

## **Rehabilitation Credit: *Leases to Tax-Exempt Entities, Tax-Exempt Partners***

The Internal Revenue Code and Department of the Treasury Regulations provide rules concerning a taxpayer's ability to claim the rehabilitation credit in certain situations involving tax-exempt entities.

The rehabilitation credit generally is not determined for property used by tax-exempt entities, governments, foreign persons, or foreign entities (each considered a "tax-exempt entity" for this purpose). However, a rehabilitation credit may be determined in the following situations:

(1) In the case of an exempt organization (other than a cooperative described in Internal Revenue Code § 521) if the property is used predominantly in an unrelated trade or business the income of which is subject to tax under Internal Revenue Code § 511.

(2) In certain situations where the property is leased to a tax-exempt entity provided all requirements are met. Internal Revenue Code §§ 47(c)(2)(B)(v) and 168(h).

(3) In certain situations where a tax-exempt entity is a partner in a partnership that owns the property provided all requirements are met. Internal Revenue Code §§ 168(h)(5) and (6).

This information is intended to provide a basic understanding of the rules concerning the rehabilitation credit and the special rules for tax-exempt entities.

The information presented does not constitute legal authority and may not be relied upon as such. The information does not amend, modify or add to the Income Tax Regulations or any other legal authority.

Most of the Department of the Treasury regulations governing the rehabilitation credit are contained in Treasury Regulation § 1.47-7 and § 1.48-12. Furthermore, the provisions of the Internal Revenue Code including the investment credit, general business credit, at-risk rules, passive activity limitation, and alternative minimum tax can affect a taxpayer's ability claim the rehabilitation credit.

### **Leases to Tax-Exempt Entities**

#### *Disqualified Lease Rules*

When a property owner leases their building or a portion of their building to a tax-exempt entity, i.e. governmental unit, a tax-exempt organization, or a foreign person/entity, it is important that they are familiar with the "disqualified lease" rules that may prevent them from claiming the rehabilitation credit.

Internal Revenue Code § 168(h) contains a comprehensive set of rules dealing with leases of property to "tax-exempt entities". Under these rules, real property, which is leased to a tax-exempt entity in a "disqualified lease," is treated as "tax-exempt use property." Expenditures associated with tax-exempt use property are not eligible for the rehabilitation credit. See Internal Revenue Code § 47(c)(2)(B)(v).

A "disqualified lease" is defined in Internal Revenue Code § 168(h)(1)(B)(ii) as a lease to a tax-exempt entity where:

- (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 § 103(a) and such entity (or related entity) participated in the financing, or
- (2) Under the lease there is a fixed or determinable purchase price or an option to buy, or
- (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 § 168(h)(1)(B)(ii).

#### *Lease Term*

When determining whether a lease has a term in excess of 20 years, the term of the lease is deemed to begin when the property is first made available to the lessee under the lease. Treasury Regulation § 1.168(j)-1T Q17 states that the lease term includes not only the stated duration, but also any additional period of time which is within the realistic contemplation of the parties at the time the property is first put into service. The Treasury Regulations cite *Hokanson v. Commissioner*, 730 F.2<sup>nd</sup> 1245, 1248 (9<sup>th</sup> Circuit 1984).

The Treasury Regulations also provide that the term of the lease includes all periods for which the tax-exempt lessee or a related party has a legally enforceable option to renew the lease, or the lessor has a legally enforceable option to compel its renewal by the tax-exempt entity or a related party, unless the option to renew is at fair market value determined at the time of renewal.

In other words, a lessor is allowed to

renew a tax-exempt entity's original "under 20-year lease" as long as the new lease is at fair market value.

#### *The 35% Threshold Test*

An exception under Internal Revenue Code § 168(h)(1)(B)(iii) provides that 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 35% of the property.

The phrase "more than 35%" means more than 35% of the net rentable floor space of the building. The net rentable floor space would not include the common areas of the building, regardless of the terms of the lease. See Treasury Regulation § 1.168(j)-1T Q-6.

If more than 35% of a building is leased to a tax-exempt entity, a taxpayer would be able to claim the rehabilitation credit on the expenditures incurred for the portion of the building not rented to a tax-exempt entity. This is illustrated in the following example:

*A taxpayer purchases a building for \$50,000 and spends \$100,000 to rehabilitate the property. Three fourths of the building is leased to a tax-exempt entity for 25 years making 75% of its net rentable space tax-exempt use property. No rehabilitation tax credit would be allowed on the \$75,000 of rehabilitation expenditures attributable to the tax-exempt use portion of the building.*

*However, the taxpayer would be allowed a rehabilitation credit on the \$25,000 expended on the portion of the building not leased to a tax-exempt entity.*

In situations where an expenditure is not considered to be a qualified rehabilitation expenditure because it is applicable to a portion of the building which is tax-exempt use property, as illustrated in the previous example, the expenditure can still be included in the computation to determine whether a building has been "substantially rehabilitated." See Internal Revenue Code § 47(c)(2)(B)(v). Thus, in the previous example, the taxpayer's expenditures of \$100,000 are included in determining whether the building is substantially rehabilitated.

### **Property Owned by Partnerships with Taxable and Tax-Exempt Partners**

Many tax-exempt organizations are affiliated with "for-profit" entities. In these situations, tax-exempt use property would not include property which is predominantly used by a tax-exempt entity in an unrelated trade or business (directly or through a partnership in which such entity is a partner) on which it pays taxes. See Internal Revenue Code § 168(h)(1)(D).

When property is owned by a partnership that consists of both taxable and tax-exempt partners, Internal Revenue Code § 168(h)(6) sets forth a number of specific rules intended to prevent the use of tiered arrangements or partnerships and other pass-through entities to allocate in a disproportionate manner the tax benefits and burdens of property owned by tax-exempt entities. In general, if any property that is not otherwise treated as tax-exempt use property is owned by a partnership that has both tax-exempt and taxable

partners, the proportionate share of the property allocated to the tax-exempt partners will be treated as tax-exempt use property.

Any allocation to the tax-exempt entity of partnership items must be a "qualified allocation" (meaning equal distribution of income, gain, loss, credit and basis) and must have "substantial economic effect" (the Treasury Regulations provide that the economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences).

### **Disqualified Lease Rule Examples**

*Example 1:* A taxpayer rehabilitates an historic structure and leases the building to the City. The taxpayer financed the rehabilitation with tax-exempt bonds issued by the City of New York. Even if the lease term is less than 20 years, the fact that the rehabilitation was financed (directly or indirectly) with bonds exempt from tax under Internal Revenue Code § 103(a), the agreement between the city and the taxpayer will result in a disqualified lease.

*Example 2:* A taxpayer rehabilitates an historic structure and leases the building to the Willow Theater, a non-profit community theater group. If the taxpayer includes in the lease agreement an option for the Willow Theater to purchase the building after 15 years, the agreement will result in a disqualified lease.

*Example 3:* A taxpayer rehabilitates an historic structure and leases the building to a foreign owned corporation. The lease agreement contains a provision where the lease term is equal to 15 years with a legally enforceable option to renew the lease for an additional 10 years at a fixed, non-negotiable price. Since the lease term is in excess of 20 years, the agreement creates a disqualified lease.

If, in this example, the lease agreement contained a 15-year option to renew at the fair market value that will be determined at the time of renewal, the agreement would **not** result in a disqualified lease.

*Example 4:* The historic Pine School was in dire need of a substantial rehabilitation. The school sold the building to a XYZ Limited Partnership for \$500,000. The Partnership spent \$1,000,000 rehabilitating the property. The Partnership leased the property back to St. Johns School. The resulting agreement would be a disqualified lease because Internal Revenue Code § 168(h)(1)(B)(iv) specifically states a disqualified lease occurs after a sale (or other transfer) of property by, or lease of the property from, the tax-exempt entity and the property has been used by the entity before the sale (or other transfer) or lease.

**[Revised April 2022]**