FINANCING FOCUS

Taking Credit

Historic preservation tax incentives offer capital solutions.

by Warren Kirshenbaum

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In the current economic climate, creative thinking is critical when it comes to securing the financing needed to purchase or rehabilitate real estate. With underwriting standards still extremely tight, banks remain less likely to lend, and when they do, loan-to-value ratios are low and collateral requirements are high. This continues to be a major challenge for some businesses.

In addition, in some highly developed metropolitan areas, it can be difficult to find properties that are financially feasible. However, urban centers that were developed historically as port cities, trading outposts, or early industrialized sites are often rife with turn-of-the-century structures that are well-suited for conversion into apartments, offices, and restaurant spaces.

But adapting a building to modern usage while preserving and restoring its historic character can be daunting — and expensive. Without the support of historic rehabilitation tax credits, the risk involved would not be worth it for investors and owners.

Tax Credit Calculations

Properties listed on the National Register of Historic Places, located within historic districts, or those that can be listed on the National Register are eligible for the historic tax credit at both the state and federal levels. The property's rehabilitation must meet certain standards that are designated by the National Park Service to maintain the building's historic character.

Property owners can use these tax credits to offset federal and state tax liabilities, or they can "sell" the tax credits and use the capital to offset rehabilitation costs. (Although federal historic tax credits are issued to the property owner and are non-transferable, a tax credit investor can be admitted to the property ownership in exchange for a capital contribution in a transaction that has "economic substance" as defined by the Internal Revenue Service.) Add to this the intrinsic value of a historic property — including desirable location and positive sentiment associated with revitalizing a piece of a neighborhood's history — and historic preservation becomes worth a second look.

In fact, developers can use historic tax credits as a financing tool. For example, a historic building costs $200,000 to buy and another $800,000 in qualified rehabilitation expenses. The historic tax credit amounts to 20 percent of the QREs on both the state and federal levels, which would be $320,000 in this example. A developer may monetize the federal tax credits and receive a term sheet for the purchase of the state tax credit, thereby raising actual capital (in tranches as construction progresses) for the federal tax credit. This could add $137,600 in construction capital and $275,200 in net monetization proceeds.

In a situation where the bank is only offering a loan of 60 percent of the cost of the purchase price and QREs, or $600,000, there would be a $400,000 equity requirement to fund the transaction. As mentioned above, the historic tax credit would cover $275,200 (after factoring in transaction costs) of the equity required, leaving slightly less than a $125,000 equity requirement, which is 12.5 percent of the purchase price and QREs.

Banks financing commercial real estate transactions traditionally require a 20 percent equity contribution by the borrower. By requiring less than the average equity requirement of 20 percent, historic tax credits make such transactions possible. As a result, the historic tax credit program has been one of the nation's most successful and cost-effective community revitalization programs to date.

Boston Example

As developers, owners, and managers look to fill gaps in project funding, state and federal tax credits can make or break the feasibility of resurrecting desired buildings with significant community value. As shown above, these credits on the state and federal level, together with accelerated depreciation, can combine to offset as much as 45 percent (on a gross basis) of a construction project's budget. Note that with transaction costs, which include the tax credit investor's purchase discount, the net capital generated may be in the 33 percent range.

The Fort Point Channel area in South Boston is a good example of an area benefiting from the historic tax credit. This urban area is comprised of several buildings that were owned by the Boston Wharf Co., and previously had been used as warehouse space and for other port and trade-related uses much more prevalent in the early 20th century. Now, these historically significant buildings are being adapted for use as residential apartments, storefronts, restaurants, and office space. Similarly, many other metropolitan areas offer historically valuable buildings in prime locations in need of varying levels of attention.

Submission Details

To start the process, the property owner applies to the state historical commission for both federal and state tax credits. In some states, an approved request on the state level is distributed via a competitive allocation process, wherein an owner can request an allocation of the total amount at various points throughout the year. In this scenario, owners may find themselves going back to the state several times as more funding is needed and approved.

The process of applying for and securing historic tax credits typically requires a development team including a lawyer, a consultant, and a syndicator. Seeking out information about this process before the project commences allows for the potential tax credit equity to be built into a proposed budget or development pro forma, which can lead to even greater control over financing costs.

Tax incentives such as the historic tax credit manage some of the inherent challenges in preserving a historic building, as well as providing solutions to potential financing conundrums.

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