



COMMONWEALTH of VIRGINIA

Department of Historic Resources

2801 Kensington Avenue, Richmond, Virginia 23221

REHABILITATION TAX CREDITS: FREQUENTLY ASKED QUESTIONS

The preservation of historic buildings benefits communities. Historic places connect us to our heritage and enrich the quality of our lives in countless intangible ways, but their preservation also provides demonstrable economic benefits. Through the federal and state Rehabilitation Tax Credit programs, property owners are given substantial incentives for private investment in preservation, resulting in enormous advantages to the public. Since the federal program's inception in 1976, over 1,400 deteriorated historically significant buildings in Virginia have been returned to productive service, representing a private investment of over \$1 billion. The state program was initiated in 1997 and has already generated over \$181 million of economic activity independent of the federal program. This money represents costs paid into the construction industry: architects, contractors, craftsmen, and suppliers, with a corresponding increase in local employment. The capital improvement to the buildings results in dramatic increases in local property taxes, as well as a general enhancement in commercial activity. The rehabilitated buildings provide desperately needed housing (in many cases, low- and moderate-income housing), and office, retail, and other commercial space. The communities benefit from property improvement, blight removal, and increased occupancy of buildings in historic core neighborhoods.

This guide describes the state and the federal Rehabilitation Tax Credit programs. Both programs are administered in Virginia through the Virginia Department of Historic Resources.

The state tax credits are available for owner-occupied, as well as income-producing, buildings. If your property is income-producing you may also be able to take advantage of the federal tax credits. Please read through this guide carefully for an overview of the programs. Additional information and assistance with projects may be requested from the Richmond office or from the regional office in your area:

Richmond Office:
(804) 367-2323
2801 Kensington Avenue
Richmond, VA 23221

Northern Region Office:
(540) 868-7029
5357 Main Street
Stephens City, VA 22655

Western Region Office:
(540) 387-5443
962 Kime Lane
Salem, VA 24153

What are the Rehabilitation Tax Credits?

The Rehabilitation Tax Credits are dollar-for-dollar reductions in income tax liability for taxpayers who rehabilitate historic buildings. Credits are available from both the federal government and the State of Virginia.

The amount of the credit is based on total rehabilitation costs. The federal credit is 20% of eligible rehabilitation expenses. The state credit is 25% of eligible rehabilitation expenses. In some cases, taxpayers can qualify under both programs, allowing them to claim credits of 45% of their eligible rehabilitation expenses.

What buildings qualify for the tax credit program?

The credits described above are available only for Certified Historic Structures, which are defined as follows:

Under the federal program, a certified historic structure is one that is either:

- Individually listed on the National Register of Historic Places, or
- Certified as contributing to a district that is so listed.

Under the state program, a certified historic structure is one that is:

- Individually listed on the Virginia Landmarks Register, or
- Certified as eligible for listing, or
- Certified as a contributing structure in a district that is so listed.

With a few exceptions, most Virginia properties that are listed on one of these registers are listed on both. Note, however, that National and Virginia Register historic districts may be different from locally designated historic districts. Certification that a building contributes to a listed district, or for purposes of the state credit, is eligible for individual listing, is obtained only by submitting Part 1 of the tax credit application.

What work qualifies for the credits?

The rehabilitation work for the entire project must meet *The Secretary of the Interior's Standards for Rehabilitation*. If the project does not meet these standards, no part of the credit may be claimed. If the work is certified as meeting these standards, the credit is based on all eligible expenses.

Technically speaking, eligible expenses include any work that is properly chargeable to a building's capital account in connection with a certified rehabilitation. Essentially, this means that all work done to structural components of the building will be eligible, as well as certain soft costs such as architectural and engineering fees, construction period interest and taxes, construction management costs, and reasonable developer fees. Expenses related to new heating, plumbing and electrical systems are eligible, as well as expenses related to updating kitchens and bathrooms, compliance with ADA, and fire suppression systems and fire escapes. Acquisition costs, however, and any expenses attributable to additions or enlargements of the building, are not eligible. Under the federal program, site work and landscaping elements are not eligible expenses. Under the state program, certain site work may be eligible.

How much money do I have to spend?

Under the federal program, the project must be a "substantial rehabilitation" to qualify the investor for the credit. The Internal Revenue Service defines "substantial" as exceeding the owner's adjusted basis in the building, or \$5000, whichever is greater. The adjusted basis is generally defined as the purchase price, minus the value of the land, minus any depreciation already claimed, plus the value of any earlier capital improvements.

The threshold requirements for the state program are different from the federal requirements. In order to qualify for the state credit, the rehabilitation expenses must be:

- For owner-occupied structures, at least 25% of the assessed value of the buildings for local real estate tax purposes for the year before the rehabilitation work began.
- For all other eligible structures, at least 50% of the assessed value of the buildings for local real estate tax purposes for the year before the rehabilitation work began.

How long do I have to complete the rehabilitation?

The rehabilitation does not have to be completed within any particular period of time. However, the “substantial rehabilitation” test (for the federal program) and the “material rehabilitation” test (for the state program) must be met within a consecutive 24-month period that ends some time during the year in which the credits are claimed. Essentially, this means that for most projects the greatest expenditures must be made within a 2-year period. For phased projects, the time limit is extended to 60 months.

My project has taken longer than I expected, and although I have spent more than my adjusted basis in the building, I have not spent it within a 24-month period. Can I decide to phase my project in order to take advantage of the 60-month measuring period?

No. In order to use the 60-month measuring period for a phased project, the taxpayer must phase the project from the beginning. This means that a phasing plan, showing what work will be completed during each phase of the project, must be submitted before work begins. For some projects, it may be a good idea to submit a phasing plan at the start of the project, even if there is a possibility the project can be completed within two years. This will “hold open” the 60-month time period, but does not obligate the taxpayer to take that long to complete the project.

If my building is in a historic district that is not yet listed, can I start my rehabilitation anyway?

Yes, but you do so at the risk that for some reason the district will not be listed. Generally speaking, it is a good idea to wait until the listing process is at least well underway and appears to be on track before doing any substantial work. You will not be eligible to claim the credit until the district is actually listed. If you complete your project before the district is listed, you will not be able to claim the credit at all unless the listing is completed within a year after your completion date.

When can I claim the credit?

The credit is claimed in the year the rehabilitation is completed. If you cannot use up the full amount of the credit in the first year, it can be carried forward. The federal credit may be carried forward for up to twenty years, and back for one year. The state credit may be carried forward for up to ten years. There is no carryback for the state credit.

Can I sell the building after I complete the rehabilitation?

Under the federal program, if the building is disposed of, or if it loses its income-producing status, within five years after the rehabilitation is completed, the taxpayer will face recapture of the credit. The amount of recapture is reduced by 20% in each succeeding year after the year the rehabilitation is completed – in other words, if the building is sold after one year, there will be recapture of 80% of the credit, if it is sold after two years, there will be recapture of 60% of the credit, and so forth. In addition, the National Park Service reserves the right to inspect a rehabilitated property any

time during the five-year period, and to revoke certification if work was not undertaken as presented in the application, or if further unapproved alterations have been made.

Under the state program there is no continuing ownership requirement following completion of the rehabilitation.

Can I sell the tax credits?

Technically speaking, no. Credits may be syndicated through the use of limited partnerships, but they may not be directly sold. Syndication is a common tool for bringing investors into a rehabilitation project, but must be carefully thought out at the beginning of the project. Federal credits must be allocated according to percentage of ownership. The state credit, however, may be allocated by agreement among partners.

How can a nonprofit organization take advantage of the tax credits?

By taking on taxpayers under a limited partnership arrangement and maintaining a minority ownership interest as a general partner, many nonprofit organizations have been able to use the tax credits to their advantage.

How do I apply for the credit?

Applying for the credit is a three-part process. Part 1 requests certification that the building is historic – i.e. eligible for the program. For properties that are individually listed, Part 1 is not necessary. For all other properties – i.e. those seeking certification that they are contributing structures in a listed historic district or individually eligible for listing – a Part 1 is required. Photographs showing the property in its pre-rehabilitation state must be submitted with Part 1.

Part 2 requests certification that the proposed rehabilitation work appears to be consistent with the Secretary's Standards. Part 2 is the most complex part of the application. It requires a description of each significant architectural feature of the property and how it will be treated in the rehabilitation. Many property owners choose to complete Part 2 themselves using the Department's **Sample Rehabilitation Proposal** as a guide. Others hire a professional consultant to assist them. A list of consultants is available from the Department upon request. Additional photographs of the property are sometimes necessary to document Part 2.

Part 3 requests certification that the completed work is consistent with the Secretary's Standards. Photographs showing the completed work must accompany Part 3.

All completed projects must have an independent CPA review the expenses incurred by the specific project. Projects below \$500,000 should follow the "Agreed-Upon Procedures Report" example; projects with rehabilitation expenses of \$500,000 or greater should follow the "Illustrative Audit Report" example. This should be submitted with the Part 3 application.

What are the standards for photographic documentation for the application?

The size and clarity of the photographic images must adequately document the before and after conditions of the building. 24 to 36 photographs are generally sufficient for the average project. However, it is better to have more photographs than to have too few. Conventional 35mm color photographs are preferred. Although the popularity of digital photographs has increased, they generally fail to provide adequate resolution of details that are an important source of information. If photographs are judged to be insufficient, the reviewer may place your application on hold and request additional photographs, which could delay your project's progress.

As noted in the application, photographs must be labeled with the following information: building name and/or address, view (e.g., north side), and description (e.g., plaster damage in dining room, north wall). Photographs must be numbered and keyed to the description of proposed work.

What should I photograph?

For most buildings, the following features should be photographed in order to allow for proper evaluation:

- Site and surrounding environment. Streetscape photographs are recommended for urban buildings.
- All exterior elevations. Where elevations are partially blocked by adjacent buildings or trees, it may be necessary to take several photographs from different angles to show the whole elevation.
- Typical exterior features: siding, window sash, foundations, roofing, shutters.
- Details of deteriorated exterior features: peeling paint, failed mortar joints, deteriorated sash.
- Exterior areas where major rehabilitation work is proposed.
- Outbuildings: garages, barns, dependencies.
- Major interior spaces: hallways, stairways, parlors, and principle rooms. Wide-angle photographs are strongly recommended.
- Typical interior spaces, including all areas to be affected by the rehabilitation.
- Major interior features: staircases, mantelpieces, woodwork, etc.
- Representative interior finishes: peeling paint, failed plaster, rotten woodwork, previously altered features.
- Interior areas where major rehabilitation work is proposed.

I began rehabilitating a historic building last year, but I have just learned about this program. Can I still qualify for the credits?

Possibly. It is much more difficult to qualify for the credits if you don't submit Parts 1 and 2 before beginning work, but in some cases it may be possible. You must have good photographs showing the building before the rehabilitation work began, as described in the preceding question. If you do not have this documentation, you probably cannot qualify for the credits. Additionally, the work which you have already completed must meet the *Secretary's Standards*.

If you have already completed your rehabilitation work, and your building is not individually listed on the National Register, you cannot qualify for the federal credit. The IRS has taken a strong position that if the Part 1 has not been submitted before the building is placed in service, it is not a certified historic building and the credit is not available. Failure to submit the Part 1 before completing work is not necessarily fatal to the state credit, provided that all other requirements of the program are met. However, the deadline for application for the state credit is one year after your completion date. You *must* submit a complete, fully documented application by this date in order to qualify for the state credit.

How do I claim the credit?

The federal credit is claimed on IRS Form 3468. The IRS requires information related to the substantial rehabilitation test and a copy of the certification of the completed work by the Secretary of the Interior. To claim the state credit, the taxpayer must complete the state Schedule CR and attach a copy of the certification of the completed work by the Department of Historic Resources.

What is the 10% credit?

The federal government allows a 10% rehabilitation tax credit for buildings which were constructed before 1936, but are not certified historic structures. If the building is listed on the National Register it is automatically a certified historic structure, and is not eligible for the 10% credit. If it is located within a listed historic district, it is eligible for the 10% credit only if it is certified (through the submission of a Part 1) as *not* contributing to the district. The building must also meet the following conditions:

- Is used for non-residential rental purposes;
- Has not been physically moved; and
- Meets the external and internal wall retention tests set forth under federal regulations.

Property owners are not required to follow the Secretary's Standards in order to claim the 10% credit.

There is no corresponding state credit for rehabilitation of buildings that are not certified historic structures.

Where can I find the regulations governing these programs?

The federal regulations governing the National Park Service's review of tax credit applications are found at *36 CFR 67*. The regulations governing the use of the tax credit itself (the IRS regulations) are found at *26 CFR 1.48-12*.

The Virginia legislation authorizing the state tax credit is found at *Va. Code. §§10.1-2202 and 58.1-339.2* of the Code of Virginia. The regulations for the state program are final as of February 10th, 2016.

How can I get additional information?

For additional information on the federal program, check out the National Park Service's website at www.cr.nps.gov/helpyou.htm#tax, or its IRS Connection at <http://www2.cr.nps.gov/tps/tax/IRS.htm>.

For additional information about the state tax credit program, check out the Department's website at www.dhr.virginia.gov. To speak to a representative or to make an appointment please call (804) 367-2323.