How Renovating a Historic Building Can Put Money in Your Pocket

The federal Rehabilitation Tax Credit, or rehab credit, offers significant financial incentives for owners or leaseholders of historic buildings to renovate those structures.

What's the big deal? Why are tax credits so exciting?

Tax credits, unlike deductions, reduce your tax bill dollar-for-dollar. If you spend $100,000 and get a 20 percent tax credit, you reduce your tax bill by $20,000. That's Uncle Sam putting $20,000 in your pocket. And there's more.

You likely reduce your taxes with depreciation deductions on the other $80,000 and also qualify for a rehab credit from your state (most states grant rehab tax credits).

The rehab credits give you a leg up on your property because you can have the feds and states giving you money without asking for any equity in your building.

On a sad note, the 2017 Tax Cuts and Jobs Act (TCJA) imposed restrictions on the rehab tax credit. This damper reduces (but does not eliminate) the significant tax savings available to you.

To find this tax money in your pocket, you need to navigate some tricky tax rules, as we explain here.

Historical Background

The federal rehab tax credit has been around in one form or another for over 40 years.

Prior to the TCJA, the tax code had two different types of buildings that qualified for one of two tax credits, as follows:

1. A 10 percent rehab credit for the renovation of non-historic buildings placed in service before 1936

2. A 20 percent credit for the rehab of historic, income-producing buildings that are determined by the Secretary of the Interior to be "certified historic structures"

Now, with the TCJA, you no longer have the 10 percent rehab tax credit for the renovation of non-historic buildings. The 20 percent tax credit for the rehab of certified historic structures survived the TCJA, but you now claim the credit ratably over a five-year period.

Program Basics

You claim the 20 percent tax credit on IRS Form 3468, Investment Credits. You can carry the credit back one year or carry it forward up to 20 years, if necessary. And if you are eligible, you can also combine the rehab credit with other tax credits (low-income housing, state historic, new markets, etc.).

Here are the five requirements for you to qualify for the historic rehab credit:

1. Certified Historical Structure

The U.S. Secretary of the Interior must accredit your building as a "certified historic structure."

Certification requests are made through your State Historic Preservation Officer on National Park Service (NPS) Form 10-168, Historic Preservation Certification Application. The request for certification should be made prior to physical work beginning on the building.

2. Income-Producing Property

Your building must be depreciable and income producing.

Thus, qualifying properties include, among others:

- Commercial buildings
- Industrial buildings
- Agricultural buildings
- Apartments
- Single-family rentals

You cannot claim the rehab credit for expenditures on tax-exempt-use property. Your project generally will be disqualified if more than 50 percent of your building is leased by a tax-exempt entity.

The building must have been placed in service before the beginning of rehabilitation. This requirement is met if the building was placed in service by any person at any time before the rehab began.

3. Substantial Expenditure and Required Time Period

The tax code says that you substantially rehabbed the structure only if the qualified rehab expenditures during the 24-month period selected by you, and ending with or within the taxable year, exceed the greater of

- the adjusted basis of such building (and its structural components, but not the land), or
- $5,000.

If you complete the rehab in phases, the same rules apply, except that you have 60 months to complete the rehab project. This phase rule is available only if you meet three conditions:

1. There is a written set of architectural plans and specifications for all phases of the rehab.

2. You must complete the written plans before the physical work on the rehab begins, and you must be reasonably certain that you will complete all phases of the rehab.

3. You must place the property in service.

Due to COVID-19, if your 24- or 60-month measuring period originally ended after March 31, 2020 and before March 31, 2021, you will be happy to know that the IRS postponed the last day of the 24- or 60-month measuring period to March 31, 2021. Thus, if you had such an end date, your measuring period is longer than the original 24 or 60 months.

4. Costs That Count

In general, only costs directly related to the repair or improvement of structural and architectural features of the historic building are eligible for the rehab credit. Therefore, you can generally claim expenditures for the following items:

- Walls, floors, ceilings, windows, doors, stairs, etc.
- Elevators, escalators, sprinkler systems, fire escapes
- Plumbing, plumbing fixtures, electrical wiring, electrical fixtures

In addition, you can generally claim any other fees paid that would normally be charged to a capital account, such as:

- Construction period interest and taxes
- Architect and engineering fees
- Construction management costs
- Reasonable developer fees

You cannot claim rehab credit for costs not related to the physical structure. Therefore, the following expenditures do not qualify:

- Furniture, appliances, cabinets, carpeting, window treatments
- Fencing, landscaping, planters, retaining walls, paving, parking lots, sidewalks, signage
- Decks, porches, patios (if not part of the original building)

Any expenditure incurred before the start of the 24-month (or 60-month) period is not eligible for the credit. Instead, the expense will increase the adjusted basis for the building.

5. *Partnership Allocations*

Partnerships may allocate the rehab tax credits among the partners if the partner(s) who incurred qualifying rehab expenditures had a meaningful stake in the success or failure of the partnership.

Due to uncertainty concerning when a partner has a meaningful stake in the success or failure of the partnership, the IRS has created a safe harbor establishing the circumstances under which the IRS will not challenge partnership allocations of the rehab credit by a partnership to its partners.

Lessees May Also Benefit

A lessee is eligible to claim a rehab tax credit when the lessee incurs the cost of the rehabilitation and the lease term is greater than the recovery period (39 years for non-residential property and 27.5 years for residential rental property).

With the lessee rehab, you determine the adjusted basis of the building by adding together:

1. The adjusted basis of the owner (lessor) in the building

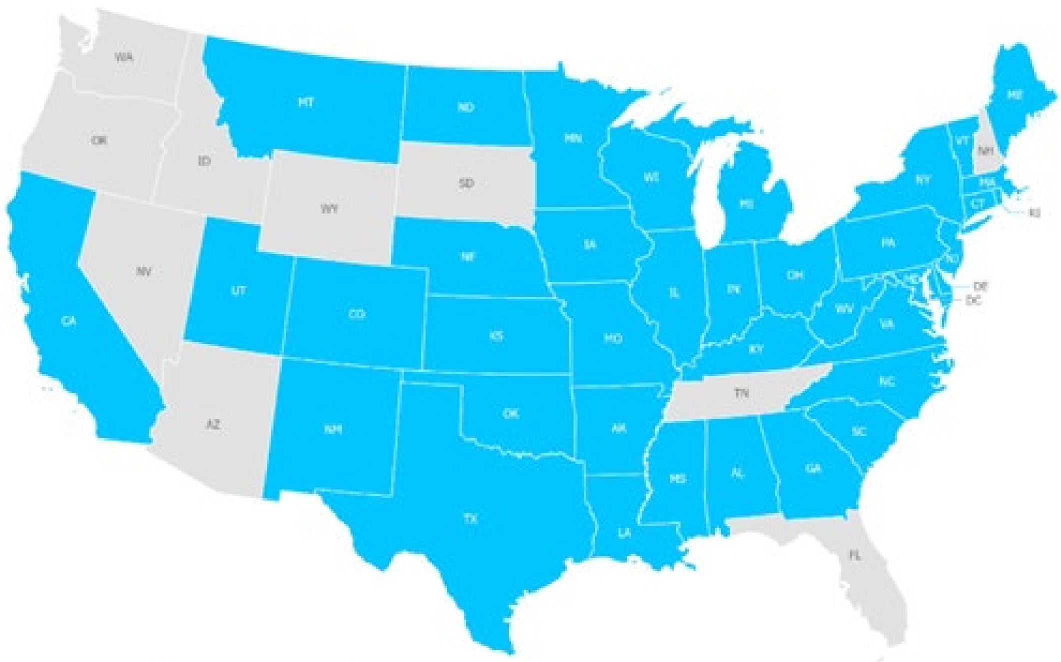
2. The adjusted basis of the lessee (or lessees) in the leasehold

3. Leasehold improvements that are structural components of the building

Don't Forget About the States

Keep in mind, we are talking about a 20 percent tax credit at the federal level. Now, we have more good news!

In addition to the federal tax credits, 39 states offer rehab tax credits ranging up to 50 percent. This means that if your building is in a state that offers a 50 percent rehab credit, the total reduction in the cost of your project could be as much as 70 percent



Many state programs are similar to the federal program, albeit with different percentages.

Five Practical Steps for the Savvy Investor

Step 1. Go to National Register Database and Research and see if the property you are thinking of rehabbing is in a historic district.

Step 2. Contact your state's historic preservation office. State offices provide valuable information and assistance as you navigate the entire process.

Step 3. Hire an architect who is experienced in historic preservation. The Secretary of the Interior must certify your rehab as a bona fide historic rehab. Regulations for the rehab include, among others (and this is why you need the experienced architect):

- Justification for any storefront alterations
- Justification for removing windows
- Ensuring that replacement sash matches the original in size, pane configuration, color, trim details, and reflective qualities

You get the idea: the law in this area is picky, picky, picky.

Step 4. Get on top of the tax credits that are available. This article gives you the big picture. You also will want to discuss the credits with your state preservation office and your tax advisor.

Step 5. Make sure you are going to make a profit. Run the numbers on this property using the after-tax adjusted rate-of-return formula (also known as the managed internal rate of return, or MIRR). Most real estate investment programs, including those in your local commercial and residential real estate offices, include this computation.

Takeaways

The federal Rehabilitation Tax Credit offers a 20 percent tax credit for owners or leaseholders of historic buildings when they undertake substantial renovations of these structures.

Here are some insights from this article:

- To qualify for the credit, your building must be designated by the Secretary of the Interior as a "designated historic structure."

- To qualify for the credit, your building must be depreciable and income producing; you cannot claim the rehab credit for expenditures on tax-exempt-use property.

- To qualify for the credit, you must incur substantial rehab expenses.

- Only costs directly related to the repair or improvement of structural and architectural features are eligible.

- You must complete the rehab and place the building in service within a 24-month period, or over 60 months if you do it in phases (additional rules apply to the phase election).

- A partnership can freely allocate the credit among the partners if they follow IRS safe-harbor guidelines.

- Long-term lessees may also claim the credit in certain situations.

- In addition to the federal tax credit, most states offer similar and even more substantial rehab tax credits.