U.S. 4th Circuit Court Decision Devastating
To Virginia's Rehabilitation Tax Credit Program

Virginia's historic rehabilitation tax credit program — a proven economic engine generating more than $2.6 billion in rehabilitation expenditures that have revitalized urban cores and neighborhoods and "main street" downtowns, while spawning thousands of jobs throughout the state since its inception in 1996 — is under siege.

A recent ruling of the U.S. 4th Circuit Court has created a firestorm here in Virginia and around the country in the business and preservation communities. The decision is already adversely affecting a key and steady sector in the state's economy — construction projects involving the rehabilitation of older buildings.

"This decision is devastating to anyone associated with the historic preservation construction industry from small contractors to architects, engineers and the building supply industry," in the words of William T. Frazier, a principal in Frazier Associates, located in Staunton, Virginia. "The current economic challenges have already slowed projects in historic districts. This decision will virtually halt the possibility of any construction rebound in most downtowns in the Commonwealth," Frazier adds.

Background:

The state tax credit program, managed by the Department of Historic Resources, was created by the State to encourage investment in historic properties.

The program has been instrumental in saving and repurposing some 2,000 Virginia landmark buildings. These buildings represent a wide spectrum of Virginia's historic fabric and traditions — from 19th-century mills and railroad depots, to warehouses and factories, to courthouses, former schools, and firehouses, among many other building types.

Additionally, historic rehabilitation through tax incentives has revitalized many urban cores by bringing residents back into downtowns and older, once blighted neighborhoods. It has bolstered sustainable development by recycling building stocks and focusing reinvestment on already developed sites and in areas with existing infrastructure and established schools, public parks, and retail pockets.

The key to this sustainable and revitalizing activity, benefitting Virginians economically, socially, and environmentally is founded on developers and their partners receiving state tax credits equal to 25 percent of eligible expenses incurred in the rehabilitation of a historic building.

Since the cost of sensitively rehabbing historic buildings usually exceeds the market value of the completed project, by design, rehabilitation tax credits offset project costs and close this gap. (State credits are typically combined with a federal tax credit of 20 percent; thus, a project in Virginia may achieve 45 percent in combined credits.) The credits help attract investors to these projects through partnerships that raise capital through the planned allocation of tax credits to the partners.

What is at stake now, in light of the court decision, is the delivery of these credits through partnerships — the very mechanism that makes rehabilitation projects attractive to both developers and their partners. In a decision that overturned a 2009 lower court ruling, the 4th Circuit Court re-characterized these allocations as “sales” and stated they should be taxed as income.

Overall Impact:

One cannot understate the devastating impact the court’s March 29 decision will have — and already has had — on property owners, communities, lenders, developers and others in Virginia involved in historic rehabilitation projects.

In fact, the ruling will have far-reaching consequences beyond Virginia and could jeopardize similar programs throughout the U.S.

"I have heard from people all over the country regarding the decision,” said DHR Director Kathleen S. Kilpatrick. “It is damaging here and also in other states. It will have a profoundly chilling effect on investment in historic rehabilitation and thus on our ability to achieve our policy goals for stewardship in Virginia.”

As Kilpatrick indicates, the court decision already has had a paralyzing effect on new rehabilitation projects coming on line. Future projects are at risk because the ruling takes a huge tax bite out of the capital contributed through partnerships to a developer’s rehab project — in effect, *40.75* percent of the money intended to repurpose landmark buildings disappears in tax liability (through 35% federal, 5.75% state tax rates) due to the holding of the court.

This resulting financial gap strikes at the heart of the economic viability of projects that rely on the allocation of tax credits through a partnership.

“The subject ruling has created a significant seizing up of liquidity needed to complete projects,” according to Thomas W. Papa, who owns a real estate development company that relies heavily on Virginia’s state tax credit program to attract investors to rehab projects. “I believe that unless the ruling is overturned, you will see a substantial drop in the use of the program for many projects,” Papa added.

The view of Papa, who deals mostly with properties in the City of Richmond, is seconded by the Staunton-based architectural firm's William Frazier, who sees the ruling’s effect in rural areas. "Revitalization activities for historic property owners in smaller Virginia communities will be particularly hard hit since a developer's construction costs are not that much cheaper than larger markets but the rents that the developer can charge are typically much lower because of their smaller market size," Frazier said.

The court ruling also thwarts the public policy goals of Virginia's and similar incentive programs that are designed to preserve history by making rehabbing landmark buildings economically feasible. DHR's concern and that of others across the country is that the ruling may result in states having to abandon long-tested and effective policy-driven programs that involve partnership allocation of tax incentives — programs that have served as successful preservation, urban renewal, and economic development tools.

In short, the unintended harm of the ruling is both profound and broad ranging.

<u>How the Ruling Chills Investment</u>:

To fully explain how the court's ruling adversely affects the program, let's look at two hypothetical but representative examples, one for a proposed project, the other for a completed and certified project.

The paralyzing effect of the ruling is due to the hit partnerships take precisely because investor-developer partnerships play such a critical role in making rehabilitation projects feasible. In summary, rehabilitation tax credit projects attract investors who make a capital contribution (and therefore risk their own capital) to the entity conducting the project. If completed appropriately and upon certification by DHR of the project, the member partners are allocated tax credits as agreed upon by the partners.

This partnership structure thus enables a developer to raise necessary funds at the outset and to secure a loan for a project as well as cover the additional and often unforeseen costs that rehabilitation entails.

<u>Example A: Proposed Project</u>

Our first example details how the 4th Circuit Court's decision adversely affects a proposed project's financing and, by extension, the economic viability of the rehabilitation tax credit program in general.

A project with $2 million in eligible expenses would receive $900,000 in state and federal tax credits:

> Federal tax credit = $400,000 (20 percent of $2 million);
> State tax credit = $500,000 (25 percent of $2 million).

If, through a partnership, the investors are allocated tax credits at 80 cents per dollar, then here's how the credits breakdown when allocated:

Federal = $320,000 ($400k x $0.80);
State = $400,000 ($500k x $0.80).

Prior to the court's decision, a lender underwriting this project had a reasonable assurance that upon certification by DHR, the project would generate a total of $720,000 ($320k + $400k) in tax credit equity.

However, following the court's ruling, the $400,000 in state tax credit equity must now be considered income. Taxed as such, at 40.75 percent (35 percent federal + 5.75 percent state), that $400k would result in an estimated $163,000 in income tax *liability*. This tax liability of $163,000 translates into *lost* tax credit equity, meaning a project that originally had $400,000 in tax credit equity now has only $237,000 in equity ($400k - $167k).

Consequently, a lender underwriting this project must reduce significantly the financing provided, which is based in part on tax credit equity that will be generated by the project.

That's a significant loss.

As illustrated by this example, when such tax credit equity losses are applied across the program, the consequences are devastating, and result in —

- Many projects being terminated, since debt financing arrangements that would have been approved prior to the court's decision are *now* no longer achievable.

- Less availability of financing on a project-by-project basis because lenders must take into consideration the tax liability attributed to the state tax credit equity in underwriting any historic rehabilitation tax credit project, due to the decrease in tax credit equity.

- Tougher obstacles for developers trying to undertake a project; now the developer must make up the difference in equity, a tough challenge in good economic times, a tougher challenge during the current economy.

- Fewer projects undertaken overall, meaning fewer jobs, less state and local tax revenues, and a lost opportunity to incentivize key investment and growth for localities and the Commonwealth.

- Faltering redevelopment in urban centers, as risky properties whose rehab is highly dependent on state and federal tax credits will remain blighted and abandoned.

- The loss in communities throughout Virginia of architectural gems that are either destroyed or inappropriately and significantly altered through renovations that are conducted outside of historic preservation standards and under no requirement to preserve historic fabric.

When one considers these multiple setbacks to the state tax credit program, it's inconceivable how the IRS can maintain that the program will be unaffected by the court's ruling.

Example B: A Completed/Certified Project

While the ruling has chilled investment in future projects, it also raises concerns about those completed and already certified. Audits would certainly mean great financial hardship for the owners and developers of completed projects.

For example, a project completed in 2007 with $2 million in qualified rehabilitation expenditures would have received $500,000 in state tax credits (at 25 percent). According to the court ruling those credits *allocated* would be taxed at 40.75 percent (35 percent federal, 5.75 percent state).

In this case, as before, the $500,000 in state tax credits that would be allocated through an investor partnership at 80 cents on the dollar would generate $400,000 in tax credit equity.

If this $400,000 in allocated state tax credits is taxed at 40.75 percent, it would result in $163,000 in back taxes owed *plus* an estimated $27,000 in interest, equaling $190,000. Accordingly, one must ask, *Would the project entity have the cash available to pay a $190,000 tax liability in addition to repaying the project financing*?

The potential results of such a liability could be —

- Foreclosure of a property and bankruptcy of a developer.

- Conflict between the lender and IRS over disposition of the property.

The predictable consequences of foreclosures would include, in addition to bankrupt property owners and developers —

- Stress on the already-troubled lending and real estate sectors.

- Negative impacts on communities through —

    - the loss of new tax revenues (no new improved properties and affiliated enterprises housed in those rehabbed buildings); and

    - the loss of re-developed neighborhoods that need stable property ownership.

Request for Rehearing: May 13:

The investors in the partnership Virginia Historic Tax Credit Fund, against whom the IRS brought the original suit, are asking the 4th Circuit Court for a review of the case, which is due on May 13. While the case centers on the tax treatment of the allocation of the credits, the facts as to the broad benefits of the Virginia historic rehabilitation state tax credit program are clear.

Since 1997, according to a study conducted by Virginia Commonwealth University's Center for Public Policy, state tax credit incentives in Virginia have resulted in $2.65 billion in total rehab expenditures. VCU's study, conducted in 2007, determined that for 65.5 percent of participants undertaking a rehabilitation project in Virginia, the state tax credit program was the *determining* factor in their decision to go forward with a rehab project.

In other words, without the state tax credits, the rehabilitation projects would *not* have been undertaken. Thus, of that $2.65 billion, $1.74 billion (or 65.5 percent of $2.65 billion) in rehabilitation expenditures is attributable *directly* to the state tax credit program. Moreover, during its 13-year period (1996–2009), the state program has resulted in —

- An estimated 5,804 jobs ("direct employment") within Virginia (including both full-time and part-time jobs);
- 7,083 jobs in other sectors of the economy; and
- Total economic impact to Virginia of $1.91 billion.

According to VCU's 2010 update of its original report, "It is estimated that the expenditures between 1997 and 2009 — including the original rehabilitation projects, spending in related sectors, and purchases made by employees — have generated an estimated $55 million of tax revenues for Virginia."

In evaluating the damage inflicted on the vitality of the state program by the court's recent ruling, which it is also estimated will result in no more taxes being collected by IRS and possibly *less*, DHR Director Kilpatrick said, "In one fell swoop the IRS and the court's ruling in its favor converted a win-win-win into a lose-lose-lose. History loses, the IRS loses, and the program with all its benefits for our citizens and communities loses."

"We have asked our Attorney General to do whatever he can to help the court understand how damaging this has been to our great program," Kilpatrick added.