Building Redevelopment 101: Using Tax Credit Financing

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Farrell Building, Camas, WA
Tax Credit Essentials – Powerful Tools in Preserving and Revitalizing Historic Architecture

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Arctic Club Hotel, Seattle
Stephen Day Architecture PLLC focuses on:

- Preservation architecture / law

- Historic properties re-development and partnership structuring

- Design analysis and research related to historic properties redevelopment

- National Register nominations and related tax credit applications

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Colman Automotive Building, Seattle
Tax Credit Segment:

I. Background on the Credits

II. Basic Rules for the Credits

III. Using the Credits – For-Profit and Non-Profit Users

IV. Washington Case Studies

V. Tax Credit Project Checklist

Hotel Carlyle, Spokane
I. BACKGROUND

Tax Credits and tax credit laws can be great tools to use in architectural preservation.

Can produce needed cash equity early in these projects.

Credits can turn marginal projects into feasible projects.

Fox Theater, Spokane
I. BACKGROUND – Legal Foundation for the Credits

Historic Preservation is a “legitimate governmental role” (Penn Central v. New York City), upholding incentive programs in exchange for limits on demolition and alteration of landmarks…

Grand Central Station, New York
NORTHWEST EXAMPLES: ARCTIC CLUB

- Arctic Club Hotel, Seattle
- Approximately $29 million in qualified rehab expenses
- Approximately $5.8 million in tax credits to investors

Arctic Club Hotel, Seattle
Weaver Architects + Stephen Day Architecture
NORTHWEST EXAMPLES: FARRELL BUILDING

- Farrell Building, Camas, WA

- Approximately $675,000 in qualified rehab expenses

- Approximately $135,000 potential in tax credits

Farrell Building, Camas, WA
II. THE HISTORIC TAX CREDIT PROGRAM: BASICS

A. WHAT IS THE PROGRAM?

Actually, TWO PROGRAMS:

• A 10% credit for the rehab of “non-historic” (non-certified) and non-residential structures built before 1936

• A 20% credit for the rehab of “certified historic structures”

Harold Poll Building, Seattle
FEDERAL INVESTMENT TAX CREDITS

20% Federal Tax Credit on Qualified Rehabilitation Expenditures

Example: For $1,000,000 in rehab expenditures a $200,000 credit can be taken.
FEDERAL INVESTMENT TAX CREDIT
WHO DOES WHAT?

STATE HISTORIC PRESERVATION OFFICE
• Technical assistance (consultation)
• Initial contact with property owners
• Reviews Tax Credit Applications

NATIONAL PARK SERVICE
• Technical assistance (publications)
• Administers Tax Credit program
• CERTIFIES National Register listings and Rehabilitations for Tax Credit program
BECOMING A CERTIFIED PROJECT
Complete a 3-part application

Part 1 – Evaluation of Significance

Part 2 – Description of Rehabilitation

Part 3 – Request for Certification of Completed Work
Since 1976 when the program began:

38,700 projects nationwide
$66 Billion Total Rehab Expend.
*$106.1 Billion (adjusted for inflation)

~1,100 projects / year
~$3 billion / year (adjusted for inflation)
Since 1978 when the program began:

260 projects statewide
$974 million Total Rehab Expend.

120 Seattle projects for
$632 million Total Rehab Expend.
FEDERAL INVESTMENT TAX CREDIT
SOCIOECONOMIC IMPACTS

• Jobs created (2.4 million 1976-2012; ~60,000 in 2012)

• Increased property values – reuse vs. blight

• Cumulative Economic Impact = $245.2 billion in output
  • GDP = $121.2 billion – Government, Services, Finance/Ins./Real Estate, Retail, Wholesale, Transp/Utilities, Manufacturing, Construction, Mining, Agriculture
  • Personal income = $89.1 billion

• Cost of program vs. net gain in Federal tax receipts
  • ($20.5 billion in tax credits vs. NET GAIN $25.9 billion in Federal tax receipts)

• Environmental impact – “the greenest building”

• Social impact – maintaining community character / sense of place
FEDERAL INVESTMENT TAX CREDIT
PROJECTS AT A DISADVANTAGE

• Smaller Projects
• In Communities with little or no knowledge of program
• In areas where technical expertise in preservation and craftsmanship is limited
• Those that do not meet Qualified Expenditure Requirements

Addressing Program Shortfalls

• Outreach:
  • CLGs reaching out to property owners and developers
  • Encourages development in smaller communities
• Education:
  • Planned workshops with focus on Eastern and Central Washington
  • Learn from other states
1. The property must be individually listed on the **NATIONAL REGISTER** of Historic Places or be certified as a contributing property in a National Register listed Historic District.
The proposed rehabilitation must meet the Secretary of the Interior’s STANDARDS for the Treatment of Historic Properties.
SECRETARY OF THE INTERIOR’S STANDARDS

3 BASIC PRINCIPLES

1. Repair or replace in-kind
2. Retain historic character
3. Compatible, reversible interventions
FEDERAL INVESTMENT TAX CREDIT
FOUR BASIC REQUIREMENTS

The project must be **SUBSTANTIAL** – meaning the amount spent on the rehab must be at least $5,000 and meet or exceed the IRS definition of the adjusted basis of the building.

*Normally this means the value of the building itself, minus any depreciation and land value.*
FEDERAL INVESTMENT TAX CREDIT
FOUR BASIC REQUIREMENTS

The property must be INCOME PRODUCING, including commercial, office, retail, and rental residential.
The applicant must be an active participant in the development of the project, usually the owner, but often a group of investors forming a limited partnership or corporation.

Cannot be a non-profit or government entity unless a private entity is established (limited partnership, LLC, etc.)
II. BASICS

HOW DO THESE PROJECTS GENERATE CASH?

- Rehab tax credits used by owners or long term lessees of certified historic structures
- Can only be used in limited circumstances by individuals
- Taxable corporations are typical credit users
TYPICAL DEAL STRUCTURE #1

**Member #1**
- Developer/Managing Member LLC
- Receives Development Fees
- Receives 0.01% of the Tax Credits
- Remains in Project

**Member #2**
- Tax Credit Investor, LLC
- Owns 99.99%
- Receives 99.99% of the Tax Credits
- Exits Project After 5+ Years

**Owner, LLC**
- Property Owner
- Leases with Tenants

"Single Entity" Structure

Contribution In Exchange for Tax Credits

Cash
TYPICAL DEAL STRUCTURE #2

Manager, LLC
- Developer/Managing Member
- Receives Development Fees

OWNER, LLC
- Property Owner
- Master Tenant LLC
- Tenant Under a 39+ Year Master Lease
  - $ Cash For Tax Credits
  - $ Rent
- Subleases with Subtenants

Other Members in Owner LLC

Master Tenant LLC
- Master Tenant Manager, LLC
- Master Tenant Member #2
- 0.01% Owner

Tax Credit Investor, LLC
- Master Tenant Member #1
- 99.99% Owner

Master Lease Structure
SIMPLEST STRUCTURE:
OWNER USES THE CREDITS INTERNALLY

OWNER, LLC

Property Owner is the User of the Historic Commercial Building

Owner uses the credits to offset tax liability of Owner’s company

Owner/User Structure
ALLOCATING OR TRANSFERRING CREDIT:

- Tax credits are not freely transferred
- Cannot be allocated without the underlying ownership interest or under a qualifying lease
- User must be an owner or master tenant – credits not “sold” to outside parties
BASICS

HOW LONG MUST TAX CREDIT USER BE IN PROJECT?

• Tax credit user must be owner or lessee for at least the **minimum 5 year** holding period

• Must be owner or lessee **before the rehab is placed in service** – cannot come in later
BASICS

• **TAX CREDIT RECAPTURE**

Can take place if tax credit user sells interest (or master lease is terminated) before end of 5 year holding period

Holley Mason Building, Spokane
III. OPPORTUNITIES IN USING THE CREDITS

THE TAX CREDIT USER

• Typically taxable corporations

• Often local lenders on smaller projects

• Can be individuals, if they are “real estate professionals”...more later

The Hastings Building, Port Townsend, WA
THE TAX CREDIT USER

• T.C. Investor must have an ownership interest in project or be a master tenant under a permitted long-term lease

Lowman Building, Seattle
THE TAX CREDIT USER

• Tax credit investor typ. Pays anywhere between 65-95 cents per $1 dollar of tax credit

• Tax credit “price” varies depending upon size, location, complexity and nature of the project

Seaboard Building, Seattle
THE TAX CREDIT USER

• The tax credits must be allocated within the partnership in the same proportion as profits/losses are allocated

• If 99% of the credits are allocated to an investor, so must 99% of the profits/losses

Seattle Steam New Post Building, Seattle
THE TAX CREDIT USER

• The minority owner is typically the developer and project manager – and the owner with day-to-day control

• The minority owner is paid fees that absorb the great majority of net cash flow
A “put-call” agreement between the partners sets out the terms for buying out the tax credit investor at some point after the minimum 5-year holding period.
THE TAX CREDIT USER

• Tax credits can be used by tenants under a long term lease (39 + years)

• Then: use the “put-call” agreement to buy out the tax credit investor after the 5-year min. holding period

Fox Theatre, Spokane
THE TAX CREDIT USER:

SIGNIFICANT RECENT COURT DECISION

August 2012 Case (3rd Circuit):

“Historic Boardwalk Hall” Case

The Tax Credit Investor MUST have some level of financial risk in the project –

Cannot be totally insulated from the partnership risk

TC Investor must have SOME upside/downside reward/risk

Historic Boardwalk Hall, Atlantic City
THE TAX CREDIT USER

CHANGES IN THE TAX CODE WITH THE “STIMULUS ACT”

• Net effect is that more individuals can use the tax credits to reduce their personal income tax

• Increases the pool of potential tax credit investors

Globe Hotel, Spokane
THE TAX CREDIT USER

• ARE YOU A “REAL ESTATE PROFESSIONAL”? YES IF:
  
  • More than half of the personal services you performed during the tax year were performed in real property trades / businesses in which you materially participated AND

  • You performed more than 750 hours of services during the tax year in those real property trades / businesses.

Alaska Building, Seattle
THE TAX CREDIT USER

A “REAL ESTATE PROFESSIONAL” CAN BE A:

- Developer
- Broker
- Contractor
- Property Manager

Again – if you are a qualified real estate professional, you may qualify to personally use the tax credits. Otherwise you need to partner with a qualified investor…

Holley Mason Building, Spokane
OPPORTUNITIES IN USING THE CREDITS:

TAX EXEMPT ENTITIES AS OWNERS/DEVELOPERS

- TAX EXEMPT ENTITIES CANNOT USE THE CREDITS DIRECTLY

- So... tax exempt entity must either co-own the property with taxable entity or long term lease the property to taxable entity

MOHAI (Naval Reserve Building), Seattle
TAX EXEMPT ENTITIES AS OWNERS/DEVELOPERS

• TAX EXEMPT ENTITY CAN BE A CO-OWNER IN A TAXABLE ENTITY

• Tax exempt entity can in this way participate as an owner in a tax credit project

MOHAI (Naval Reserve Building), Seattle
TAX EXEMPT ENTITIES AS OWNERS/DEVELOPERS

- Tax exempt partner will typically own only a small portion of the entity –

- The tax credits must be allocated according to percentage of profit/loss interests

MOHAI (Naval Reserve Building), Seattle
• Tax exempt entity cannot own the property before rehab, then immediately lease back to itself after rehab – will result in loss of the credits

The New Central, Chinatown, Seattle
“Disqualified leases” include leases to tax exempt entities that are:

- Longer than 20 years
- Contain extension options with predetermined price (ok if “at market price”)
TAX EXEMPT ENTITIES AND “DISQUALIFIED LEASES”

• “Disqualified leases” also include leases to tax exempt entities that:
  • Include an option to purchase at a set price
  • Involve development financed with tax-exempt financing, under some circumstances

Holley Mason Building, Spokane
A project can still fully utilize the tax credits even if up to 50% of the space is leased under “disqualified leases”

Spokane Dry Goods Company Building, Spokane
FINDING THE RIGHT TAX CREDIT INVESTOR

- Different projects will attract different investors
- Some national groups will be interested only in larger projects
- Other investors are open to small projects, but usually pay less per credit

Bostwick Building, Tacoma
SECURITIES REGULATIONS AND INVESTORS

- Pay attention to securities law requirements
- Soliciting investors in your projects will typically bring up securities issues
- There are limited exemptions to filing - but need to be aware of these

Colman Automotive Building, Seattle
POTENTIAL PITFALLS
Common Fails

• Proceeding with work before Part 2 approved

• Refusing to negotiate project changes in response to SHPO and NPS guidance and conditions

• Assuming local review / approval = certification of rehabilitation for tax credits
LEADING CAUSES OF DENIAL
Step One is Admitting You Have a Problem

- Insufficient pre-rehab photographic documentation
- Completing work that does not meet the Standards before contacting the SHPO or beginning the application process
- Program that is too intense for building and site
- Substantial interior demolition

Project denied for incompatible work completed prior to Part 2 review.
CODE RELIEF for HISTORIC BUILDINGS
ADA / ACCESSIBILITY

ADAAG (ADA ACCESSIBILITY GUIDELINES)
§4.1.7 Accessible Buildings: Historic Preservation
CODE RELIEF for HISTORIC BUILDINGS

ADA / Accessibility: Elevators

ADAAG 2004

§206.2.3 Multi-story buildings and facilities
CODE RELIEF for HISTORIC BUILDINGS
WA STATE ENERGY CODE (2013)

Chapter 51-11C WAC
§C101.4.2 Historic Buildings
CODE RELIEF for HISTORIC BUILDINGS
INTERNATIONAL EXISTING BUILDING CODE

IEBC 2012
Chapter 12: Historic Buildings; equivalency
Provide sprinklers in open areas or for materials not meeting fire rating requirements.
CODE RELIEF for HISTORIC BUILDINGS
IEBC: Archaic Materials, Fire Ratings

IEBC Resource A, Chapter 12 Historic Buildings
§1203.5 Interior Finishes
CODE RELIEF for HISTORIC BUILDINGS
INTERNATIONAL BUILDING CODE

IBC 2012 | Chapter 34: Historic Buildings; compliance alternatives, no distinct life safety hazard
Clarksdale, Mississippi – a main street town focusing on its place in the history of American music and literature to draw visitors and new residents.
“MAIN STREET” CASE STUDIES: THE “FIVE & DIME”

• FW WOOLWORTH BUILDING converted to restaurant and small hotel

• Approximately $1.3 million in qualified rehab expenses

• $260,000 in federal tax credits to investors in single entity structure

The Five & Dime, Clarksdale, Mississippi
“MAIN STREET” CASE STUDIES: THE “FIVE & DIME”

The Five & Dime (Former Woolworth’s, Clarksdale, Mississippi)
“MAIN STREET” CASE STUDIES: THE “FIVE & DIME”

Five & Dime Hotel/Lofts, Clarksdale, Mississippi
CASE STUDIES: SHANKERMAN’S BUILDING, Clarksdale, Mississippi

- Rehab and conversion of upper floor of this historic shop to residential use
- The first of several new projects in Clarksdale that feature residences above commercial storefronts

Shankerman’s alley facade, prior to rehab of historic building
“MAIN STREET” CASE STUDIES: SHANKERMAN’S

Shankerman’s, Clarksdale Mississippi

• Approximately $300,000 in qualified rehab expenses

• $60,000 in federal tax credits to investors in single entity structure
OPPORTUNITIES FOR SMALLER TAX CREDIT PROJECTS

1. Look for local banks as tax credit investors and lenders on same project

2. Look for ways to minimize consultant costs (local professionals? Any pro bono help possible?)

3. If your building is already a contributing building in a historic district, will simplify the NPS Parts 1, 2 applications

4. Look for local partners (or long term tenants) who can use the tax credits internally
V. HISTORIC TAX CREDIT BASIC CHECKLIST

1. Is the building on the National Register or a contributing building in an NR listed historic district?

2. If not, does the building have the potential to be listed on National Register?

3. Will there be substantial rehab costs? Are rehab costs in excess of adjusted basis (basically = cost of building - minus land, plus improvements made since purchase)

4. Is the new plan compatible with re-use of significant historic elements?
V. BASIC HISTORIC TAX CREDIT BASIC CHECKLIST

5. Does the new plan require alterations (or users) that could jeopardize approvals?

6. Does the project schedule allow time for SHPO/NPS review and approvals?

7. Will tax credit investors be invested in the project by the time the renovated building is placed in service?

8. Experienced professionals on the team?
V. HISTORIC TAX CREDIT BASIC CHECKLIST

9. Is the lender involved early on in the project?

10. State tax credits available?

11. Property tax abatement available?

12. Are New Markets Tax Credits (or) Low Income Housing Tax Credits possible for the project?
Missed Opportunities?
Financial Incentives in Walla Walla
Missed Opportunities?
Financial Incentives in Walla Walla

260 projects statewide
$974 million Total Rehab Expend.

3 Walla Walla projects for
$1.8 million Total Rehab Expend.

0.2% of total rehab expenditures
Missed Opportunities?
Financial Incentives in Walla Walla
Missed Opportunities?
Financial Incentives in Walla Walla

Walla Walla County Assessor Parcel Search
Missed Opportunities?
Financial Incentives in Walla Walla

Since 2001 in downtown Walla Walla:

18 projects potentially eligible for Tax Credits
$4,175,590 unclaimed rehab expenditures

6 additional projects potentially eligible for Special Valuation
$1,388,000 additional unclaimed rehab expenditures

24 total projects
$5,563,590 missed opportunity

*$231,816 per project
You Can Make Great Tax Credit Projects Happen.

Questions?

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