Office of the
Comptroller of the Currency
Washington, DC 20219

Community Developments

MAY 2015 COMMUNITY AFFAIRS DEPARTMENT

Insights

Historic Tax Credits: Bringing New Life to Older Communities

Abstract

For more than 35 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, the costs of rehabilitation and restoration of certified historic properties are subsidized by transferring HTCs[1] from project sponsors to third parties, which may include national banks and federal savings associations (collectively, banks).

This *Insights* report describes how this tax credit program operates, outlines the risks and regulatory considerations of participation in the program, and discusses how investments in these tax credit transactions by national banks and federal savings associations (FSA) may be considered under the Community Reinvestment Act (CRA).

This report was originally published in 2008. Since then, the Internal Revenue Service (IRS) has issued significant regulatory changes and guidance, which are described in this updated report and are important issues for banks when they consider investing in HTCs.[2]

This report includes the Office of the Comptroller of the Currency's (OCC) 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 rehabilitated more than 39,600 buildings, leveraged more than $109 billion in private funds, and generated 2.41 million jobs.[3] In 2013 alone, the HTC program completed in excess of 800 projects, which created nearly 63,000 jobs, and developed more than 25,000 new or renovated affordable housing units.[4] The U.S. Departments of the Interior and the Treasury jointly administer the HTC program. The National Park Service (NPS) acts on behalf of the

[1] The Historic Rehabilitation Tax Credit Program, which involves the rehabilitation of real property (buildings), is also referred to as the Historic Tax Credit 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 National Park Service in "Federal Tax Incentives for Rehabilitating Historic Buildings: Annual Report for Fiscal Year 2013."

[2] See IRS Revenue Procedure 2014-12, issued on December 30, 2013, and clarified on January 8, 2014.

[3] See "The Federal Historic Tax Credit: Transforming Communities," National Trust for Historic Preservation (June 2014).

[4] See "Federal Tax Incentives for Rehabilitating Historic Buildings: Annual Report for Fiscal Year 2013."

Secretary of the Interior, in collaboration with the State Historic Preservation Officer (SHPO) in each state.[5] The 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 (QRE).[6]

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.[7] When the owner of a rehabilitated property is unable to use the tax credits, it creates limited partnerships (LP) that allow third-party funders, such as banks that can use the credits, to provide financing for the project. When third parties provide funding in exchange for the credits, it helps reduce the project's need for additional financing. Under the Internal Revenue Code (IRC), to receive the HTCs, the third-party funder must acquire an interest in the entity that holds the property before the building is placed in service. These third parties typically hold such an interest during the five-year compliance period and then have the option to sell the majority of their interest back to the developer when the credits have been used.[8]

HTCs are available for properties rehabilitated for commercial, industrial, agricultural, or residential rental purposes. The rehabilitated buildings must be depreciable, income producing, and used in businesses. HTCs are not available for properties used exclusively as an owner's private residence.[9]

The HTC program has rehabilitated buildings of nearly 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 theaters across the country.[10]

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

---

[5] 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, 16 USC 470. Information about a SHPO's responsibilities is available from the National Conference of State Historic Preservation Officers.

[6] 26 USC (IRC Section 47) also provides for a 10 percent HTC for the rehabilitation of nonhistoric, older (pre-1936) non-residential properties. Unlike the 20 percent HTC, the 10 percent tax credit is used primarily 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 NPS.

[7] "Placed in service" refers to the date that the rehabilitation work was completed and a certificate of occupancy was issued. The Interior Department regulations governing the procedures for obtaining historic preservation certification are in 36 CFR 67.

[8] Banks organized under Title 26, IRC, Chapter 1, Subchapter S, as "S" corporations, pass through HTCs and passive losses to their shareholders. "S" corporation shareholders, however, 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 advisers for additional information.

[9] 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 Sections 47(c)(2)(B)(v) and 168(h), and 26 CFR 1.48-12(c)(7).

[10] See "Federal Tax Incentives for Rehabilitating Historic Buildings," National Park Service.

reduce the amount of financing for property rehabilitation.[11] Banks have various sources of legal authority that permit them to provide financing to HTC projects in return for the associated tax credits. A more detailed description of these authorities is included in section IV of this report.

II. Why Are HTCs of Interest to Banks?

Banks participate in the HTC program for a number of reasons. Through the program, banks

- earn attractive economic rates of return.
- invest in certain community development-oriented projects that may qualify for positive consideration in the bank's CRA evaluation.
- support local economic development strategies, which often include historic preservation.
- contribute to the stabilization or revitalization of historic communities, many of which are located in low- and moderate-income (LMI) geographies, designated disaster areas, or designated distressed or underserved nonmetropolitan middle-income geographies.[12]
- gain opportunities to diversify into other credit products and services.
- earn protection from alternative minimum tax (AMT) loss of credit value. Credit can be applied against an investor's AMT liability.[13]

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.

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.

---

[11] Under federal income tax law, HTCs may be taken only by property owners who have the benefits and burdens of ownership, such as LPs and limited liability company (LLC) owners.

[12] See "Annual Report on the Economic Impact of the Federal Historic Tax Credit for FY 2012," National Park Service (February 2013).

[13] See IRC Section 38(c)(4)(B)(vii). The AMT is the minimum tax that a taxpayer must pay if it is greater than the taxpayer's regular income tax (IRC Section 55). It is a method of determining a taxpayer's tax liability that runs parallel to the taxpayer's regular income tax liability computation. The passage of the Housing and Economic Recovery Act of 2008 allows HTCs claimed for QREs placed in service after December 31, 2007, to be used to reduce a taxpayer's AMT.

[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 usually secured by the unconditional commitment of funders. These credit facilities are typically used to generate the higher internal rates of return required to attract capital as well as to better manage the capital call process.

- letters of credit.
- warehouse lines of credit.[15]

CRA Consideration

Some loans or investments in projects that receive HTCs may also meet the definition of community development in the CRA regulation and therefore may receive CRA consideration. Community development includes affordable housing (including multifamily rental housing) for LMI individuals; community services for LMI individuals; and small business financing that supports permanent job creation, retention, or improvement for LMI individuals in LMI areas or in areas targeted for redevelopment by federal, state, local, or tribal governments. Community development also includes activities that revitalize or stabilize LMI geographies, designated disaster areas, or designated distressed or underserved non-metropolitan, middle-income geographies.

A bank that finances HTC properties located within its assessment area or a broader statewide or regional area that includes the bank's assessment area will receive CRA consideration for those activities that meet the definition of community development as long as the purpose, mandate, or function of the activity includes serving geographies or individuals located within the institution's assessment area(s). Further, if the bank has been responsive to community development needs and opportunities in its assessment area(s), its community development activities that benefit geographies or individuals located somewhere within a broader statewide or regional area that includes the bank's assessment area(s) will be considered even if those activities do not have a purpose that includes serving individuals or geographies in its assessment area(s).[16]

III. How Does the HTC Program Work?

HTCs are available for property owners of certified historic buildings—or developers that are long-term lessees of these properties—to finance rehabilitation projects.[17] When property owners or developers are unable to make use of the HTCs, an owner or developer of a certified property establishes a subsidiary entity with investors, such as a bank. This entity permits a bank to invest in the transaction, which reduces the cost of financing the rehabilitation project, and in return receive the HTCs.[18] A bank typically has a substantial interest (for example, 99 percent) in the subsidiary and the property owner or developer has a de minimis interest (for example, 1 percent).[19]

The subsidiary, typically an LP or limited liability company (LLC), receives the full value of 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

---

[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 and rental proceeds.

[16] See the "Interagency Questions and Answers Regarding Community Reinvestment," 78 Fed. Reg. 69678, section __.12(h)-6 (November 20, 2013) for more information about the geographic considerations for meeting community development needs.

[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 Sections 168(c) and 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] These percentage interests may be subject to a flip that would reduce the bank's interest as discussed later in this report.

year a property is placed in service. HTCs cannot be transferred to subsequent property owners/developers or funding members/partners.[20]

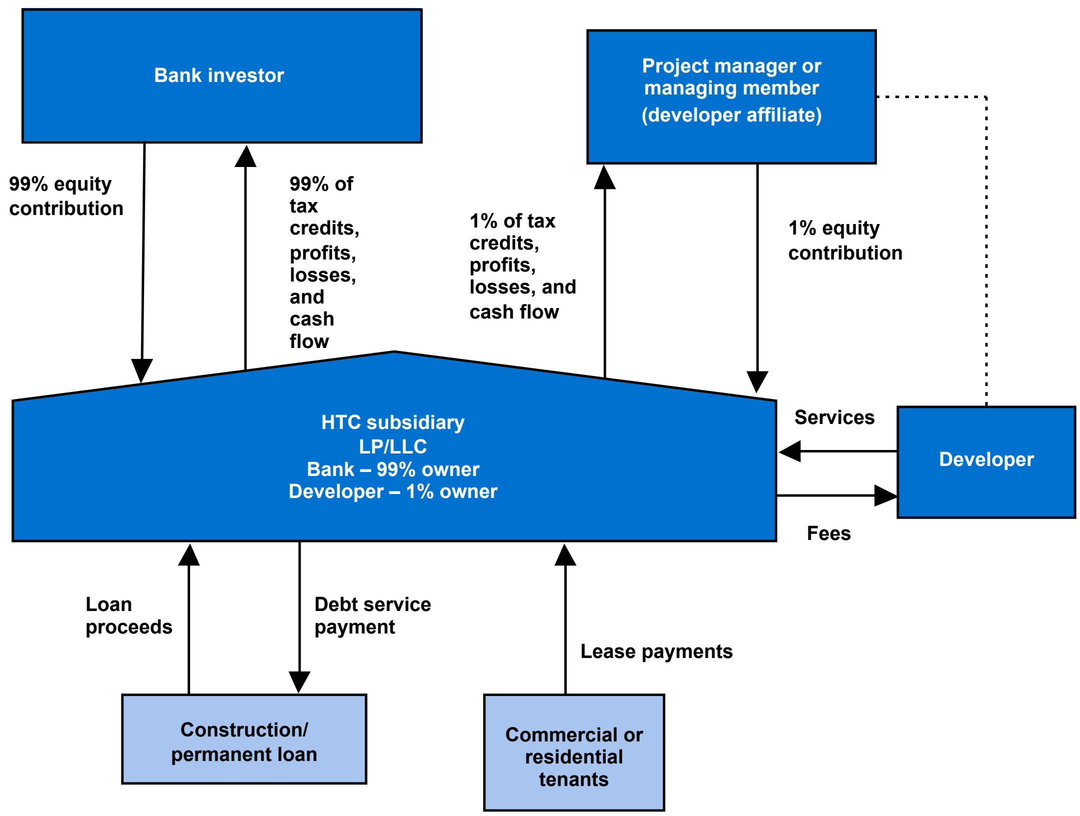
Figure 1 depicts a typical single-entity structure, a common structure for simpler HTC projects. A property owner or developer and a bank establish an HTC subsidiary, typically an LP or LLC. The bank makes an equity contribution to finance the project's rehabilitation through the purchase of the HTCs. In return, the bank investor has a substantial interest (for example, 99 percent) in the HTC subsidiary. The project manager/managing partner, a developer affiliate, provides the additional equity to the HTC subsidiary and has a de minimis interest (for example, 1 percent) in the HTC subsidiary. The bank and the project manager/managing partner receive their interest shares (99 percent and 1 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.

Equity pay-ins for the HTC traditionally are performance based. A minimum of 20 percent of investment must be paid in before placement in service. Other typical benchmarks include completion of an independent accountant's "cost certification," NPS part 3 (final) approval, and a lease up or debt service coverage threshold.

---

[20] See "Tax Aspects of Historic Preservation," by Mark Primoli, Internal Revenue Service (October 2000), for more information about tax credit recapture and ownership requirements.

Figure 1: Typical Single-Entity Structure HTCs



Financing, Tax Credits, Debt Service, and Lease Payments

- Property owner or developer and bank establish the HTC subsidiary.
- Bank investor provides equity for the rehabilitation of the HTC project and has substantial interest (for example, 99 percent) in the HTC subsidiary.
- Project manager/managing partner, typically a developer affiliate, provides equity to the HTC subsidiary and has a de minimis interest (for example, 1 percent) in the HTC subsidiary.
- Bank receives its interest share (for example, 99 percent) of tax credits, profits, losses, fees, and cash flow from the HTC subsidiary.
- Project manager/managing partner receives its interest share (for example, 1 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.

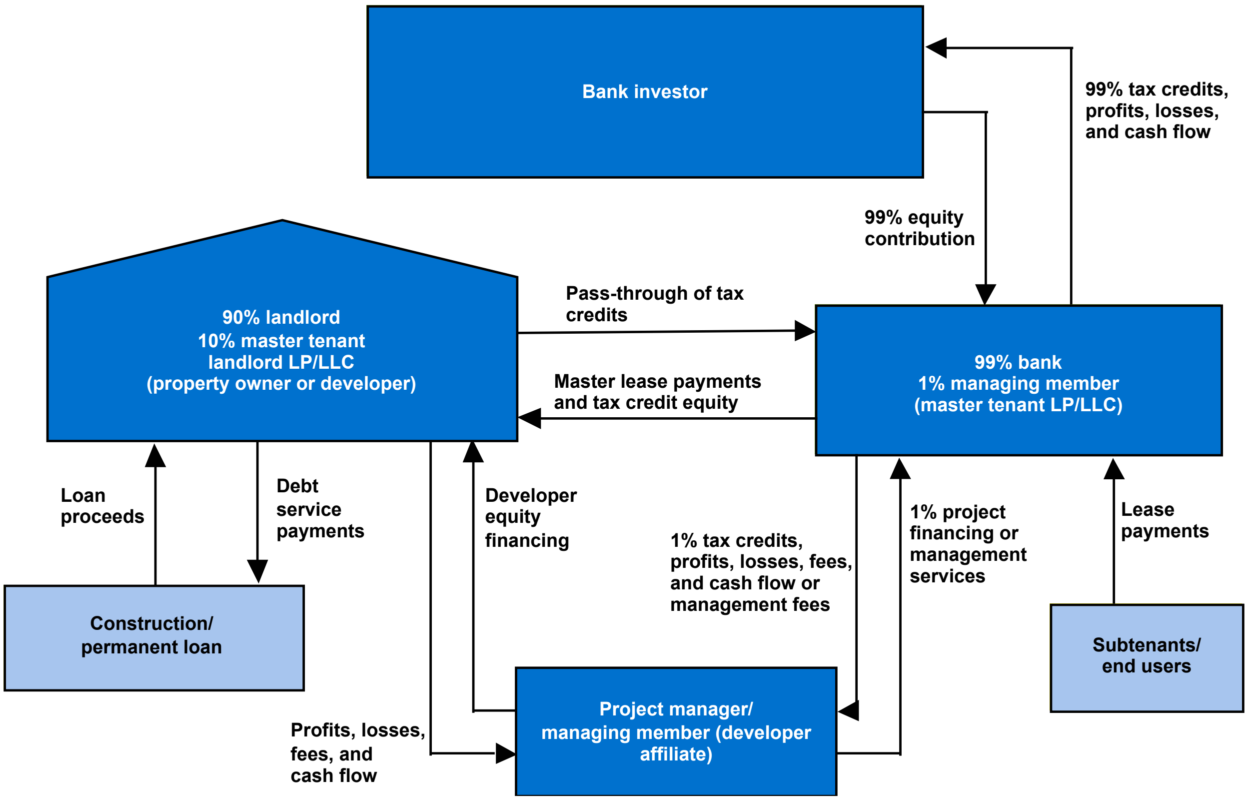
Figure 2 displays a master lease/credit pass-through structure. The property owner or developer establishes a landlord LP/LLC. The property owner or developer and the bank establish a master tenant LP/LLC. An affiliate of the developer typically manages the master tenant. The bank makes an equity contribution to finance the project's rehabilitation through the purchase of the HTCs. In return, the bank investor has a substantial interest (for example, 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 (for example, 1 percent) in the master tenant.[21] The landlord passes through tax credits and a share of residuals to the master tenant. A market rate master lease payment is made by the master tenant to the landlord and used to cover the cost of debt service. The master tenant pays the operating expenses. The subtenants or users of the property make the lease payments, which are used to cover operating expenses and the master lease payment. The bank receives its interest share (for example, 99 percent) of the tax credits, profits, losses, and cash flow from the master tenant. The project manager/managing partner receives its interest share (for example, 1 percent) of the tax credits, profits, losses, fees, and cash flow or management fees from the master tenant. 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 (for example, 51 percent to 90 percent) of the profits, losses, fees, and cash flow held by the landlord.[22]

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 typically are responsible for project underwriting, due diligence, and asset management activities for their funders over the five-year compliance period.

[21] IRC Section 47(c)(2)(B)(vi) provides that a lessee (for example, 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 Sections 48(d) and 50(d)(5) provide that HTCs can be passed from the landlord LP/LLC, as structured in this example, to the lessee (for example, master tenant). A detailed discussion about lessee use of HTCs is provided by the IRS in "Use of the Rehabilitation Tax Credit by Lessees," by Mark Primoli.

[22] The master tenant may choose to obtain a relatively small (for example, 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, which is typically managed by an affiliate of the developer.
- Bank provides equity for the rehabilitation of the HTC project and has substantial interest (for example, 99 percent) in the master tenant.
- Project manager/managing partner provides equity or management services to the master tenant and has a de minimis interest (1 percent) in the master tenant.
- Landlord passes through tax credits and share of residuals to the master tenant.
- Bank receives its interest share (for example, 99 percent) of tax credits, profits, losses, and cash flow from the master tenant.
- Project manager/managing partner receives its interest share (for example, 1 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 (for example, 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 an SHPO. There are three parts to this process:

- Part 1: Certification of the building as a 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.[23] Without the completion of part 2, a project may not receive the final rehabilitation certification (part 3), thereby putting the tax credit funds at substantial recapture risk.[24]

HTC Calculation and Pricing

A certified historic building must be depreciable and held for the production of income from a trade or business. The QREs include the development costs for which HTCs can be claimed.[25] The dollar value of tax credits is calculated by multiplying the value of the QREs by the 20 percent HTC rate. Table 1 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. In this example, a bank with a 99 percent interest paying an estimated $0.93 for each dollar of tax credits would contribute $7,365,600 in financing to the project, while receiving $8,000,000 in HTCs.[26]

Investors have noted a recent variable that can affect the pricing of master lease structures. The reporting of IRC 50(d) income has raised issues related to who will be reporting this income after the investor exits the transaction.[27] The example cited in table 1, however, is a single-tier structure for illustrative purposes only.

[23] The NPS and the IRS strongly encourage owners to apply for rehabilitation certification before starting the rehabilitation process.

[24] More information about the historic preservation certification application process is available at the NPS Web site.

[25] 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 on qualified and unqualified rehabilitation expenditures.

[26] Pricing variables in a specific transaction include, but are not limited to, size, structure, location, market, and accounting issues related to the reporting of IRC Section 50(d) income in master lease structures.

[27] See IRC Section 50(d). The mandatory basis reduction to the property in the amount of the HTC does not apply to the landlord if the HTC is passed through to the master tenant. IRC Section 50(d)(5), however, requires that the master tenant include in gross income each year an amount equal to the HTC it received from the landlord ratably over the tax depreciable life of the property that gave rise to the credit, for example, 27½ or 39 years. Thus, the HTC is amortized into income each year over the applicable recovery period. More recently, questions that have arisen include: Will the income that is required to be reported by the master tenant under IRC Section 50(d) increase the basis of the investor's interest in the master tenant? What happens to the remaining unrealized Section 50(d) income that the lessee is required to recognize into income at the time the investor exercises its put option whereby its ownership interest in the lessee is acquired? In other words, is the remaining Section 50(d) income accelerated into income in the year the investor's interest is redeemed and recognized by the investor at that time or does the Section 50(d) income continue to be included in income of the master tenant each year through the remaining recovery period? Consulting a tax adviser that is knowledgeable in HTC matters is critical for investors to analyze the impact of these issues on their overall return.

Table 1: HTC Financing for a Hypothetical HTC Project

QREs	$40,000,000
Tax credit rate	20%
Tax credit dollar amount	**$8,000,000**
Investor tax credit allocation (99% interest in project)	$7,920,000
Price per tax credit dollar	$0.93
Tax credit financing raised	**$7,365,600**

A primary economic benefit of HTC financing is the opportunity to claim the full amount of federal tax credits in the year that the property is placed in service. The compliance period, however, follows for five years thereafter, during which there is risk of recapture. This risk burns off at a rate of 20 percent per year until the entire recapture amount expires after five years.[28]

Developer Guarantees

Developers typically provide funders with numerous guarantees related to the project, but the new guidance provided by the IRS in Revenue Procedure 2014-12 specifies that most guarantees must be unfunded. Additionally, the risk of tax credit disallowance cannot be guaranteed by any partner, but the guidance states that funders may obtain third-party insurance to cover this risk.

Exit Strategy

When a partnership is established, parties typically agree on an exit strategy. One such strategy is what is referred to as a partnership flip. The parties negotiate the flip because tax credit funders may want to exit the partnership after the tax compliance period. The IRS in Revenue Procedure 2014-12 outlines a “safe harbor” governing the structuring of HTC transactions that allows the funder to put its interests back to the developer subject to certain strict requirements.[29] Under the HTC safe harbor, although the tax credit investor is permitted to have a put option to sell its interest, the developer cannot have the right to call the tax credit investor’s interests. The put price, however, which is generally agreed on at the front-end of the transaction, cannot be greater than the fair market value of the funder’s interest at the time the put option is exercised.

For the life of the transaction, the partners must maintain a meaningful upside potential (gains, deductions, credits) and downside risk (losses). At the end of the compliance period, however, the IRS allows the tax credit investor’s interest and the developer partner’s ownership interests to flip—for example, the tax credit investor’s interest during the compliance period of initially up to 99 percent can “flip down” to no less than

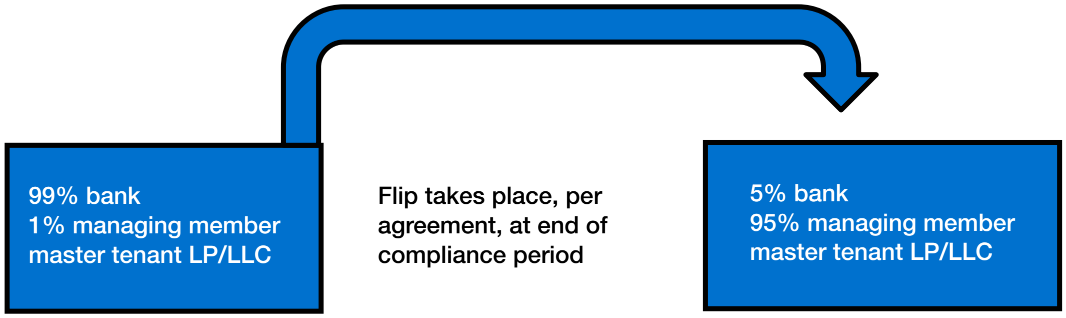
---

[28] The recapture amount is reduced by equal pro rata amounts over the five-year compliance period (unlike the Low-Income Housing Tax Credit Program and the New Markets Tax Credit Program, which do not have an “after-the-fact” compliance period).

[29] See IRS Revenue Procedure 2014-12, issued on December 30, 2013, and clarified on January 8, 2014. The IRS’s guidance clearly contemplates “flips” to be drafted into the partnership agreement between the developer and the tax credit investor. “Flip” means that the agreement between the developer and the tax credit investor will indicate that the ownership interests will change after the end of the HTC recapture period. First, the guidance provides that the minimum interest to be held by the developer at all times is 1 percent, so the HTC investor’s interest would be 99 percent during that same time period. Therefore, if the agreement between the parties allows for the “flip,” after the end of the compliance period, the HTC investor is now required to hold a minimum equal to 5 percent of the largest percentage interest. Thus, the developer and investor interests would be 1 percent and 99 percent, respectively, from the inception of their agreement through the end of the HTC compliance period, and the “flip” to 95 percent and 5 percent in favor of the developer would occur after the HTC compliance period has expired.

5 percent of the largest pre-flip percentage interest (that is, generally 5 percent of 99 percent or 4.95 percent), while simultaneously the developer partner's interest increases from a de minimis holding (1 percent) to 95.05 percent.

Figure 3: Partnership Flip



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.

As referenced in the previous section, the IRS recently issued new guidance in the form of a revenue procedure on compliance requirements for HTCs.[30] This guidance does not establish substantive law, but rather creates a "safe harbor" for funders in HTCs. If HTC transactions are structured in accordance with this guidance, the IRS will respect the allocation of credits to the funders.[31] As such, banks considering investing in HTCs should become familiar with this guidance since it will affect how future HTCs transactions are structured and their associated risks.

Tax Planning, Compliance, and Recapture Risk

HTCs are designed to reduce an investor's tax liability. A primary economic benefit from financing an HTC project is the opportunity to claim the full amount of federal tax credits in the year that the building is placed in service. The credits may be carried back one year and forward 20 years. In addition, it is important to note that unlike other federal tax credits, the HTC can be used to offset the AMT.

The potential loss of the tax credit and its recapture by the IRS, however, represent a risk to a bank. Recapture triggers, which can occur during the five-year compliance period, may include the disposition of property (for example, the sale, foreclosure, or transfer of more than one-third of managing member ownership interests), revocation of the

[30] Ibid.

[31] See memo to Historic Tax Credit Coalition members from the IRS Guidance Committee (January 10, 2014). This guidance only affects HTC transactions, not other federal credits, state credits, or transactions combining HTCs with low-income housing tax credits or new markets tax credits (http://www.novoco.com/historic/resource_files/irs/htcc-final-guidance-memo_011014.pdf).

NPS certification, and conversion by the property owner to tax-exempt status.[32] Table 2 indicates the recapture rates over the five-year compliance period. Once the five-year compliance period is over, the IRS cannot recapture the tax credit. At this point, investors typically look to exit the LP/LLC.

A study conducted for the National Trust for Historic Preservation by Novogradac & Company in 2011 found that the cumulative recapture rate for the HTC over the 10-year period 2001–2010 was only 0.73 percent. The study period included recapture activity during the recent recession. The risk of revocation of NPS certification can arise from any changes to the building during the compliance period that negatively affect character-defining features of the building and casualty loss from a natural disaster. Under good business practices, banks would require syndicators to conduct annual site visits during the compliance period to check for architectural changes. Banks should also require developers to carry casualty insurance to ensure that damage due to flooding or earthquakes can be repaired or, if not possible, to repay the credit amount.

Table 2: Recapture Rates

If the building is disposed of…	Recapture rate (%)
… less than 1 year from placement into service	100
… after year 1 but before end of year 2 from placement into service	80
… after year 2 but before end of year 3 from placement into service	60
… after year 3 but before end of year 4 from placement into service	40
… after year 4 but before 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 (that is, 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 members. Banks also rely on project managers or managing members 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 management of these properties and to mitigate the risk of recapture. Banks financing their first HTC project should consider working with experienced partners, including syndicators that have proven track records in structuring transactions and assisting with asset management functions.

Underwriting and Credit Risks

Management

Good business practices dictate that a bank should perform due diligence to determine the financial capacity, performance, management capacity, and expertise of the developer and the project manager or managing partner. These practices should include evaluation

[32] See IRC Section 50(a), which provides for recapture of the credit if, within five years from the date on which any QREs are placed in service, (a) ownership of the property changes, or (b) the property ceases to be investment credit property.

of the developer, the organization that will operate the property as the project manager or managing partner, and the syndicator, when applicable. The evaluation measures the strength of these development partners 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 that are responsible for completing the rehabilitation projects on time and on budget while meeting the NPS standards.

Banks investing in HTCs are also exposed to property operational risk. Investors in master-lease-structured properties typically participate in the cash flow as a portion of the return. When the property does not fully lease-up or the property suffers from poor operations, the investors' returns can be affected.

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 should 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 within the limitations of IRS Revenue Procedure 2014-12 to mitigate the risk associated with this type of real estate financing.

Collateral and Repayment Risks

A bank, as a limited partner in a partnership, typically has a 99 percent interest in the subsidiary entity that owns or leases the underlying real estate assets of the partnership for at least the duration of the HTC compliance period. While the HTC investor does not have a lien position, it does have the right to remove a managing member who is not performing according to its duties under the LP or LLC agreement. To the extent that an HTC project includes first mortgage financing from another source, there is repayment and foreclosure risk. The risk associated with recapture ends, however, 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. Banks providing tax credit equity in exchange for the HTCs may require the debt financing source to execute a subordination and non-disturbance agreement to protect the master tenant entity in the event that master lease payments are not being made. By keeping the master lease in place, HTC funders can buy time to replace a managing member.

Operational and Reputation Risks

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.

HTC projects tend to include unique and complex transactions, requiring compliance with numerous rules and regulations. Project development teams involve many different players, including developers, syndicators, contractors, architects, preservation consultants, lawyers, accountants, and property managers. A bank can reduce operational and reputation risk by having a team of experienced and independent third-party consultants.

Structure Risk and the New IRS Safe Harbor Guidance

IRS Revenue Procedure 2014-12 is a safe harbor that assures funders that if HTC transactions are structured in accordance with its guidelines, the IRS will respect the allocation of tax credits to funders. Highlights of Revenue Procedure 2014-12 include the following:

- The principals (developer affiliate) must have a minimum partnership interest of 1 percent.
- Funders must have a minimum interest in each material item of partnership income, gain, loss, deduction, and credit equal to at least 5 percent at all times of the largest amount that it owns as an interest in the partnership. This requirement allows for a "partnership flip" from 99/1 percent down to a minimum of 4.95/95.05 percent after the expiration of the five-year compliance period.
- Principals and partnerships may no longer have a right to "call" an investor's interest. IRS Revenue Procedure 2014-12 allows funders to "put" their interests back to the developer as long as the put payment is at or below fair market value.
- The value of an investor's interest may not be reduced by fees, lease terms, or other arrangements that are materially different from practices on non-Section 47 transactions.
- The investor must receive net project cash flow commensurate with its ownership interest. In other words, the investor must participate in the upside potential profits of the partnership's activities.
- Funders must contribute a minimum equity contribution of 20 percent of the investor's total expected capital contributions before the building is placed in service. This minimum contribution must be maintained throughout the funder's ownership of its partnership interest and must not be protected against loss through any direct or indirect arrangement, although certain "permissible guarantees" are allowed.
- At least 75 percent of the funder's expected pay-ins must be fixed in amount before the project is placed in service, but timing of contributions may be contingent on performance benchmarks.
- Investors may receive permissible guarantees, which are limited and do not result in the investor being protected from the "structural risk" of the transaction. For example, unfunded guarantees can be provided to assure the performance of acts to claim the Section 47 credits, or the avoidance of acts (or omissions) that would result in recapture of the Section 47 credits. This permits unfunded guarantees such as completion guarantees, operating deficit guarantees, environmental indemnities, and financial covenants. These guarantees must be unfunded with the exception of operating deficit reserves that may be funded up to a maximum of 12 months of

operating expenses including debt service. No party in the partnership may guarantee recapture or disallowance based on the transactional structure.

National Bank Legal Authority

The first source of authority is 12 USC 24(Eleventh).[33] This statute authorizes national banks to make 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, services, or jobs). Under this authority, a national bank may provide financing for historic property rehabilitation projects and related HTCs by taking an ownership interest in an entity that holds such properties. An HTC investment is generally permissible if the bank's investment primarily benefits LMI individuals, LMI areas, or other areas targeted by a governmental entity for redevelopment, or if the investment would receive consideration as a "qualified investment" under 12 CFR 25.23 of the CRA.[34]

The second source of authority is 12 USC 24(Seventh). Under this statute, national banks may arrange 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.[35]

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

Federal Savings Association Legal Authority

An FSA may make a public welfare investment in an entity that receives HTCs under one of several investment authorities:

- De minimis investments, generally less than or equal to the greater of 1 percent of capital or $250,000.[36]
- Community development-related equity investments in real estate.[37]

---

[33] OCC regulations at 12 CFR 24 implement this statutory authority. 12 CFR 24 contains the OCC's standards for determining whether an investment is designed to promote the public welfare and the procedures that apply to those investments. It also contains requirements for investment limits, which provide that, with OCC written permission, a national bank's aggregate public investments may go up to 15 percent of its capital and surplus. Further, a national bank may not make an investment that would expose it to unlimited liability.

[34] See Community Development Investment Letter #2000-3 (August 2004).

[35] OCC Corporate Decision #99-07 (April 1999). See also OCC Interpretive Letter #1139 (November 2013) (representations and conditions to ensure substance of transaction remains the provision of financing).

[36] Under the de minimis authority, the FSA may invest, in the aggregate, less than or equal to the greater of 1 percent of capital or $250,000 in community development investments of the type permitted for a national bank under 12 CFR 24. HTCs may be one such type of investment.

[37] Under the Home Owners' Loan Act (12 USC 1464(c)(3)(A)), the FSA may make investments in real property and obligations secured by liens on real property located in areas "receiving concentrated development assistance by a local government under Title I of the Housing and Community Development Act of 1974." To be permissible for investment, the real estate (including projects receiving Historic Tax Credits) must be located within a geographic area or neighborhood that receives assistance or is covered by, for example, the U.S. Department of Housing and Urban Development's Community Development Block Grant program. Under 12 CFR 160.30, which covers the general lending and investment powers of FSAs, the FSA's aggregate community development loans and equity investments may not exceed 5 percent of its total assets, provided that its equity investments do not exceed 2 percent of total assets. The qualitative standards for such loans and investments are explained in an opinion of the Office of Thrift Supervision Chief Counsel, dated May 10, 1995. If the FSA meets all the standards, then it would not need to provide notice to the OCC.

- Investments in service corporations and lower-tier entities for community development investments.[38]

Generally, an FSA is not required to seek approval for or provide notice to the OCC for de minimis public welfare investments or community development-related equity investments in real estate, as long as these investments comply with governing qualitative standards.[39] If the FSA meets the qualitative standards but is not eligible for expedited treatment, the FSA is required to provide notice to the OCC's Community Affairs Department at least 14 calendar days before investing.[40] If the FSA does not meet the qualitative standards, the FSA must seek a no-action letter from the OCC. Lastly, investments in service corporations and lower-tier entities for community development activities are subject to prior notice to or approval by the OCC. Accordingly, FSAs should follow the filing requirements outlined in 12 CFR 159.11.

It should be noted that these authorities are generally not affected by section 619 of the Dodd–Frank Wall Street Reform and Consumer Protection Act, known as the Volcker rule and codified at 12 USC 1851,[41] which prohibits banking entities, including national banks, FSAs, and federal branches of foreign banks, from owning, sponsoring, or having certain relationships with covered funds. The final regulations implementing section 619 exclude from the definition of covered fund those investments that are (1) designed primarily to promote the public welfare of the type permitted under 12 USC 24(Eleventh), including the welfare of LMI communities or families (such as providing housing, services, or jobs), and (2) QREs with respect to a qualified rehabilitated building or certified historic structure, as such terms are defined in Section 47 of the IRC of 1986 or a similar state HTC program.[42] Accordingly, the final regulations would not prohibit or otherwise limit the ability of banks to sponsor or invest in entities qualifying for these exclusions to provide funding and assistance to LMI communities and certain community-improving projects.[43]

Accounting Considerations

HTC projects financed directly or through syndicated funds with conduit LPs or LLCs may be accounted for under the cost or equity method of accounting or may result in consolidation, depending on the structure of the transaction.[44] Banks should seek advice

---

[38] Under the authority of 12 CFR 159, the FSA may make investments in service corporations and lower-tier entities that engage in community development activities. A service corporation may engage in certain preapproved activities, including those that serve primarily community, inner city, or community development purposes, such as investments in historic tax credit projects. The FSA may invest up to 3 percent of its assets in service corporations, but any amount exceeding 2 percent must serve "primarily community, inner city, or community development purposes."

[39] The FSA should maintain appropriate documentation to ensure that its community development investments conform to the statutory and regulatory requirements governing those investment authorities.

[40] Please refer to the OCC's "Public Welfare Investments Web Resource Directory."

[41] On December 10, 2013, the OCC, together with other agencies, adopted final rules implementing the requirements of section 619. See 79 Fed. Reg. 5536 (January 31, 2014). Section 619 adds a new section 13 to the Bank Holding Company Act.

[42] See 79 Fed. Reg. 5789. These exclusions cover any issuer that engages in the business of making tax credit investments (for example, low income housing tax credit, new markets tax credit, renewable energy tax credit, rural business investment company) that are either designed to promote the public welfare of the type permitted under 12 USC 24(Eleventh) or are QREs with respect to a qualified rehabilitated building or certified historic structure.

[43] To the extent that an entity does not qualify for an exclusion from the definition of covered fund under the final regulations, a bank would need to consider whether its investment in the entity is permissible under the final regulations and, if so, what additional requirements, including investment limits and activity restrictions, may apply under the final regulations.

[44] See *Accounting Standards Codification 810,* "Consolidation."

from accounting firms familiar with the HTC industry before making internal decisions regarding consolidation.

Additionally, the HTC industry has been working with the Financial Accounting Standards Board's (FASB) Emerging Issues Task Force to include HTC transactions for treatment under the effective yield method of accounting.[45]

V. Who Is in the HTC Business Today?

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

Developers

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

Financing Sources

HTC funders can be persons, corporations (for example, 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 asset management activities over the five-year compliance period. Banks, however, remain responsible for their fund or project-level financing due diligence. Typically, syndicators create proprietary funds or provide services for one-off transactions.

Banks

As equity investors in HTC transactions, in addition to acquiring an interest in an HTC project for the right to be allocated HTCs, some banks 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.

Third-Party Experts

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

---

[45] See "FASB Task Force Recommends Study of Effective Yield Accounting for the Historic Tax Credit," by John Leith-Tetrault, "Journal of Tax Credits," volume V, issue 1 (January 2014).

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

To determine the risk-adjusted return on a prospective transaction, 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 and earn a risk-free 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

- amount paid per dollar of tax credit and timing of capital disbursements into the project.
- associated losses from depreciation, cash flow, potential for capital gains and losses, and value of ownership interests upon disposition.
- timeline 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 developer strength, 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 purchase partnership interests on the low end of the price range and disburse funds into the transaction 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 A. 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

Yields are a function of the amount paid per dollar of tax credits, the transaction ownership structure, the pay-in schedule, the annual cash flow, and the exit strategy selected by the investor.

Calculating estimated yields for financing HTC projects involves sophisticated modeling of tax benefits and 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 transaction ownership interests, 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.

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 asset management fees.

Syndication fees typically are paid directly by the bank investor to the syndicator from gross HTC proceeds. Many of the aforementioned fees are typical for bank-financed commercial real estate transactions.

Property Management

Banks actively involved in HTC projects have found it useful to establish asset management units within their real estate departments. Asset management units work with the project manager or managing partner to ensure that the properties are well managed, operate as proposed, and comply with all HTC program requirements. Banks with large HTC portfolios also use these asset management units to monitor activities. HTC fund portfolios typically rely on the property management expertise of the developer or third-party property 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. Not every historic building can feasibly be adapted to a new use.

Complexity of the Project

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

VIII. Conclusion

For more than 35 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 offers 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 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

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 an investor include admission into the LP/LLC, placed-in-service date, independent accountant's cost certification, 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.

Table 3: Hypothetical Pay-In Schedule

Pay-in contribution	Milestone	Amount
20%	Admission to the LP/LLC	$200,000
50%	Placed-in-service/cost certification	500,000
20%	Certified historic rehabilitation approval received (part 3 approval from the NPS)	200,000
10%	Stabilization	100,000
100%	**Total financed**	**$1,000,000**

Appendix B

Resource Directory

OCC

Community Developments *Insights,* "Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks"

www.occ.gov/topics/community-affairs/publications/insights/insights-low-income-housing-tax-credits.pdf

Community Developments *Insights,* "New Markets Tax Credits: Unlocking Investment Potential"

www.occ.gov/topics/community-affairs/publications/insights/insights-new-markets-tax-credits.pdf

Public Welfare Investments Resource Directory

www.occ.gov/topics/community-affairs/resource-directories/public-welfare-investments/national-bank-public-welfare-investment-authority.html

Other

CohnReznick

www.cohnreznick.com

Institute for Professional and Executive Development

www.ipedinc.net

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

www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Rehabilitation-Tax-Credit-Real-Estate-Tax-Tips

National Conference of State Historic Preservation Officers

www.ncshpo.org

National Council of Housing Market Analysts

www.housingonline.com/NationalCouncilofAffordableHousingMarketAnalysis.aspx

National Housing & Rehabilitation Association

www.housingonline.com

National Housing Trust

www.nhtinc.org/

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

www.nps.gov/search/?affiliate=nps&query=Historic%20Rehabilitation%20Tax%20Credits

National Trust Community Investment Corporation

www.ntcic.com

National Trust for Historic Preservation

www.preservationnation.org/take-action/advocacy-center/policy-resources/historic-tax-credits.html

Nixon Peabody, LLP

www.nixonpeabody.com/tax_credit_finance_and_syndication

Novogradac & Company

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

Rutgers University Historic Tax Credits Report

http://ntcicfunds.com/rutgers/

William Reeves is the primary author of this update. Sherrie L.W. Rhine was the primary author of the original 2008 report. *Community Developments 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 and were believed current as of May 1, 2015. The use of this information, however, does not constitute an endorsement of its accuracy by the OCC.