City of Palo Alto
Finance Committee Staff Report

Report Type: Meeting Date: 10/18/2011

Summary Title: Historic Tax Credit Program Use for Roth Building

Title: Palo Alto Historic Museum’s Proposal to Use Federal Historic Tax Credit Program for Adaptive Reuse of Roth Building

From: City Manager

Lead Department: Administrative Services

Recommendation
Staff recommends that the Finance Committee review and provide input on the Historic Tax Credit financing plan developed by the Palo Alto History Museum.

Background
In April 2000, the City Council approved the $1,957,000 purchase of the Roth Building and its 0.41 acre site for potential development as a “public facility or alternative use if a public facility is not feasible,” in conjunction with the South of Forest Avenue Coordinated Area Plan (SOFA CAP).

On May 20, 2002, Council approved a Request for Proposals (RFP) and directed staff to solicit proposals for the lease of the Roth Building. The RFP specified that: preference be given to non-profit groups located in or serving Palo Alto; that the property be improved and operated at no cost to the city; and that public access to the Roth Building restrooms by users of the neighboring park be provided. In response to the RFP, one proposal was received in November 2003. The Palo Alto History Museum (PAHM) proposed to restore, preserve and improve the historic Roth Building for use as a museum. PAHM’s proposal was accepted by the Council in April 2004, at which time staff sent the Museum a draft Option Agreement for its review.

In February 2006, staff received the Museum’s proposed changes to the draft option including a request that the City contribute up to $300,000 to repair leaking and drainage problems at the Roth building. On July 10, 2006, Council created a Capital Improvement Program (CIP) for Roth Building maintenance in the amount of $415,000 to provide funding for interim measures to prevent further deterioration of the building until the Museum takes over the site. On May 14, 2007, Council authorized the Mayor to execute the Option Agreement and approved a City contribution of $150,000 for repair of the leaking and drainage problems. The Option Agreement was executed on June 22, 2007 with a twenty-four month term.
When the twenty four month period ended, the Museum requested additional extensions which were granted by the City Manager through December 2011. The Museum cited difficulties with fund raising due to the severe economic downturn and was in the process of developing a new financing plan that is discussed in this report.

On April 12, 2010, Council approved the nomination of the Category 2 Roth Building to the National Register of Historic Places and transmittal of letter of support to the State Historical Resources Commission. The Roth Building was recently listed on the National Register of Historic Places, joining several other listed Palo Alto structures such as the Norris House, the University Avenue CalTrain station and the United States Post office on Hamilton Avenue.

On March 21, 2011, in compliance with conditions of the Option Agreement and the Palo Alto Municipal Code (PAMC) Section 18, development plans for the Museum’s proposed project were conditionally approved for Architectural Review, Minor Exceptions, and a Conditional Use Permit (CUP). The proposed project includes the rehabilitation of the 19,182 square foot Roth Building and a 1,462 square foot addition for use as a museum including gallery space, office space for museum staff, and offices for future subtenants, a community meeting room, a gift shop, café, restrooms, archive storage space, and mechanical/ utility spaces. Minimal exterior modifications on the east side will accommodate a public restroom and a code-required second stairway.

On March 29, 2011, final approval of the CUP for the project was appealed in accordance with Title 18 of the Palo Alto Municipal Code. This appeal focused on parking concerns. A public hearing on the appeal was held on June 8, 2011 before the Planning and Transportation Commission (PTC), which recommended that Council deny the appeal. Subsequently, the Council accepted the PTC recommendation and denied the appeal.

Discussion
To obtain additional financing for capital improvements to the Roth Building, the Palo Alto History Museum (Museum) has solicited the services of Christine Fedukowski Consulting (CFC). In describing its services CFC states that it,

“works with developers, governmental agencies, community redevelopment agencies, and investors involved in redevelopment of urban and rural communities that focus on urban infill projects, including new construction and adaptive reuse of historic properties. CFC works with its clients to find financing solutions for these complex projects. Guided by the client’s strategic vision, it manages the financing process from beginning to end, to identify sources, structure the capital transaction, and close financing that includes federal and state historic tax credits, new markets tax credits, other state and local government incentives, as well as conventional financing.”

CFC is proposing that the Museum participate in the Federal Historic Preservation Tax Incentives program and utilize the Historic Tax Credit (HTC) to obtain additional funds to reuse and rehabilitate the Roth Building.
CFC, the Museum's Board President, and staff from Administrative Services and the Attorney’s Office have met on several occasions to understand the HTC, its requirements, and the legal structures necessary to fulfill all obligations. This program is complex in that numerous federal and IRS criteria must be followed carefully and in that several different “ownership” structures could be utilized.

The fundamental principle of the HTC program is that it provides federal tax credits to encourage the private rehabilitation of historic structures. Under the HTC an “Investor” (such as a bank or corporation) invests funds in an historic building rehabilitation project in exchange for a federal tax credit. The amount and timing of such an investment is dependent on an investor’s need for a tax credit. Per CFC, HTCs have been utilized as part of an overall financing program for historic rehabilitation of the Fox Tucson Theater in Tucson, Arizona; the Arctic Club Hotel in Seattle, Washington; and Mayo Building in Tulsa, Oklahoma (see response to Question 9 below for HTC use in California).

There are an array of requirements to obtain the tax credits and investor financing. The following represent a sampling of the most important provisions (a detailed “Program Overview” and preliminary “Proposed Roth Building Rehabilitation” can be found in Attachment A) follows:

- The HTC can only be used by a taxpayer that owns and rehabilitates a historic building
- Qualified buildings must by “certified historic structures” (Roth Building qualifies)
- HTC is limited to 20 percent of “qualified rehabilitation expenditures”
- The IRS requires that the project include:
  - substantial rehabilitation
  - qualified rehabilitation expenditures
  - building must be depreciable, so it must be income producing or used in a business
  - tax exempt entities cannot lease more than 50 percent of the rentable area...
  - “economic substance” on a pre-tax basis whereby project must demonstrate over a projected holding period of 32 years a 3 percent return on the investor equity investment. Project must have economic purpose beyond tax benefit by generating profits
  - HTC is generally claimed in year building is placed in service
  - Claimer of HTC must retain ownership for the property for at least five years after occupancy or tax credits are subject to recapture
  - HTC can be recaptured or returned to federal government if the project is sold before the end of the minimum 5 year holding period or if the property ceases to be income-producing
Based on the above, intricate criteria it appears that the Museum would have to work closely with a consultant as well as its partners or investors to comply with federal regulations. In addition, the Museum would need to secure the legal, financial and administrative expertise necessary to fulfill federal requirements.

In addition to the challenge of complying with all federal regulations, CFC states that “a recurring challenge in using the tax credits is identifying an entity that can use the credits and forming a partnership that includes that entity.” Since non-profits such as the Museum cannot make use of the HTC, it is necessary to partner with an entity that can. The typical partner is one that makes an equity investment in the project in return for the tax credits. CFC refers to this as “syndication” of the tax credit. This syndication has 2 basic structures that can be developed into different ownership arrangements. These are the “Single-Entity” and “Master Tenant Lease” structures. In both structures a limited liability company (LLC) must be formed.

CFC states that ‘in the Single Entity, the Project Sponsor is the managing member and the tax credit investor is the Investor Member of the LLC that owns and operates the building. Each is allocated, according to their percentage member interest, the tax credits, and other benefits and obligations of the project, including: 1) profits and losses; 2) depreciation; and 3) cash flow.”

In the Master Tenant Lease arrangement, the LLC that owns the building enters into a long-term lease with a master tenant entity. The LLC landlord would own the property (via fee simple title or long-term leasehold interest) and passes through the HTC to the Master Tenant entity. CFC is recommending the Master Tenant entity structure.

For more detailed information on the substance of the HTC program, please see Attachment A. In addition, CFC has provided the following WEB sites that describe the program:

Within that site: Program Summary: Click on "About the Tax Incentives" - PDF format is in the left hand column. For more Detailed IRS Matters: Click on "IRS Connection:" [http://www.nps.gov/history/hps/tps/tax/IRS.htm](http://www.nps.gov/history/hps/tps/tax/IRS.htm) (in the left hand column)

**California Office of Historic Preservation:**

Based on the multifaceted aspects of the HTC program and staff’s unfamiliarity with it, several key questions were posed to CFC. It is important to note that this would be the first transaction involving the HTC for the City. Also based on staff’s limited research this program appears to be more widely used in privately-owned, rather than publicly-owned buildings. It appears that in California, the publicly-owned scenarios involve redevelopment agencies. The questions and responses follow:
Question 1
Recognizing the potential for additional funding for the Museum to rehabilitate the Roth building, City staff views the tax incentive model as outlined by CFC as extremely complex. There are numerous and strict regulations that must be followed; partnerships to be developed; and legal questions to be resolved. At a minimum, expert consultant and legal advice will be required to guide the Museum through the historic tax credit process and to demonstrate to the IRS that it is compliant with the terms of for obtaining the tax credit. It appears that consultant expertise will be required on an ongoing basis and that the Museum will incur an ongoing cost.

Response 1
CFC has been engaged by Palo Alto History Museum ("PAHM") and continues to work on the required materials, anticipating submitting investor proposals once there is approval of this concept from the city staff and Finance Committee of their willingness to consider this structure. Also, the consultant expertise is required only through closing the transaction, to negotiate and finalize the transaction and to help put in place accounting processes and procedures to follow after construction completion. And, most of the consultant fee is earned and payable, if and when the transaction closes, so no significant monies are owed unless an HTC investment is obtained.

Please note also, that using the HTC benefits does not preclude seeking other alternative financing options - whether grants or gifts (public and private). As a matter of fact, many organizations use the HTC investment to leverage other monies.

Although complex, with the help of the consultant, as well as the investors themselves, many smaller, non-profit organizations in California and across the country have done this. For example, with respect to a small group being able to successfully complete an investor syndication, CFC has worked with, two such groups - one, a small parish in Washington, D.C. that did a $3 million rehabilitation of 2 townhouses for use as a senior center; and the second, a small San Antonio nonprofit in San Antonio providing early childcare that did a $6 million rehabilitation.

Question 2
Is the Museum prepared to take on the responsibilities described above and as discussed by the consultant?

Response 2
Yes, the museum is prepared to do this, as evidenced by engaging the consultant and bringing capacity to its board that includes a CPA.

Question 3
Does PAHM want to pursue the HTC program or, given its complexities, pursue alternative financing options?
Response 3
Yes, it has analyzed the options, and concluded it wants to pursue the HTC, and also will
continue to pursue all other alternative financing options. Furthermore, PAHM has structured
its consultant agreement so that no significant costs will be incurred prior to receipt of a term
sheet, which will detail the investment terms, from a bona-fide, third-party, established Historic
Tax Credit Investor.

Question 4:
From CFC’s materials, the federal HTC program’s goals are twofold: 1) to
rehabilitate an historic building and 2) to house an ongoing enterprise capable of generating an
annual return of 2% to 3% of the amount invested in the project. This return is payable from
cash flow at the end of the year. Also, CFC states that there is a “requirement that the tax
credit investor demonstrate that the Project has ‘economic substance’ or profit motive above
and beyond the tax credit....” Has the Museum and consultant performed the financial analysis
to demonstrate that the 2% to 3% rate of return is feasible and ongoing?

Response 4
That analysis is in process, and based on preliminary projections, the project should meet these
requirements -- however, the assumptions and analysis will be revised based on the final
project construction budget and post-construction operating projections, such to include lease
agreements, event rental fees, admissions (suggested donation), building operating costs, etc.
Note also that this “profit motive” is typically determined using a projected holding period of at
least 30 to 50 years, with project cash flow increasing significantly in later years (years 25 and on).

Finally, to put this concept of “profit motive” in context, it is helpful to understand that a key
purpose of the economic substance requirement of the Internal Revenue Code, is not
necessarily to limit this tax benefit to only highly profitable ventures, but rather to preclude so-
called “sham transactions,” that became prevalent prior to the 1986 Tax Reform Act, and
purposely created money-losing ventures solely as tax shelters.

Question 5
Is PAHM prepared to take steps necessary to create and follow a business model that will meet
the profile of an enterprise as described in the consultant’s discussion of the tax credit
program?

Response 5
Yes, PAHM recognizes the need to retain the business skills on staff and board necessary for
this business model. And, to specifically address the “profit-motive” IRS requirement, prior to
closing the transaction, the tax credit investor will require an opinion from tax counsel and tax
accountant that the transaction complies with all rules and regulations.

Question 6
CFC has generated a number of potential ownership structures the Museum can use to
facilitate the HTC financing. It is unclear to staff which model is optimal and which protects the City’s ultimate ownership of the Roth property. It appears that either the Single Entity or Master Tenant ownership structures will maintain a to-be-created “PAHM Rehab, LLC” as the property owner, but the question remains as to who will own the property should there be a recapture of the tax credit or if the LLC fails to meet the IRS requirements?

Response 6
The Master Tenant structure will be used. As to the second question, the transaction structure contemplates that City of Palo Alto is fee simple owner and enters into a long-term lease (at least 50 years) with the LLC, the Lessee. So, that leads to the question, “what happens if the PAHM affiliate, that controls the LLC, fails to meet its obligations to the HTC investor”? In that event, the HTC investor could seek to remove PAHM-affiliate as controlling member, which, if successful, would result in the HTC investor taking control of the project. However, PAHM would take steps to mitigate possible adverse effects even if such were to occur, by providing language in the transaction documents to insure rights and remedies with respect to potential removal of the PAHM-affiliate as general partner, such as:

1. The HTC investor would still be bound by the terms and conditions of the lease agreement, as well as all city requirements with respect to zoning, parking, use, etc., that are imposed on all property owners and users.

2. While the HTC investor would require that it have the right to take control, the conditions under which such could happen would be specifically defined, and such right could be exercised only if PAHM-affiliate (A) were grossly negligent; and (B) such negligence had a material adverse affect on the HTC investor. In other words, simply failing to meet attendance goals, or generate sufficient cash flow to pay the annual return, would likely not be sufficient grounds to remove PAHM-affiliate.

3. Typically, the HTC investment is made by a financial institution's community development corporation, which requires that such investments be made only for projects that provide tangible community and public benefit and/or serve the public welfare. As such, for both business and regulatory reasons, the HTC investor’s and City’s project goals are aligned: (a) maintaining the structure in a manner consistent with the Secretary Standards of Rehabilitation; (b) using the building to provide space for a museum, and supporting amenities – or similar activity – that provides community benefit, including accessibility to low- to moderate income persons; and (c) having an overall operating strategy that supports the City’s economic development objectives.

Question 7
CFC estimates that an equity investment of $1.08 million from an outside institution is possible. From prior information, it appears that $4.75 million in donations has been pledged. Together these sources total $5.85 million. The project apparently needs $6.3 million so an additional $0.45 million is yet to be identified. Staff’s understanding is that the Museum has been asked to identify a complete financing plan before approaching Council. What is the Museum’s plan
for raising the additional financing?

**Response 7**
Additional financing will come from philanthropic contributions from major gifts from corporations, foundations, and/or individuals. A broad-based community campaign will be launched shortly to target approximately $250,000.

**Question 8**
In the current economic environment, what is the likelihood of finding a bank or corporation willing to invest in the project for the tax credit?

**Response 8**
Right now, there continues to be HTC investors active in the market. And, it is this upfront work we are doing that takes the longest. Once there is an understanding with the city as to the required structure, we would be able to obtain a detailed proposal from the investor before the city had to move to the next step of its approval process.

Since a key piece of PAHM’s financing plan rests on a complicated, but viable tax credit program, PAHM staff recommend that an option extension be approved and that the Finance Committee and the full Council have additional time to review, raise questions, and provide input on the funding plan.

**Question 9**
This tax credit program is geared toward incentivizing private sector investment in historic renovation. Can you please identify three public sector projects in California where this funding approach has been utilized? It would also be helpful to have a specific city staff contact/reference.

**Response 9**
Please see the following California projects and contacts/references:

**Fox Oakland Theater**, rehabilitation of historic theater and adjacent new construction using federal historic and new markets tax credits. The Oakland Redevelopment Agency (ORA) owns the building and entered into a long-term lease with a non-profit sponsor. ORA also provided bond financing for a significant part of the project.

Contact: Patrick Lane, Oakland Redevelopment Agency: 510-238-7362
pslane@oakland.net.com.

**Ferry Building (and adjacent Piers 1, 3, 5)**. Rehabilitation of piers and buildings in San Francisco using Federal historic tax credits.

Contact: Kathleen Diehep - 415-274-0536  kathleen.diohep@sfport.com
**REA Building, Sacramento.** Rehabilitation using Federal Historic Tax Credits. The rehabilitation was done through an Owner Participation Agreement with the redevelopment agency, which also provided financing for the project.

Contact: Roberta Deering, Preservation Director, City of Sacramento: 916-808-8259 rdeering@cityofsacramento.org

**Question 10**

a) This transaction appears to be more complicated than even a city-sponsored bond financing/COPs transaction or a private-sponsored “TEFRA” bond transaction.

b) In these types of transactions, the City typically engages bond counsel and a financial advisor with significant expertise. Will these types of consultants be involved in preparing the documentation or is tax counsel only used to issue an opinion letter?

c) Who will pay for legal counsel?

**Response 10**

a) There is complexity to the HTC transaction, especially when public and/or private non-profit organizations are involved, but it is assured that as the transaction moves forward, with the support of the investor and project sponsor tax counsel, the City will better understand and become more comfortable with it. This is especially true since you are familiar with bond and COP financing. CTC believes the City will find the HTC quite simple by comparison. Moreover, there is no financial liability on the part of the city.

b) Since there is no bond or financing provided by the City, CTC does not expect such counsel or advisors will be necessary for the City, unless the City decides to hire such expertise. As to the transaction documents, the investor’s tax counsel will prepare almost all documentation, except for the PAHM-affiliate entity documents and the lease agreement between the city and PAHM. For your approval, investor or PAHM counsel will make revisions to the lease agreement required to comply with IRC. The investor counsel will issue the opinion letter on behalf of the investor. Also, if you would like to engage tax counsel with HTC expertise, we can provide referrals.

c) There is no set procedure, everything is a negotiation. Our aim, however, would be to provide as much counsel as possible to the City, so that the City or outside counsel are reviewing rather than creating documentation. While I've seen costs for bond counsel at around $100,000 for the City's specific HTC aspects of this transaction (if a city chooses to engage outside counsel), CTC expects such cost to be minimal for Palo Alto since outside counsel would be reviewing, rather than preparing documents. The City's counsel would focus primarily on the city's lease agreement and its consent to assignment.

**Conclusion and Recommendation**

As stated above, the HTC program is new to City staff, although the program has been used in
other California jurisdictions and the CFC and the History Museum have been responsive to staff questions. At this time, it appears prudent for the Finance Committee to become familiar with the HTC program, ask questions, and request additional information where needed. Staff would then return to the Finance Committee for its recommendation on whether or not to move the History Museum’s financing proposal on to the full Council.

**Resource Impact**

All costs associated with CFC are being paid by PAHM. In its current financing proposal, there are no requests for financing from the City. The City may incur, however, costs for outside experts (e.g., financial advisor and legal to advise staff and to review documents should PAHM’s historical tax credit financing plan move forward.

**Policy Implications**

The City’s goal of preserving the historical Roth structure would be achieved by PHM financing, especially since the HTC program is, by design, meant for such purpose. Although the ownership structure proposed by CFC preserves ownership of the land through a long-term lease, it is possible that tenants could change should PHM not be able to fulfill its commitments. In this situation, it is the investor and not the City that would determine the new tenant. The Finance Committee and Council should discuss this possible scenario.

**Attachments:**

- Attachment A: Public Private Partnership, The City of Palo Alto and Palo Alto History Museum, Tax Incentives for Adaptive Reuse.... (PDF)

Prepared By: Joe Saccio, Assistant Director of Administrative Services  
Department Head: Lalo Perez, Director  
City Manager Approval: James Keene, City Manager
Public-Private Partnership
The City of Palo Alto and Palo Alto History Museum, Project Sponsor
of
The Adaptive-Reuse and Rehabilitation
of the
Roth Building
300 Homer Street
Palo Alto, CA

Tax Incentives for Adaptive Reuse:
Historic Tax Credit and New Markets Tax Credits
Program Basics and Syndication Market

August 3, 2011
PROGRAM OVERVIEW

Since 1976, the Federal Historic Preservation Tax Incentives program has played a major role in real estate development involving historic properties. The IRS Code, Sections 38 and 47, includes provisions for the "rehabilitation tax credit" which can be utilized in connection with "qualified rehabilitation expenses" for rehabilitations of "certified historic structures".

Referred to as the Historic Tax Credit ("HTC"), according to the National Park Service 2010 Annual Report, this program has leveraged reimbursement into more than 37,000 historic properties, which had a total development cost of more than $58 billion and provided approximately $10.5 billion in tax credits for investors.

HTC has been used for historic rehabilitation projects by both, private and public, non-profit sponsors, as well as by for-profit developers. However, as is further explained in following sections, the HTC can only be used by a taxpayer that owns and rehabilitates a historic building. Therefore, structures, in order use HTC financing, all public-private projects require that if the building is owned by the public entity, the building's ownership ultimately be transferred to a for-profit entity. While there are a number of transaction structures (specific alternatives are attached), all require either a long-term lease (minimum 50 or more years) or a sale of the fee simple title, to the for-profit entity, such that ownership be in place prior to construction completion and remains in place for not less than five years from the date of construction completion. Projects that have done this include:

- **Fox Oakland Theater, Oakland, CA:** $11MM Historic and New Markets Equity Investment. Public-Private Partnership between Oakland Redevelopment Agency and Private Non-Profit.

- **Adler Theater, Davenport, IA:** $4.5MM Historic and New Markets Equity Investment. Public-Private Partnership between the City, Non-Profit Arts Organizations and For-Profit Theater Manager.

- **Fox Tucson Theatre, Tucson, AZ:** $3.1MM Historic and New Markets Equity Investment. Public-Private Partnership between Río Nuevo Multipurpose Facilities District (TIF Financing and grant) and Private Non-Profit Organization.

**A. What is the Historic Tax Credits Program?** This program administered jointly by the U.S. Department of the Interior (through the National Park Service) and by the Department of the Treasury (through the IRS), makes tax credits available to developers that rehabilitate qualified historic buildings. As set forth in Internal Revenue Code (IRC) § 47(c)(3)(A), qualifying buildings must be "certified historic structures" defined as: (a) buildings listed on the National Register of Historic Places; or (b) buildings that contribute to a National Register Historic District or another qualifying local historic district. Treas. Reg. § 1.48-12(d).

The HTC is equal to 20 percent of the "qualified rehabilitation expenditures" incurred in the certified rehabilitations of certified historic buildings. So if a developer spends $5 million on for a project, there could be $1 million in tax credits available to directly offset income taxes owed by that entity or one or more of its members/partners.

**B. Who Uses the Tax Credits?** The Historic Tax Credit is used by owners of certified historic structures who complete certified rehabilitations. It can be used by developers and individuals, though such use is very limited, primarily due to the passive activity rules introduced in the Tax Reform Act of 1986.

However, widely-held corporations (i.e. banks, utility companies, oil companies) regularly use the credits to reduce their income tax liabilities. So, typically, developers partner with a corporate tax credit investor. A limited partnership is formed, with the developer as general partner and corporation as limited partner. The tax credits are allocated to that investor and in exchange for the credits, the investor makes cash contribution to the partnership.
C. NPS Basics: What is a “Certified Rehabilitation” of a Historic Structure? A key eligibility requirement is that the rehabilitation work must be certified by the Secretary of the Interior as being in conformance with the Secretary of the Interior’s standards for rehabilitation. See IRS § 47 (c)(2)(B) & (C); Treas. Reg. § 1.48-12(d). This certification and review is administered through the National Park Service (NPS), in conjunction with the State Historic Preservation Officer (SHPO) in each State. Application for certification is made to the NPS through the SHPO. The SHPO reviews the applications and forwards its recommendations to the NPS for approvals. To be certified, the rehabilitation must be consistent with the historic character of the structure and/or historic district. The defining historic features and character must be maintained and not destroyed or compromised by the rehabilitation work.

D. IRS Tax Basics.

1. Substantial Rehabilitation: The project must be “substantial.” “Substantial rehabilitation” is defined in Treas. Reg. section 1.48-12(b)(2)(i) as projects that incur qualified costs in excess of the larger of: (a) the adjusted basis of all owners of the building; or (b) $5,000. The adjusted basis is generally equal to the property purchase price, less the costs of the land, less any depreciation taken to date, plus the cost of any improvements made since the purchase. These costs must be expended within any 24-month period ending with or within the tax year that the Historic Tax Credits are claimed.

2. Qualified Rehabilitation Expenditures (“QREs”): are defined in Treas. Reg. § 1.48-12 (c) and IRC § 47 (c) (2) (B) and include certain hard and soft costs associated with the existing historic building. QREs include hard construction costs, as well as costs of architecture, engineering, legal (zoning, entitlement), property insurance and utilities, and financing (closing costs, construction-period interest). Costs not included include acquisition costs, new additions to the historic structure or other new buildings, parking and landscaping costs. The total dollar value of the qualified expenditures is critical, because the total amount of tax credits is calculated as 20% of this amount.

3. Building Uses: To qualify for the Historic Tax Credits, the building must be depreciable, so it must be income producing or used in a business. Rental housing, retail, commercial and industrial uses all qualify.

4. Building Tenants: There are also limitations on the types of users and tenants that occupy the building after construction completion. Tax-exempt entities cannot lease more than 50% of the rentable area, unless the lease terms do not trigger a “disqualified lease”. The tax exempt user rules must be analyzed on a project by project basis, however, key events that trigger a disqualified lease are:
   a) Use of tax-exempt bonds or other tax-exempt financing for construction; or
   b) Under the lease there is a fixed or determinable purchase price or an option to buy; or
   c) The lease term is in excess of 20 years, or
   d) Sale - leaseback, i.e. the lease occurs after a sale or lease of the property and the tax-exempt tenant used the property before the sale or lease.

5. When is the HTC Claimed? The HTCs are generally claimed in the taxable year that the rehabilitated building is “placed in service,” i.e. when a certificate of occupancy has been issued.
6. Who Claims the HTC? If the developer (or general partner) cannot use the HTC, then the HTC may be allocated to one or more other partners of the ownership entity.

7. How Long Must the Tax Credit User Own the Property? A taxpayer that claims the HTC must retain ownership of the property for at least five years after the date the project was placed in service, or the tax credits will be subject to recapture.

8. Recapture of the Credits. HTCs can be recaptured if the project is sold before the end of the minimum five-year holding period or if the property ceases to be income-producing. These recapture rules are laid out in IRC section 50(a). Recapture can also take place if the project ceases to comply with other transfer or leasing restrictions imposed under the program or if the project is physically altered such that it no longer complies with the approved rehabilitation improvements. SEE Treas. Reg. § 1.48-12(f)(3). The amount of the credit recapture is calculated on a sliding scale based on how much of the minimum five year holding period has elapsed at the time of noncompliance.

Challenges/Opportunities in Using the Credits:

A recurring challenge in using the tax credits is identifying an entity that can use the credits and forming a partnership that includes that entity. Also, the rules are complex, and require expert analysis to ensure compliance with all rules and regulations, and to meet business objectives of the developer and investor.

But this is a challenge that can also present real opportunities. Over the years, attorneys, accountants, and investors, and preservation consultants have developed deep expertise in all areas related to the tax credit. As a result, the HTC is now one of the most important sources of financing for the rehabilitation of historic properties and has been successfully used by both for-profit and non-profit developers, for projects large and small.

Resources

The National Park Service web site at [www.nps.gov](http://www.nps.gov) includes numerous links to sites that include information on the various stages of the National Register process and Historic Tax Credits program. The IRS web site at [www.irs.gov](http://www.irs.gov) also has links to sites that focus specifically on tax aspects of the program. Some specific links:

[http://www.nps.gov/history/hps/tps/tax/incentives/index.htm](http://www.nps.gov/history/hps/tps/tax/incentives/index.htm)

b) Internal Revenue Service: Rehabilitation Tax Credit - Real Estate Tax Tips  
EXECUTIVE SUMMARY
Proposed Roth Building Rehabilitation

A summary of the HTC, HTC syndication (and NMTCs basics) is provided in the attached Exhibit A, with HTC and HTC syndication discussed in more detail below:

Federal Historic Tax Credit: Equity Investment and Investor Market:
Based on current market conditions and representative projects, investment terms and conditions that the Project can reasonably expect are as follows:

- The tax credit amount would be approximately $1,200,000, and generate an equity investment of $1,080,000, assuming a "price" of $.90. A development cost of approximately $6 Million is assumed to determine the tax credit amount (20% x $6,000,000 x $.90 = $1,080,000);

- The equity investment would be paid in 3 installments: (1) a minimal amount a construction start, (2) 85% at construction completion, and (3) the remaining amount upon receipt of NPS Part 3 Approval;

- Investors require an annual return of 2% to 3% while they remain in the partnership (typically 5 years from construction completion), with a potential buyout of investor interest at that time, at a price negotiated prior to closing, typically 5% to 20% of the investment amount.

To maximize the tax credit amount, further review would look at all costs, already, or that will be, incurred, that could potentially be considered in the tax credit amount (and equity amount) calculation, such as:

- **Soft Costs:** Architectural fees; Engineering fees; plumbing, Legal fees for zoning and entitlements; Utilities, Insurance, Janitorial and Security;
- **Equipment:** Certain kitchen equipment not considered FF&E;
- **Other:** Certain costs already incurred by the City or others, and "special purpose" items, such as the murals, antique light fixtures; and/or
- **Developer Fee:** Depending on the final 10-year operating projections, it may be possible to include a developer fee up to 20% of development costs.

Regulatory Requirements:

**National Park Service**

With respect to HTC regulatory requirements of the National Park Service ("NPS"), given that the building is individually listed on the National Register of Historic Places, for this analysis, it is assumed that it will receive NPS Approval of Part 1 and Part 2 of the Historic Preservation Certification Application. However, such Application is to be prepared and submitted by the preservation consultant, with the final determination to be made by the NPS.

**Internal Revenue Service**

With respect to regulatory requirements of the Internal Revenue Service, given that the Project Sponsor is a non-profit organization, it must create an ownership structure whereby a for-profit entity will own the building (as described below). With this ownership structure in place, the Project potentially can meet the
following threshold requirements as set forth in Section 47 of the Internal Revenue Code ("IRC"):

1. The building is **depreciable**;
2. The Project will be a "**substantial rehabilitation**";
3. The Project will not include a "**disqualified lease;**" i.e. not more than 50% of the building leases must be with tax-exempt entities; and
4. The Project will have "**economic substance,**" i.e. the Project must demonstrate "economic substance" on a pre-tax basis, over a projected holding period of 32 years, generally demonstrated by showing a 3% return on the investor equity investment.

While ownership of the building will be transferred to a to-be-formed for-profit entity, given that the building is currently owned by a non-profit organization, which was formed for the purpose of acquiring and rehabilitating the building as a certified historic structure, it may be of value to explore its continued participation in the Project. Such may permit use of grants and charitable contributions received from corporations, foundations, and individuals, for construction and/or operations.

**Ownership Structure**

The HTC is earned by an entity that (1) pays federal income tax, (2) owns a certified historic structure, and (3) completes a certified rehabilitation of that structure. Often, a property owner is not able to use the credit, and therefore, enters into a partnership with an entity, such as a bank or other corporation, that can use the credit.

In a syndication, a for-profit entity is formed, a limited liability company, to own the building, either by holding fee simple title to the property or by entering into a long-term (50 or more years) lease agreement. The tax credit investor is a member investor and the Project Sponsor (for-profit) affiliate serves as the managing member. The managing member and the investor member each agree to receive certain benefits expected to be generated by the Project, in exchange for fulfilling certain obligations required to complete and operate the Project.

**INVESTOR MARKET AND PROGRAM FUNDAMENTALS**

**HTC INVESTOR MARKET:**

1. **Credit and Equity Investment Amount:** Investors still have interest in the historic tax credit, and a $2,000,000 tax credit is considered attractive, with pricing generally a minimum of $0.90 up to $1.10. However, hotel use is considered to be higher risk, so the investment terms will look to mitigate perceived market risk, by a "staged" pay-in; strong guarantor, non-foreclosable debt, reserves and/or combination.

2. **Potential Tax Credit Investors:** Tax credit investors that would be solicited include:
   a) **Banks,** which make tax credit investments to satisfy regulatory requirements to make loans and investments in underserved communities and/or mission-oriented projects with strong community benefits, such as USBanc, Wells Fargo, Bank of America, Chase, and PNC;
   b) **"Non-bank" corporations,** Chevron for example;
   c) **Syndicators,** such as Cityscape Capital Group, and Tax Credit Capital, and NTCIC, (subsidiary of the National Trust for Historic Preservation);
   d) **Individuals,** while initial due diligence and closing may be easier, pricing may be less and other services to assist Project Sponsor after closing may not be available.

3. **Investor Market:** Overall, as a result of the significant losses that most banks incurred over the past few years, while the investor market for historic tax credits is not as strong as it was a few years ago, there is still demand for "good" projects.
a) **Investment Terms:** Terms typically include:

i) **Tax Credit Amount:** Generally, a minimum of $1.0 million (project size of approximately $5 million);

ii) **Tax Credit Equity Amount:** Currently approximately $0.90 to $1.05 per tax credit. Generally, the larger deals attract better pricing, as there is more demand for larger deals.

iii) **Annual Return on Investment:** Generally 2% to 3% of amount invested, payable from cashflow at the end of the calendar year. This is required partly due to the requirement that the tax credit investor demonstrate that the Project has "economic substance" or "profit motive," above and beyond the tax credit, and partly due to required business return;

iv) **Exit from partnership:** To comply with IRC requirements, the investors remain in the partnership for 5 years from the date of certificate of occupancy. They exit the partnership in exchange for a payment, which is negotiated prior to closing. This payment, the "Put Price," is typically 5% to 20% of the total investment amount.

v) **Other:** Investors will require a guarantee of the tax credits and possible reserves for operating deficits and replacement reserves.

b) **What Makes a Project "good" - What Investors Look For:** Generally, in addition to meeting all legal and regulatory requirements, investors look at the same things a lender or charitable foundation would, including:

i) **Sponsor Capacity:** Does the sponsor have the skills and financial strength to complete the project and to generate sustainable revenues to keep the project going;

ii) **Project Readiness:**

   1. **Construction Financing:** Are there sufficient sources to pay for all costs, what is the status of financing commitments;

   2. **Permits and Entitlements:** Are all requirements of state and local governmental agencies in place; and

   3. **Construction and Management Team** – Is there a qualified team in place to begin construction and complete construction on budget and on schedule, and to operate property after completion; and

iii) **Project Timing** – construction start, construction completion (i.e. when credits will be delivered), timing of NPS Part 3 Approval (investors typically require NPS approved Part 2 before beginning the closing process).

   1. **Credit Delivery:** Investors' returns are driven in large part by the date they can earn the credit, i.e. the date of construction completion. An investor's projected tax liability for any given year, will influence whether, and on what terms, it would be interested in making a tax credit investment, depending on when construction completion is projected. In the current market, many investors who previously had "unlimited appetite" now are looking only for investments scheduled to complete construction in 2013.

   2. **Closing Date:** "Syndicators" typically earn their fees upon closing, so are driven by the Project Sponsor's ability to close within a reasonable timeframe (2 to 4 months).
HTC REGULATORY REQUIREMENTS:

The regulatory requirements are outlined in Section 47 of the internal revenue code and other tax law. The threshold requirements are:

1. **Depreciable Property:** The building must be used in a trade or business, or held for the production of income.

2. **Substantial Rehabilitation:** A substantial rehabilitation means that the rehabilitation expenditures during a 24-month, or in certain instances, 60-month, measuring period must exceed the “adjusted basis” of the building. Provided that the construction is expected to be completed within a 24-month period, the 24-month measuring test is usually used, with a 60-month measuring period for particularly large, complex projects.
   a) The adjusted basis is generally defined as the purchase price, minus the value (or cost) of the land, plus the value of any capital improvements made since the building acquisition, minus any depreciation already claimed.
   b) For the project where there is no purchase price or the purchase price does not represent a market value, it may necessary to obtain a valuation of the property (with a value each for land and building), to determine the Project’s adjusted basis. Rather than a full appraisal, the valuation might be obtained by review of assessor records, the most recent “market” purchase price, and/or a letter from an appraiser.

3. **Disqualified Lease and Tax-Exempt Use Property:** Internal Revenue Code Section 168(h) contains a comprehensive set of rules dealing with leases of property to “tax-exempt entities”. Under these rules, real property, which is leased to a tax-exempt entity in a “disqualified lease,” is treated as “tax-exempt use property” and not eligible for the historic tax credit. A “disqualified lease” is defined in Internal Revenue Code Section 168(h)(1)(B)(ii) as a lease to a tax-exempt entity where:
   a) Part or all of the property was financed directly or indirectly by an obligation in which the interest is tax-exempt under Internal Revenue Code Section 103(a) and such entity (or related entity) participated in the financing, or
   b) Under the lease there is a fixed or determinable purchase price or an option to buy, or
   c) Lease term is in excess of 20 years, or
   d) Lease occurs after sale or lease of property and lessee used the property before the sale or lease.

4. **Economic Substance:** Generally, tax law provides that to comply with IRC rules and regulations, that a transaction cannot be undertaken solely to avoid federal income tax liability, otherwise the transaction could be considered a “sham transaction” and disregarded for federal income tax purposes. As a result, tax practitioners require that investments using historic tax credits demonstrate “economic substance,” i.e. in addition to tax benefits there is a reasonable expectation of other benefits that will result in profits and that the investment was motivated by a business purpose other than obtaining the tax benefit. While there is no specific definition of what is “economic substance,” tax practitioners agree that a 2% to 3% annual return on investment achieved during the holding period is deemed to demonstrate “profit motive,” and that the investment is not a “sham transaction.” For historic tax credit transactions, this might be achieved from the aggregate of the investor’s annual preferred return in early years of the partnership, and beginning in later years, additional benefits from annual cashflow distributions and share of proceeds from property sale.
OWNERSHIP STRUCTURE

INCOME TAX CREDITS ARE AN IMPORTANT WAY THROUGH WHICH the UNITED STATES CONGRESS CREATES INCENTIVE for activities that it deems will bring benefits to society that an organization relying solely on private investment likely would not. The historic tax credit is one of these incentive programs and was created by Congress in 1976. Current incentives under this program were established by the Tax Reform Act of 1986, and are referred to as the "Rehabilitation Tax Credit" described in Section 47 and Section 50(d) of the Internal Revenue Code.

Tax credits are available for many activities (the HTC is actually one of the smallest programs), however, for many of these activities, no taxable income will be earned for a number of years, and often, for various reasons, the activities are undertaken by entities for whom the tax credits are not beneficial at all. As a result, organizations that cannot benefit from tax credits, seek out others that do have a need for tax credits, to participate in their projects. This is referred to as "syndication" of the tax credit.

To syndicate a project, a limited liability company (LLC) is formed to own the property, with each organization (or affiliate) being a member of the LLC and having a specific ownership interest in the project. Through an agreement, the benefits and obligations of the project are "allocated" to each member, such that the tax credit investor is allocated, among other benefits, the tax credits. In return for their allocation of tax credits, the tax credit investor typically makes an equity contribution to the project.

Within this general concept, there are a number of ownership structures, with two basic structures that are used by most investors: a single-entity structure or a master tenant lease structure.

Single-Entity Structure: In the single-entity transaction structure, the Project Sponsor is the Managing Member and the tax credit investor is the Investor Member of the LLC that owns and operates the building. Each is allocated, according to their percentage member interest, the tax credits, and other benefits and obligations of the project, including: (1) Profits and Losses; (2) Depreciation; and (3) Cashflow.

Master Tenant Lease-Structure: In the master tenant lease structure, the LLC that owns the building enters into a long-term lease with a master tenant entity. Per Section 50(d) of the IRC, LLC that owns the building will "pass-through" the tax credit to the master tenant entity. The master tenant entity is a separate LLC, but again, with both the Project Sponsor and the Investor Member having ownership interests, and as in the single-entity, each allocated its share of benefits of the project - tax credits; profits and losses; depreciation; and cashflow.

On the following pages are ownership transaction structure diagrams representative of typical single-entity and master tenant-lease structures, each with a detailed step-by-step description of how the transaction works.
SINGLE-ENTITY OWNERSHIP TRANSACTION STRUCTURE: In a Single Entity structure, the tax credit investor is admitted as a non-managing member to the entity owning the property and makes a capital contribution in an amount equal to an agreed upon percentage of the historic tax credits delivered. In exchange for its capital contribution, the investor is allocated its share of the tax credits.

1. Member ownership interests: As tax credits follow profits allocation,¹ the tax credit investor holds a 99.99% investor member ownership interest, and receives 99.99% of the following: Tax Credits, Profits and Losses, and Cashflow.

2. Cashflow is an amount remaining after payment of the certain items, which may include:
   a) Property operating expenses;
   b) Debt service on all loans (including any loans made by the Project Sponsor);
   c) Investor priority return; and/or
   d) Developer Fee, if any, (potentially equal to up to 20% of eligible expenditures), in which the developer may be the Project Sponsor, or an affiliate.

The specific benefits that the Managing Member and Investor Member receive, and when they are received, are described in the terms and conditions of an operating agreement.

¹ The tax credits must follow the "profits allocation," i.e. tax credits are allocated to members according to their share of profits. As "profits" are not specifically defined in the IRC, the investor share is cashflow is generally used to determine "profits allocation." As such to maximize the tax credit amount allocated to the investor member, the investor member holds a 99.99% interest in a single-entity ownership transaction structure.
MASTER TENANT LEASE OWNERSHIP TRANSACTION STRUCTURE: A Master Tenant pass-through structure (Per IRC Sec 47 and Section 50 (d)) is typically used to enhance the overall tax credit benefit and to keep underlying real estate economic benefits and obligations consistent with the investor and developer return requirements.

The Landlord entity owns the property (via fee simple title or long-term leasehold interest) and passes through the historic tax credit to a Master Tenant entity. Both the Landlord and Master Tenant are managed and controlled by affiliates of the developer.

The Landlord Entity: LLC Manager holds 90% controlling interest and the Master Tenant holds 10% non-manager member interest. Landlord responsibilities and benefits include:

a. Earns the historic tax credit and passes through to the Master Tenant
b. Owns the building either via fee simple title or a long-term leasehold interest (typically 40 years or longer) and is responsible for:
   i. Purchase and rehabilitation of the building;
   ii. Securing Construction and Permanent Financing, including tax credit equity which is contributed by the Master Tenant;
   iii. Construction Completion and Part 3;
   iv. Enters into a lease agreement with the Master Tenant;
   v. Paying debt service on construction and permanent financing; and
   vi. Receives tax benefits of mortgage interest deduction and depreciation and other benefits of building ownership.

Master Tenant Entity: LLC Manager holds a .01% controlling interest and the Investor holds a 99.99% non-manager member interest.

a. Claims the historic tax credit (per the pass-through from the Landlord)
b. Holds a 32-year leasehold interest in the property and is responsible for:
   i. Leasing and Management of property operations;
   ii. Lease payments to Landlord in an amount not less than Landlord’s expenses, including mortgage debt service;
   iii. Payment of annual return to the investor; and
   iv. Payment of Deferred Development Fee
EXHIBIT A

20% FEDERAL HISTORIC TAX CREDIT AND HISTORIC TAX CREDIT SYNDICATION

20% FEDERAL HISTORIC TAX CREDIT BASICS
Internal Revenue Code (Section 47) and National Park Service Requirements

1. Tax Credit Amount:
   20% of Qualified Rehabilitation Expenditures (QREs) incurred in rehabilitating a building:
   a. Includes: Hard and soft costs, including a developer fee in an amount up to 20% of QREs.
   b. Excludes: Acquisition costs, landscaping-paving, FF&E, new construction (defined as a structure adjacent to or above the existing structure).

2. Building:
   Building must be a certified historic structure or contributing to a national register historic district and rehabilitated per the Secretary of Interior Standards for Rehabilitation as detailed in Part 1, 2 and 3 of the Historic Preservation Certification Application

3. Who Can Use Tax Credits?
   Earned by taxpayer(s) owning the Building, provided such ownership:
   a. Occurs before placement in service;
   b. Continues for not less than 5 years (credits vest 20% per year) - transfer of ownership prior to end of 5 years triggers recapture;
   c. Provides substantial economic benefit excluding tax benefits (Though not specifically stated in the IRC, review and interpretation by tax attorneys of rules and regulations has determined that a return on investment of approximately 3% is deemed to demonstrate such benefit.)

4. When Can Credits be Claimed?
   a. Claimed in the tax year of placement in service and receipt of NPS approval of Part 3;
   b. Credits can be carried forward 20 years and carried back one year;
   c. Taxpayers other than widely-held corporations may be subject to Passive Activity rules and At-Risk rules.

5. The program is jointly administered by:
   a. U.S. Department of Treasury – IRS
   b. U.S. Department of the Interior through State Historic Preservation Office and National Park Service that approve Part 1, 2 and 3 of the Application
HISTORIC TAX CREDIT SYNDICATION

While the tax credit can be earned by taxpayers meeting the above requirements, due to relatively limited income tax liability and certain other considerations, a taxpayer may not be able to use the tax credit. In such cases, the taxpayer will partner with a tax credit investor that can use the credit and will contribute equity to the project in exchange for the tax credit and other project benefits. This is referred to as syndicating the project, with the following key considerations:

1. Ownership Structure:
   - Single-entity structure vs. credit pass-through (also known as lease pass-through)
   - LLC or LP
   - Minimum term of investment is through end of 5-year credit compliance period

2. Equity Contribution:
   - Price based on timing of equity payments and delivery of credits
   - Payments tied to performance benchmarks (e.g. closing, certificate of occupancy, Part 3, full operations and permanent conversion)
   - Some investors offer an "upward adjuster" to provide additional capital if the project delivers more credits than projected.

3. Ongoing Operations:
   - Investors require an annual "priority return" on their investment, usually on the order of 2% to 3% of equity investment plus any tax liabilities
   - Investors usually require an annual asset management fee (nominal) to cover their costs of monitoring project operations and compliance with tax law.

4. Investor buyout:
   - Investor "put" option: usually in first 6 months after end of compliance period; usually greater of exit taxes or 5%-20% of capital contribution
   - Developer "call" option: usually after end of put period; usually greater of exit taxes or fair market value of investor ownership share
   - Issue: developer needs to be confident investor will exercise their put, otherwise cost of exiting transaction will be at higher call option amount.

5. Other Considerations:
   - Investor closing costs
   - Terms of guaranties and adjusters
   - Investors underwriting standards, reserve requirements, etc.
   - Tax implications of project structure
39% FEDERAL NEW MARKETS TAX CREDIT

1. Tax Credit Amount:
   - 39% of Qualified Equity Investment (QEI) contributed to a Community Development Entity ("CDE") that invests in a qualified low-income community business ("QALCB").
   - NMTC is claimed over a 7-year period:
     o 5% in each of the first 3 years
     o 6% in each of the next 4 years

2. Allocation and Investment Amount:
   - Assuming a $10,000,000 "allocation, and "pricing" of $0.60 (current market is $0.60 to $0.73), total investment amount (the QLICI) is $10MM, structured as follows:
     o "A" Loan - $7,660,000, interest only, at market-rate, 7-year term
     o "B" Loan - $2,340,000, interest only, at 50 to 100 bps, 40 year term.
     o (CDE "sponsor fee" would have to be paid to NMTC investor and could be approximately $500,000, payable at various benchmarks.)
   - NMTC allocation may come from one or more CDEs. CDEs typically provide allocation of not more than $8 million, and not less $5 million to a single project.

3. The Program:
   - Investment in businesses and real estate to benefit low-income communities.
   - Administered by the IRS (Section 45D) and Community development Financial Institution Fund ("CDFI"), a department of the U.S. Treasury.
   - The CDFI annually awards NMTC allocations (approximately $3.5 billion) to CDEs based on a competitive allocation process. Awards range from $10MM to small CDEs up to $150MM to large financial institutions and syndicators.

4. What is a CDE?
   - Domestic corporation or partnership that provides loans, equity investment or financial counseling in "low-income communities"
   - Community Development Corporation of major financial institutions typically are CDEs, for instance.
   - A financial institution that serves as the HTC investor, often is the NMTC investor.

5. What is a QEI:
   - Equity investment into a CDE, with a NMTC allocation;
   - Equity investment must remain invested in the same CDE for at least 7 years; and
   - QEI must be used to make a QLICI within 12 months.

6. What is a QLICI?
   - Equity investment or Loan to a QALICB.

7. What is a QALICB?
   - Real estate development projects located in qualified census tracts ("QCTs");
   - Businesses located in QCTS or that serve low-income communities.

8. CDE and NMTC Investor Requirements
   - Community Benefits:
     o Must demonstrate direct benefit to low-income persons. Specific requirements are in an Allocation Agreement between CDE and CDFI;
   - Must meet the "but-for" test, i.e. "but for" the NMTC investment, the project
would not be possible.

EXHIBIT B
Disqualified Lease Rules and Examples
Excerpt from IRS Publication
www.cr.nps.gov/hps/tps/tax/IRStaxexempt.htm

HRTC vs. LIHTC
IRS
Home Page
Questions/ Answers
IRS Code & Treasury Regulations
Facade Easements
Late Submission
Lessee use of Tax Credit
Tax Credit Recapture

IRS

PROPERTY LEASED TO A TAX-EXEMPT ENTITY

Prepared by: Mark Primoli and Tom Gavin, Internal Revenue Service

Here we review how the provisions set forth under Internal Revenue Code Section 47(c)(2)(B)(v), dealing with property leased to a tax-exempt entity, may impact the use of the rehabilitation tax credit. These rules apply for both the 10% non-historic tax credit and the 20% historic tax credit.

Disqualified Lease Rules

When a property owner leases their building or a portion of their building to a tax-exempt entity, i.e. governmental unit, a tax-exempt organization, or a foreign person/entity, it is important that they are familiar with the "disqualified lease" rules that may prevent them from claiming an otherwise eligible rehabilitation tax credit.

Internal Revenue Code Section 168(h) contains a comprehensive set of rules dealing with leases of property to "tax-exempt entities". Under these rules, real property, which is leased to a tax-exempt entity in a "disqualified lease", is treated as "tax-exempt use property". Qualified rehabilitation expenditures associated with tax-exempt use property are not eligible for the rehabilitation tax credit.

A "disqualified lease" is defined in Internal Revenue Code Section 168(h)(1)(B)(ii) as a lease to a tax-exempt entity where:
(1) Part or all of the property was financed directly or indirectly by an obligation in which the interest is tax-exempt under Internal Revenue Code Section 103(a) and such entity (or related entity) participated in the financing, or

(2) Under the lease there is a fixed or determinable purchase price or an option to buy, or

(3) The lease term is in excess of 20 years, or

(4) The lease occurs after a sale or lease of the property and the lessee used the property before the sale or lease. See Internal Revenue Code Section 168(h)(1)(B)(ii).

**Lease Term**

When determining whether a lease has a term in excess of 20 years, term of the lease is deemed to begin when the property is first made available to the lessee under the lease. Treasury Regulation 1.166(j)-1T Q17 states that lease term includes not only the stated duration, but also any additional period of time within the realistic contemplation of the parties at the time the property is first put into service. The Treasury Regulations cite Hokanson v. Commissioner 730 F.2nd 1245, 1248 (9th Circuit 1984).

The Treasury Regulations also provide that the term of the lease includes all periods for which the tax-exempt lessee or a related party has a legally enforceable option to renew the lease, or the lessor has a legally enforceable option to compel its renewal by the tax-exempt entity or a related party, unless the option to renew is at fair market value determined at the time of renewal.

In other words, a lessor is allowed to renew a tax-exempt entity's original "under 20 year lease" as long as the new lease is at fair market value.

**The 50% Threshold Test**

An exception under Internal Revenue Code Section 168(h)(1)(B)(iii) provides that property is treated as tax-exempt use property only if the portion of such property leased to tax-exempt entities under disqualified leases is more than 50% of the property.

The phrase "more than 50%" means more than 50% of the net rentable floor space of the building. The net rentable floor space would not include the common areas of the building, regardless of the terms of the lease. See Treasury Regulation 1.166(j)-1T Q-6.
If more than 50% of a building is leased to a tax-exempt entity, a taxpayer would be able to claim the rehabilitation tax credit on the expenditures incurred for the portion of the building not rented to a tax-exempt entity. This is illustrated in the following example:

A taxpayer purchases a building for $50,000 and spends $100,000 to rehabilitate the property. Three fourths of the building is leased to a tax-exempt entity for 25 years making 75% of its net rentable space tax-exempt use property. No rehabilitation tax credit would be allowed on the $75,000 of rehabilitation expenditures attributable to the tax-exempt use portion of the building. However, the taxpayer would be allowed a rehabilitation tax credit on the $25,000 expended on the portion of the building not leased to a tax-exempt entity.

In situations where an expenditure is not considered to be a qualified rehabilitation expenditure because it is applicable to a portion of the building which is tax-exempt use property, the expenditure can still be included in the computation to determine whether a building has been "substantially rehabilitated". See Internal Revenue Code Section 47(c)(2)(B)(v).

Property Owned by Partnerships with Taxable and Tax-Exempt Partners
Many tax-exempt organizations are affiliated with "for-profit" entities. In these situations, tax-exempt use property would not include property which is predominantly used by a tax-exempt entity in an unrelated trade or business (directly or through a partnership in which such entity is a partner) on which it pays taxes. See Internal Revenue Code Section 168(h)(1)(D).

When property is owned by a partnership that consists of both taxable and tax-exempt partners, Internal Revenue Code Section 168(h)(6) sets forth a number of specific rules intended to prevent the use of tiered arrangements or partnerships and other pass-through entities to allocate in a disproportionate manner the tax benefits and burdens of property owned by tax-exempt entities. In general, if any property that is not otherwise treated as tax-exempt use property is owned by a partnership that has both tax-exempt and taxable partners, the proportionate share of the property allocated to the tax-exempt partners will be treated as tax-exempt use property.

Any allocation to the tax-exempt entity of partnership items must be
a "qualified allocation" (meaning equal distribution of income, gain, loss, credit and basis) and must have "substantial economic effect" (the Treasury Regulations provide that the economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will affect substantially amounts to be received by the partners from the partnership, independent of tax consequences).

Disqualified Lease Rule Examples:

Example 1: A taxpayer rehabilitates an historic structure and leases the building to the City of Pleasantville. The taxpayer financed the rehabilitation with tax-exempt bonds issued by the City of Pleasantville. Even if the lease term is less than 20 years, the fact that the rehabilitation was financed (directly or indirectly) with bonds exempt from tax under Internal Revenue Code Section 103(a), the agreement between the city and the taxpayer will result in a disqualified lease.

Example 2: A taxpayer rehabilitates an historic structure and leases the building to the Willow Theater, a non-profit community theater group. If the taxpayer includes in the lease agreement an option for the Willow Theater to purchase the building after 15 years, the agreement will result in a disqualified lease.

Example 3: A taxpayer rehabilitates an historic structure and leases the building to a foreign owned corporation. The lease agreement contains a provision where the lease term is equal to 15 years with a legally enforceable option to renew the lease for an additional 10 years at a fixed, non-negotiable price. Since lease term is in excess of 20 years, the agreement creates a disqualified lease. If, in this example, the lease agreement contained a 15 year option to renew at the fair market value that will be determined at the time of renewal, the agreement would not result in a disqualified lease.

Example 4: The historic St. Johns School was in dire need of a substantial rehabilitation. The school sold the building to a XYZ Limited Partnership for $500,000. The Partnership spent $1,000,000 rehabilitating the property. The Partnership leased the property back to St. Johns School. The resulting agreement would be a disqualified lease because Internal Revenue Code Section 168(h)(1)(B)(iv) specifically states a disqualified lease occurs after a sale (or other transfer) of property by, or lease of the property from, the tax-exempt entity and the property has been used by the entity before the sale (or other transfer) or lease.
A. THE TAX EFFECT OF GRANT MONEY IN REHABILITATION TAX CREDIT PROJECTS

Prepared by: Mark Primoli, Internal Revenue Service

This tax brief offers guidance with respect to the tax treatment of grant proceeds in rehabilitation tax credit projects, and discusses whether or not the expenditures made with grant proceeds would be eligible for the 10% or 20% rehabilitation tax credit.

There are various forms of monetary incentives offered by governmental and tax-exempt entities to help defray the cost of rehabilitating many of our nation's historic structures. The recipient of grant money must first consider several factors before determining whether or not to include the proceeds in income. Two primary factors include whether the recipient is a corporate or non-corporate taxpayer and whether the entity receiving the money has dominion and control over the proceeds. The taxpayer must then determine if the expenditures made with grant proceeds should be included in its computation of qualified rehabilitation expenditures.

Unfortunately, our current tax law does not offer specific guidelines with respect to the issue of taxability, nor does it specifically convey rules regarding whether or not expenditures made with these grant proceeds are allowed to be included in one's computation of qualified rehabilitation expenditures. However, between various decisions rendered by our courts, actions taken through legislation, and
opinions offered through various rulings by the Office of Chief Counsel, the Internal Revenue Service can offer some guidance in this area.

**Grants Received by Non-Corporate Taxpayers**

Section 61(a) of the Internal Revenue Code provides generally that gross income means all income from whatever source derived. In Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), the United States Supreme Court held that the concept of gross income encompassed accessions to wealth, clearly realized, over which taxpayers have complete dominion.

If a grant is given to a non-corporate taxpayer (individual or partnership) and that taxpayer has dominion and control over the proceeds, the grant will generally be taxable to the recipient. An example of this type of general purpose grant would be one where the taxpayer can use the funds for any purpose, such as operating subsidies or a general improvement grant.

In Bailey v. Commissioner, 88 T.C. 1293 (1987), the court held that the recipient of a façade grant lacked complete dominion and control over the façade because the city’s urban renewal agency chose the contractors and paid them directly. Accordingly, the cost of the new façade was not included in the recipient’s income and was excluded from the property’s basis.

One can draw from this ruling that if the taxpayer had dominion and control over the grant proceeds, the amount would be taxable.

On the other hand, if a taxpayer had dominion and control over grant proceeds, but these funds were given to promote the general welfare of the community, the grant proceeds would be tax exempt under the general welfare doctrine. The Internal Revenue Service has consistently held that payments made under legislatively provided social benefit programs for the promotion of general welfare are not included in an individual’s gross income. Examples of general welfare grants include flood relief grants and disaster relocation grants. See Revenue Ruling 76-395 and TAM 200016019.

Urban Revitalization Grants used to fund improvements to business property are normally considered taxable income. Federal grants given to business owners who suffered flood damage to help them
recover and improve exterior facades and street level interiors of commercial buildings were determined to be taxable. See TAM 199919020, Doc 1999-17630.

A grant will also generally be included in gross income if the contributor expected or received something in return (quid pro quo). An example of this type of grant would be one where the contributor receives goods, services, or other direct and quantifiable benefit in exchange for the grant.

Grants Received by Corporate Taxpayers

Generally, grant proceeds received by corporations are excludable from gross income. Grant proceeds received by a corporation are considered to be a capital contribution made by a non-shareholder.

Internal Revenue Code Section 118 was enacted in 1954 to codify and to rationalize a line of court decisions. This code section provides, in part, that capital contributions made by non-shareholders are exempt from income. Internal Revenue Code Section 362 (c) further provides that these contributions will have no basis.

Non-Taxable Grants

As discussed above, the Internal Revenue Service has consistently held that payments made under legislatively provided social benefit programs for the promotion of general welfare are not included in an individual’s gross income.

In addition to general welfare grants, Revenue Ruling 82-195 provides that payments (grants) received by taxpayers under the National Historic Preservation Act, 16 U.S.C. 470, are not included in the taxpayer’s gross income. The Act of 1966 was amended by section 202 (b) in 1980 and provides that “effective December 12, 1980, no grant made pursuant to this Act shall be treated as taxable income for purposes of the Internal Revenue Code.

Effect of Grant Proceeds on Basis

Taxable Grants

If a grant is deemed taxable, the taxpayer will have basis and the rehabilitation tax credit can be taken on any qualified rehabilitation expenditures incurred with the grant proceeds.
Non-taxable Grants

If the grant is deemed non-taxable, basis has not been established and the taxpayer will not be eligible to claim the rehabilitation tax credit on the expenditures made with the proceeds.

This position is fully supported in Bailey v. Commissioner, 88 T.C. 1293 (1987). In that case, the court ruled that when a grant recipient incurs no cost attributable to the improvements made to property, the amount of the grant would not be includible in the basis of that property. The only instance where the Internal Revenue Service ruled that a non-taxable grant could also establish basis was in Revenue Ruling 74-205. This ruling concluded that replacement housing payments were not only excluded from income, but increased the recipient’s basis in the replacement home. It is important to note, however, that this ruling was criticized by the Tax Court in Henry L. Wolfers, 69 T.C. 975 (1978).

Consequently, the general rule disallowing inclusion of tax-free grant proceeds in basis is set forth in Bailey, while Revenue Ruling 74-205 is an exception to this general rule.

Internal Revenue Code Section 362 (c) clearly states that non-shareholder contributions of capital to a corporation would not establish basis in property acquired with the money or property contributed by the non-shareholder.

Conclusion

Taxpayers who receive grants must first determine if the proceeds are taxable or non-taxable. If the grant money is taxable, the taxpayer has basis and the rehabilitation tax credit will be allowed on expenditures made with this money.

If the grant money is not taxable, taxpayers will have no basis and the rehabilitation tax credit can not be claimed on the expenditures incurred with these proceeds.

Grants received by corporate taxpayers fall under the auspices of sections 118 and 362 (c) and would be considered tax-exempt contributions of capital by a non-shareholder. Consequently, no rehabilitation tax credit would be allowed for the expenditures made with these proceeds.
Grants received by non-corporate taxpayers, such as partnerships and individuals, will include the proceeds in income if they have dominion and control over the funds, unless the proceeds are provided as a general welfare grant or a National Historic Preservation Act grant.

Resources

Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955)


Graff v. Commissioner, 673 Fed 2nd 784, 5th Circuit 1982

Internal Revenue Code Sections 118 and 362(c)

Revenue Ruling 74-205

Revenue Ruling 82-195

Revenue Ruling 76-395.
Revenue Ruling 76-75
Revenue Ruling 98-19
TAM 199919020, Doc 1999-17630
TAM 200016019


Download a chart showing the tax effect of grant proceeds on the Rehabilitation Tax Credit. (MS WORD format - use the "Save As" option to download)
(1) Per Section 50(d) of the Internal Revenue Code, a taxpayer entitled to the HTC may pass-through HTC to a lessee, provided lease is at least 80% of depreciable life.
Historic Tax Credit Syndication
Sample Master Tenant Lease Structure with Non-Profit Developer
August 2, 2011 - For Discussion Only

Corporations, Foundations, Governmental Agencies, Individuals
(Note 1)

City of Palo Alto (the "City")

Donations

Transfer of Land and Building via Sale or
Long-term (50+ years) Lease
(Note 2)

Palo Alto History Museum, Inc.
("PAHM")
a 501 (c) 3,
California nonprofit corporation
("Project Sponsor")

PAHM makes 168 (h) Election

Capital Contributions of
Building and Cash
(Note 1)

PAHM Manager LLC
("PAHM Manager, LLC")
Sole Member: PAHM
LLC makes C Corp 8832 Election
Tax ID #

Manager
Equity $8

Administrative
Services

Tax Credit Equity $5

.01% Credits, Profits, Losses, Cash Flow

Tax Credits (3), Profits, Losses & Cash Flow

32-year (or 19.5 yr Net Lease) Lease Agreement
Lease Payments

PAHM Manager LLC
(\"PAHM Manager, LLC\")

Landlord Rehab, LLC
Building Owner

90% Manager - PAHM Manager, LLC
10% Member - Master Tenant

Loan Proceeds
Debt Service Payments

Lender(s)

Notes:
(1) PAHM makes capital contributions, to PAHM Manager, LLC, as needed for construction or operations after construction completion, with proceeds from charitable donations, grants, and/or loans received from financial institutions, governmental agencies, individuals. PAHM Manager, LLC will then make a capital contribution to the Landlord or Master Tenant.

(2) Landlord Rehab, LLC will take ownership of the property via (1) a leasehold interest pursuant to a long-term ground lease (at least 50 years) and development agreement between the City and the Landlord, or (2) transfer of fee simple title to land and improvements pursuant to a purchase and sale agreement (or Disposition and Development Agreement) between the City and the Landlord. This example assumes a sale from the City to the Landlord Rehab, LLC.

(3) Per Section 50 (d) of the Internal Revenue Code, a taxpayer entitled to the HTC may pass-through HTC to a lessee, provided lease is at least 80% of depreciable life. The term will be either at least 32 years or a 19.5 year net lease (as defined in IRC).

(4) To avoid entering into a "Disqualified Lease," the lease to any non-profit will be for a term of less than 20 years, and in some instances may have to be less than 5-years.

Palo Alto History Museum, Inc.
("PAHM")
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California nonprofit corporation
("Project Sponsor")

PAHM makes 168 (h) Election

Historic Ventures 1, LLC
(\"HTC Investor\")

.99% Credits, Profits, Losses, Cash Flow

.01% Manager - PAHM Manager, LLC
99.99% Member - HTC Investor

32-year (or 19.5 yr Net Lease) Lease Agreement
Lease Payments

Sub-Tenant 1:
Cafe Bookstore

Sub-Tenant 2:
PAHM

Sub-Tenant 3:

Revenue and cash from:
1. Memberships
2. Admissions
3. Facility Rentals for Events
4. PAHM Manager LLC Capital Contributions

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