Tax Considerations with Virginia Rehabilitation Tax Credits

Virginia Easement Exchange, L.L.C.
8458 West Main Street
Marshall, Virginia 20115
Phone: 540-751-0828
Fax: 540-904-4500
www.virginiataxcredit.com

The Virginia Easement Exchange, L.L.C. provides services to Virginia tax and financial professionals desiring to help their clients reduce state and federal income taxes through the purchase of tax credits from land preservation and historic rehabilitation projects.

Our core business is matching Virginia taxpayers who are interested in purchasing Virginia tax credits with landowners who desire to sell such credits. We typically work with accounting firms, financial institutions, financial planners and institutional buyers to supply the firm's clients with tax credits in a timely and efficient manner and at a competitive price. We work closely with the firm to reduce the administrative burdens of the credit transfers, while allowing the firm to provide value-added services to their clients. We also offer aid to tax professionals whose clients desire to purchase Virginia and federal historic rehabilitation credits.

The members of the Virginia Easement Exchange, L.L.C. are Keith C. Troxell and D. Brook Middleton. Keith C. Troxell is a tax attorney with the law firm of Atwill, Troxell & Leigh, P.C., in Leesburg, Virginia concentrating his practice in the areas of estate, business and tax planning. He holds a J.D. from Ohio Northern University, and received his LL.M in taxation (with distinction) from Georgetown University. Prior to private practice, he was a trial attorney in the Office of the Chief Counsel of the Internal Revenue Service at the national office in Washington, D.C. D. Brook Middleton is a certified public accountant with the accounting firm of Middleton & Middleton, Ltd., concentrating his practice on tax planning and compliance for farmers, landowners and small businesses. He is a graduate in accounting of the Pamplin School of Business at Virginia Tech and is a member of Virginia Society of Certified Public Accountants and the American Institute of Certified Public Accountants.

Version 8-1-2015

THIS OUTLINE IS FOR INFORMATIONAL PURPOSES ONLY; IT DOES NOT PROVIDE, AND SHOULD NOT BE CONSTRUED AS PROVIDING, ANY TAX ADVICE FOR PURPOSES OF IRS CIRCULAR 230. PLEASE CONSULT YOUR TAX ADVISOR AND DO NOT RELY ON ANY REPRESENTATIONS MADE HEREIN.

Tax Considerations with Virginia Rehabilitation Tax Credits

Table of Contents

I. Virginia Historic Rehabilitation Tax Credits

A. Legislative and Regulatory Authority. Section 58.1-339.2 of the Code of Virginia (1950), as amended provides that any individual, trust or estate, or corporation incurring eligible expenses in the rehabilitation of a certified historic structure shall be entitled to a credit against the income tax. The credit is also available to offset certain other Virginia taxes. *See* Va. Code Ann. § 58.1-339.2.

1. *Regulations.* The Director of the Virginia Department of Historic Resources ("DHR") is statutorily required to issue, and has issued, regulations concerning the requirements of the program. Va. Code Ann. § 58.1-339.2(E). *See* generally Title 17, Agency 10, Chapter 30.

2. *Forms.* DHR has also promulgated various forms regarding applications for certifications of buildings and rehabilitation projects. *See* 17 VAC 10-30-90.

B. Amount of Credit. The amount of the credit is 25% of the eligible rehabilitation expenses incurred in connection with the plan of rehabilitation. *See* Va. Code Ann. § 58.1-339.2(A) and 17 VAC 10-30-120. The tax credit is a dollar-for-dollar reduction in the income tax liability for taxpayers who rehabilitate historic structures.

C. Definitions. The operation of the tax credit is dependent upon two key definitions found in the Code of Virginia and the Virginia Administrative Code—the terms "certified historic structure" and "eligible rehabilitation expenses."

1. *Certified Historic Structure.* The term "certified historic structure" is defined as property: (a) listed individually on the Virginia Landmarks Register, or (b) certified by DHR as contributing to the historic significance of a historic district that is listed on the Virginia Landmarks Register, or (c) certified by DHR as meeting the criteria for listing on the Virginia Landmarks Register. Va. Code Ann. § 58.1-339.2 (D). The term "property" means a building and its site and landscape features. 17 VAC 10-30-10. Portions of buildings such as single condominium apartment units are not independently eligible for certification. 17 VAC 10-30-10. Row houses, even with abutting party walls, are eligible for certification. 17 VAC 10-30-10. Note that to claim the Virginia historic rehabilitation tax credit, the property may be income producing or residential property.

a. *"Historic District"* means any district listed on the Virginia Landmarks Register by the Historic Resources Board according to the procedures specified in Chapter 22 of Title 10.1 of the Code of Virginia. 17 VAC 10-30-10.

b. *"Virginia Landmarks Register"* means the list of historic landmarks, buildings, structures, districts, objects, and sites designated by the Virginia Landmarks Board according to the procedures specified in Chapter 22 of Title 10.1 of the Code of Virginia. 17 VAC 10-30-10.

2. *Eligible Rehabilitation Expenses.* The term "eligible rehabilitation expenses" is defined as expenses incurred by a taxpayer in the material rehabilitation of a certified historic structure and added to the property's capital account. *See* Va. Code Ann. § 58.1-339.2(D) and 17 VAC 10-30-10. The Regulations add the requirement of a "plan of rehabilitation" and state that eligible rehabilitation expenses are those expenses incurred by a taxpayer in connection with a plan of rehabilitation, in the material rehabilitation of a certified historic structure, and added to the property's capital account. 17 VAC 10-30-110(A).

a. *Plan of Rehabilitation.* Eligible rehabilitation expenses must be incurred in connection with a plan of rehabilitation. 17 VAC 10-30-50(B). A "plan of rehabilitation" means a plan pursuant to which a certified historic structure will be materially rehabilitated. 17 VAC 10-30-10(A).

i. *Rehabilitation Defined.* "Rehabilitation" means the process of returning a building or buildings to a state of utility, through repair or alteration, which makes possible an efficient use while preserving those portions and features of the building and its site and environment which are significant to its historical, architectural, and cultural values as determined by DHR. 17 VAC 10-30-10.

ii. *Rehabilitation Project.* A certified historic structure shall be treated as having been materially rehabilitated only if the eligible rehabilitation expenses incurred in a 24-month period (the measuring period) selected by the taxpayer ending with or within the completion year shall equal or exceed 50% of the assessed value of the building, unless the building is an owner-occupied building, in which case the eligible rehabilitation expenses shall amount to at least 25% of the assessed value of the building. 17 VAC 10-30-100(A). The "completion year" is the calendar year in which the last eligible rehabilitation expense is incurred or the final certificate of occupancy (if appropriate) is issued. 17 VAC 10-30-10. It is important to note that the measuring period must end in the completion year, however, you may pick any 24-month period that ends in the completion year. Also note that the measuring

period applies only for purposes of determining if the rehabilitation is material, it does not dictate which costs are eligible rehabilitation expenses. As is discussed below, eligible rehabilitation expenses may include expenses incurred before, during and after the measuring period.

iii. *Phased Projects.* In the case a rehabilitation project that may reasonably be expected to be completed in phases set forth in the plan of rehabilitation, the taxpayer has a period of 60-months in lieu of the 24-month period stated above. 17 VAC 10-30-100(B). A rehabilitation project may reasonably be expected to be completed in phases if the project consists of two or more distinct stages of development. 17 VAC 10-30-100(B). However, a phased project cannot be designated a certified rehabilitation until all of the phases are completed. 17 VAC 10-30-100(B). A taxpayer may elect to claim the credit allowable for each completed phase of a phased project, nevertheless, any such initial claims are contingent upon final certification of the completed project. 17 VAC 10-30-100(B). Note that a phased project must be considered as such from the beginning of the project so that taxpayers may not use the 60-month rule to avoid the 24-month measuring period after the fact. To avoid this issue, a project could be submitted as a phased project and if the material rehabilitation test is met within a 24-month period, the taxpayer could complete the project earlier.

b. *Material Rehabilitation.* Tax credits are only available for the material rehabilitation of a certified historic structure. Va. Code Ann. § 58.1-339.2(D) "Material rehabilitation" is defined as improvements or reconstruction consistent with the standards for rehabilitation, the cost of which amounts to at least 50% of the assessed value of the building, unless the building is an owner-occupied building, in which case the costs shall amount to at least 25% of the assessed value of such building. *See* Va. Code Ann. § 58.1-339.2(D) and 17 VAC 10-30-10. Assessed value is the assessed value of the building for local real estate tax purposes for the year prior to the start of rehabilitation. 17 VAC 10-30-120. The term "start of rehabilitation" means the date on which the taxpayer applies for a building permit for the work to be completed under the plan of rehabilitation, or the date on which actual work begins under the plan of rehabilitation. 17 VAC 10-30-10. The assessed value of the building for local real estate tax purposes does not include any assessment for land. 17 VAC 10-30-120. In the case of a partnership, LLC or S

corporation, the determination of whether rehabilitation has been material is made at the entity level, not at the partner or shareholder level. 17 VAC 10-30-120. Taxpayers must be careful with the selection of the measuring period, so as to be certain that the eligible rehabilitation expenses exceed 50% or 25% of the assessed value in the first preceding year before the start of rehabilitation.

i. *Standards for Rehabilitation.* "Standards for rehabilitation" means the Secretary of the Interior's Standards for Rehabilitation (36 CFR Part 67), established by the United States Department of the Interior. 17 VAC 10-30-10. If the project does not meet these standards, no part of the expenses are eligible for the tax credit.

ii. *Owner-Occupied Building*. The Code of Virginia provides that an "owner-occupied building" means any building that is used as a personal residence by the owner. *See* Va. Code Ann. § 58.1-339.2(D). The Regulations elaborate further providing that an "owner-occupied building" is any building, at least 75% of which is used as a personal residence by the owner, or which is available for occupancy by the owner for at least 75% of the year. 17 VAC 10-30-10. An "owner" is the person, partnership, corporation, public agency, or other entity holding a fee simple interest in a property, or any other person or entity recognized by the Department of Taxation for purposes of the applicable tax benefits. 17 VAC 10-30-10.

c. *Added to the Property's Capital Account*. Amounts are chargeable to capital account if they are included in computing the basis of real property under Section 1.46-3(c) of the Treasury Regulations. 17 VAC 10-30-110(C). Amounts treated as an expense and deducted in the year paid or incurred or amounts that are otherwise not added to the basis of real property do not qualify. Amounts paid for historic preservation consultant fees, architectural and engineering fees, site fees and other construction-related costs that are added to the basis of property satisfy this requirement. 17 VAC 10-30-110(C). Also included are expenses related to new heating and plumbing, electrical systems, as well as updated kitchens, bathrooms, and ADA compliance costs.

d. *Timing of Expenses.* Eligible rehabilitation expenses may include expenses in connection with the rehabilitation that were incurred prior to the start of the rehabilitation and may include expenses incurred prior to the completion of a formal plan of rehabilitation. 17 VAC 10-30-130(A). Once the material rehabilitation

test is met, the eligible rehabilitation expenses upon which a credit may be claimed include: (1) expenses incurred prior to the start of the 24-month measuring period, provided that the expenses were incurred in connection with the rehabilitation process that resulted in the material rehabilitation of the building; (2) within the measuring period; and (3) after the end of the measuring period as defined, but prior to the completion of the project. 17 VAC 10-130-110(B).

e. *Ineligible Expenses.* Certain expenses are not eligible rehabilitation expenses. These expenses generally include acquisition costs, costs to enlarge the building, and expenses incurred in projects that fail to meet certain statutory and regulatory requirements. 17 VAC 10-30-110(D)(1).

i. *Acquisition Costs*. Eligible rehabilitation expenses do not include the cost of acquiring a building, any interest in a building (including a leasehold interest) or land; provided however, that interest incurred on a construction loan, the proceeds of which are used for eligible rehabilitation expenditures (and which is added to the basis of the property), is not treated as a cost of acquisition. 17 VAC 10-30-110(D)(2).

ii. *Costs to Enlarge Building.* Eligible rehabilitation expenses do not include any expense attributable to an enlargement of a building. 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. If expenditures only partially qualify as eligible 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 a 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. 17 VAC 10-30-110(D)(3).

iii. *Expenses for Uncertified Rehabilitations.* Eligible rehabilitation expenses do not include any expense attributable to the rehabilitation of a certified historic structure, or a

building located in a registered historic district, which is not a certified rehabilitation. 17 VAC 10-30-110(D)(4).

iv. *Expenses incurred before the Statutory Effective Date.* Eligible rehabilitation expenses do not include any expense incurred before January 1, 1997. 17 VAC 10-30-110(D)(5).

v. *Expenses incurred by Non-taxpayers, Local Governments or Agencies.* Eligible rehabilitation expenses do not include any expense not incurred by a taxpayer, including expenses incurred by a local government or any agency thereof, or by any agency, unit, or instrumentality of the Commonwealth. 17 VAC 10-30-110(D)(6). Presumably non-profits may participate in the program through partnership or LLC arrangements with other "taxpayers" so long as such arrangements are properly structured. *See also* Ruling of the Tax Commissioner, P.D. 05-125 (July 26, 2005) (non-profit entity is a taxpayer for purposes of Section 58.1-512 of the Code of Virginia).

vi. *State Financed Projects.* Eligible rehabilitation expenses do not include any rehabilitation expense financed, directly or indirectly, by an obligation of the Commonwealth of Virginia. 17 VAC 10-30-110(D).

f. *Allocation of Eligible Rehabilitation Expenses to Tenant.* A taxpayer who has incurred eligible rehabilitation expenses may elect to treat a tenant or tenants as having incurred the rehabilitation expenses, provided that the lease of the tenant is for a term of at least five years. 17 VAC 10-30-110(F). This election shall be made on the application for the certification of rehabilitation. In the event an election is made that treats multiple tenants as having incurred the rehabilitation expenses, the allocation of eligible rehabilitation expenses to these tenants is to be made based on: ((1) the relative square footage occupied by each the tenants, or (2) the relative amounts of eligible rehabilitation expenses spent in connection with each tenant's space. 17 VAC 10-30-110(F). If the eligible rehabilitation expenses are not readily allocable by specific space, then the expenses should be allocated to the tenants in a manner consistent with the allocation method chosen. 17 VAC 10-30-110(F).

g. *Allocation of Eligible Rehabilitation Expenses to New Purchaser.* A taxpayer may take into account eligible rehabilitation expenses created in connection with the same plan of rehabilitation by

any other entity with an interest in the building. 17 VAC 10-30-110(E). Where eligible rehabilitation expenses are created with respect to a building by an entity other than the taxpayer and the taxpayer acquires the building or a portion of the building to which the expenses were allocable, the taxpayer acquiring such property will be treated as having incurred the eligible rehabilitation expenses actually created by the transferor, provided that no credit with respect to such qualified rehabilitation expenses is claimed by anyone other than the taxpayer acquiring the property. 17 VAC 10-30-110(E).

D. Certification Process. In order to claim the tax credit, a complete Historic Preservation Certification Application must be filed with DHR within one year after the final expenses are incurred or the final certificate of occupancy is issued. 17 VAC 10-30-130(B). Properties that do not meet the criteria for individual listing on the Virginia Landmarks Register must be located in a registered historic district by such date. 17 VAC 10-30-130(B). However, the application is actually a three part application involving confirmation that the building is a certified historic structure, certification of the plan of rehabilitation, and certification of completed work. Part 1 of the application, Evaluation of Significance, is used to request certification of historic significance. 17 VAC 10-30-20(B). Part 2 of the application, Description of Rehabilitation, is used to request certification of a proposed rehabilitation project. 17 VAC 10-30-20(B). Part 3 of the application, Request for Certification of Completed Work, is used to request certification of a completed rehabilitation project. 17 VAC 10-30-20(B). If a rehabilitation project is completed before preparing Part 2 of the application, the applicant shall prepare Parts 2 and 3 simultaneously. 17 VAC 10-30-20(B). The Regulations also warn that if Parts 1 and 2 are not submitted prior to the beginning of work, taxpayers run the risk that the project may not be certified. 17 VAC 10-30-130(B).

1. *Who May File.* Any individual, estate, partnership, trust, or corporation may apply for certification of historic significance and certification of a rehabilitation. 17 VAC 10-30-20(A).

2. *Timing for Review.* DHR generally completes reviews of certification requests within 30 days of receiving a complete application. Expedited review of projects is available upon request. *See* 17 VAC 10-30-80.

3. *Fees.* Non-refundable fees are charged for reviewing rehabilitation certification requests and are due at the time of application. In general, each rehabilitation of a separate certified historic structure will be considered a separate project for purposes of computing the fee. 17 VAC 10-30-80.

E. Part 1-Evaluation of Historical Significance. Part 1 of the Application provides for the DHR evaluation of the historical significance of the property for purposes of the tax credits. *See generally* 17 VAC 10-30-30. As previously discussed, to be certified, the property must be either: (1) listed individually on the Virginia Landmarks Register, (2) certified by DHR as contributing to the historic significance of a historic district that is listed on the Virginia Landmarks Register, or (3) certified by DHR as meeting the criteria for listing on the Virginia Landmarks Register. If the property is individually listed on the Virginia Landmarks Register, Part 1 is not necessary (unless there are outbuildings). If the property is not individually listed, DHR certification is required.

1. *Contributing Properties in Historic Districts*. For properties located in registered historic districts, the taxpayer submits Part 1 so that DHR may determine whether the property is of historic significance to the district. 17 VAC 10-30-30(C). Properties within registered historic districts will be evaluated to determine if they contribute to the historic significance of the district by application of the standards set forth in 17 VAC 10-30-40. *See* 17 VAC 10-30-30(E).

a. *Standards for Determining Historical Significance in a District.* DHR will evaluate properties located within registered historic districts to determine if they contribute to the historic significance of the district. 17 VAC 10-30-40(B). A property contributing to the historic significance of a district is one which by location, design, setting, materials, workmanship, feeling, and association adds to the district's sense of time and place and historical development. 17 VAC 10-30-40(B). A property not contributing to the historic significance of a district is one that does not add to the district's sense of time and place and historical development; or one where the location, design, setting, materials, workmanship, feeling and association have been so altered or have so deteriorated that the overall integrity of the building has been irretrievably lost. 17 VAC 10-30-40(B). Typically, buildings that have been built within the past 50 years are not considered to contribute to the significance of a district unless a strong justification concerning their historical or architectural merit is given or the historical attributes of the district are considered to be less than 50 years old. 17 VAC 10-30-40(B).

b. *Preliminary Determination.* Owners of properties that are located in potential historic districts may request preliminary determinations from DHR as to whether the potential historic district meets the criteria for listing on the Virginia Landmarks Register. 17 VAC 10-30-30(G). Owners of properties located in historic districts

determined to be eligible for listing may apply for preliminary certification of their properties, as specified in 17 VAC 20-30-40. Preliminary certifications will become final, and the properties will become certified historic structures, as of the date of listing the district on the Virginia Landmarks Register. 17 VAC 10-30-30(G). The regulations warn that a taxpayer proceeds with rehabilitation projects at their own risk; if the historic district is not listed in the Virginia Landmarks Register, the preliminary certification will not become final. 17 VAC 10-30-30(G). Accordingly, you may not claim the tax credit until the district is listed and also run the risk of the district not being listed within one year of the completion date of the project. For this reason, it is a good idea to wait until the listing process has been initiated before beginning substantial work.

2. *Properties Eligible for Listing on Register*. Owners of properties that are not listed on the Virginia Landmarks Register may request a determination from DHR as to whether the property meets the criteria for listing on the Virginia Landmarks Register. 17 VAC 10-30-30(F). Individual properties determined by DHR to be eligible for listing in the Virginia Landmarks Register are certified historic structures. 17 VAC 10-30-30(F).

3. *Relocation of Structures*. The relocation of historic structures is discouraged as part of a historic rehabilitation project and the regulations provide detailed rules regarding situations where a building will be moved as part of a historic rehabilitation project. *See generally* 17 VAC 10-30-30(J).

F. Part 2-Description of Rehabilitation. The application for Part 2 provides for the certification by DHR of the rehabilitation project. Part 2 details the plan of rehabilitation. Part 2 is the most complex portion of the Application and for this reason, many taxpayers will hire a professional consultant to help them through the process. Although DHR has not set any formal requirements for a plan of rehabilitation, every plan shall include, at a minimum, the name of the owner of the property, the location of the property, and a description of the proposed, ongoing, or completed rehabilitation project. 17 VAC 10-30-50(B). A plan of rehabilitation must provide DHR with sufficient information to determine whether the rehabilitation qualifies for certification. The burden is on the applicant to supply sufficient information for DHR to make a determination. 17 VAC 10-30-50(B).

1. *Scope of Work*. A rehabilitation project for certification purposes encompasses all work on the interior and exterior of the certified historic structure or structures and its site and environment, as well as related demolition, new construction or rehabilitation work that may affect the historic qualities, integrity, site, landscape features, and environment of the property. 17 VAC 10-30-50(C).

2. *Each Project Unique.* Because the circumstances of each rehabilitation project are unique, certifications that may have been granted to other rehabilitations are not specifically applicable and may not be relied on by applicants as applicable to other projects. 17 VAC 10-30-50(A)(1).

3. *Changes to Workplan*. After approval, the taxpayer is required to bring to the attention of DHR, any substantive changes in the work as described in the original application. 17 VAC 10-30-50(E).

4. *Standards of Rehabilitation*. All elements of the rehabilitation project shall be consistent with the standards for rehabilitation, as set forth in 17 VAC 10-30-60. Upon receiving the application, DHR determines if the project is consistent with the standards for rehabilitation. The applicant is allowed to make revisions to the application to satisfy DHR. The standards for rehabilitation are the criteria used to determine if a rehabilitation project qualifies as a certified historic rehabilitation. 17 VAC 10-30-60(A). The intent of the standards is to promote the long-term preservation of a property's significance through the preservation of historic materials and features. 17 VAC 10-30-60(A). The standards pertain to historic buildings of all materials, construction types, sizes, and occupancy and encompass the exterior and the interior of historic buildings. 17 VAC 10-30-60(A). The standards also encompass related landscape features and the building's site and environment, as well as attached, adjacent, or related new construction. 17 VAC 10-30-60(A). To be certified, a rehabilitation project shall be determined by DHR to be consistent with the historic character of the structure or structures and, where applicable, the district in which it is located. 17 VAC 10-30-60(A). The standards for rehabilitation shall be applied to specific rehabilitation projects in a reasonable manner, taking into consideration economic and technical feasibility. 17 VAC 10-30-60(B).

G. Part 3-Certification of Completed Work. To request certification of a completed rehabilitation project, the taxpayer submits Part 3 of the Historic Preservation Certification Application, "Request for Certification of Completed Work." According to the instructions accompanying the application, the taxpayer must provide documentation that the completed project is consistent with the work described in Part 2 of the Application. 17 VAC 10-30-50(A)(2). This documentation includes the assessed value information for the building in the year preceding the start of rehabilitation and the final costs attributed to the rehabilitation work. 17 VAC 10-30-50(A)(2). If the rehabilitation expenses exceed $100,000, a certified public accountant or equivalent, must certify in writing the actual costs attributed to the rehabilitation of the historic structure. 17 VAC 10-30-50(A)(2).

H. Late Filing. While not recommended, it is possible to file parts of the application with DHR after the project has commenced. If work has already started, DHR requests that Part 1 and Part 2 be submitted as soon as possible. If

the project is completed before preparing part 2 of the application, the applicant should prepare and file parts 2 and 3 simultaneously.

I. Inspection, Denial and Appeal. DHR may inspect projects to determine if the work meets the standards for rehabilitation at any time up to three years after completion of the rehabilitation and to revoke a certification, after giving the applicant 30 days to comment on the matter, if it is determined that the rehabilitation project was not undertaken as represented in the application and supporting documentation. 17 VAC 10-30-50(F). The tax consequences of a revocation of certification will be determined by the Department of Taxation. However, certification shall not be revoked for changes that are determined to have been made following good-faith completion of the project. 17 VAC 10-30-50(F). A project applicant may appeal any denial of certification within 60 days of receipt of the decision that is the subject of the appeal. The appeal process is an administrative review of decisions made by DHR and is not a judicial proceeding. 17 VAC 10-30-70(A). The decision of the director of DHR shall be the final administrative decision on the appeal. 17 VAC 10-30-70(C).

J. Virginia Income Tax Rules Regarding the Application of the Credit. The Code of Virginia and the Virginia Administrative Code provide limited guidance regarding the application of the tax credits by a taxpayer.

1. *Non-Refundable and Carry Over*. The tax credit is non-refundable, meaning that if the amount of the tax credit exceeds the taxpayer's tax liability for the taxable year, the taxpayer is not entitled to an additional refund for that year. Va. Code Ann. § 58.1-339.2(B). Rather, if the amount of such credit exceeds the taxpayer's tax liability for such taxable year, the amount that exceeds the tax liability may be carried over for credit against the taxes of such taxpayer in the next ten taxable years or until the full credit is used, whichever occurs first. Va. Code Ann. § 58.1-339.2(B). However, this is the only limitation on the use of the tax credit by the property owner. *Compare* Va. Code Ann. § 58.1-339.2 with Va. Code Ann. § 58.1-512(C)(1) ($50,000 annual limitation for land preservation tax credits). For pass through entities, the carryforward limitation is applied at the member, partner or shareholder level. 17 VAC 10-30-140(C). There is no carryback of the credit allowed.

2. *Claim of the Tax Credit*. To claim the tax credit, the project developer applies to DHR, which determines the amount of eligible rehabilitation expenses and issues a certificate thereof to the taxpayer. The taxpayer attaches the certificate to their Virginia income tax return to claim the credit. Va. Code Ann. § 58.1-339.2(B). More specifically, the taxpayer files Schedule CR (Credit Computation Schedule) and attached DHR's certification of completed work to the return.

3. *Certification of Eligible Rehabilitation Expenses and Allocation of the Credit.* DHR certifies the amount of the eligible rehabilitation expenses in a letter signed by an authorized representative of DHR confirming that the rehabilitated property is a certified historic structure and the letter is to specify the amount of the eligible rehabilitation expenses based on Part 3 (Request for Certification of Completed Work) 17 VAC 10-30-140(B). The letter will also reference any allocation of the credit based on any allocation document of the entity. The application shall set forth the name of the individual or entity that will claim the credit on their return. 17 VAC 10-30-140(B).

4. *Who May Claim Credit.* A person with an interest in the property (including a possessory interest) who rehabilitated a certified historic structure may apply for the tax credit. 17 VAC 10-30-140(B). This rule and 17 VAC 10-30-110(F) allows a tenant to claim the tax credit.

5. *No Adjustment to Basis.* Unlike the rules at the federal level regarding basis reduction, for Virginia income tax purposes, the property owner is not required to reduce the basis in the property by the amount of the claimed credit. *Compare* Va. Code Ann. § 58.1-339.2

6. *Pass Through Entities*. Credits granted to a partnership or electing small business corporation (S corporation) are passed through to the partners or shareholders, respectively and are allocated among all partners or shareholders either in proportion to their ownership interest in such entity or as the partners or shareholders mutually agree as provided in an executed document, the form of which shall be prescribed by DHR. Va. Code Ann. § 58.1-339.2(B) and 17 VAC 10-30-140(A). The tax credits are allocated to the members, partners or shareholder at the end of the taxable year in which there is entitlement to the credit. 17 VAC 10-30-140(A). The partnership, LLC or S corporation files Form PTE (Pass-through Credit Allocation) with the Department of Taxation.

7. *Transfer of the Tax Credits*. As a technical matter, historic rehabilitation tax credits may not be transferred to another taxpayer. *Compare* Va. Code Ann. §§ 58.1-339.2(B) and 58.1-513(C). Nevertheless, because of the tenant allocation rules of 17 VAC 10-30-140(B) and 17 VAC 10-30-110(F) as well as the pass-through allocation rules of 17 VAC 10-30-140(A), tax credits may be syndicated through the use of partnerships and limited liability companies. Because of the complexity of these deals, proper legal, tax and accounting advice is required from qualified professionals. Nevertheless, there exists a healthy market for the purchase of Virginia historic rehabilitation tax credits through these syndicated arrangements. See Part III below for a discussion of the transfer of Virginia rehabilitation tax credits.

8. *Subsequent Disposition of the Property*. Unlike the federal program, there is no continuing ownership requirement for the building following the rehabilitation. Accordingly, there is no reduction or recapture of the state income tax credit. *See* 17 VAC 10-30-110(E). *Compare* Va. Code Ann. §58.1-339.2 and I.R.C. § 50(a).

9. *Rehabilitation Projects in other States*. Individuals, trusts, estates, or corporations in Virginia that incur eligible expenses in the rehabilitation of a certified historic structure in any other state that has in effect, a reciprocal historic structure rehabilitation tax credit program and agreement for residents of that state who rehabilitate historic structures in Virginia shall be entitled to a credit to the same extent as if the structure was in Virginia. Va. Code Ann. §58.1-339.2.

10. *Relationship to Virginia Land Preservation Tax Credit*. Section 58.1-513(A) of the Code of Virginia bars a taxpayer from claiming the historic rehabilitation tax credit for the costs related to a project for which the land preservation tax credit is claimed for a period of five years. Conversely, the Section also bars a taxpayer from claiming the land preservation tax credits where such credits are based on any building on which historic rehabilitation credits are claimed for a period of five years. However, if expenses incurred to rehabilitate a historic structure do not increase the value of the conservation easement, that section would not bar a claim of the historic rehabilitation tax credit. *See* Ruling of the Tax Commissioner, P.D. 02-158 (December 10, 2002). *See also* Va. Code Ann. § 58.1-339.2.

11. *Relationship to the Federal Tax Credit*. Certifications of properties and rehabilitation projects by the National Park Service, U.S. Department of the Interior are not equivalent to certification of properties and rehabilitation projects by DHR. 17 VAC 10-30-160(A). The regulations caution that deadlines and requirements for certifications under these state regulations may differ from deadlines and requirements for certifications under the federal program. 17 VAC 10-30-160(A). Notwithstanding the general rule above, certifications of historic significance of properties (Part 1, Historic Preservation Certification Application) by the National Park Service, U.S. Department of the Interior, dated after January 1, 1995, are accepted as equivalent of certification of historic significance by DHR under the provisions of 17 VAC 10-30-20. *See* 17 VAC 10-30-160(B).

12. *Death of Holder of Credit.* Since the credit is not transferable, the tax credit will expire on the death of an individual holding the tax credit. In Ruling of the Tax Commissioner, P.D. 05-170 (December 5, 2005), the Tax Commissioner ruled that land preservation tax credits expired upon the death of the holder, because the statute requires the holder to transfer the credits during his or her lifetime. The same logic would apply to the historic

preservation tax credit as the credit is non-transferable, it will expire upon the death of the holder. In addition, the same rule would seem to apply to the dissolution of an entity holding the credits.

II. Brief Discussion of the Federal Historic Rehabilitation Tax Credit

A. General Overview of the Program. Historic rehabilitation tax credits are also available as a reduction in the federal income tax. *See generally* I.R.C. §47(c). However, two limitations at the federal level make this tax credit program less attractive. First, the property must be either (i) held for the production of income, or (ii) used in a trade or business to qualify for the federal tax credit. I.R.C. § 47(c)(2)(A)(i). Property owners rehabilitating structures that constitute their personal residence, or a part thereof, are not eligible for the federal credit. *See Dennis v. Commissioner*, T.C. Memo. 1993-345. Second, several federal tax limitations, namely the at-risk rules and the passive loss rules, apply to individuals, closely-held corporations and partnerships. *See generally* I.R.C. §§ 465 and 469. These rules will limit the use of the credit by individual owners and investors. An exception to these rules exists if the rehabilitated property is owner-occupied by a trade or business. *See* PLR 8951072 (September 28, 1989). Accordingly, the effect of these rules is to shift the focus of rehabilitation tax credits at the federal level away from individual property owners and investors to larger corporations and developers using syndicated investment vehicles. A complete discussion of the federal historic rehabilitation tax credit is beyond the scope of this outline. Nevertheless, a brief discussion of the federal rehabilitation tax credit follows.

B. Amount of Credit. The federal tax credit is allowed against the federal income tax and is equal to 10% of the eligible rehabilitation expenditures for a non-residential building placed in service prior to 1936 that is not a certified historic structure, and 20% of the eligible rehabilitation expenses for a certified historic structure. *See* I.R.C. §§ 47(a) and 47(c)(1)(B). Accordingly, in certain situations, under both the Virginia and federal programs, a property owner with a certified historic structure may be eligible to receive credits for 45% of their eligible rehabilitation expenses. The 10% credit is not available for a property that is a certified historic structure. *See Girgis v. Commissioner*, T.C. Memo. 1991-191.

C. Certified Historic Structure. Under the federal program, a certified historic structure is one that is listed individually on the National Register of Historic Places or is certified as contributing to a district that is listed on the National Register. I.R.C. § 47(c)(3)(A).

D. Qualified Rehabilitation Expenses. Qualified rehabilitation expenditures are defined as any expenses that are properly chargeable to a capital

account for property for which depreciation is allowed under Section 168 of the Code, and are made in connection with the rehabilitation of a qualified rehabilitated building. *See* I.R.C. § 47(a)(2)(A) and Treas. Reg. § 1.48-12(c). For a certified historic structure, the rehabilitation must also be a "certified rehabilitation." I.R.C. § 47(c)(2)(B)(iv).

E. Substantial Rehabilitation. A substantial rehabilitation is defined as rehabilitation where the qualified rehabilitation expenses incurred in a 24-month measuring period exceed the owner's adjusted basis in the property or $5,000 whichever is greater. I.R.C. § 47(c)(1)(A)(i). For these purposes adjusted basis is the cost of the property plus the cost of any prior improvements, less the value of the land and allowable depreciation. I.R.C. § 47(c)(1)(A)(i)(II).

F. Claim of the Tax Credit. The federal tax credit is claimed on Form 3468 (Investment Tax Credit) and the taxpayer must submit information related to the substantial rehabilitation test and a copy of the certification of completed work by the Secretary of the Interior. Federal historic rehabilitation credit projects are frequently syndicated with investors who will invest in the rehabilitation project in exchange for an allocation of the rehabilitation tax credits. In a recent case, *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425 (3rd Cir. 2012), the Third Circuit reversed the Tax Court and remanded the case finding the investor had made a "zero risk investment" in the partnership. In response, the Service issued Rev. Proc. 2014-12, 2014-3 I.R.B. 415 (January 13, 2014), providing a safe harbor to project developers and investors on structuring federal historic rehabilitation partnerships where the Service will not challenge the underlying allocation of the rehabilitation tax credits to the partners.

G. Non-refundable/Carryforward. Like the Virginia historic rehabilitation tax credit, the federal rehabilitation credit is non-refundable, meaning it may only be used to offset the amount of tax liability for the year the credits are certified. I.R.C. 39(a)(1). However, the federal credit may be carried back 1 year and carried forward for 20 years. I.R.C. 39(a)(1).

H. Recapture. Under the federal program, if the building is sold, or loses its income-producing or business use status within five years after the rehabilitation is complete, the taxpayer is required to recapture all or a portion of the credit. I.R.C. § 50(a). The amount of recapture is reduced by 20% for each succeeding year after the year of completion. Casualty losses are also treated as disposition. Treas. Reg. § 1.48-1(a). Also note that the grant of a conservation easement will trigger historic rehabilitation tax credit recapture at the federal level. *See* Rev. Rul. 89-90, 1989-2 C.B. 3. *See also Rome I, Ltd. V. Commissioner,* 96 T.C. 697 (1991) (approving of Rev. Rul. 89-90 and providing the rationale that to allow the investment tax credit and the charitable deduction on the donated property would yield a double benefit to the taxpayer).

III. Income Tax Issues with the Issuance and Transfer of Virginia Historic Rehabilitation Tax Credits

A. Federal and State Rulings on Issuance and Transfer of Tax Credits. The precise federal tax treatment of the transfer of Virginia historic tax credits is currently uncertain and a matter of controversy. The Internal Revenue Service has issued two identical Chief Counsel Advisories concerning the use of partnerships to transfer Virginia rehabilitation tax credits to investors by way of partnership allocations. *See* Chief Counsel Advisory 200704028 (January 26, 2007) and Chief Counsel Advisory 200704030 (January 26, 2007). In response, the Department of Taxation has issued Ruling of the Tax Commissioner, P.D. 07-82 (May 25, 2007). The rulings create fundamental differences of the tax treatment of the transaction at the state and federal levels. The Service treats the transaction as a direct sale of the tax credits to the investor, while the state treats the transaction as an allocation of the credit among investors in the project.

In *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, T.C. Memo 2009-295 (December 21, 2009), the Tax Court rejected the position of the Service. However, on appeal, the Fourth Circuit Court of appeal reversed the Tax Court finding that the standard structure used to syndicate Virginia historic rehabilitation credits was a transfer of property and was a disguised sale under I.R.C. § 707. *See Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011). The rulings and the case are discussed below.

1. *Typical Transaction.* Virginia historic tax credits are transferred through syndicated partnerships and LLCs. Generally, a taxpayer desiring Virginia tax credits will "invest" in the underlying rehabilitation project through a capital contribution to an entity with a possessory interest in the property to be rehabilitated. Credits are then allocated to the members of the entity in compliance with the Code of Virginia. Each member receives their respective share of the tax credits and may claim those credits on their individual return. Subsequent to the investment in the entity, the purchaser would be redeemed out of the partnership or LLC for a nominal amount. Many purchasers would then claim a capital loss on this exit transaction. In the past, transactions were structured so that the investment, allocation and redemption occurred within a two-year period.

2. *IRS Rulings.* Chief Counsel Advisory 200704028 (January 26, 2007) and Chief Counsel Advisory 200704030 (January 26, 2007) discuss the Internal Revenue Service's position with respect to these types of transactions. The ruling involved two key issues relevant here. The issues for decision were whether the investors in the partnership should be respected as partners for federal income tax purposes and whether the

transaction is a disguised sale under Section 707(a)(2)(B) of the Internal Revenue Code. The Service ruled that pursuant to the substance-over-form doctrine, the investors were not partners in the partnerships. The Service stated further that the transfers of the credits for cash between the partnership and the investors were recharacterized as direct sales and purchases of the tax credits. This treatment applies whether or not the credit is transferable under state law and whether or not the transaction is treated as a partnership allocation for state law purposes. The ruling further stated that the partnerships generating the credits are required to report gains from the sale of the credits, which have a basis of zero in the partnership's hands. Next, the ruling states that when the investors use the credits to reduce their state tax liability, they are treated as having satisfied their liability with property, resulting in a disposition of the credits under I.R.C. § 1001 and payments of state tax for purposes of I.R.C. § 164(a). This allows the investors a state income tax deduction, but the investor is required to include the "spread" between the value of the credit and the purchase price in income for the year the credit is applies. Lastly the capital losses claimed by the investors upon exiting the partnership were disallowed.

3. *Tax Commissioner Ruling.* In response to the rulings by the Internal Revenue Service, the Department of Taxation issued Ruling of the Tax Commissioner, P.D. 07-82 (May 25, 2007). In the ruling, the Tax Commissioner stated that the impact of the ruling by the Service is limited in that Service continues to recognize that the partnership is valid for purposes of state law and the partnership is able to effectively transfer the tax credits to the investor. The Tax Commissioner found further that the Service's disregard of the partnership under substance-over-form principles recognized the form of the transaction for purposes of Virginia law. As such, the allocation of the credit to the partners is still respected by the Department of Taxation. The ruling states further that the fact that an entity is ignored for federal income tax purposes does not mean that it is similarly ignored for Virginia income tax purposes. Lastly, the Department of Taxation noted that there is nothing in Virginia law that ties any amount or determination related to the credit to the federal tax treatment of a related item.

4. *Virginia Historic Tax Credit Fund Case*. As stated, in *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, T.C. Memo. 2009-295, the Tax Court rejected the Service's position, but the Tax Court was overruled by the Fourth Circuit Court of Appeal in *Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011). The Fourth Circuit made two fundamental holdings. The first holding was that the tax credit constituted property for federal tax purposes. The second holding was that the allocation of the tax credit to the investors was a disguised sale under Section 707 of the Internal Revenue Code. The opinion

of the Fourth Circuit, nevertheless, did not detail the exact tax consequences to the seller and the buyer. Presumably, practitioners could also follow the Service's position detailed in Chief Counsel Advisory 200704028 (January 26, 2007) and Chief Counsel Advisory 200704030 (January 26, 2007).

5. *Gateway Hotel Partners Case*. In a recent case, *Gateway Hotel Partners, LLC v. Commissioner,* T,C, Memo. 2014-5, the Tax Court held that the allocation of certain Missouri historic rehabilitation tax credits did not constitute a disguised sale. The Tax Court provided a detailed analysis of the factors listed in the disguised sale regulations found Treas. Reg. § 1.707-3(b). The key facts in the determination that a disguised sale had not occurred were that (1) some of the credits were allocated more than two years following the contribution by the investor, (2) the timing and amount of the allocations were uncertain at the time of the investment, and (3) the investor never had a legal right to the tax credits. *Id*.

B. Income Tax Considerations For The Buyer. The buyer faces some complex income tax issues mostly related to the tax impact of the application of the credit to the buyer's Virginia taxable income and the corresponding federal income tax deduction for state income taxes paid.

1. *No Limitation on Purchase Amount*. There is no limitation on the amount of Virginia historic income tax credits that may be purchased by a buyer. *Compare* Va. Code Ann. § 58.1-339.2 with Va. Code Ann. § 58.1-512(C)(1) ($50,000 annual limitation for land preservation tax credits). This is because the buyer is considered an investor in the project for purposes of state law.

2. *Excess Credit Purchased by the Buyer.* Because the purchaser of the credit is allocated the credits as a partner or member of the entity, the purchaser has a ten-year carryforward in which to utilize the credits. Va. Code Ann. § 58.1-339.2(A).

3. *Federal Income Tax Consequences to the Buyer.* Based on the Service's position, state income taxes paid with the use of a rehabilitation tax credit remain deductible under I.R.C. § 164 for federal income tax purposes. *See* PLR 200445046 (October 29, 2004) (regarding Massachusetts historic rehabilitation and low-income housing credits). Based on *Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011), presumably, practitioner's should follow the Service's position detailed in Chief Counsel Advisory 200704028 (January 26, 2007) and Chief Counsel Advisory 200704030 (January 26, 2007). The Service continues to assert many of the arguments provided in these rulings, despite the findings in the two *Virginia Historic* opinions. *See* Field Attorney Advice 201224002 (October 5, 2012). Indeed, the Service has not issued a safe harbor for the

allocation of state historic rehabilitation tax credits as they have at the federal level. *See* Rev. Proc. 2014-12, 2014-3 I.R.B. 415 (January 13, 2014). Unlike Service position, in the two *Virginia Historic* opinions, the Tax Court and the Fourth Circuit did not disregard the partnership or the partner's status as a partner. Accordingly, rather than an I.R.C. § 164 deduction, the investor would be entitled to a loss on redemption from the partnership, with the question of whether the loss is capital or ordinary. Practitioners should carefully review their client's situation to determine the best position.