The definition of qualified rehabilitation expenditures (QREs) is important not just for purposes of satisfying the substantial rehabilitation test. The amount of QREs determines the amount of historic tax credits a project is eligible for, meaning every additional dollar of QREs results in 20 cents more in tax credits. In this episode of Tax Credit Tuesday, Michael Novogradac, CPA, and Tom Fantin, CPA, discuss commonly overlooked QREs and costs that some developers may assume are QREs but are not.

Summaries of each topic:

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2. Defining QREs (06:07-07:54)
3. Commonly overlooked QREs (07:55-08:30)
4. Costs that are not QREs (08:31-11:35)
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Transcript

[00:00:11] **Michael Novogradac, CPA:** Hello. I'm Michael Novogradac. And this is Tax Credit Tuesday. This is the May 24th, 2022, podcast. Welcome to episode two of a two-part series for historic tax credit developers. Last week, we had a great discussion about what developers need to know about the substantial rehabilitation test. In a nutshell, to qualify for the historic tax credit, a historic rehabilitation project must undergo a "substantial rehabilitation."

That generally means that the qualified rehabilitation expenditures have to exceed the adjusted basis of the building being renovated. Now, if you missed last week's episode, please be sure to check it out. We went into more detail as to how to meet the substantial rehabilitation tasks and how to avoid common pitfalls.

I'll include a link to the episode in today's show notes. Now our episode this week picks up where last week's episode left off. We take a deeper dive into the definition of qualified rehabilitation expenditures or the QRE portion of the substantial rehabilitation test. Now the definition of QREs is important, not just for purposes of satisfying a substantial rehabilitation test. The amount of QREs or qualified rehabilitation expenditures determine the amount of historic tax credits a project is eligible for. In short, every additional dollar of QREs means 20 cents more in tax credits, which translates into more tax credit equity.

This podcast will address several questions. Namely what costs qualify as QREs and what costs do not qualify as QREs? And we'll also cover some commonly overlooked eligible costs. Costs are often overlooked even by experienced historic tax credit developers.

But before we start, I do want to note and emphasize that the historic tax credit is a by-right credit as opposed to an allocated. Now many of our listeners may be familiar with the low-income housing tax credit and new markets tax credit. Both of these are generally speaking, allocated tax credits with a finite amount authorized each year. As a result, developers, project sponsors and community entities generally have to compete for the right to claim or benefit from those tax credits.

Now, by contrast, the historic tax credit is a non-competitive, by-right credit, similar to a renewable energy investment tax credit. This means that if your project meets the program requirements, you can claim the tax credit on your eligible costs. Now there are certification requirements for the historic tax credit that do involve the National Park Service and state historic preservation offices, but there's not a formal or informal competition for tax credits or tax credit financing.

And joining me in this episode is my partner, Tom Fantin of Novogradac's Dover, Ohio office. Tom has extensive experience providing tax audit and consulting services to clients, working with federal tax incentives, including opportunity zones, new markets tax credits, renewable energy tax credits and, of course, historic tax credits.

Tom is a frequent speaker at Novogradac and other industry conferences and seminars. So we're very fortunate to have him on the show today to share his insights. If you're ready, let's get started.

[00:03:39] **Michael Novogradac, CPA:** Tom, welcome to the Tax Credit Tuesday.

[00:03:42] **Tom Fantin, CPA:** Hi, Mike, thanks for letting me be a part of this episode.

[00:03:47] **Michael Novogradac, CPA:** Well, it's—glad to have you on, I believe it's your first time, correct?

[00:03:50] **Tom Fantin, CPA:** That is correct.

[00:03:51] **Michael Novogradac, CPA:** Okay. Well, hopefully it won't be your last. So Tom, the historic tax credit is used by developers of historic properties to raise equity capital to finance the renovation of existing notable older buildings. As I mentioned in my introduction, this historic tax credit is an as-of-right credit, which means there's no allocating agency to monitor or confirm the amount of tax credits that a developer qualified for. That said, investors in tax credits want some type of independent confirmation of the amount of tax credits that are being claimed. As such, investors generally require a cost certification. So Tom, maybe you could unpack that a little bit and share your thoughts as to why investors require a cost certification and what that process involves.

[00:04:38] **Tom Fantin, CPA:** Sure, Mike. So as you mentioned, there is no formal process in place to submit a cost certification, and there's no oversight of the amount of credits being claimed. So there is a risk that the IRS could disallow some of these credits. So the investor members at the time they're closing the deal typically want to see financial projections. As part of the process, they'll also include in the operating agreements language that specifies the use of an accountant, approved by the investor member to complete the cost certification process, to provide better assurance that the costs being claimed are qualified.

[00:05:15] **Michael Novogradac, CPA:** So thank you for that. And it is a critical component because you do obviously have the oversight by the IRS, in terms of the IRS could audit a development and disallow some of the costs, and that's what the investors want to avoid. And that's the same truth with other types of tax credits and the cost certification is it gives the investors some comfort that the credits that are being claimed are—the project is eligible for those credits.

So let's talk about the important definition of qualified rehabilitation expenditure. And as I mentioned in the intro, the qualified rehabilitation expenditure or the QRE is the foundation of calculating the amount of tax credits. And it's a simple calculation. Just take your QREs times 20% and that's amount of credits that you're eligible for.

So maybe you could define for our listeners what qualifies as a qualified rehabilitation expenditure.

[00:06:07] **Tom Fantin, CPA:** Sure. So, so QREs are defined as any amount, properly chargeable to a capital account for property for which depreciation is allowable under IRC Section 168 in which is or is added to non-residential real property, residential rental property, real property which has a class life of more than 12.5 years and in connection with the rehabilitation of a qualified rehabilitation building.

[00:06:38] **Michael Novogradac, CPA:** So maybe you can unpack that a little bit more in terms of it's capitalized to the building, but not capitalized to, say, personal property.

[00:06:46] **Tom Fantin, CPA:** That's correct. Personal property is not included in the definition of a QRE. Typically the, the common types of items are structural components, walls, partitions, floors, windows, doors, plumbing, fixtures, electrical wiring, things of that nature.

[00:07:02] **Michael Novogradac, CPA:** Stuff that basically gets capitalized and depreciated over the life of the building, albeit a separate asset than the underlying acquisition of the building.

[00:07:12] **Tom Fantin, CPA:** Correct. And you can also look at what we call hard costs, which are the things I just previously mentioned, as well as soft costs, which are more of the architect and engineering fees, other types of fees, insurance, real estate taxes, things like that during the construction process.

[00:07:31] **Michael Novogradac, CPA:** So as you kind of go through and when you're working on cost certifications or maybe perhaps more appropriately when you're doing the initial review, when you're helping a client with a financial forecast in advance of beginning renovation, are there some commonly overlooked costs, various expenditures where a developer, even an experienced historic tax credit developer, might think doesn't qualify as QREs?

[00:07:55] **Tom Fantin, CPA:** Yeah, in my experience, I've run across situations where developers sometimes miss the costs related to the operation and maintenance of a building. Those types of costs can be overlooked. This sometimes includes utility connections that take place outside of a building or structures built to protect those utilities, for example, freestanding air conditioning units and things of that nature. Also certain landscaping costs, which site work typically isn't a qualified rehabilitation expenditure, but certain landscaping costs designed to protect the building may also be eligible as well.

[00:08:31] **Michael Novogradac, CPA:** Let's talk about the flip side of that question. You know, what are the costs that are not eligible for tax credits, that don't qualify as QREs. I mentioned earlier personal property, because obviously the personal property isn't part of the building and they gave me a credit for renovating the building, not for buying personal property to put in the building.

So that's one cost that doesn't get included, but maybe talk about some of the other costs that that many developers may not be aware don't get included.

[00:09:00] **Tom Fantin, CPA:** Yeah. So some of the general ones that, that are common are any type of costs that add to the existing footprint of the building. If you're going outside the original envelope, those types of costs are not eligible, but certain things that might get missed that people think are eligible usually revolve around some of those non-tangible soft costs.

I mentioned architect and engineering fees, real estate taxes, insurance and other fees. I've had some developers assume that all loan fees, for example, are QREs. Loan fees include bank fees, attorney's fees and other costs associated with obtaining a loan. The loan fees related to a construction loan are not direct QREs. Rather they're set up as a separate amortizable asset that's amortized over the life of the loan. It's the amortized portion of that loan that is capitalized to the cost of the construction. So if a loan maturity extends past the placed-in-service date of the qualified building or in the case of a permanent loan where the loan term doesn't begin until after the building's placed in service, that portion of the loan fee amortization that is incurred is expensed and not capitalized.

Therefore things like that would not be included as a QRE.

[00:10:13] **Michael Novogradac, CPA:** So when you're going through and working on a projection, then do you find that you're basically looking at all your hard costs and looking at the hard costs, finding those that qualify and those that don't. And then once you do that, then look at all the soft costs and then figure out how those soft costs get apportioned among your various hard costs or get expensed or other otherwise amortized. And then some subset of the soft costs end up making their way into capitalize the building and qualify as QREs?

[00:10:43] **Tom Fantin, CPA:** That's correct. We, we typically try and look at all the costs being incurred related to the development of that building and determine what is or isn't included.

[00:10:55] **Michael Novogradac, CPA:** Yeah. And it's almost like there's that step function where you start with what you know, and what you know is in and what you know isn't in. And then when you start getting to the soft costs, you have a series of allocations that have to be done.

[00:11:10] **Tom Fantin, CPA:** That's right.

[00:11:11] **Michael Novogradac, CPA:** Go ahead. Do you want to say something else?

[00:11:13] **Tom Fantin, CPA:** Yeah, no, I was just going to mention, even in a situation like a developer fee, we dig into those agreements and if services that are being included in a development agreement, such as a painting financing or accounting services, the portion of the developer fee is usually carved out for those types of services.

And we'll look at that to help ensure the integrity of the costs.

[00:11:36] **Michael Novogradac, CPA:** So when you and I were preparing for this podcast, we talked about the IRS and how in April, just last month, they published some clarifying guidance on the IRS website as to what costs generally qualify as QREs. And then they also listed costs that generally do not qualify as QREs. And then they had a list of costs that qualify as QREs under certain circumstances. So basically those buckets, the bucket of in, the bucket of out and the bucket of maybe. Was there anything in that guidance that stood out to you?

[00:12:08] **Tom Fantin, CPA:** So there were things that we in the industry already know. But the guidance that you're referring to was expanded to include detailed information about costs associated with flood adaptation. Additionally, this clarifying guidance included costs related to solar panels, wind turbines and geothermal systems, which are generally a five-year property under section 168.

This guidance specifically noted that these costs are not included in the basis of the building and should not qualify for the rehabilitation credit. And it also stated that, the same property that is used to claim a rehabilitation credit cannot also be used to claim an energy credit.

[00:12:51] **Michael Novogradac, CPA:** Right. As you said, you're sort of confirming a lot of what we already knew, but I would encourage the listeners to review the guidance and we'll put a link to it in today's show notes because I do think it's a good refresher just to kind of walk through and look at the categories that the IRS calls out.

So Tom, in last week's episode, Roy Chou and I discussed what developers needed to know about the substantial rehabilitation test when they're buying an historic property. And we also focused on what they need to know when they're buying a historic property from an owner who has rehabilitation work in process.

And in that scenario, there's a step-into-the-shoes rule that can help the building generate more QREs, could you explain that for our listeners?

[00:13:40] **Tom Fantin, CPA:** Sure. So if you're a taxpayer or a buyer who purchases a building from another taxpayer who incurred QREs prior to that acquisition, the buyer can claim the previous owners' QREs as part of their overall HTC basis. As long as the rehabilitation expenditures incurred by the previous owner were not placed in service.

As you and Roy discussed last week, the costs must still meet the measuring period rules and are included in the substantial rehabilitation computation. But in general, the buyer shall be treated as having an incurred the QREs incurred by the seller on the date that the transfer or incurred the expenditure.

So if the previous owner did place the rehabilitation in service, the purchase of the property is characterized as an acquisition cost. It would be ineligible for inclusion as a QRE.

[00:14:39] **Michael Novogradac, CPA:** How often do you see buyers avail themselves of this opportunity? You're going to say often? Not very often? Not as often as they could?

[00:14:48] **Tom Fantin, CPA:** I would probably lean to maybe not as often as they could. Sometimes, those buyers just lump all of that into the acquisition costs, but not realizing that some of that work may have previously been completed.

[00:15:03] **Michael Novogradac, CPA:** So maybe that brings me to my next question because probably the situation when they reach out to you after they've negotiated the purchase agreement, they didn't think to carve out a portion of the purchase agreement to be stepping into the shoes of the QREs. So my next question is if I'm a developer and I'm assessing the feasibility of renovating the possibly historic tax credit property, when should I call you?

[00:15:26] **Tom Fantin, CPA:** That's a good question. And ideally, I would say you'd want to reach out once you have a project site in mind and before speaking with an investor. So, we at Novogradac can assist with preparing financial models as mentioned that will provide a good estimate of the QREs and the HTCs, to be claimed, which, as we mentioned, an investor is most likely going to request anyway.

So if you're starting to run the numbers behind the sources and uses of a project, that's a good time to call. If you're already past that point though, and you're in the process of negotiating with an investor or you've even closed a deal at that point, it's still always a positive thing to call us because we can assist you with the process of preparing the cost certification to help maximize those credits.

[00:16:12] **Michael Novogradac, CPA:** And as you noted earlier, obviously if you haven't finalized the negotiation for the purchase price of the building, reaching out to us and working with the seller of the building to see if they have any in-progress expenditures that you can step into the shoes of that can add to the qualified rehabilitation expenditures.

And then maybe you could say something about the importance of having a good estimate of historic tax credits when they initially negotiate with the investor and how you won't actually know what your historic tax credits are because the only thing you know about a budget is that's not what's going to happen.

You hope you have sufficient contingency that it comes in at a lower cost. Oftentimes it comes in at a higher cost and your rehabilitation, your actual tax credits are going to be a function of what you actually spend the dollars on. So there will be some variability in the amount of credits that you ultimately claim versus what you project.

So can you say something about what investors generally provide for in terms of adjusters?

[00:17:09] **Tom Fantin, CPA:** So typically investors will include adjusters in their operating agreements, as far as what the credits are, and those can be upward or downward adjusters. The downward adjusters are typically looked at like a penalty if you don't reach a certain threshold as to where the credits fall out to be. In the upward adjusters, will usually be capped to a certain dollar amount.

So if you go well over budget and incur a lot more QRE expenses, they only pay up to a certain point.

[00:17:43] **Michael Novogradac, CPA:** I like to point out the adjuster factor because it just shows you how important it is to have a really good estimate of historic tax credits. You don't want to end up so short that you have so many more historic tax credits that the cap on the adjuster kicks in, such that you're generating additional historic tax credits, but not getting more equity.

And then similarly, you don't want to go in promising a certain amount of historic tax credits and then find you don't deliver. So you get a downward adjuster and then you lose that tax credit equity. And now your project isn't as financially viable as it would have been because just as a, you know, it's an indirect way or direct way of saying you want to have really good estimate to begin with.

And you want to make sure that you understand the adjuster provisions and how they work operationally from the financing of your development. Once again, that's what, all of that gets dealt with in the financial modeling. And you can run stress tests and the rest. Tom, I want to thank you for joining me on the podcast.

I'm sure our listeners are going to reach out to you with their specific questions. So if you could share your email address and I'll also include it in today's show notes.

[00:18:47] **Tom Fantin, CPA:** Sure, you can reach me at any time at Tom.Fantin@novoco.com.

[00:19:05] **Michael Novogradac, CPA:** And that'll be posted also, as I mentioned in our show notes at www.novoco.com/podcast. Now to our listeners and you hang around, Tom, I have some Off-Mike questions for you in a moment, which is always a fun part of the podcast, but for our listeners, please be sure to tune into next week's episode of Tax Credit Tuesday. Next week's episode is going to focus on new market tax credits and a particular sort of structuring opportunity. My partner, Bryan Hung, and I will discuss what is really underutilized and it's a really beneficial way to qualify a business for new markets tax credit financing and to serve low-income households, families and persons, even when a business is not located in an eligible census tract. The technique you might have guessed is using target populations. And I would note that even if your business is in an eligible census track, such that you might think targeted populations isn't something you need to be focused on, that tract that you're in may not be sufficiently distressed to attract new markets tax credit subsidized financing.

Whereas a targeted populations approach may enable your business or nonprofit to serve more highly distressed persons and families and thereby attract new market tax credit financing. So please tune in next week and find out how to avail yourself of this tool or this option. You can make sure that you're notified of that episode and each week's episode, by following or subscribing to the task road, Tuesday podcast, go to www.novoco.com/podcast to subscribe to and stream the show.

You can also follow us. Subscribe attached for Tuesday on iTunes, Spotify, Google Podcast, Stitcher and Radio Public.

[00:20:47] **Michael Novogradac, CPA:** Now I'm pleased to reach our Off-Mike section where listeners get some off-topic advice and words of wisdom from our podcast guests. Since this is part two of our historic tax credit developer series, I'm going to start by asking Tom the same questions that I asked Roy last week.

So I'm looking forward to your answers, Tom. So the first question and these aren't coming as a surprise to you because you listened to last week's podcast.

[00:21:12] **Tom Fantin, CPA:** That's correct.

[00:21:13] **Michael Novogradac, CPA:** So what's the best career advice you've ever gotten?

[00:21:17] **Tom Fantin, CPA:** So, I think for me, I had a mentor once tell me to not accept no to a question that I have if it hinders me from reaching my goals. You know, they explained to me to understand why I received that response in the first place and adjust my timing of the question or the strategy about how I develop that question to achieve my desired results.

[00:21:42] **Michael Novogradac, CPA:** So, can you give an example of how you put that in practice?

[00:21:45] **Tom Fantin, CPA:** Yeah, a real good example is, you know, trying to get new business. If you inquire somebody, you know that, “Hey, I want to work with you. And, I think we can provide the services for you,” and they say, no, sometimes it's just about timing. Maybe for them, it's not the right timing to switch firms and things like that, but keep your perseverance up and keep fresh in those people's heads.

[00:22:08] **Michael Novogradac, CPA:** Yeah. Next, you know, it's a popular topic on this podcast. What's your favorite work-life balance tip?

[00:22:15] **Tom Fantin, CPA:** So probably an answer, you get a lot, but I may have to agree with, it is to find an activity or a hobby to help take your mind away from work and just reset nowa and then. You know, whether it's reading, exercising, as we mentioned last week, cooking, or anything else that that can kind of give you a break from the day-to-day nuances and things we deal with at work. It's important to take time for those activities as well.

[00:22:41] **Michael Novogradac, CPA:** So you mentioned cooking from last week's podcast. So last week I asked Roy what's a skill or talent most people don't know you have. And how did you develop that skill or talent? And Roy did say that he was a great chef and obviously now, not only I, but many others are asking him to cook for them.

So I'll ask you the same question, but be careful. It might lead people to ask you.

[00:23:06] **Tom Fantin, CPA:** And understood and cooking is not my forte, but one of the skills I have that a lot of people don't know is I play the guitar. Actually, in a prior life, I was in a band that Cleveland Magazine here in Ohio had named the Best Bar Band in Northeast, Ohio, at one time. So, I developed that skill through, as mentioning in my previous comment, just taking some time for that work-life balance. But, to this point I've been playing guitar for almost 35 years. And, just use that as a good break. So, maybe I can provide, some musical entertainment while Roy cooks a dinner.

[00:23:45] **Michael Novogradac, CPA:** And what was the name of that band?

[00:23:47] **Tom Fantin, CPA:** The band at that time was called The Knockoffs.

[00:23:49] **Michael Novogradac, CPA:** Got it. Got it. That sounds like a good bar band name.

[00:23:52] **Tom Fantin, CPA:** Right.

[00:23:54] **Michael Novogradac, CPA:** And so I presume that was electric guitar? Do you play acoustic guitar now?

[00:23:58] **Tom Fantin, CPA:** Yeah, that was electric guitar. I'm actually in a band now, just a small downsize acoustic thing that I play acoustic guitar in as well. And just do that on some weekends now and then as well.

[00:24:11] **Michael Novogradac, CPA:** And then what type of music is your—do you play a certain type of music?

[00:24:16] **Tom Fantin, CPA:** Yes. So, so our genre really focuses on what I would say is the '80s and '90s kind of pop alternative scene, but on an acoustic level.

[00:24:27] **Michael Novogradac, CPA:** Got it. Well, that's great. It was good to hear those ideas and learn a little bit more about you. So, thank you again, Tom, and to our listeners. I'm Mike Novogradac. Thanks for listening.

Additional Resources

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