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How to utilize the federal rehabilitation tax credit (RTC) for your older building

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Are you considering rehabilitating an older building? Current federal tax law provides incentives for preserving, renovating, or reconstructing older buildings in the form of the rehabilitation tax credit (RTC). The RTC can provide you with a dollar-for-dollar tax credit against federal taxes owed. This is a per project credit based on a fixed percentage of the rehabilitation costs. The availability of the RTC can help subsidize the cost of any rehab whether the credits are used by the developer or used to help lure equity investors.

To qualify for the RTC, the building must qualify as a qualified rehabilitated building (QRB). A QRB is a certified historic structure or a pre-1936 building on which depreciation is allowable, has been substantially rehabilitated, and was placed in service prior to the beginning of the rehabilitation. A certified historic structure is defined as a building which is either listed in the National Register or located in a registered historic district that is certified by the Secretary of the Interior or under a statute of the appropriate state or local government. It should be noted that if the QRB is a pre-1936 building but not a certified historic structure, 50% or more of the existing external walls must be retained in place as external walls, 75% or more of the existing external walls must be retained in place as internal or external walls, and 75% or more of the existing internal structural framework must be retained in place during the rehabilitation process.

A building is considered to be substantially rehabilitated if the qualified rehabilitation expenses ("QRE") incurred materially extend the useful life of the building, significantly upgrade the building's usefulness, or preserve it in a manner which significantly improves its condition or historic value. The QRE's must be more than the greater of $5,000 or the adjusted basis in your building and must be incurred within a 24 month measurement period. A QRE is defined as an expenditure made in connection with the rehabilitation of a QRB that must be capitalized and depreciated using the straight-line method. It does not include acquisition costs, costs to enlarge the building, or cost incurred on tax-exempt use property. Additionally, there are certification requirements for certified historic structures. These certification requirements include certification by the Secretary of the Interior which deems the rehabilitation consistent with the historic character of the property.

If your rehabilitation expenditures meet the above requirements, you will be eligible for a 10% credit if the building is a pre-1936 structure or a 20% credit if the building is a certified historic property. The amount of the credit is calculated by multiplying the applicable percentage by the QRE's. The basis of the building is then reduced by the credit. Typically, the credit is claimed in the year that the QRB is placed in service and is available to a taxpayer with an appropriate ownership interest at the time the building is placed in service. It is important to note that the credit is subject to recapture if the building is disposed of or if a partner disposes of a substantial part of its interest within 5 years of being placed in service. The recapture amount is reduced by 20% for each year the building is held.

The RTC is considered a general business credit that usually cannot offset an AMT liability. However, for tax years beginning in 2010, an eligible small business may use the RTC, related to QRE's incurred for periods after December 31, 2007, to offset an AMT liability. An eligible small business is a sole proprietor, partnership, or a non-publicly traded corporation that meets the $5 million gross receipts test. The RTC is also a passive activity credit that can be limited under the passive activity loss rules. This credit may only offset a passive taxpayer's tax liability to the extent of passive income. However, there are exceptions to the passive activity rules. Passive activities credits that cannot be used are suspended and carried forward.

There are planning opportunities available when there is a limited ability to use the rehabilitation tax credits or a lack of funding for the project. A potential opportunity is to have an equity partner who can use the credits contribute funds into a partnership in return for an allocation of the credit. This is a useful technique to raise capital to fund the rehabilitation.

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