



# Novogradac Journal of Tax Credits

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

August 2015 • Volume VI • Issue VIII

Published by Novogradac & Company LLP

## HISTORIC TAX CREDIT TOOL BOX



### Avoiding Historic Tax Credit Recapture using Post-Certification Amendments

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**T**he National Park Service (NPS) historic tax credit (HTC) review process is often referred to as the 1-2-3 process, which makes one think that securing certification for a historic preservation rehabilitation project is easy as 1, 2, 3. First there's a Part 1—Evaluation of Significance, followed by a Part 2—Description of Rehabilitation, and finished off with a Part 3—Request for Certification of Completed Work. However, there's one part that is often overlooked, the five-year recapture and compliance periods.

Most developers of historic properties generally understand that for five years following completion of a certified rehabilitation project, it's possible for the Internal Revenue Service (IRS) to recapture some or all of the HTCs. Issues that can lead to recapture are, for the most part, preventable. Many of the items that can trigger recapture are technical ownership/accounting infractions. But perhaps the most common issue that can lead to post rehab problems relates to owners forgetting that the NPS has design review over a project for five years after a Part 3 is secured. Specifically, HTC program regulations state that completed projects may be inspected by an authorized representative of the Secretary of the Interior (Secretary) to determine if the work meets the Standards

for Rehabilitation and that the Secretary reserves the right to make inspections and can revoke a certification if it is determined that a rehabilitation was not undertaken as represented in the application. Failure to adhere to this requirement can lead to costly fixes and in the worst-case scenario, possible tax credit recapture. These potential problems can be avoided through the post-certification amendment process.

This article explains the post-certification amendment process to help developers and investors take simple, but necessary, steps to avoid problems during the IRS recapture period and the NPS post-review period. It includes examples of the proactive approaches to post-certification alterations as well as a cautionary tale.

There are a few key points about recapture that are important to understand. First, the NPS and IRS recognize slightly different five-year periods: the NPS review clock begins with the approval of the Part 3; the IRS starts the five-year recapture period with the placed-in-service date. For most HTC projects, the building is placed in service before NPS approves the Part 3 certification. Second, the recapture penalty is calculated on a sliding scale, diminishing by 20 percent each year after the building

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is placed into service. If infractions are made within the first year, 100 percent of the credits will be recaptured. Thereafter, the penalty drops incrementally: 80 percent will be recaptured in the second year, 60 percent in the third, 40 percent in the fourth, and finally, in the fifth and final year, 20 percent of the total credits will be recaptured. A third key point is that it's the owner's/ taxpayer's responsibility to initiate and follow up on post-certification amendments. Neither the state historic preservation office (SHPO) nor the NPS typically conduct follow-up inquiries or inspections, unless it comes to their attention that inappropriate work has taken place. This relatively reduced oversight role makes it easy for owners to overlook their obligations for gaining post-certification approvals, thereby jeopardizing their projects.

Post-rehabilitation problems are generally preventable by keeping appropriate rehabilitation team members engaged during the post-rehabilitation period. This may include the accountant, attorney, and preservation consultant. For example, if the building is sold, ceases to be a "business-use property," or a partner disposes of more than one-third of its interest within the five-year period, it can result in the recapture of credits. In this case, the accountant and attorney should be engaged to help work through these issues. Another way to lose HTC's is if the building is a "destroyed by a casualty;" in other words, if the building is destroyed beyond repair as a result of a natural disaster, the tax credits are subject to recapture. Finally, if a property is removed from the National Register or is no longer contributing to a Registered Historic District, the HTC's may be recaptured. A property may lose its historic status if any alterations are determined to be inappropriate and no longer meets the Standards. Here again, engaging proper professional will help work through these issues. Also, keep in mind that some of these events noted here are events that could also result in a denial of the HTC's for the project. A denial of the HTC's would differ from a recapture event. In a denial situation where the taxpayer had previously claimed the credits, prior tax returns that claimed the HTC's would have to be amended. In a recapture event, the taxpayer recognizes the recaptured credits as additional federal income tax in the tax year that the HTC's are recaptured. Specific information regarding the recapture provisions are found under Internal Revenue Code Section 50(a).

For historic preservation issues regarding keeping

a project in conformance with the Standards, post-certification amendments are the tool used to avoid revoking a project's Part 3 Certification for inappropriate post-rehabilitation work. The process is a means to verify that any alterations made to the building during that five-year period are acceptable per the Standards and will not result in the recapture of the credits.

The post-amendment process is similar to the Part 2 review process. As in the case of a Part 2 amendment there is a necessary "order of magnitude" consideration when determining whether your proposed work needs to go through the SHPO/NPS review process. Typical factors include scale, visibility and reversibility of proposed work. For example, if a building has an open-floor plan office space and a new tenant wishes to paint the walls a different color, this work will not merit a post-certification amendment. However, should this tenant wish to construct offices and conference rooms along the perimeter resulting in walls abutting the windows or the installation of a dropped ceiling, this should be reviewed.

For the most part, the elements of a building that could trigger a post-certification amendment are essentially the same as those addressed in the Part 2. The Standards and review process and times are the same for post-certification amendments as they are for Part 2 or Part 3. In other words, postponing contentious alterations that were deemed unacceptable during the Part 2 process and submitting them as a post-certification amendment will not increase the probability of SHPO and NPS approval.

An example of a proactive post-certification approach is the certified historic rehabilitation of the Wrigley Building in Chicago. This \$78 million historic certified rehabilitation was completed in September 2014. The Wrigley Building, designed by Graham, Anderson, Probst & White, includes a 30-story, south tower (1921) and a 21-story, north tower (1924). It is in the Michigan-Wacker Historic District and prominently located on the north bank of the Chicago River. The rehabilitation focused on upgrading the building for continued use, including ground-floor retail with upper-floor offices. Offices and floors targeted for releasing were upgraded with new office finishes. The Wrigley Building tenant spaces have been leased incrementally, resulting in both Part 2 and Part 3 amendments. At the north tower, the first- and second-floor retail spaces were leased before the Part

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3 was submitted, and the tenant improvements were submitted as a Part 2 amendment. At the time of the Part 3 submission, the unleased retail spaces in the south tower were left as a “white box” finish. This is a typical NPS-required level of finish on unoccupied spaces with the anticipation that a post-certification amendment may be necessitated with the five-year review period. In the case of the Wrigley Building, within a year of completion, two of the spaces in the south tower underwent tenant improvements. Post-certification amendments were submitted and approved. If the remaining empty retail space is leased during the five-year review period another post-certification amendment would be warranted.

The Wrigley Building example shows how a hands-on approach can prevent post-certification problems. In some instances, however, developers and property owners are willing to gamble or just forget and will add incompatible elements to a building during the five-year recapture period, jeopardizing their final certification. Such was the case for a former manufacturing plant developed into housing. The 1916, five-story building is the archetype of a manufacturing facility designed by the notable industrial architect Albert Kahn. The half-block, brick-clad building features cast stone details, steel multi-light windows and a water tower. The building was rehabilitated using HTCs and received its approved Part 3 in 2005. Four years later, it came to the NPS’ attention that incompatible balconies had been installed. The balconies were not only installed improperly into the masonry, but were also inappropriate to the historic use of the building. As a result, the property lost its certification. In order to bring the project back into conformance with the Standards, the balconies had to be removed. The project was also inspected for other

incompatible alterations, a couple of which were found. Once the balconies were removed and the other issues addressed, the owner had to apply for recertification of the project. It was an expensive and time-consuming process, and one that could have been easily avoided.

Typically, once a HTC project is placed in service and the Part 3 is secured, from the owner’s standpoint the project is determined complete and the project team disbands. Changes made to the building continue, are incremental and often involve tenant improvements designed by architects unaware of the post-design review requirements.

Smart and cautious owners are cognizant of the post-IRS and -NPS rehabilitation five-year review periods. These owners continue working with their accountants, attorneys and other appropriate team members throughout both the IRS and NPS five-year post-certification periods and avoid costly and time-consuming post-rehabilitation problems. Finally, today it is more common for equity investors to monitor projects during the five-year period to ensure conformance with applicable regulations and requirements. A proactive attitude will satisfy the tax credit partner and ensure that a historic rehabilitation property remains certified. ❖

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*This article first appeared in the August 2015 issue of the Novogradac Journal of Tax Credits.*

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ISSN 2152-646X

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