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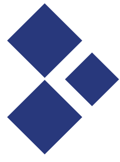

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THE LIHTC Property Compliance ISSUE

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Issues to Consider When Completing an HTC Property with Tax-Exempt Entities

FRANK BUSS, CPA, NOVOGRADAC

Q: What are some issues to look for when completing a historic tax credit (HTC) project with tax-exempt entities involved?

A: There are two main issues that can arise from the addition of tax-exempt entities in a transaction: tax-exempt use property and tax-exempt ownership. Both situations can cause complications for the transaction. First though, let's look at what is considered a tax-exempt entity. For a historic rehabilitation, the Internal Revenue Code (IRC) defines a tax-exempt entity as being:

1. the government of the United States and any state or local government agency or any political subdivision;
2. an organization that is exempt from income taxes;
3. a foreign person or entity; or
4. an Indian tribal government.

Tax-Exempt Use Property

Generally, tax-exempt use property is any portion of an expenditure that is allocable to tax-exempt use within the meaning of IRC Section 168(h). As a result, any expenditure treated as tax-exempt use will not be included in the HTC basis.

Where we normally see issues with tax-exempt use property is disqualified leases. If the underlying HTC property is leased to a tax-exempt entity pursuant to a disqualified lease, the portion of the expenditures related to that portion of the building would be excluded from HTC basis. A disqualified lease to a tax-exempt entity may occur in one of four ways:

1. Part of the property was financed by an obligation which the interest is tax-exempt under IRC Section 103(a) and the entity participated in the financing,
2. there is a fixed or determinable purchase price,
3. the lease term is more than 20 years or finally,
4. the lease occurs after a sale (note that leasebacks during the first three months of use are not considered).

One example of a disqualified lease would be as follows: A taxpayer rehabilitated a historic structure and leases the building to a city. The taxpayer financed the rehabilitation with tax-exempt bonds issued by the city. Even if the lease term is less than 20 years, the rehabilitation was financed (directly or indirectly) with bonds exempt from tax under IRC Section 103(a) and the tenant is a tax-exempt entity. Therefore, the lease agreement between the city and the taxpayer will result in a disqualified lease.

An important note: nonresidential property is treated as tax-exempt use property only if the portion of such property leased to tax-exempt entities under disqualified leases is *more than 50%* of the property. The portion of such property leased to tax-exempt entities is based on the net rentable floor space of the building. The net rentable floor space does not include the common areas of the building, regardless of the lease provisions.

Thus, if greater than 50% of the net rentable floor space of the building is leased to tax exempt entities under disqualified leases, the taxpayer would only be able to claim the HTCs on the expenditures incurred for the portion of the building not leased to a tax-exempt entity.

Tax-Exempt Partners

If a partnership contains both taxable and tax-exempt partners, the qualified rehabilitation expenditures (QREs) incurred by the partnership will be considered tax-exempt use property based on the ownership percentage of the tax-exempt or disqualifying entity. The percentage of ownership regarding the tax-exempt use property is based on the highest allocable share of income, gain, loss, deduction or credit at any time during the life of the partnership.

For example, a partnership rehabilitates a historic building and spends $10 million on QREs. The partnership agreement calls for loss allocations of 1% to the tax-exempt partner, but 99% of income allocations to the same partner. In that case, the highest allocable share ownership is 99% to the tax-exempt partner. In this example, 99% of the QREs would be deemed to be tax-exempt use property and only 1% would be eligible for HTC. This result is also applicable to an entity controlled by a tax-exempt entity, "a tax-exempt controlled entity." Thus a 1% general partner owned 100% by a tax-exempt or nonprofit entity could trigger this type of situation.

To remedy this dilemma, a "tax-exempt controlled entity" that is a limited liability company would first elect to be taxed as a taxable entity using IRS Form 8832 and then make an election under IRC 168(h)(6)(F)(ii). The election is to treat any gain recognized by its tax-exempt parent on any disposition of an interest in as unrelated business taxable income. The election is irrevocable and should be made in the first taxable year. These steps will establish the tax-exempt controlled entity as a blocker corporation inserted between the tax-exempt nonprofit and the HTC entity. Income and gains will be taxed at the blocker entity, including any state and local amounts.

As one can see, having a tax-exempt entity as part of the transaction can add several complexities to a historic rehabilitation project. There are many issues that must be considered and agreements and deal specifics must be altered so that a portion of the building is not considered tax-exempt use property. Novogradac is highly experienced in this type of transaction and in navigating through these difficult tax areas. If your project is considering a historic project with a tax-exempt entity, please reach out to your Novogradac professional for assistance. ❖

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