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Tax Aspects of Historic Preservation

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Internal Revenue Service
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Who can claim a rehabilitation tax credit?

The rehabilitation tax credit is available to the person(s) and/or the entity who holds title to the property.

How can property owned by a tax exempt entity utilize rehabilitation tax credits?

The rehabilitation tax credit would be of no use to a tax exempt entity. However, in many instances, tax exempt entities are involved in rehabilitation projects by forming a limited partnership and maintaining a minority ownership interest as a general partner. In these situations, the limited partners would be entitled to the rehabilitation tax credit and the tax exempt entity is able to ensure that their organizational goals are being met.

When can a taxpayer claim the rehabilitation tax credit?

The property must be substantially rehabilitated. During a 24-month period selected by the taxpayer, rehabilitation expenditures must exceed the greater of the adjusted basis of the building and its structural components or $5,000. The basis of the land is not taken into consideration. It is important to note that any expenditure incurred by the taxpayer before the start of the 24-month period will increase the original adjusted basis. See Treasury Regulation 1.48-12(b)(2).

If the rehabilitation is completed in phases, the same rules apply, except that instead of a 24-month period, a 60-month period is substituted. This phase rule is available only if the taxpayer meets three conditions:

(1) There is 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.

The property must be placed in service. See Treasury Regulation 1.46-3(d) for definition of placed in service. 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. 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 Treasury Regulation 1.48-12(b).

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 District Director stating such fact and shall be requested to sign an extension to the statute of limitations. See Treasury Regulation 1.48.12(f)(2).

What is the definition of placed in service?

"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.

How do you define placed in service when a building is never taken out of service?

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

What relationship exists between the substantially rehabilitated requirement and the placed in service requirement?

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 Internal Revenue Code Section 47(b)(1) and 47(c)(1)(C) and Treasury Regulation 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 Treasury Regulation 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. U.S. 93-1 USTC.

How do you compute adjusted basis?

Adjusted basis of a building is the cost of the property (excluding land) plus or minus adjustments to basis. The County Assessor's office would be able to provide a building to land value ratio. Increases to basis include capital improvements, legal fees incurred in perfecting title, zoning costs, etc. Decreases to basis include deductions previously allowed or allowable for depreciation. See Treasury Regulation 1.48-12(b)(2)(iii).

For the substantial rehabilitation test, the date to determine the adjusted basis of the building is the first day of the 24-month measuring period or the first day of the taxpayer's holding period of the building, whichever is later. Generally the holding period is deemed to begin the day after acquisition.

What is the effect on basis when a structure is rehabilitated?

The basis of rehabilitated buildings, including certified historic structures, must be reduced by 100% of the rehabilitation credit earned regardless of whether the credit is used or carried forward. The reduction amount is added back if the credit is recaptured. See Treasury Regulation 1.48-12(e).

What method of depreciation is required when claiming the rehabilitation tax credit?

The rehabilitation credit is available only if the taxpayer uses the straight-line method of depreciation. The current recovery period is 27.5 years for residential rental property and 39 years for non-residential real property. See Treasury Regulation 1.48-12(c)(8).

How do the recapture rules apply?

The rehabilitation credits are subject to recapture if the building is sold or ceases to be business use property. No recapture is required after five years. The amount of such recapture is reduced by 20% for each full year that elapses after the property is placed in service. Thus there is a 100% recapture if the property is disposed of less than one year after the property is first placed in service; an 80% recapture after one year, a 60% recapture after two years; a 40% recapture after three years; and a 20% recapture after four years. See Internal Revenue Code Section 50(a).

If a partner sells his interest in a partnership will this trigger recapture?

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. Treasury Regulation 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:

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

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

If rehabilitation tax credit property is destroyed by casualty, will this trigger recapture?

When a building that qualified for the rehabilitation tax credit is destroyed by a casualty (i.e. hurricane, flood, tornado, earthquake), within five years of first

claiming the credit, the recapture provisions of Internal Revenue Code Section 50(a) apply.

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

How is the rehabilitation tax credit computed when a portion of the property is not used for business?

A qualified rehabilitation expenditure must be "properly chargeable to a capital account". This means the property must be depreciable. If a structure is used for both business and non-business (personal) use, an allocation of the rehabilitation expenditures must be made. The allocation is generally made based on a square footage percentage. The only expenditures eligible for the tax credit would be those associated with the business use portion of the property. When a personal residence is used also for business, the business use portion of the home (e.g. home office) would be eligible. Expenditures associated with common living areas, such as a kitchen, bedrooms, living room, bathrooms, would not be eligible because they are not used **exclusively** for business. If the owners of a Bed & Breakfast live on the premises, the business use portion would only be those areas which are used **exclusively** for business.

To be eligible for the rehabilitation tax credit, the property must be substantially rehabilitated. This means that the qualified rehabilitation expenses must exceed the entire building's adjusted basis. If property is used for both business and personal use, the adjusted basis would include both the business and personal use portion.

What is the tax effect of grant proceeds on rehabilitation tax credit projects?

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 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.

Can the unused portion of the rehabilitation tax credit be carried back and carried forward?

If the credit, or a portion of tax credit, can not be used, the excess can be carried back one year and forward for 20 years. See Internal Revenue Code Section 39(a).

Can a seller pass the rehabilitation tax credit to a buyer?

The 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 Treasury Regulation 1.48-12(c)(3)(ii)(B).

Can a taxpayer incur and claim additional rehabilitation costs in a taxable year after the year in which the rehabilitation credit was originally claimed?

The rehabilitation tax credit is 20% of the qualified rehabilitation expenditures incurred before and during, but not after, a taxable year in which the property, or a portion thereof, was placed in service. Remedial work, or expenses necessary to obtain final approval by the National Park Service, will qualify provided the substantial rehabilitation test period includes these costs. It is possible that an additional rehabilitation credit would be allowable on a new project within the same property as long as that project involves a portion of the building that was not placed in service.

Alternatively, a taxpayer is allowed to perform second rehabilitation tax credit project on the same building provided the substantial rehabilitation test is met.

Can a lessee of a building or a portion of the building claim a rehabilitation tax credit?

If a lessee incurs the cost of rehabilitating a building and the lease term is greater than the recovery period determined under Internal Revenue Code Section 168(c), (39 years for non-residential real property, 27.5 years for residential rental), the lessee can claim the rehabilitation tax credit on qualified rehabilitation expenditures provided the substantial rehabilitation test is met.

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 Internal Revenue Code Section 48(d) and 50(d)(5).

A tax exempt entity can not pass the rehabilitation tax credit to its lessee(s) because Treasury Regulation 1.48-4(a)(1) requires that 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.

How is the rehabilitation tax credit claimed on a tax return?

The credit is claimed on Form 3468. Attached to the Form 3468 (or by way of a marginal notation), the following information must be provided. See Treasury Regulation 1.48-12(b)(2)(viii).

(1) The beginning and ending dates of the measuring period selected by the taxpayer.
(2) The adjusted basis of the building as of the beginning of the measuring period.
(3) The amount of qualified rehabilitation expenditures incurred or treated as incurred during the measuring period.
(4) A copy of the final certification of completed work by the Secretary of Interior.
(5) If the adjusted basis is determined in whole or in part by reference to the adjusted basis of a person other than the taxpayer, the taxpayer must attach a statement by such third party as to the first day of the holding period, measuring period and adjusted basis calculation.

Can a taxpayer claim the 10% rehabilitation tax credit on any building built before 1936?

No. A taxpayer cannot claim a 10% rehabilitation tax credit on a building which 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 through the submission of 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% rehabilitation tax credit may be utilized provided the building:

(1) Was placed in service before 1936 [See Treasury Regulation 1.48-12(b)(4)];
(2) Is used for non-residential rental purposes [See Internal Revenue Code Section 50(b)(2)];
(3) Has not been physically moved [See Treasury Regulation 1.48-12(b)(5)];
(4) Meets the following internal and external wall retention [See Treasury Regulation 1.48-12(b)(3)]:
    (a) 50% or more of the existing external walls are retained in place as external walls,
    (b) 75% or more of the existing external walls are retained in place as internal or external walls,
    (c) 75% or more of the existing internal structural framework is retained in place.

Is the rehabilitation tax credit available for condominiums?

The rehabilitation tax credit can generally be used by an individual condominium owner provided the condominium unit is held for the production of income, or is used in a trade or business. Thus, rehabilitation expenditures otherwise qualifying will not be eligible for the credit if the property is used for the taxpayer's personal use.

Can a taxpayer claim the rehabilitation tax credit on property that is leased by a tax exempt entity, i.e. a governmental agency or a non-profit organization?

Yes, taxpayers can lease their property to a tax exempt entity provided the lease does not result in a "disqualified lease" as defined in Internal Revenue Code Section 168(h)(1). A disqualified lease occurs when:

(1) Part or all of the property was financed directly or indirectly by an obligation in which the interest is tax exempt under Internal Revenue Code Section 103(a) and such entity (or related entity) participated in the financing,
(2) Under the lease there is a fixed or determinable purchase price or an option to buy,
(3) The lease term is in excess of 20 years, or
(4) The lease occurs after a sale or lease of the property and the lessee used the property before the sale or lease. See Internal Revenue Code Section 168(h)(1)(B)(ii).

An exception under the Treasury Regulations provides that property is not considered tax exempt use property if 35% or less of the property is leased to tax exempt entities in disqualified leases.

If a building was rehabilitated and placed in service, can a taxpayer apply for certification and claim the rehabilitation tax credit "after the fact"?

Yes, if the building is individually listed in the National Register.

No, if the building is located within a registered historic district. If the building is within a registered historic district, the taxpayer must request on or before the date the property was placed in service a determination from the Department of Interior that such building is an historic structure and the Department of Interior later determines that the building is a certified historic structure. This is accomplished with the submission of Part 1 of the Historic Preservation Certification Application. If Part 1 of the application was not submitted prior to when the property was placed in service, the taxpayer would not be eligible for the rehabilitation tax credit. See Treasury Regulation 1.48-12(d)(1).

Can the rehabilitation tax credit be used in conjunction with the low income housing tax credit?

Yes. As long as the building and rehabilitation expenditures qualify for both credits, there is no prohibition within the Internal Revenue Code for using the tax credits in tandem. The taxpayer must reduce the amount of rehabilitation expenditures eligible for

the low income housing tax credit by the amount of rehabilitation tax credit allowed. The computation for annual depreciation includes a reduction of the depreciable basis by the amount of rehabilitation tax credit allowed.

Can the rehabilitation tax credit be used in conjunction with a façade easement contribution?

Yes. Once the building and rehabilitation are "certified" by the Department of Interior, the owner of the building can donate the façade easement. Generally these donations are made to qualified organizations under Internal Revenue Code Section 170 and are considered to be donated in perpetuity. The rehabilitation tax credit and depreciable basis are reduced and no credit or depreciation can be taken on that portion of the building. If the donation occurs after the building is placed in service, the credit recapture provisions of Internal Revenue Code Section 50(a) apply. (See Rome I Ltd. v. Commissioner, 96 T.C. No. 29) By donating the façade easement, the taxpayer may be allowed a charitable contribution deduction pursuant to Internal Revenue Code Section 170(h) and Treasury Regulation 1.170A-14. The value of the façade easement is measured by the difference between the value of the property before and after the easement was conveyed.

A donation can be made by a subsequent owner of a certified historic structure as long as the façade was not donated by the previous owner.

Can the rehabilitation tax credit be bought and sold?

The rehabilitation tax credit, by itself, can not be bought or sold. The rehabilitation tax credit is only available to the person or entity who holds title to the property. There can be no transfer of the credit without the requisite ownership. Syndication through limited partnerships is allowed and is a common tool to bring investors into rehabilitation projects.

Treasury Regulation 1.48-12(b)(2)(B)(vii) does allow the transfer of qualified rehabilitation expenditures to a new owner provided the previous owner did not place the property in service.

Can a taxpayer claim the rehabilitation tax credit without receiving final approval by the National Park Service?

Yes. Treasury Regulation 1.48-12(d)(7)(ii) states that if the final certification of completed work has not been issued by the Secretary of 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 Part 2 of the *Historic Preservation Certification Application* must be attached to Form 3468 filed with the tax return. The taxpayer must reasonably expect that they will receive final approval and that their project will be certified by the National Park Service.

Final certification by the Department of Interior is required. If the taxpayer fails to receive final certification within 30 months after the date the taxpayer filed a tax return on which the credit was

claimed, the taxpayer must agree to extend the period of assessment for any tax relating to the time for which the credit was claimed. 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.

Can a rehabilitation tax credit be claimed for expenses associated with noncontributing additions?

Any expenditure attributable to an enlargement of an existing structure, i.e. a new addition, is specifically excluded from the definition of a qualified rehabilitation expenditure. See Internal Revenue Code Section 47(c)(2)(B)(iii). A building is enlarged to the extent that the total volume of the building increases. However, if the addition was made previously or over a period of time, the cost of rehabilitating this noncontributing addition may qualify for the rehabilitation tax credit.

What is the definition of a building?

Treasury Regulation 1.48-1(e) defines a building as any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space.

Is a sports stadium considered a building?

A stadium was considered a building within the definition of Treasury Regulation 1.48-1(e) in Revenue Ruling 69-170.

How does a cash basis taxpayer account for qualified rehabilitation expenditures?

Treasury Regulation 1.48-12(c)(3) states that an expense is incurred by the taxpayer on the date such expenditure would be considered incurred under an accrual method of accounting, regardless of the method of accounting used by the taxpayer with respect to the other items of income and expense.

What is not included in qualified rehabilitation expenditures?

Qualified rehabilitation expenditures do not include:

(1) Costs of acquiring the building or interest therein. See Treasury Regulation 1.48-12(c)(9).
(2) Enlargement costs which expand the total volume of the existing building. Interior modeling which increases floor space is not considered enlargement. See Treasury Regulation 1.48-12(c)(10).
(3) Expenditures attributable to work done to facilities related to a building such as parking lots, sidewalks and landscaping. See Treasury Regulation 1.48-12(c)(5).
(4) New building construction costs. See Treasury Regulation 1.48-12(b)(2)(B)(iv).

What are some examples of expenses that do not qualify for the rehabilitation tax credit?

- Acquisition costs
- Appliances
- Cabinets
- Carpeting (if tacked in place and not glued)
- Decks (not part of original building)
- Demolition costs (removal of a building on property site)
- Enlargement costs (increase in total volume)
- Fencing
- Feasibility studies
- Financing fees
- Furniture
- Landscaping
- Leasing Expenses
- Moving (building) costs (if part of acquisition)
- Outdoor lighting remote from building
- Parking lot
- Paving
- Planters
- Porches and Porticos (not part of original building)
- Retaining walls
- Sidewalks
- Signage
- Storm sewer construction costs
- Window treatments

What are some expenses that qualify for the rehabilitation tax credit?

Any expenditure for a structural component of a building will qualify for the rehabilitation tax credit. Treasury Regulation 1.48-1(e)(2) defines structural components to include walls, partitions, floors, ceilings, permanent coverings such as paneling or tiling, windows and doors, components of central air conditioning or heating systems, plumbing and plumbing fixtures, electrical wiring and lighting fixtures, chimneys, stairs, escalators, elevators, sprinkling systems, fire escapes, and other components related to the operation or maintenance of the building.

In addition to the above named "hard costs", there are "soft costs" which also qualify. These include construction period interest and taxes, architect fees, engineering fees, construction management costs, reasonable developer fees, and any other fees paid that would normally be charged to a capital account.

Are there provisions in the Internal Revenue Code that could prevent a taxpayer from using the rehabilitation tax credit?

Yes, certain provisions within the Internal Revenue Code can impact the full use of the rehabilitation tax credit. These include alternative minimum tax, tentative minimum tax and the passive activity rules. Consequently, taxpayers may not be able to use the entire tax credit available to them in one tax year. In situations where the tax credit can not be used as a result of alternative minimum tax the unused credit can be carried back or forward. The passive activity rules, however, allow unused credit only to be carried forward.

Form 3800, General Business Credit, will guide you through a series of computations to determine how much, if any, of the rehabilitation tax credit can be used in the current year. To alleviate any surprises, tax planning

should include a "what if" scenario using Form 3800 as a guide to determine the anticipated tax credit.

What is alternative minimum tax?

Taxpayers who are not required to pay tax under the regular tax system may still be liable for tax under alternative minimum tax laws. The purpose of alternative minimum tax (AMT) is to ensure that all taxpayers share the tax burden fairly. It prevents a taxpayer with substantial income from avoiding significant tax liability. Alternative minimum taxable income is computed from regular taxable income with certain adjustments and the addition of all appropriate tax preference items.

What will trigger alternative minimum tax?

Common adjustments and tax preferences that could trigger alternative minimum tax include:

A) Large Schedule A itemized deductions such as:

- Medical and dental expenses
- Taxes (i.e. tax and local, real estate, personal property)
- Miscellaneous deductions (i.e. unreimbursed employee business
- expenses, investment expenses, education expenses)

B) Tax refunds (i.e. income tax, personal or real property tax)
C) Use of accelerated depreciation.
D) Gains or losses resulting from the sale of assets in which accelerated depreciation was used.

Other adjustments and preferences that could trigger alternative minimum tax, but are not as common as those described above, include: certain interest on a home mortgage not used to buy, build or improve your home; investment interest; incentive stock options; passive activities; beneficiaries of estates and trusts; tax-exempt interest from private activity bonds; certain charitable contributions; depletion; installment sales; intangible drilling costs; mining costs; tax shelter farm activities.

Even if alternative minimum tax applies, can the rehabilitation tax credit still be used to offset regular income tax?

No, the rehabilitation tax credit can not be used to reduce regular income tax if alternative minimum tax applies - no matter how large or small the alternative minimum tax.

Since the taxpayer has been denied the benefit of the rehabilitation tax credit due to the applicability of alternative minimum tax, the unused credit can be carried back 1 year and forward 20 years.

What is tentative minimum tax?

Tentative minimum tax is computed on Form 6251, Alternative Minimum Tax - Individuals. Tentative minimum tax, which effects a great number of taxpayers, will reduce the amount of rehabilitation tax credit that can be used.

Once again, it is important that a taxpayer perform a "what if" computation to determine the effect of

tentative minimum tax on the rehabilitation tax credit allowed for the current year.

Tentative minimum tax can exist without alternative minimum tax. Unlike alternative minimum tax, tentative minimum tax reduces the allowable tax credit rather than deny the benefit entirely.

Passive Activity Restrictions

The Tax Reform Act of 1986 introduced tax law changes which indirectly impacted the rehabilitation tax credit. One of these changes, the "Passive Activity Provisions," was intended to stop "abusive tax shelters." Although not directly related, these changes have impacted the availability of the rehabilitation tax credit for certain types of investors.

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's business services for the taxable year, amounting to more than 750 hours of services, are performed in real property trade or business in which the taxpayer materially participates.

How do the passive activity restrictions effect taxpayers with adjusted gross income greater than $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.

If a taxpayer’s investment is passive and income is below $200,000, how is the tax credit effected?

Generally, rental real estate losses up to $25,000 my 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% 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.

If a taxpayer has net passive income, could the full use the rehabilitation credit be restricted?

Perhaps, as 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.

Under what circumstances would a taxpayer's rehabilitation tax credit not be 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:

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 (i.e. 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% of the outstanding stock must materially participate in the activity in order for the corporation to meet the material participation standard.

Can a taxpayer's involvement be non-passive in one year and passive in the next year?

Yes, 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.