The Role of Tax Credits in Economic Development:

Historic and New

62nd Annual Tax Institute

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I. OVERVIEW

What to Expect: We will discuss the role of tax credits in economic development. Specifically how federal and state Historic Tax Credits (“HTC”) and New York State Brownfield tax credits have helped fuel the rehabilitation of historic buildings and development on environmentally challenged properties. We will look at the structure of the deal from the developer’s counsel perspective as well as recent changes in deal structures as the result of the Historic Boardwalk Hall case and subsequent safe harbor rules. We will consider the history of the New York State Brownfield Cleanup Program (“BCP”).

What Not to Expect: We will not review in detail how to determine if any tax credits can be used by a specific taxpayer (loss limitation rules etc.) or how the amount of credit are calculated (i.e. a detailed analysis of “Qualified Rehabilitation Credits” (“QRE”) or the BCP tangible property credit)
II. HISTORIC TAX CREDITS

The IRS explains the Rehabilitation Tax Credit in a Market Segment Specialization Program publication as follows:

“GENERAL BACKGROUND

Prior to 1976, there existed no tax incentive to rehabilitate or preserve historic buildings. The Tax Reform Act of 1976 added IRC section 191 which permitted taxpayers to amortize over a 60-month period certain expenditures to rehabilitate property listed in the National Register of Historic Places or property located in Registered Historic Districts and certified as significant to the district.

The 60-month amortization period was enhanced to a 10 percent rehabilitation tax credit in 1978. In 1981, Congress expanded the rehabilitation tax credit to a three-tier credit: a 25 percent credit for "historic rehabilitations," a non-historic rehabilitation credit of 20 percent for buildings at least 40 years old, and a 15 percent credit for buildings at least 30 years old.

The rehabilitation tax credit survived the Tax Reform Act of 1986, but imposed several constraints that made the rehabilitation tax credit less attractive to individual real estate investors. The credit was retained as a two-tier credit with a 20 percent credit available for historical buildings and a 10 percent credit for non-historic buildings which were first placed in service before 1936.

The Historic Preservation Tax Incentives Program, jointly administered by the National Park Service and the State Historic Preservation Offices, is the nation’s most effective Federal program to promote urban and rural revitalization and to encourage private investment in rehabilitating historic buildings. The tax credit applies specifically to preserving income-producing historic property and has generated billions of dollars in historic preservation activity since its inception in 1976. Its tremendous effects are evident in not only the major cities in the United States, but also in many small towns and communities throughout the country. The completed projects have brought renewed life to deteriorated business and residential districts, created new jobs and new housing units, increased local and state revenues, and helped ensure the long-term preservation of irreplaceable cultural resources.

LEGISLATIVE HISTORY

Before 1976, there were no incentives for restoring or rehabilitating older buildings in our Nation's tax laws. Prior law actually encouraged the destruction of these buildings by allowing deductions related to their demolition. In addition, the erection of newer buildings in their place benefited from quicker depreciation methods.”

Federal and State Historic Tax Credits (HTC) are an important part of urban (and suburban and rural) redevelopment. This access to capital has been essential in bringing numerous projects to development. The explosion of tax credit projects locally was the direct result of the State of New York enhancing the New York state historic tax credit component, piggybacked on to the federal historic tax credit. Now a New York State taxpayer can take the 20% federal tax credit against federal tax obligations and also be eligible for a 20% credit against their New York State tax obligations. Offering this enhanced state tax credit has significantly increased the number of investors willing to provide equity to local projects. New York credits are currently subject to a $5 Million cap. These credits are refundable at the state level with limitations. Although the senate and assembly both passed amendments that would increase the cap to $12 Million, the Governor did not sign the Bill into Law.

The tangible impact of Historic Tax Credits as a part of Buffalo’s redevelopment can be seen everywhere. This access to capital has assisted numerous projects in development including but not limited to the AC Cory Buildings, Seneca Paper, the Curtiss Hotel, the RC Lofts Building (“Corn Exchange”), the Lafayette Hotel, Bethune Lofts, The Knights, and the Tishman Building.

**Historic Tax Credit Basics:**

Tax Credits in general are offered by the government to incentivize or disincentive certain actions on the part of the private sector. Historic tax credits are used to incentivize the restoration and rehabilitation of historic structures to standards developed by the Department of the Interior. The cost of preserving historic structures can be prohibitive in a standard business model. To preserve historic fabric is often more expensive than to build new. The tax credits help cover the additional costs associated with redeveloping these historic properties such as remediation of lead, asbestos and structural issues.

Federal law provides tax credits to taxpayers who rehabilitate older commercial buildings. There are two basic programs for commercial buildings: a 10% tax credit is available for non-historic buildings
originally placed in service before 1936. A more lucrative 20% credit is available for projects undertaken to rehabilitate “historic buildings”. There are also incentives available for donation of easements or other property rights that serve to protect historic structures. It is important to understand that these are different programs and the rules and benefits differ. There are also state historic tax credit programs in many states including New York. Some like New York “piggy-back” onto the federal process for.

To be eligible the taxpayer must follow a three part process.

Part 1 is the evaluation of historic significance of the property. To qualify for the 20% credit a building must not only be old but must have historical significance.

Part 2 is the description of the proposed rehabilitation which requires approval of the construction plans as being compliant with DOI standards for rehabilitation. The Part 2 proposal is processed through the states historic preservation office (SHPO) for a recommendation to the federal Department of Interior. Once a Part 2 application is approved the property can be redeveloped in strict compliance with the approved application.

Part 3 is the certification process. Assuming that the project is completed in strict compliance with the Part 2 application the DOI will issue a Part 3 certification. The certification is the “Golden Ticket” that allows a taxpayer to claim historic tax credits as a credit against taxes otherwise due.

The tax credit can be carried back one year and carried forward 20 years.

As with all tax credits there is a burden that goes along with the benefit. These limitations should be acknowledged and considered. They include:

1. Authority over design and rehabilitation by Department of the Interior
2. Additional time to complete the project
3. “20% and 20% does not equal 40%”
   a. Additional fees
   b. Discount to syndicate
   c. “Guaranteed” returns
Qualified Rehabilitation Expenditures (QRE’s):

The final amount of available credit is a function of the amount of “qualified rehabilitation expenditures” (“QRE”). Not all money spent in the redevelopment of an historic property is considered a QRE. Essentially, QRE’s are depreciable capital expenditures including most hard and some soft construction costs. A good rule of thumb is 80% of a project’s costs should be QRE’s. Using that calculation for a $10 Million project you may have approximately $8 Million in QRE’s. The tax credit is calculated as a percentage (i.e. 20%) of eligible QRE’s. The reader is cautioned however that all tax code provisions are interpreted and applied on a very fact specific basis. There are very specific and technical definitions, regulations and time frames which must be observed. Every project is different and a qualified tax professional should be consulted prior to making a determination as to what would constitute a QRE.

Once the property is put in service, the tax payer must own and maintain the property in accordance with the approved Part 2 plans for a minimum five year period.

Projects can be and are audited during the five (5) year holding period to assure compliance.

Syndication

Since not all property owners can take advantage of these tax credits, (due to passive loss and other limitations) the law allows the credits to be “syndicated” to investors to bring additional equity into the project. The key is that the investors’ money be deemed equity not debt; the investor must be at risk as to their investment. There are many large national syndication players including insurance companies, banks, and large corporations that have a need to reduce their overall tax obligations. Since not all taxpayers have New York State tax credit obligations, and the credits cannot be “bi-furcated” there are additional considerations and limitations when syndicating credits in New York.
Historic Boardwalk Hall, LLC v IRS

Who is the eligible “Taxpayer”? : Historic Boardwalk Hall vs. IRS


In essence the IRS challenged whether members of an investor LLC were entitled to a flow through of the tax credit benefits. In that case the Court determined that the investors were not entitled to take the tax credit benefits because they were not truly “investors” in the LLC. The ruling did not invalidate the tax credits themselves, nor did the ruling affect the projects Part 1, 2 or 3 certifications. The ruling was an examination of who the proper taxpayer is that could claim the credits under the facts of that particular tax credit investment scenario. It had a significant impact on the syndication of tax credits. The IRS explains:

“In Historic Boardwalk Hall, LLC. v. Commissioner, 694 F.3d 425 (3d Cir. 2012), cert. denied, U.S., No. 12-901, May 28, 2013, the Third Circuit considered whether an investor’s interest in the success or failure of a partnership that incurred qualifying rehabilitation expenditures was sufficiently meaningful for the investor to qualify as a partner in that partnership. The agreements governing the Historic Boardwalk Hall transaction ensured that the investor would receive the § 47 rehabilitation credits (or their cash equivalent) and a preferred return, with only a remote opportunity for additional sharing in profit. Both the § 47 rehabilitation credits and the preferred return were guaranteed as part of the transaction. The preferred return guarantee was funded. The Third Circuit determined that the investor’s return from the partnership was effectively fixed, and that the investor also had no meaningful downside risk because its investment was guaranteed. The Third Circuit agreed with the Commissioner’s reallocation of all of the partnership’s claimed losses and tax credits from the investor to the principal, holding that “because [the investor] lacked a meaningful stake in either the success or failure of [the partnership], it was not a bona fide partner.” Id. at 463”

**At Risk Rules**

The key to the *Historic Boardwalk Hall* case is an understanding that the Internal Revenue Service will not recognize a business transaction that is without a real business purpose and/or structured solely for tax purposes. This is true of investment tax credits as well as sales and purchases. There must be a business basis for the transaction beyond the avoidance of taxes. If the historic tax credit investor is not at “risk” because the investor is protected by so many layers of cross guarantees etc. they may not qualify as members of the LLC for purposes of the tax credits. These issues are not limited to historic tax credit treatment. Any “flip model” such as renewable energy credits or low income housing may be affected by these interpretations.

**Safe Harbor**

Following the decision in *Historic Boardwalk Hall* the Service issued safe harbor rules for these tax credit projects.

**SECTION 1. PURPOSE**

This revenue procedure establishes the requirements (the Safe Harbor) under which the Internal Revenue Service (the Service) will not challenge partnership allocations of § 47 rehabilitation credits by a partnership to its partners. The Treasury Department and the Service intend for the Safe Harbor to provide partnerships and partners with more predictability regarding the allocation of § 47 rehabilitation credits to partners of partnerships that rehabilitate certified historic structures and other qualified rehabilitated buildings.


The Safe Harbor Rules help to determine who is an “investor”. Section 4.01 defines “Investor” as:

“**.01 Investors Defined.**

Investors are Partnership partners (other than Principals) that hold an interest in the Partnership that is described in section 4.02(2) of this revenue procedure. An Investor may be an initial partner in the Partnership or may be a person who later becomes an Investor by purchasing a Partnership interest. If the Investor receives an allocation of § 47 rehabilitation credits from a Master Tenant Partnership, the Investor cannot also invest in the Developer Partnership other than through an indirect interest in the Developer Partnership held through the Master Tenant Partnership. This prohibition does not apply to a separately negotiated, distinct economic arrangement (e.g., a
separate arm’s length investment into the Developer Partnership to share in allocations of federal new markets tax credits or low income housing credits).”

The Safe Harbor also establishes the requirements regarding the investor’s partnership interest.

“02(2)(b) Requirements regarding the Investor’s Partnership interest.

The Investor’s Partnership interest must constitute a bona fide equity investment with a reasonably anticipated value commensurate with the Investor’s overall percentage interest in the Partnership, separate from any federal, state, and local tax deductions, allowances, credits, and other tax attributes to be allocated by the Partnership to the Investor. An Investor’s Partnership interest is a bona fide equity investment only if that reasonably anticipated value is contingent upon the Partnership’s net income, gain, and loss, and is not substantially fixed in amount. Likewise, the Investor must not be substantially protected from losses from the Partnership’s activities. The Investor must participate in the profits from the Partnership’s activities in a manner that is not limited to a preferred return that is in the nature of a payment for capital.”

A key component of the safe harbor rules is the discussion concerning “impermissible guarantees”.

These guarantees are ways in which investors that would otherwise have been at risk on a project are not really at risk in the final analysis. It was partially this scenario that caused the IRS to determine that the funding was not an investment but rather more akin to a loan or other transaction. The party seeking a flow-through of the tax credits was not entitled to be determined a tax credit “investor”.

“.05(2)(a) Impermissible guarantees.

(a) No person involved in any part of the rehabilitation transaction may directly or indirectly guarantee or otherwise insure the Investor’s ability to claim the § 47 rehabilitation credits, the cash equivalent of the credits, or the repayment of any portion of the Investor’s contribution due to inability to claim the § 47 rehabilitation credits in the event the Service challenges all or a portion of the transactional structure of the Partnership. Further, no person involved in any part of the rehabilitation transaction may guarantee that the Investor will receive Partnership distributions or consideration in exchange for its Partnership interest (except for a fair market value sale right described in section 4.06(2)). This requirement does not prohibit the Investor from procuring insurance from persons not involved with the rehabilitation or the Partnership”
CONCLUSION

Historic Tax credits are provided to the eligible taxpaying entity that either owns or master leases the property at the time the property is placed in service. In a master lease scenario the owner enters into an agreement with the master tenant to pass thought the tax credits to the master tenant. A developer and potential investor need to understand the rules governing membership in the taxpaying entity that is entitled to the credits.

In the event that a tax credit investment scenario is disallowed by the IRS the real harm is felt by the project and the owner, not necessarily the investors. Most investor agreements have guarantees, cross guarantees, indemnifications, belts, suspenders, band aids, scotch tape, duct tape and glue protecting the actual investor in the event that the credits are disallowed. It is the project and the owners of the project who will need to come up with significant funds to reimburse the “Disallowed investor”.
III. HISTORY OF THE DEVELOPMENT OF NEW YORK STATE BROWNFIELD TAX CREDITS

New York has a very robust tax credit program to incentivize the redevelopment of contaminated property. Although sharply reduced from its original version the tax credit portion of the state’s program rivals any states Brownfield incentive.

Background

The term “brownfield” is often misused, misunderstood and misapplied. It is important to understand that when referencing “Brownfield” under the New York State Brownfield Cleanup Program. The use of the term “brownfield” in general may apply to properties that do not necessarily meet the criteria required to be eligible for tax credits.

The concept of brownfield’s arose out of the aggressive liability regime put together after the disasters such as Love Canal in Niagara Falls. It was the Love Canal scenario that led to the Comprehensive Environmental Response Compensation and Liability Act or “CERCLA” sometimes referred to as the “Superfund” law. The aggressive implementation of CERCLA and its “polluter pays” policy led to contaminated or potentially contaminated properties being abandoned instead of redeveloped and or reclaimed. The definition of “polluter” was stretched to include lenders, subsequent owners and others not traditionally thought of as having a role in the actual contamination of property. Since the definition of “polluter” could include even those that might otherwise be thought of as “innocent” both investors and lenders shied away from properties that were or may potentially be contaminated. In addition investing in these properties was problematic because the cost of any development required undertaking a cleanup which could be very expensive.

Voluntary Cleanup Program (VCP)

Volunteers who were willing to take on abandoned contaminated properties needed to be protected from liability that might otherwise be imposed under CERCLA. In order to address this phenomenon New
York established a Voluntary Cleanup Program ("VCP") in the 1990’s. The program had significant flaws. Since the VCP was only a policy program of the New York State Department of Environmental Conservation it provided limited liability protection. In addition there were no tax credits or incentives attached to the program which left the potential investor little option when deciding whether to invest in an unknown cleanup or constructing its development on less problematic “green fields”.

**Brownfield Cleanup Program ("BCP")**

In order to address these limitations on the Voluntary Cleanup Program and to incentivize redevelopment of significant industrial properties the New York State Legislature introduced a Brownfield Cleanup Program in 2007. The program is a combination of amendments to the Environmental Conservation Law and New York State Tax Law. The program is implemented through regulations developed by the New York State Department of Environmental Conservation as to what constitutes an eligible site as well as the process by which a participant or volunteer can receive a Certificate of Completion. The Certificate of Completion is the ticket that allows a volunteer or participant to claim the tax credits. The tax credits took many forms (credits involved in the cost of cleanup, credits involved in the site preparation cost, overall credits involved in the redevelopment (investment credits) real property tax credits, wage tax credits and a credit against the cost of environmental remediation insurance.

In a highly publicized case arising out of New York City an investor cleaned up a former petroleum contaminated lot for less than a few million dollars and claimed a tax credit of over $160 million. The New York Times Building case gained the attention of the New York Comptroller and New York regulators as well as people who felt the Brownfield program was overly generous with state tax dollars and liability limitations.

**2011 Amendment to the BCP**

As a result of the perceived abuses the New York State Brownfield Cleanup Program was amended in 2011. The amendment related the amount of credits available to the amount of the cleanup creating caps
on the credit based on the ultimate use of the property as either manufacturing or otherwise. The program based on the 2011 amendment was set to “sunset” as of December 31, 2015.

**2015 Enacted Budget Brownfield Cleanup Program Reforms**

The Brownfield cleanup program was amended pursuant to Chapter 56 of the laws of 2015 of the State of New York part BB. The amendments took several forms. The BCP now requires that an eligible participant or volunteer prove that the property is actually contaminated, not just potentially contaminated. The program distinguishes between sites in New York City (where property values are already high and the need for incentive is less) in terms of what properties qualify and will be eligible for credits. The law eliminated the real property tax credit and environmental remediation insurance credits. The Brownfield Cleanup Program now allows for an express cleanup track with easier oversight for the DEC in return for giving up the lucrative tax credits. In essence - a return to the Voluntary Cleanup Program but by statute.
The DEC provides a BCP tangible property/tax credits explanation in chart form as follows:

BCP Tangible Property Tax Credits

<table>
<thead>
<tr>
<th>Tangible Property Tax Credits</th>
<th>Current, Accepted Prior to June 23, 2008</th>
<th>Current, Accepted after June 23, 2008</th>
<th>Reformed, Accepted after July 1, 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baseline (Based on Tax Status)*</td>
<td>10-12%</td>
<td>10-12%</td>
<td>10%</td>
</tr>
<tr>
<td>Plus the sum of the following:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Environmental Zone: At least 50% of the site is located in an EN-zone (high poverty and unemployment rates)</td>
<td>8%</td>
<td>8%</td>
<td>5%</td>
</tr>
<tr>
<td>Track 1 Cleanup: Unrestricted soil and groundwater cleanup</td>
<td>2%</td>
<td>2%</td>
<td>5%</td>
</tr>
<tr>
<td>Brownfield Opportunity Areas: Development conforms with the goals and priorities of the designated Brownfield Opportunity Area (BOA) in which the site is located</td>
<td>N/A</td>
<td>2%</td>
<td>5%</td>
</tr>
<tr>
<td>Affordable Housing</td>
<td>N/A</td>
<td>N/A</td>
<td>5%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>N/A</td>
<td>N/A</td>
<td>5%</td>
</tr>
<tr>
<td>Maximum Percentage</td>
<td>22%</td>
<td>24%</td>
<td>24%</td>
</tr>
<tr>
<td>Cap Non-Manufacturing</td>
<td>N/A</td>
<td>$30M or 3X Site Prep</td>
<td>$30M or 3X Site Prep</td>
</tr>
<tr>
<td>Cap Manufacturing</td>
<td>N/A</td>
<td>$45M or 6X Site Prep</td>
<td>$45M or 6X Site Prep</td>
</tr>
</tbody>
</table>

http://www.dec.ny.gov/chemical/101350.html

Conclusion

In order to attract potential investors to cities like Buffalo the availability of tax credits based on our significant assets: historical buildings as well as our legacy of highly industrialized activity is critical. The process is not always “intuitive” and as some have said, “the juice is not always worth the squeeze”. A thoughtful approach including legal and accounting advice must be taken to each project. The structure must carefully reflect the needs of the business deal as well as the regulations and limitations of the desired tax benefits. It is important to remember that the BCP is at its essence a tax credit program. Therefore it is not the environmental lawyer who was going to guide you to your benefits but rather your tax professional.
I. Historic Tax Credits

**Internal Revenue Service**


**Department of the Interior / National Parks Service**

http://www.nps.gov/tps/tax-incentives.htm

http://www.nps.gov/tps/standards/rehabilitation/rehab/index.htm


**New York State SHPO**

http://www.parks.ny.gov/shpo/tax-credit-programs/

**Historic Boardwalk Hall v IRS**

Historic Boardwalk Hall Timeline: Novogradac & Company

https://www.youtube.com/watch?v=PrCyjjNOS2Y

Published on Sep 27, 2012

This video is a 5-minute excerpt from the Historic Boardwalk Hall Case webinar hosted by Novogradac & Company on September 19, 2012. Novogradac partner, Tom Boccia, lays out timing of several significant events in the transaction. To see the entire 1.5-hour webinar, go to www.novoco.com/webinars


Third Circuit Court of Appeals Decision: http://www2.ca3.uscourts.gov/opinarch/111832p.pdf

**New York Brownfield Cleanup Program**

**New York State Department of Environmental Conservation**

http://www.dec.ny.gov/chemical/8450.html

*The Knoer Group, PLLC represents major Buffalo developers and provides real estate, environmental and tax credit advice. The Knoer Group PLLC operates in Downtown Buffalo and surrounding areas.*