IRS Info

This information has been prepared by the Internal Revenue Service for use by applicants for the Historic Preservation Tax Incentives. Its purpose is to present an overview of the issues set forth, and it should not be relied upon as definitive tax advice. Applicants are strongly encouraged to consult their tax advisor or the Internal Revenue Service about the tax implications of the Historic Preservation Tax Incentives.

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Internal Revenue Service Regulations 26 CFR 1.48-12. Qualified rehabilitated buildings; expenditures incurred after December 31, 1981

Internal Revenue Code Section 47. Rehabilitation Credit

Internal Revenue Code of 1986, Section 170(h). Qualified Charitable Contributions, as amended

Frequently Asked Questions

Prepared by Mark Primoli, Internal Revenue Service, October 2000

Adjusted Basis

32. How do you compute adjusted basis?

Adjusted basis of a building is the cost of the property (excluding land) plus or minus adjustments to basis. The County Assessor's office would be able to provide a building to land value ratio. Increases to basis include capital improvements, legal fees incurred in perfecting title, zoning costs, etc. Decreases to basis include deductions previously allowed or allowable for depreciation. See Treasury Regulation 1.48-12(b)(2)(iii).

For the substantial rehabilitation test, the date to determine the adjusted basis of the building is the first day of the 24-month measuring period or the first day of the taxpayer's holding period of the building, whichever is later. Generally the holding period is deemed to begin the day after acquisition.

33. What is the effect on basis when a structure is rehabilitated?

The basis of rehabilitated buildings, including certified historic structures, must be reduced by 100% of the rehabilitation credit earned regardless of whether the credit is used or carried forward. The reduction amount is added back if the credit is recaptured. See Treasury Regulation 1.48-12(e).

Ownership and Leasing

34. How can property owned by a tax-exempt entity utilize rehabilitation tax credits?

The rehabilitation tax credit would be of no use to a tax-exempt entity. However, in many instances, tax-exempt entities are involved in rehabilitation projects by forming a limited partnership and maintaining a minority ownership interest as a general partner. In these situations, the limited partners would be entitled to the rehabilitation tax credit and the tax exempt entity is able to ensure that their organizational goals are being met.

35. How is the rehabilitation tax credit computed when a portion of the property is not used for business?

A qualified rehabilitation expenditure must be "properly chargeable to a capital account". This means the property must be depreciable. If a structure is used for both business and non-business (personal) use, an allocation of the rehabilitation expenditures must be made. The allocation is generally made based on a square footage percentage. The only expenditures eligible for the tax credit would be those associated with the business use portion of the property. When a personal residence is used also for business, the business use portion of the home (e.g. home office) would be eligible. Expenditures associated with common living areas, such as a kitchen, bedrooms, living room, bathrooms, would not be eligible because they are not used exclusively for business. If the owners of a Bed & Breakfast live on the premises, the business use portion would only be those areas which are used exclusively for business.

To be eligible for the rehabilitation tax credit, the property must be substantially rehabilitated. This means that the qualified rehabilitation expenses must exceed the entire building's adjusted basis. If property is used for both business and personal use, the adjusted basis would include both the business and personal use portions.

36. Can a lessee of a building or a portion of the building claim a rehabilitation tax credit?

If a lessee incurs the cost of rehabilitating a building and the lease term is greater than the recovery period determined under Internal Revenue Code Section 168(c), (39 years for non-residential real property, 27.5 years for residential rental), the lessee can claim the rehabilitation tax credit on qualified rehabilitation expenditures provided the substantial rehabilitation test is met.

A building owner, who incurs the cost of rehabilitating an historic structure, can elect to pass the rehabilitation tax credit to its lessee(s) provided the owner is not a tax exempt entity. See Internal Revenue Code Section 48(d) and 50(d)(5).

A tax exempt entity cannot pass the rehabilitation tax credit to its lessee(s) because Treasury Regulation 1.48-4(a)(1) requires that the property must be Section 38 property in the hands of the lessor; that is, it must be property with respect to which depreciation is allowable to the lessor.

37. Can a taxpayer claim the rehabilitation tax credit on property that is leased by a tax exempt entity, i.e. a governmental agency or a non-profit organization?

Yes, taxpayers can lease their property to a tax exempt entity provided the lease does not result in a "disqualified lease" as defined in Internal Revenue Code Section 168(h)(1). A disqualified lease occurs when:

1. Part or all of the property was financed directly or indirectly by an obligation in which the interest is tax exempt under Internal Revenue Code Section 103(a) and such entity (or related entity) participated in the financing,

2. Under the lease there is a fixed or determinable purchase price or an option to buy,

3. The lease term is in excess of 20 years, or

4. The lease occurs after a sale or lease of the property and the lessee used the property before the sale or lease. See Internal Revenue Code Section 168(h)(1)(B)(ii).

An exception under the Treasury Regulations provides that property is not considered tax exempt use property if 50% or less of the property is leased to tax exempt entities in disqualified leases.

38. Can a seller [of a building] pass the rehabilitation tax credit to a buyer?

The seller can pass the rehabilitation tax credit to a buyer provided that no one has already claimed the rehabilitation tax credit and the building acquired has not been placed in service by the seller before the date of acquisition.

The amount of expenditures that are treated as incurred by the buyer is the lesser of:

- the amount of expenses actually incurred before the acquisition; or
- an allocable portion of the cost of the property if it is bought for an amount less than the rehabilitation expenditures actually incurred. See Treasury Regulation 1.48-12(c)(3)(ii)(B).

Recapture

39. How do the recapture rules apply?

The rehabilitation credits are subject to recapture if the building is sold or ceases to be business use property. No recapture is required after five years. The amount of such recapture is reduced by 20% for each full year that elapses after the property is placed in service. Thus there is a 100% recapture if the property is disposed of less than one year after the property is first placed in service; an 80% recapture after one year, a 60% recapture after two years; a 40% recapture after three years; and a 20% recapture after four years. See Internal Revenue Code Section 50(a).

40. If a partner sells his interest in a partnership will this trigger recapture?

When rehabilitated property is owned by a partnership and a partner sells or disposes of all or a part of his partnership interest tax credit recapture may be required. Treasury Regulation 1.47-6(a)(2) states that if a partner's interest in the partnership is reduced to less than two-thirds of what it was when the property for which the rehabilitation tax credit is claimed was placed in service, the reduction is treated as a proportional disposition of the property. This is illustrated in the following example:

A limited partner has an 80% interest in a limited partnership that rehabilitated an historic structure in 1996. This limited partner's share of the rehabilitation tax credit amounted to $100,000. If the limited partner's interest is reduced to 50% in 1999, three years from when the property was first placed in service, credit recapture is required. Since the limited partner's interest was reduced below two thirds (62.5%), the partner is considered to have disposed of 30/80 or 37.5% of the property. Recapture is computed as follows:

$100,000 x 37.5% = $37,500

$37,500 x 40% (recapture %) = $15,000

41. If rehabilitation tax credit property is destroyed by casualty, will this trigger recapture?

When a building that qualified for the rehabilitation tax credit is destroyed by a casualty (i.e. hurricane, flood, tornado, earthquake), within five years of first claiming the credit, the recapture provisions of Internal Revenue Code Section 50(a) apply.

Unlike the provisions set forth in Internal Revenue Code Section 42(j)(4)(E) which does not require recapture of low income housing tax credit property when it is completely destroyed but replaced within a reasonable amount of time, rehabilitation tax credit property would be subject to full recapture. Partially damaged property would not trigger recapture if the owner makes the necessary repairs and places the property back in service. If historic property in which the rehabilitation tax credit was claimed is destroyed and it is beyond the recapture period (five years from when building was placed in service), no recapture of rehabilitation credit would be required.