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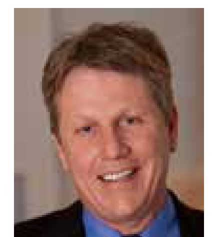
HISTORIC TAX CREDIT TOOL BOX

Opportunity Found: Historic Rehabilitations in Distressed Areas



JOHN M. TESS, HERITAGE CONSULTING GROUP

Besides keeping the 20 percent federal historic rehabilitation tax credit (HTC), tax reform at the end of 2017 created the opportunity zones (OZ) incentive.

OZs provide a tax incentive for investors to reinvest unrealized capital gains from prior investments into opportunity funds. In turn, qualified opportunity funds (QOFs) must place at least 90 percent of their assets in qualified OZ businesses and/or business property. These zones are defined by census tracts which have been nominated for designation by the governor of every U.S. state and territory.

As often as not, HTC developments are located in economically distressed areas. Not every distressed area is an OZ and not every QOF investment need be in real estate. Nonetheless, the creation of the OZ incentive offers the owners of older and historic buildings a potentially substantial equity source for redevelopment.

The definition of low-income community census tracts roughly is the same as that used for the New Markets Tax Credit program–a low-income community census tract has an individual poverty rate of at least 20 percent and median family income of no more than 80 percent of the area median income (AMI). Additionally, up to 5 percent of census tracts that do not meet this definition could be designated under an exemption. Exempt census tracts must be contiguous with an OZ and the median family income of the exempt tract must not exceed 125 percent of the AMI of the designated low-income community census tract with which it is contiguous.

There are approximately 8,800 OZs of an estimated 66,500 U.S. census tracts. There are a number

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of online resources which can be used to determine whether a particular census tract is designated.

QOFs represent a new potential source of additional funding for historic rehabilitation projects, an equity source that can seamlessly leverage federal and state HTCs. Within the required census tract, the use of QOFs is broad and not restricted to real property investment or development, but is open to such investments. As such, QOFs can be an important equity source for HTC projects. Of particularly interest is that the regulatory framework for QOFs appears to encourage a "holding" position that aligns well with the five-year post-rehabilitation ownership requirement of HTCs.

While QOFs and OZs are largely untested, what is particularly attractive for the HTC developer is that currently the vast majority of HTC developments occur in likely OZs. According to the most recent Annual Report on the Economic Impact of the Federal Historic Tax Credit, prepared by Rutgers University's Bloustein School of Planning and Public Policy, 2017 saw $6.5 billion in HTC investment. Seventy-nine percent ($5.1 billion) of HTC investment was located in economically distressed areas while $3.25 billion occurred in established low- and moderate-income census tracts. As a public policy tool, HTCs often target the same universe of real property investment that is attractive to QOFs.

Image: Courtesy of Alcove Media
A 1922 warehouse in Philadelphia was converted into Pyramid Lofts apartments.

Example: Pyramid Lofts

One recent HTC development in Philadelphia is illustrative. The Harry C. Kahn & Son's Warehouse is at 3101 W. Glenwood Avenue. It was designed by noted Philadelphia architect Leroy Rothschild and built in 1922 as a furniture warehouse. In 1961, Kahn & Sons closed and the property was acquired by Pyramid Electric Supply, again as a warehouse. By the late 1990s, the building was abandoned.

It was nonetheless iconic: Six stories tall and at a prominent five-corner intersection, the reinforced-concrete building with floor-to-ceiling windows was a visual landmark of the neighborhood.

The surrounding North Philadelphia neighborhood historically was industrial. Large manufacturing complexes ran along the rail line with nearby workforce housing to the east with associated neighborhood commercial main streets. The specific section of North

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Philly was called Brewerytown for its concentration of local breweries.

The area thrived in the first half of the 20th century, and then suffered the challenges–first from Prohibition, then the Great Depression and finally World War II. After the war, industrial uses faded–factories closed, neighborhood jobs disappeared, commercial enterprises shut and people fled to the suburbs. By the 21st century, like many Rust Belt areas, the neighborhood was marked by disinvestment, abandonment and blight.

It was about this time that Philadelphia entrepreneurs David Waxman, Jacob Roller and Aaron Smith formed MM Partners. Their vision was to create a vertically integrated development and construction company that concentrated on adaptive reuse, particularly loft apartments, in their hometown's underutilized neighborhoods. They placed their headquarters in Brewerytown and began buying property for redevelopment in the neighborhood. In particular, they were drawn to the neighborhood's central location, transportation access, great building stock and solid local population. They also believed that the neighborhood was cohesive and contained enough that they could achieve a critical mass of development that would transform the district. New development could not only enhance the neighborhood, but also feed on itself.

In June 2016, having completed a number of developments, MM Partners purchased the Kahn Warehouse for $1.4 million. At the time, the property had already been permitted by a previous owner for redevelopment into residential units. Proposed work was comprehensive, including full repair of the building envelope (including its acres of windows), development of loft-style residential units and complete systems replacement. Despite the head start in design, the development pro forma still had a funding gap of approximately $2 million. MM Partners filled the gap with federal and Pennsylvania state HTC equity. Planning began immediately and the HTC application was filed. By 2017, the warehouse was listed on the National Register. In late 2017, the $12 million development was complete and the 50 units were ready for occupancy.

The investment of MM Partners has demonstrated the viability of Brewerytown as a successful new neighborhood, and has spawned not only additional rehabilitation investments by MM Partners and others, but also new infill projects on vacant parcels within the district. The district is rapidly transforming from one marked by blight into one of the city's more vital and active neighborhoods. It seems to have a healthy and self-propelling mix of rehabilitation and new construction, fueled by a new critical mass of people who can support local shops and restaurants within close walking distance.

For most communities, the incentive toolbox to encourage redevelopment of older and historic buildings is limited. Public funds, such as urban renewal and tax increment financing, can and do play a role in facilitating historic preservation. However, the reality is that putting such public sources into new construction often is more politically palpable and more predictable. Where markets alone cannot support revitalization, as shown by Pyramid Lofts, federal and state HTCs can play an important role in maintaining and enhancing a community's iconic buildings and thus building its economic base. The arrival of QOFs, which must invest in distressed neighborhoods, offers a potentially significant source of equity.

Public Housing and OZs

Another significant potential for QOFs lies with the rehabilitation of public housing. The U.S. Department of Housing and Urban Development's (HUD's) Rental

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Assistance Demonstration (RAD) program has opened the door for public housing agencies (PHAs) to work with private developers. HUD estimates that cumulatively public housing has a $25.6 billion capital improvement backlog. Most of these developers are familiar with low-income housing tax credit programs and structures. More and more PHAs are becoming familiar with federal and state HTCs, as are PHA developers. With most public housing construction occurring before 1976, many if not most public housing potentially can qualify as certified historic structures. PHA properties as recent as 1976 have been listed on the National Register for their association with the trend of government investments in public housing.

One recent RAD/HTC development was the Coffelt-Lamoreaux complex in Phoenix. Built in 1954, the complex consists of 302 duplex units in 151 ranch-style buildings set on 38 acres. Gorman & Company worked with the Housing Authority of Maricopa County on a comprehensive $47 million renovation that completely upgraded the property and eliminated all deferred capital improvements. It was the first comprehensive upgrade for the property in its 63-year history.

Similar examples are found in Texas where the Groesbeck Housing Authority worked with Housing Solution Alliance (HSA) on a comprehensive redevelopment of 1963/1973 Liberty Square and Liberty Village complexes. As Gorman did with Coffelt, HSA worked with the PHA using RAD and HTC funding, also using state tax credits.

In moving forward, QOFs potentially can join this mix of funding sources to provide additional equity and thereby reducing reliance on any one or two sources. ❖

John M. Tess is president and founder of Heritage Consulting Group, a national firm that assists property owners seeking local, state and federal historic tax incentives for the rehabilitation of historic properties. Since 1982 Heritage Consulting Group has represented historic projects totaling more than $3 billion in rehabilitation construction. He can be reached at 503-228-0272 or jmtess@heritage-consulting.com.

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