Fall Preview

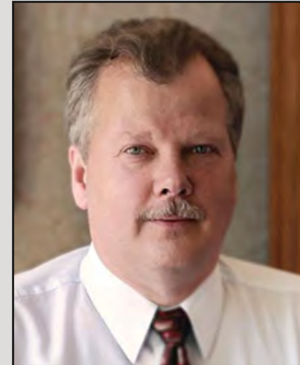
Accounting

Andy Smith
Baker Newman Noyes

Appraisal

William Pastuszek
Shepherd Associates

Architect



Thomas House
THA Architects, LLC

Attorney

Philip Hastings
Cleveland, Waters and Bass, P.A.

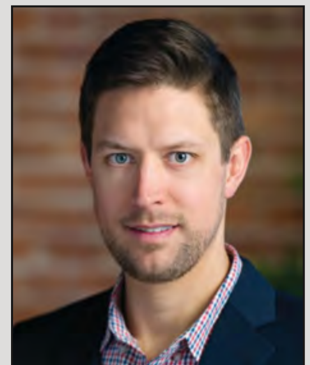
Attorney

Jeffrey Christensen
Cleveland, Waters and Bass, P.A.

Broker - New Hampshire

Bill Norton
Norton Asset Management

Broker - Vermont



Matt Tedder
The Kingsland Company

Accounting

How reviving historic New England can save on income tax

Andy Smith

Baker Newman Noyes

New England is filled with beautiful old buildings. Many once proudly served in varied roles like textile mills, warehouses or military barracks, but were neglected when those uses ended. Lately, forward thinking developers have transformed many of those structures into trendy apartments, retail space, hotels or office space.

To attract these projects, Connecticut, Maine, Massachusetts, Rhode Island, and Vermont all have state historic tax credit programs in place. Each state's rules are unique and separate from the federal credit, but most use similar criteria to determine eligible properties and expenses. Particularly astute developers will utilize both federal and state tax credits to attract investors and maximize investments.

The Federal Historic Preservation Tax Incentive program described in Internal Revenue Code (IRC) Section 47 provides two credits. The first (and most commonly used) provides a 20% federal tax credit for the certified rehabilitation of historic structures. The structure and rehab must be approved by the Secretary of the Interior, through the National Park Service. This certification ensures that the historically significant characteristics will survive the rehabilitation. Although not the focus of this article, a 10% credit (requiring less oversight, but sharing many of the 20% credit's characteristics) is available for non-historic structures that were placed in service prior to 1936 and are rehabilitated for non-residential use.

This Historic Tax Credit (HTC) is based on the amount of qualifying rehabilitation expenses. Cost of acquisition, personal property and footprint enlargement do not qualify. Generally, the entire federal credit is claimed in the tax year the property is placed in service. However, longer projects may generate partial credits in earlier years.

The HTC is one of the general business credits under IRC Section 38. As such, it potentially can reduce income tax to zero, including (in some cases) the Alternative Minimum Tax. If not fully utilized when generated, it can be carried back one year and then forward twenty years.

The depreciable basis of the structure is reduced by the amount of the credit claimed, and only the person or the entity that holds title to the property may claim the credit. However, there is an election available under Treasury Regulation Section 1.48-4 that allows a non tax-exempt lessor to pass the HTC through to the lessee under certain circumstances. This structure is often referred to as a master lease or inverted lease structure and is extremely common in HTC projects as a way of attracting outside investment dollars.

Under the master lease structure, two separate partnerships are created. One partnership holds the legal title to the property and the other partnership operates the building as the tenant. This essentially allows the depreciation benefits of ownership to be isolated from the tax credit benefits. Outside investors are typically sought as a financing mechanism using the attraction of the passed-through tax credits. Investors, often C Corporations with significant taxable income, make capital contributions to the project in exchange for the allocation of the tax credits. This often reduces or eliminates the amount of cash down payment required by a developer's lender.

The 2011 *Historic Boardwalk Hall, LLC v. Comm'r* case caused a huge stir in the industry when the IRS successfully challenged the allocation of tax credits by the partnership to certain "investor-members." In Boardwalk, the investor who was claiming 100% of the tax credits was brought into the deal late in the rehabilitation process with a guaranteed rate of return. The IRS convinced the Third Circuit Court of Appeals that the allocation was erroneous since the investor was not a true "partner" based on its late entry into the project and various contractual provisions, warranties, and indemnifications that guaranteed a preferred return and eliminated downside risk. This landmark decision served as the proverbial bucket of cold water to HTC projects everywhere. Many companies waited for additional guidance from the IRS before they would commit to new projects.

IRS Revenue Procedure 2014-12 brought that relief in 2014 with its list of "safe harbor" requirements that must be met for a project to qualify as a historic rehabilitation project. Tax advisors should be consulted to ensure compliance, but this recent rule has made investors and developers comfortable with the new playing field, which provides reduced risk and well defined economic and tax outcomes.

Many historic rehabilitation projects provide long term economic benefits to the community by bringing buildings back to life. Interested developers and owners should take advantage of the significant tax breaks that make qualifying projects less expensive and more attractive.

Andy Smith is a principal in the tax department of Baker Newman Noyes, Portland, ME.

REAL ESTATE TAX MADE SIMPLE

As one of *Accounting Today's* Top 100 U.S. firms, Baker Newman Noyes is the preferred choice for progressive accounting solutions in New England.

Clients turn to us to advise and service residential, commercial, hospitality, historic tax credit, and cost segregation study projects, just to name a few.

Let our team of real estate tax professionals get to work for you.

CONTACT: Andrew Smith, Principal, asmith@bnncpa.com

BAKER NEWMAN NOYES

SIGN UP FOR OUR REAL ESTATE NEWSLETTER by emailing bnn.news@bnncpa.com

MAINE | MASSACHUSETTS | NEW HAMPSHIRE
www.bnncpa.com