

## **Treasury Decision 8233, 26 CFR, IRC Sec(s). 42**

**October 11, 1998**

### **AGENCY:**

Internal Revenue Service, Treasury.

### **ACTION:**

Final regulations.

### **SUMMARY:**

This document contains final regulations under sections 46, 48 and 191 relating to an investment tax credit for qualified rehabilitation expenditures to qualified rehabilitated buildings. Changes to the applicable law were made by the Economic Recovery Tax Act of 1981, the Technical Corrections Act of 1982, the Tax Reform Act of 1984, and the Tax Reform Act of 1986. These regulations would provide the public with the guidance needed to comply with the law as amended by these Acts.

### **DATE:**

The amendments are generally effective for rehabilitation expenditures incurred after December 31, 1981.

### **FOR FURTHER INFORMATION CONTACT:**

Stuart G. Wessler of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Ave, NW., Washington, DC 20224 (Attention: CC:LR:T), (202-566-3297, not a toll-free call).

### **SUPPLEMENTARY INFORMATION:**

#### *Paperwork Reduction Act*

The collections of information contained in this final regulation have been reviewed by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-0155. The estimated average burden per respondent/recordkeeper varies from 30 to 70 minutes, depending on individual circumstances, with an estimated average of 45 minutes.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to The Internal Revenue Service, Washington, DC 20224, Attention: IRS Reports Clearance Officer TR:FP, and to the Office of Management and Budget, Washington, DC 20503, Attention Desk Officer for the Internal Revenue Service.

#### *Background*

Proposed amendments to the Income Tax Regulations (26 CFR Part 1) were published in the Federal Register (50 FR 26794) on June 28, 1985. Those amendments were proposed to conform the regulations to section 212 of the Economic Recovery Tax Act of 1981 (95 Stat. 235), section 102(f) of the Technical Corrections Act of 1982 (96 Stat. 2371), and section 31(c), 111(e)(8), and 1043(a) of the Tax Reform Act of 1984 (98 Stat. 518, 631, and 1044).

Approximately 30 written comments were received in response to the proposed regulations. A public hearing was held on November 15, 1985. Six speakers spoke at the public hearing.

Subsequently, the provisions of the Code dealing with the rehabilitation tax credit were amended by section 251 of the Tax Reform Act of the 1986 (100 Stat. 2183). This Treasury decision reflects the revisions made to section 46(b)(4) and 48(g) by that Act.

### *In General*

Section 38 of the Internal Revenue Code provides for a credit against tax in the case of investment in certain depreciable property (i.e., section 38 property). Section 48(a)(1)(E) of the Code defines section 38 property so as to include the portion of the basis of a qualified rehabilitated building that is attributable to qualified rehabilitation expenditures. Section 48(g) and §1.48-12 define the terms "qualified rehabilitated building" and "qualified rehabilitation expenditure". Section 46(b)(4)(A) provides rules for determining the rehabilitation percentage that is to be applied to qualified rehabilitation expenditures in order to determine the amount of the investment tax credit that is allowable under section 38 to a taxpayer.

### *Rehabilitation Percentage*

The rehabilitation percentage has been substantially amended by the Tax Reform Act of 1986. As a result of these amendments, there is now a 20 percent credit for rehabilitations of certified historic structures and a 10 percent credit for rehabilitations of other buildings first placed in service before 1936. These percentages apply to property placed in service after December 31, 1986, unless such property qualifies under the transitional rules, in which case the rehabilitation percentage in the case of a certified historic structure remains at 25 percent, and the percentages for rehabilitations of 30-year buildings and 40-year buildings are 10 and 13 percent, respectively. Prior to this amendment, section 46(b)(4) provided for a three-tier rehabilitation percentage in the case of qualified rehabilitation expenditures. In general, section 46(b)(4)(A) provided that the rehabilitation percentage was 15 percent in the case of a 30-year building, 20 percent in the case of 40-year building, and 25 percent in the case of a certified historic structure. These percentages still apply to property placed in service before January 1, 1987. Section 46(b)(4)(C), prior to its repeal in the Tax Reform Act of 1986, provided definitions relating to the three types of buildings. In general, a 30-year building was a building where 30 years have elapsed between the date the building was first placed in service and the date physical work on the rehabilitation began. A 40-year building was a building where 40 years have elapsed between these dates. The final regulations provide for an allocation rule in certain cases where additions have been made to a building.

Section 46(b)(4) provides that the regular percentages and the energy percentages do not apply to that portion of the basis of any property which is attributable to qualified rehabilitation expenditures.

#### *Property Used for Lodging*

In general, section 48(a)(3) provides that section 38 property does not include property which is used predominantly to furnish lodging. The Economic Recovery Tax Act amended section 48(a)(3) to provide an exception to this exclusion in the case of certified historic structures.

#### *Qualified Rehabilitated Buildings*

The term "qualified rehabilitated building" is defined in section 48(g)(1) and §1.48-12(b). In order to qualify as a qualified rehabilitated building, four requirements must be met. First, the building must have been placed in service before the beginning of the rehabilitation. Second, the building must meet an existing external wall or internal structural framework retention test. Third, the building must meet an age requirement unless it is a certified historic structure. Fourth, the building must have been substantially rehabilitated.

The final regulations contain additional restrictions that apply in the cases of buildings that have been moved. Rehabilitation is distinguished from new construction in these final regulations. A quantitative test for substantial rehabilitation is provided in section 48(g)(1)(C) and §1.48-12(b)(2). In general, the qualified rehabilitation expenditures during the appropriate measuring period must exceed the greater of \$5,000 or the adjusted basis of the property. The final regulations provide rules for applying the test in various contexts.

#### *Qualified Rehabilitation Expenditure*

The term "qualified rehabilitation expenditure" is defined in section 48(g)(2) and §1.48-12(c). In general, the expenditures must be for property chargeable to capital account and must be incurred after December 31, 1981, for depreciable real property in connection with the rehabilitation of a qualified rehabilitated building. Section 48(g)(2)(B) and §1.48-12(c) exclude certain expenditures from the definition of qualified rehabilitation expenditures. The final regulations clarify that the term "qualified rehabilitation expenditures" is not limited to those expenditures incurred during the relevant measuring period used for purposes of the substantial rehabilitation test. In the case of rehabilitated property placed in service in a taxable year, if the building qualified as a qualified rehabilitated building for that year, the taxpayer can claim as qualified rehabilitation expenditures the expenditures incurred before the beginning of the measuring period, during the measuring period, and after the measuring period but before the end of the taxable year.

#### *Certified Historic Structure*

The term "certified historic structure" is defined in section 48(g)(3) and §1.48-12(d). In general, a certified historic structure is a building (and its structural components) which is listed in the National Register, or which is located in a registered historic district and is certified by the Secretary of the Interior as being of historic

significance to the district. Although procedures for obtaining a National Register listing or a certification of significance are generally within the authority of the Department of Interior, (and therefore outside the scope of the Internal Revenue Code), these final regulations to address the issue of when an investment tax credit can be claimed in the case of a pending application for certification by the Department of Interior.

#### *Adjustments To Basis*

Section 48(q) and §1.48-12(e) provides rules concerning an adjustment to the basis of a qualified rehabilitated building. In general, the increase in the basis of the building that would result from the qualified rehabilitation expenditures must be reduced by the amount of the credit allowed under section 38 (50 percent of the credit in the case of property attributable to a certified historic structure that is either placed in service before January 1, 1987, or qualifies under the transitional rules).

#### *Coordination With Other Provisions*

Section 1.48-12(f) provides rules relating to the coordination between section 48(g) and various other provisions of the Internal Revenue Code of 1986. Rules and cross-references to other provisions of the Code are provided.

#### *Section 191*

Section 191, relating to amortization of rehabilitation expenditures for certified historic structures, was repealed by the Economic Recovery Tax Act of 1981 for expenditures incurred after December 31, 1981. These final regulations reflect the repeal.

#### *Public Comments and Changes in Response To Public Comments Moved Buildings*

A number of commentators questioned the rule in the proposed regulations concerning buildings other than certified historic structures that have been moved within the last thirty or forty years. Some of these commentators asked for limited exceptions in the case of certain relocations. The Treasury Department continues to believe that the nonhistoric credit provisions were specifically intended to stimulate rehabilitations of buildings at their existing locations. Therefore, no change was made.

#### *Substantial Rehabilitation Determination with Respect to Acquiring Taxpayer*

Several commentators asked that the regulations be modified to provide that a transferor who substantially rehabilitated a building be allowed to transfer the building to an acquiring taxpayer without the acquiring taxpayer making a substantial rehabilitation determination based on his cost basis at the time of transfer. The final regulations require that, in certain cases, an acquiring taxpayer is treated as having incurred the rehabilitation expenditures actually incurred by a transferor. However, section 48(g)(1)(C) requires the taxpayer to determine the adjusted basis of the building for purposes of the substantial rehabilitation test at the beginning of his holding period if he holds the building for less than 24 months. Given this statutory requirement, the Treasury Department continues to believe that

the substantial rehabilitation test must be applied with respect to the transferee rather than being simply carried over from the transferor. A limited exception is provided, however, in the case of lessees who rehabilitate buildings that are transferred by the lessor during the rehabilitation project.

#### *Late Certification of Building's Status as Certified Historic Structure*

A number of commentators asked that the regulations be clarified to provide that in the case of the credit for certified historic structures a building need not have been determined to be a certified historic structure at the time the expenditures were incurred, at the time the rehabilitated expenditures were placed in service, or at the time the credit was claimed so long as there was a pending application for certification at such time which was later approved. Since this was the intent of the proposed rule dealing with late certifications, this clarifying change has been made.

#### *Construction Period Interest Incurred in Connection With Acquisition of Building or Land*

A commentator questioned the rule in the proposed regulations that treated interest incurred on a loan to acquire the building shell or the land on which the building rests as a disqualifying cost of acquisition. The Treasury Department gave careful consideration to this comment, and continues to believe that interest incurred on a loan to acquire or carry the land or shell should not be treated as a qualified rehabilitation expenditure. However, interest incurred on a construction loan used to finance the rehabilitation can be treated as a qualified rehabilitation expenditure if such interest is properly capitalized and added to basis of the building.

#### *Other Comments*

Numerous other comments were received that asked for clarification of the proposed rules. In general, these final regulations provide that clarification.

#### *Regulatory Flexibility Act and Executive Order 12291*

The Commissioner of Internal Revenue has determined that this final rule is not a major rule as defined in Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required. Although a notice of proposed rulemaking that solicited public comment was issued, the Internal Revenue Service concluded when the notice was issued that the regulations are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

#### *Drafting Information*

The principal author of these final regulations is John G. Schmalz of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of style and substance.

*List of Subjects*

*26 CFR 1.0-1-1.58-8*

Income taxes, Tax liability, Tax rates, Credits.

*26 CFR 1.61-1-1.281-4*

Income taxes, Taxable income, Deductions, Exemptions.

*26 CFR Part 602*

Reporting and recordkeeping requirements.

*Adoption of Amendments to the Regulations*

Accordingly, 26 CFR Part 1 and Part 602 are amended as follows:

**PART 1-[AMENDED]**

Paragraph 1. The authority for Part 1 continues to read in part:

**Authority:**

26 U.S.C. 7805. Section 1.48-12(b)(2) also issued under 26 U.S.C. 48(g)(1)(C) (i) and (iii).

Par. 2. Section 1.46-1 is amended by revising paragraphs (a)(2) and (d), by adding a new paragraph (e)(5), and by adding a new paragraph (q) at the end thereof, to read as follows:

**§1.46-1 Determination of amount.**

(a) Effective dates.

(2) Acts covered. This section reflects changes made by the following Acts of Congress:

*Act and Section*

Tax Reduction Act of 1975, section 301.

Tax Reform Act of 1976, sections 802, 1701, 1703.

Revenue Act of 1978, sections 311, 312, 315.

Energy Tax Act of 1978, section 301.

Economic Recovery Tax Act of 1981, section 212.

Technical Corrections Act of 1982, section 102(f).

Tax Reform Act of 1986, section 251.

(d) Credit earned. The credit earned for the taxable year is the sum of the following percentages of qualified investment (as determined under section 46 (c) and (d))-

(1) The regular percentage (as determined under section 46),

(2) For energy property, the energy percentage (as determined under section 46), and

(3) For the portion of the basis of a qualified rehabilitated building (as defined in §1.48-12(b)) that is attributable to qualified rehabilitation expenditures (as defined in §1.48-12(c)), the rehabilitation percentage (as determined under section 46(b)(4)).

(e) Designation of credits. The credit available for the taxable year is designated as follows:

(5) The credit attributable to the rehabilitation percentage for qualified rehabilitation expenditures is the rehabilitation investment credit.

(q) Rehabilitation percentage-(1) General rule-(i) In general. Due to amendments made by the Tax Reform Act of 1986, different rules apply depending on when the property attributable to the qualified rehabilitated expenditures (as defined in §1.48-12(c)) is placed in service. Paragraph (q)(1)(ii) of this section contains the general rule relating to property placed in service after December 31, 1986. Paragraph (q)(1)(iii) of this section contains rules relating to property placed in service before January 1, 1987. Paragraph (q)(1)(iv) of this section contains rules relating to property placed in service after December 31, 1986, that qualifies for a transition rule.

(ii) Property placed in service after December 31, 1986. Except as otherwise provided in paragraph (q)(1)(iv) of this section, in the case of section 38 property described in section 48(a)(1)(E) placed in service after December 31, 1986, the term "rehabilitation percentage" means-

(A) 10 percent in the case of qualified rehabilitation expenditures with respect to a qualified rehabilitated building other than a certified historic structure, and

(B) 20 percent in the case of qualified rehabilitation expenditures with respect to a certified historic structure.

(iii) Property placed in service before January 1, 1987. For qualified rehabilitation expenditures (as defined in §1.48-12(c)) with respect to property placed in service before January 1, 1987, section 46(b)(4)(A) as in effect prior to the enactment of the Tax Reform Act of 1986 provided for a three-tier rehabilitation percentage. The applicable rehabilitation percentage for such expenditures depends on whether the qualified rehabilitated building is a "30-year building," a "40-year building," or a certified historic structure (as defined in section 48(g)(3) and §1.48-12(d)(1)). The rehabilitation percentage for such qualified rehabilitation expenditures incurred with respect to a qualified rehabilitated building is 15 percent to the extent that the building is a 30-year building (i.e., at least 30 years, but less than 40 years, has elapsed between the date the physical work on the rehabilitation began and the date the building was first placed in service), 20 percent to the extent that the building is a 40-year building (i.e., at least 40 years has so elapsed), and 25 percent for certified historic structures, regardless of age. See paragraph (q)(2)(ii) of this section for rules concerning buildings to which additions have been added.

(iv) Property placed in service after December 31, 1986, that qualifies under the transition rules. In the case of section 38 property described in section 48(a)(1)(E) placed in service after December 31, 1986, and to which the amendments made by section 251 of the Tax Reform Act of 1986 do not apply because the transition rules

in section 251(d) of that Act and §1.48-12(a)(2)(iv) (B) or (C) apply, the rehabilitation percentage for a "30-year building" (within the meaning of paragraph (q)(1)(iii) of this section) shall be 10 percent, the rehabilitation percentage for a "40-year building" (within the meaning of paragraph (q)(1)(iii) of this section) shall be 13 percent, and the rehabilitation percentage for a certified historic structure shall be 25 percent.

(2) Special rules-

(i) Moved buildings. With respect to paragraph (q)(1)(ii) of this section, §1.48-12(b)(5) provides that a building (other than a certified historic structure) is not a qualified rehabilitated building unless it has been at the location where it is being rehabilitated since January 1, 1936. In addition, for purposes of paragraph (q)(1) (iii) and (iv) of this section, a building is not a "30-year building" unless it has been at the location where it is being rehabilitated for the thirty-year period immediately preceding the beginning of the rehabilitation process, and is not a "40-year building" unless it has been at the location where it is being rehabilitated for the forty-year period immediately preceding the beginning of the rehabilitation process.

(ii) Building to which additions have been added-

(A) Property placed in service after December 31, 1986. For purposes of paragraph (q)(1)(ii) of this section, if part of a building meets the definition of a qualified rehabilitated building, and part of the building does not meet the definition of a qualified rehabilitated building because such part is an addition that was placed in service after December 31, 1935, the qualified rehabilitation expenditures made to the building must be allocated to the pre-1936 portion of the building and the post-1935 portion of the building using the principles in §1.48-12(c)(10)(ii). Qualified rehabilitation expenditures attributable to the post-1935 addition shall not qualify for the 10 percent rehabilitation percentage.

(B) Property placed in service before January 1, 1987, and property qualifying for a transitional rule. For purposes of paragraph (q)(1) (iii) and (iv) of this section, if part of a building meets the definition of a "40-year building" and part of the building is an addition that was placed in service less than forty years before physical work on the rehabilitation began but more than thirty years before such date, then the qualified rehabilitation expenditures made to the building shall be allocated between the forty year old portion of the building and the thirty year old portion of the building, and a 20 percent rehabilitation percentage shall be applied to the forty year old portion of the building and a 15 percent rehabilitation percentage shall be applied to the thirty year old portion. This allocation shall be made using the principles in §1.48-12(c)(10)(ii). If an allocation cannot be made between the expenditures to the forty year old portion of the building and the thirty year old portion of the building, then the building will be considered to be a 30-year building. Furthermore, for purposes of this paragraph (q), a building (other than a certified historic structure) is not a qualified rehabilitated building to the extent of that portion of the building that is less than 30 years old. If rehabilitation expenditures are incurred with respect to an addition to a qualified rehabilitated building, but the addition is not considered to be part of the qualified rehabilitated building because the addition does not meet the age requirement in section 48(g)(1)(B) (as in effect prior to its amendment by the Tax Reform Act of 1986) and §1.48-12(b)(4)(i)(B), then no rehabilitation percentage will be applied to the expenditures attributable to the rehabilitation of the addition. Thus, for purposes of paragraph (q)(1) (iii) and (iv) of this section, it may be necessary to allocate rehabilitation expenditures incurred with respect to a building between the original portion of the building and the addition.

(iii) Mixed-use buildings. If qualified rehabilitation expenditures are incurred for property that is excluded from section 38 property described in section 48(a)(1)(E) (because, for example, they are made with respect to a portion of the building used for lodging within the meaning of section 48(a)(3) and §1.48-1(h)), an allocation of

the expenditures must be made between the expenditures that result in an addition to basis that is section 38 property and the expenditures that result in an addition to basis that is excluded from the definition of section 38 property since the rehabilitation percentage is applicable only to section 38 property. These allocations should be made using the principles contained in §1.48-12(c)(10)(ii).

(3) Regular and energy percentages not to apply. The regular percentage and the energy percentage shall not apply to that portion of the basis of any building that is attributable to qualified rehabilitation expenditures (as defined in §1.48-12(c)).

(4) Effective date. The rehabilitation percentage is applicable only to qualified rehabilitation expenditures (as defined in §1.48-12(c)). For rules relating to applicability of the regular percentage to qualified rehabilitation expenditures (as defined in §1.48-11(c)), see §1.48-11.

Par. 3. Section 1.48-1 is amended by adding new paragraphs (h)(1)(iii) and (h)(2)(iv) to read as follows:

**§1.48-1 Definition of section 38 property.**

(h) Property used for lodging-(1) In general.

(iii) Notwithstanding any other provision of this paragraph (h), in the case of a qualified rehabilitated building (within the meaning of section 48(g)(1) and §1.48-12(b)), expenditures for property resulting in basis described in section 48(a)(1)(E) shall not be treated as section 38 property to the extent that such property is attributable to a portion of the building that is used for lodging or in connection with lodging. For example, if expenditures are incurred to rehabilitate a five story qualified rehabilitated building, three floors of which are used for apartments and two floors of which are used as commercial office space, the portion of the basis of the building attributable to qualified rehabilitated expenditures attributable to the commercial part of the building shall not be considered to be expenditures for property, or in connection with property, used predominantly for lodging. Allocation of expenditures between the two portions of the building are to be made using the principles contained in §1.48-12(C)(10)(ii).

(2) Exceptions.

(iv) Certified historic structures. For purposes of this paragraph (h), regardless of the actual use of a certified historic structure, that portion of the basis of such certified historic structure which is attributable to qualified rehabilitation expenditures (as defined in §1.48-12(c)) shall not be considered as property which is either used predominantly to furnish lodging or predominantly in connection with the furnishing of lodging. Accordingly, such portion of the basis may qualify as section 38 property. (For the definition of "certified historic structure," see section 48(g)(3) and §1.48-12(d).)

Par. 4. There is inserted immediately after §1.48-11 a new §1.48-12 to read as follows:

**§1.48-12 Qualified rehabilitated building; expenditures incurred after December 31, 1981.**

(a) General rule-(1) In general. Under section 48(a)(1)(E), the portion of the basis of a qualified rehabilitated building that is attributable to qualified rehabilitation expenditures (within the meaning of section 48(g) and this section) is section 38 property. Property that is section 38 property by reason of section 48(a)(1)(E) is treated as new section 38 property and, therefore, is not subject to the used property limitation in section 48(c). Section 48(g)(1) and paragraph (b) of this section define the term "qualified rehabilitated building." Section 48(g)(2) and paragraph (c) of this section define the term "qualified rehabilitation expenditure." Section 48(g)(2)(B)(iv) and (3) and paragraph (d) of this section describe the rules applicable to "certified historic structures." Section 48(q) and paragraph (e) of this section provide rules concerning an adjustment to the basis of the rehabilitated

building. Paragraph (f) of this section provides guidance for coordination of these provisions with other sections of the Code, including rules for determining when the rehabilitation credit may be claimed.

(2) Effective dates and transition rules-(i) In general. Except as otherwise provided in this paragraph (a)(2)(i), this section applies to expenditures incurred after December 31, 1981, in connection with the rehabilitation of a qualified rehabilitated building. (See paragraph (c)(3)(i) of this section for rules concerning the determination of when an expenditure is incurred.) If, however, physical work on the rehabilitation began before January 1, 1982, and the building does not meet the requirements of paragraph (b) of this section, the rules in §1.48-11 shall apply to the expenditures incurred after December 31, 1981, in connection with such rehabilitation. (See paragraph (b)(6)(i) of this section for rules determining when physical work on a rehabilitation begins.)

(ii) Transition rules concerning ACRS lives. (A) For property placed in service before March 16, 1984, and any property subject to the exception set forth in section 111(g)(2) of Pub. L. 98-369 (Deficit Reduction Act of 1984), the references to "19 years" in paragraph (c) (4)(ii) and (7)(v) shall be replaced with "15 years" and the reference to "19-year real property" in paragraph (c)(4)(ii) shall be replaced with "15-year real property."

(B) Except as otherwise provided in paragraph (a)(2)(ii)(A) of this section, for property placed in service before May 9, 1985, and any property subject to the exception set forth in section 105(b) (2) and (5) of Pub. L. 99-121 (99 Stat. 501, 511), the reference to "19 years" in paragraph (c) (4)(ii) and (7)(v) shall be replaced with "18 years" and the references to "19-years real property" in paragraph (c)(4)(ii) shall be replaced with "18-year real property."

(iii) Transition rule concerning external wall definition. Notwithstanding the definition of external wall contained in paragraph (b)(3)(ii) of this section, in any case in which the written plans and specifications for a rehabilitation were substantially completed on or before June 28, 1985, and the building being rehabilitated would fail to meet the requirement of paragraph (b)(1)(iii) of this section if the definition of external wall in paragraph (b)(3)(ii) of this section were used, the term "external wall" shall be defined as a wall, including its supporting elements, with one face exposed to the weather or earth, and a common wall shall not be treated as an external wall. See paragraph (b)(2)(v) of this section for the definition of written plans and specifications.

(iv) Transition rules concerning amendments made by the Tax Reform Act of 1986-(A) In general. Except as otherwise provided in section 251(d) of the Tax Reform Act of 1986 and this paragraph (a)(2)(iv), the amendments made by section 251 of the Tax Reform Act of 1986 shall apply to property placed in service after December 31, 1986, in taxable years ending after that date, regardless of when the rehabilitation expenditures attributable to such property were incurred. If property attributable to qualified rehabilitation expenditures is incurred with respect to a rehabilitation to a building placed in service in segments or phases and some segments are placed in service before January 1, 1987, and the remaining segments are placed in service after December 31, 1986, the amendments under the Tax Reform Act would not apply to the property placed in service before January 1, 1987, but would apply to the segments placed in service after December 31, 1986, unless one of the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section applies.

(B) General transition rule. The amendments made by sections 251 and 201 of the Tax Reform Act of 1986 shall not apply to property that qualifies under section 251(d) (2), (3), or (4) of the Tax Reform Act of 1986. Property qualifies for the general transition rule in section 251(d)(2) of the Act if such property is placed in service before January 1, 1994, and if such property is placed in service as part of-

(1) A rehabilitation that was completed pursuant to a written contract that was binding on March 1, 1986, or

(2) A rehabilitation incurred in connection with property (including any leasehold interest) acquired before March 2, 1986, or acquired on or after such date pursuant to a written contract that was binding on March 1, 1986, if-

(i) Parts 1 and 2 of the Historic Preservation Certificate Application were filed with the Department of the Interior (or its designee) before March 2, 1986, or

(ii) The lesser of \$1,000,000 or 5 percent of the cost of the rehabilitation is incurred before March 2, 1986, or is required to be incurred pursuant to a written contract which was binding on March 1, 1986.

(C) Specific rehabilitations. See section 251(d) (3) and (4) of the Tax Reform Act of 1986 for additional rehabilitations that are exempted from the amendments made by sections 251 and 201 of the Tax Reform Act of 1986.

(b) Definition of qualified rehabilitated building- (1) In general. The term "qualified rehabilitated building" means any building and its structural components-

(i) That has been substantially rehabilitated (within the meaning of paragraph (b)(2) of this section) for the taxable year,

(ii) That was placed in service (within the meaning of §1.46-3(d)) as a building by any person before the beginning of the rehabilitation, and

(iii) That meets the applicable existing external wall retention test or the existing external wall and internal structural framework retention test in accordance with paragraph (b)(3) of this section.

**The requirement in paragraph (b)(1)(iii) of this section does not apply to a certified historic structure. See paragraph (b) (4) and (5) of this section for additional requirements related to the definition of a qualified rehabilitated building.**

(2) Substantially rehabilitated building-(i) Substantial rehabilitation test. A building shall be treated as having been substantially rehabilitated for a taxable year only if the qualified rehabilitation expenditures (as defined in paragraph (c) of this section) incurred during any 24-month period selected by the taxpayer ending with or within the taxable year exceed the greater of-

(A) The adjusted basis of the building (and its structural components), or (B) \$5,000.

(ii) Date to determine adjusted basis of the building-(A) In general. The adjusted basis of the building (and its structural components) shall be determined as of the beginning of the first day of the 24-month period selected by the taxpayer or the first day of the taxpayer's holding period of the building (within the meaning of section 1250(e)), whichever is later. For purposes of determining the holding period under section 1250(e), any reconstruction that is part of the rehabilitation shall be disregarded.

(B) Special rules. In the event that a building is not owned by the taxpayer, the adjusted basis of the building shall be determined as of the date that would have been used if the owner had been the taxpayer. The adjusted basis of a building that is being rehabilitated by a taxpayer other than the owner shall thus be determined as of the beginning of the first day of the 24-month period selected by the taxpayer or the first day of the owner's holding period, whichever is later. Therefore, if a building that is being rehabilitated by a lessee is sold subject to the lease prior to the date that the lessee has substantially rehabilitated the building, the lessee's adjusted basis is determined as of the beginning of the first day of the new lessor's holding period or the beginning of the first day of the 24-month period selected by the lessee (the taxpayer), whichever is later. If, therefore, the first day of the new lessor's holding period were later than the first day of the 24-month period selected by the lessee (the taxpayer), the lessee's adjusted basis for purposes of the substantial

rehabilitation test would be the same as the adjusted basis of the new lessor as determined under paragraph (b)(2)(vii) of this section. If a building is sold after the date that a lessee has substantially rehabilitated the building with respect to the original lessor's adjusted basis, however, the lessee's basis may be determined as of the first day of the 24-month period selected by the lessee or the first day of the original lessor's holding period, whichever is later, and the transfer of the building will not affect the adjusted basis for purposes of the substantial rehabilitation test. The preceding sentence shall not apply, however, if the building is sold to the lessee or a related party within the meaning of section 267(b) or section 707(b)(1).

(iii) Adjusted basis of the building- (A) In general. The term "adjusted basis of the building" means the aggregate adjusted basis (within the meaning of section 1011(a)) in the building (and its structural components) of all the parties who have an interest in the building.

(B) Special rules. In the case of a building that is leased to one or more tenants in whole or in part, the adjusted basis of the building is determined by adding the adjusted basis of the owner (lessor) in the building to the adjusted basis of the lessee (or lessees) in the leasehold and any leasehold improvements that are structural components of the building. Similarly, in the case of a building that is divided into condominium units, the adjusted basis of the building means the aggregate adjusted basis of all of the respective condominium owners (including the basis of any lessee in the leasehold and leasehold improvements) in the building (and its structural components). If the adjusted basis of a building would be determined in whole or in part by reference to the adjusted basis of a person or persons other than the taxpayer (e.g., a rehabilitation by a lessee) and the taxpayer is unable to obtain the required information, the taxpayer must establish by clear and convincing evidence that the adjusted basis of such person or persons in the building on the date specified in paragraph (b)(2)(ii) of this section is an amount that is less than the amount of qualified rehabilitation expenditures incurred by the taxpayer. If no such amount can be so established, the adjusted basis of the building will be deemed to be the fair market value of the building on the relevant date. For purposes of determining the adjusted basis of a building, the portion of the adjusted basis of a building that is allocable to an addition (within the meaning of paragraph (b)(4)(ii) of this section) to the building that does not meet the age requirement in paragraph (b)(4)(i) of this section shall be disregarded. (See paragraph (b)(2)(vii) of this section for the rule applicable to the determination of the adjusted basis of a building when qualified rehabilitation expenditures are treated as incurred by the taxpayer.)

(iv) Rehabilitation. Rehabilitation includes renovation, restoration, or reconstruction of a building, but does not include an enlargement (within the meaning of paragraph (c)(10) of this section) of new construction. The determination of whether expenditures are attributable to the rehabilitation of an existing building or to new construction shall be based upon all the facts and circumstances.

(v) Special rule for phased rehabilitation. In the case of any rehabilitation that may reasonably be expected to be completed in phases set forth in written architectural plans and specifications completed before the physical work on the rehabilitation begins, paragraphs (b)(2) (i), (ii), and (vii) of this section shall be applied by substituting "60-month period" for "24-month period." A rehabilitation may reasonably be expected to be completed in phases if it consists of two or more distinct stages of development. The determination of whether a rehabilitation consists of distinct stages and therefore may reasonably be expected to be completed in phases shall be made on the basis of all the relevant facts and circumstances in existence before physical work on the rehabilitation begins. For purposes of this paragraph and paragraph (a)(2)(iii) of this section, written plans

that describe generally all phases of the rehabilitation process shall be treated as written architectural plans and specifications. Such written plans are not required to contain detailed working drawings or detailed specifications of the materials to be used. In addition, the taxpayer may include a description of work to be done by lessees in the written plans. For example, where the owner of a vacant four story building plans to rehabilitate two floors of the building and plans to require, as a condition of any lease, that tenants of the other two floors must rehabilitate those floors, the requirements of this paragraph (b)(2)(v) shall be met if the owner provides written plans for the rehabilitation work to be done by the owner and a description of the rehabilitation work that the tenants will be required to complete. The work required of the tenants may be described in the written plans in terms of minimum specifications (e.g., as to lighting, wiring, materials, appearance) that must be met by such tenants. See paragraph (b)(6)(i) of this section for the definition of physical work on a rehabilitation.

(vi) Treatment of expenses incurred by persons who have an interest in the building. For purposes of the substantial rehabilitation test in paragraph (b)(2)(i) of this section, the taxpayer may take into account qualified rehabilitation expenditures incurred during the same rehabilitation process by any other person who has an interest in the building. Thus, for example, to determine whether a building has been substantially rehabilitated, a lessee may include the expenditures of the lessor and of other lessees; a condominium owner may include the expenditures incurred by other condominium owners; and an owner may include the expenditures of the lessees.

(vii) Special rules when qualified rehabilitation expenditures are treated as incurred by the taxpayer. In the case where qualified rehabilitation expenditures are treated as having been incurred by a taxpayer under paragraph (c)(3)(ii) of this section, the transferee shall be treated as having incurred the expenditures incurred by the transferor on the date that the transferor incurred the expenditures with the meaning of paragraph (c)(3)(i) of this section. For purposes of the substantial rehabilitation test in paragraph (b)(2)(i) of this section, the transferee's adjusted basis in the building shall be determined as of the beginning of the first day of a 24-month period, or the first day of the transferee's holding period, whichever is later, as provided in paragraph (b)(2)(ii) of this section. The transferee's basis as of the first day of the transferee's holding period for purposes of the substantial rehabilitation test in paragraph (b)(2)(i) of this section, however, shall be considered to be equal to the transferee's basis in the building on such date less-

(A) The amount of any qualified rehabilitation expenditures incurred (or treated as having been incurred) by the transferor during the 24-month period that are treated as having been incurred by the transferee under paragraph (c)(3)(ii) of this section, and

(B) The amount of qualified rehabilitation expenditures incurred before the transfer and during the 24-month period by any other person who has an interest in the building (e.g., a lessee of the transferor). The preceding sentence shall not apply, however, unless the transferee's basis in the building is determined with reference to (1) the transferee's cost of the building (including the rehabilitation expenditures), (2) the transferor's basis in the building (where such basis includes the amount of the expenditures), or (3) any other amount that includes the cost of the rehabilitation expenditures. In the event that the transferee's basis is determined with reference to an amount not described above (e.g., transferee's basis in one building is determined with reference to the transferee's basis in another building under section 1031(d)), the amount of the expenditures incurred by the transferor and treated as having been incurred by the transferee are not deducted from the transferee's basis for purposes of the substantial rehabilitation test. If a transferee's basis is determined under section 1014, any expenditures incurred by the decedent

within the measuring period that are treated as having been incurred by the transferee under paragraph (c)(3)(ii) of this section shall decrease the transferee's basis for purposes of the substantial rehabilitation test.

(viii) Statement of adjusted basis, measuring period, and qualified rehabilitation expenditures. In the case of any tax return filed after August 27, 1985, on which an investment tax credit for property, described in section 48(a)(1)(E) is claimed, the taxpayer shall indicate by way of a marginal notation on, or a supplemental statement attached to, Form 3468-

(A) The beginning and ending dates for the measuring period selected by the taxpayer under section 48(g)(1)(C)(i) and paragraph (b)(2) of this section,

(B) The adjusted basis of the building (within the meaning of paragraph (b)(2) (iii) or (vii) of this section) as of the beginning of such measuring period, and

(C) The amount of qualified rehabilitation expenditures incurred, and treated as incurred, respectively, during such measuring period.

**Furthermore, for returns filed after August 27, 1985, if the adjusted basis of the building for purposes of the substantial rehabilitation test is determined in whole or in part by reference to the adjusted basis of a person, or persons, other than the taxpayer (e.g., a rehabilitation by a lessee), the taxpayer must attach to the Form 3468 filed with the tax return on which the credit is claimed a statement addressed to the District Director, signed by such third party, that states the first day of the third party's holding period and the amount of the adjusted basis of such third party in the building at the beginning of the measuring period or the first day of the holding period, whichever is later. If the taxpayer is unable to obtain the required information, that fact should be indicated and the taxpayer should state the manner in which the adjusted basis was determined and, if different, the fair market value of the building on the relevant date.**

(ix) Partnerships and S corporations. If a building is owned by a partnership (i.e., the building is partnership property) or an S corporation, the substantial rehabilitation test shall be determined at the entity level. Thus, the entity shall compare the amount of qualified rehabilitation expenditures incurred during the measuring period against its basis in the building at the beginning of its holding period or the beginning of its measuring period, whichever is later. (See section 1223(2) for rules concerning the determination of a partnership's holding period in the case of a contribution of property to the partnership meeting the requirements of section 721.) The adjusted basis of the building to a partnership shall be determined by taking into account any adjustments to the basis of the building made under section 743 and section 734. Any adjustments to the building's basis that are made under section 743 or section 734 after the beginning of the partnership's holding period, but before the end of the measuring period, shall be deemed for purposes of the substantial rehabilitation test to have been made on the first day of the partnership's holding period. However, in such case, the partnership's basis in the building shall be reduced by the amount of qualified rehabilitation expenditures incurred by the partnership. In the case of any tax return filed after January 9, 1989 on which a credit is claimed by a partner or a shareholder of an S corporation for rehabilitation expenditures incurred by a partnership or an S corporation, the partner or shareholder shall indicate on the Form 3468 on which the credit is claimed the name, address, and identification number of the partnership or S corporation that incurred the rehabilitation expenditures, and the partnership or S corporation shall, by way of a marginal notation on or a supplemental statement attached to the entity's return, provide the information required by paragraph (b)(2)(viii) of this section.

(x) Examples. The following examples illustrate the application of the substantial rehabilitation test in this paragraph (b)(2):

Example (1). Assume that A, a calendar year taxpayer, purchases a building for \$140,000 on January 1, 1982, incurs qualified rehabilitation expenditures in the amount of \$48,000 (at the rate of \$4,000 per month) in 1982, \$100,000 in 1983, and \$20,000 (at the rate of \$2,000 per month) in the first ten months of 1984, and places the rehabilitated building in service on October 31, 1984. Assume that A did not have written architectural plans and specifications describing a phased rehabilitation within the meaning of paragraph (b)(2)(v) of this section in existence prior to the beginning of physical work on the rehabilitation. For purposes of the substantial rehabilitation test in paragraph (b)(2) of this section, A may select any 24-consecutive-month measuring period that ends in 1984, the taxable year in which the rehabilitated building was placed in service. Assume that on A's 1984 return, A selects a measuring period beginning on February 1, 1982, and ending on January 31, 1984, and specifies that A's basis in the building (within the meaning of section 1011(a)) was \$144,000 on February 1, 1982 (\$140,000+\$4,000). (The \$4,000 of rehabilitation expenditures incurred during January 1982 are included in A's basis under section 1011 even though such property has not been placed in service.) The amount of qualified rehabilitation expenditures incurred during the measuring period was \$146,000 (\$44,000 from February 1 to December 31, 1982, plus \$100,000 in 1983, plus \$2,000 in January 1984). The building shall be treated as "substantially rehabilitated" within the meaning of this paragraph (b)(2) for A's 1984 taxable year because the \$146,000 of expenditures incurred by A during the measuring period exceeded A's adjusted basis of \$144,000 at the beginning of the period. If the other requirements of section 48(g)(1) and this paragraph are met, the building is treated as a qualified rehabilitated building, and A can treat as qualified rehabilitation expenditures the amount of \$168,000 (i.e., \$146,000 of expenditures incurred during the measuring period, \$4,000 of expenditures incurred prior to the beginning of the measuring period as part of the rehabilitation process, and \$18,000 of expenditures incurred after the measuring period during the taxable year within which the measuring period ends (See paragraph (c)(6) of this section.)). The result would generally be the same if the property attributable to the rehabilitation expenditures was placed in service as the expenditures were incurred, but A would have \$148,000 of qualified rehabilitation expenditures for 1983 and \$20,000 of qualified rehabilitation expenditures for 1984. (See paragraph (f)(2) of this section).

Example (2). Assume the same facts as in example (1), except that additional rehabilitation expenditures are incurred after the portion of the basis of the building attributable to qualified rehabilitation expenditures was placed in service on October 31, 1984. Such expenditures are incurred through the end of 1984 and in 1985 when the portion of the basis attributable to the additional expenditures is placed in service. The fact that the building qualified as a substantially rehabilitated building for A's 1984 taxable year has no effect on whether the building is a qualified rehabilitated building for property placed in service in A's 1985 taxable year. In order to determine whether the building is a qualified rehabilitated building for A's 1985 taxable year, A must select a measuring period that ends in 1985 and compare the expenditures incurred within that period with the adjusted basis as of the beginning of the period. Solely for the purpose of determining whether the building was substantially rehabilitated for A's 1985 taxable year, expenditures incurred during 1983 and 1984, even though considered in determining whether the building was substantially rehabilitated in 1984, may also be used to determine whether the building was substantially rehabilitated for A's 1985 taxable year, provided the expenditures were incurred during any 24-month measuring period selected by A that ends in 1985.

Example (3). (i) Assume the B purchases a building for \$100,000 on January 1, 1982, and leases the building to C who rehabilitates the building. Assume that C, a

calendar year taxpayer, places the property with respect to which rehabilitation expenditures were made in service in 1982 and selects December 31, 1982, as the end of the measuring period for purposes of the substantial rehabilitation test. The beginning of the measuring period is January 2, 1982, the beginning of B's holding period under section 1250 (e), and the adjusted basis of the building is \$100,000. Accordingly, if C incurred more than \$100,000 of qualified rehabilitation expenditures during 1982, the building would be substantially rehabilitated within the meaning of paragraph (b)(2)(i) of this section.

(ii) Assume the facts of example (3)(i), except that after C begins physical work on the rehabilitation, but before C incurs \$100,000 of expenditures, D acquires the building, subject to C's lease, from B for \$200,000. D's holding period under section 1250(e) begins on the day after D acquired the building, and C's adjusted basis for purposes of the substantial rehabilitation test is \$200,000, less the amount of expenditures incurred by C before the transfer. (See paragraph (b)(2) (ii) and (vii) of this section.) Accordingly, if C incurred more than \$200,000 (less the amount of expenditures incurred prior to the transfer) of qualified rehabilitation expenditures during 1982, the building would be substantially rehabilitated within the meaning of paragraph (b)(2) of this section. Under paragraph (b)(2)(ii)(B) of this section, however, C's adjusted basis for purposes of the substantial rehabilitation test would be \$100,000 if C had substantially rehabilitated the building (i.e., incurred more than \$100,000 in rehabilitation expenditures) prior to B's sale to D.

Example (4). E owns a building with a basis of \$10,000 and E incurs \$5,000 of rehabilitation expenditures. Before completing the rehabilitation project, E sells the building to F for \$30,000. Assume that F is treated under paragraph (c)(3)(ii) of this section as having incurred the \$5,000 of rehabilitation expenditures actually incurred by E. Because F's basis in the building is determined under section 1011 with reference to F's \$30,000 cost of the building (which includes the property attributable to E's rehabilitation expenditures), F's basis for purposes of the substantial rehabilitation test is \$25,000 (\$30,000 cost basis less \$5,000 rehabilitation expenditures treated as if incurred by F). (See paragraph (b)(2)(vii) of this section.) F would thus be required to incur more than \$20,000 of rehabilitation expenditures (in addition to the \$5,000 incurred by E and treated as having been incurred by F) during a measuring period selected by F to satisfy the substantial rehabilitation test.

Example (5). G owns Building I with a basis of \$10,000 and a fair market value of \$20,000. H owns Building II with a basis of \$5,000 and a fair market value of \$20,000, with respect to which H has incurred \$1,000 of rehabilitation expenditures. G and H exchange their buildings in a transaction that qualifies for nonrecognition treatment under section 1031. Assume that G is treated under paragraph (c)(3)(ii) of this section as having incurred \$1,000 of rehabilitation expenditures. G's basis in Building II, computed under section 1031(d), is \$10,000. G's basis in Building II is not determined with reference to (A) the cost of Building II, (B) H's basis in Building II (including the cost of the rehabilitation expenditures) or (C) any other amount that includes the cost of expenditures, but is instead determined with reference to G's basis in other property (Building I). Therefore, G's basis in Building II for purposes of the substantial rehabilitation test is not reduced by the \$1,000 of rehabilitation expenditures treated as if incurred by G. (See paragraph (b)(2)(vii) of this section.) Accordingly, G's basis in Building II for purposes of the substantial rehabilitation test is \$10,000, and G must incur additional rehabilitation expenditures in excess of \$9,000 within a measuring period selected by G to satisfy the test.

(3) Retention of existing external walls and internal structural framework-(i) In general-(A) Property placed in service after December 31, 1986. Except in the case of property that qualifies for the transition rules in paragraph (a)(2)(iv) (B) and (C)

of this section, in the case of property that is placed in service after December 31, 1986, a building (other than a certified historic structure) meets the requirement in paragraph (b)(1)(iii) of this section only if in the rehabilitation process-

(1) 50 percent or more of the existing external walls of such building are retained in place as external walls;

(2) 75 percent or more of the existing external walls of such building are retained in place as internal or external walls, and

(3) 75 percent or more of the internal structural framework of such building (as defined in paragraph (b)(3)(iii) of this section) is retained in place.

(B) Expenditures incurred before January 1, 1984, for property placed in service before January 1, 1987. With respect to rehabilitation expenditures incurred before January 1, 1984, for property that is either placed in service before January 1, 1987, or that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, a building meets the requirement in paragraph (b)(1)(iii) of this section only if 75 percent or more of the existing external walls of the building are retained in place as external walls in the rehabilitation process. If an addition to a building is not treated as part of a qualified rehabilitated building because it does not meet the 30-year requirement in paragraph (b)(4)(i)(B) of this section, then the external walls of such addition shall not be considered to be existing external walls of the building for purposes of section 48(g)(1)(A)(iii) (as in effect prior to enactment of the Tax Reform Act of 1986), and this section.

(C) Expenditures incurred after December 31, 1983, for property placed in service before January 1, 1987. With respect to expenditures incurred after December 31, 1983, for property that is either placed in service before January 1, 1987, or that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, the requirement of paragraph (b)(1)(iii) of this section is satisfied only if in the rehabilitation process either the existing external wall retention requirement in paragraph (b)(3)(i) (B) of this section is satisfied, or:

(1) 50 percent or more of the existing external walls of the building are retained in place as external walls,

(2) 75 percent or more of the existing external walls are retained in place as internal or external walls, and

(3) 75 percent or more of the existing internal structural framework of such building is retained in place.

(D) Area of external walls and internal structural framework. The determinations required by paragraph (b)(3)(i) (A), (B), and (C) of this section shall be based upon the area of the external walls or internal structural framework that is retained in place compared to the total area of each prior to the rehabilitation. The area of the existing external walls and internal structural framework of a building shall be determined prior to any destruction, modification, or construction of external walls or internal structural framework that is undertaken by any party in anticipation of the rehabilitation.

(ii) Definition of external wall. For purposes of this paragraph (b), a wall includes both the supporting elements of the wall and the nonsupporting elements, (e.g., a curtain, windows or doors) of the wall. Except as otherwise provided in this paragraph (b)(3), the term "external wall" includes any wall that has one face exposed to the weather, earth, or an abutting wall of an adjacent building. The term "external wall" also includes a shared wall (i.e., a single wall shared with an adjacent building), generally referred to as a "party wall," provided that the shared wall has no windows or doors in any portion of the wall that does not have one face exposed to the weather, earth, or an abutting wall. In general, the term "external wall" includes only those external walls that form part of the outline or perimeter of the building or that surround an uncovered courtyard. Therefore, the walls of an

uncovered internal shaft, designed solely to bring light or air into the center of a building, which are completely surrounded by external walls of the building and which enclose space not designated for occupancy or other use by people (other than for maintenance or emergency), are not considered external walls. Thus, for example, a wall of a light well in the center of a building is not an external wall. However, walls surrounding an outdoor space which is usable by people, such as a courtyard, are external walls.

(iii) Definition of internal structural framework. For purposes of this section, the term "internal structural framework" includes all load-bearing internal walls and any other internal structural supports, including the columns, girders, beams, trusses, spandrels, and all other members that are essential to the stability of the building.

(iv) Retained in place. An existing external wall is retained in place if the supporting elements of the wall are retained in place. An existing external wall is not retained in place if the supporting elements of the wall are replaced by new supporting elements. An external wall is retained in place, however, if the supporting elements are reinforced in the rehabilitation, provided that such supporting elements of the external wall are retained in place. An external wall also is retained in place if it is covered (e.g., with new siding). Moreover, an external wall is retained in place if the existing curtain is replaced with a new curtain, provided that the structural framework that provides for the support of the existing curtain is retained in place. An external wall is retained in place notwithstanding that the existing doors and windows in the wall are modified, eliminated, or replaced. An external wall is retained in place if the wall is disassembled and reassembled, provided the same supporting elements are used when the wall is reassembled and the configuration of the external walls of the building after the rehabilitation is the same as it was before the rehabilitation process commenced. Thus, for example, a brick wall is considered retained in place even though the original bricks are removed (for cleaning, etc.) and replaced to form the wall. The principles of this paragraph (b)(3)(iv) shall also apply to determine whether internal structural framework of the building is retained in place.

(v) Effect of additions. If an existing external wall is converted into an internal wall (i.e., a wall that is not an external wall), the wall is not retained in place as an external wall for purposes of this section.

(vi) Examples. The provisions of this paragraph (b)(3) may be illustrated by the following examples:

Example (1). Taxpayer A rehabilitated a building all of the walls of which consisted of wood siding attached to gypsum board sheets (which covered the supporting elements of the wall, i.e., studs). A covered the existing wood siding with aluminum siding as part of a rehabilitation that otherwise qualified under this subparagraph. The addition of the aluminum siding does not affect the status of the existing external walls as external walls and they would be considered to have been retained in place.

Example (2). Taxpayer B rehabilitated a building, the external walls of which had a masonry curtain. The masonry on the wall face was replaced with a glass curtain. The steel beam and girders supporting the existing masonry curtain were retained in place. The walls of the building are considered to be retained in place as external walls, notwithstanding the replacement of the curtain.

Example (3). Taxpayer C rehabilitated a building that has two external walls measuring 75' × 20' and two other external walls measuring 100' × 20'. C demolished one of the larger walls, including its supporting elements and constructed a new wall. Because one of the larger walls represents more than 25 percent of the area of the building's external walls, C has not satisfied the requirements that 75 percent of the existing external walls must be retained in place as either internal or

external walls. If however, C had not demolished the wall, but had converted it into an internal wall (e.g., by building a new external wall), the building would satisfy the external wall requirements.

Example (4). The facts are the same as in example (3), except that C does not tear down any walls, but builds an addition that results in one of the smaller walls becoming an internal wall. In addition, C enlarged 8 of the existing windows on one of the larger walls, increasing them from a size of 3' x 4' to 6' x 8'. Since the smaller wall accounts for less than 25 percent of the total wall area, C has satisfied the requirement that 75 percent of the existing external walls must be retained in place as external walls in the rehabilitation process. The enlargement of the existing windows on the larger wall does not affect its status as an external wall.

Example (5). Taxpayer D rehabilitated a building that was in the center of a row of three buildings. The building being rehabilitated by D shares its side walls with the buildings on either side. The shared walls measure 100' x 20' and the rear and front walls measure 75' x 20'. As part of a rehabilitation, D tears down and replaces the front wall. Because the shared walls as well as the front and back walls are considered external walls and the front wall accounts for less than 25 percent of the total external wall area (including the shared walls), D has satisfied the requirement that 75 percent of the existing external walls must be retained in place as external walls in the rehabilitation process.

(4) Age requirement- (i) In general- (A) Property placed in service after December 31, 1986. Except in the case of property that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, a building other than a certified historic structure shall not be considered a qualified rehabilitated building unless the building was first placed in service (within the meaning of §1.46-3(d)) before January 1, 1936.

(B) Property placed in service before January 1, 1987, and property qualifying under a transition rule. In the case of property placed in service before January 1, 1987, and property that qualifies under the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, a building other than a certified historic structure is considered a qualified rehabilitated building only if a period of at least 30 years has elapsed between the date physical work on the rehabilitation of the building began and the date the building was first placed in service (within the meaning of §1.46-3(d)) as a building by any person.

(ii) Additions. A building that was first placed in service before 1936 in the case described in paragraph (b)(4)(i)(A) of this section, or at least 30 years before physical work on the rehabilitation began in the case described in paragraph (b)(4)(i)(B) of this section, will not be disqualified because additions to such building have been added since 1936 in the case described in paragraph (b)(4)(i)(A) of this section, or are less than 30 years old in the case described in paragraph (b)(4)(i)(B). Such additions, however, shall not be treated as part of the qualified rehabilitated building. The term "addition" means any construction that resulted in any portion of an external wall becoming an internal wall, that resulted in an increase in the height of the building, or that increased the volume of the building.

(iii) Vacant periods. The determinations required by paragraph (b)(4)(i) of this section include periods during which a building was vacant or devoted to a personal use and is computed without regard to the number of owners or the identify of owners during the period.

(5) Location at which the rehabilitation occurs. A building, other than a certified historic structure is not a qualified rehabilitated building unless it has been located where it is rehabilitated since before 1936 in the case described in paragraph (b)(4)(i)(A) of this section. Similarly, in the case described in paragraph (b)(4)(i)(B) of this section, a building, other than a certified historic structure, is not a qualified

rehabilitation building unless it has been located where it is rehabilitated for the thirty-year period immediately preceding the date physical work on the rehabilitation began in the case of a "30-year building" or the forty-year period immediately preceding the date physical work on the rehabilitation began in the case of a "40-year building." (See >§1.46-1(q)(1)(iii) for the definitions of "30-year building" and "40-year building.")

(6) Definition and special rule-(i) Physical work on a rehabilitation. For purposes of this section, "physical work on a rehabilitation" begins when actual construction, or destruction in preparation for construction, begins. The term "physical work on a rehabilitation," however, does not include preliminary activities such as planning, designing, securing financing, exploring, researching, developing plans and specifications, or stabilizing a building to prevent deterioration (e.g., placing boards over broken windows).

(ii) Special rule for adjoining buildings that are combined. For purposes of this paragraph (b), if as part of a rehabilitation process two or more adjoining buildings are combined and placed in service as a single building after the rehabilitation process, then, at the election of the taxpayer, all of the requirements for a qualified rehabilitated building in section 48(g)(1) and this section may be applied to the constituent adjoining buildings in the aggregate. For example, if such requirements are applied in the aggregate, any shared walls or abutting walls between the constituent buildings that would otherwise be treated as external walls (within the meaning of paragraph (b)(3) of this section) would not be treated as external walls of the building, and the substantial rehabilitation test in paragraph (b)(2) of this section would be applied to the aggregate expenditures with respect to all of the constituent buildings and to the aggregate adjusted basis of all of the constituent buildings. A taxpayer shall elect the special rule of this paragraph (b)(6)(ii) for adjoining buildings by indicating by way of a marginal notation on, or a supplemental statement attached to, the Form 3468 on which a credit is first claimed for qualified rehabilitation expenditures with respect to such buildings that such buildings are a single qualified rehabilitated building because of the application of the special rule in this paragraph (b)(6)(ii).

(c) Definition of qualified rehabilitation expenditures-(1) In general. Except as otherwise provided in paragraph (c)(7) of this section, the term "qualified rehabilitation expenditure" means any amount that is-

(i) Properly chargeable to capital account (as described in paragraph (c)(2) of this section),

(ii) Incurred by the taxpayer after December 31, 1981 (as described in paragraph (c)(3) of this section),

(iii) For property for which depreciation is allowable under section 168 and which is real property described in paragraph (c)(4) of this section, and

(iv) Made in connection with the rehabilitation of a qualified rehabilitated building (as described in paragraph (c)(5) of this section).

(2) Chargeable to capital account. For purposes of paragraph (c)(1) of this section, amounts are chargeable to capital account if they are properly includible in computing basis of real property under §1.46-3(c). Amounts treated as an expense and deducted in the year they are paid or incurred or amounts that are otherwise not added to the basis of real property described in paragraph (c)(4) of this section do not qualify. For purposes of this paragraph (c), amounts incurred for architectural and engineering fees, site survey fees, legal expenses, insurance premiums, development fees, and other construction related costs, satisfy the requirement of this paragraph (c)(2) if they are added to the basis of real property that is described in paragraph (c)(4) of this section. Construction period interest and taxes that are amortized under section 189 (as in effect prior to its repeal by the Tax Reform Act of

1986) do not satisfy the requirement of this paragraph (c)(2). If, however, such interest and taxes are treated by the taxpayer as chargeable to capital account with respect to property described in paragraph (c)(4) of this section, they shall be treated in the same manner as other costs described in this paragraph (c)(2). Any construction period interest or taxes or other fees or costs incurred in connection with the acquisition of a building, any interest in a building, or land, are subject to paragraph (c)(7)(ii) of this section. See paragraph (c)(9) of this section for additional rules concerning interest.

(3) Incurred by the taxpayer-

(i) In general. Qualified rehabilitation expenditures are incurred by the taxpayer for purposes of this section on the date such expenditures would be considered incurred under an accrual method of accounting, regardless of the method of accounting used by the taxpayer with respect to other items of income and expense. If qualified rehabilitation expenditures are treated as having been incurred by a taxpayer under paragraph (c)(3)(ii) of this section, the taxpayer shall be treated as having incurred the expenditures on the date such expenditures were incurred by the transferor.

(ii) Qualified rehabilitation expenditures treated as incurred by the taxpayer-(A) Where rehabilitation expenditures are incurred with respect to a building by a person (or persons) other than the taxpayer and the taxpayer subsequently acquires the building, or a portion of the building to which some or all of the expenditures are allocable (e.g., a condominium unit to which rehabilitation expenditures have been allocated), the taxpayer acquiring such property shall be treated as having incurred the rehabilitation expenditures actually incurred by the transferor (or treated as incurred by the transferor under this paragraph (c)(3)(ii)) allocable to the acquired property, provided that-

(1) The building, or the portion of the building, acquired by the taxpayer was not used (or, if later, was not placed in service (as defined in paragraph (f)(2) of this section)) after the rehabilitation expenditures were incurred and prior to the date of acquisition, and

(2) No credit with respect to such qualified rehabilitation expenditures is claimed by anyone other than the taxpayer acquiring the property. For purposes of this paragraph (c)(3)(ii), use shall mean actual use, whether personal or business. In the case of a building that is divided into condominium units, expenditures attributable to the common elements shall be allocable to the individual condominium units in accordance with the principles of paragraph (c)(10)(ii) of this section. Furthermore, for purpose of this paragraph (c)(3)(ii), a condominium unit's share of the common elements shall not be considered to have been used (or placed in Service) prior to the time that the particular condominium unit is used.

(B) The amount of rehabilitation expenditures described in paragraph (c)(3)(ii)(A) of this section treated as incurred by the taxpayer under this paragraph shall be the lesser of-

(1) The amount of rehabilitation expenditures incurred before the date on which the taxpayer acquired the building (or portion thereof) to which the rehabilitation expenditures are attributable, or

(2) The portion of the taxpayer's cost or other basis for the property that is properly allocable to the property resulting from the rehabilitation expenditures described in paragraph (c)(3)(ii)(B)(1) of this section.

(C) For purposes of this paragraph (c)(3)(ii), the amount of rehabilitation expenditures treated as incurred by the taxpayer under this paragraph (c) shall not be treated as costs for the acquisition of a building. The portion of the cost of acquiring a building (or an interest therein) that is not treated under this paragraph as qualified rehabilitation expenditures incurred by the taxpayer is not treated as section 38 property in the hands of the acquiring taxpayer. (See paragraph (c)(7)(ii)

of this section.) (See paragraph (b)(2)(vii) for rules concerning the application of the substantial rehabilitation test when expenditures are treated as incurred by the taxpayer.)

(iii) Examples. The provisions of this paragraph (c) may be illustrated by the following examples:

Example (1). In 1981, A, a taxpayer using the cash receipts and disbursements method of accounting, commenced the rehabilitation of a 30-year old building. In June 1981, A signed a contract with a plumbing contractor for replacement of the plumbing in the building. A agreed to pay the contractor as soon as the work was completed. The work was completed in December 1981, but A did not pay the amount due until January 15, 1982. The expenditures for the plumbing are not qualified rehabilitation expenditures (within the meaning of this paragraph (c)) because they were not incurred under an accrual method of accounting after December 31, 1981.

Example (2). B incurred qualified rehabilitation expenditures of \$300,000 with respect to an existing building between January 1, 1982, and May 15, 1982, and then sold the building to C on June 1, 1982. The portion of the building to which the expenditures were allocable was not used by B or any other person during the period from January 1, 1982, to June 1, 1982, and neither B nor any other person claimed the credit. Consequently, C will be treated as having incurred the expenditures on the dates that B incurred the expenditures.

Example (3). D, a taxpayer using the cash receipts and disbursements method of accounting, begins the rehabilitation of a building on January 11, 1982. Prior to May 1, 1982, D makes rehabilitation expenditures of \$16,000. On May 3, 1982, D sells the building, the land, and the property attributable to the rehabilitation expenditures to E for \$35,000. The purchase price is properly allocable as follows:

Land .....		\$5,000	Existing building
.....	11,000	Property attributable to rehabilitation	
expenditures .....	19,000	-----	Total purchase price
.....	35,000		

The property attributable to the rehabilitation expenditures is placed in service by E on September 5, 1982. E may treat a portion of the \$35,000 purchase price as rehabilitation expenditures paid or incurred by him. Since the rehabilitation expenditures paid by D (\$16,000) are less than the portion of the purchase price properly allocable to property attributable to these expenditures (\$19,000), E may treat only \$16,000 as rehabilitation expenditures paid or incurred by him. The excess of the purchase price allocable to rehabilitation expenditures (\$19,000) over the rehabilitation expenditures paid by D (\$16,000), or \$3,000, is treated as the cost of acquiring an interest in the building and is not a qualified rehabilitation expenditure treated as incurred by E.

Example (4). The facts are the same as in example (3), except that the purchase price properly allocable to the property attributable to rehabilitation expenditures is \$15,000. Under these circumstances, E may treat only \$15,000 of D's \$16,000 expenditures as rehabilitation expenditures paid by D. The excess of the rehabilitation expenditures paid by D (\$16,000) over the purchase price allocable to rehabilitation expenditures (\$15,000), or \$1,000, is treated as the cost of acquiring an interest in the building and is not a qualified rehabilitation expenditure treated as incurred by E.

(4) Incurred for depreciable real property-(i) Property placed in service after December 31, 1986. Except as otherwise provided in paragraph (c)(4)(ii) of this section (relating to certain property that qualifies under a transition rule), in the case of property placed in service after December 31, 1986, an expenditure is incurred for

depreciable real property for purposes of paragraph (c)(1)(iii) of this section, only if it is added to the depreciable basis of depreciable property which is-

- (A) Nonresidential real property,
- (B) Residential rental property,
- (C) Real property which has a class life of more than 12.5 years, or
- (D) An addition or improvement to property described in paragraph (c)(4)(i) (A), (B), or (C) of this section.

**For purposes of this paragraph (c)(4)(i), the terms "nonresidential real property", "residential rental property", and "class life" have the respective meanings given to such terms by section 168 and the regulations thereunder.**

(ii) Property placed in service before January 1, 1987, and property that qualifies under a transition rule. In the case of property placed in service before January 1, 1987, and property placed in service after December 31, 1986, that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, an expenditure attributable to such property shall be a qualified rehabilitation expenditure only if such expenditure is incurred for property that is real property (or additions or improvements to real property) with a recovery period (within the meaning of section 168 as in effect prior to its amendment by the Tax Reform Act of 1986) of 19 years (15 years for low-income housing) and if the other requirements of this paragraph (c) are met. For purposes of this section, an expenditure is incurred for recovery property having a recovery period of 19 years only if the amount of the expenditure is added to the basis of property which is 19-year real property or 15-year real property in the case of low-income housing. For purposes of this section, the term "low-income housing" has the meaning given such term by section 168(c)(2)(F) (as in effect prior to the amendments made by the Tax Reform Act of 1986).

(5) Made in connection with the rehabilitation of a qualified rehabilitated building. In order for an expenditure to be a qualified rehabilitation expenditure, such expenditure must be incurred in connection with a rehabilitation (as defined in paragraph (b)(2)(iv) of this section) of a qualified rehabilitated building. Expenditures attributable to work done to facilities related to a building (e.g., sidewalk, parking lot, landscaping) are not considered made in connection with the rehabilitation of a qualified rehabilitated building.

(6) When expenditures may be incurred. An expenditure is a qualified rehabilitation expenditure only if the building with respect to which the expenditures are incurred is substantially rehabilitated (within the meaning of paragraph (b)(2) of this section) for the taxable year in which the property attributable to the expenditures is placed in service (i.e., the building is substantially rehabilitated during a measuring period ending with or within the taxable year in which a credit is claimed). (See paragraph (f)(2) of this section for rules relating to when property is placed in service.) Once the substantial rehabilitation test is met for a taxable year, the amount of qualified rehabilitation expenditures upon which a credit can be claimed for the taxable year is limited to expenditures incurred:

- (i) Before the beginning of a measuring period during which the building was substantially rehabilitated that ends with or within the taxable year, provided that the expenditures were incurred in connection with the rehabilitation process that resulted in the substantial rehabilitation of the building;
- (ii) Within a measuring period during which the building was substantially rehabilitated that ends with or within the taxable year, and
- (iii) After the end of a measuring period during which the building was substantially rehabilitated but prior to the end of the taxable year with or within which the measuring period ends.

(7) Certain expenditures excluded from qualified rehabilitation expenditures. The term "qualified rehabilitation expenditures" does not include the following expenditures:

(i) Except as otherwise provided in paragraph (c)(8) of this section, any expenditure with respect to which the taxpayer does not use the straight line method over a recovery period determined under section 168 (c) and (g).

(ii) The cost of acquiring a building, any interest in a building (including a leasehold interest), or land, except as provided in paragraph (c)(3)(ii) of this section.

(iii) Any expenditure attributable to an enlargement of a building (within the meaning of paragraph (c)(10) of this section).

(iv) Any expenditure attributable to the rehabilitation of a certified historic structure or a building located in a registered historic district, unless the rehabilitation is a certified rehabilitation. (See paragraph (d) of this section which contains definitions and special rules applicable to rehabilitations of certified historic structures and buildings located in registered historic districts.)

(v) Any expenditure of a lessee of a building or a portion of a building, if, on the date the rehabilitation is completed with respect to property placed in service by such lessee, the remaining term of the lease (determined without regard to any renewal period) is less than the recovery period determined under section 168(c) (or 19 years in the case of property placed in service before January 1, 1987, and property placed in service that qualifies under the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section).

(vi) Any expenditure allocable to that portion of a building which is (or may reasonably be expected to be) tax-exempt use property (within the meaning of section 168 and the regulations thereunder), except that the exclusion in this paragraph (c)(7)(vi) shall not apply for purposes of determining whether the building is a substantially rehabilitated building under paragraph (b)(2) of this section.

(8) Requirement to use straight line depreciation-(i) Property placed in service after December 31, 1986. The requirement in section 48(g)(2)(B)(i) and paragraph (c)(7)(i) of this section to use straight line cost recovery does not apply to any expenditure to the extent that the alternative depreciation system of 168(g) applies to such expenditure by reason of section 168(g)(1) (B) or (C). In addition, the requirement in section 48(g)(2)(B)(i) and paragraph (c)(7)(i) of this section applies only to the depreciation of the portion of the basis of a qualified rehabilitated building that is attributable to qualified rehabilitation expenditures.

(ii) Property placed in service before January 1, 1987, and property placed in service after December 31, 1986, that qualifies for a transition rule. In the case of expenditures attributable to property placed in service before January 1, 1987, and property that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, the term "qualified rehabilitation expenditure" does not include an expenditure with respect to which an election was not made under section 168(b)(3) as in effect prior to its amendment by the Tax Reform Act of 1986, to use the straight line method of depreciation. In such case, the requirement that an election be made to use straight line cost recovery applies only to the cost recovery of the portion of the basis of a qualified rehabilitated building that is attributable to qualified rehabilitation expenditures. See section 168(f)(1), as in effect prior to its amendment by the Tax Reform Act of 1986, for rules relating to the use of different methods of cost recovery for different components of a building. In addition, such requirement shall not apply to any expenditure to the extent that section 168(f)(12) or (j), as in effect prior to the amendments made by the Tax Reform Act of 1986, applied to such expenditure.

(9) Cost of acquisition. For purposes of paragraph (c)(7)(ii) of this section, cost of acquisition includes any interest incurred on indebtedness the proceeds of which are

attributable to the acquisition of a building, an interest in a building, or land open which a building exists. Interest incurred on a construction loan the proceeds of which are used for qualified rehabilitation expenditures, however, is not treated as a cost of acquisition.

(10) Enlargement defined-(i) In general. A building is enlarged to the extent that the total volume of the building is increased. An increase in floor space resulting from interior remodeling is not considered an enlargement. The total volume of a building is generally equal to the product of the floor area of the base of the building and the height from the underside of the lowest floor (including the basement) to the average height of the finished roof (as it exists or existed). For this purpose, floor area is measured from the exterior faces of external walls (other than shared walls that are external walls) and from the centerline of shared walls that are external walls.

(ii) Rehabilitation that includes enlargement. If expenditures for property only partially qualify as qualified rehabilitation expenditures because some of the expenditures are attributable to the enlargement of the building, the expenditures must be apportioned between the original portion of the building and the enlargement. The expenditures must be specifically allocated between the original portion of the building and the enlargement to the extent possible. If it is not possible to make a specific allocation of the expenditures, the expenditures must be allocated to each portion on some reasonable basis. The determination of a reasonable basis for an allocation depends on factors such as the type of improvement and how the improvement relates functionally to the building. For example, in the case of expenditures for an air-conditioning system or a roof, a reasonable basis for allocating the expenditures among the two portions generally would be the volume of the building, excluding the enlargement, served by the air-conditioning system or the roof relative to the volume of the enlargement served by the improvement.

(d) Rules applicable to rehabilitations of certified historic structures-(1) Definition of certified historic structure. The term "certified historic structure" means any building (and its structural components) that is-

(i) Listed in the National Register of Historic Places ("National Register"); or

(ii) Located in a registered historic district and certified by the Secretary of the Interior to the Internal Revenue Service as being of historic significance to the district.

**For purposes of this section, a building shall be considered to be a certified historic structure at the time it is placed in service if the taxpayer reasonably believes on that date the building will be determined to be a certified historic structure and has requested on or before that date a determination from the Department of Interior that such building is a certified historic structure within the meaning of this paragraph (d) (1) (i) or (ii) and the Department of Interior later determines that the building is a certified historic structure.**

(2) Definition of registered historic district. The term "registered historic district" means any district that is-

(i) Listed in the National Register, or

(ii) (A) Designated under a statute of the appropriate State or local government that has been certified by the Secretary of the Interior to the Internal Revenue Service as containing criteria that will substantially achieve the purpose of preserving and rehabilitating buildings of historic significance to the district, and (B) certified by the Secretary of the Interior as meeting substantially all of the requirements for the listing of districts in the National Register.

(3) Definition of certified rehabilitation. The term "certified rehabilitation" means any rehabilitation of a certified historic structure that the Secretary of the Interior has certified to the Internal Revenue Service as being consistent with the historic character of the building and, where applicable, the district in which such building is located. The determination of the scope of a rehabilitation shall be made on the basis of all the facts and circumstances surrounding the rehabilitation and shall not be made solely on the basis of ownership. The Secretary of the Interior shall take all of the rehabilitation work performed as part of a single rehabilitation, including any post-certification work, into account in determining whether the rehabilitation complies with the Department of Interior standards for rehabilitation and whether the certification should be granted, revoked, or otherwise invalidated.

(4) Revoked or invalidated certification. If the Department of Interior revokes or otherwise invalidates a certification after it has been issued to a taxpayer, the basis attributable to rehabilitation of the decertified property shall cease to be section 38 property described in section 48 (a) (1) (E). Such cessation shall be effective as of the date the activity giving rise to the revocation or invalidation commenced. See section 47 for the rules applicable to property that ceases to be section 38 property.

(5) Special rule for certain buildings located in registered historic districts. The exclusion in paragraph (c) (7) (iv) of this section does not apply to a building in a registered historic district if-

(i) Such building was not a certified historic structure during the rehabilitation process; and

(ii) The Secretary of the Interior certified to the Internal Revenue Service that such building was not of historic significance to the district.

**In general, the certification referred to in paragraph (d) (5) (ii) of this section must be requested by the taxpayer prior to the time that physical work on the rehabilitation began. If, however, the certification referred to in paragraph (d) (5) (ii) of this section is requested by the taxpayer after physical work on the rehabilitation of the building has begun, the taxpayer must certify to the Internal Revenue Service that, prior to the date that physical work on the rehabilitation began, the taxpayer in good faith was not aware of the requirement of paragraph (d) (5) (ii) of this section. The certification referred to in the previous sentence must be attached to the Form 3468 filed with the tax return for the year in which the credit is claimed.**

(6) Special rule for certain rehabilitations begun before an area is designated as a registered historic district. In general, the exclusion from the definition of qualified rehabilitation expenditure in paragraph (c) (7) (iv) of this section applies to any rehabilitation expenditures that are incurred after a building becomes a certified historic structure within the meaning of section 48 (g) (3) (A) and paragraph (d) (1) of this section or the area in which a building is located becomes a registered historic district within the meaning of section 48 (g) (3) (B) and paragraph (d) (2) of this section. Rehabilitation expenditures incurred prior to such date, however, are not disqualified. In addition, rehabilitation expenditures made after the date the area in which a building is located becomes a registered historic district shall not be disqualified under paragraph (c) (7) (iv) of this section in any case in which physical work on the rehabilitation of a building begins prior to the date the taxpayer knows or has reason to know of an intention to nominate the area in which such building is located as a registered historic district. For purposes of this paragraph (d) (6), the taxpayer knows or has reason to know of such an intention if there is (A) a communication (written or oral) to the owner of any building within the district from the Department of the Interior, or any agency or instrumentality of the appropriate state or local government (or a designee of such agency or instrumentality) that the

district in which the building is located is being considered for designation as a registered historic district, (B) a legal notice of such consideration published in a newspaper, or (C) a public meeting held to discuss such consideration. In order to take advantage of the special rule of this paragraph (d) (6), the taxpayer must attach to the Form 3468 filed for the taxable year in which the credit is claimed a statement that the taxpayer in good faith did not know, or have reason to know, of an intention to nominate the area in which the building is located as a registered historic district.

(7) Notice of certification-(i) In general. Except as otherwise provided in paragraph (d)(7)(ii) of this section, a taxpayer claiming the credit for rehabilitation of a certified historic structure (within the meaning of section 48(g)(3) and paragraph (d)(1) of this section) must attach to the Form 3468 filed with the tax return for the taxable year in which the credit is claimed a copy of the final certification of completed work by the Secretary of the Interior, and for returns filed after January 9, 1989, evidence that the building is a certified historic structure.

(ii) Late certification. If the final certification of completed work has not been issued by the Secretary of the Interior at the time the tax return is filed for a year in which the credit is claimed, a copy of the first page of the Historic Preservation Certification Application-Part 2-Description of Rehabilitation (NPS Form 10-168a), with an indication that it has been received by the Department of the Interior or its designate, together with proof that the building is a certified historic structure (or that such status has been requested), must be attached to the Form 3468 filed with the return. A notice from the Department of the Interior or the State Historic Preservation Officer, stating that the nomination or application has been received, or a date-stamped nomination or application shall be sufficient indication that the nomination or application has been received. The building need not be either listed in the National Register or be determined to be of historic significance to a registered historic district at the time the return is filed for the year in which the credit is claimed. (See paragraph (d)(1) of this section.) The taxpayer must submit a copy of the final certification as an attachment to Form 3468 with the first income tax return filed after the receipt by the taxpayer of the certification. If the final certification is denied by the Department of Interior, the credit will be disallowed for any taxable year in which it was claimed. If the taxpayer fails to receive final certification of completed work prior to the date that is 30 months after the date that the taxpayer filed the tax return on which the credit was claimed, the taxpayer must submit a written statement to the District Director stating such fact prior to the last day of the 30th month, and the taxpayer shall be requested to consent to an agreement under section 6501(c)(4) extending the period of assessment for any tax relating to the time for which the credit was claimed. The procedure permitted by the preceding sentence shall be used whenever the entire rehabilitation project is not fully completed by the date that is 30 months after the taxpayer filed the tax return upon which the credit was claimed (e.g. a phased rehabilitation) and the Secretary of the Interior has thus not yet certified the rehabilitation.

(e) Adjustment to basis-(1) General rule. Except as otherwise provided by this paragraph (e), if a credit is allowed with respect to property attributable to qualified rehabilitation expenditures incurred in connection with the rehabilitation of a qualified rehabilitated building, the increase in the basis of the rehabilitated property that would otherwise result from the qualified rehabilitation expenditures must be reduced by the amount of the credit allowed. See section 48(q) and the regulations there under for other rules concerning adjustments to basis in the case of section 38 property.

(2) Special rule for certain property relating to certified historic structures. If a rehabilitation investment credit is allowed with respect to property that is placed in

service before January 1, 1987, or property that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, and such property is attributable to qualified rehabilitation expenditures incurred in connection with the rehabilitation of a certified historic structure, the increase in the basis of the rehabilitated property that would otherwise result from the qualified rehabilitation expenditures must be reduced by one-half of the amount of the credit allowed.

(3) Recapture of rehabilitation investment credit. If during any taxable year there is a recapture amount determined with respect to any credit that resulted in a basis adjustment under paragraph (e) (1) or (2) of this section, the basis of such building (immediately before the event resulting in such recapture) shall be increased by an amount equal to such recapture amount. For purposes of the preceding sentence, the term "recapture amount" means any increase in tax (or adjustment in carrybacks or carryovers) determined under section 47(a)(5).

(f) Coordination with other provisions of the Code-(1) Credit claimed by lessee for rehabilitation performed by lessor. A lessee may take the credit for rehabilitation performed by the lessor if the requirements of this section and section 48(d) are satisfied. For purposes of applying section 48(d), the fair market value of section 38 property described in section 48(a)(1)(E) shall be limited to that portion of the lessor's basis in the qualified rehabilitated building that is attributable to qualified rehabilitation expenditures. In the case of a portion of a building that is divided into more than one leasehold interest, the qualified rehabilitation expenditures attributable to the common elements shall be allocated to the individual leasehold interests in accordance with the principles of paragraph (c)(10)(ii) of this section. Furthermore, a leasehold interest's share of the common elements shall not be considered to have been placed in service prior to the time that the particular leasehold interest is placed in service.

(2) When the credit may be claimed-(i) In general. The investment credit for qualified rehabilitation expenditures is generally allowed in the taxable year in which the property attributable to the expenditure is placed in service, provided the building is a qualified rehabilitated building for the taxable year. See paragraph (b) of this section and section 46(c) and §1.46-3(d). Under certain circumstances, however, the credit may be available prior to the date the property is placed in service. See section 46(d) and §1.46-5 (relating to qualified progress expenditures). Solely for purposes of section 46(c), property attributable to qualified rehabilitation expenditures will not be treated as placed in service until the building with respect to which the expenditures are made meets the definition of a qualified rehabilitated building (as defined in section 48(g)(1) and paragraph (b) of this section) for the taxable year. Accordingly, in the first taxable year for which the building becomes a qualified rehabilitated building, the property described in section 48(a)(1)(E) attributable to expenditures described in paragraph (c) of this section shall be considered to be placed in service, if such property was considered placed in service under section 46(c) and the regulations thereunder without regard to this paragraph (f)(2)(i) in that taxable year or a prior taxable year. For purposes of the preceding sentence, the requirement of section 48(g)(1)(A)(iii) and paragraph (b)(3) of this section relating to the definition of a qualified rehabilitated building shall be deemed to be met if the taxpayer reasonably expects that no rehabilitation work undertaken during the remainder of the rehabilitation process will result in a failure to satisfy the requirements of paragraph (b)(3) of this section. If the requirements of paragraph (b)(3) are not satisfied, however, the credit shall be disallowed for the taxable year in which it was claimed. If a taxpayer fails to complete physical work on the rehabilitation prior to the date that is 30 months after the date that the taxpayer filed a tax return on which the credit is claimed, the taxpayer must submit a written statement to the District Director stating such fact prior to the last day of the 30th

month, and shall be requested to consent to an agreement under section 6501(c)(4) extending the period of assessment for any tax relating to the item for which the credit was claimed.

(ii) Section 38 property described in section 48(a)(1)(E). In the case of section 38 property described in section 48(a)(1)(E), the section 38 property is not the building. Instead, the section 38 property is the portion of the basis of the building that is attributable to qualified rehabilitation expenditures. Therefore, for example, for purposes of the determination of when such section 38 property is placed in service, a determination must be made regarding when property attributable to the portion of the basis of the building attributable to qualified rehabilitation expenditures is placed in service. The issue of when the building is placed in service is thus not relevant. In fact, under this test, the building itself may never have been taken out of service during the rehabilitation process. If the building is rehabilitated over several years in stages (e.g., by floors), section 38 property attributable to qualified rehabilitation expenditures to a qualified rehabilitated building placed in service in each taxable year shall, generally, be treated as a separate item of section 38 property.

(iii) Example. The application of this paragraph (f)(2) may be illustrated by the following example:

Example. Assume that A, a calendar year taxpayer, purchases a four-story building on January 1, 1983, for \$100,000, and incurs \$10,000 of qualified rehabilitation expenditures in 1983 to rehabilitate floor one, \$50,000 of qualified rehabilitation expenditures in 1984 to rehabilitate floor two, \$70,000 of qualified rehabilitation expenditures in 1985 to rehabilitate floor three, and \$60,000 of qualified rehabilitation expenditures in 1986 to rehabilitate floor four. Assume further that A places the property attributable to these expenditures in service on the last day of the year in which the respective expenditures were incurred and that the building is never taken out of service since as each floor is rehabilitated, the other three floors are occupied by tenants. Under the rule in this paragraph (f)(2), the portion of the basis of the building that is attributable to qualified rehabilitation expenditures incurred with respect to floor one and two are deemed to be placed in service in 1985, because that is the first year that the substantial rehabilitation test described in paragraph (b) of this section is met (\$120,000 of expenditures incurred by A during a measuring period ending on December 31, 1985 is greater than the \$110,000 basis at the beginning of the period). Assume that as of December 31, 1985, at least 75 percent of the external walls of the building have been retained during the rehabilitation process and that A has a reasonable expectation that no work during the remainder of the rehabilitation process will result in less than 75 percent of the external walls being retained. A may claim a credit for A's 1985 taxable year on \$130,000 of qualified rehabilitation expenditures (\$10,000 in 1983, \$50,000 in 1984, and \$70,000 in 1985). (See paragraph (c)(6) of this section for rules applicable to when qualified expenditures may be incurred. In addition, see section 46 (d) and §1.46-5 for rules relating to qualified progress expenditures.) The fact that the building was a qualified rehabilitated building for A's 1985 taxable year, however, has no effect on whether the building is a qualified rehabilitated building for A's 1986 taxable year. In order to determine whether A is entitled to claim a credit on A's 1986 return for the \$60,000 of qualified rehabilitation expenditures incurred in 1986, A must select a measuring period ending in 1986 and must determine whether the building is a qualified rehabilitated building for that year. Solely for purposes of determining whether the building was substantially rehabilitated, expenditures incurred in 1984 and 1985, even though considered in determining whether the building was substantially rehabilitated for A's 1985 taxable year, may be used in addition to the expenditures incurred in 1986 to determine whether the building was substantially rehabilitated for A's 1986 taxable year,

provided the expenditures were incurred during any measuring period selected by A that ends in 1986.

(3) Coordination with section 47. If property described in section 48(a)(1)(E) is disposed of by the taxpayer, or otherwise ceases to be "section 38 property," section 47 may apply. Property will cease to be section 38 property, and therefore section 47 may apply, in any case in which the Department of Interior revokes or otherwise invalidates a certification of rehabilitation after the property is placed in service or a building (other than a certified historic structure) is moved from the place where it is rehabilitated after the property is placed in service. If, for example, the taxpayer made modifications to the building inconsistent with Department of Interior standards, the Secretary of the Interior might revoke the certification. In addition, if all or a portion of a substantially rehabilitated building becomes tax-exempt use property (see paragraph (c)(7)(vi) of this section) for the first time within five years after the credit is claimed, the credit will be recaptured under section 47 at that time as if the building or portion of the building which becomes tax-exempt use property had then been sold.

Par. 5. Section 1.191-1 is amended by revising paragraphs (a), (b) (1)(i) and (3), and (c)(2)(iii), and by adding a new paragraph (f) to read as follows:

**§1.191-1 Amortization of certain rehabilitation costs for certified historic structures.**

(a) In general. Section 191 allows an owner of a certified historic structure who rehabilitates the structure to elect to amortize over a 60-month period certain expenditures attributable to certified rehabilitation. The election may be made only if the certified historic structure (as defined in §1.191-1(a)) and the improvements made are otherwise of a character subject to depreciation under section 167. In general, only those rehabilitation expenditures which result in additions to capital account after June 14, 1976, and before January 1, 1984, are eligible for this special amortization procedure. To qualify for the election, the rehabilitation must be certified by the Secretary of the Interior to the Internal Revenue Service as consistent with the historic character of the structure. See §1.191-2(d) for the definition of certified rehabilitation. Along with the amortization deductions, the taxpayer may continue otherwise allowable depreciation deductions of the basis of the structure, exclusive of rehabilitation costs which are a part of the amortizable basis (as defined in §1.191-2(e)).

(b) Allowance of deduction-(1) Determination of amortization period-(i) General rule. The taxpayer may elect to begin the 60-month amortization period with the month following the month in which the amortizable basis is acquired, or with the first month of the succeeding taxable year. Generally amortizable basis must be acquired after June 14, 1976, and before January 1, 1984. For purposes of this section, the month in which the amortizable basis is acquired is the latest of the month in which the work (or a component part of the work) is completed, the month in which costs are added to capital account, or the month in which depreciation deductions under section 167 would be first allowable with respect to the structure. See, however, §1.191-2(e)(8) for special rules for certified rehabilitations in part occurring outside the effective period of section 191. No amortization deduction may be claimed before a building is used (or held for use) in a trade or business or for the production of income.

(3) Relation to section 167(o) and other provisions. If an election involving a certified historic structure is made under section 191, no election may be made under section 167(o) either for the same rehabilitation or for any subsequent rehabilitation of the same structure undertaken by the taxpayer making an election under section 191. Additionally, no election is permitted under section 191 if depreciation deductions or credits against tax based upon any part of the costs qualifying for amortization under

section 191, are at any time claimed (or allowable) under any depreciation or other provision of the Internal Revenue Code of 1954. However, this limitation with respect to investment tax credits under section 38 applies only to structures placed in service after October 31, 1978. Except as provided in paragraph (f)(3) of this section, if section 191 treatment is timely elected on a structure placed in service after October 31, 1978, the investment tax credit under section 38 is considered not to have been allowable with respect to that structure for the same rehabilitation. However, the rule in the preceding sentence does not preclude a taxpayer from claiming an investment tax credit with respect to a separate and distinct rehabilitation to a structure on which a section 191 election was previously made.

(c) Person to claim deduction.

(2) Exceptions and special rules.

(iii) Certain transferees of historic structures. If expenditures for certified rehabilitation are in fact made by the owner of a certified historic structure, and if one or more transferees then acquire the ownership of the rehabilitated structure directly from that owner before the structure is placed in service in its rehabilitated use, the transferees, solely for purposes of section 191, may be treated as having incurred the rehabilitation expenditures actually incurred by the transferor on the date that the transferor actually incurred those expenditures. Transferees acquiring structures in transfers occurring after the structure is placed in service after its rehabilitation but before the first day of the following taxable year, are not eligible for section 191 treatment, because depreciation deductions for rehabilitation costs are allowable to the transferor before the transfer. The amount of rehabilitation expenditures treated as made by the transferees under this subdivision (iii) is the lesser amount of-

(A) The rehabilitation expenditures actually made before the date on which the transferee acquired ownership of the structure, or

(B) The portion of the transferee's cost or other basis for the property (determined according to the rules of section 167) which is attributable to rehabilitation expenditures made before the date on which the transferee acquires ownership of the structure.

(f) Termination-(1) In general. Except as provided in paragraph (f)(2) of this section, section 191, this section, §§1.191-2, and 1.191-3 shall not apply to expenditures incurred after December 31, 1981, in taxable years ending after such date.

(2) Transition rule. Section 191 and this section shall continue to apply to expenditures incurred after December 31, 1981, and before January 1, 1984, for the rehabilitation of a building if-

(i) The physical work on the rehabilitation began before January 1, 1982, and

(ii) The building does not meet the requirements of §1.48-12(b).

(3) Coordination with section 38. The fact that section 191 has been timely elected with respect to expenditures incurred prior to January 1, 1982, shall not prevent the investment tax credit under section 38 from being allowed with respect to qualified rehabilitation expenditures (within the meaning of section 48(g)(2) and §1.48-12(c)) incurred after December 31, 1981, as part of the same rehabilitation.

Par. 6. Section 1.191-2 is amended by revising paragraph (e)(8) to read as follows:

**§1.191-2 Definitions and special rules.**

(e) Amortizable basis.

(8) Time when amounts are added to capital account. Under section 191, expenditures are treated as added to capital account at the time they are actually made (paid or accrued). However, amortizable basis includes only expenditures attributable to component parts of the structure completed before January 1, 1984. Therefore, expenditures for improvements completed after December 31, 1983, are not a part of the taxpayer's amortizable basis even though they may have been paid

or accrued prior to that date. In the case of a single and continuous rehabilitation project all of which is certified by the Secretary of the Interior, expenditures for rehabilitation begun before June 14, 1976, but completed and charged thereafter, are a part of the taxpayer's amortizable basis. However, even where there is a single and continuous rehabilitation project, expenditures made for any component part of the improvements completed and charged before June 14, 1976, are not a part of the taxpayer's amortizable basis.

Par. 7. Section 1.191-3 is amended by revising paragraph (b)(4) to read as follows:

**§1.191-3 Time and manner of making election.**

(b) Special rules.

(4) Elections to begin amortization deductions after December 31, 1983. Notwithstanding the rules of §1.191-1(b)(1)(i), expenditures for component parts of a rehabilitation project which is not completed and placed in service until after December 31, 1983, are included in amortizable basis if the component parts are completed and the expenditures are added to capital account under §1.191-2(e)(8) by that date. Amortization deductions for the costs of such component parts are allowable beginning with the month in which the entire rehabilitation would qualify under §1.191-1(b)(1), but for the expiration of section 191 on December 31, 1983.

**PART 602-[AMENDED]**

Par. 8. The authority for Part 602 continues to read as follows:

**Authority:**

26 U.S.C. 7805.

**§602.101 [Amended]**

Par. 9. Section 602.101(c) is amended by inserting in the appropriate place in the table:

**§1.48-12(b)(2)(vii) .....1545-0155**

**§1.48-12(b)(6)(ii) .....1545-0155**

**§1.48-12(d)(5) .....1545-0155**

**§1.48-12(d)(6) .....1545-0155**

**§1.48-12(d)(7) .....1545-0155**

This Treasury decision includes amendments that conform the regulations to the amendments made to sections 46, 48, and 191 of the Internal Revenue Code of 1954 by the Economic Recovery Tax Act of 1981, the Technical Corrections Act of 1982, the Tax Reform Act of 1984, and the Tax Reform Act of 1986. The rules prescribed reflecting these changes are interpretative. For this reason and because there is need for immediate guidance the requirement for notice and public procedure under subsection (b) of section 553 of title 5 of the United States Code and the effective date limitation of subsection (d) of that section are found to be inapplicable.

Lawrence B. Gibbs,

Commissioner of Internal Revenue.

Approved: August 19, 1988.

O. Donaldson Chapoton,

Assistant Secretary of the Treasury.