MSSP

Market Segment Specialization Program

Rehabilitation Tax Credit

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Rehabilitation Tax Credit

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Chapter 1

INTRODUCTION

GENERAL BACKGROUND

Prior to 1976, there existed no tax incentive to rehabilitate or preserve historic buildings. The Tax Reform Act of 1976 added IRC section 191 which permitted taxpayers to amortize over a 60-month period certain expenditures to rehabilitate property listed in the National Register of Historic Places or property located in Registered Historic Districts and certified as significant to the district.

The 60-month amortization period was enhanced to a 10 percent rehabilitation tax credit in 1978. In 1981, Congress expanded the rehabilitation tax credit to a three-tier credit; a 25 percent credit for "historic rehabilitations," a non-historic rehabilitation credit of 20 percent for buildings at least 40 years old, and a 15 percent credit for buildings at least 30 years old.

The rehabilitation tax credit survived the Tax Reform Act of 1986, but imposed several constraints that made the rehabilitation tax credit less attractive to individual real estate investors. The credit was retained as a two-tier credit with a 20 percent credit available for historical buildings and a 10 percent credit for non-historic buildings which were first placed in service before 1936.

The Historic Preservation Tax Incentives Program, jointly administered by the National Park Service and the State Historic Preservation Offices, is the nation's most effective Federal program to promote urban and rural revitalization and to encourage private investment in rehabilitating historic buildings. The tax credit applies specifically to preserving income-producing historic property and has generated billions of dollars in historic preservation activity since its inception in 1976. Its tremendous effects are evident in not only the major cities in the United States, but also in many small towns and communities throughout the country. The completed projects have brought renewed life to deteriorated business and residential districts, created new jobs and new housing units, increased local and state revenues, and helped ensure the long-term preservation of irreplaceable cultural resources.

LEGISLATIVE HISTORY

Before 1976, there were no incentives for restoring or rehabilitating older buildings in our Nation's tax laws. Prior law actually encouraged the destruction of these buildings by allowing deductions related to their demolition. In addition, the erection of newer buildings in their place benefited from quicker depreciation methods.

The year 1976 was the first year that Congress endeavored to shape public policy regarding the preservation and rehabilitation of older buildings through our Nation's tax laws. The Tax Reform Act of 1976 made four major law changes regarding the treatment of deductions in reference to older buildings. These law changes became a foundation for the current tax provisions regarding rehabilitation.

1. A provision to allow a 5-year amortization of rehabilitation expenditures. (Costs except land and original shell.)

2. Alternative to the above which allowed for accelerated method of depreciation to be used on both the shell and rehabilitation costs.

3. A provision which allowed only a straight-line method of depreciation on any new building constructed where an older building had been demolished.

4. A prohibition against any deduction or recognition for tax purposes of any costs for demolition or site clearing and no deduction for the purchase price of the property, (building before demolition).

The next tax change, the Revenue Act of 1978, brought about an additional incentive in the form of a tax credit. This tax credit, at a rate of 10 percent, was available in place of the 5-year amortization from the 1976 Tax Reform Act. Congress believed that a credit at a rate of 10 percent, similar to the Investment Tax Credit, would be more attractive to owners or investors than amortization or depreciation deductions.

In 1981, the Economic Reform Tax Act brought about the most substantial tax credit incentives for rehabilitation to date. In addition to historical buildings, the new law also recognized older non-historical buildings, and allowed credits to rehabilitate buildings at least 30 years old. The credits for rehabilitation were in a three tier system as outlined below:

1. Buildings at least 30 years old were allowed a 15 percent credit for qualifying rehabilitation expenditures.

2. Buildings at least 40 years old were allowed a 20 percent credit for qualifying rehabilitation expenditures.

3. Qualifying rehabilitation expenditures for a "Certified Historic Rehabilitation" were allowed a 25 percent credit.

The next change affecting the rehabilitation provisions came as part of the Tax Reform Act of 1986. This Tax Reform Act was one of the most comprehensive and sweeping changes in our Nation's history. Although many deductions and most credits were eliminated, the Rehabilitation Credit provisions were retained with only minor modifications. The credit is now a two-tier credit as outlined below:

1. A 10 percent credit available for the rehabilitation of non-historic buildings with an additional requirement that the building must have been originally constructed before 1936, or

2. A 20 percent credit available for the rehabilitation of a Certified Historic Structure, (one listed on the National Register of Historic Places or located in a Registered Historic District and determined to be of significance to the Historical District).

The actual law provisions surrounding this two-tier credit, as enacted by the Tax Reform Act of 1986, are very similar to those under prior law. Many of the principles regarding the application of the law and Congressional intent date back to the original law to preserve historical buildings as enacted in 1976.

The most recent change affecting the rehabilitation tax credit was a provision of the Revenue Reconciliation Act of 1990. This change only slightly altered the content of prior provisions by moving the location of the provisions from IRC section 48(g) to IRC section 47.

PASSIVE ACTIVITY RULES

The Tax Reform Act of 1986 introduced "passive activity loss provisions" that were intended to stop "abusive tax shelters" that had plagued our tax system. Although not directly related, these changes materially impacted the availability of the rehabilitation tax credit to certain investors. Because of these changes, some investors are restricted to amount of credit they may claim. Those investors with adjusted gross income over $250,000 may be totally precluded from taking any credit. The effect of these passive activity restrictions has significantly changed the type of individual investor who can benefit from rehabilitation tax credit projects as well as the entity form of ownership.

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REHABILITATION TAX CREDIT CHECK SHEET

Chapter 3	CERTIFIED HISTORIC REHABILITATION CREDIT PRIOR TO TRA 86 - 25 percent TRA 86 CREDIT - 20 percent **Also Note Transition Rules Treas. Reg. § 1.48-12(a) Applicable Law: IRC § 47(a) (2) IRC § 47(c) (2) (B) & (C) IRC § 47(c) (3) Treas. Reg. § 1.48-12(d) Treas. Reg. § 1.48-12(d) (7) (i) Treas. Reg. § 1.48-12(d) (7) (ii) Treas. Reg. § 1.48-12(d) (2) to (6) Anderson Case Dennis Case Girgis Case *Prior to 1991: IRC § 48(g) contains similar provisions	Two certifications are necessary: Certification of the Structure Must be a "Certified Structure" or located in a historical district and contribute to the significance of the district. This is only a prerequisite to potentially qualify for the rehabilitation credit as outlined below. Certification of the Rehabilitation Additionally, the rehabilitation must be a "Certified Rehabilitation" as certified by the Dept. of Interior/National Park Service. Must have an approved Part III certification from the NPS. Note, review of the Parts I, II and III applications along with the project folder at the National Park Service can be helpful to develop and support many issues. NOTE: If a project lacks certification from the NPS, the credit should be disallowed in the year taken. Also note that a position has been developed that can be used on cases lacking certification even if the 3 year statute is barred. This position will be supported by Chief Counsel. See Chapter 3.
Chapter 4	NON-HISTORIC CREDIT Prior to TRA 86 - 20 percent CREDIT (40 YR BLDG) 15 percent CREDIT (30 YR BLDG) TRA 86 - 10 percent CREDIT ** Also Note Transition Rules Treas. Reg § 1.48-12 (a) Applicable Law: IRC § 47 (a) (1) IRC § 47(c) (1) IRC § 47(c) (2) (B) & (C) Treas. Reg. § 1.48-12(d) (1) to (6) Treas. Reg. § 1.48-12(c) (7) (iv) Treas. Reg. § 1.48-12(b) (3) to (5) Bailey Case Depot Investors Case Girgis Case Nalle Case *Prior to 1991: IRC § 48(g) contains similar provisions.	Prior to TRA 86, Non-historic Credits were as follows: For 20 percent credit, Must be 40 year old bldg. For 15 percent credit, Must be 30 year old bldg. Non-historic credit after TRA 86 changes: Under TRA 86 the building must have been originally built before 1936. Certification by the Dept. of the Interior is not required. NOTE: If the property is in a certified historic district, then it must receive DECERTIFICATION from the Dept. of the Interior that the building is not of significance to the district. If NO decertification, then no credit is allowable. Also, Non-historic credits may not be taken for buildings separately listed on the National Register. Decertification was required both before and after TRA 86. Treas. Reg. § 1.48-12(c) (7) (iv). NOTE: Non-historic credits are not available for buildings which are residential rental. NOTE: Wall retention requirements apply to non-historic rehabs after TRA 86 and all rehabs prior to TRA 86.

Chapter 5	PLACED IN SERVICE **Applies both before and after TRA 86 Applicable Law: IRC § 47(b) Treas. Reg. § 1.48-12(f) (2) Treas. Reg. § 1.48-12(c) (6) Girgis Case	The rehab credit for qualified rehab expenditures is generally allowed in the taxable year in which the property is placed in service. NOTE: The concept of "Placed in Service" can relate to either the entire building or a portion of the building which is completed and available for rent or its respective income producing activity.
Chapter 6	SUBSTANTIAL REHABILITATION **Applies both before and after TRA 86 Applicable Law: IRC § 47(c) (1) Treas. Reg. § 1.48-12(b) (1) & (2) Alexander Case ** Also note section regarding multiple buildings ("Site").	In addition to receiving certification, projects must meet a substantial rehabilitation test in order to qualify for the credit. The qualified rehabilitation expenditures during the 24 month period selected by the taxpayer must exceed the greater of $5,000 or the adjusted basis of the property determined at the beginning of such 24 month period. NOTE: Special 60 month rule (if phased rehab) must be part of architects plans, etc., IRC § 47(c) (1)(c)(ii) & Treas. Reg. § 1.48-12(b) (1). NOTE: Congress' intent was that a substantial amount of work was done and not just cosmetics. The test is intended to quantify "substantial". This is one of the most confusing areas of Rehab Law.
Chapter 7	BASIS REDUCTION ** Applies both before and after TRA 86 but at different percent's. Applicable Law: Treas. Reg. § 1.48-12(e)	Basis reduction required: After TRA 86: The basis of the rehab expenditures must be reduced by 100 percent of the credit as taken. Before TRA 86: The basis of the rehab expenditures must be reduced by 50 percent of the credit as taken. For Non-historic projects, the basis reduction was increased to 100 percent for projects started after 1985.
Chapter 8	STRAIGHT LINE COST RECOVERY **Required both before and after TRA 86. Applicable Law: IRC § 47(c) (2) (B) (I) Treas. Reg. § 1.48-12(c) (7) (I) Au Case DeMarco Case Manning Case	Straight Line Cost Recovery Required: Before TRA 86: -Incurred after 12/31/81: 15 yrs. S/L -Incurred after 03/15/84: 18 yrs. S/L -Incurred after 05/08/85: 19 yrs S/L After TRA 86: (MACRS-Methods) -Incurred after 12/31/86 Residential - 27.5 Yrs. Non-Residential - 31.5 Yrs. -Incurred after 5/12/93: Residential = 27.5, Non-Residential = 39 Under the rehab provisions, there is a requirement that a straight-line method of depreciation be used.

Chapter 9	CREDIT RECAPTURE ** Required both before and after TRA 86 Applicable Law: IRC § 50 (a) Treas. Reg. § 1.48-12(f) (3) Rome Case *Prior to Rev Rec of 90 IRC § 47(a) contains similar provisions.	If there is a disposition or if the property ceases to be ITC property before the close of the recapture period of 5 years, there is a recapture of the credit amounting to 20 percent of the credit taken for each year less than 5 full years. NOTE: Although the credit is fully allowed in a given year, as long as the property had been placed in service by year end, the credit recapture is based on a "Full Year" concept. It is necessary to determine the actual date placed in service in order to compute the recapture.
Chapter 10	ACQUISITION COSTS EXCLUDED ** Both before and after TRA 86. Applicable Law: IRC § 47(c) (2)(B)(ii) Treas. Reg. § 1.48-12(c)(7)(ii) Treas. Reg. § 1/48-12(d) (9)	Acquisition costs are specifically excluded from the definition of qualified rehabilitation expenditures. The cost of acquiring any building or interest, therein; pre-rehab cost of acquiring the building or the cost of acquiring a rehabilitation building that had previously been placed in service would not qualify. Acquisition costs are still included in the depreciable basis using the straight method. Also see issue regarding developer's fees and other costs which could potentially be recharacterized for their proper tax treatment.
Chapter 11	ENLARGEMENT EXPENDITURES AND DEMOLITION EXCLUDED ** Both before and after TRA 86. Applicable Law: IRC § 47 (c)(2)(B)(iii) Treas. Reg. § 1.48-12(c)(7)(iii) Treas. Reg. § 1.48-12(d)(10) IRC § 280B - Demolition	Enlargement costs of an existing building are specifically excluded from the definition of qualified rehabilitation expenditures. A building is enlarged to the extent that total volume is increased. Enlargement costs are still includible in the depreciable basis using the straight line method. Enlargement costs should be removed from the credit basis using a reasonable method of allocation. Demolition costs qualify as long as the building remains after the allowable demolition.
Chapter 12	SITEWORK EXPENDITURES EXCLUDED ** Applies both before and after TRA 86. Applicable Law: Treas. Reg. § 1.48-12(c) (5)	Sitework expenditures do not qualify for the credit and should be removed from the credit basis. Sitework includes any expenditures incurred for areas adjacent to or related to the rehabilitated building including sidewalks, paving, landscaping, parking lots, decks, remote site lighting, fencing, railings, ornamental fencing, gazebos, etc.
Chapter 13	SECTION 38/PERSONAL PROPERTY EXCLUDED ** Applies both before and after TRA 86 Applicable Law: IRC § 47(c) (2) (A) IRC § 38 ** See numerous court cases included in this section	Regular IRC § 38 Investment Credit property does not qualify for the rehab credit. Examples are office equipment, furniture, carpeting, drapes, kitchen appliances, cabinets, etc. NOTE: If disallowing or removing Section 38 property from the rehab basis then the straight line recovery election is no longer required for those items. Can allow ACRS, MACRS, etc. The Rehab Credit is only for the building and its structural components. There is sufficient law/cases under the ITC sections to support.

Chapter 14	TAX EXEMPT USE PROPERTY EXCLUDED Applicable Law: IRC § 47(c) (2) (B) (v) Treas. Reg. § 1.48-12(c) (7) (vi) IRC § 168 (h)	Tax exempt use property is specifically excluded from the definition of qualified rehabilitation expenditures. Any expenditures allocated to the portion of the property which is tax exempt use property must be removed from the credit basis. NOTE: There are special rules used to determine what is tax exempt use property
Chapter 15	LESSEE EXPENDITURES ** Applies both before and after TRA 86. IRC § 47(c) (2)(B)(vi) IRC § 168(c) Treas. Reg. § 1.48-12(c)(7)(v) Eubanks Case	Lessees are permitted to qualify their leasehold improvements incurred after 12/31/81 which otherwise qualify as rehab expenditures for the credit as long as the remaining term of the lease (without renewal periods) is less than the recovery period as defined in IRC § 168(c). (27.5 yrs for residential and 39 yrs for non-residential real property). NOTE: Lessees are also subject to the other issues previously mentioned.
Chapter 16	CONSTRUCTION PERIOD INTEREST AND TAXES ** Applies both before and after TRA 86. Applicable Law: IRC § 266 Treas. Reg. § 1.48-12(d)(9)	Election under IRC § 266 for construction period interest and taxes during the actual rehab qualifies for the credit. A statement of the election should be attached to the original return. Be sure to exclude any acquisition related interest from the rehab basis.
Chapter 17	PROGRESS EXPENDITURES Applicable Law: IRC § 47(d) Treas. Reg. § 1.48-12(f) (2) *Prior to Rev Rec of 90 IRC § 46(d) contains similar provisions	Usually, placed in service is the correct timing for taking the credit. An election can also be made to take credit corresponding to progress expenditures incurred during a tax year. It is still necessary to meet the requirements of the substantial rehabilitation test as previously mentioned. There are also special provisions of self-rehabilitated property
Chapter 18	FACADE EASEMENT REDUCTION OF BASIS Applicable Law: Rev. Rul. 89-90 Rev. Rul. 64-205 Treas. Reg. § 1.170A-13(h) (3)(iii) Rome Case Note: Disregard any Letter Rulings to the contrary	Reduction of basis of property retained should be adjusted by the part of the basis allocable to the easement granted. The method of determining the reduction of basis regarding the donation of the easement is to allocate the value of the easement to the shell, land and building and thus to reduce the basis of the rehab expenditures to the extent of disposition via the contribution. NOTE: If the building was rehabilitated and the credit taken prior to contribution of the facade easement then a recapture would be necessary based on the disposition and as calculated according to Section 50(a).

Chapter 19	DEVELOPER FEE/DEVELOPMENT COSTS ** Applies both before and after TRA 86. Applicable Law: ** See Phila. District Developers Fee Brief Carp/Zuckerman Case	Since the inception of the Rehabilitation Credit, "soft costs" such as architectural and engineering fees, consulting fees, site survey fees and "developer's fees" have always been allowable as part of the "Qualified Rehab Basis". As the term "developer's fees" has never been "quantified or qualified", this remains a "gray area" and has been discovered as a major area of abuse for these type cases. Issues addressed include non-allowable developer's profit included in a purchase price, disguised syndication fees, or amortizable costs, and non-arm's length transactions.
Chapter 23	PASSIVE ACTIVITY CREDIT RESTRICTIONS ** Applies after TRA 86. Applicable Law: See Sidell vs. Commissioner IRC § 469 Treas. Reg. § 1.469-1T	If the activity of the project is rental or is a non-rental activity in which the owner/investor does not materially participate, the passive activity rules will set limits on the amount of credit that can be taken. Individuals can offset credit not exceeding $7,000 ($25,000 X 28% tax bracket) against their regular tax liability. The credit is phased out for individuals with income of $200,000 to $250,000.

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Chapter 2

CERTIFICATION PROCESS

The owner of a rehabilitated building can claim a rehabilitation tax credit as long as three conditions are met. The building must have been substantially rehabilitated, it must have been placed in service as a building before the beginning of the rehabilitation work, and must be considered a certified historic structure. The term "certified historic structure" is defined by IRC section 47(c)(3)(A). It is defined as any building (and its structural components) which is either (a) listed in the National Register, or (b) located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

The rehabilitation of a certified historic structure must meet the Department of the Interior's standards for rehabilitation to qualify rehabilitation expenditures for the rehabilitation credit. If the building or site is not separately listed, the owner can apply to the Department of the Interior's National Park Service for an Evaluation of Significance. This is done by filing Historic Preservation Certification Application Part 1 - Evaluation of Significance (Form 10-168). This certification is not needed for the non-historic credit.

Part 1 is used for the following purposes:

To request certification that a building contributes to the significance of a registered historic district.

To request certification that a building or structure, and where appropriate, the land area on which such building or structure is located contributes to the significance of a registered historic district for charitable contribution for conservation purposes.

To request certification that the building does not contribute to the significance of a registered historic district (needed to claim the non-historic rehabilitation credit, see Chapter 4, Non-Historic Credits).

To request a preliminary determination whether an individual listing not yet on the National Register meets the National Register Criteria for Evaluation and will likely be listed in the National Register when nominated.

To request a preliminary determination that a building located within a potential historic district contributes to the significance of the district.

To request a preliminary determination that a building outside the period or area of significance of a registered historic district contributes to the significance of the district.

The application must include a description of the physical appearance of each building, including all major features of the building, a statement of significance, and photographs and maps.

All applications for preliminary determinations must contain all documentation showing that the building, or the district where the building is located, meets the National Register Criteria for Evaluation.

Historic Preservation Certification Application – Part 2 (Description of Evaluation Form 10-168a) - must be completed by all owners of Historic Structures seeking to have rehabilitation certified by the Secretary of the Interior. This form should be completed and submitted prior to the initiation of any rehabilitation work. Proposed work, which does not appear to be consistent with the Department of the Interior's standards, will be identified. The owner will also be advised how to bring the project into conformance with the Standards for Rehabilitation.

The application should include: name of the property; relevant data on existing property; a detailed description of all the rehabilitation work, including all site work, exterior and interior work, and new construction; internal and external "before" photographs; drawing or sketches for plan alterations or new construction; and any other special rehabilitation concerns. Examples of special rehabilitation concerns may include storefront alterations; new heating, ventilation, or air conditioning systems; windows; interior partitions and removing interior plaster; masonry restoration; and new additions and new construction.

Once the rehabilitation work is completed, the owner must then submit a Request for Certification of Completed Work (Form 10-168c). This form is often referred to as Part 3. Part 3 must provide: completion date; signed statement by the owner(s) expressing their opinion that the project meets the standards and it is consistent with the work described in part 2; include costs and photographs of the completed work. In addition, the names and taxpayer identification numbers of all the owners must be provided. The overall project does not become a certified rehabilitation until the Part 3 is completed and approved by the National Park Service, and the building is designated a "Certified Historic Structure."

A Representative of the Interior Department may inspect the completed work to see if it meets the Standards for Rehabilitation. The Secretary of the Interior reserves the right to make inspections at any time, up to 5 years after completion of the rehabilitation, and to withdraw certification. A certification can be withdrawn if it is found that the rehabilitation was not undertaken as presented by the owner in the application and supporting documentation or that the owner made unapproved additional alterations inconsistent with the Standards. Prior to the certification being withdrawn, the owner is given 30 days to comment.

All completed application parts are sent to the State Historic Preservation Office (SHPO). The SHPO will forward the applications to the appropriate National Park Service Regional Office, generally with a recommendation. Parts 1 and 2 of the application will generally be reviewed within 60 days (30 days at the State level and 30 days at the Federal level). The National Park Service will make notification as to

certification in writing. A copy of each notification is provided to the Internal Revenue Service and the SHPO.

A nonrefundable processing fee is charged for review of all Part 2 applications. Final action will not be taken on an application until payment is received.

The final certification of both the structure and the rehabilitation work is not necessary at the time the credit is taken. However, the certification must ultimately be obtained by the building owners/taxpayers.

The certification of the structure and the rehabilitation work should be filed with the return on which the credit was taken (Tax Form 3468 Investment Tax Credit). If the final certification has not been obtained, then Parts 1 and 2 (as filed with the State Historic Preservation Office) should be attached to Form 3468 indicating that the National Park Service or the applicable State Historic Preservation Office received it.

There are additional requirements if a taxpayer does not obtain certification within 30 months of filing the tax return on which the Rehabilitation Tax Credit is claimed (30-Month Rule). (Refer to Chapter 3, Certification Requirements, for detailed explanation.)

Exhibit 2-1 National Park Service, Technical Preservation Services

Exhibit 2-2 is a listing of the State Historic Preservation Offices.

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Exhibit 2-1

NATIONAL PARK SERVICE

Technical Preservation Services

Office Issuing Certifications:

National Park Service
Heritage Preservation Services
1849 C Street N.W. Suite 200
Washington D.C. 20240

Phone Number: 202-343-9578

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STATE HISTORIC PRESERVATION OFFICES

Alabama:	State Historic Preservation Officer Alabama Historical Commission 468 South Perry Street Montgomery, Alabama 36130-0900 334-242-3184
Alaska:	State Historic Preservation Officer Department of Natural Resources Division of Parks and Outdoor Recreation 550 W 7th Avenue, Suite 1310 Anchorage, Alaska 99501-3565 907-269-8715
American Samoa:	Territorial Historic Preservation Officer American Samoa Historic Preservation Office American Samoa Government Pago Pago, American Samoa 96799 684-633-2384
Arizona:	State Historic Preservation Officer Office of Historic Preservation Arizona State Parks 1300 W. Washington Phoenix, Arizona 85007 602-542-4009
Arkansas:	State Historic Preservation Officer Arkansas Historic Preservation Program 1500 Tower Building 323 Center Street Little Rock, Arkansas 72201 501-324-9880

California:	State Historic Preservation Officer Office of Historic Preservation Department of Parks and Recreation P.O. Box 942896 Sacramento, California 94296-0001 916-653-6624
Colorado:	State Historic Preservation Officer Colorado History Museum 1300 Broadway Denver, Colorado 80203-2137 303-866-3355
Connecticut:	State Historic Preservation Officer Connecticut Historical Commission 59 South Prospect Street Hartford, Connecticut 06106 860-566-3005
Delaware:	State Historic Preservation Officer Division of Historical and Cultural Affairs Hall Of Records P.O. Box 1401 Dover, Delaware 19901 302-739-5313
District of Columbia:	State Historic Preservation Officer D.C. Financial and Control Board 941 No. Capitol Street NE Room 2100 Washington, D.C. 20002 202-442-4570
Florida:	State Historic Preservation Officer Division of Historical Resources R.A. Gray Building 500 S. Bronough Street Tallahassee, Florida 32399-0250 850-488-1480

Georgia:	Commissioner Department of Natural Resources 205 Butler Street, SE. Atlanta, Georgia 30334 404-656-3500
Guam:	Acting Historic Preservation Officer Department of Parks and Recreation Division of Historic Resources P.O. Box 2950 Agana Heights, Guam 96910 671-475-6290
Hawaii:	State Historic Preservation Officer Department of Land and Natural Resources 1151 Punchbowl Street Honolulu, Hawaii 96813 808-548-6550
Idaho:	Director State Historic Preservation Office 210 Main Street Boise, Idaho 83702-7264 208-334-3890
Illinois:	State Historic Preservation Officer Illinois Historic Preservation Agency Preservation Services Division One Old State Capitol Plaza Springfield, Illinois 62701 217-785-9045
Indiana:	State Historic Preservation Officer Department of Natural Resources 402 W. Washington Street Room W 274 Indianapolis, Indiana 46204 317-232-4020

Iowa:	State Historic Preservation Officer State Historical Society of Iowa 600 East Locust Street Des Moines, Iowa 50319-0290 515-281-8837
Kansas:	State Historic Preservation Officer Kansas State Historical Society Cultural Resources Division 6425 Southwest 6th Avenue Topeka, Kansas 66615-1099 785-272-8681
Kentucky:	State Historic Preservation Officer Kentucky Heritage Council 300 Washington Street Frankfort, Kentucky 40601 502-564-7005
Louisiana:	State Historic Preservation Officer Office of Cultural Development P.O. Box 44247 Baton Rouge, Louisiana 70804 225-342-8160
Maine:	State Historic Preservation Officer Maine Historic Preservation Commission 55 Capitol Street Station 65 Augusta, Maine 04333-0065 207-287-2132
Mariana Islands:	State Historic Preservation Officer Department of Community and Cultural Affairs Northern Mariana Islands Saipan, Mariana Islands 96950 670-664-2120

Marshall Islands:	State Historic Preservation Officer Republic of the Marshall Islands P.O. Box 1454 Majuro, Marshall Islands 96960 692-625-4642
Maryland:	State Historic Preservation Officer Department of Housing and Community Development Peoples Resource Center 100 Community Place, 3rd floor Crownsville, Maryland 21032-2023 410-514-7600
Massachusetts:	State Historic Preservation Officer Massachusetts Historical Commission Massachusetts Archives Facility 220 Morrissey Boulevard Boston, Massachusetts 02125 617-727-8470
Michigan:	State Historic Preservation Officer Bureau of Michigan History Department of State 717 W. Allegan Lansing, Michigan 48918-0001 517-373-0511
Minnesota:	State Historic Preservation Officer Minnesota Historical Society State Historic Preservation Office 345 Kellogg Boulevard West St. Paul, Minnesota 55102 651-296-2747
Mississippi:	State Historic Preservation Officer Mississippi Department of Archives and History P.O. 571 Jackson, Mississippi 39205 601-359-6850

Missouri:	State Historic Preservation Officer Department of Natural Resources P.O. Box 176 Jefferson City, Missouri 65102 573-751-4732
Montana:	State Historic Preservation Officer Montana Historical Society 1410 8th Avenue P.O. Box 201202 Helena, Montana 59620-1202 406-444-7715
Nebraska:	State Historic Preservation Officer Nebraska State Historical Society 1500 R Street P.O. Box 82554 Lincoln, Nebraska 68501 402-471-4746
Nevada:	State Historic Preservation Officer Department of Museums, Library and Arts 100 No. Stewart Street Capitol Complex Carson City, Nevada 89701-4285 775-684-3440
New Hampshire:	State Historic Preservation Officer Division of Historical Resources P.O. Box 2043 Concord, New Hampshire 03302-2043 603-271-6435
New Jersey:	State Historic Preservation Officer Department of Environmental Protection CN-402 401 East State Street Trenton, New Jersey 08625 609-292-2885

New Mexico:	Acting Director Office of Cultural Affairs Villa Rivera Building, 3rd Floor 228 E. Palace Avenue Santa Fe, New Mexico 87503 505-827-6320
New York:	State Historic Preservation Officer Office of Parks, Recreation and Historic Pres. Empire State Plaza Agency Building 1, 20th Floor Albany, New York 12238 518-474-0443
North Carolina:	State Historic Preservation Officer Department of Cultural Resources Division of Archives and History 4617 Mail Service Center Raleigh, North Carolina 27699-4617 919-733-7305
North Dakota:	State Historic Preservation Officer State Historical Society of North Dakota ND Heritage Center 612 East Boulevard Avenue Bismarck, North Dakota 58505-0830 701-328-2672
Ohio:	State Historic Preservation Officer Ohio Historic Preservation Office Ohio Historical Society 567 E. Hudson Street Columbus, Ohio 43211-1030 614-297-2470
Oklahoma:	State Historic Preservation Officer Oklahoma Historical Society Wiley Post Historical Building 2100 N. Lincoln Boulevard Oklahoma City, Oklahoma 73105 405-521-2491

Oregon:	State Historic Preservation Officer Oregon Parks and Recreation Department 1115 Commercial Street N.E. Salem, Oregon 97310-1001 503-378-5019
Palau:	Historic Preservation Officer Ministry of Social Services Division of Cultural Affairs P.O. Box 100, Government of Palau Koror, Palau 96940 680-488-2489
Pennsylvania:	State Historic Preservation Officer Pennsylvania Historical and Museum Commission P.O. Box 1026 Harrisburg, Pennsylvania 17108-1026 717-787-2891
Pohnpei State F.M.:	Historic Preservation Officer Dept. of Health, Education & Social Affairs FSM National Government P.O. Box PS 70 Palikir, Pohnpei State FM 96941 691-320-2343
Puerto Rico:	State Historic Preservation Officer La Fortaleza P.O. Box 82 San Juan, Puerto Rico 00901 787-721-2676
Rhode Island:	State Historic Preservation Officer Hist. Preservation and Heritage Commission Old State House 150 Benefit Street Providence, Rhode Island 02903 401-222-2678

South Carolina:	State Historic Preservation Officer Department of Archives and History 8301 Parklane Road Columbia, South Carolina 29223-4905 803-896-6100
South Dakota:	State Historic Preservation Officer South Dakota State Historical Society 900 Governors Drive Pierre, South Dakota 57501-2217 605-773-3458
Tennessee:	State Historic Preservation Officer Department of Environment and Conservation 2941 Lebanon Road Nashville, Tennessee 37243-0442 615-532-0109
Texas:	State Historic Preservation Officer Texas Historical Commission P.O. Box 12276 Capitol Station Austin, Texas 78711-2276 512-463-6100
Utah:	State Historic Preservation Officer Utah State Historical Society 300 Rio Grande Salt Lake City, Utah 84101 801-533-3551
Vermont:	State Historic Preservation Officer Agency of Commerce & Community Development VT Division for Hist. Preservation National Life Bldg., Drawer 20 Montpelier, Vermont 05620-0501 802-828-3056

Virginia:	State Historic Preservation Officer Department of Historic Resources 2801 Kensington Avenue Richmond, Virginia 23221 804-367-2323
Virgin Islands:	State Historic Preservation Officer Dept. of Planning & Natural Resources Nisky Center, Suite 231 No. 45A Estate Nisky St. Thomas, Virgin Islands 00803 340-776-8605
Washington:	State Historic Preservation Officer Office of Archeology & Historic Preservation Commerce, Trade & Econ. Dev. 420 Golf Club Road S.E., Suite 201 Lacey, Washington 98504-1048 360-407-0765
West Virginia:	State Historic Preservation Officer Division of Culture and History 1900 Kanawha Boulevard E. Capitol Complex Charleston, West Virginia 25305 304-558-0220
Wisconsin:	State Historic Preservation Officer State Historical Society 816 State Street Madison, Wisconsin 53706 608-264-6500
Wyoming:	State Historic Preservation Officer Wyoming State Historic Preservation Office Dept. of State Parks & Cultural Resources 2301 Central Avenue, Barrett Bldg., 3rd floor Cheyenne, Wyoming 82002 307-777-7697

Chapter 3

CERTIFICATION REQUIREMENTS

BACKGROUND

To obtain the 20 percent Certified Historic Rehabilitation Credit the property must either be listed on the National Register of Historic Places or located in a Registered Historical District and be determined "significant" to that district. Additionally, the Secretary of the Interior must certify to the Secretary of the Treasury that the project meets their "standards" and is a "Certified Rehabilitation." The owner obtains this certification by filing the three-part application with the National Park Service.

To have work on a rehabilitation project certified by the National Park Service, there are a series of applications that are filed with the appropriate State Historic Preservation Office (SHPO). These applications are reviewed and then forwarded, with recommendations by the SHPO, to the National Park Service for approval or denial. The applications include:

Part 1 - Evaluation of Significance - This part should contain a narrative that describes the history of the particular building and the present condition of the building. This part should also include a summary as to how the building contributes to the significance of the historical district within which it is located.

Part 2 - Description of Rehabilitation - This part is intended to provide both the State Historic Preservation Office and the National Park Service with a narrative describing proposed rehabilitation work. The owners should also include photographs to document the particular architectural and historical features of the building as they currently exist.

Note: It is usually recommended that both Part 1 and 2 are filed before any work is started on the project.

Part 3 - Request for Certification of Completed Work - This final part of the application process is intended to be filed by the owners to notify both the State Historic Preservation Office and the National Park Service that the project is completed. By filing the final part, the owners are requesting that the project be reviewed to receive certification. This part includes photographs of the completed rehabilitation project. In some cases, an authorized representative of the Secretary may inspect the completed project to determine if the work meets the “Standards for Rehabilitation”.

When examining a return exhibiting the Historic Rehabilitation Credit, it is necessary (at a minimum) to verify:

1. the project has received "certification" of the work, and

2. the building was deemed a "Certified Historic Structure" by virtue of either

   a. being separately listed in the National Register of Historic Places, or

   b. by its location in a registered historic district and the determination that it "contributes to the significance" of that district.

This certification of both the structure and the rehabilitation work is not necessary at the time that the credit is taken. Ultimately, however, the certification must be obtained by the building owners/taxpayers. Under Treasury Regulation section 1.48-12(d)(7)(i) and (ii), it is indicated that the certification should be filed with the return on which the credit was taken. If final certification has been obtained, the owner must submit a copy of the Part 3 certification as an attachment to Form 3468 with the first income tax return filed after certification is received. If the final certification has not been obtained, then Parts 1 and 2 (as filed with the State Historic Preservation Office) should be attached to Form 3468 indicating that the National Park Service or the applicable State Historic Preservation Office received it.

(Please note: Form 3468 is in the process of being revised to accommodate electronic filers. This revision may no longer require attaching Part 3 to Form 3468. Part 3 information, however, may be obtained from the State Historic Preservation Office or the National Park Service.)

Treas. Reg. section 1.48-12(f)(2), states that the credit may be claimed if the property is placed in service, and the substantial rehabilitation test has been met. The pro forma Information Document Request (Form 4564) addresses this issue based on the request of items number 2, 5, 6, and 15. (See Exhibit 3-1.) Treas. Reg. section 1.48-12(d)(7)(ii) lists the steps prescribed for dealing with late certifications. Included with this section is a "30 Month Rule" which indicates that if the taxpayer fails to receive final certification of completed work prior to the date that is 30 months after the date that the taxpayer filed the tax return on which the credit was claimed, the taxpayer must submit a written statement to the district director stating such fact prior to the last day of the 30th month, and the taxpayer should be requested to consent to an agreement under IRC section 6501(c)(4) extending the period of assessment for any tax relating to the time for which the credit was claimed.

Based on the above, and legal arguments including the "Doctrine of Equitable Estoppel," examiners in conjunction with the offices of District Counsel, and Chief Counsel, have developed a position for dealing with cases where the normal 3-year statute of limitations is barred. This position has been applied to cases where the proper certification was never obtained, and where the 30 month rule as cited above was ignored. These cases can be completely developed based on documentation from the National Park Service.

If the final certification was not obtained, and an examiner has a case either within statute, or where the statute is barred, that taxpayer/owner should be notified, and afforded one last opportunity to obtain the proper certification from the National Park Service. If the certification is denied, and all avenues of attaining the certification

have been exhausted, then the credit should be disallowed in the year taken. Lack of certification does not constitute a credit recapture under IRC section 50(a), or previously under IRC section 47(a), but in fact should be disallowed in the year taken based on the law sections which follow.

Also note that the estoppel position can only be used in cases where IRS becomes aware of the lack of certification after the normal 3-year statute has expired. If you are examining a tax return that exhibits an historic credit, and you have determined that the subject building lacks the necessary certification, you should ensure that the statute is protected until the final certification is obtained, or the credit has been properly disallowed. If an examiner discovers that they have a case lacking certification where the statute is barred, and the estoppel position may be applied, they should contact their District Counsel.

LATE SUBMISSION OF THE HISTORIC PRESERVATION CERTIFICATION APPLICATION

Chapter 2 Treas. Reg. section 1.48-12(d)(1) and 1.48-12(d)(7) deals directly with the late submission of Parts 1, 2 and 3 of the "Historic Preservation Certification Application" and how late submission may prevent a taxpayer from claiming the rehabilitation tax credit.

To better understand the consequences that result from the late submission of Parts 1, 2, and 3 of the "Historic Preservation Certification Application", it is important to review the pertinent sections of the Treasury Regulations and the Internal Revenue Code.

IRC section 47(b) indicates that the credit should be claimed when the building is placed in service. It specifically provides that "qualified rehabilitation expenditures, with respect to any qualified rehabilitated building, shall be taken in to account for the taxable year in which such qualified rehabilitated building is placed in service."

Treas. Reg. section 1.48(f)(2) reiterates the fact that the credit is claimed when the property is placed in service, and adds the language "meets the definition of a qualified rehabilitated building for the taxable year." This special language means that, in addition to the placed in service provision, the building owner must also meet the substantial rehabilitation test for that year.

LATE SUBMISSION OF PART 1

To be eligible for the 20 percent rehabilitation tax credit, the property must also be a certified historic structure. Treas. Reg. section 1.48-12(d)(1) provides rules relating to the rehabilitation of certified historic structures. A certified historic structure is defined in this regulation as "any building and its structural components that is listed in the National Register of Historic Places or located in a registered historic district and certified by the Secretary of Interior as being of historic significance to the district.

For purposes of this section, a building shall be considered to be a certified historic structure at the time it is placed in service if the taxpayer reasonably believes on that date the building will be determined to be a certified historic structure **and has requested on or before that date a determination from the Department of Interior that such building is a certified historic structure within the meaning of this paragraph and the Department of Interior later determines that the building is a certified historic structure.**"

Simply stated, Treas. Reg. section 1.48(d)(1) requires that the taxpayer submit Part 1 of the Historic Preservation Certification Application before the property is placed in service.

The only exception where Part 1 would not have to be submitted prior to the placed in service date would be if the building were already individually listed in the National Register. If a building were listed in the National Register, the property owner would have already requested a determination from the Department of Interior that the building was a certified historic structure.

It is important to note that a building that is simply located in a registered historic district would not fall under this exception. This is true even if the building was specifically listed as one of the contributing buildings in the registered historic district nomination.

LATE SUBMISSION OF PART 3

Treas. Reg. section 1.48-12(d)(7) and (f)(2) indicate that if the property is placed in service and the taxpayer reasonably expects that the National Park Service will approve Part 3 of the "Historic Preservation Certification Application", *Certification of Completed Work*, the tax credit can be claimed by the taxpayer. If the taxpayer, however, fails to receive the final certification of completed work within 30 months after filing the tax return on which the credit was claimed, the taxpayer must submit a written statement to the Internal Revenue Service stating such fact prior to the last day of the 30th month. In such case the taxpayer will be requested to extend the normal 3-year statute of limitation period for the return on which the credit was claimed.

If the taxpayer claims the rehabilitation tax credit, but never receives Part 3 approval from the National Park Service, the taxpayer must recapture the entire credit.

A taxpayer does not have a "certified rehabilitation" until it receives a Part 3 approval. In other words, the taxpayer is not entitled to the rehabilitation tax credit unless the Department of the Interior has certified the rehabilitation project by signing Part 3 of the "Historic Preservation Certification Application". The definition of the term "certified rehabilitation" is found in Treas. Reg. section 1.48-12(d)(3).

Treas. Reg. section 1.48-12(d)(3) states that the term "certified rehabilitation" means any rehabilitation of a certified historic structure that the Secretary of the Interior has

certified to the Internal Revenue Service as being consistent with the historic character of the building and, where applicable, the district in which such building is located.

STATUTE OF LIMITATIONS

In general, the statute of limitation is 3 years from the due date of the return. IRC section 6511(a) provides that a claim for credit or refund of an overpayment of any tax shall be filed by the taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever the periods expire the later.

If a taxpayer placed a "certified rehabilitation" in service, but never claimed the rehabilitation tax credit, the taxpayer would have 3 years from the due date of the return filed for the year the property was placed in service, to file a claim for refund. Once this period expires, the taxpayer will not be eligible to claim the rehabilitation tax credit.

AUDIT TECHNIQUES

Determine if the building was listed in the National Register before the property was placed in service. The State Historic Preservation Office will be able to provide this information. If the taxpayer was only required to submit a Part 2 and 3 of the Historic Preservation Certification Application, this would be an indication that the property is already listed in the National Register and would fall under the exception to the rule that Part 1 be submitted prior to the placed in service date.

Review Part 1 of the Historic Preservation Certification Application to determine when it was submitted to the State Historic Preservation Office. If the building is located in a historic district determine if Part 1 was submitted prior to the placed in service date. If a determination is made that the Part 1 was not submitted before the placed in service date, an adjustment should be made to recapture the entire credit.

CERTIFICATION LAW SECTIONS

IRC section 47(a) - Rehabilitation Credit/Amount of Credit

IRC section 47(b) - When the credit may be claimed.

Treas. Reg. section 1.48-12(f)(2) - When the credit may be claimed/if placed in service and substantial rehabilitation test has been met.

IRC sections 47(c)(2)(B), 47(c)(2)(C) and 47(c)(3), and Treas. Reg. section 1.48-12(d) - Certain expenditures are not included.

Treas. Reg. section 1.48-12(d)(7)(i) - Notice of certification required with return.

Treas. Reg. section 1.48-12(d)(7)(ii) - Late Certification and 30-Month Rule.

Treas. Reg. section 1.48-12(d)(2) - Definition of Registered Historic District.

Treas. Reg. section 1.48-12(c)(7)(iv) - Non-certified rehabilitation is not allowable for certified, historic structures (building separately listed on the National Register of Historic Places) or for buildings located in a registered historic district (buildings determined to be "significant to the district").

COURT CASES

In ***Girgis V. Commissioner***, T.C. Memo 1991-191, a decision was entered that in order for an expenditure in connection with the rehabilitation of a "Certified Historic Structure" to be a "Qualified Rehabilitation Expenditure," the rehabilitation must be a "Certified Rehabilitation" as defined under IRC section 48(g)(2)(B)(iv) (or under current law 47(c)(2)(B)(iv)). It goes on further to define a "Certified Rehabilitation" as "any rehabilitation of a certified historic structure which the Secretary of the Interior has certified to the Secretary (of the Treasury) as being consistent with the historical character of such property or the district in which such property is located," IRC section 48(g)(2)(C) (or under current law 47(c)(2)(C)). It was also held that if a building is deemed to be a "Certified Historic Structure", that building will only qualify for the historic rehabilitation credit and does not qualify for the non-historic credit for older buildings. The courts cited IRC sections 48(g)(1) and 46(b)(4)(C)(ii) (under current law, sections 47(a)(1) and 47(c)(1)).

In ***B. G. Anderson***, 62 TCM 1324, Dec. 47,769(M), T.C. Memo, 1991-583, no rehabilitation tax credit was allowed based on the mere listing of a building on the National and Philadelphia Register of Historic Places.

In ***Booker T. Washington Broadcasting Services Inc. v. United States***, 92-2 U.S.T.C. 50,545, a taxpayer was not entitled to the certified rehabilitation tax credit because taxpayer failed to apply for certification until nearly 3 years after taxpayer claimed the credit.

In ***J. Franklin Dennis and Beverly A. Dennis v. Commissioner***, T.C. Memo 1993-345, a property owner was denied the rehabilitation tax credit because the owner used the property solely as his personal residence. Further, he had not received a certification of the rehabilitation from the Secretary of the Interior. Furthermore, there was no evidence that the owner followed the "30 month rule."

In ***Schneider Partnership***, DC N. J., 89-1 U.S.T.C. 9319, no rehabilitation tax credit was allowed where the certification was denied by the Secretary of the Interior.

Form 4564 Rev. 6/88	Department of the Treasury Internal Revenue Service INFORMATION DOCUMENT REQUEST	Request Number
TO: Name of Taxpayer and Co. Div. or Branch Please return Part 2 with listed documents to requester identified below.		Subject SAIN No. | Submitted to: Dates of Previous Requests

Description of Documents Requested

Please present the following documents and information regarding the partnership examination for tax year(s) _____.

1. A copy of the Prospectus/Offering Memorandum relating to the above partnership activity.

2. Certification of rehabilitation expenses by The Department of The Interior (Parts I, II, and III) if applicable.

   a. Exact address or location of the building.

   b. Does the above partnership own the entire rehabilitated structure. If not, please provide a statement indicating what portion of the building the partnership owns.

   ____%; ____units of a total of____units; ____floors of a total of ____floors; etc.

Information Due By_____ At Next Appointment [ ] Mail In [ ]		
FROM:	Name and Title of Requester	Date
	Office Location	

Form 4564 Rev. 6/88	Department of the Treasury Internal Revenue Service INFORMATION DOCUMENT REQUEST	Request Number
TO: Name of Taxpayer and Co. Div. or Branch Please return Part 2 with listed documents to requester identified below.		Subject SAIN No. | Submitted to: Dates of Previous Requests

Description of Documents Requested

3. If the building is not a certified rehabilitation, then please provide the following information:

   a. Exact address or location of the building.

   b. Does the above partnership own the entire rehabilitated structure. If not, please provide a statement indicating what portion of the building the partnership owns.

   ____%;____units of a total of ____units; ____floors of a total of ____floors; etc.

4. Settlement sheets for the acquisition of any properties relating to the form 1065 filed.

5. Certificate and/or Statement of Occupancy.

6. Copy of the first lease executed.

7. If a facade easement is involved, please provide the Deed and Appraisal of the facade easement.

8. A copy of the partnership Form 1065 for tax year(s)_____.

9. Workpapers used in preparing the return.

10. Copies of any Partnership Agreements executed.

Information Due By_____ At Next Appointment [ ] Mail In [ ]		
FROM:	Name and Title of Requester	Date
	Office Location	

Form 4564 Rev. 6/88	Department of the Treasury Internal Revenue Service INFORMATION DOCUMENT REQUEST	Request Number
TO: Name of Taxpayer and Co. Div. Or Branch Please return Part 2 with listed documents to requester identified below.		Subject SAIN No. | Submitted to: Dates of Previous Requests

Description of Documents Requested

11. All bank statements and canceled checks for the Partnership.

12. Financing Agreements/Mortgages for all properties.

13. Construction contract including a specific breakdown of rehabilitation costs and any construction loan agreements.

14. Ledger Account/AIA statements for the construction mortgage showing draws for work performed.

15. Identification of the partnership's 24 or 60 month measuring period for purposes of the substantial rehabilitation provisions.

16. Documentation/Records pertaining to the capital contributions made by all of the partners, including all notes.

17. Records of all loans and repayments.

****
Note: The above IDR should be modified for different types of owners including Corporations and Individuals, and should also be expanded to address any other issues that the examiner determines to warrant review. Some of the items should be deleted if not applicable, for example, the question regarding the Facade could be deleted if no Facade Contribution was taken by the taxpayer under audit. Also for example, if you were examining a corporate taxpayer then the Corporate Minutes might be requested instead of a Partnership Offering Memorandum.
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Information Due By_____ At Next Appointment [ ] Mail In [ ]		
FROM:	Name and Title of Requester	Date
	Office Location	

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Chapter 4

NON-HISTORIC CREDITS

BACKGROUND

As discussed in Chapter 1, the Economic Recovery Tax Act of 1981 introduced two tiers of non-historic rehabilitation tax credits - a 20 percent credit for buildings that were at least 40 years old, and a 15 percent credit for buildings that were at least 30 years old. The Tax Reform Act of 1986 created a single credit for non-historic rehabilitation projects that amounts to 10 percent provided the building had been originally placed in service before 1936.

To obtain the 10 percent non-historic rehabilitation tax credit, the property must meet certain criteria. A taxpayer cannot claim a 10 percent rehabilitation tax credit on a building that is in the National Register of Historic Places or is located within a Registered Historic District unless it has been certified by the National Park Service as **not** contributing to the significance of the district. To request "decertification", the taxpayer should submit Part 1 of the Historic Preservation Certification Application.

If a building is not in the National Register, or if it is located in a Registered Historic District but has been determined to be a non-contributing structure by the Department of the Interior, a 10 percent rehabilitation tax credit may be utilized provided the building:

? Was placed in service before 1936 [See Treas. Reg. section 1.48-12(b)(4)];

? Is used for non-residential rental purposes [See IRC section 50(b)(2)];

? Has not been physically moved [See Treas. Reg. section 1.48-12(b)(5)];

? Meets the following internal and external wall retention [See Treas. Reg. section 1.48-12(b)(3)]:

- 50 percent or more of the existing external walls are retained in place as external walls,

- 75 percent or more of the existing external walls are retained in place as internal or external walls,

- 75 percent or more of the existing internal structural framework is retained in place.

Buildings that are “certified historic structures” are precluded from taking the 10 percent non-historic tax – only the historic 20 percent credit would apply.

DECERTIFICATION PROCEDURES

If a building is located within a historic district, but is generally of a different age than the time frame as reflected in that district, or for any other reason the building does not contribute to, or is not characteristic of the historical integrity of that district, the owner may apply to the National Park Service for "decertification."

Using the "Part 1" application, the owner submits a narrative to the State Historic Preservation Office (and ultimately the National Park Service) to demonstrate that the building, although physically located within the district, does not contribute to the significance of the district.

NOTE: “Decertification” is the only way that the building owner would be entitled to take the non-historic credit (assuming all other law provisions are followed). If a case exhibiting a non-historic credit is encountered, the examiner should ensure that the property is not separately listed, is not located within a historic district, or, if it is located within a historic district, that the proper "decertification" was obtained in order to qualify for the non-historic credit. As with the historic credits, if an examiner encounters a case where a non-historic credit has been taken for property located within a historic district, then the examiner should afford the building owner the necessary time to obtain the "decertification." If the "decertification" cannot be obtained, then the non-historic credit should be disallowed in full, unless the owner can attain historic certification which would then qualify the building for the historic rehabilitation credit. The State Historic Preservation Offices can usually provide detailed maps of registered historic districts within the state.

The wall retention requirements previously existed for both the historic and the non-historic credits prior to the Tax Reform Act of 1986, but were dropped for the historic credits based on the practical implications. For certified projects, destruction of walls, whether internal or external, must be approved by the National Park Service, and is usually discouraged. The Code and regulations that follow address the definitions and various technicalities of this section.

The pro forma Information Document Request (see Exhibit 3-1) addresses the non-historic credit issue through the request of Item 3. The certification of the work is not required for non-historic buildings as long as they are not considered "Certified Historic Structures." It should also be noted that besides meeting the "use", "age," and "wall retention" requirements, it is also necessary to fulfill the other law requirements such as the substantial rehabilitation test, use of straight-line depreciation, etc.

NON-HISTORIC CREDITS LAW

Rehabilitation Credit/Amount of Credit - See IRC section 47(a).

The prohibition of residential rental property for purposes of the credit exists for non-historic credits but not those which qualify for the certified historic credit. See Treas. Reg. section 1.48-1(h)(1)(i) and (h)(2)(iv).

For rules applicable to the rehabilitation of certified historic structures/certification requirements refer to Treas. Reg. section 1-48-12(d).

Treas. Reg. section 1.48- 12(d) provides the definition of a Registered Historic District.

IRC section 47(c) - Definitions/Qualified Rehabilitated Building

IRC section 47(c)(1)(B) - Non-certified rehabilitation projects

Treas. Reg. section 1.48-12(b)(4) - Age Requirement/Non-certified rehabilitation projects

Treas. Reg. section 1.48-12(b)(4)(ii) and (iii) - Effect of post-1936 building additions and the effect of vacant periods for non-certified rehabilitation projects.

Treas. Reg. section 1.48-12(b)(5) - Building must not have been moved before 1936.

Treas. Reg. section 1.48-12(b)(6)(i) and (iii) – Definition and special rules for "physical work" on a rehabilitation and adjoining buildings that were combined.

Wall Retention Requirements - IRC section 47(c)(1)(A), Treas. Reg. section 1.48-12(b)(3)((i), Treas. Reg. section 1.48-12(b)(3)(i)(C) and (D), Treas. Reg. section 1.48- 12(b)(3)(ii), Treas. Reg. section 1.48- 12(b)(3)(iii), and Treas. Reg. section 1.48- 12(b)(3)(iv), (v) and (vi).

COURT CASES

In ***Girgis V. Commissioner***, T.C. Memo 1991- 191, a decision was entered that if a building is deemed to be a "Certified Historic Structure," that building will only qualify for the historic rehabilitation credit, and does not qualify for the non-historic credit for a 40-year old building. The courts cited IRC sections 48(g)(1) (or under current law, IRC section 47(a)(1)), and 46(b)(4)(C)(ii).

J. Bailey, 88 T.C. 1293, Dec. 43,924, no rehabilitation credit was allowed for improvements to a building which was used as residential property, and the structure was not a certified historic structure.

In ***Depot Investors LTD***, 63 TCM 2344, Dec. 48,065(M), T.C. Memo 1992- 145, no rehabilitation credit was allowed for a building because the wall retention requirements were not met.

Nalle v. Commissioner., 997 F.2d 1134 (5th Cir 1993) (Trea. Reg. section 1.48-12(b)(5) invalid as unreasonable interpretation of the statute).

Chapter 5

PLACED IN SERVICE

BACKGROUND

The rehabilitation tax credit is available to the person(s) and/or the entity who holds title to the property. The rehabilitation credit is generally allowed in the taxable year the rehabilitated property is placed in service provided that the building has met the "qualified rehabilitated building" requirements for the 24 month period ending in that taxable year. "Placed in service" generally means that the appropriate work has been completed which would allow for occupancy of either the entire building, or some identifiable portion of the building. A qualified rehabilitated building is defined as that which has been substantially rehabilitated and was placed in service as a "building" before the beginning of the rehabilitation (as opposed to a ship, airplane, bridge, etc). See Treas. Reg. section 1.48-12(b).

If the substantial rehabilitation test has not been met at the time a building, or some portion of the building is actually placed in service, the building does not meet the definition of a qualified rehabilitated building. As such, placed in service is deemed to be at the point in time when the substantial rehabilitation test is actually met. See IRC section 47(b)(1) and 47(c)(1)(C) and Treas. Reg. section 1-48-12(f)(2) and 1.48-12(c)(6).

Generally speaking, the 24-month measuring period ends sometime during the year in which the property is placed in service. When comparing the taxpayer's qualified rehabilitation expenses to its basis, the expenses accrued over a 24-month period must end with or within the tax year the credit is being claimed. Exceptions to this rule exist if the building is never taken out of service during the rehabilitation. Then only the substantial rehabilitation test must be met. See Treas. Reg. section 1.48-12(f)(2). In an elected 60-month phased rehabilitation, the court has ruled that the tax credit could not be claimed on assumed eligibility. The substantial rehabilitation test must be met. See ***Ford vs. United States***, 93-1 U.S.T.C. 50,268.

If the property remains in service during the rehabilitation, the placed in service date will be commensurate with the project completion date.

If the taxpayer fails to complete the physical work of the rehabilitation prior to the date that is 30 months after the date the taxpayer filed a tax return on which the credit is claimed, the taxpayer must submit a written statement to the Internal Revenue Service stating such fact and shall be requested to sign an extension to the statute of limitations. See Treas. Reg. section 1.48-12(f)(2).

It is important to note that if property is first used for a personal use and then later converted to an income producing activity, rental real estate, etc., no credit is allowed upon a conversion.

ACQUIRING PROPERTY RULES

The placed in service date is critical in situations where one party who starts a rehabilitation project sells the property before completing the work. A 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:

1. The amount of expenses actually incurred before the acquisition or
2. An allocable portion of the cost of the property if it is bought for an amount less than the rehabilitation expenditures actually incurred. See Treas. Reg. section 1.48-12(c)(3)(ii)(B).

TAX CREDIT RECAPTURE

Only the property owner who first places the building in service is entitled to the rehabilitation tax credit. In the event the property is sold or ceases to be business use property, recapture of the tax credit is required. The recapture period is based on the placed in service date, not the tax year in which the credit was first claimed. (See Chapter 9, Credit Recapture on Disposition.)

AUDIT TECHNIQUES

"Placed in service" generally means that the appropriate work has been completed which would allow occupancy of either the entire building, or some identifiable portion of the building. The taxpayer/owner cannot have just incurred expenditures related to various parts of the building, and include them in a rehabilitation basis unless the related building or part of the building is available to be placed in service. A "Certificate of Occupancy" is one means of verifying the "Placed in Service" date for the entire building (or part thereof).

The Information Document Request (IDR) (see Exhibit 3-1) addresses this issue through Items 4, 5, 6, and 14. The best approach to this issue is not to rely on one single item of verification, but to look at all of the various items and how they relate to each other. All of the items should be consistent in reflecting that either all or part of the building was available to be placed in service as of the particular date that the taxpayer/owner purported to have placed the building in service per the return. This approach provides cohesive evidence to accept the "placed in service" date if all are consistent.

PLACED IN SERVICE LAW

IRC section 47(b) and Treas. Reg. section 1.48-12(f)(2) covers when the credit may be claimed.

Treas. Reg. section 1.48- 12(c)(6) covers when expenditures may be incurred and when are expenditures considered qualified rehabilitation expenditures.

Treas. Reg. section 1.48- 12(c) - Definition of Qualified Rehabilitation Expenditures.

COURT CASE

In ***Girgis V. Commissioner***, T.C. Memo 1991- 191, a decision was entered that the petitioner does not qualify for the rehabilitation credit because the prior owner had already placed the building in service and had already claimed credits based on the rehabilitation expenditures made in connection with the said building. The courts cited Treas. Reg. section 1.48- 12(c)(3)(ii).

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Chapter 6

SUBSTANTIAL REHABILITATION

BACKGROUND

Aside from Congress' primary intent that incentives be created to rehabilitate older and historical buildings, they also wanted building owners to "substantially rehabilitate" the property rather than provide only minor restoration. Substantial rehabilitation is essentially defined by the prescribed substantial rehabilitation test, as included in both the Internal Revenue Code and Treasury Regulations, and its various practical implications. The substantial rehabilitation test is met if the qualified rehabilitation expenditures during a 24-month period selected by the owners exceed the greater of $5,000 or the adjusted basis of the property.

> NOTE: This is only a test and once met, expenditures before and after the 2-year period generally will qualify for inclusion in the Rehabilitation Tax Credit basis.

Long-term projects may use an alternative 60-month period if the long-term nature of the project is evident from the outset – through architectural plans, etc.

This section of the law can be confusing; the key fact to remember is that it was designed only as a test to ensure that something more than cosmetic repairs are performed on the building. It was not intended to limit the owners to a strict 2-year period during which all work must be started and concluded.

Qualified Expenditures are defined in Treas. Reg. 1.48-12(c) and generally include costs chargeable to a capital account and made in connection with the rehabilitation of a qualified building. Land costs are not a qualified costs. Special rules exist for costs incurred by a prior owner and assumed through purchase by a new owner. These rules are found in Treas. Reg. 1.48-11(c)(3)(ii). Example 4 of Treas. Reg. 1.48-12(b)(2)(x) provides guidance on costs that can be assumed "incurred" by a subsequent owner.

For purposes of the substantial rehabilitation test, adjusted basis is the cost of the property (excluding land) plus or minus adjustments to basis and is determined as of the first day of the 24-month period selected by the taxpayer.

THE SUBSTANTIAL REHABILITATION TEST

IRC section 47(c)(1)(C) defines "substantially rehabilitated" and Treas. Reg. section 1.48-12(b)(2)(i) defines "substantial rehabilitation." The regulations also state that if a building is owned by a partnership or an S-Corporation, then the Substantial

Rehabilitation Test shall be determined at the entity level (at the partnership or S-Corp level rather than at the partner or shareholder level).

Examples of the application of the Substantial Rehabilitation Test are as follow.

Example 1

"A" purchases the building on January 1, 1998 for $140,000. Rehabilitation costs incurred in 1998 were $4,000 per month for a total of $48,000 for the year 1998. Rehabilitation costs were $100,000 in 1999. Rehabilitation costs in 2000 were $2,000 a month for 10 months through October 31, 2000, for a total of $20,000. There were no architectural plans to complete the project in phases - "A" is limited to a "24-month" measuring period to meet the substantial rehabilitation test.

"A" selects the measuring period beginning on February 1, 1998 and ending on January 31, 2000 (24 months). The beginning adjusted basis (for purposes of the test only), and based on the 24-month test start date is $144,000 (Purchase price of $140,000 + $4,000 of rehabilitation costs incurred through January 31, 1998).

Substantial Rehabilitation Test:

Rehabilitation expenditures in 1998:	$ 44,000 (Feb 1st to Dec 31st)
Rehabilitation expenditures in 1999:	100,000
Rehabilitation expenditures through 1/31/00	2,000
Total	$146,000

NOTE: In the example above, the test was met because the beginning adjusted basis was $144,000 while the rehabilitation costs incurred during the 24-month period from February 1, 1998, through January 31, 2000, were $146,000, and exceeded the adjusted basis of the building. Since the test is now met, the actual costs which qualify are as follows:

The $4,000 of rehabilitation costs incurred before the test period (from January 1, 1998, through January 31, 1998).

The $146,000 of rehabilitation costs incurred during the test period from February 1, 1998, through January 31, 2000.

The $18,000 of rehabilitation costs incurred through the end of the calendar year within which the test period ends.

The qualifying rehabilitation basis would be:
$4,000 + 146,000 + 18,000 = $168,000

========
NOTE: Although the test was met due to the $146,000 of rehabilitation costs incurred during the 24-month test period exceeding the $144,000 adjusted basis of the property at the beginning of the test period, the actual qualifying costs were $168,000. Once met, the test disappears and costs actually incurred qualify, including the following:

Costs incurred prior to the 24-month test period,
Costs incurred during the 24-month test period
Costs incurred after the 24-month test period, but only through the end of the calendar year within which the test period ends.

Example 2

Same facts as above, except "A" selects the measuring period beginning on March 1, 1998, and ending on February 28, 2000 (24 months).

The beginning adjusted basis (for purposes of the test only), and based on the 24 month test starting date would be $148,000 (Purchase Price of $140,000 + 4,000 of Rehabilitation Costs for January 1998 + $4,000 of Rehabilitation Costs for February 1998).

Substantial Rehabilitation Test:

Rehabilitation expenditures in 1998:	$ 40,000 (Mar 1st to Dec 31st)
Rehabilitation expenditures in 1999:	100,000
Rehabilitation expenditures through 2/28/00:	4,000
Total	$144,000

NOTE: The test is not met in this example because the rehabilitation costs of $144,000 did not exceed the beginning adjusted basis of $148,000 for the 24-month test period. Therefore, none of the costs prior to the test period, during the test period, or after the test period qualify.

THE 60-MONTH ALTERNATE TEST PERIOD

Mechanically, and from a law standpoint, the 60-month test period works exactly the same as the 24-month test period with the only difference being the substitution of a 60-month period in place of the 24 months.

NOTE: The law sections indicate that to use the "60-month test period" the rehabilitation must be one that "may reasonably be expected to be completed in phases set forth in architectural plans and specifications completed before the rehabilitation begins."

Three conditions must be met in order for the "60 month test period" to become available to the taxpayer:

1. There must be a written set of architectural plans and specifications for all phases of the rehabilitation. (If the written plans outline and describe all phases of the rehabilitation, this will be accepted as written plans and specifications);

2. The written plans must be completed before the physical work on the rehabilitation begins, and;

3. It can be reasonably expected that all phases of the rehabilitation will be completed.

MULTIPLE OVERLAPPING TEST PERIODS

Although, in general, all qualified expenditures will be included in basis once the substantial rehabilitation test is met, the inclusion of expenditures is allowed only for those costs incurred through the end of the tax year in which the 24-month period ends. In Example 1 above if the taxpayer had continued to incur costs throughout 2000 and into 2001, only those expenditures incurred by the end of 2000 would be included in basis. None of the costs incurred in 2001 would be qualified by the substantial rehabilitation test that ran from February 1st, 1998 and ended on January 31st of 2000.

Treas. Reg. section 1.48 provides a solution for problems that could arise when costs are incurred in the year or years following the year in which the 24-month test period ends.

This regulation provides for multiple test periods to be used to qualify costs incurred in years beyond those which are qualified through the end of the calendar year within which the test period ends. In Example 1, if the owner incurred expenditures in 2001, then a second test period would have to be selected which ended in 2001 to qualify expenditures in that year. To qualify expenditures in any given year, the test period must end at least one month within that year.

Generally, as indicated in Example 2 of Treas. Reg. section 1.48-12(b)(2)(x), situations in which multiple overlapping test periods would be used would involve buildings that have more than one section or portion and placed-in-service years which are different for each portion of the building.

The “placed-in-service” date is generally the date that the building or some portion of the building is ready for occupancy. If the property remained in service during rehabilitation, the placed-in-service date will be commensurate with the project completion date.

MULTIPLE BUILDING COMPLEX FOR PURPOSES OF THE SUBSTANTIAL REHABILITATION TEST

There are some rehabilitation tax credit projects that involve multiple buildings that are part of an historic complex. Often, the National Park Service will treat these historic complexes as one project requiring only one Historic Preservation Certification Application. IRC sections pertinent to the rehabilitation tax credit, however, discuss the substantial rehabilitation test in terms of only one building. The Treasury Regulations do not specifically address how the "substantial rehabilitation test" would be applied to a grouping of buildings determined to be an historic complex. Absent an official ruling to the contrary, the “substantial rehabilitation test" should be applied to each individual building as it is placed in service. National Park Service will not issue Part 3, “Final Certification of Completed Work” until all buildings within the complex are complete.

A property owner may be eligible to claim the rehabilitation tax credit in the year their building is placed in service, even though the National Park Service has not provided the owner with an approved Part 3, “Final Certification of Completed Work”. It may take several years before the last building in a complex is completed and the National Park Service issues an approved Part 3. This is a good example of when a building owner would be required to notify the Internal Revenue Service (within 30-months from the due date of the return claiming the credit) of the late or pending certification of a project for which they have previously taken the credit and agree to extend the statute of limitations. See Treas. Reg. section 1.48-12(d)(7).

AUDIT CONSIDERATIONS

Items or documents that may be helpful in determining compliance with the substantial rehabilitation requirements include:

? The offering memorandum (which may exist only in a larger partnership situation);

? Time lines or outlines related to costs incurred;

? Acquisition costs;

? Estimated costs of rehabilitation expenditures;

? Projected time frames within which the work will be done;

? National Park Service filing which outlines project costs, and starting and completion dates;

? The ledger accounts and formatted "draw" statements regarding the construction mortgage can be helpful in supporting not only the substantial rehabilitation test, but many other issues. The "draw" vouchers can also be used to establish costs during a given period, or indicate levels of completion at various times;

? The settlement sheet which should establish the cost of the property/shell and also the acquisition date. When determining the acquisition basis, the examiner may encounter situations where the owner, in making the allocation between land and shell, inflates the land basis and reduces the shell basis solely for purposes of making the project meet the substantial rehabilitation test;

? The mechanics of the substantial rehabilitation test may be addressed in the accountant’s workpapers and, if so, should be reviewed as part any consideration of this issue.

The issue of "substantial rehabilitation" and the Substantial Rehabilitation Test as the prescribed method to determine if substantial rehabilitation is achieved, is a very confusing area of the law. As examiners, it is beneficial to understand the

Congressional intent behind these provisions before trying to work with the prescribed mechanics to ensure compliance. Congress determined that, in addition to having buildings rehabilitated to preserve both historical and non-historical buildings built before 1936, they also desired to have these buildings “substantially” rehabilitated. The test, as described in both the Code and Regulations, makes the measurement process relative to the project size, and introduces a minimum threshold of rehabilitation expenditures of $5,000. To interject fairness into this "artificial" test as created by tax law, there is an allowance for the taxpayer/owner to select the measuring period based on the time frames of their project work.

The regulations require the owner to identify their measuring period for purposes of the substantial rehabilitation test by indicating the measuring period on the return. The absence of either a measuring period or a notation referring to substantial rehabilitation on the return could indicate either ignorance of this particular provision by the building owner or a problem in meeting this test. With the above in mind, examiners should gather facts and documentation which will assist in determining if an issue exists regarding the substantial rehabilitation test. However, in practice, many owners/taxpayers claiming the credit do not include a measuring period with the return filed. In these cases, it is necessary for examiners to ascertain whether or not substantial rehabilitation was achieved, and that a 24-month or 60-month measuring period within which the test could be met existed. The underlying intent of the substantial rehabilitation test should be stressed when pursuing its practical implications. If a project is properly certified, or otherwise properly qualified, an examiner should make every attempt to identify the correct test period.

SUBSTANTIAL REHABILITATION TEST TAX LAW

Definitions/Qualified rehabilitated building - see IRC Section 47(c)

Substantial Rehabilitation Requirements - see IRC section 47(c)(1)(C) and (D) and Treas. Reg. section 1.4812(b)(1) and (2).

The 60-month alternate period for phased rehabilitations. See Treas. Reg. section 1.48-12(b)(2)(v).

Substantial Rehabilitation Aggregate Expenditures. See Treas. Reg. section 1.48-12(b)(2)(vi) and (vii).

Statement regarding substantial rehabilitation test to be included with returns filed after August 27, 1985. See Treas. Reg. section 1.48-12(b)(2)(viii).

Substantial rehabilitation test at entity level for sub-S-Corporations and Partnerships. Treas. Reg. section 1.48-12(b)(2)(ix).

Examples of application of the substantial rehabilitation test can be found Treas. Reg. section 1.48-12(b)(2)(x).

COURT CASE

In ***Alexander v. Commissioner***, 97 T.C. 244 (1991), the courts held that the taxpayer was not entitled to the rehabilitation credit based upon certain rehabilitation expenditures since those expenditures did not exceed the adjusted basis of the building as required by IRC section 48(g)(1)(C)(i)(I), (or undercurrent law 47(c)(1)(C)(i)(I)). The taxpayers rented the first floor of their personal residence and although the qualified rehabilitation expenditures allocable to the first floor exceeded the portion of the adjusted basis allocable to the first floor, the first floor is not a separate building within the meaning of IRC section 48(g)(1), (or under current law section 47(c)(1)(A)). Therefore, the credit was disallowed because the qualified rehabilitation expenditures did not exceed the adjusted basis of the **entire** building.

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Chapter 7

BASIS REDUCTION REQUIRED

BACKGROUND

The basis of the building must be reduced by 100 percent of the Rehabilitation Credit for purposes of computing depreciation, etc. An example of this basis reduction is as follows:

Example: land = $10,000
shell = $50,000
rehabilitation costs = $100,000

For purposes of depreciation, the basis of the project would be determined in the following manner:

? Land is not depreciable, and does not qualify for the credit.

? The shell does not qualify for the credit, but the full $50,000 would be added to the basis for computing depreciation.

? The rehabilitation costs of $100,000 qualify for the credit. Assuming a historical rehabilitation, the rate would be 20 percent, or $20,000 ($100,000 x 20 percent). The depreciable basis of the rehabilitation costs would be $80,000 ($100,000 - $20,000).

The total depreciable basis would be $130,000, that is, the $50,000 cost of the shell and the $80,000 reduced rehabilitation costs.

As previously noted, a straight-line method of depreciation should be applied to the depreciable basis. Currently, basis would be depreciated over 27.5 years for residential rental, and 39 years for commercial properties.

> NOTE: If an adjustment is made to reduce the qualified basis, and the resulting credit, then the previous basis reduction should be restored to the extent of the disallowed credit. This is an automatic technical adjustment on any cases involving credit disallowance.

This issue may be evident from the return as filed. In other cases it may be necessary to review the owner's books and records and/or the return preparer's workpapers to determine if the appropriate basis reduction has been made.

BASIS REDUCTION LAW

Treas. Reg. section 1.48-12(e)(1) - General rule

Treas. Reg. section 1.48-12(e)(3) – Effect on basis when rehabilitation tax credit is recaptured

Chapter 8

STRAIGHT LINE COST RECOVERY

BACKGROUND

The qualified rehabilitation expenditures, along with the shell, must be depreciated using a straight-line method. Under current law, a period of 27.5 years is used for residential rental property and a 39-year period is used for nonresidential property.

> NOTE: The property must be used in a trade or business or for the production of rental income in all instances. This is one of the few areas of rehabilitation tax court law where there is a court case to supplement existing law. The case, cited at the end of this chapter, finds that if a rehabilitation tax credit is taken and an accelerated method has been used instead of a straight-line method, the credit taken can be disallowed in full. In some cases, the issue will be evident on the face of the return as filed. In other cases, it will be necessary to review the books and records, depreciation schedules, etc., to ascertain if the issue is present.

STRAIGT-LINE DEPRECIATION REQUIRED

Straight line depreciation must be used to meet the definition of "Qualified Rehabilitation Expenditures" found in the code and reiterated in the regulations. Property placed in service after December 31, 1986, to which the alternative depreciation system of IRC section 168(g) applies is excepted from the requirement.

LAW

IRC section 47(c)(2)(B)(i) – General rule

Treas. Reg. section 1.48-12(c)(7)(i)

Treas. Reg. section 1.48-12(c)(8)

COURT CASES

DeMarco v. Commissioner, 87 T.C. 518 (1986). In ***DeMarco***, the Tax Court held that the taxpayer's failure to use a straight-line method of depreciation on either their original or amended return disqualified them from taking a Rehabilitation Tax Credit. The taxpayer appealed and the finding of the Tax Court was affirmed (***DeMarco***, 831 F.2d 281, (1st Cir. 1987)).

Manning v. Commissioner, T.C. Memo 1993-127. In ***Manning***, the Rehabilitation Credit was disallowed because the taxpayer failed to elect to depreciate the expenditures under an approved straight-line method.

Au v. Commissioner, T.C. Memo 1990-203. In ***Au***, no Rehabilitation Tax Credit was allowed for rehabilitation expenditures when the owners failed to affirmatively elect to use the straight-line ACRS method of depreciation.

Chapter 9

CREDIT RECAPTURE ON DISPOSITION

BACKGROUND

The rehabilitation tax credit is subject to recapture if the building on which it was claimed is sold or ceases to be business use property within 5 years from the date it was first placed in service. The recapture provisions are found under IRC section 50(a)

The amount of such recapture is reduced by 20 percent for each full year that elapses after the rehabilitated property is placed in service. Thus there is a 100 percent recapture if the property is disposed of less than 1 year after the property is first placed in service; an 80 percent recapture after 1 year, a 60 percent recapture after 2 years; a 40 percent recapture after 3 years; and a 20 percent recapture after 4 years.

DISPOSTITION OF A PARTNERSHIP INTEREST

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. Treas. Reg. section 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:

Example 1

A limited partner has an 80 percent 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 percent in 1999, 3 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 percent), the partner is considered to have disposed of 30/80 or 37.5 percent of the property. Recapture is computed as follows:

$100,000 x 37.5% = $37,500
$37,500 x 40% (recapture %) = $15,000

WHEN A BUILDING IS REMOVED FROM THE NATIONAL REGISTER

If the National Park Service removes a "qualified rehabilitated building" from the National Register or determines the building no longer contributes to a Registered Historic District within 5 years from when it was first placed in service, the recapture provisions apply.

Revocation of a building's status as a certified historic structure can occur when a building loses its historic integrity and/or character. This could happen, for example, if the building owner materially alters the building's façade or a new building addition overshadows the historic structure or if the building is destroyed and cannot be rebuilt. In each of these situations, the alteration to the historic structure would be irreversible and would result in its deletion from the National Register.

RECAPTURE WHEN PROPERTY IS DESTROYED BY CASUALTY

When a building that qualified for the rehabilitation tax credit is destroyed by a casualty (that is, hurricane, flood, tornado, earthquake), within 5 years of first claiming the credit, the recapture provisions of IRC section 50(a) apply.

Unlike the provisions set forth in IRC 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 (5 years from when building was placed in service), no recapture of rehabilitation credit would be required.

WHEN RECAPTURE IS NOT REQUIRED

The recapture rules do not apply when there is a simple transfer of interest between spouses or when there is a transfer of interest due to divorce. The transferee, in these cases, steps into the shoes of the transferor with respect to the transferred property for purposes of tax credit recapture. See IRC section 50(a)(5).

The recapture rules will not apply when property is transferred by reason of death. See IRC section 50(a)(4).

The recapture rules will not apply when property is transferred in certain tax-free liquidations and reorganizations pursuant to IRC section 381(a). See IRC section 50(a)(4).

Recapture will not apply in situations where there is a mere change in the form of conducting a trade or business provided the property is retained in the trade or business as IRC section 38 property and the taxpayer retains a substantial interest in the trade or business. See IRC section 50(a)(4).

BASIS ADJUSTMENT UPON RECAPTURE

Treas. Reg. section 1.48-12(e) requires that the basis of rehabilitated buildings, including certified historic structures, must be reduced by 100 percent of the rehabilitation credit earned regardless of whether the credit is used or carried forward. If the rehabilitated property is disposed of or ceases to be business use property within the 5-year recapture period, the amount of the recaptured credit is added back to the building's basis.

Congress intended that rehabilitated buildings be retained by the first owner to place the building in service after the rehabilitation is completed and is entitled to take the credit. A 5-year recapture period is prescribed by law. The recapture period is 5 full years from the original date of "placed in service," and is equal to 20 percent of the original credit as taken for each year less than 5 full years that the property is held by the owner in an income producing activity.

A recapture would be triggered by a disposition of the property by the owner or when the property ceases to be income producing. If it is determined that there was a disposition of the property, then the examiner should ascertain the specific date "placed in service" and the date of disposition to calculate the recapture using the full year recapture provisions of IRC section 50.

AUDIT TECHNIQUES

Examiner should ascertain whether there has been a disposition of the property by using local property records, inspecting the premises, questioning the owner/taxpayer, and inspection of corporate minutes. Books and records may reflect gain or loss on sale. A decrease in depreciation or other expense relating to the property may also be an indication of disposition. A decrease in income from the preceding year may be evidence of disposition of property or a conversion from business to personal usage. Inspection of the balance sheet may also show decrease in assets and possible corresponding decrease in mortgage liability. Examiners should also be alert for partial dispositions.

If it is determined that there was a disposition of the property, the examiner should ascertain the specific date "placed in service", see chapter 5, and the date of disposition using available evidence such as a settlement sheet or property records, to calculate the recapture.

A third party contact with the National Park Service may be needed to determine if a structure has been removed from the National Register or no longer contributes to a Registered Historic District.

When auditing partnership or partner interest, inspection of Forms K-1 should reveal any transfer of interest.

CREDIT RECAPTURE LAW

IRC section 50(a) - Recapture in Case of Dispositions, etc.

Treas. Reg. section l.48- 12(f)(3) - Credit recapture upon disposition of building/rehabilitation.

COURT CASE

In ***Rome I Ltd. v. Commissioner***, 96 T.C. 697 (1991), the Court in approving the conclusion of Rev. Rul. 89-90, 1989-2 C.B.3, held that the grant of a historical facade easement constitutes a disposition for purposes of IRC section 47, (or IRC section 50 under current law). The taxpayer had to recapture the portion of the rehabilitation credit which is attributable to the facade easement and reduce its basis in the underlying property upon granting of the facade easement. This situation would only occur if the facade easement is granted subsequent to the building being placed in service for a period of time.

Chapter 10

NO CREDIT FOR ACQUISITION COSTS

BACKGROUND

All structural components of the building normally qualify as basis for the rehabilitation tax credit, as well as some additional items outlined by the Internal Revenue Code, regulations, and court cases. Acquisition costs, or related costs incurred for the acquisition of the original shell, and land do not qualify for purposes of the rehabilitation tax credit. They are specifically excluded from the definition of qualified rehabilitation expenditures.

The cost of acquiring any building or interest therein, including a leasehold interest, pre-rehabilitation costs or the cost of acquiring a previously rehabilitated building that was already placed in service do not qualify. These costs are still included in the depreciable basis.

AUDIT TECHNIQUES

This issue is examined through the documents requested as Items 4, 9, and 12 of the sample Information Document Request (see Exhibit 3-1), in addition to local property records.

Inspection of the settlement sheets, and the accountant's workpapers would disclose the acquisition basis or depreciable basis.

Any financing agreements, or mortgages would also provide this information, as well as information regarding the acquisition interest.

If this documentation is not readily available, the information can be obtained through local property records.

If an examiner determines that acquisition costs were included in the credit basis, the costs should be removed from the credit basis and the depreciable basis should be restored.

ACQUISITION COST LAW

Acquisition costs are not included in qualified rehabilitation expenditures. See IRC section 47(c)(2)(B)(ii).

Acquisition costs do not included certain qualified rehabilitation expenditures. See Treas. Reg. section 1.48-12(c)(7)(ii).

Acquisition costs include interest on indebtedness to acquire the property/shell. See Treas. Reg. section l.48-l2(c)(9).

Chapter 11

ENLARGEMENT COSTS EXCLUDED

BACKGROUND

IRC section 47(c)(2)(B)(iii) excludes any expenditure attributable to the enlargement of an existing building from the definition of qualified rehabilitation expenditures. Section 1.48-12(c)(10) of the Treasury Regulations provides that a building is enlarged to the extent that the total volume of the building is increased. The total volume of a building is generally equal to the product of the floor area of the base of the building and the height from the underside of the lowest floor to the average height of the finished roof. The floor area is measured from the exterior faces of external walls.

A building is considered enlarged if the total volume is increased. Interior remodeling may increase floor space but if total volume is not increased it is not considered an enlargement.

ISSUES

Taxpayers will often try to include the cost of an enlargement as part of the rehabilitation tax credit basis. Examples of an enlargement include a roof top addition, extension of an external wall to increase floor space, the cost of a new basement or sub-basement, or any other building addition that has gone out beyond the original footprint of the building.

This issue is particularly prevalent with rehabilitation projects involving non-historic structures seeking the 10 percent rehabilitation tax credit. With these types of projects there exists no oversight by the National Park Service or State Historic Preservation Office.

The expenditures associated with the rehabilitation of a post-1936 building addition would not be eligible for the 10 percent rehabilitation tax credit per Treas. Reg. section 1.48-12(b)(4)(ii). Many taxpayers are not aware of this requirement.

AUDIT TECHNIQUES

The National Park Service (NPS) administrative files are particularly helpful for developing this issue in historical rehabilitation cases because these files usually contain documentation to establish the extent of a building addition.

A review of historical photographs may be helpful to determine if the building was enlarged as part of the rehabilitation project. The State Historic Preservation Office would be able to provide the examiner with this information.

It is important to review Part 2 of the Historic Preservation Certification Application. This part of the application contains questions regarding before and after square footage of the building undergoing rehabilitation.

Review the AIA documents. The AIA formatted construction vouchers will usually be separated to reflect an addition if it is of a material nature, or will contain a separate line item for the respective addition.

Once it has been determined that an addition is present, the examiner should determine the costs attributable to the addition. If costs are not separately stated, the examiner should ensure that a reasonable allocation of project costs (that is, square footage method or specific cost method) has been made. If the costs related to the addition do not appear to have been reasonably allocated by the taxpayer, an adjustment should be made. If the addition is significant and the cost allocations appear to be inaccurate, it is recommended that a referral to an IRS Engineering Group be made.

ENLARGEMENT EXPENDITURES LAW AND RULINGS

IRC section 47(c)(2)(B)(iii).

Treas. Reg. section 1.48-12(b)(2)(iv) - Rehabilitation includes renovation, restoration or reconstruction of a building, but does not include an enlargement or new construction.

Treas. Reg. section 1.48- 12(c)(10) - Enlargement is defined.

Treas. Reg. section 1.48- 12(c)(7)(iii) -- Enlargement expenditures not included in qualified rehabilitation expenditures.

A Private Letter Ruling held that the expenditures incurred to fill in a light and air well would be allowed as qualified rehabilitation expenditures eligible for the 20 percent rehabilitation tax credit. It was determined that converting the light and air well into useable space would not be considered an enlargement.

> Note: Filling an internal courtyard in to usable floor space, however, would be considered an enlargement.

Chapter 12

SITE WORK EXPENDITURES EXCLUDED

BACKGROUND

Site work expenditures, including any landscaping, sidewalks, parking lots, paving, decks, site utilities, outdoor lighting remote from the building, fencing, retaining walls, or similar expenditures related to the building, do not qualify for the rehabilitation tax credit. These items are specifically excluded from the definition of qualified rehabilitation expenditures because they are not considered made in connection with the rehabilitation of a qualified rehabilitated building. See Treas. Reg. section 1.48-12(c)(5).

Items 2, 9, 13, and 14 of the Information Document Request (see Exhibit 3-1) address this issue.

RECOMMENDED AUDIT TECHNIQUES/PROCEDURES

A visit should be made to the site where the building was rehabilitated. This not only confirms that the rehabilitated property exists, but also gives the examiner an idea of possible site work involved. Look for items such as landscaping, parking lots, decks, fencing, and sidewalks.

Secure a copy of the Historic Preservation Certification Application from either the National Park Service or the State Historic Preservation Office. Review the costs detailed on Part 2 of the Application. This part will detail site work, new construction, alterations, etc.

Review the administrative file for this rehabilitation project. This will be available from either the State Historic Preservation Office or the National Park Service. The file may contain pictures that show the type of site work performed.

Many States have comparable state rehabilitation tax credit. Some of these states require the taxpayer to provide a list of expenditures certified by an independent auditor to qualify for the state credit. Determine what the particular state requirements are and secure a copy of the lists of expenditures. Also, document all signatures on the application.

Part 3 of the Historic Preservation Certification Application, Request for Certification of Completed Work, contains a question regarding estimated costs attributable to site work and other excludible items. Compare these amounts to actual amounts incurred and note any differences.

Review the construction contract searching for site work costs. Within the contract you should find the detail of the construction to be performed, payment terms, change orders, arbitration disputes, etc. Document all signatures on the contract to determine potential related party issues.

Review the AIA formatted construction vouchers or pay estimates searching for site work. These pay estimates should be traced back to your account analysis.

Analyze all fixed asset accounts on the general ledger. For all entries above a pre-determined amount, request invoices. Some taxpayers will be lackadaisical about their record keeping. Advise the taxpayer that Treas. Reg. section 1.6001 requires the taxpayer maintain such records as are sufficient to establish the amount of credits shown on the return.

Journal entries made at or near the yearend should be reviewed for accuracy, particularly reclassification entries between, site work, land, and building accounts.

Reconcile the qualified rehabilitation expenditures claimed on the tax return to the general ledger and the tax return trial balance. The general ledger should represent all entries paid by check, accruals, and debt. This procedure will substantiate whether or not operating expenses were added to the eligible basis.

Review the qualified expenditures claimed for costs that are allocated between building and land. Usually the taxpayer will want to understate land and other site work costs in order to keep the qualified expenditures as high as possible. Consider reviewing real estate valuations of surrounding properties at the county courthouse. Remember that most state agencies are not set up to address issues such as reasonableness.

Inquire if financial statements are available. If bank financing is involved, the bank may require audited financial statements or at a minimum review statements. Compare the various fixed asset accounts on the financial statements to the tax return trial balance. Determine that no reclassifications have been made.

Scan the depreciation schedule for site work and personal property expenditures. If none are found, it may be an indication that they were included in the qualified rehabilitation expenditures.

Certain site work expenditures (such as landscaping) maybe immaterial, but parking lots and paving expenditures can result in a considerable adjustment. If an examiner determines that site work expenditures were included in the credit basis, the costs should be removed from the credit basis and the proper depreciation allowed.

SITEWORK EXPENDITURES LAW

See Treas. Reg. section 1.48- 12(c)(5).

Chapter 13

PERSONAL PROPERTY EXCLUDED

BACKGROUND

Personal property or furnishings, including any furniture and appliances, cabinets and movable partitions or carpeting, (if tacked in place versus glued) do not qualify for the Rehabilitation Tax Credit. The major expenditures to be removed from the qualified rehabilitation basis of most projects are the appliances and carpeting in residential rental or condo units. Refer to the law sections, court cases, and rulings below for more examples of personal property. Essentially, personal property is defined as "Section 38 Property" or Investment Tax Credit Property. These items are specifically excluded from the definition of qualified rehabilitation expenditures because they do not relate to the building or its structural components.

Items 9, 13, and 14 of the Information Document Request (see Exhibit 3-1) address this issue. Procedures outlined in Chapter 12 should be followed.

If an examiner discovers that the credit basis includes items which are considered personal property, the costs should be removed from the credit basis and the proper depreciation allowed. In this case, the straight-line method is not required and any accelerated method is allowable.

PERSONAL PROPERTY LAW

IRC section 47(c)(2)(A) - Personal Property Items/Non-Structural Components.

IRC section 168 (e)(2)(B) - Defines “non-residential real property” as section 1250 property which is not (1) residential rental property or (2) property with a class life of less than 27.5 years.

IRC section 1250(c) states that section 1250 means any real property (other than section 1245 property, as defined in section 1245(a)(3)) which is or has been property of a character subject to the allowance for depreciation provided in section 167.

IRC section 1245(a)(3) defines section 1245 property as any property which is or has been property of a character subject to the allowance for depreciation provided in section 167 and is either (1) personal property, (2) other property (not including a building or its structural components) but only if such property is tangible in which such property (or other property) (i) was used as an integral part of manufacturing, production, or extraction *** (ii) constituted a research facility *** (iii) constituted a facility used in connection for bulk storage of fungible commodities, (3) any real

property which has an adjusted basis in which there are reflected adjustments for amortization under IRC sections 169, 179, 179A, 185, 188, 190, 193, or 194.

Public Law (P.L.) 99-514 section 201(d)(11)C removed elevators and escalators from the list of definitions of IRC section 1245 property. These costs are eligible for the rehabilitation credit.

Treas. Reg. section 1.48-1 - Definition of IRC section 38 property.

Treas. Reg. section 1.48-1(c).

Treas. Reg. section 1.48-1(e).

Treas. Reg. section 1.48-11 Personal Property/"IRC section 38 property" items are excluded from qualified rehabilitation expenditures.

Treas. Reg. section 1.48-11(c)(6)(i) states that certain expenditures are excluded from qualified rehabilitation expenditures.

Treas. Reg. section 1.48-(12)(c)(i) states that expenditures are chargeable to a capital account if they are properly included in the year they are paid or incurred. Therefore, even if the taxpayer reports its other items of income and expense on the cash method of accounting, he is on the accrual method of accounting for qualified rehabilitation expenditures.

COURT CASES, REVENUE RULINGS, AND SENATE FINANCE COMMITTEE REPORT

Court Cases

In ***A. Liebl***, (DC)72- 2 U.S.T.C. 9581, ranges and refrigerators installed in apartments rented otherwise unfurnished were ineligible for the investment tax credit but the reasoning was because they were property used in a lodging facility.

In ***Alabama Displays, Inc***, Ct. Cl., 75- 1 U.S.T.C. 9116,507 F.2d 844, ***National Advertising Co***., Ct Cl. 75- 1 U.S.T.C. 9117, 507 F.2d 850 and ***Whiteco Ind Inc***., 65 T.C. 664, DEC 33,594, billboards for outdoor advertising purposes were tangible personal property and qualified for the investment credit.

In ***Minot Federal Savings and Loan Assn***., (CA-8) 71- 1 U.S.T.C. 9131, 435 F.2d 1368, it was found that removable partitions, which were not permanent and could be changed and moved without injury to the building, qualified for investment credit.

In ***S. Mandler***, 65 T.C. 586 DEC 33,500, coin operated washing machines and dryers leased for use in apartment buildings were eligible for the investment credit. The machines were not used predominantly in connection with the furnishing of lodging because they were accessible to non-residents as well as tenants.

Revenue Rulings

In Revenue Ruling (Rev. Rul.) 65-79, 1965-1 C.B. 26, bank vault doors, record vault doors, night depository facilities, and walk up and drive up teller windows which constitute depreciable units, are tangible personal property and qualify as IRC section 38 property. Drive up teller booths are considered buildings and do not qualify. Rev. Rul. 67-349, 1967-2 C.B. 48, stated that wall-to-wall carpeting as installed in the guestrooms, office space, bar areas and dining rooms of the motel buildings in this case, is tangible personal property within the meaning of IRC section 1.48-1(c) of the income tax regulations and will qualify as "IRC section 38" property for investment credit purposes provided it is depreciable property having a useful life of 4 years or more.

In Rev. Rul. 81-133, 1981-1, furniture leased to owners and operators of apartment buildings, duplex houses, and similar establishments that lease those facilities to tenants for periods of more than 30 days is property used in connection with the furnishing of lodging and is not IRC section 38 property for investment credit purposes. However, furniture leased directly to tenants of those facilities qualifies as IRC section 38 Property.

Senate Finance Committee Report

In the Senate Finance Committee Report for the 1978 Revenue Act (P.L. 95- 600), the following items were listed as qualifying for the investment credit (IRC section 38 property) as tangible personal property under existing law (highlights committee intent); special lighting, false balconies, exterior ornamentation, identity symbols such as materials attached to the exterior or interior of the building, signs, floor coverings which are not an integral part of the floor, carpeting, wall panel inserts, beverage bars, ornamental fixtures, artifacts (if depreciable), booths for seating, movable and removable partitions, large and small pictures which are attached to walls or suspended from the ceiling.

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Chapter 14

TAX-EXEMPT USE PROPERTY

BACKGROUND

The provisions set forth under IRC section 47(c)(2)(B)(v), dealing with property leased to a tax-exempt entity, may impact the use of the rehabilitation tax credit. These rules apply for both the 10 percent non-historic tax credit and the 20 percent historic tax credit.

DISQUALIFIED LEASE RULES

When a property owner leases their building or a portion of their building to a tax-exempt entity, that is, governmental unit, a tax-exempt organization, or a foreign person/entity, it is important that they are familiar with the "disqualified lease" rules that may prevent them from claiming an otherwise eligible rehabilitation tax credit.

IRC section 168(h) contains a comprehensive set of rules dealing with leases of property to "tax-exempt entities". Under these rules, real property, which is leased to a tax-exempt entity in a "disqualified lease", is treated as "tax-exempt use property." Qualified rehabilitation expenditures associated with tax-exempt use property are not eligible for the rehabilitation tax credit.

A "disqualified lease" is defined in IRC section 168(h)(1)(B)(ii) as a lease to a tax-exempt entity where:

? Part or all of the property was financed directly or indirectly by an obligation in which the interest is tax-exempt under IRC section 103(a) and such entity (or related entity) participated in the financing, or

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

? The lease term is in excess of 20 years, or

? The lease occurs after a sale or lease of the property and the lessee used the property before the sale or lease. See IRC section 168(h)(1)(B)(ii).

LEASE TERM

When determining whether a lease has a term in excess of 20 years, the term of the lease is deemed to begin when the property is first made available to the lessee under the lease. Treas. Reg. section 1.168(j)-1T Q17 states that the lease term includes not only the stated duration, but also any additional period of time which is within the realistic contemplation of the parties at the time the property is first put into service. The Treas. Reg. sections cite ***Hokanson v. Commissioner*** 730 F.2nd 1245, 1248 (9th Circuit 1984).

The Treasury Regulations also provide that the term of the lease includes all periods for which the tax-exempt lessee or a related party has a legally enforceable option to renew the lease, or the lessor has a legally enforceable option to compel its renewal by the tax-exempt entity or a related party, unless the option to renew is at fair market value determined at the time of renewal.

In other words, a lessor is allowed to renew a tax-exempt entity's original "under 20 year lease" as long as the new lease is at fair market value.

THE 35-PERCENT THRESHOLD TEST

An exception under IRC section 168(h)(1)(B)(iii) provides that property is treated as tax-exempt use property only if the portion of such property leased to tax-exempt entities under disqualified leases is more than 35 percent of the property.

The phrase "more than 35 percent" means more than 35 percent of the net rentable floor space of the building. The net rentable floor space would not include the common areas of the building, regardless of the terms of the lease. See Treas. Reg. section 1.168(j)-1T Q-6.

If more than 35 percent of a building is leased to a tax-exempt entity, a taxpayer would be able to claim the rehabilitation tax credit on the expenditures incurred for the portion of the building not rented to a tax-exempt entity. This is illustrated in the following example:

> A taxpayer purchases a building for $50,000 and spends $100,000 to rehabilitate the property. Three fourths of the building is leased to a tax-exempt entity for 25 years making 75 percent of its net rentable space tax-exempt use property. No rehabilitation tax credit would be allowed on the $75,000 of rehabilitation expenditures attributable to the tax-exempt use portion of the building. However, the taxpayer would be allowed a rehabilitation tax credit on the $25,000 expended on the portion of the building not leased to a tax-exempt entity.

In situations where an expenditure is not considered to be a qualified rehabilitation expenditure because it is applicable to a portion of the building which is tax-exempt use property, the expenditure can still be included in the computation to determine whether a building has been "substantially rehabilitated". See IRC section 47(c)(2)(B)(v).

PROPERTY OWNED BY PARTNERSHIPS WITH TAXABLE AND TAX-EXEMPT PARTNERS

Many tax-exempt organizations are affiliated with "for-profit" entities. In these situations, tax-exempt use property would not include property which is predominantly used by a tax-exempt entity in an unrelated trade or business (directly or through a partnership in which such entity is a partner) on which it pays taxes. See IRC section 168(h)(1)(D).

When property is owned by a partnership that consists of both taxable and tax-exempt partners, IRC section 168(h)(6) sets forth a number of specific rules intended to prevent the use of tiered arrangements or partnerships and other pass-through entities to allocate in a disproportionate manner the tax benefits and burdens of property owned by tax-exempt entities. In general, if any property that is not otherwise treated as tax-exempt use property is owned by a partnership that has both tax-exempt and taxable partners, the proportionate share of the property allocated to the tax-exempt partners will be treated as tax-exempt use property.

Any allocation to the tax-exempt entity of partnership items must be a "qualified allocation" (meaning equal distribution of income, gain, loss, credit and basis) and must have "substantial economic effect" (the Treasury Regulations provide that the economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences)

DISQUALIFIED LEASE RULE EXAMPLES

Example 1

A taxpayer rehabilitates an historic structure and leases the building to the City of Pleasantville. The taxpayer financed the rehabilitation with tax-exempt bonds issued by the City of Pleasantville. Even if the lease term is less than 20 years, the fact that the rehabilitation was financed (directly or indirectly) with bonds exempt from tax under IRC section 103(a), the agreement between the city and the taxpayer will result in a disqualified lease.

Example 2

A taxpayer rehabilitates an historic structure and leases the building to the Willow Theater, a non-profit community theater group. If the taxpayer includes in the lease agreement an option for the Willow Theater to purchase the building after 15 years, the agreement will result in a disqualified lease.

Example 3

A taxpayer rehabilitates an historic structure and leases the building to a foreign owned corporation. The lease agreement contains a provision where the lease term is equal to 15 years with a legally enforceable option to renew the lease for an additional 10 years at a fixed, non-negotiable price. Since the lease term is in excess of 20 years, the agreement creates a disqualified lease.

If, in this example, the lease agreement contained a 15 year option to renew at the fair market value that will be determined at the time of renewal, the agreement would not result in a disqualified lease.

Example 4

The historic St. Johns School was in dire need of a substantial rehabilitation. The school sold the building to a XYZ Limited Partnership for $500,000. The Partnership spent $1,000,000 rehabilitating the property. The Partnership leased the property back to St. Johns School. The resulting agreement would be a disqualified lease because IRC section 168(h)(1)(B)(iv) specifically states a disqualified lease occurs after a sale (or other transfer) of property by, or lease of the property from, the tax-exempt entity and the property has been used by the entity before the sale (or other transfer) or lease.

AUDIT TECHNIQUES

The Information Document Request should address this issue.

The examiner should review all leases to determine length of lease and the existence of sale options.

The examiner should determine how the rehabilitation project was financed and whether any lessee participated in the financing.

Property ownership history should be reviewed to determine if the current lessee was ever the owner or lessee of the property before rehabilitation.

TAX LAW

IRC section 47(c)(2)(B)(v).

IRC section 168(h).

IRC section 168(h)(1)(B)(iii).

Treas. Reg. section 1.168(j)-1T Q-6.

IRC section 168(h)(1)(D).

IRC section 168(h)(6).

ACKNOWLEDGEMENT

William F. Machen, Esq., Holland & Knight LLP, “The Historic Rehabilitation Tax Credit: Selected Tax Structuring Issues”

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Chapter 15

EXPENDITURES OF LESSEE

BACKGROUND

IRC section 47(c)(2)(B)(vi) provides that a lessee is eligible to claim a rehabilitation tax credit when the lessee incurs the cost of rehabilitation and the lease term, without regard to renewals, is greater than the recovery period determined under IRC section 168(c). The recovery period currently is 39 years for non-residential real property and 27.5 years for residential rental. The lessee, under these conditions, can claim the rehabilitation tax credit on qualified rehabilitation expenditures provided the "substantial rehabilitation test" is met.

SUBSTANTIAL REHABILITATION TEST

Treas. Reg. section 1.48-12(b)(2)(ii)(B), (iii)(B) and (vi) impose a substantial rehabilitation test on lessees seeking to utilize the rehabilitation tax credit. Under this test, the aggregate of qualified rehabilitation expenditures incurred by the lessor and any lessees must exceed the aggregate adjusted basis of all parties who have an interest in the building. As a result, the property owner (lessor) and several lessees could all qualify for the tax credit as long as the aggregate rehabilitation expenditures of all parties are considered when determining if the project meets the substantial rehabilitation test. The amount of credit each party would claim would be based on the amount each party expended during the rehabilitation.

Example 1

Taxpayer X owns a building and leases space in the building to Taxpayer A, Taxpayer B and Taxpayer C. Each lessee has a lease term that is in excess of 39 years. The adjusted basis of the building before rehabilitation is $75,000. Taxpayers X, B, and C spend a total of $80,000 to substantially rehabilitate the building. A credit has been generated of $16,000 ($80,000 x 20 percent). If Taxpayer X spent $25,000, Taxpayer B spent $10,000 and Taxpayer C spent $45,000, they will each be entitled to claim a portion of the allowable rehabilitation tax credit. $5,000 for Taxpayer X, $2,000 for Taxpayer B and $9,000 for Taxpayer C.

The lessee is responsible for establishing the lessor's basis when determining if the substantial rehabilitation test has been met. Generally, the lessor will provide the lessee with this information. In the event the lessor does not provide the required basis information, the lessee must show that their qualified rehabilitation expenditures incurred during the 24-month period exceeded the fair market value of the building on the relevant date.

In the event a lessee has undertaken the expense of a rehabilitation project and the lessor sells the building before the lessee met the substantial rehabilitation test, the lessee would be forced to use the purchase price of the new owner when determining if the project was substantially rehabilitated.

Example 2

Taxpayer X owns property and leases it to taxpayer A for 40 years. Taxpayer X has an adjusted basis of $500,000 in the property and does not wish to spend any money on rehabilitating the building. Taxpayer A must spend more than $500,000 during a 24-month measuring period to be eligible for the rehabilitation tax credit. If during the project, but before Taxpayer A spends more than $500,000, Taxpayer X sells the building to Taxpayer Z for $750,000, Taxpayer A must now spend more than $750,000 to be eligible for the rehabilitation tax credit.

PASS-THROUGH ELECTION BY LESSOR

IRC section 48(d) permitted a lessor and lessee to agree to treat the lessee as having incurred all or a portion of the rehabilitation expenditures incurred by the lessor. This "pass-through" election, under IRC section 48(d) was repealed in 1990, but its content was re-enacted under IRC section 50(d)(5).

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 IRC section 48(d) and 50(d)(5).

A tax-exempt entity cannot pass the rehabilitation tax credit to its lessee(s) because Treas. Reg. section 1.48-4(a)(1) requires that the property must be IRC 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.

In order for a lessee to qualify for the pass-through rehabilitation tax credit under IRC section 48(d), the following conditions must be satisfied:

? 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 and it must satisfy the other requirements set forth under Section 1.48-1 of the Treasury Regulations, "Definition of section 38 property."

? The property must be "new section 38 property" in the hands of the lessor, and the original use of such property must commence with the lessor.

? The property must be such that it would have constituted "new section 38 property" to the lessee if such lessee had actually purchased the property.

? A statement of election to treat the lessee as a purchaser must be made. See Treas. Reg. section 1.48-4.

? The lessor cannot be a mutual savings bank, cooperative bank, or an entity described in Treas. Reg. section 1.48-4(a)(1)(v).

As stated above, the property must be new section 38 property in the hands of the lessor and the pass-through election is not available unless the lessee is the "original user of the property". This means that as long as the lessee is the first person to use the property for its intended function (that is, placed in service by the lessee) the lessee will be treated as the original user of the property.

BASIS AND INCOME IMPLICATIONS

Treas. Reg. section 1.48-12(e) requires that the depreciable basis of a rehabilitated building be reduced by the amount of rehabilitation tax credit allowed. In the case of an election to pass-through the rehabilitation tax credit to a lessee, the basis adjustment required under Treas. Reg. section 1.48-12(e) and IRC section 48(q) does not apply. Consequently, the property owner (lessor) would not reduce its depreciable basis by the amount of rehabilitation tax credit allowed. However, in lieu of such basis adjustment, IRC section 48(d)(5)(B) (as in effect before the date of enactment of Revenue Reconciliation Act of 1990) requires the lessee to include in gross income an amount equal to the allowable rehabilitation tax credit spread over the recovery period.

Example 3

Taxpayer X incurs qualified rehabilitation expenditures of $500,000 and elects to pass-through his allowable $100,000 rehabilitation tax credit to his lessee. The lessee is entitled to claim the $100,000 tax credit, but must include in income an amount equal to $2,564 each year for the balance of the 39-year recovery period.

SHORT-TERM LEASE ELECTION

If a lessor elects to pass-through the rehabilitation tax credit to its lessee and the lease term is less than 80 percent of the class life of such property, the amount of the allowable credit is reduced. Accordingly, if the lease term is at least 31.2 years for non-residential rental property or 22 years for residential rental property, the short-term lease election rules do not apply. See Treas. Reg. section 1.48-4(a)(2).

In the case of a short-term lease, the rehabilitation tax credit is determined by the fair market value of the leased premises multiplied by a fraction, "the numerator of which is the term of the lease and the denominator of which is the class life of the property leased. See Treas. Reg. section 1.48-4(c)(3).

Example 4

Taxpayer X agrees to lease its entire property to Taxpayer A for 10 years. Taxpayer X rehabilitates his property and elects to pass-through its allowable rehabilitation tax credit to Taxpayer A. The fair market value of the property after rehabilitation is $120,000. Taxpayer A is allowed a rehabilitation tax credit in the amount of $6,154. [20% x ($120,000 x 10/39)]

NET LEASE

If the lease term is less than 80 percent of the class life of the property, the lease will not be considered short term if the lease constitutes a "net lease" within the meaning of IRC section 57(c)(1)(B) (as in effect before the date of enactment of the Tax Reform Act of 1986). See Treas. Reg. section 1.48-4(a)(2). A "net lease" is one where the lessor is either guaranteed a specified return or is guaranteed in whole or in part against loss of income.

AUDIT TECHNIQUES

The Information Document Request should address this issue.

Construction contracts and AIA vouchers may show items built to tenant specifications and separate billings to the lessee.

The workpapers may also show lessee/tenant expenditures for each unit and/or amounts reimbursed by the lessee.

If the examiner discovers that the credit basis includes lessee expenditures, or if a lessee is claiming a credit for lessee expenditures incurred, the examiner should inspect all leases to determine if the lease is considered long-term as determined by the initial term of the lease without regards to any renewal periods or options.

If the lease is not considered long-term, the examiner should remove the portion of the credit basis which pertains to lessee expenditures, or disallow the lessee's credit and allow the proper depreciation.

COURT CASE

In ***S.G. Eubanks***, 59 TCM 529, Dec. 46,567(M), T.C. Memo, 1990-227, no rehabilitation credit was allowed where the remaining term of the lease was less than the period prescribed by statute for amounts expended by a lessee which were considered qualified rehabilitation expenditures.

Chapter 16

CONSTRUCTION INTEREST & TAXES

BACKGROUND

The interest on the construction loan (as incurred during the construction period) can be included in the rehabilitation credit basis. This is also true for the taxes incurred during this period. Once the building is placed in service, the interest and taxes are considered period expenses no longer chargeable to the capital account. There are some instances where a portion of the construction loan is used for the acquisition of the building (or shell) and land. An allocation should be made using a reasonable method; the interest pertaining to the acquisition financing would be a period expense and any other interest chargeable to a capital account during the construction period would be allocated to the rehabilitation tax credit basis. The amount of interest attributable to the acquisition of the building, or the land on which the building exists is specifically excluded from the term " qualified rehabilitation expenditures".

AUDIT TECHNIQUES

Review the election (if any) made to capitalize interest, taxes, or other charges on the tax return.

Often times the acquisition costs include interest on acquisition of the property/shell. Make certain capitalized interest does not include interest on the acquisition. This expense relates to the acquisition and is specifically excluded from qualified rehabilitation expenditures. See IRC section 1.48-12(c)(9).

Review all schedules detailing IRC section 266 capitalized costs. Compare to the election made for consistency and reasonableness.

If the capitalized costs are material, review the Certificate of Occupancy and a copy of the first lease executed to verify when the building was placed in service.

Prepare or secure an analysis of all notes payable. Examine all notes payable for terms such as collateral, date of note(s), interest rate, due date, etc. Document signatures and corresponding titles of all entities signing the document. Determine if the note(s) were executed for the purpose of acquisition or for construction.

Calculate or secure a calculation of interest expense from the date of the note(s) to the date of completion. A review of any journal entries for interest accruals capitalized should be made.

Review cancelled checks made on debt payments. Note signature on check. Vouch significant payments during the period to the cash disbursements journal.

CONSTRUCTION INTEREST AND TAXES LAW

Treas. Reg. section 1.266-1(c) (2) states an election to capitalize annual taxes, mortgage interest, and other carrying charges on unimproved or unproductive real property may be made in one year but not in the following year.

Treas. Reg. section 1.266-1(c)(1) and 1.266(c)(2)(ii) indicates that if there are two or more items described in paragraph (b)(1) of Treas. Reg. section 1.266, which relate to the same project to which the election is applicable, the taxpayer may elect to capitalize any one or more of such items. However, if expenditures for several items of the same type are incurred with respect to a single project, the election to capitalize must, if exercised, be exercised as to all items of that type in later years.

Chapter 17

PROGRESS EXPENDITURES

BACKGROUND

In general, the rehabilitation tax credit can only be claimed when the building is placed in service. A taxpayer can make an election to claim the rehabilitation tax credit for qualified rehabilitation expenditures on qualified “progress expenditure property.” Qualified progress expenditure property is any property which has a normal construction period of 2 years or more, and which will be a qualified rehabilitated building in the hands of the taxpayer when it is placed in service.

The 2-year construction period begins on the first day the rehabilitation begins or the first day of the taxable year which the election is made, and ends when the building is available to be "placed in service." Any expenditures which are incurred prior to the beginning of the 2-year period do not qualify as progress expenditures. Expenses do not qualify as progress expenditures in the year the property is placed in service, or in the year the credit is recaptured under IRC section 50(a), if applicable.

Qualified progress expenditures are amounts chargeable to the capital account during the taxable year for self-rehabilitated property if more than half of the rehabilitation expenses for the property are made directly by the taxpayer. If the property is not self-rehabilitated, qualified rehabilitation expenditures would be the lesser of amounts paid during the taxable year to another person for rehabilitation of the property, or the amount which represents the portion of the taxpayer's total cost for the rehabilitation by the other person which is properly attributable to the rehabilitation completed during the taxable year. Any amount not allowed in the current year would be carried over to the subsequent year.

Although the law is silent to the application of the substantial rehabilitation test, it is the Internal Revenue Service's position that the substantial rehabilitation test must first be met before progress expenditures would qualify in a given year. Refer to Chapter 6, Substantial Rehabilitation Test, for auditing techniques and the law to support the substantial rehabilitation requirements.

A credit based on the progress expenditure method constitutes an election under this section. However, the progress expenditure method is used very infrequently when compared to the conventional method based on placed in service.

NOTE: In a situation where "placed in service" is the correct timing for taking the credit and the Service is raising an issue regarding the building (or a portion of the building) not being placed in service timely, the taxpayer should not be allowed to use the progress expenditure method regarding the disallowed items.

PROGRESS EXPENDITURE LAW

Refer to IRC section 47(d).

Chapter 18

FACADE EASEMENT

BACKGROUND

Many historical property owners elect to use IRC section 170(h) and make a charitable donation of a facade easement to an organization that is exempt from tax under IRC section 501(c)(3). A preservation easement is a legal agreement designed to protect a significant historic, archaeological, or cultural resource. In the case of a façade easement, the historic property owner is assured that the building's facade will be maintained, protected and preserved forever.

Other qualified conservation easements that could result in a charitable contribution deduction include the donation of a historically important land area or the donation of a historically important building interior easement.

The deduction the taxpayer is entitled to is equal to the fair market value of the easement, which is generally the decrease in fair market value of the property caused by the restrictions placed on the property because of the easement.

The gift of a facade easement must be made for conservation purposes, such as the preservation of a certified historic structure and must be protected in perpetuity (forever). A certified historic structure is any building, structure or land area which is either: (1) Listed in the National Register; or (2) Located in a registered historic district and certified by the Secretary of Interior as being of historic significance to the district. A structure is certified for purposes of this definition if it is certified either at the time of the contribution or on the due date, including extensions, for filing the donor's tax return for the taxable year of the contribution.

Unlike property eligible for the rehabilitation tax credit, the conservation easement donation can be from a structure that is used for either business or non-business (that is, personal residence). If the historic structure is not visible from a public way, the terms of the easement must permit regular viewing by the general public of the historic characteristics and features of the property, to the extent such viewing is consistent with the nature and condition of the property.

A special rule applies for contributions of interests in real property subject to a mortgage. No charitable deduction is allowed unless the mortgagee agrees to subordinate its rights to the property to the right of the donee to enforce the conservation purposes in perpetuity.

Internal Revenue Service Engineers have concluded that the proper valuation of a façade easement should range from approximately 10 percent to 15 percent of the value of the property. Once fair market values have been determined, the same ratios

are used to allocate the basis of the building and the underlying land to the façade easement for both rehabilitation tax credit and depreciation purposes. See Treas. Reg. section 1.170A-14(h).

If an individual, personal service corporation, closely held corporation, partnership, or an S-corporation donates and claims a deduction for property valued in excess of $5,000, the taxpayer must obtain a qualified appraisal and attach a fully completed summary of the appraisal to the income tax return. If the donor is an S-corporation or partnership, it must provide a copy of the "appraisal summary" to each partner or shareholder that receives an allocation of the charitable contribution deduction.

The "appraisal summary" is a summary of a qualified appraisal that includes the following information:

? The name and tax identification number of the donor.
? A description of the property in sufficient detail.
? A brief summary of the physical condition of the property.
? An account of the manner of acquisition.
? The cost or other basis of the property.
? The name, address and tax identification number of the donee.
? The date the donee received the property.
? A statement explaining whether or not the contribution was made by means of a bargain sale and the amount of any consideration received from the donee for the contribution.
? The name, address and identification number of the qualified appraiser.
? The fair market value of the property on the date of the contribution.
? A description of the fee arrangement between donor and the appraiser.

See Treas. Reg. section 1.170A-13(c) for additional information relating to qualified appraisals.

The donor who makes a qualified conservation easement must reduce the adjusted basis in the portion of the property retained by the amount of the total adjusted basis of the property allocable to the interest contributed. For example:

Fair Market Value before	$80,000	
Fair Market Value after	68,000	(85% of FMV)
Value of easement	12,000	
Adjusted Basis before	20,000	
Adjusted Basis after	17,000	(85% of Adjusted Basis)

When a façade easement is conveyed during the same year a qualified rehabilitated building is placed in service, the taxpayer would not be entitled to claim the portion of the rehabilitation tax credit attributable to the façade easement.

If a taxpayer claimed a rehabilitation tax credit with respect to property and subsequently makes a qualified conservation contribution (that is, façade easement) with respect to the property, the charitable contribution is considered a partial disposition of the property. This event will trigger recapture of all or part of the credit if the contribution is made within the recapture period (5 years from the placed in service date).

AUDIT TECHNIQUES

When a facade easement donation appears on the tax return, the examiner should:

? Determine if the property is a certified historic structure. The State Historic Preservation Office should be able to provide this information.

? Ascertain if the contribution was made after the property was certified. If not, disallow the contribution. However, if the property was certified before the due date of the return including extensions, there is no issue.

? Determine if the donation was made to a qualified organization (IRC section 501(c)3).

? If the valuation of the easement appears high, refer the case to an IRS Engineer for review.

? If the taxpayer had previously claimed a rehabilitation tax credit on this property, make certain the taxpayer has recaptured a portion of the credit. If the taxpayer is making this contribution in conjunction with a rehabilitation tax credit project, make certain the tax credit has been reduced to reflect the amount of attributable to the façade easement.

FACADE EASEMENT COURT CASES/REVENUE RULINGS

Refer to Revenue Ruling 89-90 and ***Rome I, Ltd v. Commissioner***, 96 T.C.697 (1991) for further information on the tax effect of combining the rehabilitation tax credit with a façade easement donation.

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Chapter 19

DEVELOPER FEES

BACKGROUND

One of the most material issues encountered on rehabilitation tax credit cases is the inclusion of development fees in the reported qualified basis of the projects. The characterization of these fees as purportedly incurred for "development," as well as the percentage charged in relation to the hard costs of the various projects, have made them questionable as properly qualifying rehabilitation expenditures. The Regulations indicate that developer fees are included in the qualified rehabilitation basis. The flaw in the law section is that the term "developer fee" or "development fee" is never defined. The general idea of allowing the inclusion of a cost in the basis, without defining what is properly included, can lead to improper inclusion in basis, significant credit disallowance, and tax change once the real character of the costs incurred has been determined.

The text which follows identifies the potential issues and highlights any possible forms the developer fees may take, the applicable law sections, and positions successfully taken to address the issues encountered regarding developer fees.

To successfully address potential developer fee issues, an examiner must first identify various aspects of the developer fee, as it has been included in the rehabilitation project under examination. The primary task is to identify the following:

? The amount of the developer fee and method of payment, cash or note. Determine if the cash payments, and payments per any notes or financing, were actually paid to date, or if the were incurred, accrued, and never paid.

? The reasonableness of the developer fee amount, for example, arms-length negotiations, disguised costs, etc.

? The definition of developer. Note: If the developer is an entity, determine who is behind that entity; identify the ownership through any tiers, etc., which may have been layered to insulate the real owner of the developer entity. Trace the entire series of transactions to specifically identify all entities, and who owns/controls them.

TYPES OF DEVELOPER FEES

Turnkey Project - Where the partnership enters into an agreement with a developer to pay an amount, which includes all hard construction costs, and the

balance is earned by the developer as the developer fee. An example of this arrangement would be a situation where the development agreement calls for a payment of $2 million with the estimated hard costs of the project budgeted at $1,200,000. If the actual costs are consistent with the budgeted amounts then the developer will have earned a fee of $800,000. The key factor to establish in this case is the type of service the developer has performed to justify this compensation or fee, and how these amounts should be characterized for tax purposes. The partnership/owner usually acquires the building before the development contract is entered. There may be a variation of this “Turnkey” situation where, in addition to contracting for the development of the project, the shell purchase is also included in the contract price.

Fixed Amount Developer Fee - A fixed amount developer fee occurs in a situation where the "hard costs" and the developer fee are separately stated items. The developer fee is usually based on the estimate or budget for hard costs. For example, $1 million of hard costs with a developer fee added in a fixed amount of $150,000. In this situation, the partnership/owner has usually already acquired the shell prior to entering into the development contract. Unlike a Turnkey Agreement, the developer fee does not decrease if the hard costs exceed their budgeted amounts.

Completed Project Developer Fee - A completed project developer fee is one that is passed on to the ultimate purchaser of the building as a component of the purchase price. The building in this case is sold as a completed package after the rehabilitation work is finished. The sales price includes components or costs for the original land, shell, rehabilitation costs, and any development costs or other "soft costs." The primary task is to determine the components of the purchase price, who was involved in the transaction, what was their purported role in the transaction, and what their actual role was in the transaction. This analysis will probably lead to conclusions that include "substance versus form" arguments. To make this argument, the facts and transactions must be established, and the players and their roles properly identified. If done correctly, a good and substantive argument for recharacterization of these soft costs can be made. These costs are not included in the rehabilitation tax credit, depreciation, or amortization basis. Depending on the size of the project or the materiality of the fees involved, substantial adjustments may be warranted. In some cases, the partnership may be buying one or more condominium units in a completed project. If this is the case, then an additional issue may be involved due to extensive sales and marketing expenses, which are passed through to the purchaser when the condominium units are sold. Although these costs can be included in the basis for depreciation purposes, they do not qualify for inclusion for purposes of the Rehabilitation Tax Credit.

Failed Project Developer Fee -- A developer fee under either a Turnkey Agreement or a Fixed Amount Developer Agreement may be evident in another type of project which is commonly referred to as a "Failed Project." The key factor to remember in this situation is that the failure referred to is usually one in terms of depleted finances or total bankruptcy of a former owner. Usually the salvaging of this project by the new developer depends upon their ability to

syndicate and sell this project to a new group of investors. Enough capital must be generated to buy the project, complete the remaining rehabilitation items, and also cover the "soft costs" incurred for the services of the individuals involved in completing the project. As in all the above scenarios the identification of all the transactions and players is imperative in raising any issues regarding fees or soft costs.

In addition to the identification of the particular developer fee scenario, there are various examination techniques and Information Document Request items that can help in developing these issues. Refer to Items 1, 4, 9, 11, 12, 13, 14, and 17 on the IDR (see Exhibit 3-1) for the following documentation:

? The Offering Memorandum for a syndicated partnership will probably discuss the transactions of the partnership, including any development contracts to be entered into or development fees to be paid. Offering Memorandums are also helpful because the parties to the various transactions will be disclosed, particularly if there are conflicts of interest which would signal transactions which are not at arms-length.

? The settlement sheet may contain not only the purchase of the shell, but also all development costs.

? Workpapers used to prepare the tax return, and audit workpapers (if the accountant performed an audit), may contain narrative and numbers related to a development contract or fees.

? Bank statements and canceled checks could document payments made as developer fees or related to a development contract.

? Financing agreements, particularly for construction financing, also assist in making determinations regarding the propriety of developer fees.

? Both the construction contract and the AIA (American Institute of Architects) formatted construction vouchers provide insight into the size of the project, the hard costs, the time frames and degree of completion at various intervals throughout the construction period.

NON-QUALIFYING COSTS

Based on both past and current tax law provisions dating from 1976 through 1993, developer fees are an allowable part of the qualified rehabilitation basis. However, when the transactions are analyzed and the facts established, there are opportunities for adjustments to recharacterize items that are not development fees, but have been characterized as such to increase non-qualifying costs included for computation of the Rehabilitation Tax Credit basis.

Examples of expenses, which may be incorrectly characterized to obtain tax benefits, include:

? **Syndication Costs** -- The cost of syndicating a partnership and its related investment units. Syndication costs are normally items incurred for the packaging of the investment unit, the partnership, and the promotion as an investment, including any marketing of the actual units, the production of any Offering Memorandums or promotional materials, the mobilization of any brokers/dealers who will sell the partnership units, and the actual sales commissions paid to the sellers of the partnership whether they be unrelated third parties or the individuals who promoted the investment. Note that the individual or entity who acts as the developer may have been involved in the syndication aspects of the project, including the structuring of the investment unit, the work necessary to coordinate and effectuate the promotion of the investment units through syndication, and the subscription for the partnership units. Also note that the developer, in many instances, is the one who originally created the investment units. The individual or entities involved in the project will characterize all of their activities as "development" in nature, and will include the associated costs in the Rehabilitation Tax Credit basis. Under IRC section 709 these costs should not be currently expensed, or amortized, and are not included in the qualified rehabilitation basis for purposes of the Rehabilitation Tax Credit; nor are they included for depreciation purposes.

? **Organization Costs** -- The cost of organizing a partnership should be amortized over a period of time not less than 60 months. This organization cost should include the legal and accounting costs necessary to organize the partnership, facilitate the filings of the necessary legal documents, and other regulatory paperwork required at the state and national level. In addition to the requirement that these costs be amortized, they are not includible in the Rehabilitation Tax Credit basis nor are they allowable for depreciation purposes.

? **Acquisition Costs** -- Under the provisions of IRC section 47, (formerly IRC section 48(g)), the costs of acquiring the shell before rehabilitation are not qualified rehabilitation expenditures. These costs may be passed on to the partnership in the purchase price of a completed project. If the partnership purchased the building before rehabilitation then there are two components that must be identified. The actual cost of the land and shell can be identified through review of the settlement sheet while additional indirect costs of acquisition are more difficult to detect. These indirect costs include amounts paid to the promoters who have actually purchased the property on behalf of the partnership. The compensation for the promoter’s services will be characterized as developer fees rather than acquisition costs to qualify them for the rehabilitation credit. These costs may be significant (depending on the size of the project) because promoters will complete feasibility studies to determine if they want the property. Also, buildings may be purchased months or years prior to rehabilitation and extensive "holding costs" may be

incurred. Throughout this time period, the promoter's services are necessary and reimbursements for these services are made.

? **Rent-Up/Lease-Up Costs -** "Rent-up" or "lease-up" costs are the costs necessary to fully rent the newly renovated building. This initial rental can take several years and costs can be extensive, including advertising, sample unit costs, on-site rental managers and staff, initial rental incentives, and any other costs to fully rent out the buildings. These costs should be amortized over the life of the leases if long term, but if short term then the amortization should be over the period necessary to rent out all units, (24 months or 36 months).

? **Rental Management -** Rental management is the continuing day-to-day managing of the property including all dealings with the tenants, renewal of current leases, procurement of new tenants for any vacancies, etc. Rental management fees are usually a set amount plus 6 percent for any lease renewals and incentives for new tenants obtained to fill vacancies. These amounts should be expensed on a yearly basis and matched against current rental income.

The above costs are the most common expenses incorrectly included in the Rehabilitation Tax Credit basis. If additional categories or terminology are encountered, determine what they were for, how paid, and who received the payment. An analysis will then be necessary to determine the proper tax treatment.

TIMING OF EXPENSE

An expenditure is incurred by a taxpayer when such expenditure would be considered incurred under an accrual method of accounting. Under the accrual method of accounting, an expenditure is incurred when all the events have occurred which determine the fact of the liability and the amount can be determined with reasonable accuracy. Accordingly, a taxpayer may treat an expense as incurred when its liability for that expense is fixed and absolute. However, if a taxpayer's liability for an expense is only contingent or conditional (that is, it is not fixed and absolute), the taxpayer may not treat that expense as incurred.

COURT CASE

In ***Brassard v. Commissioner***, 183 F. 3d. 909 (8th Cir. 1999); 99-2 U.S.T.C. P50,752, 84 A.F.T.R. 2d 5386, the partnership's liability for the developer's fee was only conditional under the terms of the limited partnership agreement. Under the terms of the agreement, the partnership was obligated to pay the developer's fee "only to the extent of available cash." The Court interpreted this provision of

the agreement as imposing only a conditional liability because the partnership's obligation to pay does not arise until or unless it has "available cash." To the extent the partnership lacks or avoids having available cash, no enforceable liability exists. Because the partnership did not have available cash in the year the credit was claimed, it had no fixed obligation to pay the developer's fee and, thus, improperly treated the fee as an accrued expense. In conclusion, the partnership did not incur the developer's fee expense in the year the credit was claimed because its liability for the fee was only conditional, therefore, the fee is not included in the rehab credit basis.

POSITION PAPER

A position paper was created to address the developer fee issue. See Exhibit 19-1. This is a sample report that can be used to address the development fee issue. This position was tested in a Tax Court Case that the Service won. Details regarding the Tax Court Case will follow this position in synopsis form. For purposes of this guide, fictitious names have been used. This report can be adapted to address different developer fee scenarios. Case examinations revealed some fees were as high as 100 percent of the project's hard construction costs. Even allowing consideration based on arguments that to rehabilitate an existing building according to the historical standards was more difficult than undertaking new construction, these fees were excessive when compared to arms-length transactions. The development of the facts surrounding the fees and what services were really provided to warrant the fees, are the items that will support the position, and make adjustments plausible.

The case presented in the sample report (Exhibit 19-1) is ***Richard E. Kara and Mind Kara v. Commissioner, and Franklin D. Zuckerman and Lois Zuckerman v. Commissioner***, T.C. Memo 1991-436. The court determined that the partners/developers failed to establish that they performed any of the services relating to the renovation of the property as set forth in the development agreement and the examiner discovered that most of the services had actually been performed by a third party under a separate agreement and for which that third party was separately compensated. As previously indicated, factual development of these cases is imperative.

The sample report can be modified to accommodate various situations involving development fees. However, recharacterization of credit and depreciable basis amounts must be supported by adequate factual development. Cases with similar fact patterns have been sustained in the courts using the above report as a guide. The significance of the case lies in the Court's acceptance of the analysis of purported development fees and determination of proper tax treatment.

Finally, examiners should be aware that there are regulations that address situations where a developer fee is paid upon the sale of a completed rehabilitated building that is first placed in service by the new owner. In these situations,

examiners can use the following law sections that treat the developer fees as addition to the purchase price as costs of acquisition, and not a qualified rehabilitation expenditure. Treas. Reg. section 1.48-12(c)(3)(iii) provides examples of expenses incurred by the taxpayer for purposes of qualified rehabilitation expenditures.

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Sample Report

FORM 886-A EXPLANATION OF ITEMS

Issue

Whether syndication expenses in the amount of $650,000 are included in the "qualified rehabilitation basis" for purposes of rehabilitation tax credit and for depreciation basis purposes.

General Background/Facts

Historic Associates Partnership started on October 15, YYYY, per the YYYY partnership return and the partnership agreement as submitted during audit. Per the YYYY partnership return, there are 33 partners in Historic Associates. The partnership is a limited partnership and the sole general partner is "X." "X" has also been designated as the Tax Matters Partner per the partnership agreement, and based on recent correspondence, that Tax Matters Partner designation remains currently in force and effect.

The Offering Memorandum indicates that Historic Associates is a partnership formed under Pennsylvania Law to acquire a four story building in the Old City Historic District of Philadelphia, Pennsylvania. The partnership rehabilitated the structure into 42 luxury apartments and 8,000 square feet of commercial space. Based on the Offering Memorandum and background obtained during the audit, the partnership intended to, and actually has, operated this project as an apartment rental project.

The partnership, from the outset, intended to obtain historical certification of the project's qualifying rehabilitation costs and take the 20 percent Certified Historical Rehabilitation Credit. Based on verification with the National Park Service and the Part III Certification as submitted by the partnership during audit, the rehabilitation work as performed has been "certified" by the National Park Service. As long as the costs are for "qualified rehabilitation expenditures" they can be included in the basis for the 20 percent Historical Rehabilitation Credit. Historic Associates was one of various partnerships promoted, syndicated, organized, and managed through various general partners on behalf of the "Y" Group. These partnerships were very similar in nature in that all were primarily formed to acquire, rehabilitate and subsequently rent the historic structures as residential/luxury apartments.

A major selling feature of these limited partnership interests was the 20 percent Certified Historic Rehabilitation Tax Credit available for "qualifying rehabilitation expenditures" as defined by Federal tax law and subject to the rehabilitation works approval by the National Park Service. Adding to the attractiveness of these partnerships was their leveraged nature whereby usually less than 10 percent of the purchase price of the investors limited partnership interest was required to be paid by cash, while the remaining amounts were paid by notes from the investors to the partnership and which were payable over a 5-year period.

The partnerships were also similar in that various functions and services necessary to carry out the intended purposes of the partnerships were usually performed by the many affiliates that operate under the auspices of "Y" Group.

These functions included but were not limited to the following:

? The sponsoring, syndication, and promotion of the various limited partnerships to raise the necessary capital to acquire, rehabilitate, and subsequently rent out the projects. "Y" and its affiliates were responsible for creating an investment package, (the limited partnership interests), that had an appeal to investors. Without this attractive investment package, as created and promoted by "Y," the functions performed by "X" as indicated below would be impossible to accomplish.

After creation and formation of the various partnership investment vehicles it was then necessary to seek out and engage various broker/dealers capable of selling these investments to the ultimate limited partner/investors throughout the country. Once engaged, "Y" had to mobilize these broker/dealers to sell the units and complete syndication of the respective limited partnerships.

One of the company's strengths was the creation of partnerships that had appeal to investors. Their staff had to communicate the merits of their programs. The limited partnerships were marketed through stock brokers, insurance agents, and financial planners who then communicate with and sell the partnership units to the investing public. "Y," through its employees, had to educate the registered securities dealers of the benefits of investing in the limited partnerships in addition to the economic and tax incentives. Additionally, for the later year projects, the company had a "Due Diligence Office" which provided detailed financial and tax information to broker/dealers on all more recent offerings.

As indicated above, a substantial amount of time and work was invested in the creation of the investment package and the subsequent promotion, syndication, and sale of these limited partnership investments by "Y."

? The placement of a general partner for the various partnerships to act in the capacity of, and to perform the normal functions and duties of general partner. In this fiduciary role as general partner, the individuals or entities that acted as general partners had the exclusive right to manage the business affairs of the partnership. In most of the promotions, the general partners were either "key employees"/owners of "Y," entities owned by "key employees"/owners of "Y," or shared some "affiliation" with the "key employees"/owners of "Y" and usually acted under the guidance of "Y" in their role as general partner.

? The work necessary to "organize" the partnership which was more in the nature of an expenditure in relation to the creation of the partnership than of an expenditure relating to the carrying on of the intended business operations or "day-to-day business" of the partnership.

? The "acquisition" work necessary by "Y" and its "affiliates" to find potential buildings and perform economic and feasibility studies of the buildings, and their general market areas including phone and on-site type reviews, and analysis, negotiations by "Y" and its affiliates on behalf of the partnerships for the purchase of the land and buildings, the settlements/closings on the ultimately selected land and buildings, and the work necessary to maintain, manage, and hold such land and buildings until the rehabilitation is commenced by a developer on behalf of the partnership.

? The formation/engagement of a developer entity to directly perform (or to subjugate to an affiliate in order to have performed) the necessary development work performed for the rehabilitation of the "Historically Certified" building owned by the particular partnership. This development work/contract usually includes a commitment of the various "Y" entities to effect the rehabilitation and renovation of the particular project owned by the partnership under audit. The development agreements are usually "Turn Key" in nature and for a fixed price the "developer" will arrange for, manage, and pay for the construction and completion of the rehabilitation and renovations planned for the particular project. In all of the examined partnerships, the identified "developer entities" were determined to be owned by individuals or entities which were also determined to have been "Key Employees" or owners of "Y."

? Two additional services included as "developer fees" were "Cash Flow Guarantees" and "Investor Surety." While outside unrelated sureties were engaged to guarantee the payment of the "Limited Partners Investor Notes" for a non-refundable premium price, the "Cash Flow Guarantees" were provided by an entity which was an affiliate of "Y." These affiliates would, for a set price, guarantee to lend to the particular partnership the cash amounts necessary to pay the obligations of the partnership under particular notes or, in some promotions, the guarantee was limited to a particular dollar amount.

? A final category which appeared in the partnerships or promotions was the use of an affiliate of "Y" as manager of the subsequent rental operations of the particular projects as the buildings became available to be "placed in service." These management agreements usually addressed renting, leasing, operating, and managing the projects for various commissions based on gross annual rentals. Additional incentives were paid for re-rentals and renewals at the various apartment buildings.

Additional Facts

NOTE: The preceding pages included general facts and background regarding both Historic Associates and the promoter "Y." Additional facts will address the dates, amounts, and specifics regarding the transactions entered into by the partnership during the acquisition and rehabilitation phase of the project.

All of the information presented below was obtained during the examination through review of the Offering Memorandum, the books and records, legal documents (including but not limited to the Settlement Sheet for the acquisition of the

property/shell), the "Development Agreement," "Development Note, "Partnership Agreement, AIA (American Institute of Architects) Application and Certificate for Payment, Statement/Certificate of Occupancy, the first lease executed after completion for occupancy, National Park Service application and responses Parts I, II, and III which verify the Historical Certification of the rehabilitation work on the particular project, and any oral testimony as presented by attorneys or accountants acting as Powers of Attorney for the examined partnership, and officers or employees of the "Y" organization.

? The partnership name is Historic Associates and is located in Philadelphia. The rehabilitated building is also located in Philadelphia. The building shell was purchased September 6, 1990. The purchase price of the shell was $600,000, ($400,000 as cash and $200,000 as seller take back mortgage from a bank).

? The developer entity is known as Development Company. The ownership of Development Company is as follows:

65 percent--Apartments Inc. (100 percent Owned By "Z")
15 percent--"X" (Current General Partner of Historic Associates)
15 percent--"A" (Key Employee of "Y")
5 percent--"B" (Key Employee of "Y")

? The development contract is a "Turn Key Contract" and the amount is $3,600,000 with $750,000 to be paid in cash while the remainder of $2,850,000 will be paid by note (development note).

? The rehabilitation expenditures, reflected as basis for the Rehabilitation Tax Credit, have been tied to the books and records and verified by documents submitted during the audit. Based on all items as submitted, and information obtained during the audit, the examining revenue agent isolated "non-qualifying" items.

TAX LAW

Tax Treatment of Syndication and Organization Expenses. Under IRC section 709, the following treatment is applied to organization and syndication fees.

IRC section Treatment of Organization and Syndication Fees

(a) General Rule - Except as provided in subsection (b), no deduction shall be allowed under this chapter to the partnership or to any partner for any amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such partnership.

(b) Amortization of Organization Fees-- (1) Deduction- amounts paid or incurred to organize a partnership may, at the election of the partnership (made in accordance with regulations prescribed by the secretary), be treated as deferred expenses and shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the partnership (beginning with the month in which the partnership begins business), or if the partnership is liquidated before the end of such 60 month period, such deferred expenses (to the extent not deducted under this section) may be deducted to the extent provided in section 165. **(2) Organization Expense Defined-** The organizational expenses to which paragraph (1) applies, are expenditures which-

(a) Are incident to the creation of the partnership;
(b) Are chargeable to capital account; and
(c) Are of a character which if expended incident to the creation of a partnership having an ascertainable life, would be amortized over such life.

Under Treas. Reg. sections 1.709-1 and 1.709-2, the following treatment is applied to organization and syndication fees.

Treas. Reg. section 1.709-1

Treatment of Organization and Syndication Costs.--(a) *General Rule.* Except as provided in paragraph (b) of this section, no deduction shall be allowed under Chapter 1 of the code to a partnership or to any partner for any amounts paid or incurred, directly or indirectly, in partnership taxable years beginning after December 31, 1975, to organize a partnership, or to promote the sale of, or to sell, an interest in the partnership.

(b) *Amortization of organization expenses.* (1) Under section 709(b) of the Code, a partnership may elect to treat its organizational expenses (as defined in IRC section 709(b)(2) and in 1.709-2 (a)) paid or incurred in partnership taxable years beginning after December 31, 1976, as deferred expenses. If a partnership elects to amortize organizational expenses, it must select a period of not less than 60 months, over which the partnership will amortize all such expenses on a straight-line basis. This period must begin with the month in which the partnership begins business (as determined under 1.709-2 (c)). However, in the case of a partnership on the cash receipts and disbursements method of accounting, no deduction shall be allowed for a taxable year with respect to any such expenses which would have been deductible under section 709(b) in a prior taxable year if the expenses have been paid are deductible in the year of payment. The election is irrevocable and the period selected by the partnership in making its election may not be subsequently changed. (2) If there is a winding up and complete liquidation of the partnership prior to the end of the amortization period, the unamortized amount of organizational expenses is a partnership deduction in its final taxable year to the extent provided under section 165 (relating to losses). However, there is no partnership deduction with respect to capitalized syndication expenses.

(c) *** The election to amortize organizational expenses provided by section 709(b) shall be made by attaching a statement to the partnerships return of income for the taxable year in which the partnership begins business. *** In the case of a partnership which begins business in a taxable year that ends after March 31, 1983, the original return and statement must be filed (and the election made) not later than the date prescribed by law for filing the return (including any extensions of time) for that taxable year. Once an election has been made, an amended return (or returns) and statement (or statements) may be filed to include any organizational expenses not included in the partnerships original return and statement.

Treas. Reg. section 1.709-2

Definitions.--***(a) Organizational expenses***. Section 709(b)(2) of the Internal Revenue Code defines organizational expenses as expenses that:

(1) are incident to the creation of a partnership;
(2) are chargeable to capital account; and
(3) are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would (but for section 709(a) be amortized over such life.

An expenditure, which fails to meet one or more of these three tests, does not qualify as an organizational expense for purposes of section 709(b) and this section. To satisfy the statutory requirement described in paragraph (a)(1) of this section, the expense must be incurred during the period beginning at a point which is a reasonable time before the partnership begins business and ending with the date prescribed by law for filing the partnership return (determined without regard to any extensions of time) for the taxable year the partnership begins business. In addition, the expenses must be for creation of the partnership and not for operation or starting operation of the partnership trade or business. To satisfy the statutory requirement described in paragraph (a)(3) of this section, the expense must be for an item of a nature normally expected to benefit the partnership throughout the entire life of the partnership. The following are examples of organizational expenses within the meaning of section 709 and this section: Legal fees for services incident to the organization of the partnership, such as negotiation and preparation of a partnership agreement; accounting fees for services incident to the organization of the partnership; and filing fees. The following are examples of expenses that are not organizational expenses within the meaning of section 709 and this section (regardless of how the partnership characterizes them): Expenses connected with acquiring assets for the partnership or transferring assets to the partnership; expenses connected with the admission or removal of partners other than at the time the partnership is first organized; expenses connected with a contract relating to the operation of the partnership trade or business (even where the contract is between the partnership and one of its members); and syndication expenses.

(b) Syndication expenses. Syndication expenses are expenses connected with the issuing and marketing of interests in the partnership. Examples of syndication expenses are brokerage fees; registration fees; legal fees of the underwriter or placement agent and the issuer (the general partner or the partnership) for securities advice and for advice pertaining to the adequacy of tax

disclosures in the prospectus or placement memorandum for securities law purposes; accounting fees for preparation of representations to be included in the offering materials; and printing costs of the prospectus, placement memorandum, and other selling and promotional materials. These expenses are not subject to the election under section 709(b) and must be capitalized.

(c) ***Beginning business.*** The determination of the date a partnership begins business for purposes of section 709 presents a question of fact that must be determined in each case in light of all the circumstances of the particular case. Ordinarily a partnership begins business when it starts the business operation for which it was organized. The mere signing of a partnership agreement is not alone sufficient to show the beginning of business. If the activities of the partnership have advanced to the extent necessary to establish the nature of its business operations, it will be deemed to have begun business. Accordingly the acquisition of operating assets which are necessary to the type of business contemplated may constitute beginning business for these purposes. The term "operating assets", as used herein, means assets that are in a state of readiness to be placed in service within a reasonable period following their acquisition.

Revenue Rulings and Applicable Court Cases

Revenue Ruling 81-153, 1981-1 C.B. 387, states the following: An investor in a limited partnership may not deduct that part of the purchase price that is paid, through a rebate or discount arrangement, by the investor to a tax advisor on behalf of the partnership for services related to the sale of the partnership interest. The partnership may not amortize this amount under IRC section 709(b). The investors' basis in the partnership is the amount of cash contributed.

Revenue Ruling 85-32, 1985-1 C.B. 186, states the following: Syndication costs incurred in connection with the sale of limited partnership interests are chargeable by the partnership to a capital account and cannot be amortized.

In ***G. E. Vandenhoff***, 53 TCM 271, T.C. Memo. 1987-116 and ***L. Isenberg***, 53 TCM 946, T.C. Memo. 1987-269, guaranteed payments by a motion picture partnership to the general partners was in the nature of a syndication expense and was required to be capitalized.

In ***M. Schwartz***, 54 TCM 11, T.C. Memo. 1987-381, payments made to a partner were syndication expenses that must be capitalized and were not deductible as guaranteed payments.

In ***G. H. Driggs***, 87 T.C., No. 46, it was found that amounts paid to a general partner as "sponsors fees" were not deductible because the partnership failed to prove whether the expenses were for syndication fees or for organization costs.

In ***V. Finoli***, 86 T.C. 697, it was determined that amounts paid for preparation of a tax opinion, incurred to promote or facilitate the sale of partnership interests, and commissions and consulting fees constituted non-deductible syndication expenses.

In ***A. B. Surloff***, 81 T.C. 210, fees paid to an attorney by partnerships mainly for the preparation of a tax opinion letter that was used in a prospectus given to potential investors were syndication expenses and had to be capitalized.

In ***G. T. Flower***, 80 T.C. 914, it was determined that expenditures for tax advice were incurred for purposes of obtaining the tax opinion letter that accompanied organization and sales promotion of limited partnership interests and were nondeductible capital expenditures.

In ***N. Tolwinsky***, 86 T.C. 1009, and ***W. J. Law***, 86 T.C. 1065, it was found that organizational expenses for a motion picture tax shelter were amortizable only to the extent that such expenses were substantiated.

In ***R.P. Wendland***, 79 T.C. 335, it was determined that legal expenses paid to a law firm by a coal mining tax shelter partnership constituted organizational expenses that had to be capitalized in the absence of evidence allocating such expenses between legal advice and tax advice.

In ***J. K. Johnsen***, 83 T.C. 103, it was found that a partner could not deduct his share of claimed expenses for legal and tax advice because the evidence showed that the services concerned the organization and promotion of the partnership.

In ***W. T. Golf,*** 87 T.C., No. 2, it was held that a partnership could not currently deduct organization and syndication costs by indirectly paying them to a partner under the guise of management fees. Since no election was made by the partnership, no amortization of partnership organization expenses was allowed.

In ***T. J. Darken***, 87 T.C. 1329, the court ruled that payments made by a partnership to two general partners for services were for expenses in connection with organizing the partnership and the offering and such payments were not currently deductible as guaranteed payments. The partnership was entitled to amortize the expenses.

In ***T. Collins***, 53 TCM 873, T.C. Memo. 1987-259, it was found that management and consulting fees paid shortly after the formation of a general partnership were held to be organizational expenses and were required to be amortized rather than currently deducted. Similarly, legal and accounting fees incurred shortly after formation were nondeductible organization and syndication expenses.

Revenue Ruling 88-4, IRB 1988-3. It states that the fee paid by a syndicated limited partnership for the tax opinion used in the partnerships prospectus is a syndication expense chargeable by the partnership to a capital account and cannot be amortized.

Argument and Conclusion

Syndication Expenses have been adjusted as follows:

Development Contract of $650,000 has been recharacterized as Syndication Expense, and as such is not included in either the depreciable basis nor the "qualified rehabilitation expenditures" for purposes of the Historic Rehabilitation Tax Credit.

The promoter of the examined partnership was "Y" and its related and affiliated entities. Their primary function as sponsor, syndicator, and promoter of the various partnerships they syndicated was necessary to raise the required capital to acquire, rehabilitate, and subsequently place the projects in service. "Y" and its affiliates created an investment package and "trained" various brokers/dealers to sell the units to the ultimate limited partner investors. "Y" had an in-house "Investment Marketing Division" and "Syndication Department" which were responsible for sponsoring, syndicating, and promoting their partnerships. A substantial amount of time was expended to create, syndicate, and market these investment packages or limited partnership units. Additionally, the primary source of compensation for these services are the development contracts as entered into with Historic Associates.

It has been determined, for the partnership Historic Associates, that the amounts as specified above were attributable to the "syndicating aspects" of the project and as such these costs have been recharacterized to reflect their proper tax treatment.

Taxpayer's Position

The Tax Matters Partners have indicated they are in agreement with the adjustments as presented on this report.

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Chapter 20

Tax Effect of Grant Money

BACKGROUND

There are various forms of monetary incentives offered by governmental and tax-exempt entities to help defray the cost of rehabilitating many of our nation's historic structures. The recipient of grant money must first consider several factors before determining whether or not to include the proceeds in income. Two primary factors include whether the recipient is a corporate or non-corporate taxpayer and whether the entity receiving the money has dominion and control over the proceeds. The taxpayer must then determine if the expenditures made with grant proceeds should be included in its computation of qualified rehabilitation expenditures.

Unfortunately, our current tax law does not offer specific guidelines with respect to the issue of taxability, nor does it specifically convey rules regarding whether or not expenditures made with these grant proceeds are allowed to be included in one's computation of qualified rehabilitation expenditures. However, between various decisions rendered by our courts, actions taken through legislation, and opinions offered through various rulings by the Office of Chief Counsel, the Internal Revenue Service can offer some guidance in this area.

GRANTS RECEIVED BY NON-CORPORATE TAXPAYERS

Section 61(a) of the Internal Revenue Code provides generally that gross income means all income from whatever source derived. In ***Commissioner v. Glenshaw Glass Co***., 348 U.S. 426 (1955), the United States Supreme Court held that the concept of gross income encompassed accessions to wealth, clearly realized, over which taxpayers have complete dominion.

If a grant is given to a non-corporate taxpayer (that is, individual or partnership) and that taxpayer has dominion and control over the proceeds, the grant will generally be taxable to the recipient. An example of this type of general purpose grant would be one where the taxpayer can use the funds for any purpose, that is, operating subsidies or a general improvement grant.

In ***Bailey v. Commissioner***, 88 T.C. 1293 (1987), the court held that the recipient of a façade grant lacked complete dominion and control over the façade because the city's urban renewal agency chose the contractors and paid them directly. Accordingly, the cost of the new facade was not included in the recipient's income and was excluded from the property's basis.

One can draw from this ruling that if the taxpayer had dominion and control over the grant proceeds, the amount would be taxable.

On the other hand, if a taxpayer had dominion and control over grant proceeds, but these funds were given to promote the general welfare of the community, the grant proceeds would be tax exempt under the general welfare doctrine. The Internal Revenue Service has consistently held that payments made under legislatively provided social benefit programs for the promotion of general welfare are not included in an individual's gross income. Examples of general welfare grants include flood relief grants and disaster relocation grants. See Revenue Ruling 76-395.

Urban Revitalization Grants used to fund improvements to business property are normally considered taxable income. Federal grants given to business owners who suffered flood damage to help them recover and improve exterior facades and street level interiors of commercial buildings were determined to be taxable.

A grant will also generally be included in gross income if the contributor expected or received something in return (quid pro quo). An example of this type of grant would be one where the contributor receives goods, services, or other direct and quantifiable benefit in exchange for the grant.

GRANTS RECEIVED BY CORPORATE TAXPAYERS

Generally, grant proceeds received by corporations are excludible from gross income. Grant proceeds received by a corporation are considered to be a capital contribution made by a non-shareholder.

IRC section 118 was enacted in 1954 to codify and to rationalize a line of court decisions. This code section provides, in part, that capital contributions made by non-shareholders are exempt from income. IRC section 362 (c) further provides that these contributions will have no basis.

NON-TAXABLE GRANTS

As discussed above, the Internal Revenue Service has consistently held that payments made under legislatively provided social benefit programs for the promotion of general welfare are not included in an individual's gross income.

In addition to general welfare grants, Revenue Ruling 82-195 provides that payments (grants) received by taxpayers under the National Historic Preservation Act, 16 U.S.C. 470, are not included in the taxpayer's gross income. The Act of 1966 was amended by section 202 (b) in 1980 and provides that "effective December 12, 1980, no grant made pursuant to this Act shall be treated as taxable income for purposes of the Internal Revenue Code.

EFFECT OF GRANT PROCEEDS ON BASIS

Taxable Grants

If a grant is deemed taxable, the taxpayer will have basis and the rehabilitation tax credit can be taken on any qualified rehabilitation expenditures incurred with the grant proceeds.

Non-taxable Grants

If the grant is deemed non-taxable, basis has not been established and the taxpayer will not be eligible to claim the rehabilitation tax credit on the expenditures made with the proceeds.

This position is fully supported in ***Bailey v. Commissioner***, 88 T.C. 1293 (1987). In that case, the court ruled that when a grant recipient incurs no cost attributable to the improvements made to property, the amount of the grant would not be includible in the basis of that property.

The only instance where the Internal Revenue Service ruled that a non-taxable grant could also establish basis was in Revenue Ruling 74-205. This ruling concluded that replacement housing payments were not only excluded from income, but increased the recipient's basis in the replacement home. It is important to note, however, that this ruling was criticized by the Tax Court in **Henry L. Wolfers**, 69 T.C. 975 (1978).

Consequently, the general rule disallowing inclusion of tax-free grant proceeds in basis is set forth in ***Bailey***, while Revenue Ruling 74-205 is an exception to this general rule.

IRC section 362 (c) clearly states that non-shareholder contributions of capital to a corporation would not establish basis in property acquired with the money or property contributed by the non-shareholder.

SUBSTANTIAL REHABILITATION TEST

When determining whether a taxpayer has met the substantial rehabilitation test, total qualified rehabilitation expenditures **can** include those expenditures made with non-taxable grant money even if the taxpayer has no basis in the building improvements.

CONCLUSION

Taxpayers who receive grants must first determine if the proceeds are taxable or non-taxable. If the grant money is taxable, the taxpayer has basis and the rehabilitation tax credit will be allowed on expenditures made with this money.

If the grant money is not taxable, taxpayers will have no basis and the rehabilitation tax credit can not be claimed on the expenditures incurred with these proceeds.

Grants received by corporate taxpayers fall under the auspices of IRC sections 118 and 362 (c) and would be considered tax-exempt contributions of capital by a non-shareholder. Consequently, no rehabilitation tax credit would be allowed for the expenditures made with these proceeds.

Grants received by non-corporate taxpayers, such as partnerships and individuals, will include the proceeds in income if they have dominion and control over the funds, unless the proceeds are provided as a general welfare grant or a National Historic Preservation Act grant.

AUDIT TECHNIQUES

Determine if the taxpayer received any grant proceeds to rehabilitate the property.

Determine the source of the grant proceeds. Make certain taxable grants have been picked up in gross income.

Determine how the grant proceeds were spent. Since non-taxable grants do not effect depreciable building basis, taxpayers may try to allocate the proceeds to land basis.

Review depreciation records. If the taxpayer treated the grant proceeds as non-taxable, make certain the taxpayer is not depreciating the improvements. Taxpayer should not have any basis in the improvements made with the grant money.

RESOURCES

Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955

Bailey v. Commissioner, 88 T.C. 1293 (1987).

Henry L. Wolfers, 69 T.C. 975 (1978).

Graff v. Commissioner, 673 Fed 2nd 784, 5th Circuit 1982

IRC sections 118 and 362(c)

Revenue Ruling 74-205

Revenue Ruling 82-195

Revenue Ruling 76-395

Revenue Ruling 76-75

Revenue Ruling 98-19

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Chapter 21

Special Allocation of Tax Credit

OVERVIEW

It is impossible to evaluate whether or not a tax credit was properly allocated without first understanding the nature of the credit, the nature of the debt being used to finance the property (recourse or non-recourse), and the complex rules of IRC section 704(b) concerning economic effect, substantiality, and the allocation of non-recourse deductions. A basic understanding of the principles presented in this chapter is necessary in order to determine if the allocation of credits should be respected.

The Tax Code has numerous provisions for tax credits. The credits most commonly seen in the partnership context are the low-income housing credit under IRC section 42 and the rehabilitation tax credit under IRC section 47. The rehabilitation credit is part of the investment tax credit. Both the investment tax credit and the low-income housing credit fall under the IRC section 38, General Business Credit.

The regulations treat the allocation of the investment tax credit (which includes the rehabilitation credit) differently from other credits. For this reason, the allocation of the rehabilitation credit will be discussed separately.

TAX CREDITS IN GENERAL

In general, tax credits do not impact the partner's capital account. They, therefore, have no effect on the dollar entitlements of the partners in terms of cash distributions or cash upon liquidation. Thus, an allocation of a credit cannot have substantial economic effect and must be allocated according to the partners' interests in the partnership.

There is no specific, mechanical, safe harbor for allocating tax credits. The regulations state that if a partnership expenditure that gives rise to a tax credit also gives rise to valid allocations of loss or deduction, then the credit will allocated in the same manner as the loss or deduction which decreases the partners' capital accounts. The regulations also state that identical principles apply with credits that arise from receipts of the partnership. Treas. Reg. section 1.704-1(b)(4)(ii).

Example 1

Development Corp., a real estate developer, is a partner in a low-income housing partnership. The other partner is an investment partnership. Profits and losses are split 50/50, with the depreciation and low income housing credit specially allocated 99 percent to the investment partnership and 1 percent to Development Corp. The debt is recourse debt from an unrelated lender and both partners are general partners. The partnership agreement complies with all of the requirements of Treas. Reg. section 1.704-1 concerning economic effect.

Since a partnership expenditure which gives rise to the tax credit (the building's qualified basis) also gives rise to a valid allocation of partnership deduction (depreciation) which reduces the capital accounts, then the allocation of tax credit 99 percent to the investment partnership partner will be respected.

In the above example, the allocation of credit is respected because its associated allocation of depreciation deduction is respected. The allocation of credit parallels the allocation of depreciation. The allocation of depreciation is respected because the partnership complies with the safe harbor for economic effect, at least so long as the deductions are attributable to positive balance in the partner's capital accounts. The allocation must be independently examined to determine if such economic effect is substantial.

In analyzing whether or not credits are properly allocated, it is critical to determine if the "other valid allocation" to which the credit is tied is to be analyzed using the economic effect rules of Treas. Reg. section 1.704-1(b)(2) or the rules in Treas. Reg. section 1.704-2 concerning the allocation of non-recourse deductions.

If, in the above example, the debt were non-recourse, the allocation of the credit would be altered. It would not be possible to simply tie the allocation of the credit to the allocation of the property's depreciation deductions. In a non-recourse context, the depreciation deductions cannot have economic effect because no partner bears the economic risk of loss. Non-recourse deductions must be allocated either in accordance with the partners' interests in the partnership under Treas. Reg. section 1.704-1(b)(3) or under the safe harbor non-recourse deduction provisions under Treas. Reg. section 1.704-2(e).

The second requirement of the non-recourse safe harbor presents an area of concern in evaluating the allocation of a tax credit in a non-recourse context. This consistency requirement stipulates that allocations of non-recourse deductions are allocated in a manner that is reasonably consistent with some other "significant" partnership item (other than a minimum gain chargeback) having substantial economic effect. This item must be attributable to the property securing the non-recourse debt.

Example 2

The facts are the same as in Example 1, but the debt (from an unrelated lender) is non-recourse debt. The partnership agreement meets the non-recourse debt safe harbor under Treas. Reg. section 1.704-2(e). The partnership agreement calls for allocating the credit in accordance with the partnership's profit share since this is a significant partnership item, which has both substantial economic effect and relates to the property secured by the non-recourse debt. The credit is therefore allocated 50 percent to Development Corp. and 50 percent to the investment partnership partner.

Banks often become investors in low income housing partnerships. If a bank acts as a non-recourse lender in addition to being a partner, the bank is considered to bear the economic risk of loss to the extent that the liability is not borne by another partner. Treas. Reg. section 1.752-2(c) (1).

Example 3

A real estate development corporation and a bank form a partnership to develop low-income housing. The bank acts as the lender and provides non-recourse financing. The partnership agreement calls for profits and losses to be split equally with all of the depreciation and credit being allocated to the bank. In this case, the special allocation of depreciation and tax credit to the bank would be evaluated under the economic effect rules since the bank bears the economic risk of loss. If the partnership agreement adheres to the requirements economic effect (Treas. Reg. section 1.704-1(b)(2)(ii)(b)), and if there is no substantiality problem, the special allocations to the bank will be respected.

ALLOCATING THE REHABILITATION TAX CREDIT

Unlike the low-income housing tax credit, the rehabilitation tax credit does have an impact on the partners' capital accounts. The partnership must reduce the depreciable basis of the building by the amount of the rehabilitation tax credit. Similarly, a partner must reduce his capital account by his ratable share of the rehabilitation tax credit.

The rule for allocating the rehabilitation tax credit is found in Treas. Reg. section 1.46-3(f)(2). The general rule is that each partner's share of the rehabilitation costs is based on the general profit ratio of the partnership. This ratio should reflect the partners' real economic sharing arrangement.

The exception to the general rule is that a special allocation is possible if:

1. All related items of income, gain, loss, and deduction with respect to the property are specially allocated in the same manner and
2. Such allocation is either made in accordance with the partner's interest in the partnership or has substantial economic effect.

Example 3 in Treas. Reg. section 1.46-3(f)(3) discusses a partnership engaged in the business of renting equipment whose cost qualified for the investment tax credit. Under the partnership agreement, the income, gain or loss on disposition, depreciation and other deductions attributable to the equipment are specially allocated 70 percent to one partner and 30 percent to the other partner. The conclusion is that if this allocation is made in accordance with the partners' interests in the partnership or has substantial economic effect, the cost of the equipment (and therefore the tax credit) will be taken into account 70 percent by one partner and 30 percent by the other partner.

These regulations do not permit the flexibility of separately allocating items being generated by the same property. It would not be possible to sever the depreciation and credits from other items of deduction or income being generated by the same property. All related items of income gain, loss, and deduction from a particular property must be allocated together. Additionally, such allocation must meet the other requirements of IRC section 704(b).

Example 4

A real estate professional and a bank form a partnership to rehabilitate and rent a historic building. The bank is also acting as the partnership's lender. The bank is to receive 99 percent of the depreciation deductions and 99 percent of the rehabilitation credit. All other profits and losses are to be split 50/50. The partnership will maintain capital accounts in accordance with the regulations, positive capital account balances will be respected upon liquidation, and the partnership agreement contains an unlimited deficit restoration agreement. The debt is recourse debt.

In this example, the allocation of the tax credit 99 percent to the bank will not be respected because a) it is not in accordance with the general profit sharing ratio of the partnership and b) the income, loss, and deductions are not allocated in the same manner.

In situations where the rehabilitation costs are being funded by non-recourse debt, the non-recourse allocation safe harbor rules would apply in addition to the requirements of Treas. Reg. section 1.46-3(f)(2).

Chapter 22

PASSIVE ACTIVITY RESTRICTIONS

BACKGROUND

The Tax Reform Act of 1986 introduced tax law changes which indirectly impacted the rehabilitation tax credits. One of these changes, the "Passive Activity Provision," was intended to stop "abusive tax shelters." Although not directly related, these changes have impacted on the availability of the credit to certain types of investors. As a result, the main effect of the passive activity restrictions has been a significant change in the character of the users from the partnership form to other forms of ownership.

Modifications to the Passive Activity provisions under the Omnibus Budget Reconciliation Act of 1993, (effective for taxable years after December 31, 1993), provides some relief. The Act provides that deductions and credits, from rental real estate in which an eligible taxpayer materially participates, are not subject to limitation under the passive loss rules. An individual taxpayer is eligible if more than one-half of the taxpayer business services for the taxable year, amounting to more than 750 hours of services, are performed in real property trades or business in which the taxpayer materially participates.

PASSIVE ACTIVITY RESTRICTIONS - TAXPAYERS WITH AGI OVER $250,000

Individuals, including limited partners, with adjusted gross income greater than $250,000 who invest in a rehabilitation tax credit project can not use the tax credit to offset income tax in that tax year. The credit is suspended and carried forward and will be available when either income falls below $200,000 (it is partially available when income falls between $200,000 and $250,000) or there exists net passive income sufficient to offset the passive losses generated by the rehabilitation project.

A computation is required to figure the regular tax liability allotted to passive activities. In other words, even if a taxpayer has net passive income, they might not be able to utilize all of the rehabilitation tax credit. Please see net passive income example below.

PASSIVE ACTIVITY RESTRICTIONS - TAXPAYERS WITH AGI UNDER $250,000

Generally, rental real estate losses up to $25,000 may be deducted in full by anyone whose modified adjusted gross income is less than $100,000. For investors in rehabilitation projects, this income level is raised to $200,000. The rehabilitation tax credit, however, is limited to the credit equivalent of $25,000. This does not mean that the taxpayer can deduct a credit of $25,000. Instead a taxpayer is allowed the tax equivalent of $25,000 for the rehabilitation tax credit. Thus, a taxpayer in the 36 percent tax bracket could use $9,000 of tax credits per year (36% x $25,000 = $9,000). Unused credits can be carried forward indefinitely until they can be used.

NET PASSIVE INCOME

If a taxpayer has net passive income, full use the rehabilitation tax credit may be restricted. This, perhaps, is best illustrated in the following example:

> John rehabilitates a certified historic structure used in a business in which he does not materially participate and generates a rehabilitation tax credit of $43,000. He files a joint return in 1996 reflecting $160,000 in taxable income. Of this total, $40,000 is from a passive activity (commercial rental).
>
> John's total tax liability on the $160,000 taxable income is: $42,095
>
> John's taxable income reduced by net passive activity income is 120,000 ($160,000-$40,000).
>
> Tax on $120,000 is: $29,080
>
> Tax liability applicable to the passive activity: $13,015

John can use passive credits up to $13,015 and carry forward unused credits of $29,985 (43,000 - $13,015). Simply stated, the more passive income, the more tax credit can be used. The less passive income, the less tax credit can be used.

Please note: Credits generated from non-passive rehabilitation projects will not be limited.

CIRCUMSTANCES WHERE REHABILITATION TAX CREDIT IS NOT LIMITED

Material Participation - Generally if a taxpayer either works more than 500 hours a year or performs substantially all of the work in a business, he or she is deemed to be materially participating, and losses and/or income are non-passive. However, the material participation rules do not apply to long-term rental real estate activities. Real estate rental is passive by definition regardless of the 500-hour test.

Example 1

John is an architect and rehabilitates a certified historic structure. If John uses the building for his architectural business, the credit is not limited because it is stemming from a non-passive activity. (Non-passive credit)

If John rehabilitates the same building and rents the space to a restaurant, the rehabilitated building is now rental real estate (passive by definition) and will be limited. (Passive credit)

Real Estate Professionals - If more than one half of a taxpayer's personal services in all business are in real property businesses (property development, construction, acquisition, conversion, rental, management, leasing, or brokering) and the taxpayer spends more than 750 hours a year in real property trade or businesses, the taxpayer is a real estate professional. If this is the case, any rehabilitation project the taxpayer is involved with, including rental real estate, will generate non-passive rehabilitation tax credits.

Short-term Rentals - If a taxpayer rehabilitates an historic building and uses it for short term rental, such as a Bed & Breakfast or a Hotel/Motel, and materially participates in the operation of the business (that is, spends more than 500 hours), the rehabilitation tax credit generated from this project is deemed to be non-passive, and the credit will not be restricted.

Corporate Entity - While the passive activity loss rules do not generally apply to regular C-Corporations, they do apply to personal service corporations and to closely held corporations in a limited way. For personal service corporations and closely held corporations, material participation is determined based on the level of participation of the shareholders. One or more individuals who hold more than 50 percent of the outstanding stock must materially participate in the activity in order for the corporation to meet the material participation standard.

A taxpayer’s involvement in an activity may be non-passive in one year and passive in the next year. The passive activity rules are applied on a year by year basis. A taxpayer could materially participate in a business generating a rehabilitation tax credit in one year, use the rehabilitation tax credit and have a passive interest in the business operation the following year.

AUDIT TECHNIQUES

For more detailed information, examiners should review the audit technique guide, Passive Activity Losses, Training 3149-115, TPDS No. 83479V and Passive Loss Issues with Real Estate, Training 3318-001, TPDS No. 89430Y

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For Rental Real Estate Activities

Verify that the taxpayer is not a qualifying real estate professional. This can easily be verified via Schedule E. The taxpayer's occupation next to his signature on Form 1040 is also an indicator.

If the taxpayer is a qualified real estate professional, verify that he materially participated in the activity generating the rehabilitation tax credit. If the taxpayer did not materially participate in the rental real estate activity, the credit is subject to the passive loss limitations.

Review Form 8582-CR part III and verify that the rehabilitation tax credit has been limited to the tax equivalent of $25,000 ($7,000 for 28 percent bracket).

Verify that the allowable credit has been reduced by modified AGI. If the taxpayer's modified AGI exceeds $250,000, no rehabilitation tax credit is allowed.

For Trade or Businesses

Verify if the taxpayer materially participates in the business generating the credit. If he or she does not materially participate, the credit is subject to the passive loss limitations and must be entered on Form 8582-CR

COURT CASE

Sidell v. Commissioner, T.C, Memo 1999-301, ***aff'd*** 225 F.3d 103 (1st Cir. 2000) – In this case, the Tax Court held that the self-rented rule of Treas. Reg. section 1.469-2(f)(6) is valid and, thus, that rental income the taxpayers received from properties rented to the husband's wholly owned C-corporation was non-passive. The taxpayers had reported net rental income or loss from five properties. They also claimed a rehabilitation tax credit with respect to one property that contained a certified historic structure. The IRS, applying the self-rented rule of Treas. Reg. section 1.469-2(f)(6), re-characterized the positive income from three properties from passive to non-passive, resulting in an increase in the ***Sidell's*** taxable income for each year. As a further result, the ***Sidell's*** regular tax liability allocable to passive activities was insufficient for them to use the claimed rehabilitation tax credits. Because the taxpayers no longer had passive income, the Court ruled that they had no

"regular tax liability allocable to passive activities" and, thus, were not entitled to the rehabilitation tax credit. In order to utilize a tax credit allocated to a passive activity, a taxpayer must have passive income in excess of passive deductions. Even if the passive income is re-characterized as non-passive, the tax credit associated with that activity remains passive.

PASSIVE ACTIVITY TAX CODE PROVISIONS

IRC section 469.

IRC section 469(a) and (b) - Passive activity losses and credits are limited.

IRC section 469(i)(3) - Phase out of exemption.

IRC section 469(i)(6) - Covers active participation not required for rehabilitation credit.

IRC section 469(m) - Covers phase-in of disallowance of credits for pre-enactment interests.

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Chapter 23

SYNOPSIS OF LOW INCOME HOUSING CREDIT PROVISIONS

The following is intended to provide an overview of the Low-Income Housing Credit Provisions. For more information refer to the Audit Technique Guide for Low-Income Housing (Training 3123-006-Revision 6/99 - TPDS No. 89018m).

BACKGROUND

Many taxpayers that rehabilitate historic building also intend to provide affordable housing. These taxpayers will qualify for both the Rehabilitation Tax Credit and the Low-Income Housing Credit (LIHC).

The Low Income Housing Credit is currently available under section 42 of the Internal Revenue Code of 1986. This credit is available to owners of buildings as an incentive to rehabilitate affordable multi-family housing for occupants who meet specific income requirements. The credit is available for up to 10 years as long as the project remains in compliance with the occupants' income limitations. To fully attain the credit, the "low income housing" portion of a building must remain in service with qualified occupants for 15 years. Under current tax law, an investor/owner can generally take approximately $7,000 of tax credit in a given year, (depending on their individual tax situation). In some cases, the taxpayer, the owners may also benefit from the use of the Historical Rehabilitation Tax Credit if the Low-Income Housing project also meets the criteria established by the Department of the Interior, National Park Service.

PROVISIONS REGARDING LOW INCOME HOUSING

To qualify as low income housing for purposes of the LIHC, the property must be residential rental use property. This could be multiple buildings, an entire building, or a portion of a building through allocation, (a mixed-use building with commercial and residential use/tenants). The units must be generally available to the public, and be consistent with HUD rules and regulations. Units, generally may not be used as transient housing or be a cooperative corporation.

INCOME TARGETING

For a building to qualify as low-income housing, one of several income targets must be met regarding the tenants:

? At least 20 percent of the rental units must be rented to tenants with qualifying income at or below 50 percent of "area median income", or

? At least 40 percent of the rental units must be rented to tenants with qualifying income at or below 60 percent of "area median income," or

? At least 15 percent of the rental units must be rented to tenants with qualifying income at or below 40 percent of the "area median income." In addition, the rent for the tenants that are not low income must be at least 200 percent of the average rent charged to low income tenants for a comparable unit.

NOTE: Owners must make an election by the time the building is placed in service. This election stays in effect for the entire 15-year period and is irrevocable.

ALLOWABLE CREDIT PERCENTAGES

Generally, the credit is taken in each of 10 years as long as the building/units continue to qualify based on the income targeting restrictions. The credit amount/rate is determined as follows:

? 70 percent present value credit for new construction or rehabilitation. The rehabilitation must be substantial and meet on one of the two following tests:

a. owners must incur the greater of 10 percent of the adjusted basis at the beginning of a 24 month test period, or

b. $3,000 for each unit.

NOTE: If federally subsidized, the 70 percent present value credit is not available to the extent of the subsidy. Owners may either reduce their basis by the amount of the subsidy and take the 70 percent present value credit on the remainder or include the subsidy amounts with the qualified basis but limit the credit to the 30 percent present value credit (explanation below).

? 30 percent present value credit for the cost of building acquisition and also for federally subsidized amounts. As indicated above, the owner does have the option to remove the federal subsidy amounts from the qualifying basis and take the 70 percent present value credit on the non-federal subsidy.

NOTE: The yearly credits, based on the present value, are approximately 9 percent per year for the 70 percent Present Value Credit and approximately 4 percent per year for the 30 percent Present Value Credit. These percentages are adjusted monthly through Revenue Rulings and will be dependent on the respective month and year the property is placed in service.

WHEN THE CREDIT MAY BE CLAIMED

The owner(s) of the building(s) qualifying for the LIHC are eligible to take the credit as follows:

1. For the period of 10 taxable years beginning in either the taxable year in which the building is placed in service, or
2. At the election of the owner, the credit may be taken in the year following the year placed in service.

NOTE: The building must be a "qualified" low income building as of the first taxable year above.

EFFECT OF FEDERAL GRANTS

Eligible basis must be reduced by federal grants. If, in any year of the 15 year compliance period, a grant is made with respect to either the building or the operation of the building and any portion of such grant is funded with federal funds, the eligible basis of such building for such taxable year, and all succeeding taxable years, shall be reduced to the extent of such grant.

NOTE: The above relates to federal grants either disbursed directly to the owners or indirectly through state or local governments. Also note that the federal funds must be in the form of a grant when given to the owner in order to be excluded. If a federal grant was given to a state or local government, which then created a loan program for owners, then this would not be treated as a federal grant but as a federal loan.

EFFECTS OF LOANS/FEDERAL SUBSIDY

Projects are considered "federally subsidized" if there is, or was, any obligations outstanding which carry interest which is exempt from taxation under section 103 of the Internal Revenue Code, (interest on state and local bonds). Additionally, projects are considered "federally subsidized" if any below-market federal loans are used to finance any of the project if the proceeds were used (directly or indirectly) with respect to the building or the operation thereof. If tax-exempt financing or below-market federal loans are involved, then two options are available. The owner(s) may:

1. Remove all tax-exempt financing and below-market federal loans from the basis of the property and claim the 70 percent Present Value Credit on the remaining basis (approximately 9 percent per year for 10 years), or
2. Leave all tax-exempt financing and below-market federal loans in the eligible basis and take the 30 percent Present Value Credit on the entire basis (approximately 4 percent per year for 10 years).

NOTE: "Below-market federal loans" are any loans funded, in whole or in part, with federal funds if the interest on such loans is less than the "Applicable Federal Rate" (AFR) in effect under IRC section 1274(d) as of the date the loan was made. Below-market federal loans by reason of assistance under IRC section 106, 107 or 108 of the Housing and Community Development Act of 1974 (as in effect in 1986) are not included in the above.

RECAPTURE PROVISIONS

The credit is recaptured based on situations where the qualified basis in a given year is less than the qualified basis of the preceding year. The owner(s)/investor(s) tax will be increased by the credit recapture amount.

The credit is recaptured as shown in the following example:

(1) (2) (3) (4)
(30,000 - 20,000) x 5 Years = 50,000 (recapture)

1. Represents the actual credit allowed/claimed per year.

2. Represents the credit that would be allowed (per year) if the credit had been taken over the 15-year compliance period.

3. Represents the number of prior years the credit was already claimed. NOTE: There is no credit allowed for the current year or any future year unless the building again qualifies.

4. Represents the recapture amount and also the accelerated portion of the credit. The accelerated portion is the difference between the credit if allowed over the 15-year compliance period and the credit taken yearly over the 10-year credit period. The difference is then multiplied by the number of years the credit was claimed since the property was placed in service.

STATE HOUSING CREDIT CEILING

The state housing credit ceiling applicable to any state for any calendar year shall be an amount equal to the sum of:

1. $1.25 multiplied by the state's population,

2. The unused State Housing Credit Ceiling (if any) of such state for the preceding calendar year,

3. The amount of State Housing Credit Ceiling returned in the calendar year, plus

4. The additional amount (if any) allocated to such state by the Secretary of the Treasury.

LOW INCOME HOUSING CREDIT CLAIMED IN CONJUNCTION WITH THE REHABILITATION TAX CREDIT

If a project has both the intent of historical rehabilitation and the creation of affordable housing, then the owners can potentially qualify for both the Low Income Housing Credit and the Historic Rehabilitation Tax Credit. As there are separate and independent provisions for each of these credits, all the requirements for each credit must be met, as well as the computational correctness of the amounts claimed.

After determining the qualified basis for the Historic Rehabilitation Tax Credit and reducing the basis of the qualified expenses by the full amount credit taken, the owner can determine what the correct Low Income Housing Credit should be. After reduction for the amount of the Rehabilitation Tax Credit, the remaining basis will qualify for the 70 percent Present Value Low Income Housing Credit. Further reduction of the remaining basis would be required if either federal grants or below-market loans were used to finance the rehabilitation.

Treatment of acquisition costs differs for the two credits. For purposes of the Rehabilitation Tax Credit, acquisition costs are excluded from the qualified basis; acquisition costs are recognized for purposes of the 30 percent Present Value Low Income Housing Credit. The 30 percent LIHC is also used as an alternative method for including federally subsidized loans or tax exempt financing.

An example where a taxpayer is using both the rehabilitation tax credit and the low income housing tax credit follows.

Example1

A taxpayer purchases an apartment building that has been designated a certified historic structure for $3,000,000. Of the total price, $500,000 is allocated to land. The taxpayer decides to rehabilitate the building and spends $4,000,000 on qualified rehabilitation expenditures and claims the 20 percent rehabilitation tax credit. If the taxpayer rents 40 percent of the building to low-income tenants and qualifies the project for the low income housing tax credit, the tax benefits for this project are as follows:

Amount of Rehabilitation Tax Credit –
$4,000,000 X 20% = $800,000

Amount of Low Income Housing Tax Credit –
Acquisition $2,500,000 X 40% X 4% = $40,000
($3,000,000 purchase price - $500,000 land)
Rehabilitation $3,200,000 X 40% X 9% = $115,200
($4,000,000 - $800,000 tax credit = $3,200,000)

Total Annual Credit = $155,200

Amount of Annual Depreciation –
$6,500,000 - $800,000 = $5,700,000
($2,500,000 acquisition + $4,000,000 improvements = $6,500,000)
$5,700,000 divided by 27.5 years = $207,273

Annual Depreciation = $207,273
Annual Tax Benefit = $58,036 (assumes a 28 percent tax bracket)

Chapter 24

MODIFICATIONS TO MEET THE AMERICANS WITH DISABILITY ACT OF 1990

BACKGROUND

With the passage of the American's with Disabilities Act in 1990(PL 101-336), access to properties open to the public is a civil right. Most historical buildings were not designed to be readily accessible for people with disabilities, yet accommodating people with disabilities could jeopardize the significance and integrity of the historic nature of the property. In 1997, this Act was amended to balance accessibility and historic preservation.

DISABLED ACCESS CREDIT

Amounts paid or incurred by an eligible small business for the purpose of removing barriers that prevent a business from being accessible to or usable by disabled individuals qualify for a credit under IRC section 44(c)(1). The Disabled Access Credit is a nonrefundable credit equal to 50 percent, up to a $5,000 credit, of the amount of eligible expenditure that exceed $250 but do not exceed $10,250 for any taxable year. The credit is computed on Form 8826 and is claimed as one of the components of the general business credit subject to the limitations of IRC section 38. IRC section 44(d)(7) states that if the Disabled Access Credit is claimed, no other credit or deduction is allowed for the same expenditures. Either the disabled access credit, or the rehabilitation tax credit can be claimed, and the basis of the asset must be reduced by the amount of the credit (See Basis Reduction Chapter).

IRC section 44(b) defines an eligible small business as any business or person who elects to claim the credit and either had gross receipts that did not exceed $1 million for the preceding tax year, or had no more than 30 full-time employees during the preceding tax year. Eligible access expenditures as defined in IRC section 44(c) must be reasonable, and must meet the standards as set forth by the Architectural and Transportation Barriers Compliance board.

Under IRC section 190, large businesses not eligible for the disabled access credit under IRC section 44 can deduct up to $15,000 for expenses paid or incurred for the removal of any barriers. Once again, if this deduction is claimed, the rehabilitation tax credit or any other credit or deduction can not be claimed for the same expenditures.

MAKING HISTORIC PROPERTIES ACCESSABLE

Most historic structures are not disabled accessible and require modifications or additions to remove such barriers. In most instances, the State Historic Preservation Officer (SHPO) and the National Park Service (NPS) will allow for required architectural modifications for elevators, entrances and ramps within the interior structure. Certification will not be jeopardized if the building owner/lessee first consults with the SHPO. They should provide detailed photographs and explanations of proposed modifications, whether interior or an exterior addition, early in the rehabilitation and approval process. If it is determined that full access requirements would alter the historic integrity of the property or its environment, alternative minimum requirements may be followed.

TAX LAW APPLICATION

IRC section 47 and the related Treasury Regulations are silent regarding this issue. Treas. Reg. section 1.191-2(e)(4)(repealed) states that "the addition of an attached facility exclusively for elevators, fire stairs, or barrier-free access will also be considered rehabilitation, if the construction of elevators, fire stairs, or barrier-free access within the existing structure is prohibited by the Secretary of the Interior as destructive of the historic character of the structure." Since there is no current law and this issue has not been litigated, reliance on the repealed regulation section coupled with practical interpretation and application is necessary.

Any expenses for disclosed interior modifications such as elevators, entrance/doorway modifications, or interior ramps would be includible. Generally additions are not included in the rehabilitation basis (See Enlargement Cost Chapter). If the State Historic Preservation Office and the National Park Service have mandated an addition at an exterior location, such as an elevator tower, the expenditures are includible in the rehabilitation credit basis if interior construction of the elevator would destroy the historical integrity of the building. Exterior modifications, such as access ramps, grading, walks, etc. would be considered site work and would be eligible for the disable access credit, or other deductions, but not for the rehabilitation credit (See Site Work Expenditures Chapter).

The examiner should first determine which credit or deduction has been claimed and that there is no duplication of credits or deductions. If it has been determined that both credits have been claimed, or that a deduction and credit has been claimed for the same expenses, the examiner should allow the credit or deduction that is most beneficial to the taxpayer. The examiner should review the NPS Applications and any correspondence between the NPS, SHPO and the building owner. If it has been determined that the modifications and/or additions were disclosed and acceptable based on NPS Standards of Rehabilitation and ADA Accessibility Standards, then the qualifying expenditures would be includible in the rehabilitation basis. Otherwise, these amounts may be allowable for the

disabled access credit or capitalized/expensed depending on the nature of the expenditure.

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Chapter 25

CONSIDERATION OF PENALTIES

BACKGROUND

As with all examination cases, it is important to consider applicable penalties based on the facts and circumstances of the individual case. However, based on the technical nature of the issues, and potential confusion because the taxpayer must also interact with the State Historic Preservation Office and the National Park Service, assertion of penalties for most cases is not recommended. The National Park Service has "standards for rehabilitation" which must be met, and both the "standards," and the procedures implemented to process the cases with the National Park Service and the State Historic Preservation Office can create many practical dilemmas when viewed from a tax law perspective.

Examples of where the assertion of penalties is recommended are:

A taxpayer claims the rehabilitation tax credit after receiving a letter from the National Park Service that denied certification of their project. This includes a Part 1, 2 or 3 denial letter.

A taxpayer claims the rehabilitation tax credit and knowingly does not comply with the 30-month rule described in Treas. Reg. section 1.48-12(d)(7).

In these cases, assertion of the Accuracy Related Penalty under IRC section 6662 is recommended.

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TITLE 26 - INTERNAL REVENUE CODE
IRC section 47

(**a) General rule** - For purposes of section 46, the rehabilitation credit for any taxable year is the sum of –

(1) 10 percent of the qualified rehabilitation expenditures with respect to any qualified rehabilitated building other than a certified historic structure, and
(2) 20 percent of the qualified rehabilitation expenditures with respect to any certified historic structure.

(b) When expenditures taken into account -

(1) In general - Qualified rehabilitation expenditures with respect to any qualified rehabilitated building shall be taken into account for the taxable year in which such qualified rehabilitated building is placed in service.
(2) Coordination with subsection (d) - The amount which would (but for this paragraph) be taken into account under paragraph (1) with respect to any qualified rehabilitated building shall be reduced (but not below zero) by any amount of qualified rehabilitation expenditures taken into account under subsection (d) by the taxpayer or a predecessor of the taxpayer (or, in the case of a sale and leaseback described in section 50(a)(2)(C), by the lessee), to the extent any amount so taken into account has not been required to be recaptured under section 50(a).

(c) Definitions - For purposes of this section -

(**1) Qualified rehabilitated building**

(A) In general - The term "qualified rehabilitated building" means any building (and its structural components) if -

(i) such building has been substantially rehabilitated,
(ii) such building was placed in service before the beginning of the rehabilitation,
(iii) in the case of any building other than a certified historic structure, in the rehabilitation process -

(I) 50 percent or more of the existing external walls of such building are retained in place as external walls,
(II) 75 percent or more of the existing external walls of such building are retained in place as internal or external walls, and
(III) 75 percent or more of the existing internal structural framework of such building is retained in place, and

(iv) depreciation (or amortization in lieu of depreciation) is allowable with respect to such building.

(**B) Building must be first placed in service before 1936 -** In the case of a building other than a certified historic structure, a building shall not be a qualified rehabilitated building unless the building was first placed in service before 1936.

(C) Substantially rehabilitated defined

(i) In general - For purposes of subparagraph (A)(i), a building shall be treated as having been substantially rehabilitated only if the qualified rehabilitation expenditures during the 24-month period selected by the taxpayer (at the time and in the manner prescribed by regulation) and ending with or within the taxable year exceed the greater of

(I) the adjusted basis of such building (and its structural components), or
(II) $5,000.

The adjusted basis of the building (and its structural components) shall be determined as of the beginning of the 1st day of such 24-month period, or of the holding period of the building, whichever is later. For purposes of the preceding sentence, the determination of the beginning of the holding period shall be made without regard to any reconstruction by the taxpayer in connection with the rehabilitation.

(ii) Special rule for phased rehabilitation - In the case of any rehabilitation which may reasonably be expected to be completed in phases set forth in architectural plans and specifications completed before the rehabilitation begins, clause (i) shall be applied by substituting “60-month period" for "24-month period".

(iii) Lessees - The Secretary shall prescribe by regulation rules for applying this subparagraph to lessees.

(**D) Reconstruction -** Rehabilitation includes reconstruction.

(**2) Qualified rehabilitation expenditure defined**

(A) In general - The term "qualified rehabilitation expenditure" means any amount properly chargeable to capital account -

(i) for property for which depreciation is allowable under section 168 and which is

(I) nonresidential real property,
(II) residential rental property,
(III) real property which has a class life of more than 12.5 years, or
(IV) an addition or improvement to property described in subclause (I), (II), or (III), and

(ii) in connection with the rehabilitation of a qualified rehabilitated building.

(B) Certain expenditures not included - The term "qualified rehabilitation expenditure" does not include -

(i) Straight line depreciation must be used - Any expenditure with respect to which the taxpayer does not use the straight line method over a recovery period determined under subsection (c) or (g) of section 168. The preceding sentence shall not apply to any expenditure to the extent the alternative depreciation system of section 168(g) applies to such expenditure by reason of subparagraph (B) or (C) of section 168(g)(1).

(ii) Cost of acquisition - The cost of acquiring any building or interest therein.

(iii) Enlargements - Any expenditure attributable to the enlargement of an existing building.

(**iv) Certified historic structure**, etc. - Any expenditure attributable to the rehabilitation of a certified historic structure or a building in a registered historic district, unless the rehabilitation is a certified rehabilitation (within the meaning of subparagraph (C)). The preceding sentence shall not apply to a building in a registered historic district if -

(I) such building was not a certified historic structure,
(II) the Secretary of the Interior certified to the Secretary that such building is not of historic significance to the district, and
(III) if the certification referred to in subclause (II) occurs after the beginning of the rehabilitation of such building, the taxpayer certifies to the Secretary that, at the beginning of such rehabilitation, he in good faith was not aware of the requirements of subclause (II).

(**v) Tax-exempt use property**

(I) In general - Any expenditure in connection with the rehabilitation of a building which is allocable to the portion of such property which is (or may reasonably be expected to be) tax-exempt use property (within the meaning of section 168(h)).

(II) Clause not to apply for purposes of paragraph (1)(C) - This clause shall not apply for purposes of determining under paragraph (1)(C) whether a building has been substantially rehabilitated.

(vi) Expenditures of lessee - Any expenditure of a lessee of a building if, on the date the rehabilitation is completed, the remaining term of the lease (determined without regard to any renewal periods) is less than the recovery period determined under section 168(c).

(C) Certified rehabilitation - For purposes of subparagraph (B), the term "certified rehabilitation" means any rehabilitation of a certified historic structure which the Secretary of the Interior has certified to the Secretary as being consistent with the historic character of such property or the district in which such property is located.

(D) Nonresidential real property; residential rental property; **class life -** For purposes of subparagraph (A), the terms "nonresidential real property," "residential rental property," and "class life" have the respective meanings given such terms by section 168.

(3) Certified historic structure defined

(A) In general - The term "certified historic structure" means any building (and its structural components) which -

(i) is listed in the National Register, or
(ii) is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary as being of historic significance to the district.

(B) Registered historic district - The term "registered historic district" means -

(i) any district listed in the National Register, and
(ii) any district -

(I) which is designated under a statute of the appropriate State or local government, if such statute is certified by the Secretary of the Interior to the Secretary as containing criteria which will substantially achieve the purpose of preserving and rehabilitating buildings of historic significance to the district, and

(II) which is certified by the Secretary of the Interior to the Secretary as meeting substantially all of the requirements for the listing of districts in the National Register.

(d) Progress expenditures

(1) In general - In the case of any building to which this subsection applies, except as provided in paragraph (3) -

(A) if such building is self-rehabilitated property, any qualified rehabilitation expenditure with respect to such building shall be taken into account for the taxable year for which such expenditure is properly chargeable to capital account with respect to such building, and

(B) if such building is not self-rehabilitated property, any qualified rehabilitation expenditure with respect to such building shall be taken into account for the taxable year in which paid.

(2) Property to which subsection applies

(A) In general - This subsection shall apply to any building which is being rehabilitated by or for the taxpayer if -

(i) the normal rehabilitation period for such building is 2 years or more, and
(ii) it is reasonable to expect that such building will be a qualified rehabilitated building in the hands of the taxpayer when it is placed in service. Clauses (i) and (ii) shall be applied on the basis of facts known as of the close of the taxable year of the taxpayer in which the rehabilitation begins (or, if later, at the close of the first taxable year to which an election under this subsection applies).

(B) Normal rehabilitation period - For purposes of subparagraph (A), the term "normal rehabilitation period" means the period reasonably expected to be required for the rehabilitation of the building -

(i) beginning with the date on which physical work on the rehabilitation begins (or, if later, the first day of the first taxable year to which an election under this subsection applies), and
(ii) ending on the date on which it is expected that the property will be available for placing in service.

(3) Special rules for applying paragraph (1) - For purposes of paragraph (1) -

(A) Component parts, etc. - Property which is to be a component part of, or is otherwise to be included in, any building to which this subsection applies shall be taken into account

(i) at a time not earlier than the time at which it becomes irrevocably devoted to use in the building, and
(ii) as if (at the time referred to in clause (i)) the taxpayer had expended an amount equal to that portion of the cost to the taxpayer of such component or other property which, for purposes of this subpart, is properly chargeable (during such taxable year) to capital account with respect to such building.

(B) Certain borrowing disregarded - Any amount borrowed directly or indirectly by the taxpayer from the person rehabilitating the property for him shall not be treated as an amount expended for such rehabilitation.

(C) Limitation for buildings which are not self-rehabilitated

(i) In general - In the case of a building which is not self-rehabilitated, the amount taken into account under paragraph (1)(B) for any taxable year shall not exceed the amount which represents the portion of the overall cost to the taxpayer of the rehabilitation which is properly attributable to the portion of the rehabilitation which is completed during such taxable year.

(ii) Carryover of certain amounts - In the case of a building which is not a self-rehabilitated building, if for the taxable year -

(I) the amount which (but for clause (i)) would have been taken into account under paragraph (1)(B) exceeds the limitation of clause (i), then the amount of such excess shall be taken into account under paragraph (1)(B) for the succeeding taxable year, or

(II) the limitation of clause (i) exceeds the amount taken into account under paragraph (1)(B), then the amount of such excess shall increase the limitation of clause (i) for the succeeding taxable year.

(D) Determination of percentage of completion - The determination under subparagraph (C)(i) of the portion of the overall cost to the taxpayer of the rehabilitation which is properly attributable to rehabilitation completed during any taxable year shall be made, under regulations prescribed by the Secretary, on the basis of engineering or architectural estimates or on the basis of cost accounting records. Unless the taxpayer establishes otherwise by clear and convincing evidence, the rehabilitation shall be deemed to be completed not more rapidly than ratably over the normal rehabilitation period.

(E) No progress expenditures for certain prior periods - No qualified rehabilitation expenditures shall be taken into account under this subsection for any period before the first day of the first taxable year to which an election under this subsection applies.

(F) No progress expenditures for property for year it is placed in service, etc. - In the case of any building, no qualified rehabilitation expenditures shall be taken into account under this subsection for the earlier of -

(i) the taxable year in which the building is placed in service, or
(ii) the first taxable year for which recapture is required under section 50(a)(2) with respect to such property, or for any taxable year thereafter.

(**4) Self-rehabilitated building** - For purposes of this subsection, the term "self-rehabilitated building" means any building if it is reasonable to believe that more than half of the qualified rehabilitation expenditures for such building will be made directly by the taxpayer.

(4) **Election** - This subsection shall apply to any taxpayer only if such taxpayer has made an election under this paragraph. Such an election shall apply to the taxable year for which made and all subsequent taxable years. Such an election, once made, may be revoked only with the consent of the Secretary.

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Treasury Regulation Section 1.48-12

Sec. 1.48-12 Qualified rehabilitated building; expenditures incurred after December 31, 1981.

(a) General rule--(1) In general. Under section 48(a)(1)(E), the portion of the basis of a qualified rehabilitated building that is attributable to qualified rehabilitation expenditures (within the meaning of section 48(g) and this section) is section 38 property. Property that is section 38 property by reason of section 48(a)(1)(E) is treated as new section 38 property and, therefore, is not subject to the used property limitation in section 48(c). Section 48(g)(1) and paragraph (b) of this section define the term ``qualified rehabilitated building." Section 48(g)(2) and paragraph (c) of this section define the term ``qualified rehabilitation expenditure." Section 48(g) (2)(B)(iv) and (3) and paragraph (d) of this section describe the rules applicable to ``certified historic structures." Section 48(q) and paragraph (e) of this section provide rules concerning an adjustment to the basis of the rehabilitated building. Paragraph (f) of this section provides guidance for coordination of these provisions with other sections of the Code, including rules for determining when the rehabilitation credit may be claimed.

(2) Effective dates and transition rules--(i) In general. Except as otherwise provided in this paragraph (a)(2)(i), this section applies to expenditures incurred after December 31, 1981, in connection with the rehabilitation of a qualified rehabilitated building. (See paragraph (c)(3)(i) of this section for rules concerning the determination of when an expenditure is incurred.) If, owever, physical work on the rehabilitation began before January 1, 1982, and the building does not meet the requirements of paragraph (b) of this section, the rules in Sec. 1.48-11 shall apply to the expenditures incurred after December 31, 1981, in connection with such rehabilitation. (See paragraph (b)(6)(i) of this section for rules determining when physical work on a rehabilitation begins.)

(ii) Transition rules concerning ACRS lives. (A) For property placed in service before March 16, 1984, and any property subject to the exception set forth in section 111(g)(2) of Pub. L. 98-369 (Deficit Reduction Act of 1984), the references to "19 years" in paragraph (c)(4)(ii) and (7)(v) shall be replaced with "15 years" and the reference to "19-year real property" in paragraph (c)(4)(ii) shall be replaced with "15-year real property."

(B) Except as otherwise provided in paragraph (a)(2)(ii)(A) of this section, for property placed in service before May 9, 1985, and any property subject to the exception set forth in section 105(b) (2) and (5) of Pub. L. 99-121 (99 Stat. 501, 511), the reference to "19 years" in paragraph (c)(4)(ii) and (7)(v) shall be replaced with "18 years" and the references to "19-years real roperty" in paragraph (c)(4)(ii) shall be replaced with "18-year real property."

(iii) Transition rule concerning external wall definition. Notwithstanding the definition of external wall contained in paragraph (b)(3)(ii) of this section, in any case in which the written plans and specifications for a rehabilitation were substantially completed on or before June 28,

1985, and the building being rehabilitated would fail to meet the requirement of paragraph (b)(1)(iii) of this section if the definition of external wall in paragraph (b)(3)(ii) of this section were used, the term "external wall" shall be defined as a wall, including its supporting elements, with one face exposed to the weather or earth, and a common wall shall not be treated as an external wall. See paragraph (b)(2)(v) of this section for the definition of written plans and specifications.

(iv) Transition rules concerning amendments made by the Tax Reform Act of 1986--(A) In general. Except as otherwise provided in section 251(d) of the Tax Reform Act of 1986 and this paragraph (a)(2)(iv), the amendments made by section 251 of the Tax Reform Act of 1986 shall apply to property placed in service after December 31, 1986, in taxable years ending after that date, regardless of when the rehabilitation expenditures attributable to such property were incurred. If property attributable to qualified rehabilitation expenditures is incurred with respect to a rehabilitation to a building placed in service in segments or phases and some segments are placed in service before January 1, 1987, and the remaining segments are placed in service after December 31, 1986, the amendments under the Tax Reform Act would not apply to the property placed in service before January 1, 1987, but would apply to the segments placed in service after December 31, 1986, unless one of the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section applies.

(B) General transition rule. The amendments made by sections 251 and 201 of the Tax Reform Act of 1986 shall not apply to property that qualifies under section 251(d) (2), (3), or (4) of the Tax Reform Act of 1986. Property qualifies for the general transition rule in section 251(d)(2) of the Act if such property is placed in service before January 1, 1994, and if such property is placed in service as part of—

(1) A rehabilitation that was completed pursuant to a written contract that was binding on March 1, 1986, or

(2) A rehabilitation incurred in connection with property (including any leasehold interest) acquired before March 2, 1986, or acquired on or after such date pursuant to a written contract that was binding on March 1, 1986, if--

(i) Parts 1 and 2 of the Historic Preservation Certificate Application were filed with the Department of the Interior (or its designee) before March 2, 1986, or

(ii) The lesser of $1,000,000 or 5 percent of the cost of the rehabilitation is incurred before March 2, 1986, or is required to be incurred pursuant to a written contract which was binding on March 1, 1986.

(C) Specific rehabilitations. See section 251(d) (3) and (4) of the Tax Reform Act of 1986 for additional rehabilitations that are exempted from the amendments made by sections 251 and 201 of the Tax Reform Act of 1986.

(b) Definition of qualified rehabilitated building-- (1) In general. The term "qualified rehabilitated building" means any building and its structural components—

(i) That has been substantially rehabilitated (within the meaning of paragraph (b)(2) of this section) for the taxable year,

(ii) That was placed in service (within the meaning of Sec. 1.46-3(d)) as a building by any person before the beginning of the rehabilitation, and

(iii) That meets the applicable existing external wall retention test or the existing external wall and internal structural framework retention test in accordance with paragraph (b)(3) of this section.

The requirement in paragraph (b)(1)(iii) of this section does not apply to a certified historic structure. See paragraphs (b) (4) and (5) of this section for additional requirements related to the definition of a qualified rehabilitated building.

3. Substantially rehabilitated building--(i) Substantial rehabilitation test. A building shall be treated as having been substantially rehabilitated for a taxable year only if the qualified rehabilitation expenditures (as defined in paragraph (c) of this section) incurred during any 24-month period selected by the taxpayer ending with or within the taxable year exceed the greater of—

(A) The adjusted basis of the building (and its structural components), or
(B) $5,000.

(ii) Date to determine adjusted basis of the building--(A) In general. The adjusted basis of the building (and its structural components) shall be determined as of the beginning of the first day of the 24-month period selected by the taxpayer or the first day of the taxpayer's holding period of the building (within the meaning of section 1250(e)), whichever is later. For purposes of determining the holding period under section 1250(e), any reconstruction that is part of the rehabilitation shall be disregarded.

(B) Special rules. In the event that a building is not owned by the taxpayer, the adjusted basis of the building shall be determined as of the date that would have been used if the owner had been the taxpayer. The adjusted basis of a building that is being rehabilitated by a taxpayer other than the owner shall thus be determined as of the beginning of the first day of the 24-month period selected by the taxpayer or the first day of the owner's holding period, whichever is later. Therefore, if a building that is being rehabilitated by a lessee is sold subject to the lease prior to the date that the lessee has substantially rehabilitated the building, the lessee's adjusted basis is determined as of the beginning of the first day of the new lessor's holding period or the beginning of the first day of the 24-month period selected by the lessee (the taxpayer), whichever is later. If, therefore, the first day of the new lessor's holding period were later than the first day of the 24-month period selected by the lessee (the taxpayer), the lessee's adjusted basis for purposes of the substantial rehabilitation test would be the same as the adjusted basis of the new lessor as determined under paragraph (b)(2)(vii) of this section. If a building is sold after the date

that a lessee has substantially rehabilitated the building with respect to the original lessor's adjusted basis, however, the lessee's basis may be determined as of the first day of the 24-month period selected by the lessee or the first day of the original lessor's holding period, whichever is later, and the transfer of the building will not affect the adjusted basis for purposes of the substantial rehabilitation test. The preceding sentence shall not apply, however, if the building is sold to the lessee or a related party within the meaning of section 267(b) or section 707(b)(1).

(iii) Adjusted basis of the building--(A) In general. The term ``adjusted basis of the building'' means the aggregate adjusted basis (within the meaning of section 1011(a)) in the building (and its structural components) of all the parties who have an interest in the building.

(B) Special rules. In the case of a building that is leased to one or more tenants in whole or inpart, the adjusted basis of the building is determined by adding the adjusted basis of the owner (lessor) in the building to the adjusted basis of the lessee (or lessees) in the leasehold and any leasehold improvements that are structural components of the building. Similarly, in the case of a building that is divided into condominium units, the adjusted basis of the building means the aggregate adjusted basis of all of the respective condominium owners (including the basis of any lessee in the leasehold and leasehold improvements) in the building (and its structural components). If the adjusted basis of a building would be determined in whole or in part by reference to the adjusted basis of a person or persons other than the taxpayer (e.g., a rehabilitation by a lessee) and the taxpayer is unable to obtain the required information, the taxpayer must establish by clear and convincing evidence that the adjusted basis of such person or persons in the building on the date specified in paragraph (b)(2)(ii) of this section is an amount that is less than the amount of qualified rehabilitation expenditures incurred by the taxpayer. If no such amount can be so established, the adjusted basis of the building will be deemed to be the fair market value of the building on the relevant date. For purposes of determining the adjusted basis of a building, the portion of the adjusted basis of a building that is allocable to an addition (within the meaning of paragraph (b)(4)(ii) of this section) to the building that does not meet the age requirement in paragraph (b)(4)(i) of this section shall be disregarded. (See paragraph (b)(2)(vii) of this section for the rule applicable to the determination of the adjusted basis of a building when qualified rehabilitation expenditures are treated as incurred by the taxpayer.)

(iv) Rehabilitation. Rehabilitation includes renovation, restoration, or reconstruction of a building, but does not include an enlargement (within the meaning of paragraph (c)(10) of this section) of new construction. The determination of whether expenditures are attributable to the rehabilitation of an existing building or to new construction shall be based upon all the facts and circumstances.

(v) Special rule for phased rehabilitation. In the case of any rehabilitation that may reasonably be expected to be completed in phases set forth in written architectural plans and specifications completed before the physical work on the rehabilitation begins, paragraphs (b)(2) (i), (ii), and (vii) of this section shall be applied by substituting ``60-month period'' for ``24-month period.'' A

rehabilitation may reasonably be expected to be completed in phases if it consists of two or more distinct stages of development. The determination of whether a rehabilitation consists of distinct stages and therefore may reasonably be expected to be completed in phases shall be made on the basis of all the relevant facts and circumstances in existence before physical work on the rehabilitation begins. For purposes of this paragraph and paragraph (a)(2)(iii) of this section, written plans that describe generally all phases of the rehabilitation process shall be treated as written architectural plans and specifications. Such written plans are not required to contain detailed working drawings or detailed specifications of the materials to be used. In addition, the taxpayer may include a description of work to be done by lessees in the written plans. For example, where the owner of a vacant four story building plans to rehabilitate two floors of the building and plans to require, as a condition of any lease, that tenants of the other two floors must rehabilitate those floors, the requirements of this paragraph (b)(2)(v) shall be met if the owner provides written plans for the rehabilitation work to be done by the owner and a description of the rehabilitation work that the tenants will be required to complete. The work required of the tenants may be described in the written plans in terms of minimum specifications (e.g., as to lighting, wiring, materials, appearance) that must be met by such tenants. See paragraph (b)(6)(i) of this section for the definition of physical work on a rehabilitation.

(vi) Treatment of expenses incurred by persons who have an interest in the building. For purposes of the substantial rehabilitation test in paragraph (b)(2)(i) of this section, the taxpayer may take into account qualified rehabilitation expenditures incurred during the same rehabilitation process by any other person who has an interest in the building. Thus, for example, to determine whether a building has been substantially rehabilitated, a lessee may include the expenditures of the lessor and of other lessees; a condominium owner may include the expenditures incurred by other condominium owners; and an owner may include the expenditures of the lessees.

(vii) Special rules when qualified rehabilitation expenditures are treated as incurred by the taxpayer. In the case where qualified rehabilitation expenditures are treated as having been incurred by a taxpayer under paragraph (c)(3)(ii) of this section, the transferee shall be treated as having incurred the expenditures incurred by the transferor on the date that the transferor incurred the expenditures within the meaning of paragraph (c)(3)(i) of this section. For purposes of the substantial rehabilitation test in paragraph (b)(2)(i) of this section, the transferee's adjusted basis in the building shall be determined as of the beginning of the first day of a 24-month period, or the first day of the transferee's holding period, whichever is later, as provided in paragraph (b)(2)(ii) of this section. The transferee's basis as of the first day of the transferee's holding period for purposes of the substantial rehabilitation test in paragraph (b)(2)(i) of this section, however, shall be considered to be equal to the transferee's basis in the building on such date less—

(A) The amount of any qualified rehabilitation expenditures incurred (or treated as having been incurred) by the transferor during the 24-month period that are treated as having been incurred by the transferee under paragraph (c)(3)(ii) of this section, and

(B) The amount of qualified rehabilitation expenditures incurred before the transfer and during the 24-month period by any other person who has an interest in the building (e.g., a lessee of the transferor). The preceding sentence shall not apply, however, unless the transferee's basis in the building is determined with reference to (1) the transferee's cost of the building (including the rehabilitation expenditures), (2) the transferor's basis in the building (where such basis includes the amount of the expenditures), or (3) any other amount that includes the cost of the rehabilitation expenditures. In the event that the transferee's basis is determined with reference to an amount not described above (e.g., transferee's basis in one building is determined with reference to the transferee's basis in another building under section 1031(d)), the amount of the expenditures incurred by the transferor and treated as having been incurred by the transferee are not deducted from the transferee's basis for purposes of the substantial rehabilitation test. If a transferee's basis is determined under section 1014, any expenditures incurred by the decedent within the measuring period that are treated as having been incurred by the transferee under paragraph (c)(3)(ii) of this section shall decrease the transferee's basis for purposes of the substantial rehabilitation test.

(viii) Statement of adjusted basis, measuring period, and qualified rehabilitation expenditures. In the case of any tax return filed after August 27, 1985, on which an investment tax credit for property, described in section 48(a)(1)(E) is claimed, the taxpayer shall indicate by way of a marginal notation on, or a supplemental statement attached to, Form 3468—

(A) The beginning and ending dates for the measuring period selected by the taxpayer under section 48(g)(1)(C)(i) and paragraph (b)(2) of this section,

(B) The adjusted basis of the building (within the meaning of paragraph (b)(2)(iii) or (vii) of this section) as of the beginning of such measuring period, and

C) The amount of qualified rehabilitation expenditures incurred, and treated as incurred, respectively, during such measuring period.

Furthermore, for returns filed after August 27, 1985, if the adjusted basis of the building for purposes of the substantial rehabilitation test is determined in whole or in part by reference to the adjusted basis of a person, or persons, other than the taxpayer (e.g., a rehabilitation by a lessee), the taxpayer must attach to the Form 3468 filed with the tax return on which the credit is claimed a statement addressed to the District Director, signed by such third party, that states the first day of the third party's holding period and the amount of the adjusted basis of such third party in the building at the beginning of the measuring period or the first day of the holding period, whichever is later. If the taxpayer is unable to obtain the required information, that fact should be indicated and the taxpayer should state the manner in which the adjusted basis was determined and, if different, the fair market value of the building on the relevant date.

(ix) Partnerships and S corporations. If a building is owned by a partnership (that is,, the building is partnership property) or an S corporation, the substantial rehabilitation test shall be determined at the entity level. Thus, the entity shall compare the amount of qualified

rehabilitation expenditures incurred during the measuring period against its basis in the building at the beginning of its holding period or the beginning of its measuring period, whichever is later. (See section 1223(2) for rules concerning the determination of a partnership's holding period in the case of a contribution of property to the partnership meeting the requirements of section 721.) The adjusted basis of the building to a partnership shall be determined by taking into account any adjustments to the basis of the building made under section 743 and section 734. Any adjustments to the building's basis that are made under section 743 or section 734 after the beginning of the partnership's holding period, but before the end of the measuring period, shall be deemed for purposes of the substantial rehabilitation test to have been made on the first day of the partnership's holding period. However, in such case, the partnership's basis in the building shall be reduced by the amount of qualified rehabilitation expenditures incurred by the partnership. In the case of any tax return filed after January 9, 1989 on which a credit is claimed by a partner or a shareholder of an S corporation for rehabilitation expenditures incurred by a partnership or an S corporation, the partner or shareholder shall indicate on the Form 3468 on which the credit is claimed the name, address, and identification number of the partnership or S corporation that incurred the rehabilitation expenditures, and the partnership or S corporation shall, by way of a marginal notation on or a supplemental statement attached to the entity's return, provide the information required by paragraph (b)(2)(viii) of this section.

(x) Examples. The following examples illustrate the application of the substantial rehabilitation test in this paragraph (b)(2):

Example 1. Assume that A, a calendar year taxpayer, purchases a building for $140,000 on January 1, 1982, incurs qualified rehabilitation expenditures in the amount of $48,000 (at the rate of $4,000 per month) in 1982, $100,000 in 1983, and $20,000 (at the rate of $2,000 per month) in the first ten months of 1984, and places the rehabilitated building in service on October 31, 1984. Assume that A did not have written architectural plans and specifications describing a phased rehabilitation within the meaning of paragraph (b)(2)(v) of this section in existence prior to the beginning of physical work on the rehabilitation. For purposes of the substantial rehabilitation test in paragraph (b)(2) of this section, A may select any 24-consecutive-month measuring period that ends in 1984, the taxable year in which the rehabilitated building was placed in service. Assume that on A's 1984 return, A selects a measuring period beginning on February 1, 1982, and ending on January 31, 1984, and specifies that A's basis in the building (within the meaning of section 1011(a)) was $144,000 on February 1, 1982 ($140,000+$4,000). (The $4,000 of rehabilitation expenditures incurred during January 1982 are included in A's basis under section 1011 even though such property has not been placed in service.) The amount of qualified rehabilitation expenditures incurred during the measuring period was $146,000 ($44,000 from February 1 to December 31, 1982, plus $100,000 in 1983, plus $2,000 in January 1984). The building shall be treated as ``substantially rehabilitated'' within the meaning of this paragraph (b)(2) for A's 1984 taxable year because the $146,000 of expenditures incurred by A during the measuring period exceeded A's adjusted basis of $144,000 at the beginning of the period. If the other requirements of section 48(g)(1) and this paragraph are met, the building is treated as a qualified rehabilitated building, and A can treat as qualified rehabilitation

expenditures the amount of $168,000 (that is,, $146,000 of expenditures incurred during the measuring period, $4,000 of expenditures incurred prior to the beginning of the measuring period as part of the rehabilitation process, and $18,000 of expenditures incurred after the measuring period during the taxable year within which the measuring period ends (See paragraph (c)(6) of this section.)). The result would generally be the same if the property attributable to the rehabilitation expenditures was placed in service as the expenditures were incurred, but A would have $148,000 of qualified rehabilitation expenditures for 1983 and $20,000 of qualified rehabilitation expenditures for 1984. (See paragraph (f)(2) of this section).

Example 2. Assume the same facts as in example 1, except that additional rehabilitation expenditures are incurred after the portion of the basis of the building attributable to qualified rehabilitation expenditures was placed in service on October 31, 1984. Such expenditures are incurred through the end of 1984 and in 1985 when the portion of the basis attributable to the additional expenditures is placed in service. The fact that the building qualified as a substantially rehabilitated building for A's 1984 taxable year has no effect on whether the building is a qualified rehabilitated building for property placed in service in A's 1985 taxable year. In order to determine whether the building is a qualified rehabilitated building for A's 1985 taxable year, A must select a measuring period that ends in 1985 and compare the expenditures incurred within that period with the adjusted basis as of the beginning of the period. Solely for the purpose of determining whether the building was substantially rehabilitated for A's 1985 taxable year, expenditures incurred during 1983 and 1984, even though considered in determining whether the building was substantially rehabilitated in 1984, may also be used to determine whether the building was substantially rehabilitated for A's 1985 taxable year, provided the expenditures were incurred during any 24-month measuring period selected by A that ends in 1985.

Example 3. (i) Assume the B purchases a building for $100,000 on January 1, 1982, and leases the building to C who rehabilitates the building. Assume that C, a calendar year taxpayer, places the property with respect to which rehabilitation expenditures were made in service in 1982 and selects December 31, 1982, as the end of the measuring period for purposes of the substantial rehabilitation test. The beginning of the measuring period is January 2, 1982, the beginning of B's holding period under section 1250(e), and the adjusted basis of the building is $100,000. Accordingly, if C incurred more than $100,000 of qualified rehabilitation expenditures during 1982, the building would be substantially rehabilitated within the meaning of paragraph (b)(2)(i) of this section.

(ii) Assume the facts of example 3(i), except that after C begins physical work on the rehabilitation, but before C incurs $100,000 of expenditures, D acquires the building, subject to C's lease, from B for $200,000. D's holding period under section 1250(e) begins on the day after D acquired the building, and C's adjusted basis for purposes of the substantial rehabilitation test is $200,000, less the amount of expenditures incurred by C before the transfer. (See paragraphs (b)(2) (ii) and (vii) of this section.) Accordingly, if C incurred more than $200,000 (less the amount of expenditures incurred prior to the transfer) of qualified rehabilitation expenditures

during 1982, the building would be substantially rehabilitated within the meaning of paragraph (b)(2) of this section. Under paragraph (b)(2)(ii)(B) of this section, however, C's adjusted basis for purposes of the substantial rehabilitation test would be $100,000 if C had substantially rehabilitated the building (that is,, incurred more than $100,000 in rehabilitation expenditures) prior to B's sale to D.

Example 4. E owns a building with a basis of $10,000 and E incurs $5,000 of rehabilitation expenditures. Before completing the rehabilitation project, E sells the building to F for $30,000. Assume that F is treated under paragraph (c)(3)(ii) of this section as having incurred the $5,000 of rehabilitation expenditures actually incurred by E. Because F's basis in the building is determined under section 1011 with reference to F's $30,000 cost of the building (which includes the property attributable to E's rehabilitation expenditures), F's basis for purposes of the substantial rehabilitation test is $25,000 ($30,000 cost basis less $5,000 rehabilitation expenditures treated as if incurred by F). (See paragraph (b)(2)(vii) of this section.) F would thus be required to incur more than $20,000 of rehabilitation expenditures (in addition to the $5,000 incurred by E and treated as having been incurred by F) during a measuring period selected by F to satisfy the substantial rehabilitation test.

Example 5. G owns Building I with a basis of $10,000 and a fair market value of $20,000. H owns Building II with a basis of $5,000 and a fair market value of $20,000, with respect to which H has incurred $1,000 of rehabilitation expenditures. G and H exchange their buildings in a transaction that qualifies for nonrecognition treatment under section 1031. Assume that G is treated under paragraph (c)(3)(ii) of this section as having incurred $1,000 of rehabilitation expenditures. G's basis in Building II, computed under section 1031(d), is $10,000. G's basis in Building II is not determined with reference to (A) the cost of Building II, (B) H's basis in Building II (including the cost of the rehabilitation expenditures) or (C) any other amount that includes the cost of expenditures, but is instead determined with reference to G's basis in other property (Building I). Therefore, G's basis in Building II for purposes of the substantial rehabilitation test is not reduced by the $1,000 of rehabilitation expenditures treated as if incurred by G. (See paragraph (b)(2)(vii) of this section.) Accordingly, G's basis in Building II for purposes of the substantial rehabilitation test is $10,000, and G must incur additional rehabilitation expenditures in excess of $9,000 within a measuring period selected by G to satisfy the test.

(3) Retention of existing external walls and internal structural framework--(i) In general--(A) Property placed in service after December 31, 1986. Except in the case of property that qualifies for the transition rules in paragraphs (a)(2)(iv) (B) and (C) of this section, in the case of property that is placed in service after December 31, 1986, a building (other than a certified historic structure) meets the requirement in paragraph (b)(1)(iii) of this section only if in the rehabilitation process—

(1) 50 percent or more of the existing external walls of such building are retained in place as external walls;
(2) 75 percent or more of the existing external walls of such building are retained in place as internal or external walls; and
(3) 75 percent or more of the internal structural framework of such building (as defined in paragraph (b)(3)(iii) of this section) is retained in place.

(B) Expenditures incurred before January 1, 1984, for property placed in service before January 1, 1987. With respect to rehabilitation expenditures incurred before January 1, 1984, for property that is either placed in service before January 1, 1987, or that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, a building meets the requirement in paragraph (b)(1)(iii) of this section only if 75 percent or more of the existing external walls of the building are retained in place as external walls in the rehabilitation process. If an addition to a building is not treated as part of a qualified rehabilitated building because it does not meet the 30-year requirement in paragraph (b)(4)(i)(B) of this section, then the external walls of such addition shall not be considered to be existing external walls of the building for purposes of section 48(g)(1)(A)(iii) (as in effect prior to enactment of the Tax Reform Act of 1986), and this section.

(C) Expenditures incurred after December 31, 1983, for property placed in service before January 1, 1987. With respect to expenditures incurred after December 31, 1983, for property that is either placed in service before January 1, 1987, or that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, the requirement of paragraph (b)(1)(iii) of this section is satisfied only if in the rehabilitation process either the existing external wall retention requirement in paragraph (b)(3)(i) (B) of this section is satisfied, or:

(1) 50 percent or more of the existing external walls of the building are retained in place as external walls,
(2) 75 percent or more of the existing external walls are retained in place as internal or external walls, and
(3) 75 percent or more of the existing internal structural framework of such building is retained in place.

(D) Area of external walls and internal structural framework. The determinations required by paragraphs (b)(3)(i) (A), (B), and (C) of this section shall be based upon the area of the external walls or internal structural framework that is retained in place compared to the total area of each prior to the rehabilitation. The area of the existing external walls and internal structural framework of a building shall be determined prior to any destruction, modification, or construction of external walls or internal structural framework that is undertaken by any party in anticipation of the rehabilitation.

(ii) Definition of external wall. For purposes of this paragraph (b), a wall includes both the supporting elements of the wall and the nonsupporting elements, (e.g., a curtain, windows or doors) of the wall. Except as otherwise provided in this paragraph (b)(3), the term "external wall"

includes any wall that has one face exposed to the weather, earth, or an abutting wall of an adjacent building. The term "external wall" also includes a shared wall (i.e., a single wall shared with an adjacent building), generally referred to as a "party wall," provided that the shared wall has no windows or doors in any portion of the wall that does not have one face exposed to the weather, earth, or an abutting wall. In general, the term "external wall" includes only those external walls that form part of the outline or perimeter of the building or that surround an uncovered courtyard. Therefore, the walls of an uncovered internal shaft, designed solely to bring light or air into the center of a building, which are completely surrounded by external walls of the building and which enclose space not designated for occupancy or other use by people (other than for maintenance or emergency), are not considered external walls. Thus, for example, a wall of a light well in the center of a building is not an external wall. However, walls surrounding an outdoor space which is usable by people, such as a courtyard, are external walls.

(iii) Definition of internal structural framework. For purposes of this section, the term "internal structural framework" includes all load-bearing internal walls and any other internal structural supports, including the columns, girders, beams, trusses, spandrels, and all other members that are essential to the stability of the building.

(iv) Retained in place. An existing external wall is retained in place if the supporting elements of the wall are retained in place. An existing external wall is not retained in place if the supporting elements of the wall are replaced by new supporting elements. An external wall is retained in place, however, if the supporting elements are reinforced in the rehabilitation, provided that such supporting elements of the external wall are retained in place. An external wall also is retained in place if it is covered (e.g., with new siding). Moreover, an external wall is retained in place if the existing curtain is replaced with a new curtain, provided that the structural framework that provides for the support of the existing curtain is retained in place. An external wall is retained in place notwithstanding that the existing doors and windows in the wall are modified, eliminated, or replaced. An external wall is retained in place if the wall is disassembled and reassembled, provided the same supporting elements are used when the wall is reassembled and the configuration of the external walls of the building after the rehabilitation is the same as it was before the rehabilitation process commenced. Thus, for example, a brick wall is considered retained in place even though the original bricks are removed (for cleaning, etc.) and replaced to form the wall. The principles of this paragraph (b)(3)(iv) shall also apply to determine whether internal structural framework of the building is retained in place.

(v) Effect of additions. If an existing external wall is converted into an internal wall (i.e., a wall that is not an external wall), the wall is not retained in place as an external wall for purposes of this section.

(vi) Examples. The provisions of this paragraph (b)(3) may be illustrated by the following examples:

Example 1. Taxpayer A rehabilitated a building all of the walls of which consisted of wood siding attached to gypsum board sheets (which covered the supporting elements of the wall, i.e., studs). A covered the existing wood siding with aluminum siding as part of a rehabilitation that otherwise qualified under this subparagraph. The addition of the aluminum siding does not affect the status of the existing external walls as external walls and they would be considered to have been retained in place.

Example 2. Taxpayer B rehabilitated a building, the external walls of which had a masonry curtain. The masonry on the wall face was replaced with a glass curtain. The steel beam and girders supporting the existing masonry curtain were retained in place. The walls of the building are considered to be retained in place as external walls, notwithstanding the replacement of the curtain.

Example 3. Taxpayer C rehabilitated a building that has two external walls measuring 75' x 20' and two other external walls measuring 100' x 20'. C demolished one of the larger walls, including its supporting elements and constructed a new wall. Because one of the larger walls represents more than 25 percent of the area of the building's external walls, C has not satisfied the requirements that 75 percent of the existing external walls must be retained in place as either internal or external walls. If however, C had not demolished the wall, but had converted it into an internal wall (e.g., by building a new external wall), the building would satisfy the external wall requirements.

Example 4. The facts are the same as in example 3, except that C does not tear down any walls, but builds an addition that results in one of the smaller walls becoming an internal wall. In addition, C enlarged 8 of the existing windows on one of the larger walls, increasing them from a size of 3' x 4' to 6' x 8'. Since the smaller wall accounts for less than 25 percent of the total wall area, C has satisfied the requirement that 75 percent of the existing external walls must be retained in place as external walls in the rehabilitation process. The enlargement of the existing windows on the larger wall does not affect its status as an external wall.

Example 5. Taxpayer D rehabilitated a building that was in the center of a row of three buildings. The building being rehabilitated by D shares its side walls with the buildings on either side. The shared walls measure 100' x 20' and the rear and front walls measure 75' x 20'. As part of a rehabilitation, D tears down and replaces the front wall. Because the shared walls as well as the front and back walls are considered external walls and the front wall accounts for less than 25 percent of the total external wall area (including the shared walls), D has satisfied the requirement that 75 percent of the existing external walls must be retained in place as external walls in the rehabilitation process.

4. Age requirement--(i) In general--(A) Property placed in service after December 31, 1986. Except in the case of property that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, a building

other than a certified historic structure shall not be considered a qualified rehabilitated building unless the building was first placed in service (within the meaning of Sec. 1.46-3(d)) before January 1, 1936.

(B) Property placed in service before January 1, 1987, and property qualifying under a transition rule. In the case of property placed in service before January 1, 1987, and property that qualifies under the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, a building other than a certified historic structure is considered a qualified rehabilitated building only if a period of at least 30 years has elapsed between the date physical work on the rehabilitation of the building began and the date the building was first placed in service (within the meaning of Sec. 1.46-3(d)) as a building by any person.

(ii) Additions. A building that was first placed in service before 1936 in the case described in paragraph (b)(4)(i)(A) of this section, or at least 30 years before physical work on the rehabilitation began in the case described in paragraph (b)(4)(i)(B) of this section, will not be disqualified because additions to such building have been added since 1936 in the case described in paragraph (b)(4)(i)(A) of this section, or are less than 30 years old in the case described in paragraph (b)(4)(i)(B) of this section. Such additions, however, shall not be treated as part of the qualified rehabilitated building. The term "addition" means any construction that resulted in any portion of an external wall becoming an internal wall, that resulted in an increase in the height of the building, or that increased the volume of the building.

(iii) Vacant periods. The determinations required by paragraph (b)(4)(i) of this section include periods during which a building was vacant or devoted to a personal use and is computed without regard to the number of owners or the identify of owners during the period. (5) Location at which the rehabilitation occurs. A building, other than a certified historic structure is not a qualified rehabilitated building unless it has been located where it is rehabilitated since before 1936 in the case described in paragraph (b)(4)(i)(A) of this section. Similarly, in the case described in paragraph (b)(4)(i)(B) of this section, a building, other than a certified historic structure, is not a qualified rehabilitation building unless it has been located where it is rehabilitated for the thirty-year period immediately preceding the date physical work on the rehabilitation began in the case of a "30-year building" or the forty-year period immediately preceding the date physical work on the rehabilitation began in the case of a "40-year building." (See Sec. 1.46-1(q)(1)(iii) for the definitions of "30-year building" and "40-year building.")

(6) Definition and special rule--(i) Physical work on a rehabilitation. For purposes of this section, "physical work on a rehabilitation" begins when actual construction, or destruction in preparation for construction, begins. The term "physical work on a rehabilitation," however, does not include preliminary activities such as planning, designing, securing financing, exploring, researching, developing plans and specifications, or stabilizing a building to prevent deterioration (e.g., placing boards over broken windows).

(ii) Special rule for adjoining buildings that are combined. For purposes of this paragraph (b), if as part of a rehabilitation process two or more adjoining buildings are combined and placed in service as a single building after the rehabilitation process, then, at the election of the taxpayer, all of the requirements for a qualified rehabilitated building in section 48(g)(1) and this section may be applied to the constituent adjoining buildings in the aggregate. For example, if such requirements are applied in the aggregate, any shared walls or abutting walls between the constituent buildings that would otherwise be treated as external walls (within the meaning of paragraph (b)(3) of this section) would not be treated as external walls of the building, and the substantial rehabilitation test in paragraph (b)(2) of this section would be applied to the aggregate expenditures with respect to all of the constituent buildings and to the aggregate adjusted basis of all of the constituent buildings. A taxpayer shall elect the special rule of this paragraph (b)(6)(ii) for adjoining buildings by indicating by way of a marginal notation on, or a supplemental statement attached to, the Form 3468 on which a credit is first claimed for qualified rehabilitation expenditures with respect to such buildings that such buildings are a single qualified rehabilitated building because of the application of the special rule in this paragraph (b)(6)(ii).

(c) Definition of qualified rehabilitation expenditures--(1) In general. Except as otherwise provided in paragraph (c)(7) of this section, the term "qualified rehabilitation expenditure" means any amount that is--

(i) Properly chargeable to capital account (as described in paragraph (c)(2) of this section),
(ii) Incurred by the taxpayer after December 31, 1981 (as described in paragraph (c)(3) of this section),
(iii) For property for which depreciation is allowable under section 168 and which is real property described in paragraph (c)(4) of this section, and
(iv) Made in connection with the rehabilitation of a qualified rehabilitated building (as described in paragraph (c)(5) of this section).

(2) Chargeable to capital account. For purposes of paragraph (c)(1) of this section, amounts are chargeable to capital account if they are properly includible in computing basis of real property under Sec. 1.46-3(c). Amounts treated as an expense and deducted in the year they are paid or incurred or amounts that are otherwise not added to the basis of real property described in paragraph (c)(4) of this section do not qualify. For purposes of this paragraph (c), amounts incurred for architectural and engineering fees, site survey fees, legal expenses, insurance premiums, development fees, and other construction related costs, satisfy the requirement of this paragraph (c)(2) if they are added to the basis of real property that is described in paragraph (c)(4) of this section. Construction period interest and taxes that are amortized under section 189 (as in effect prior to its repeal by the Tax Reform Act of 1986) do not satisfy the requirement of this paragraph (c)(2). If, however, such interest and taxes are treated by the taxpayer as chargeable to capital account with respect to property described in paragraph (c)(4) of this section, they shall be treated in the same manner as other costs described in this paragraph (c)(2). Any construction period interest or taxes or other fees or costs incurred in connection with the acquisition of a building, any interest in a building, or land, are subject to paragraph (c)(7)(ii) of this section. See paragraph (c)(9) of this section for additional rules concerning interest.

(3) Incurred by the taxpayer--(i) In general. Qualified rehabilitation expenditures are incurred by the taxpayer for purposes of this section on the date such expenditures would be considered incurred under an accrual method of accounting, regardless of the method of accounting used by the taxpayer with respect to other items of income and expense. If qualified rehabilitation expenditures are treated as having been incurred by a taxpayer under paragraph (c)(3)(ii) of this section, the taxpayer shall be treated as having incurred the expenditures on the date such expenditures were incurred by the transferor.

(ii) Qualified rehabilitation expenditures treated as incurred by the taxpayer--(A) Where rehabilitation expenditures are incurred with respect to a building by a person (or persons) other than the taxpayer and the taxpayer subsequently acquires the building, or a portion of the building to which some or all of the expenditures are allocable (e.g., a condominium unit to which rehabilitation expenditures have been allocated), the taxpayer acquiring such property shall be treated as having incurred the rehabilitation expenditures actually incurred by the transferor (or treated as incurred by the transferor under this paragraph (c)(3)(ii)) allocable to the acquired property, provided that—

(1) The building, or the portion of the building, acquired by the taxpayer was not used (or, if later, was not placed in service (as defined in paragraph (f)(2) of this section)) after the rehabilitation expenditures were incurred and prior to the date of acquisition, and

(2) No credit with respect to such qualified rehabilitation expenditures is claimed by anyone other than the taxpayer acquiring the property. For purposes of this paragraph (c)(3)(ii), use shall mean actual use, whether personal or business. In the case of a building that is divided into condominium units, expenditures attributable to the common elements shall be allocable to the individual condominium units in accordance with the principles of paragraph (c)(10)(ii) of this section. Furthermore, for purpose of this paragraph (c)(3)(ii), a condominium unit's share of the common elements shall not be considered to have been used (or placed in service) prior to the time that the particular condominium unit is used.

(B) The amount of rehabilitation expenditures described in paragraph (c)(3)(ii)(A) of this section treated as incurred by the taxpayer under this paragraph shall be the lesser of--

(1) The amount of rehabilitation expenditures incurred before the date on which the taxpayer acquired the building (or portion thereof) to which the rehabilitation expenditures are attributable, or

(2) The portion of the taxpayer's cost or other basis for the property that is properly allocable to the property resulting from the rehabilitation expenditures described in paragraph (c)(3)(ii)(B)(1) of this section.

(C) For purposes of this paragraph (c)(3)(ii), the amount of rehabilitation expenditures treated as incurred by the taxpayer under this paragraph (c) shall not be treated as costs for the acquisition of a building. The portion of the cost of acquiring a building (or an interest therein) that is not

treated under this paragraph as qualified rehabilitation expenditures incurred by the taxpayer is not treated as section 38 property in the hands of the acquiring taxpayer. (See paragraph (c)(7)(ii) of this section.) (See paragraph (b)(2)(vii) for rules concerning the application of the substantial rehabilitation test when expenditures are treated as incurred by the taxpayer.)

(iii) Examples. The provisions of this paragraph (c) may be illustrated by the following examples:

Example 1. In 1981, A, a taxpayer using the cash receipts and disbursements method of accounting, commenced the rehabilitation of a 30-year old building. In June 1981, A signed a contract with a plumbing contractor for replacement of the plumbing in the building. A agreed to pay the contractor as soon as the work was completed. The work was completed in December 1981, but A did not pay the amount due until January 15, 1982. The expenditures for the plumbing are not qualified rehabilitation expenditures (within the meaning of this paragraph (c)) because they were not incurred under an accrual method of accounting after December 31, 1981.

Example 2. B incurred qualified rehabilitation expenditures of $300,000 with respect to an existing building between January 1, 1982, and May 15, 1982, and then sold the building to C on June 1, 1982. The portion of the building to which the expenditures were allocable was not used by B or any other person during the period from January 1, 1982, to June 1, 1982, and neither B nor any other person claimed the credit. Consequently, C will be treated as having incurred the expenditures on the dates that B incurred the expenditures.

Example 3. D, a taxpayer using the cash receipts and disbursements method of accounting, begins the rehabilitation of a building on January 11, 1982. Prior to May 1, 1982, D makes rehabilitation expenditures of $16,000. On May 3, 1982, D sells the building, the land, and the property attributable to the rehabilitation expenditures to E for $35,000. The purchase price is properly allocable as follows:

Land.....	$5,000
Existing building.....	11,000
Property attributable to rehabilitation expenditures....	19,000

Total purchase price.....	35,000

The property attributable to the rehabilitation expenditures is placed in service by E on September 5, 1982. E may treat a portion of the $35,000 purchase price as rehabilitation expenditures paid or incurred by him. Since the rehabilitation expenditures paid by D ($16,000) are less than the portion of the purchase price properly allocable to property attributable to these expenditures ($19,000), E may treat only $16,000 as rehabilitation expenditures paid or incurred by him. The excess of the purchase price allocable to rehabilitation expenditures ($19,000) over the rehabilitation expenditures paid by D ($16,000), or $3,000, is treated as the cost of acquiring an interest in the building and is not a qualified rehabilitation expenditure treated as incurred by E.

Example 4. The facts are the same as in example 3, except that the purchase price properly allocable to the property attributable to rehabilitation expenditures is $15,000. Under these circumstances, E may treat only $15,000 of D's $16,000 expenditures as rehabilitation expenditures paid by D. The excess of the rehabilitation expenditures paid by D ($16,000) over the purchase price allocable to rehabilitation expenditures ($15,000), or $1,000, is treated as the cost of acquiring an interest in the building and is not a qualified rehabilitation expenditure treated as incurred by E.

(4) Incurred for depreciable real property--(i) Property placed in service after December 31, 1986. Except as otherwise provided in paragraph (c)(4)(ii) of this section (relating to certain property that qualifies under a transition rule), in the case of property placed in service after December 31, 1986, an expenditure is incurred for depreciable real property for purposes of paragraph (c)(1)(iii) of this section, only if it is added to the depreciable basis of depreciable property which is--

(A) Nonresidential real property,
(B) Residential rental property,
(C) Real property which has a class life of more than 12.5 years, or
(D) An addition or improvement to property described in paragraph (c)(4)(i) (A), (B), or (C) of this section.

For purposes of this paragraph (c)(4)(i), the terms "nonresidential real property", "residential rental property", and "class life" have the respective meanings given to such terms by section 168 and the regulations thereunder.

(ii) Property placed in service before January 1, 1987, and property that qualifies under a transition rule. In the case of property placed in service before January 1, 1987, and property placed in service after December 31, 1986, that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, an expenditure attributable to such property shall be a qualified rehabilitation expenditure only if such expenditure is incurred for property that is real property (or additions or improvements to real property) with a recovery period (within the meaning of section 168 as in effect prior to its amendment by the Tax Reform Act of 1986) of 19 years (15 years for low-income housing) and if the other requirements of this paragraph (c) are met. For purposes of this section, an expenditure is incurred for recovery property having a recovery period of 19 years only if the amount of the expenditure is added to the basis of property which is 19-year real property or 15-year real property in the case of low-income housing. For purposes of this section, the term "low-income housing" has the meaning given such term by section 168(c)(2)(F) (as in effect prior to the amendments made by the Tax Reform Act of 1986).

(5) Made in connection with the rehabilitation of a qualified rehabilitated building. In order for an expenditure to be a qualified rehabilitation expenditure, such expenditure must be incurred in connection with a rehabilitation (as defined in paragraph (b)(2)(iv) of this section) of a qualified

rehabilitated building. Expenditures attributable to work done to facilities related to a building (e.g., sidewalk, parking lot, landscaping) are not considered made in connection with the rehabilitation of a qualified rehabilitated building.

(6) When expenditures may be incurred. An expenditure is a qualified rehabilitation expenditure only if the building with respect to which the expenditures are incurred is substantially rehabilitated (within the meaning of paragraph (b)(2) of this section) for the taxable year in which the property attributable to the expenditures is placed in service (i.e., the building is substantially rehabilitated during a measuring period ending with or within the taxable year in which a credit is claimed). (See paragraph (f)(2) of this section for rules relating to when property is placed in service.) Once the substantial rehabilitation test is met for a taxable year, the amount of qualified rehabilitation expenditures upon which a credit can be claimed for the taxable year is limited to expenditures incurred:

(i) Before the beginning of a measuring period during which the building was substantially rehabilitated that ends with or within the taxable year, provided that the expenditures were incurred in connection with the rehabilitation process that resulted in the substantial rehabilitation of the building;

(ii) Within a measuring period during which the building was substantially rehabilitated that ends with or within the taxable year, and

(iii) After the end of a measuring period during which the building was substantially rehabilitated but prior to the end of the taxable year with or within which the measuring period ends.

(7) Certain expenditures excluded from qualified rehabilitation expenditures. The term ``qualified rehabilitation expenditures" does not include the following expenditures:

(i) Except as otherwise provided in paragraph (c)(8) of this section, any expenditure with respect to which the taxpayer does not use the straight line method over a recovery period determined under section 168 (c) and (g).

(ii) The cost of acquiring a building, any interest in a building (including a leasehold interest), or land, except as provided in paragraph (c)(3)(ii) of this section.

(iii) Any expenditure attributable to an enlargement of a building (within the meaning of paragraph (c)(10) of this section).

(iv) Any expenditure attributable to the rehabilitation of a certified historic structure or a building located in a registered historic district, unless the rehabilitation is a certified rehabilitation. (See paragraph (d) of this section which contains definitions and special rules applicable to rehabilitations of certified historic structures and buildings located in registered historic districts.)

(v) Any expenditure of a lessee of a building or a portion of a building, if, on the date the rehabilitation is completed with respect to property placed in service by such lessee, the remaining term of the lease (determined without regard to any renewal period) is less than the recovery period determined under section 168(c) (or 19 years in the case of property placed in service before January 1, 1987, and property placed in service that qualifies under the transition rules in paragraph (a)(2)(iv)(B) or (C) of this section).

(vi) Any expenditure allocable to that portion of a building which is (or may reasonably be expected to be) tax-exempt use property (within the meaning of section 168 and the regulations thereunder), except that the exclusion in this paragraph (c)(7)(vi) shall not apply for purposes of determining whether the building is a substantially rehabilitated building under paragraph (b)(2) of this section.

(8) Requirement to use straight line depreciation--(i) Property placed in service after December 31, 1986. The requirement in section 48(g)(2)(B)(i) and paragraph (c)(7)(i) of this section to use straight line cost recovery does not apply to any expenditure to the extent that the alternative depreciation system of section 168(g) applies to such expenditure by reason of section 168(g)(1)(B) or (C). In addition, the requirement in section 48(g)(2)(B)(i) and paragraph (c)(7)(i) of this section applies only to the depreciation of the portion of the basis of a qualified rehabilitated building that is attributable to qualified rehabilitation expenditures.

(ii) Property placed in service before January 1, 1987, and property placed in service after December 31, 1986, that qualifies for a transition rule. In the case of expenditures attributable to property placed in service before January 1, 1987, and property that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, the term ``qualified rehabilitation expenditure" does not include an expenditure with respect to which an election was not made under section 168(b)(3) as in effect prior to its amendment by the Tax Reform Act of 1986, to use the straight line method of depreciation. In such case, the requirement that an election be made to use straight line cost recovery applies only to the cost recovery of the portion of the basis of a qualified rehabilitated building that is attributable to qualified rehabilitation expenditures. See section 168(f)(1), as in effect prior to its amendment by the Tax Reform Act of 1986, for rules relating to the use of different methods of cost recovery for different components of a building. In addition, such requirement shall not apply to any expenditure to the extent that section 168(f)(12) or (j), as in effect prior to the amendments made by the Tax Reform Act of 1986, applied to such expenditure.

(9) Cost of acquisition. For purposes of paragraph (c)(7)(ii) of this section, cost of acquisition includes any interest incurred on indebtedness the proceeds of which are attributable to the acquisition of a building, an interest in a building, or land open which a building exists. Interest incurred on a construction loan the proceeds of which are used for qualified rehabilitation expenditures, however, is not treated as a cost of acquisition.

(10) Enlargement defined--(i) In general. A building is enlarged to the extent that the total volume of the building is increased. An increase in floor space resulting from interior remodeling is not considered an enlargement. The total volume of a building is generally equal to the product

of the floor area of the base of the building and the height from the underside of the lowest floor (including the basement) to the average height of the finished roof (as it exists or existed). For this purpose, floor area is measured from the exterior faces of external walls (other than shared walls that are external walls) and from the centerline of shared walls that are external walls.

(ii) Rehabilitation that includes enlargement. If expenditures for property only partially qualify as qualified rehabilitation expenditures because some of the expenditures are attributable to the enlargement of the building, the expenditures must be apportioned between the original portion of the building and the enlargement. The expenditures must be specifically allocated between the original portion of the building and the enlargement to the extent possible. If it is not possible to make a specific allocation of the expenditures, the expenditures must be allocated to each portion on some reasonable basis. The determination of a reasonable basis for an allocation depends on factors such as the type of improvement and how the improvement relates functionally to the building. For example, in the case of expenditures for an air-conditioning system or a roof, a reasonable basis for allocating the expenditures among the two portions generally would be the volume of the building, excluding the enlargement, served by the air-conditioning system or the roof relative to the volume of the enlargement served by
the improvement.

(d) Rules applicable to rehabilitations of certified historic structures--(1) Definition of certified historic structure. The term ``certified historic structure" means any building (and its structural components) that is—

(i) Listed in the National Register of Historic Places (``National Register"); or
(ii) Located in a registered historic district and certified by the Secretary of the Interior to the Internal Revenue Service as being of historic significance to the district.

For purposes of this section, a building shall be considered to be a certified historic structure at the time it is placed in service if the taxpayer reasonably believes on that date the building will be determined to be a certified historic structure and has requested on or before that date a determination from the Department of Interior that such building is a certified historic structure within the meaning of this paragraph (d)(1)(i) or (ii) and the Department of Interior later determines that the building is a certified historic structure.

(2) Definition of registered historic district. The term "registered historic district" means any district that is--

(i) Listed in the National Register, or

(ii) (A) Designated under a statute of the appropriate State or local government that has been certified by the Secretary of the Interior to the Internal Revenue Service as containing criteria that will substantially achieve the purpose of

preserving and rehabilitating buildings of historic significance to the district, and (B) certified by the Secretary of the Interior as meeting substantially all of the requirements for the listing of districts in the National Register.

(3) Definition of certified rehabilitation. The term "certified rehabilitation" means any rehabilitation of a certified historic structure that the Secretary of the Interior has certified to the Internal Revenue Service as being consistent with the historic character of the building and, where applicable, the district in which such building is located. The determination of the scope of a rehabilitation shall be made on the basis of all the facts and circumstances surrounding the rehabilitation and shall not be made solely on the basis of ownership. The Secretary of the Interior shall take all of the rehabilitation work performed as part of a single rehabilitation, including any post-certification work, into account in determining whether the rehabilitation complies with the Department of Interior standards for rehabilitation and whether the certification should be granted, revoked, or otherwise invalidated.

(4) Revoked or invalidated certification. If the Department of Interior revokes or otherwise invalidates a certification after it has been issued to a taxpayer, the basis attributable to rehabilitation of the decertified property shall cease to be section 38 property described in section 48(a)(1)(E). Such cessation shall be effective as of the date the activity giving rise to the revocation or invalidation commenced. See section 47 for the rules applicable to property that ceases to be section 38 property.

(5) Special rule for certain buildings located in registered historic districts. The exclusion in paragraph (c)(7)(iv) of this section does not apply to a building in a registered historic district if—

(i) Such building was not a certified historic structure during the rehabilitation process; and

(ii) The Secretary of the Interior certified to the Internal Revenue Service that such building was not of historic significance to the district.

In general, the certification referred to in paragraph (d)(5)(ii) of this section must be requested by the taxpayer prior to the time that physical work on the rehabilitation began. If, however, the certification referred to in paragraph (d)(5)(ii) of this section is requested by the taxpayer after physical work on the rehabilitation of the building has begun, the taxpayer must certify to the Internal Revenue Service that, prior to the date that physical work on the rehabilitation began, the taxpayer in good faith was not aware of the requirement of paragraph (d)(5)(ii) of this section. The certification referred to in the previous sentence must be attached to the Form 3468 filed with the tax return for the year in which the credit is claimed.

(6) Special rule for certain rehabilitations begun before an area is designated as a registered historic district. In general, the exclusion from the definition of qualified rehabilitation expenditure in paragraph (c)(7)(iv) of this section applies to any rehabilitation expenditures that

are incurred after a building becomes a certified historic structure within the meaning of section 48 (g)(3)A) and paragraph (d)(1) of this section or the area in which a building is located becomes a registered historic district within the meaning of section 48 (g)(3)(B) and paragraph (d)(2) of this section. Rehabilitation expenditures incurred prior to such date, however, are not disqualified. In addition, rehabilitation expenditures made after the date the area in which a building is located becomes a registered historic district shall not be disqualified under paragraph (c)(7)(iv) of this section in any case in which physical work on the rehabilitation of a building begins prior to the date the taxpayer knows or has reason to know of an intention to nominate the area in which such building is located as a registered historic district. For purposes of this paragraph (d)(6), the taxpayer knows or has reason to know of such an intention if there is (A) a communication (written or oral) to the owner of any building within the district from the Department of the Interior, or any agency or instrumentality of the appropriate state or local government (or a designee of such agency or instrumentality) that the district in which the building is located is being considered for designation as a registered historic district, (B) a legal notice of such consideration published in a newspaper, or (C) a public meeting held to discuss such consideration. In order to take advantage of the special rule of this paragraph (d)(6), the taxpayer must attach to the Form 3468 filed for the taxable year in which the credit is claimed a statement that the taxpayer in good faith did not know, or have reason to know, of an intention to nominate the area in which the building is located as a registered historic district.

(7) Notice of certification--(i) In general. Except as otherwise provided in paragraph (d)(7)(ii) of this section, a taxpayer claiming the credit for rehabilitation of a certified historic structure (within the meaning of section 48(g)(3) and paragraph (d)(1) of this section) must attach to the Form 3468 filed with the tax return for the taxable year in which the credit is claimed a copy of the final certification of completed work by the Secretary of the Interior, and for returns filed after January 9, 1989, evidence that the building is a certified historic structure.

(ii) Late certification. If the final certification of completed work has not been issued by the Secretary of the Interior at the time the tax return is filed for a year in which the credit is claimed, a copy of the first page of the Historic Preservation Certification Application--Part 2--Description of Rehabilitation (NPS Form 10-168a), with an indication that it has been received by the Department of the Interior or its designate, together with proof that the building is a certified historic structure (or that such status has been requested), must be attached to the Form 3468 filed with the return. A notice from the Department of the Interior or the State Historic Preservation Officer, stating that the nomination or application has been received, or a date-stamped nomination or application shall be sufficient indication that the nomination or application has been received. The building need not be either listed in the National Register or be determined to be of historic significance to a registered historic district at the time the return is filed for the year in which the credit is claimed. (See paragraph (d)(1) of this section.) The taxpayer must submit a copy of the final certification as an attachment to Form 3468 with the first income tax return filed after the receipt by the taxpayer of the certification. If the final certification is denied by the Department of Interior, the credit will be disallowed for any taxable year in which it was claimed. If the taxpayer fails to receive final certification of completed work prior to the date that is 30 months after the date that the taxpayer filed the tax return on which the credit was claimed, the taxpayer must submit a written statement to the District Director stating

such fact prior to the last day of the 30th month, and the taxpayer shall be requested to consent to an agreement under section 6501(c)(4) extending the period of assessment for any tax relating to the time for which the credit was claimed. The procedure permitted by the preceding sentence shall be used whenever the entire rehabilitation project is not fully completed by the date that is 30 months after the taxpayer filed the tax return upon which the credit was claimed (e.g. a phased rehabilitation) and the Secretary of the Interior has thus not yet certified the rehabilitation.

(e) Adjustment to basis--(1) General rule. Except as otherwise provided by this paragraph (e), if a credit is allowed with respect to property attributable to qualified rehabilitation expenditures incurred in connection with the rehabilitation of a qualified rehabilitated building, the increase in the basis of the rehabilitated property that would otherwise result from the qualified rehabilitation expenditures must be reduced by the amount of the credit allowed. See section 48(q) and the regulations there under for other rules concerning adjustments to basis in the case of section 38 property.

(2) Special rule for certain property relating to certified historic structures. If a rehabilitation investment credit is allowed with respect to property that is placed in service before January 1, 1987, or property that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, and such property is attributable to qualified rehabilitation expenditures incurred in connection with the rehabilitation of a certified historic structure, the increase in the basis of the rehabilitated property that would otherwise result from the qualified rehabilitation expenditures must be reduced by one-half of the amount of the credit allowed.

(3) Recapture of rehabilitation investment credit. If during any taxable year there is a recapture amount determined with respect to any credit that resulted in a basis adjustment under paragraph (e) (1) or (2) of this section, the basis of such building (immediately before the event resulting in such recapture) shall be increased by an amount equal to such recapture amount. For purposes of the preceding sentence, the term `'recapture amount" means any increase in tax (or adjustment in carrybacks or carryovers) determined under section 47(a)(5).

(f) Coordination with other provisions of the Code--(1) Credit claimed by lessee for rehabilitation performed by lessor. A lessee may take the credit for rehabilitation performed by the lessor if the requirements of this section and section 48(d) are satisfied. For purposes of applying section 48(d), the fair market value of section 38 property described in section 48(a)(1)(E) shall be limited to that portion of the lessor's basis in the qualified rehabilitated building that is attributable to qualified rehabilitation expenditures. In the case of a portion of a building that is divided into more than one leasehold interest, the qualified rehabilitation expenditures attributable to the common elements shall be allocated to the individual leasehold interests in accordance with the principles of paragraph (c)(10)(ii) of this section. Furthermore, a leasehold interest's share of the common elements shall not be considered to have been placed in service prior to the time that the particular leasehold interest is placed in service.

(2) When the credit may be claimed--(i) In general. The investment credit for qualified rehabilitation expenditures is generally allowed in the taxable year in which the property attributable to the expenditure is placed in service, provided the building is a qualified rehabilitated building for the taxable year. See paragraph (b) of this section and section 46(c) and Sec. 1.46-3(d). Under certain circumstances, however, the credit may be available prior to the date the property is placed in service. See section 46(d) and Sec. 1.46-5 (relating to qualified progress expenditures). Solely for purposes of section 46(c), property attributable to qualified rehabilitation expenditures will not be treated as placed in service until the building with respect to which the expenditures are made meets the definition of a qualified rehabilitated building (as defined in section 48(g)(1) and paragraph (b) of this section) for the taxable year. Accordingly, in the first taxable year for which the building becomes a qualified rehabilitated building, the property described in section 48(a)(1)(E) attributable to expenditures described in paragraph (c) of this section, shall be considered to be placed in service, if such property was considered placed in service under section 46(c) and the regulations thereunder without regard to this paragraph (f)(2)(i) in that taxable year or a prior taxable year. For purposes of the preceding sentence, the requirement of section 48(g)(1)(A)(iii) and paragraph (b)(3) of this section, relating to the definition of a qualified rehabilitated building shall be deemed to be met if the taxpayer reasonably expects that no rehabilitation work undertaken during the remainder of the rehabilitation process will result in a failure to satisfy the requirements of paragraph (b)(3) of this section. If the requirements of paragraph (b)(3) of this section, are not satisfied, however, the credit shall be disallowed for the taxable year in which it was claimed. If a taxpayer fails to complete physical work on the rehabilitation prior to the date that is 30 months after the date that the taxpayer filed a tax return on which the credit is claimed, the taxpayer must submit a written statement to the District Director stating such fact prior to the last day of the 30th month, and shall be requested to consent to an agreement under section 6501(c)(4) extending the period of assessment for any tax relating to the item for which the credit was claimed.

(ii) Section 38 property described in section 48(a)(1)(E). In the case of section 38 property described in section 48(a)(1)(E), the section 38 property is not the building. Instead, the section 38 property is the portion of the basis of the building that is attributable to qualified rehabilitation expenditures. Therefore, for example, for purposes of the determination of when such section 38 property is placed in service, a determination must be made regarding when property attributable to the portion of the basis of the building attributable to qualified rehabilitation expenditures is placed in service. The issue of when the building is placed in service is thus not relevant. In fact, under this test, the building itself may never have been taken out of service during the rehabilitation process. If the building is rehabilitated over several years in stages (e.g., by floors), section 38 property attributable to qualified rehabilitation expenditures to a qualified rehabilitated building placed in service in each taxable year shall, generally, be treated as a separate item of section 38 property.

(iii) Example. The application of this paragraph (f)(2) may be illustrated by the following example:

Example. Assume that A, a calendar year taxpayer, purchases a four-story building on January 1, 1983, for $100,000, and incurs $10,000 of qualified rehabilitation expenditures in 1983 to rehabilitate floor one, $50,000 of qualified rehabilitation expenditures in 1984 to rehabilitate floor two, $70,000 of qualified rehabilitation expenditures in 1985 to rehabilitate floor three, and $60,000 of qualified rehabilitation expenditures in 1986 to rehabilitate floor four. Assume further that A places the property attributable to these expenditures in service on the last day of the year in which the respective expenditures were incurred and that the building is never taken out of service since as each floor is rehabilitated, the other three floors are occupied by tenants. Under the rule in this paragraph (f)(2), the portion of the basis of the building that is attributable to qualified rehabilitation expenditures incurred with respect to floor one and two are deemed to be placed in service in 1985, because that is the first year that the substantial rehabilitation test described in paragraph (b) of this section is met ($120,000 of expenditures incurred by A during a measuring period ending on December 31, 1985 is greater than the $110,000 basis at the beginning of the period). Assume that as of December 31, 1985, at least 75 percent of the external walls of the building have been retained during the rehabilitation process and that A has a reasonable expectation that no work during the remainder of the rehabilitation process will result in less than 75 percent of the external walls being retained. A may claim a credit for A's 1985 taxable year on $130,000 of qualified rehabilitation expenditures ($10,000 in 1983, $50,000 in 1984, and $70,000 in 1985). (See paragraph (c)(6) of this section for rules applicable to when qualified expenditures may be incurred. In addition, see section 46 (d) and Sec. 1.46-5 for rules relating to qualified progress expenditures.) The fact that the building was a qualified rehabilitated building for A's 1985 taxable year, however, has no effect on whether the building is a qualified rehabilitated building for A's 1986 taxable year. In order to determine whether A is entitled to claim a credit on A's 1986 return for the $60,000 of qualified rehabilitation expenditures incurred in 1986, A must select a measuring period ending in 1986 and must determine whether the building is a qualified rehabilitated building for that year. Solely for purposes of determining whether the building was substantially rehabilitated, expenditures incurred in 1984 and 1985, even though considered in determining whether the building was substantially rehabilitated for A's 1985 taxable year, may be used in addition to the expenditures incurred in 1986 to determine whether the building was substantially rehabilitated for A's 1986 taxable year, provided the expenditures were incurred during any measuring period selected by A that ends in 1986.

(3) Coordination with section 47. If property described in section 48(a)(1)(E) is disposed of by the taxpayer, or otherwise ceases to be "section 38 property," section 47 may apply. Property will cease to be section 38 property, and therefore section 47 may apply, in any case in which the Department of Interior revokes or otherwise invalidates a certification of rehabilitation after the property is placed in service or a building (other than a certified historic structure) is moved from the place where it is rehabilitated after the property is placed in service. If, for example, the taxpayer made modifications to the building inconsistent with Department of Interior standards, the Secretary of the Interior might revoke the certification. In addition, if all or a portion of a substantially rehabilitated building becomes tax-exempt use property (see paragraph (c)(7)(vi) of

this section) for the first time within five years after the credit is claimed, the credit will be recaptured under section 47 at that time as if the building or portion of the building which becomes tax-exempt use property had then been sold.

TITLE 26 - INTERNAL REVENUE CODE
IRC section 48(d)
Repealed, but incorporated by reference in IRC section 50(d)(5)

48(d) Certain Leased Property --

(1) General Rule. -- A person (other than a person referred to in section 46(e)(1)) who is a lessor of property may (at such time, in such manner, and subject to such conditions as are provided by regulations prescribed by the Secretary) elect with respect to any new section 38 property (other than property described in paragraph (4)) to treat the lessee as having acquired such property for an amount equal to--

(A) except as provided in subparagraph (B), the fair market value of such property, or

(B) if the property is leased by a corporation which is a component member of a controlled group (within the meaning of section 38(c)(3)(B)) to another corporation which is a component member of the same controlled group, the basis of such property to the lessor.

(2) Special Rule for Certain Short Term Leases.--

(A) In General.--A person (other than a person referred to in section 46(e)(1)) who is a lessor of property described in paragraph (4) may (at such time, in such manner, and subject to such conditions as are provided by regulations prescribed by the Secretary) elect with respect to such property to treat the lessee as having acquired a portion of such property for the amount determined under subparagraph (B).

(B) Determination of Lessee's Investment.--The amount for which a lessee of property described in paragraph (4) shall be treated as having acquired a portion of such property is an amount equal to a fraction, the numerator of which is the term of the lease and the denominator of which is the class life of the property leased (determined under section 167(m)), of the amount for which the lessee would be treated as having acquired the property under paragraph (1).

(C) Determination of Lessor's Qualified Investment.--The qualified investment of a lessor of property described in paragraph (4) in any such property with respect to which he has made an election under this paragraph is an amount equal to his qualified investment in such property (as determined under section 46(c)) multiplied by a fraction equal to the excess of one over the fraction used under subparagraph (B) to determine the lessee's investment in such property.

(3) Limitations.--The elections provided by paragraphs (1) and (2) may be made with respect to property which would be new section 38 property if acquired by the lessee. For purposes of the preceding sentence and section 46(c), the useful life of property in the hands of the lessee is the useful life of such property in the hands of the lessor. If a lessor makes the election provided by paragraph (1) with respect to any property, the lessee shall be treated for all purposes of this subpart as having acquired such property. If a lessor makes the election provided by paragraph (2) with respect to any property, the lessee shall be treated for all purposes of this subpart as having acquired a fractional portion of such property equal to the fraction determined under paragraph (2)(B) with respect to such property.

(4) Property to Which Paragraph (2) Applies.--Paragraph (2) shall apply only to property which--

(A) is new section 38 property,

(B) has a class life (determined under section 167(m)) in excess of 14 years,

(C) is leased for a period which is less than 80 percent of its class life, and

(D) is not leased subject to a net lease (within the meaning of section 57(c)(1)(B) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986)).

(5) Coordination with Basis Adjustment.--In the case of any property with respect to which an election is made under this subsection--

(A) subsection (q) (other than paragraph (4)) shall not apply with respect to such property,

(B) the lessee of such property shall include ratably in gross income over the shortest recovery period which could be applicable under section 168 with respect to such property an amount equal to 50 percent of the amount of the credit allowable under section 38 to the lessee with respect to such property, and

(C) in the case of a disposition of such property to which section 47 applies, this paragraph shall be applied in accordance with regulations prescribed by the Secretary.

(6) Coordination with At-Risk Rules.--

(A) Extension of at-Risk Rules to Certain Lessors.--

(i) In General.--If--

(I) a lessor makes an election under this subsection with respect to any at-risk property leased to an at-risk lessee, and

(II) but for this clause, section 46(c)(8) would not apply to such property in the hands of the lessor, section 46(c)(8) shall apply to the lessor with respect to such property.

(ii) Exceptions.--Clause (i) shall not apply--

(I) if the lessor manufactured or produced the property,

(II) if the property has a readily ascertainable fair market value, or

(III) in circumstances which the Secretary determines by regulations to be circumstances where the application of clause (i) is not necessary to carry out the purposes of section 46(c)(8).

(B) Requirement That Lessor be at Risk.--In the case of any property which, in the hands of the lessor, is property to which section 46(c)(8) applies, the amount of the credit allowable to the lessee under section 38 with respect to such property by reason of an election under this subsection shall at no time exceed the credit which would have been allowable to the lessor with respect to such property (determined without regard to section 46(e)(3) if--

(i) the lessor's basis in such property were equal to the lessee acquisition amount, and

(ii) no election had been made under this subsection.

(C) Lessee Subject to At-Risk Limitations.--

(i) In General.--In the case of any lease where--

(I) the lessee is an at-risk lessee,

(II) the property is at-risk property, and

(III) the at-risk percentage is less than the required percentage, any credit allowable under section 38 to the lessee by reason of an election under this subsection (hereinafter in this paragraph referred to as the "total credit") shall be allowable only as provided in subparagraph (D).

(ii) At-Risk Percentage.--For purposes of this paragraph, the term "at-risk percentage" means the percentage obtained by dividing--

(I) the present value (as of the time the lease is entered into) of the aggregate lease at-risk payments, by

(II) the lessee acquisition amount.

For purposes of subclause (I), the present value shall be determined by using a discount rate equal to the underpayment rate in effect under section 6621 as of the time the lease is entered into.

(iii) Required Percentage.--For purposes of clause (i)(III), the term "required percentage" means the sum of--

(I) 2 times the sum of the percentages applicable to the property under section 46(a), plus

(II) 10 percent.

In the case of 3-year property, such term means 60 percent of the required percentage determined under the preceding sentence.

(iv) Lessee Acquisition Amount.--For purposes of this paragraph, the term "lessee acquisition amount" means the amount for which the lessee is treated as having acquired the property by reason of an election under this subsection.

(v) Lease At-Risk Payment.--For purposes of this paragraph, the term "lease at-risk payment" means any rental payment--

(I) which the lessee is required to make under the lease in all events, and

(II) with respect to which the lessee is not protected against loss through nonrecourse financing, guarantees, stop-loss agreements, or other similar arrangements.

(D) Year for Which Credit Allowable.--

(i) In General.--Except as provided in clause (ii), in any case to which subparagraph (C)(i) applies, the portion of the total credit allowable for any taxable year shall be an amount which bears the same ratio to such total credit as--

(I) the aggregate rental payments made by the lessee under the lease during such taxable year, bears to

(II) the lessee acquisition amount.

(ii) Remaining Amount Allowable for Year in Which Aggregate Rental Payments Exceed Required Percentage of Acquisition Amount.--The total credit (to the extent not allowable for a preceding taxable year) shall be allowable for the first taxable year as of the close of which the aggregate rental payments made by the lessee under the lease equal or exceed the required percentage (as defined in subparagraph (C)(iii)) of the lessee acquisition amount.

(E) Definition of At-Risk Lessee and At-Risk Property.--For purposes of this paragraph--

(i) At-Risk Lessee.--The term "at-risk lessee" means any lessee who is a taxpayer described in section 465(a)(1).

(ii) AT-RISK PROPERTY.--The term "at-risk property" means any property used by an at-risk lessee in connection with an activity with respect to which any loss is subject to limitation under section 465.

(F) Special Rules For Subparagraphs (C) And (D).--

(i) Subparagraphs (C) And (D) Apply In Lieu Of Other At-Risk Rules.--In the case of any election under this subsection, paragraphs (8) and (9) of section 46(c) and subsection (d) of section 47 shall only apply with respect to the lessor.

(ii) Application to Partnerships and S Corporations.--For purposes of subparagraphs (C) and (D), rules similar to the rules of subparagraph (E) of section 46(c)(8) shall apply.

(iii) Subsequent Reductions in At-Risk Amount.--Under regulations prescribed by the Secretary, the principles of subsection (d) of section 47 shall apply for purposes of subparagraphs (C) and (D).

(G) Regulations.--The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this paragraph, including regulations--

(i) providing for such adjustments as may be appropriate where expenses connected with the lease are borne by the lessor, and

(ii) providing the extent to which contingencies in the lease will be disregarded.

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Ten Core Ethical Principles *

Honesty
Integrity/Principled
Promise-Keeping
Loyalty
Fairness
Caring and Concern for Others
Respect for Others
Civic Duty
Pursuit of Excellence
Personal Responsibility/Accountability

The Five Principles of Public Service Ethics *

Public Interest
Objective Judgment
Accountability
Democratic Leadership
Respectability

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