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Insights

Community Affairs
Department

Historic Tax Credits: Bringing New Life to Older Communities

Abstract:

For more than 30 years, the federal Historic Tax Credit (HTC) Program has helped revitalize communities by encouraging the flow of private funds to facilitate the rehabilitation of historic buildings. Under the program, owners of historic properties partially finance the costs of rehabilitation and restoration of certified historic properties by “selling” the credits to third parties, which may include national banks. The acquirers of the HTCs are able to acquire the tax credits through the purchase of an interest in limited partnerships that own the underlying historic property. This *Insights* report describes how this tax credit program operates, outlines the risks and regulatory considerations of participation in the program, and discusses how the purchase of these credits by national banks may be considered under the Community Reinvestment Act (CRA).¹

The report includes the OCC’s understanding of U.S. federal income tax laws and regulations but does not constitute tax advice. Banks should consult their own tax advisers about these tax treatments and the consequences that may apply to their own transactions.

I. What Is the HTC Program?

Since the Tax Reform Act was enacted in 1976, the HTC program has leveraged more than \$45 billion in private funds to create nearly 382,000 rehabilitated housing units, of which 24 percent are low- and moderate-income (LMI) housing units.² The U.S. Departments of the Interior and Treasury jointly administer the HTC program.³ The National Park Service (NPS) acts on behalf of

¹ National banks have two sources of legal authority that permit them to provide financing to HTC projects in return for the tax credits associated with the project: 12 USC 24(Eleventh) and 12 USC 24(Seventh). Under 12 USC 24(Eleventh), national banks are given authority to make loans and investments to promote the public welfare. Under 12 USC 24(Seventh), national banks may arrange the financing for an HTC project in such a manner as to make the bank eligible to receive the federal HTCs by acquiring an interest in the entities that hold the properties for rehabilitation. The substance of the transaction must remain the provision of financing for the rehabilitation of historic property. See Section I, National Bank Legal Authority, of this *Insights* report.

² The Historic Rehabilitation Tax Credit Program, which involves the rehabilitation of real property (buildings), is also referred to as the Historic Tax Credit (HTC) program in Treasury Regulation Section 1.48-12, 26 CFR 1.48-12. For simplicity, this report refers to the HTC program. Facts about the performance of the HTC program are available from the U.S. Department of the Interior, National Park Service, “Federal Tax Incentives for Rehabilitating Historic Buildings,” Statistical Report and Analysis for Fiscal Year 2007, Technical Preservation Services, February 2008.

³ Additional information about the federal tax incentives for historic preservation and rehabilitation is available from the U.S. Department of the Interior, National Park Service at www.nps.gov/history/hps/tps/tax/brochure1.htm. Information about the HTC program is also available from the U.S. Department of the Treasury and the IRS at www.irs.gov/businesses/small/industries/article/0,,id=97599,00.html.

the Secretary of the Interior, in collaboration with the State Historic Preservation Officer (SHPO) in each state.⁴ The Internal Revenue Service (IRS) acts on behalf of the Secretary of the Treasury. The HTC program encourages the rehabilitation, restructure, and reconstruction of certified historic buildings through the provision of tax credits to property owners equal to 20 percent of the qualified rehabilitation expenditures.⁵

The year a property is placed in service, an owner of a certified rehabilitated historic property is eligible to receive the tax credits and is subject to a five-year compliance period.⁶ When the owners of the rehabilitated properties are unable to use the tax credits, they create limited partnerships that allow third-party funders, such as national banks that can use the credits, to provide financing for the project. When third parties provide funding in exchange for use of the credits, it helps to reduce the project's financing costs. Under the Internal Revenue Code (IRC), in order to receive the HTCs, the third-party funder must acquire an interest in the entity that holds the property for rehabilitation. These third parties typically hold such an interest during the five-year compliance period and then dispose of their interest when the credits have been used.⁷

HTCs are available to properties rehabilitated for commercial, industrial, agricultural, or residential rental purposes. The rehabilitated buildings must be depreciable and income-producing or used in businesses. HTCs are not available for properties used exclusively as an owner's private residence.⁸

The HTC program has rehabilitated buildings of every size, style, type, and historic period. Examples of properties include railroad apartments in Mississippi, art deco hotels in Miami, office towers in Chicago, skyscrapers in Michigan, row houses in Baltimore, bungalows in Los Angeles, miners' cottages in Colorado, post offices in rural areas and inner cities, and churches and theatres across the country.⁹

⁴ SHPOs carry out the National Historic Preservation Program as delegates of the Secretary of the Interior pursuant to the National Historic Preservation Act of 1966, as amended, National Historic Preservation Act, 16 USC 470. Information about a SHPO's responsibilities is available from the National Conference of State Historic Preservation Officers at www.ncshpo.org.

⁵ Title 26 of the USC, the IRC, Section 47 (formerly Section 48) also provides for a 10 percent HTC for the rehabilitation of nonhistoric, older (pre-1936) non-residential properties. Unlike the 20 percent HTC, however, the 10 percent tax credit is primarily used by building owners for personal tax purposes and does not typically include financial contributions from funders. This *Insights* report focuses only on the 20 percent HTC. A detailed description of the 20 percent and 10 percent HTC is provided by the National Park Service, "Historic Preservation Tax Incentives: Technical Preservation Services," U.S. Department of the Interior, at www.nps.gov/history/hps/tps/tax/brochure1.htm.

⁶ "Placed in service" refers to the date that the rehabilitation work has been completed and a certificate of occupancy has been issued. The U.S. Department of the Interior regulations governing the procedures for obtaining historic preservation certification are located in 36 CFR Part 67.

⁷ National banks organized under Title 26, IRC, Chapter 1, Subchapter S, as "S" corporations, pass through HTCs and passive losses to their shareholders. However, "S" corporation shareholders are subject to the normal limitations on taking those credits or deductions, including the passive activity loss limitations, which limit passive loss deductions. Interested parties should contact their tax advisors for additional information.

⁸ Some limitations also exist for certain tenants of rehabilitated historic properties. For example, tax exempt entities cannot lease more than 35 percent of the rentable area in a rehabilitated building unless the lease terms are limited in length and there are no purchase options at the end of the lease term. There are also restrictions on the sale and leaseback arrangements with tax exempt entities. The tax exempt user rules are complex and should be analyzed carefully on a project-by-project basis. See IRC Section 47(c)(2)(B)(v), 26 CFR 1.48-12(c)(7), and IRC Section 168(h).

⁹ See U.S. Department of the Interior, National Park Service, "Federal Tax Incentives for Rehabilitating Historic Building," National Center for Cultural Resources, Heritage Preservation Services Division, Technical Preservation Services, Washington, DC, June 2001.

National Bank Legal Authority

Typically, if developers of HTC projects cannot use the tax credits, they will offer the credits to third parties, including banks, to raise the funding for a project and thereby reduce the financing costs for property rehabilitation.¹⁰ National banks have two sources of legal authority that permit them to provide financing to HTC projects in return for the tax credits associated with the project.

The first source of authority is 12 USC 24(Eleventh). Section 24(Eleventh) authorizes national banks to make loans and investments, each of which is designed primarily to promote the public welfare, including the welfare of LMI communities or families (such as by providing housing, service, or jobs). OCC regulations at 12 CFR 24 (Part 24) implement this statutory authority.¹¹ Under this authority, national banks may provide financing for historic property rehabilitation projects-related tax credits that promote public welfare by taking interests in entities that hold such properties for rehabilitation.¹²

The second source of authority is 12 USC 24(Seventh). Under Section 24(Seventh), depending on the specifics of the transaction, national banks may be authorized to finance an HTC project in such a manner as to make the bank eligible to receive the federal HTCs by acquiring an interest in the entities that hold the properties for rehabilitation. The substance of the transaction must remain the provision of financing for the rehabilitation of the historic property.¹³

Under both authorities, a national bank acquires an interest in an entity that holds the properties for rehabilitation. Using this structure, national banks provide the funding for HTC projects in return for the associated tax credits.

II. Why Are HTCs of Interest to Banks?

Banks participate in the HTC program for a number of reasons. Among them are:

- Earning attractive economic rates of return.
- Leveraging other tax credit programs and increasing the possibility of receiving favorable CRA consideration.
- Contributing to the stabilization or revitalization of historic communities, many of which are located in LMI geographies, designated disaster areas, or designated distressed or underserved nonmetropolitan middle-income geographies.
- Gaining opportunities to diversify into other credit products and services.

¹⁰ Under federal income tax law, HTCs may be taken only by property owners who have the benefits and burdens of ownership, such as limited partnerships (LPs) and limited liability companies (LLCs) owners.

¹¹ The Part 24 public welfare investment authority permits banks to make investments that benefit LMI individuals or LMI areas as well as areas targeted for redevelopment by a governmental agency. Eligible public welfare investments also include projects that would be “qualified investments” under CRA. Further discussion about Part 24 investments is given in Section IV.

¹² Pursuant to this authority, the provision of funds is limited to 5 percent of a national bank’s capital and surplus without prior OCC approval, with up to an additional 10 percent (15 percent total) if the OCC determines, by order, that an additional amount will not pose a risk to the deposit insurance fund and that the bank is not undercapitalized. National banks seeking to use the Part 24 authority to fund HTC projects must either request prior OCC approval or submit an after-the-fact notice to the OCC, depending on the bank’s safety and soundness profile and the nature of the activity.

¹³ See OCC Corporate Decision No. 99-07 (March 26, 1999) available at www.occ.treas.gov/interp/apr99/cd99-07.pdf. By structuring the financing to take advantage of the tax credits, the bank may reduce the borrower’s financing costs while itself receiving an appropriate yield. The provision of financing pursuant to Section 24(Seventh) is subject to a national bank’s legal lending limits, 12 USC Section 84 and 12 CFR Part 32. However, the financing is not subject to the limitations and restrictions in Section 24(Eleventh) and Part 24.

Competitive Yields

The HTC program is an additional financing opportunity banks may pursue, depending on their risk tolerance and tax credit appetite. According to industry sources, the returns on HTC financing arrangements have been consistently above the after-tax, five-year Treasury yields. In recent years, the returns have ranged between 7 percent and 10 percent in competitive geographies and 10 percent or higher in less competitive areas.

Additional Commercial Lending Opportunities

HTC projects are essentially commercial real estate transactions undertaken by developers and property owners. The program provides banks with opportunities to expand their existing customer relationships and to develop new ones by offering additional products and services related to a developer's proposed project. Loan products that are often required in conjunction with the development of HTC projects include:

- Predevelopment and acquisition loans.
- Bridge loans.¹⁴
- Construction loans.
- Permanent mortgage financing.
- Letters of credit.
- Warehouse lines of credit.¹⁵

Favorable CRA Consideration

Some projects that receive HTCs may also meet the definition of community development in the CRA regulation and therefore may receive favorable CRA consideration. Community development includes affordable housing (including multifamily rental housing) for LMI individuals and community services targeted to LMI individuals. It also includes community development activities that revitalize or stabilize LMI geographies, designated disaster areas, or designated distressed or underserved non-metropolitan middle-income geographies.

Banks that finance HTC properties located within the bank's assessment area would receive positive CRA consideration, to the extent that the community development definition is met. In addition, financing HTC properties located in the broader statewide or regional area that includes the bank's assessment area(s), may receive positive CRA consideration, provided the bank has otherwise adequately addressed the community development needs of its assessment area(s), even if these properties will not directly benefit the institution's assessment area(s).¹⁶

¹⁴ Bridge loans are short-term loan credit facilities provided by banks to cover capital calls during the construction period. Also known as "subscription obligation financing," these credit facilities are typically secured by the unconditional commitment of funders. These credit facilities are typically used to generate higher internal rates of return required to attract capital as well as to better manage the capital call process.

¹⁵ Banks can provide warehouse lines of credit, allowing developers to acquire the historic properties. The repayment source is financing from tax credit funders and capital generated by lease payments/rental proceeds.

¹⁶ See the 2001 Interagency CRA Questions and Answers, Section 12(i) & 563e.12(h)-5 (66 Federal Register 36620 and 36626-27, (July 12, 2001)) and the 2007 proposed Interagency CRA Question and Answers, Section 23(a)-2 (72 Federal Register 37922 and 37944, (July 11, 2007)) for more information about the geographic considerations for meeting community development needs.

III. How Does the HTC Program Work?

HTCs are used by property owners of certified historic buildings—or developers that are long-term lessees of these properties—to finance rehabilitation projects.¹⁷ Typically, property owners or developers are unable to make use of the HTCs that would arise with the rehabilitation. To lower the cost for rehabilitation, an HTC property owner/developer and a financier, such as a bank, establish a subsidiary entity. This structure permits a bank to receive the HTCs while reducing the cost of financing the rehabilitation project.¹⁸ A bank typically has a substantial interest (e.g., 99.99 percent) in the subsidiary and the property owner/developer has a *de minimis* (e.g., 0.01 percent) interest.

The subsidiary, typically a limited partnership (LP) or limited liability company (LLC), receives HTCs the year that a property is placed in service. Members/partners of the subsidiary receive an interest share of tax credit benefits, profits, losses, and cash flows associated with the property. To avoid tax credit recapture, the members/partners of the subsidiary must retain ownership of the property for a five-year compliance period following the year a property is placed in service. HTCs cannot be transferred to subsequent property owners/developers or funding members/partners.¹⁹ (Appendix A illustrates an HTC project case study.)

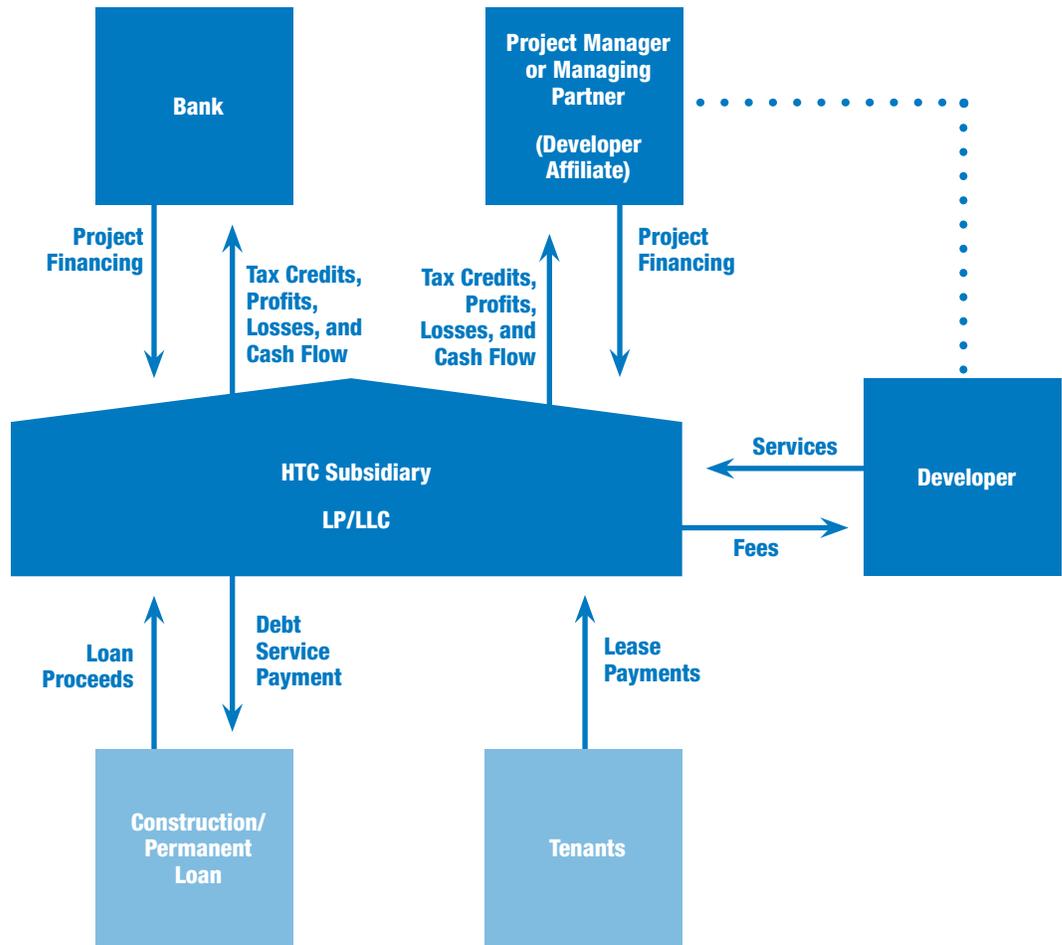
Figure 1 describes a typical single-entity structure, a common structure for simpler HTC projects. A property owner/developer and a bank establish an HTC subsidiary, typically a LP/LLC. The bank provides financing for the HTC project's rehabilitation and has a substantial interest (e.g., 99.99 percent) in the HTC subsidiary. The project manager/managing partner, a developer affiliate, provides financing to the HTC subsidiary and has a *de minimis* interest (e.g., 0.01 percent) in the HTC subsidiary. The bank and the project manager/managing partner receive their interest share (99.99 percent and 0.01 percent, respectively) of tax credits, profits, losses, fees, and cash flow from the HTC subsidiary. Tenant lease payments flow to the HTC subsidiary, while the HTC subsidiary makes debt service payments on construction and permanent loans to the lender.

¹⁷ Taxable lessees may be eligible to claim HTCs provided that the lease term is as long as the recovery period, currently 39 years for non-residential property and 27.5 years for rental residential real estate property. See IRC Section 168(e) and IRC Section 47(c)(2)(B).

¹⁸ Under 26 CFR 1.46-3(d), HTCs may be taken by property owners, including LP and LLC property owners, who have the benefits and burdens of ownership.

¹⁹ See Mark Primoli, "Tax Aspects of Historic Preservation," IRS, October 2000, for more information about tax credit recapture and ownership requirements at www.irs.gov/pub/irs-utl/faqrehab.pdf.

Figure 1
Typical Single-Entity Structure
HTCs



Financing, Tax Credits, Debt Service, and Lease Payments

- Property owner/developer and bank establish the HTC subsidiary.
- Bank provides financing for the rehabilitation of the HTC project and has substantial interest (e.g., 99.99 percent) in the HTC subsidiary.
- Project manager/managing partner, typically a developer affiliate, provides financing to the HTC subsidiary and has a *de minimis* interest (e.g., 0.01 percent) in the HTC subsidiary.
- Bank receives its interest share (e.g., 99.99 percent) of tax credits, profits, losses, fees, and cash flow from the HTC subsidiary.
- Project manager/managing partner receives its interest share (e.g., 0.01 percent) of tax credits, profits, losses, fees, and cash flow from the HTC subsidiary.
- HTC subsidiary receives lease payments and makes the debt service payments on construction and permanent loans to the lender.
- Developer provides services and receives fees from the HTC subsidiary.

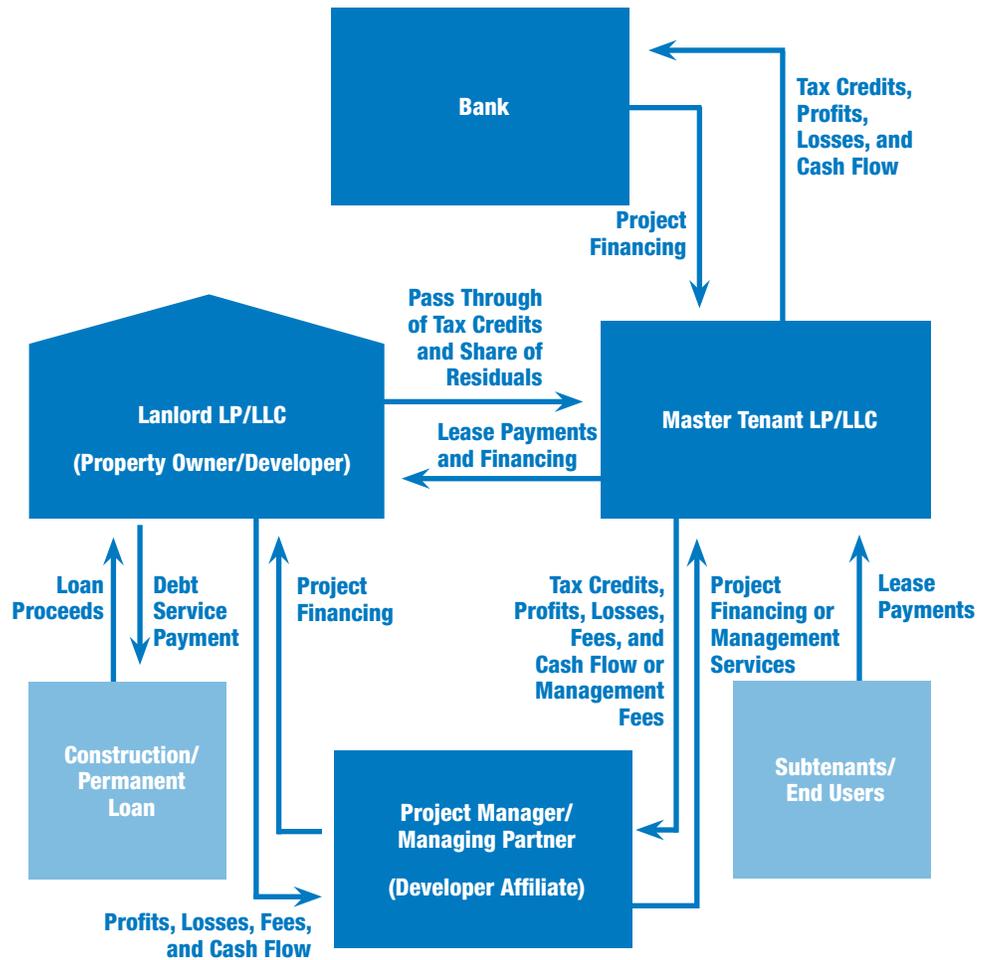
Figure 2 displays a master lease/credit pass-through structure. The property owner/developer establishes a landlord LP/LLC (landlord). The property owner/developer and the bank establish a master tenant LP/LLC (master tenant). An affiliate of the developer typically manages the master tenant. The bank provides financing for the HTC project's rehabilitation and has substantial interest (e.g., 99.99 percent) in the master tenant. The project manager/managing partner provides financing or management services to the master tenant and has a *de minimis* interest (e.g., 0.01 percent) in the master tenant.²⁰ The landlord passes through tax credits and share of residuals to the master tenant. The bank receives its interest share (e.g., 99.99 percent) of the tax credits, profits, losses, and cash flow from the master tenant. The project manager/managing partner receives its interest share (e.g., 0.01 percent) of the tax credits, profits, losses, fees, and cash flow or management fees from the master tenant. Lease payments made by the subtenants/end users, along with financing, flow from the master tenant to the landlord. The landlord makes the debt service payments on construction and permanent loans to the lender. The project manager/managing partner may contribute financing and receive a substantial share (e.g., 70 percent to 90 percent) of the profits, losses, fees, and cash flow held by the landlord.²¹

Funding for certified historic properties also can be raised from syndication. Typically, syndicators identify potential HTC projects for funders based on the relationships they have cultivated with property owners, developers, accountants, lawyers, architects, and others in the historic preservation industry. A syndicator creates a fund LP/LLC that is financed by a single funder who provides financing for one or more HTC projects. Syndicators are typically responsible for project underwriting, due diligence, and property management activities for their funders over the five-year compliance period.

²⁰ IRC Section 47(c)(2)(B)(vi) provides that a lessee (e.g., master tenant) is eligible to claim HTCs when the lessee incurs the costs of rehabilitation, and the lease term is greater than the recovery period determined under IRC Section 168(c). Moreover, IRC Section 48(d) and 50(d)(5) provide that HTCs can be passed from the landlord LP/LLC (landlord), as structured in this example, to the lessee (e.g., master tenant). A detailed discussion about lessee use of HTCs is provided by the IRS, "Topical Tax Brief: Use of Rehabilitation Tax Credits by Lessees," written by Mark Primoli and available at www.nps.gov/history/hps/tps/tax/IRSlessee.html.

²¹ The master tenant may choose to obtain a relatively small (e.g., 10 percent to 30 percent) ownership interest in the landlord (not shown in Figure 2).

Figure 2
Typical Master Lease/Credit Pass-Through Structure
HTCs



Financing, Tax Credits, Debt Service, and Lease Payments

- Property owner/developer establishes landlord LP/LLC (landlord).
- Property owner/developer and bank establish master tenant LP/LLC (master tenant), which is typically managed by an affiliate of the developer.
- Bank provides financing for the rehabilitation of the HTC project and has substantial interest (e.g., 99.99 percent) in the master tenant.
- Project manager/managing partner provides financing or management services to the master tenant and has a *de minimis* interest (0.01 percent) in the master tenant.
- Landlord passes through tax credits and share of residuals to the master tenant.
- Bank receives its interest share (e.g., 99.99 percent) of tax credits, profits, losses, and cash flow from the master tenant.
- Project manager/managing partner receives its interest share (e.g., 0.01 percent) of the tax credits, profits, losses, fees, and cash flow or management fees from the master tenant.
- Landlord receives lease payments and financing from the master tenant. Landlord makes the debt service payments on construction and permanent loans to the lender.
- Project manager/managing partner may contribute financing to the landlord and receive a substantial share (e.g., 70 percent to 90 percent) of the landlord's profits, losses, fees, and cash flow.

Historic Preservation Certification Application Process

To receive HTCs, property owners must complete the historic preservation certification application process. Typically, this process involves developer interaction with a SHPO. There are three parts to this process:

- Part 1 – certification of the building as an historic structure.
- Part 2 – certification of the proposed rehabilitation plan for the building.
- Part 3 – certification that the rehabilitation has been completed according to the certified rehabilitation plan.

A developer’s completion of at least Part 1 and Part 2 of the certification application process is an important consideration for banks contemplating funding an HTC project.²² Without having completed Part 2 certification, a project may not receive the final rehabilitation certification (Part 3), thereby putting the tax credit funds at substantial recapture risk.²³

HTC Calculation and Allocation

A certified historic building must be depreciable in terms of being held for the production of income for purposes that include a trade or business. The qualified rehabilitation expenditures (QREs) include the development costs for which HTCs can be claimed.²⁴ The dollar value of tax credits is calculated by multiplying the value of the QREs by the 20 percent HTC rate. Figure 3 is an example of how HTCs are calculated for a hypothetical HTC project. It shows the financing generated from HTCs for the project. The hypothetical project has \$40 million in QREs. This translates to \$8 million in tax credits. In this example, a bank with a 99.99 percent interest paying an estimated \$0.93 for each dollar of tax credits would contribute \$7,439,256 in financing to the project, while receiving \$7,999,200 in HTCs.²⁵

Figure 3
HTC Financing for a Hypothetical HTC Project

	Project
Qualified Rehabilitation Expenditures (QREs)	\$ 40,000,000
Tax Credit Rate	20 %
Tax Credit Dollar Amount	\$ 8,000,000
Funder Tax Credit Allocation (99.99% interest in project)	\$ 7,999,200
Price Per Tax Credit Dollar	\$0.93
Tax Credit Financing Raised	\$ 7,439,256

²² The NPS and the IRS strongly encourage owners to apply for rehabilitation certification prior to beginning the rehabilitation process.

²³ More information about the historic preservation certification application process is available at www.nps.gov/history/hps/tps/tax/hpcappl.htm.

²⁴ QREs include, but are not limited to, the costs related to walls, partitions, floors, ceilings, windows, doors, air conditioning/heating systems, plumbing and plumbing fixtures, other related building construction, and specific fees. Fees considered as qualified expenditures may include, but are not limited to, certain payments for developer, architectural, engineering, and legal services. See IRC Section 47(c)(2). The National Trust Community Investment Corporation also provides a detailed discussion about qualified and unqualified rehabilitation expenditures at www.ntcicfunds.com/taxcreditguide.

²⁵ Industry sources suggest that a price of \$0.93 per dollar of tax credits is a reasonable mid-range value for this example.

A primary economic benefit from HTC financing is the opportunity to claim the full amount of federal tax credits in the year that the property is placed in service. However, the compliance period follows for five years thereafter, during which there is risk of recapture.

Developer Guarantees

Developers provide funders with numerous guarantees related to the project. Guarantees are typically given for construction completion deadlines, operating deficit, environmental indemnification, and tax credit indemnity. Other guarantees provided by the developer will depend on the project, its pay-in structure, and perceived risk to the funder.

Exit Strategy

When a partnership is established, parties typically agree to a put or call exit strategy. The parties do this because tax credit funders want to exit the partnership after the tax compliance period. Regardless of whether a put or call option is exercised, profit must be the motivation used for valuing these exit strategy options.²⁶ A put option gives the funder the right to sell its LP/LLC interest. Under these circumstances, the developer (or its affiliate) is obligated to purchase the put option from the funder at a price typically calculated as a percentage of total capital contributions made by the funder plus any unpaid priority return due to the funder.²⁷ A call option gives the developer (or its affiliate) the right to purchase the LP/LLC interest at a fair market value determined at the time the option is exercised.

IV. What Are the Key Risks and Regulatory Issues Associated with HTC Financing?

Banks active in the HTC business typically underwrite project funding requests under commercial real estate credit guidelines. Developers and syndicators provide banks with project-specific construction budgets, operating income projections, and financial statements. Once banks have completed normal due diligence to their satisfaction, they need to understand and accept the risks associated with this transaction for the five-year compliance period.

Tax Planning, Compliance, and Recapture Risk

HTCs are designed to reduce a funder's tax liability. Banks must be able to project taxable income over the term of the compliance period. Moreover, banks should evaluate their exposure to the alternative minimum tax (AMT) because the tax credits may be used to reduce ordinary tax liability but not their AMT liability.²⁸ As a result, banks that expect to be subject to the AMT should carefully evaluate to what extent they can use tax credits to reduce their overall tax liability when calculating their rate of return.

A primary economic benefit from financing a HTC project is the opportunity to claim the full amount of federal tax credits in the year that the building is placed in service. However, the potential loss of the tax credit and its recapture by the IRS represent a substantial risk to a bank. Recapture triggers, which can occur during the five-year compliance period, may include, but are

²⁶ The put/call provision in a partnership agreement must be carefully drawn up to avoid mischaracterization of the partnership arrangement and sale of ownership, potentially invalidating the tax credit allocation.

²⁷ According to industry sources, the percentage used for this calculation is typically between 15 percent and 20 percent.

²⁸ See also the amendments made to the treatment of the AMT on HTCs in the Housing and Economic Recovery Act of 2008 enacted July 30, 2008.

not limited to, the disposition of property (e.g., sale, foreclosure, or transfer of more than one-third ownership), revocation of the NPS certification, and conversion by the property owner to tax-exempt status.²⁹ Figure 4 shows the recapture rates over the five-year compliance period. Once the five-year compliance period is over, the IRS cannot recapture the tax credit and bank funders typically exit the LP/LLC.

Figure 4
Recapture Rates

	Recapture Rate (%)
If the building is disposed of:	
less than 1 year from placement into service	100
after year 1 but prior to end of year 2 from placement into service	80
after year 2 but prior to end of year 3 from placement into service	60
after year 3 but prior to end of year 4 from placement into service	40
after year 4 but prior to end of year 5 from placement into service	20
after year 5	0

Source: IRC Section 50(a).

Banks financing HTC projects in syndicated funds rely on the syndicators to aggregate all of the required tax information. Syndicators are also responsible for monitoring projects and managing the risks associated with the funders' portfolios over the five-year compliance period.

Banks that directly finance HTC projects (i.e., through a means other than syndicated funds) are primarily responsible for their own tax compliance activities. This information is typically provided to banks by project managers or managing partners. Banks also rely on project managers or managing partners to maintain the properties in a tax compliant manner. Banks with large HTC portfolios typically have established property management units within their commercial real estate departments to oversee the maintenance of these properties and to mitigate the risk of recapture. Banks financing their first HTC project should consider experienced partners, including syndicators that have proven track records in structuring and managing HTC projects.

Underwriting and Credit Risk

Management

A bank must perform due diligence to determine the financial capacity, performance, management capacity, and expertise of the developer and the project manager or managing partner. Evaluations must be made of the developer, the organization that will operate the property as the project manager or managing partner, and the syndicator, when applicable. The strength of these

²⁹ See the IRS, "Rehabilitation Tax Credit Recapture," written by Mark Primoli and available at www.nps.gov/history/hps/tps/tax/IRSrecapture.htm and the IRS, "Use of the Rehabilitation Tax Credit by Lessees," written by Mark Primoli and available at www.nps.gov/history/hps/tps/tax/IRSlessee.html.

development partners is measured by their proven track records and management skills. A bank should ensure that these development partners have adequate financial, management, and compliance monitoring resources to support the viability and success of the project. Confidence in the development partners' abilities to meet the rehabilitation standards required to complete the historic preservation certification process and to fulfill the other managerial responsibilities is needed to minimize uncertainties about whether the project will meet the bank's targeted rate of return.

Real Estate Underwriting

Banks review HTC projects as commercial real estate transactions. For example, during the construction and lease-up phase (which typically lasts one to three years), banks consider all of the sources and uses of construction financing and calculate expected costs to be included in the eligible basis. Because all HTC projects involve construction, banks will also need to evaluate the experience, strength, and reputation of the general contractors who are responsible for completing the rehabilitation projects on time and on budget while meeting the NPS standards.

Other typical underwriting elements include such items as site location within a neighborhood, market demand, rents and expenses, and project financing rates and terms. Additionally, banks must understand the project's reserves, debt service coverage, and guarantees. Developers and managing partners or project managers typically provide funders with completion, operating, and tax credit delivery guarantees to mitigate the risk associated with this type of real estate financing. Unconditional guarantees for timely completion of construction and the receipt of historic certification are important considerations because a non-certified and unfinished project will never produce tax credits.

Collateral and Repayment Risk

A bank, as a limited partner in a partnership, typically has a 99.99 percent interest in the subsidiary entity that owns or leases the underlying real estate assets of the partnership. To the extent that an HTC project includes first mortgage financing from another source, there is repayment and foreclosure risk. However, the risk associated with recapture ends when the five-year compliance period ends. A bank that funds HTC projects relies on these underlying properties to perform and produce cash flows as proposed.

Operational and Reputation Risk

HTC projects tend to include unique and complex transactions, requiring compliance with numerous rules and regulations. Project development teams involve many different players, including, but not limited to, developers, syndicators, contractors, architects, lawyers, accountants, and property managers. Having a team of experienced and independent third-party consultants, such as real estate lawyers, tax accountants, finance consultants, appraisers, real estate management companies, and regulatory compliance experts, can help banks reduce operational and reputation risk.

Part 24

On the regulatory side, national banks may make investments primarily to promote the public welfare under the community development investment authority in 12 USC 24(Eleventh) and its implementing regulation, 12 CFR 24 (Part 24). As discussed earlier in section I of this *Insights* report, the OCC's Part 24 implements that section of the act, which authorizes national banks to make loans and investments to promote the public welfare by benefiting primarily LMI individuals, LMI areas, or government-targeted redevelopment areas. Eligible public welfare investments also include projects that would be "qualified investments" under CRA. Under this authority, national banks may provide financing for historic property rehabilitation projects, and gain the related tax credits, by taking interests in entities that hold such properties for rehabilitation if the projects are consistent with the public welfare requirements of Part 24.

National banks seeking to provide financing to HTC projects under Part 24 must either request prior OCC approval or submit an after-the-fact notice to the OCC, depending on the bank's safety and soundness profile, CRA performance, and the nature of the project financing.³⁰

Accounting Considerations

HTC projects financed directly or through syndicated funds with conduit LPs or LLCs could be accounted for under the cost or equity method of accounting or may result in consolidation depending on the level of control the bank exercises over these entities.³¹

V. Who Is in the HTC Business Today?

Numerous parties are involved in the complex process of rehabilitating certified historic properties.

NPS, IRS, and SHPOs

The NPS administers the HTC program in partnership with the IRS and the SHPOs. To receive a 20 percent HTC, property owners must complete the historic preservation certification application process administered by the NPS and the SHPO in their states and follow the laws and regulations stipulated by the IRS tax authority.

Developers

HTC developers may be for-profit or nonprofit organizations, joint ventures, partnerships, limited partnerships, trusts, corporations, and limited corporations. Some developers (or their affiliates) will also participate in HTC transactions as project managers (in LPs) or managing partners (in LLCs) for property owners and/or master tenants that sublease the buildings. In addition, some developers may create joint ventures with nonprofits or for-profit organizations that manage the HTC properties after the projects have been placed in service.

Funders

HTC funders can be persons, corporations (e.g., banks), public entities, and nonprofit organizations.

Syndicators

Syndicators are usually for-profit organizations that identify HTC financing opportunities for funders and property owners. They are generally responsible for project underwriting, due diligence, and property management activities over the five-year compliance period. However, banks remain responsible for their fund or project-level financing due diligence. Typically, syndicators create proprietary funds used to finance HTC projects.

Banks

In addition to purchasing tax credits, banks, as credit providers in HTC transactions, offer numerous other types of financing to developers of historic properties. Among the types of credit facilities provided are predevelopment and acquisition loans, bridge financing, construction loans, permanent mortgage financing, letters of credit, and warehouse lines of credit.

³⁰ Resource information about the provisions of Part 24 community development investments is available on the OCC's Community Affairs Web page at www.occ.gov/cdd/pt24toppage.htm.

³¹ See the Financial Accounting Standards Board Interpretation No. 46, available at www.fasb.org/pdf/fin%2046.pdf.

Third-party Experts

Financing HTCs involves a fairly complex set of transactions. Real estate lawyers, tax accountants, architects, historic rehabilitation consultants, appraisers, real estate management companies, and regulatory compliance experts are among the numerous professionals that bring important expertise and experience in terms of organizing, financing, and managing HTC projects.

VI. How Does the Cost/Pricing Structure of HTCs Work?

To determine the risk-adjusted return on a transaction offered to them, most banks have established an internal hurdle rate for HTC projects that is above the five-year U.S. Treasury note. Understanding that U.S. Treasury securities preserve principal plus earn a low-risk rate of return, banks will expect to obtain a return in excess of the current yield on a five-year U.S. Treasury note.

Banks use a number of variables to determine the returns associated with proposed HTC transactions. These variables include, but are not limited to:

- Price paid per dollar of tax credit and timing of capital disbursements into the project.
- Time line for the project to be placed in service and receipt of Part 3 certification from the NPS.
- Typical risk factors associated with commercial real estate development, such as guarantees, operations, cash flow, and property management.

Ideally, a bank would finance an HTC project with an experienced developer that has a strong balance sheet and a well-regarded general contractor who has a proven track record. The bank would pay on the low end of prices for the tax credits and disburse funds into the project in accordance with the partnership agreement. An illustrative example of a pay-in schedule for funds dispersed into an HTC project is shown in Appendix B. Variations on this type of financing are negotiated between a bank, as a limited partner, and a project manager or managing partner, or, in the case of a proprietary fund, a syndicator. Banks may obtain higher “all in” returns from HTC project transactions when they also provide construction and permanent financing.

Yields

The price paid per dollar of tax credits depends on the current market conditions, amount of tax credits, the transaction ownership structure, the pay-in schedule, the annual cash flow, the developer guarantees, and the exit strategy option.

Calculating estimated yields for financing HTC projects involves sophisticated modeling of cash flow and differs for each transaction and funder. Each transaction represents different financing elements and basis. Likewise, each funder has its own tax liability profile and risk-adjusted return expectations. The primary elements in the calculation of estimated returns from HTC projects include a bank’s federal income tax rate, the price paid for tax credits, the net value of the tax credits, and the timing of capital contributions. In addition, passive losses, such as those generated by depreciation and interest expenses, are considered for the yield projections. To maintain the projected yields on HTC projects, funders typically negotiate with developers for guarantees against factors that include tax credit recapture, cost overruns, and operating deficits.³² These guarantees help HTC funders achieve their projected yields. In recent years, the typical after-tax internal rate of return has been between 7 percent and 10 percent in competitive geographies and 10 percent or higher in less competitive areas.

³² More information about project terms and conditions, including developer guarantees, is available from the National Trust Community Investment Corporation at www.ntcicfunds.com/funds/ntcif.html.

Fees

The HTC rehabilitation business involves many interested parties and service providers. There may be fees for market and environmental analyses, architectural consulting, historical rehabilitation and NPS certification consulting, appraisals, tax accounting, syndication, legal services, and real estate management that can involve substantial initial costs and ongoing expenses. Syndicators may earn acquisition fees based on a percentage of the net capital brought to projects as well as annual property management fees. These fees are typical to bank-financed commercial real estate transactions that are traditionally funded from development budgets and operating cash flow.

Property Management

Banks actively involved in HTC projects have found it useful to establish property management units within their real estate departments. Property management units work with the project manager or managing partner to ensure the properties are well managed, operate as proposed, and comply with all HTC program requirements. Banks with large HTC portfolios also use these property management units to monitor activities. Banks with smaller HTC fund portfolios typically rely on the property management expertise of the fund manager to provide this oversight.

VII. What Barriers Have Constrained the Growth of HTCs?

Historic Preservation Certification Application Process

Eligibility for HTCs depends on the property owner's ability to complete the NPS certification application process. Successful financing opportunities are contingent on the experience and expertise of the property owner and developer to navigate through the NPS process promptly.

Highly Customized and Complex

The HTC marketplace is characterized by a substantial number of highly customized projects with complex regulatory, financial, and tax reporting issues.

VIII. Conclusion

For more than 30 years, the federal HTC program has been used to attract new private capital to the historic cores of cities and Main Streets across the nation. These funds have enhanced property values, created jobs, generated local, state and federal tax revenues, and revitalized communities. For banks, this program is an opportunity to earn attractive economic rates of return and potentially receive favorable CRA consideration. It also is a way for banks to expand existing customer relationships and establish new ones by offering additional products and services related to HTC projects. In addition, banks can partner with community-based organizations and other developers to encourage economic stability and revitalization, especially in low-income and distressed communities. When carefully implemented, financing historic properties can provide banks with economic and regulatory benefits, while contributing to the stabilization and growth of the communities in which they do business.

Appendix A

Case Study: An HTC Project

Project Size: Total project development cost was \$6 million.

Project Overview: This HTC project rehabilitated a former manufacturing building located in a low-income urban community into a mixed-use property. The rehabilitated property includes ground floor retail space, lower-level, public-use parking garage, and upper-floor residential rental units. In total, this project created 18 rental units and 6 commercial units.

Tax Credit Project Financing: A national bank was a direct funder in a limited partnership that used HTC allocations to bring an additional \$908,000 in financing. In addition, the national bank provided a letter of credit in the amount of \$200,000.

Sources of Funds	
HTC Funds (One-Time Allocation)	\$ 908,000
Permanent Financing	5,000,000
Deferred Development Fee	92,000
Total	\$ 6,000,000
Uses of Funds	
Land Costs	\$ 500,000
Rehabilitation Costs	5,400,000
Soft Costs	100,000
Total	\$ 6,000,000

Note: The facts described in the case study are based loosely on an actual HTC transaction; however, some figures and geographic markers were modified to preserve anonymity.

Appendix B
Example of a Pay-In Schedule

(For Illustrative Purposes Only)

This schedule illustrates how the financing may be disbursed into an HTC project. The timing of the financing contributions is flexible and negotiable. Frequently used pay-in milestones for a funder include admission into the LP/LLC, placed-in-service date, Part 3 certification approval date from the NPS, and stabilization of the project. Pay-in schedules reflect the unique circumstances of each project, the requirements of funders (as limited partners), and the needs of the general or managing partner.

Pay-In Contributions in Percent	Milestones	Dollar Amounts
20	Admission of funder into the LLC/LP	\$ 200,000
30	Placed-in-service date	300,000
20	Date certified historic rehabilitation approval received (Part 3 approval from the NPS)	200,000
30	Stabilization	300,000
100	Total Financed	\$1,000,000

Appendix C

Resource Directory

OCC

Part 24 Community Development Investments
www.occ.gov/cdd/pt24toppage.htm#OCCsPt24Resources

Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks
www.occ.treas.gov/ftp/release/2008-10a.pdf

New Markets Tax Credits: Unlocking Investment Potential
www.occ.treas.gov/cdd/InsightsNMTC.pdf

CityScape Capital Group

www.historicequity.com

Ernst & Young

www.ey.com/global/content.nsf/US/Tax_-_Tax_Credit_Investment_Advisory_-_Overview

Foss and Company

www.fossandco.com/fossnewpretest2.swf

Institute for Professional and Executive Development, Inc.

www.ipedinc.net

Internal Revenue Service: Rehabilitation Tax Credit – Real Estate Tax Tips

www.irs.gov/businesses/small/industries/article/0,,id=97599,00.html

National Conference of State Historic Preservation Officers

www.ncshpo.org

National Council of Affordable Housing Market Analysts

www.housingonline.com/NationalCouncilofAffordableHousingMarketAnalysis.aspx

National Housing & Rehabilitation Association

www.housingonline.com

National Housing Trust

www.nhtinc.org/index.asp

National Park Service, U.S. Department of the Interior

www.nps.gov/history/hps/tps/tax/brochure1.htm

National Trust Community Investment Corporation

www.nationaltrust.org/ntcicfunds/index.html

National Trust For Historic Preservation

www.preservationnation.org/issues/rehabilitation-tax-credits

Nixon Peabody, LLP

www.nixonpeabody.com/services_overview.asp?SID=220

Novogradac & Company, LLP

www.novoco.com/related_program/historic_tax_credit/index.php

Reznick Group

www.reznickgroup.com/sub_main.php?section_id=11&document_id=60&subpage=11

Tax Credit Capital, LLC, Small Deal Fund

www.taxcreditcapital.com

Sherrie L. W. Rhine is the primary author of this report. Other contributors include William Reeves, Beth Castro, Barry Wides, and Julie L. Williams. *Community Development Insights* reports differ from OCC advisory letters, bulletins, and regulations. *Insights* reports do not reflect agency policy nor should they be considered as definitive regulatory or supervisory guidance. Some of the information used in the preparation of this paper was obtained from publicly available sources that are considered reliable. However, the use of this information does not constitute an endorsement of its accuracy by the OCC.

