Historic Preservation Tax Credit Seminar
Alabama Historical Commission

Assembling and Structuring the HTC Investment

June 15, 2018

Presented by: Jimmy Long
TIMELINE OF FEDERAL AND ALABAMA HTC

- **1976** – Congress creates tax deduction for Qualified rehabilitation expenditures ("QREs") for historic buildings
- **1982** – Congress adopts IRC Section 47 creating 10% tax credit for "certified historic structures" as part of economic stimulus
- **1986** – Congress amends IRC Section 47 increasing tax credit to 20% for "certified historic structures" and creating 10% credit for non-historic buildings older than 1936
- **2013** – Alabama State Legislature adopts 25% historic tax credit (and 10% credit non-historic buildings older than 1936)
- **2014** – IRS provides safe harbor guidance in response to Historic Boardwalk Hall
- **2014** – Alabama Historical Commission selects 22 projects to participate in the AL HTC Program (program also amended to allow for one-time transfer); ultimately $60 million in credits are awarded over three years (with approx. $8 million on waiting list)
- **2016** – Initial Alabama HTC program sunsets
- **2017** – Alabama HTC program reinstated through 2022; Congress repeals 10% tax credit but retains 25% historic credit under Tax Cuts and Jobs Act
The objective of the Federal HTC program is to encourage private sector investment in the rehabilitation and re-use of historic buildings.

The National Park Service (NPS) and the IRS administer the federal program in partnership with State Historic Preservation Offices.
- The NPS manages all national parks, many national monuments, and other conservation and historical properties.
- The NPS is an agency of the Department of the Interior.
- NPS works with State Historic Preservation Office.

By the Numbers –
- According to the National Park Service, since 1977 federal HTCs have:
  - Supported 42,293 rehabilitation projects
  - Generated $84.15 billion in historic preservation
  - Rehabilitated 271,174 housing units
  - Supported the development of 277,831 new housing units
  - Contributed to the development of 153,255 low-moderate income units
  - Created an estimated 2.44 million jobs
FEDERAL HTC PROGRAM

The property must be used in a trade or business or for the production of rental income in all instances.

The qualified rehabilitation expenditures, along with the shell, must be depreciated using a Straight-Line Depreciation Cost Recovery Method

✓ Apartments
✓ Hotels
✓ Office Buildings
✓ Warehouses
✓ Distribution Facilities
✓ Back-Office Support/Computer/Call Centers
✓ Mixed Use of Any of the Above

Ø Private Residence
Ø Tax exempt use property

<table>
<thead>
<tr>
<th>Type</th>
<th>FY 10</th>
<th>FY 11</th>
<th>FY 12</th>
<th>FY 13</th>
<th>FY 14</th>
</tr>
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<tbody>
<tr>
<td>Housing</td>
<td>43%</td>
<td>69%</td>
<td>47%</td>
<td>46%</td>
<td>42%</td>
</tr>
<tr>
<td>Office</td>
<td>23%</td>
<td>16%</td>
<td>21%</td>
<td>21%</td>
<td>18%</td>
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<tr>
<td>Commercial</td>
<td>24%</td>
<td>3%</td>
<td>16%</td>
<td>19.50%</td>
<td>25%</td>
</tr>
<tr>
<td>Other</td>
<td>1%</td>
<td>12%</td>
<td>16%</td>
<td>13.50%</td>
<td>15%</td>
</tr>
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</table>

Federal HTC Program – 20%

- **Three Part Process:**
  - Part 1 – Confirming the Building Qualifies
  - Part 2 – Plans for the Rehab
  - Part 3 – Confirmation the Rehab was consistent with the architectural standards

- Developer’s Primary Contact is State Historic Preservation Officer

- Ultimate Approval is Under Control of the National Park Service

- Residential rental property and real property are eligible

- Building need not be currently listed on the National Register, but must be eligible for listing
**QUALIFIED REHABILITATION EXPENDITURES**

Qualified Rehabilitation Expenditures are defined in Treas. Reg. 1.48-12(c) and generally include costs chargeable to a capital account and made in connection with the rehabilitation of a qualified building. Land costs are **NOT** a qualified costs. Special rules exist for costs incurred by a prior owner and assumed through purchase by a new owner.

For purposes of the substantial rehabilitation test, adjusted basis is the cost of the property (excluding land) plus or minus adjustments to basis and is determined as of the first day of the 24-month period selected by the taxpayer. QREs must exceed the adjusted basis of the property in order to meet “substantial” test.

**Qualified:**
- Construction and construction-related costs
- Construction period interest
- Architectural and engineering fees
- Site survey fees
- Legal expenses
- Insurance premiums
- Development fees
- Property taxes

**NOT Qualified:**
- Costs related to the acquisition or enlargement of the building
- Furniture, fixtures and equipment
- Expenses incurred for building-related areas:
  - Sidewalks
  - Parking lots
  - Landscaping
Federal HTC – Other Tax Implications

- Subject to transition rule, credit is now claimed pro rata over a 5 year period from the placed in service date
- Property must be a building
- Property cannot be a personal residence
- Depreciable base reduced by credit
- Recapture
  - Trigger events: disposal of property (or more than 2/3 partnership interest), removal from national register or casualty loss
  - Five-year holding period (compliance period)
  - 20% of credit earned for every full 12 months held past date taken
Federal HTC – Other Tax Implications

- At risk rules
  - Do not apply if widely held C corp. investor
  - Property cannot be financed by person related to buyer of property
  - Non-recourse financing cannot exceed 80% of credit base

- AMT and Passive Activity restrictions also create problems for individual investors/owners

- Unused credits can be carried back 1 year and forward for 20 years

- Credits are allocated based on profit percentage
Alabama Historic Tax Credit Reinstated

- Act 2017-380 (House Bill 345) reauthorizes the Alabama income tax credit for the rehabilitation of certain historic structures. Notable differences from prior program:
  - Refundable credit
  - Lottery replaced with 9 member evaluating committee
  - Rural preference during first six months
  - Historical property must be at least 60 years (as opposed to 50 for federal)
  - Required completion milestones (50% within 36 months; 100% within 5 years)
Calculation of Credit

- Tax credit is vested when property is placed in service and the amount is:
  - 25% of the QREs for certified historic structures
  - 10% of the QREs for pre-1936 non-historic structures
  - $5 million max for commercial project; $50k for residential
  - Alabama QRE = Federal QRE
- Refundable credit claimed at the owner level (including pass-through entity)
- One-time transfer still permitted; must be sold for at least $.85 per dollar of credit
Application Timeline

- Applications may be submitted on November 1, 2017 (quarterly review)
  - Must submit both Part A and B at same time
- Can incur certain A&E and mitigation costs six months prior to application
- Owner must “commence rehabilitation” (incur at least 20% of costs) within 18 months of reservation
- Annual cap on credit reservations - $20 million
- Sunset date – December 31, 2022
ASSEMBLING THE DEAL

**Developer**
- Apartment
- Hotel
- Office Building
- Warehouse
- Distribution Facility
- Mixed use Facility

- Identifies historic rehabilitation project
- If necessary, engages historic consultant
- Raises capital
- Engage Accounting firm
- Selects reputable contractor with historic rehab experience
- Work with the NPS and AL HC to ensure project qualifies
- Select counsel

**NPS & AL HC**
- Federal – application review by AL HC, then submitted to NPS
- Alabama – application reviewed by AL HC, then submitted to Evaluating Committee

**HTC Investor**
- Determine purchase price per credit dollar
- Provide term sheets details investment
- Engages counsel

**Operating Partnership**
- SPE to rehab and operate/lease the project
ASSEMBLING THE DEAL - CONSIDERATIONS

5 P's
- Partners – HTC consultant, accountants, legal team
- Pricing
- Pay-in Schedule
- Priority Distribution / Return?
- Put

Investors
- Developer Experience
- Sources/Uses and Timing
- Real Estate Issues (title, environmental, zoning, parking, other permitting, etc.)
- Leasing Commitments/Market Study
- Part I and II Status

All Parties
- Exit Strategy
- Guarantees
- Structure
- Due Diligence Requirements
- Experience/Reputation and Closing Process
- Compliance with IRS Safe Harbor
Safe Harbor: Revenue Procedure 2014-12

- **Before** the building is placed in service:
  - Investor must contribute a minimum of 20% of its total expected capital contributions
  - A minimum of 75% of Investor’s total capital contributions must be fixed in amount

- Investor may not receive the following guarantees in exchange for its capital contribution:
  - Investor’s ability to claim the FHTC, the cash equivalent of the FHTC, or the repayment of any portion as a result of Investor’s inability to claim the FHTC
  - Payment of Investor’s costs or indemnification of Investor in the event of the IRS challenging Investor’s claim of the FHTC
  - Any guarantee which requires money or property to be set aside to fund all or any portion of the guarantee
  - Any guarantee which requires the guarantor to maintain a minimum net worth in connection with a guarantee

- Allows partnership “flip” from 99/1 to 5/95 after five year compliance period
STRUCTURING THE DEAL

Federal:
- Direct Structure
  - Also known as a single tier structure
  - Developer has a 1% interest in the entity that owns the building
  - Investor has a 99% interest in the entity that owns the building
- Master Tenant Structure
  - Also known as lessee pass-through
  - The entity that owns the building leases the building to the Master Tenant
  - The Master Tenant leases the building to the actual occupants
  - Developer owns 1% of the Master Tenant
  - Investor owns 99% of the Master Tenant

Alabama:
- Direct Purchase
  - One-time transfer
  - Typically no ownership at project level (unless both state and federal investor)
- **Refundable** at project level (not allocated to owners) when placed in service
  - Under the old program, the project or owners could utilize credits through allocation and could carryforward any unused credits for up to 10 years
  - Partial transfer and partial use by owner is permitted
# Understanding the Variables

<table>
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<tr>
<th>Description</th>
<th>Amount</th>
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<tr>
<td>Qualified Rehabilitation Expenses</td>
<td>$25,000,000</td>
</tr>
<tr>
<td>Federal Historic Tax Credit %</td>
<td>20.0%</td>
</tr>
<tr>
<td>Federal Historic Tax Credits</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Investor %</td>
<td>99.0%</td>
</tr>
<tr>
<td>Developer Managing Member %</td>
<td>1.0%</td>
</tr>
<tr>
<td>Price per Credit</td>
<td>$0.90</td>
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<tr>
<td>Federal Historic Equity</td>
<td>$4,455,000</td>
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<tr>
<td>State Historic Tax Credit %</td>
<td>25.0%</td>
</tr>
<tr>
<td>State Historic Tax Credits</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>State Historic Proceeds</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Total Federal &amp; State Historic Equity</td>
<td>$9,455,000</td>
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<tr>
<td>Tax Credit Equity as a % of QREs</td>
<td>37.82%</td>
</tr>
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</table>

*State HTC are refundable under new Alabama program.*
**DIRECT STRUCTURE**

- **Landlord (Owner/Developer)** – Charged with completing rehabilitation
- **Developer** – Sponsor party; Membership interest in Landlord
- **Federal HTC Investor** – Member interest in Landlord; Allocated HTCs in line with membership interest
- **Financing** – Construction, Bridge, Mezzanine

- **Landlord**
  - 1% Interest
  - $3,050M Equity
  - $12,500M Debt

- **Federal Historic Tax Credit Investor Member**
  - 99% Interest
  - $4,950M Equity

- **Alabama Department of Revenue**
  - $5,000M State HTCs

- **Construction Financing**
  - $12,500M Debt

- **Developer Member**
  - $3,050M Equity

- **Financing**
  - $12,500M Debt

**Additional Notes:**

- **Alabama Department of Revenue** provides $5,000M State HTCs to the Landlord.
- **Developer Member** contributes $3,050M Equity to the project.
- **Construction Financing** provides $12,500M Debt to the project.
- **Federal Historic Tax Credit Investor Member** contributes $4,950M Equity to the project.
**MASTER TENANT STRUCTURE**

- **Developer Member**
  - 90% Interest
  - $3,050M Equity

- **Construction Financing**
  - $12,500M Debt

- **Federal Historic Tax Credit Investor Member**
  - 99% Interest
  - $4,450M Equity

- **Landlord**
  - $5,000M State HTCs
  - $5,000M Federal HTCs

- **Master Tenant**
  - 5% Interest
  - $12,500M Debt

- **Master Tenant Managing Member**
  - 1% Interest

- **Alabama Department Of Revenue** (Member interest in Master Tenant; Allocated HTCs in line with membership interest)

- **Financing** (Construction, Bridge, Mezzanine)

- **Master Lease Payments**

- **• Landlord (Owner/Developer)** – Charged with completing rehabilitation
  - **Developer** – Sponsor party; Membership interest in Landlord
  - **Master Tenant** – Membership interest in the Landlord; Incurs QREs as if it entity completed the rehabilitation
  - **Federal HTC Investor** – Member interest in Master Tenant; Allocated HTCs in line with membership interest
  - **Financing** – Construction, Bridge, Mezzanine
Federal HTC - What the Credit is Worth

- Valuation dependent on structure, pay-in, limited partner holding period, expected rate of return and deal size
  - Direct Investment - .75 to .89
  - Lease pass thru - .87 to .95
  - Preferred return – 2% to 3%
  - Exit put cost – 5% to 15%
  - Bridge Lender
  - Transaction/closing costs
Federal HTC - What the Credit is Worth

- Investor candidates
  - Investment funds/syndicators
  - Local financial institutions with unfulfilled community reinvestment requirements
  - Profitable locally-based national company
  - Most local companies are not profitable enough to overcome alternate minimum tax limitations
  - Large national companies
Related Incentives in Alabama

- Downtown Redevelopment Authority
- TIRA and Brownfield Abatements / Other Local Assistance
- Leverage with other federal credits
  - Low-Income Housing Tax Credit
  - New Markets Tax Credit
- Conservation Easement
  - Generally complete prior to commencing rehabilitation to avoid recapture
  - High probability of audit
Questions?

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