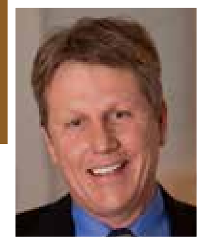
Novogradac
Journal of Tax Credits
News, Analysis and Commentary On Affordable Housing, Community Development and Renewable Energy Tax Credits
August 2014 • Volume V • Issue VIII
Published by Novogradac & Company LLP

HISTORIC TAX CREDIT TOOL BOX



The Opportunities and Challenges Presented by State Rehabilitation Credits

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It is tempting to assume that if some historic tax credits (HTCs) are good, then more HTCs are better. Several public policy studies support this position. According to some studies, an active state tax credit program boosts the use of the federal program, on average, by between $15 million and $35 million in certified expenditures. Put another way, states with active tax credit programs bring in $3 million to $7 million in federal dollars that would not otherwise be available. As public policy, a state credit, like the federal credit, makes sense, for promoting investment in the redevelopment of older and historic buildings. Without the investment, there is no benefit, and the size of the benefit is directly proportional to the size of the investment.

Today, 35 states offer some type of state rehabilitation credit for commercial buildings. In addition, Illinois offers HTCs in the River Edge Redevelopment Zone along the Mississippi River and there are local and state programs that focus on property tax abatements, such as Oregon's Special Assessment Program, California's Mills Act and Chicago's Class L incentive.

But not all state programs are created equal. There are significant distinctions between state tax credit programs. The first variation is the credit percentage. Most states match the 20 percent federal HTC. In some states, however, the state credit ranges anywhere from 5 to 25 percent.

Perhaps more important than the amount of the state HTC is how the credit is granted. There are two typical paths: by right and through a competitive process. Some states grant the credits by right through a process similar to that of the National Park Service (NPS), whereby qualifying projects are guaranteed the credits without limitations. Such is the case in Virginia, Mississippi and Delaware, for example.

Many states follow a different path. Typically, in these states, the legislature allocates a specific dollar amount that is distributed through a competitive application process. One reason for this approach is the source of funds backing the state credit. Another is that a finite allocation allows budget-strapped state governments to control the outlay of credits. For example, in Connecticut there is a cap of $5 million per building and $50 million in state credit for each three-year cycle. In New York, income producing properties receive 20 percent state credits for expenditures up to $5 million.

For developers, this allocation process can be problematic. When the credits are granted by right, there is uncertainty as to the amount of the credit that will be awarded.

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Under the federal program and those state programs that emulate the federal process, a theoretical project with $10 million in qualified rehabilitation expenditures would receive $2 million in credits. In a state competitive process, a developer applies to the limits (which could be 20 percent of qualifying expenditures), but the award is determined by the geographic distribution and number of applicants. For example, Pennsylvania has $3 million available in credits but this amount is divided into five districts plus $500,000 for use statewide.

At the same time, the competitive programs also have a higher cost of participation. Part of that cost is direct; for example, the Ohio HTC has a $2,000 non-refundable application for projects larger than $1 million. But a larger cost, the effort required to file the application, is indirect. Typically, the competitive process rewards projects that are "shovel-ready." Preference is given to projects that are well-along in the design process and have secured sources of financing. The challenge presented by this preference is that if the project truly relies on federal and state tax credits, the developer must complete a considerable amount of leg work must on a project that might not be funded. This runs contrary to the federal program, whereby a developer may approach the project more speculatively and only need to invest time and money once the project is proven viable as a tax credit project.

Another problem area involves the historic status of the buildings. The federal program allows a developer to explore the potential for a tax credit development by seeking a preliminary designation of eligibility for listing on the National Register of Historic Places. This process offers the developer the potential for the 20 percent HTC but reserves the right to the 10 percent tax credit. Some states, such as Ohio, don't offer that opportunity. To apply for the state credit, if not in a registered historic district or designated a local landmark, the property must already be listed on the National Register.

There are other challenges involved with using state HTCs that focus more on the accounting side, such as the ability to transfer the HTC to a third party and the ability to carry the HTC forward. It would be wrong to simply assume that the rules governing the state program are parallel

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Photo: Courtesy of Heritage Consulting Group
PMC Properties adapted the Dennison Manufacturing Company Paper Box Factory into 93 market rate apartments in Marlborough, Mass.

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to those of the federal program. Those intending to use state HTCs should fully understand how the program works, how the program should benefit their specific project and what is involved in applying for those credits.

The upshot is that a developer anticipating using state HTCs should patiently explore the detail of the specific program.

Apart from the application, costs and benefits, state HTCs may also create an odd dynamic in the review process. Under the federal program, HTCs are secured when there is a certified rehabilitation of a certified historic structure. The basis for determining whether rehabilitation is certified is whether the work proposed in the Part 2 application meets the Secretary of Interior's Standards. That determination is made by an NPS reviewer after receiving a recommendation from the reviewer at the state historic preservation office.

However, when state HTCs are sought, the state reviewer no longer is simply making a recommendation but must also approve the work. As most people recognize, the Secretary of Interior's Standards are intentionally broad. Reviewers may interpret those standards, and their associated guidance, liberally or conservatively. Reviewers may differ on which aspects they consider character-defining and may differ on the proper treatment of certain elements. Particularly for those projects that are challenging or push the design envelope, this dual approval process can be burdensome.

Ultimately, however, as noted earlier it's largely true that if some HTCs are good, then more HTCs are better. Success stories can be found under both paradigms—by right and competitive—that have aided the redevelopment of historic buildings.

Photo: Courtesy of HRI Properties

The Hilton Garden Inn Jackson Downtown in Jackson, Miss. was formerly known as the King Edward Hotel.

"By Right" HTC Case Study: Mississippi's King Edward Hotel

Mississippi offers a 25 percent state HTC by right, similar to the federal program. Properties qualifying for the 20 percent federal HTC automatically qualify for the state credit. Procedurally, applicants must submit a three-part application that mimics the applications submitted for federal HTCs, along with a one-page statement of intent form that conveys the applicant's intention to utilize the state program.

This incentive helped developer HRI Properties tackle the King Edward Hotel, a legendary downtown hotel in the state capital that was restored as a combination

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of apartments and the Hilton Garden Inn Jackson Downtown. This four-year, $70 million rehabilitation transformed the blighted vacant building, along with adjacent historic structures, to create 140 apartments, 186 hotel rooms and more than 2,600 square feet of retail. In particular, the project involved the rehabilitation of the historic lobby, ballroom and rooftop sign.

"Competitive" HTC Case Study: Massachusetts's Dennison Manufacturing Company Paper Box Factory

In contrast to the simplicity of the Mississippi state HTC, the Massachusetts credit is awarded on a competitive basis in three application cycles per year. Applicants may apply for up to 20 percent of qualifying expenses, but the amount awarded is often diminished by the fund cap and competing projects. Applicants may apply for multiple rounds; ironically, the longer a project takes the more rounds of state credits it may be eligible for. In addition to the project information, the state requires additional material that includes an assessment of the level of preservation, economic and community impact, project pro forma and budget, as well as evidence of public support. The paperwork and process aside, the Massachusetts credit was critical to the rehabilitation of the Dennison factory in Marlborough, Mass.

PMC Properties adapted the 100,000-square-foot building into 93 market rate apartments. Included in the scope of work were much needed masonry repair and the replacement of modern, incompatible windows with new custom-manufactured, historically appropriate windows. The industrial character of the property was retained in the loft apartments which feature refinished wood floors, exposed concrete ceilings, mushroom columns and painted brick walls.

Conclusion

The potential for state HTCs is very real. Any developer pursuing the federal HTCs should check to see if there are associated state credits available for their project. But, the developer should fully understand the parameters of the state program. For those states where the state credit is by right and piggybacks on the federal credit, there are few reasons not to pursue the credits. For those states where credits are awarded through a competitive application process, a developer should assess the costs of the credits in terms of time and money. In most instances, it is still a worthwhile endeavor, but the developer should pursue the state credits with eyes wide-open.

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This article first appeared in the August 2014 issue of the Novogradac Journal of Tax Credits.

Novogradac
Journal of Tax Credits

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ISSN 2152-646X