Novogradac
Journal of Tax Credits
News, Analysis and Commentary On Affordable Housing, Community Development and Renewable Energy Tax Credits

November 2012, Volume III, Issue XI

Published by Novogradac & Company LLP

Due Diligence: The New Necessity

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In the recent past, developers often neglected due diligence in an effort to close deals. It was not uncommon 10 years ago for developers of historic tax credit (HTC) projects to skip this step, and the tax credit investors rarely investigated the project themselves. Due diligence is not a new concept, however. It is simply doing one's homework, checking and rechecking the pro forma's veracity and logic. It is a necessary step for sound real estate development performed by sound real estate developers, and tax credit investors are realizing its importance in projects. As the marketplace rekindles, investors are hiring historic preservation consultants to verify their HTC projects. The following pages explore the most common problem areas for HTC projects and provide a breakdown of the due diligence process.

More than Just Peer Review

Due diligence is often thought of as a "peer review." This is inaccurate. Due diligence is not checking the application's style and form, it is not passing judgment on whether the application is well written or if it includes enough plans and photographs. Rather, those performing due diligence evaluate the tax credit application on behalf of the tax credit investor to minimize risk and identify areas of exposure. The most common pitfalls involve certifying the historic structure and certifying the rehabilitation work.

Certified Historic Structure

To be eligible for the HTC, a property must be a certified historic structure, meaning that the building must be listed on the National Register of Historic Places or be a contributing resource in a historic district. If the building is not listed on the National Register, the National Park Service determines its eligibility during Part 1 of the HTC application. A simple process, yes, but, mistakes happen.

One of the most common mistakes that a developer makes when applying for HTCs for a building not in a historic district is that once the Part 1 approval is secured, he or she does not pursue a National Register designation. A less common mistake is for the Part 1: Determination of Eligibility and the Part 2: Description of Rehabilitation to be out of alignment. Is it clear that the property described in the Part 1 is the same property in the Part 2? It is surprising how often the building names and addresses in the Part 1 differ from those in Part 2. Developers often dismiss such discrepancies as minor, but usually those doing the dismissing are not the ones whose money is at risk.

Sometimes, insufficient guidance causes problems. This is particularly true for multi-building complexes that are physically and functionally interconnected. Developers will seek advice from State Historic Preservation Office (SHPO) staff, but the National Park Service (NPS) is the final arbiter of the program, so unless that SHPO staff person has confirmed their answer with NPS, there is the potential for problems. If that guidance is not written, then the exposure for the investor is elevated.

Certified Historic Rehabilitation

The second requirement of the tax credit program is that the rehabilitation meet the Secretary of Interior's Standards. Here, there are three common problem areas.

First, though not as common today, is that the developer does not file the Part 3: Request for Certification of Completed Work when they complete the project. Similar to the issue of applying for the credits but then not listing the property on the National Register, this puts the tax credits at risk.

The second potential problem is that the developer fails to

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submit the work to the NPS or the NPS never reviews the work. Given the complicated nature of historic rehabilitation projects, surprises and changes are common during the construction process. Most projects also have design/build elements and design decisions, such as to leave a brick wall exposed, are often made on the fly in response to market conditions.

There are two ways this problem can come about. The first is work where the developer, architect or preservation consultant reached an informal understanding with SHPO that the proposed work is acceptable. If SHPO guidance is not in writing, there is exposure risk for the tax credits. The second is that the development team simply never thought to ask for approval. Not uncommon is the phrase, "it's new construction, so why would NPS care?" The comment is the result of a misunderstanding of the HTC program. The NPS has 100 percent design review of all project aspects. The most egregious examples of violating program rules involve the construction of rooftop or side additions, but more commonly may include interior finishes and tenant build-outs.

The third problem area is when a project receives a conditional approval that requires follow-up submittals but those submittals are never made. Examples include test patches for exterior cleaning or mortar repair, as well as larger elements such as signs, tenant improvements or mechanical systems.

The developers, who typically bear the cost of those doing the due diligence, sometimes object to the added cost of a thorough project review, but the reality is that due diligence is critical to protecting both the developer and tax credit investor. Diligence throughout the project can minimize the risk of project problems.

The Due Diligence Process

There are four phases to due diligence:

Application Review

The first step is reviewing the formal application. Unlike city permit applications where a baseline level of information is required and the drawings are paramount, HTC applications rely on the accompanying narratives, which describe the proposed work. These narratives, although accompanied by drawings, are the primary source of information to the reviewers and provide differing amounts of information depending on the preparer. Applications with little information may be approved but a significant amount of work may go unreviewed, and there is no implicit approval in this program. An application with a high level of detail may have more upfront issues from the reviewer but in general will have fewer issues moving forward as the initial review was more thorough.

Those doing due diligence will look to ensure that the historic

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ISSN 2152-646X

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tax credit HTC application is sound. Is the property correctly identified? Are there unusual (read: concerning) aspects to the application? This could include a change of ownership to a stopped project, a commercial condo-minimization of the building, or a partial rehabilitation of a larger building. Does the phasing align with the project? Is the ownership entity current and accurate? Does a National Register nomination need to be prepared? Were there additional submissions promised in the Part 2 application that need to be prepared and is there a plan for preparing them? Were there any conditions in the Part 2 approval that require additional submissions, and again, is there a plan for such submittals? In addition, if submittals are made, has the issue been resolved and documented, or are there subsequent conditions?

Site Visit

To be effective, it is critical that those doing due diligence visit the site. This site visit allows them to understand the sufficiency of the application and the fullness of the project. If circumstances are incorrectly portrayed, such as the condition of a decorative plaster ceiling, there may be exposure. Alternatively, a developer may not be fully aware of the extent of NPS review and there may have been aspects of the development not included in the application. The site visit allows those doing due diligence to assess the application against the project and to know it in other than theoretical terms.

Monitoring Construction

During the construction phase, due diligence is focused on remedying conditions, getting approvals for changes in scope and ensuring that work is completed as approved in the Part 2 and subsequent submissions. There are two elements to this. First, it is critical that those doing due diligence received the construction minutes. This will allow an understanding of whether the project is on schedule, whether any unusual circumstances have been found, whether there have been any design changes and whether there is any additional work.

The second element is a periodic site visit. Typically, the reviewer visits the site a couple of times a year, depending on the nature and progress of the project. The initial site visit should involve a property tour and a meeting with the project team. Subsequent visits allow for an understanding of actual conditions and processes. They also give a qualitative sense of the construction team and its understanding of the historic preservation issues.

Project Close Out

The fourth and final step is a final site visit. At this juncture, the visit should be largely a formality. There should be no surprises, but sometimes problems occur with the timing of the Part 3 submittal. There is often pressure to close out the project and

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submit it for final certification prior to the property being ready for occupancy. Given the review cycle, sometimes it is better to wait an extra week or two to submit the application.

Benefits of Due Diligence

Typically, due diligence firms bring an added benefit to their projects. Due diligence firms are typically senior in the field with deep and broad national experience. As such, they can be a resource for the project's historic preservation consultant and development team. They may be able to offer guidance on treatments that may be acceptable but not common in that locality. In the case of complex projects, they may offer a road map to how other developers have treated such projects. At the very least, they are a driver to keep the project on-track and properly documented.

By any measure, due diligence makes sense and in today's marketplace is a necessity. The project developer and the tax credit investor need to agree on the degree of exposure within the project. What may be a nagging detail to one party may be an unnecessary risk to the other. The project application needs to be coherent and complete. It needs to reflect accurately the project. If additional submittals are promised, they need to be filed. Work not documented in the original application also needs to be submitted. Informal verbal reviews cannot take the place of formal documentation.

The due diligence consultant creates the opportunity to minimize risk and maximize the potential for success. Success is defined as a certified historic structure that meets the Secretary of the Interior's Standards for Rehabilitation. Only the NPS reviewer can formally affirm compliance in the Part 3 review. Until that time, projects retain a degree of risk that they will not qualify for the tax credits. The due diligence allows the project team to identify issues that may affect the rehabilitation tax credit and is useful in preventing costly remedial work or Part 3 denial.

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This article first appeared in the November 2012 issue of the Novogradac Journal of Tax Credits.