Potential Effects to Historic Rehabilitation Spending in Virginia from the Taxation of Capital Investment Received by Historic Rehabilitation Partnerships

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In 2007, VCU's Virginia Center for Urban Development & Economic Development (VCUD/ED) conducted an economic analysis of Virginia's rehabilitation tax credit program. This research, and a 2010 update, found that the state's rehabilitation tax credit program has provided an estimated $1.9 billion of economic impact to Virginia.

As part of our research for the 2007 report "An Economic Analysis of Virginia's Historic Rehabilitation Tax Credit Program," we administered a survey with 361 recipients of state rehabilitation tax credits during 2005 and the first half of 2006. A total of 179 surveys were completed and the response rate was 49.5 percent. Twenty-six (26) percent of respondents indicated that they formed a partnership with other investors for their approved rehabilitation project. Over two-thirds (70 percent) of these respondents further indicated that they would <u>not</u> have rehabilitated the property without the state tax credit assistance.

Through Virginia's rehabilitation tax credit program, individuals and businesses rehabilitating historic structures can receive income tax credits for 25 percent of the qualified project expenses. Property owners and developers may form partnerships with other investors to provide additional capital investment for the historic rehabilitation projects. If the project is completed appropriately (according to specific rehabilitation standards) and certified by DHR, the resulting tax credits are delivered to the partnership rather than the individual property owner or developer. These tax credits are allocated among the partners according to their partnership agreement.

Our analysis of Virginia's historic rehabilitation tax credit program (for 2005 and the first half of 2006) found that rehabilitation expenses were larger for projects where the tax credits were allocated through a partnership agreement. The average expense for these projects was $2.7 million, the median was $1.2 million, and total spending was $128.9 million – 74 percent of total rehabilitation expenditures during this time period.[1] More property owners and developers are able to afford rehabilitation projects by receiving additional capital investment through a partnership, especially for larger rehabilitation projects.

Table 1 provides the rehabilitation expenditures, and corresponding state income tax credits, for projects that were approved for historic rehabilitation tax credits and were completed in 2007, 2008, and 2009.[2] These data were combined with historic information to provide insight into the potential effects to historic rehabilitation spending in Virginia if funds received through the allocation of historic rehabilitation tax credits by partnerships are subject to State and Federal income taxes.

Table 1. Historic Rehabilitation Tax Credit Program Data

Year	Rehabilitation Expenditures *Millions of $*	State Income Tax Credits Awarded *Millions of $*
2007	$291.8	$74.0
2008	$467.7	$116.6
2009	$331.6	$84.7

Source: Virginia Department of Historic Resources

Using the historic percentage, we estimated that 74 percent of total rehabilitation expenditures (i.e., the investment in historic buildings) during these recent years (2007, 2008, and 2009) were for projects where tax credits were distributed through a partnership. Taking 74 percent of the rehabilitation expenditures in Table 1 resulted in the revised rehabilitation expenditure amounts shown in Table 2. That table also shows the amount of tax credits that were estimated to be generated from these projects – 25 percent of qualified project expenses.

[1] The median is the value with 50 percent of the other values above it and 50 percent below it.

[2] 2009 was the most recent year for which a full year of data were available.

Table 2. Revised Rehabilitation Expenditures and Corresponding State Income Tax Credits Estimated Value for Projects where Historic Rehabilitation Tax Credits would be Distributed through a Partnership		
Year	**Revised Rehabilitation Expenditures** (74% of total) *Millions of $*	**State Income Tax Credits** *Millions of $*
2007	$215.9	$53.9
2008	$346.1	$86.5
2009	$245.4	$61.4

Source: VCU - Virginia Center for Urban Development & Economic Development

Data from our survey of tax credit recipients indicated that 70 percent of respondents who formed partnerships to receive the tax credits also said that they would not have rehabilitated the specific property without state tax credit assistance. These projects represented 78 percent of the expenditures for the projects where tax credits were distributed through a partnership ($100.8 million out of $128.9 million).

Table 3 shows the estimated rehabilitation expenditures that would correspond to projects where tax credits were distributed through a partnership and where the project would not have been undertaken without the state tax credit assistance. This represents 78 percent of total revised project rehabilitation expenditures. These data also represent the value of rehabilitation expenditures that may be forgone if all of the projects that were formerly feasible (through an investment partnership) no longer take place. This is a possibility if property

Table 3. Potentially Forgone Rehabilitation Expenditures					
		Rehabilitation Expenditures Taking Place Because of State Income Tax Credits (78% of Revised Rehabilitation Expenditures)			
Year	**Revised Rehabilitation Expenditures** (74% of total) *Millions of $*	**Expenditures Due to State Income Tax Credits** *Millions of $*	**75% of these Expenditures** *Millions of $*	**50% of these Expenditures** *Millions of $*	**25% of these Expenditures** *Millions of $*
2007	$215.9	$168.4	$126.3	$84.2	$42.1
2008	$346.1	$269.9	$202.5	$134.9	$67.5
2009	$245.4	$191.4	$143.6	$95.7	$47.9

Source: VCU - Virginia Center for Urban Development & Economic Development owners are no longer able to realize the full benefit of the equity generated through tax credits and, as a result, are not able to afford to undertake the rehabilitation work. For example, in 2009, the taxation of capital contributions made to partnerships could have meant that up to $191 million of rehabilitation expenditures would not have occurred. The remaining columns of Table 3 show the dollar amount of rehabilitation expenditures that would be forgone if a smaller percentage of the projects no longer take place – 75 percent, 50 percent, and 25 percent, respectively.

Table 4 shows the potential tax liability (and reduction in tax credit equity) resulting from the taxation of capital contributions made to a project. This reduced equity would make investing in the rehabilitation of historic buildings less attractive to investors and, therefore, make rehabilitation projects less financially feasible for developers and property owners. For example, $245 million of qualified rehabilitation expenditures (2009) would receive $61 million of state income tax credits. If these tax credits were subject to State and Federal income taxes (at a total rate of 40.75 percent), however, there would be a corresponding tax liability of $25 million.[3]

Table 4. Potential State and Federal Income Tax Liability from the Taxation of Capital Investment Received by Historic Rehabilitation Partnerships

Year	**Revised Rehabilitation Expenditures** (74% of total) *Millions of $*	**Corresponding State Income Tax Credits** *Millions of $*	**Federal Income Tax** (at 35%) *Millions of $*	**State Income Tax** (at 5.75%) *Millions of $*	**Potential Tax Liability** *Millions of $*
2007	$215.9	$53.9	$18.9	$3.1	$22.0
2008	$346.1	$86.5	$30.3	$4.9	$35.2
2009	$245.4	$61.4	$21.5	$3.5	$25.0

Source: VCU - Virginia Center for Urban Development & Economic Development

For the majority of projects with large rehabilitation costs, the developer or property owner cannot afford to conduct the rehabilitation work alone. These projects require the support of additional investors. If projects are not financially feasible, fewer historic buildings will be rehabilitated and fewer jobs will be created.

[3] This total combines a Federal income tax rate of 35 percent and a State income tax rate of 5.75 percent.