neighborhood-serving retail in some of the rural and minority communities that are most in need of reinvestment.

Providing Downtown Housing in Historic Buildings (Section 5 of the Previous Bill)

Amendment to Section 50 of the Tax Code to permit the 10 percent non-historic credit for older buildings to be used for rehabilitating residential rental property.

Under current law, the 20 percent portion of the Section 47 historic tax credit is available for the rehabilitation of any income producing property, including residential rental property. Housing is not allowed, however, under the 10 percent portion of the credit for non-historic older buildings that were placed in service prior to 1936. Allowing the Section 47 non-historic older buildings credit to incentivize rental housing rehabilitation would enable a useful inventory of Main Street, neighborhood-oriented commercial buildings to provide places to live. Many were originally constructed with “above-the-store” dwelling units that once housed tenants. These are often located in areas served by transportation and existing infrastructure in communities that need housing the most.

Using a Practical Definition for “Older Building” (Section 6 of the Previous Bill)

Amendment to Section 47 to use the common definition of an older building as one that is at least fifty-years old in determining eligibility for the 10 percent non-historic rehabilitation credit.

Historic preservation experts routinely use 50 years old or older as basic way to classify older and historic buildings. Back in 1986 when Section 47 was amended, Congress recognized this standard by establishing 1936 as the placed-in-service requirement for projects qualifying for the 10 percent non-historic older buildings portion of the credit. It has not been changed since then, preventing whole categories of noteworthy older buildings from rehabilitation through the credit. Buildings must now be 66-years old to qualify and fewer will

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be eligible as time passes. Rather than use a fixed date to determine eligibility, it would be a better public policy approach to define an older building as one that is simply “fifty-years old or older.”

Rehabilitating Qualified Non-Profit and Public Historic Buildings (Section 7 of the Previous Bill)

Amendment to Section 47 of the Tax Code to allow for certain leasing arrangements with non-profits and other tax-exempt entities that are now precluded.

The tax-exempt use rules of Section 168(h) penalize many non-abusive, community revitalization-oriented historic tax credit projects. With some slight changes, many of these projects could use the historic tax credit without weakening the anti-abuse function the rules were designed originally to perform.

Section 168(h) defines as a “tax-exempt use property” any property leased to a tax-exempt entity in a “disqualified lease.” As such they are subject to slower and less advantageous depreciation rules. In addition, a special historic tax credit provision (Section 47(c)(2)(B)(v)) does not allow historic tax credits to be claimed on rehabilitation expenditures for these tax-exempt use properties. There are four types of disqualified leases. The best known of these is the “sale leaseback,” but the others leases are:

- terms in excess of 20 years;
- sales options; and
- entities that are part of any tax-exempt rehabilitation financing.

Properties in which 50 percent or less of the building is subject to disqualified leases are exempt.

With changes to the historic tax credit section itself and NOT to Section 168, many worthwhile non-profit, civic, and community-use building rehabilitations would be incentivized through the historic tax credit. The proposal would modify Section 47(c) to maintain that historic tax credits cannot be claimed on tax-exempt use property expenditures, but ONLY if that property is so designated because it falls under the sale leaseback disqualification. The other three types of disqualified leases would allow the historic tax credit on qualified expenditures for tax-exempt use properties. This proposal recognizes that the abuse Congress sought to correct in approving Section 168(h) was largely in only one of the four categories -- sale leasebacks - and not in the other three lease types.

Making Historic Buildings as Energy-Efficient as They Can Be (Not in Previous Bill)

Amendment to Sections 47 and 45 that encourages building owners who are in the process of rehabilitating historic buildings to achieve substantial energy savings and allow graduated increases in the historic credit based on a scale of energy efficiencies achieved.

Forty-three percent of all carbon dioxide emissions in the United States come from the operation of buildings. They are the source of 72 percent of all electricity consumption in America. The historic tax credit should encourage the rehabilitation of historic buildings for energy efficiency. This is what Congress intended when it passed the National Historic Preservation Act of 1966 finding that “the preservation of historic properties is in the public interest not only because of cultural, educational, aesthetic, inspirational, economic, and energy benefits.” The reuse, recycling, and preservation of older and historic buildings in and of itself conserves the energy expended to construct them and reduces the use of additional energy and natural resources required by new construction. The historic tax credit, however, currently needs substantial improvement to incentivize meaningful energy efficiencies in building rehabilitations.

The amendment would provide a boost in the credit available for historic rehabilitations with an additional \$2.00 to \$5.00 per square foot depending on a range of energy savings starting at 30 percent and graduating

up to \$50 percent. The added incentive could not exceed 50 percent of the total cost of a building's rehabilitation expenditures. If a building owner should fail to meet the 30 percent energy savings goal outlined in this section, but attains a base reduction of at least 25 percent, he may receive a partial credit for his efforts. This would mirror a similar provision and formula currently in Section 179(D) of the Tax Code.

Facilitating Smaller Projects through Transferability (Not in Previous Bill)

Amendment to Section 47 that would allow for the transfer of historic tax credits to another taxpayer for projects under \$5 million in qualified rehabilitation costs.

By making the historic tax credit transferable in limited circumstances, property owners without much income could sell the credit and use the proceeds for the equity needed by a bank to enable them to finance renovations on their building. The taxpayer would be allowed to transfer his qualified expenditures to another taxpayer only if the initial taxpayer has not used the same qualified expenditures to obtain the credit. Once the expenditures and credits are assigned the transferee would be treated as the taxpayer under Section 47.

Encouraging Moderate Rehabilitation through Reducing the Substantial Rehabilitation Requirements (Not in Previous Bill)

Amendment to Section 47 to allow for moderate rehabilitation by reducing by half the substantial rehabilitation requirements.

Under current law historic tax credits can only be used if the property being developed meets certain requirements for substantial rehabilitation. During a 24-month period selected by the taxpayer, rehabilitation expenditures must exceed the greater of \$5,000 or the full adjusted basis of the building and its structural components. The adjusted basis is generally the purchase price, minus the cost of land, plus improvements already made, minus depreciation already taken. This proposal would allow the historic tax credit to be claimed if rehabilitation is fifty-percent and not one-hundred percent of the adjusted basis.

The current substantial rehabilitation requirement adversely affects historic building rehabilitations particularly those in markets with very high real estate values. In certain high cost areas, when a taxpayer acquires an expensive property with a high basis -- especially if the building is in relatively good condition -- the owner is precluded from using historic tax credits because it is unlikely that their qualified expenditures will exceed their basis and satisfy the substantial rehabilitation test. In some cases, this requirement has encouraged owners to disinvest in their buildings until a more extensive rehabilitation is in order, rather than fostering ongoing repairs through more modest rehabilitation work.

Allowing State Historic Tax Credits to Work More Effectively with the Federal Credit

Amendment to Section 47 to specify that state historic tax credits should not be considered federal income for tax purposes.

Many states have their own historic tax credits and the federal historic tax credit, when combined with a state incentive, can provide additional subsidy for building rehabilitations. In order to ensure the maximum amount of resources are targeted to offset the high cost of restoring historic structures, state historic tax credit proceeds should not be taxed by the Internal Revenue Service and considered federal income unless the taxpayer elects to report it as such. Furthermore, the transfer or disposition of a state historic tax credit should not affect or reduce the federal tax credit's qualified rehabilitation expenditures or trigger any recapture of income.