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ATTORNEY GENERAL OF TEXAS

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Mr. Mark Wolfe
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Post Office Box 12276
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Opinion No. KP-0290

Re: Whether a nonprofit organization leasing a publicly-owned property may qualify for and obtain the state tax credit for certified rehabilitation of certified historic structures on behalf of the public owner (RQ-0303-KP)

Dear Mr. Wolfe:

You ask whether a nonprofit organization may qualify for and obtain a state tax credit for historic preservation under particular facts.¹ Your question relates to a program the Legislature established to incentivize the preservation of historic buildings through the award of franchise tax credits based on a percentage of the amount spent on a completed project.² See Request Letter at 1. The program, codified in chapter 171, subchapter S, of the Tax Code, utilizes a multistep application process administered by the Texas Historical Commission (the "Commission") and the Comptroller. See generally TEX. TAX CODE §§ 171.901–.909 ("Tax Credit for Certified Rehabilitation of Certified Historic Structures"). As part of this process, an applicant for the state tax credit must first obtain a certificate of eligibility from the Commission. *Id.* § 171.904(a); see also *id.* § 171.904(b) (providing that the Commission "shall issue [the certificate] to an entity that has incurred eligible costs and expenses as provided by" subchapter S). Through the certificate, the Commission confirms that the property related to the expenses meets the definition of "certified historic structure" in subsection 171.901(1) and that the rehabilitation qualifies as a "certified rehabilitation" as federally defined in 36 C.F.R. § 67.7.³ *Id.* § 171.904(a)(2), (b). The applicant then forwards the certificate along with certain cost information and other documentation to the Comptroller. *Id.* §§ 171.904(c), .907. An entity is eligible for the tax credit if:

¹See Letter from Mr. Mark Wolfe, Exec. Dir., Tex. Historical Comm'n, to Honorable Ken Paxton, Tex. Att'y Gen. at 1 (Sept. 4, 2019), <https://www2.texasattorneygeneral.gov/opinion/requests-for-opinion-rqs> ("Request Letter").

²An awarded tax credit may also be used against insurance premium taxes and may be sold or assigned. See TEX. TAX CODE § 171.908(e); see also Tex. Att'y Gen. Op. No. GA-1045 (2014) at 5–6 (concluding that eligibility for the tax credit is not limited to entities subject to the franchise tax).

³The certificate must also specify the date the certified historic structure was first placed into service after the rehabilitation. TEX. TAX CODE § 171.904(b)(2).

- (1) the rehabilitated certified historic structure is placed into service on or after September 1, 2013;
- (2) the entity has an ownership interest in the certified historic structure in the year during which the structure is placed in service after the rehabilitation; and
- (3) the total amount of the eligible costs and expenses incurred exceeds \$5,000.

Id. § 171.903.⁴

You tell us the Commission “received an application for a property owned by an independent school district and operated as part of an active public school.” Request Letter at 1. You explain that a nonprofit entity “has been formed to act as the tax credit applicant, indicating on the submitted application that the nonprofit holds a long-term lease on the property.” *Id.* You further state that the nonprofit “proposes to undertake a rehabilitation of the building, after which it will be returned to use as a school by the school district,” and that the nonprofit “will sell the tax credits to an entity subject to the state franchise tax.” *Id.* You question “whether or not a nonprofit organization leasing a publicly-owned property can qualify for and obtain the state tax credit on behalf of the public owner who is, presumably, paying the costs of rehabilitation.”⁵ *Id.* Whether a particular applicant may obtain a historic preservation tax credit ultimately depends on specific facts, which cannot be determined in the opinion process. *See* Tex. Att’y Gen. Op. No. KP-0239 (2019) at 3. Thus, we advise you only generally. But your question raises legal issues regarding the standing of nonprofit lessee applicants under the eligibility criteria of section 171.903, particularly as it relates to ownership and the incurrence of costs and expenses.

We begin with ownership. The eligibility criteria for the state tax credit requires an applicant to have “an ownership interest in the certified historic structure in the year during which the structure is placed in service after the rehabilitation.” TEX. TAX CODE § 171.903(2). Commission rules establish that “[a] long term lessee of a property may be considered an owner if [its] current lease term is at a minimum . . . 39 years for nonresidential real property, as referenced by § 47(c)(2), Internal Revenue Code.” 13 TEX. ADMIN. CODE § 13.1(18) (Tex. Historical Comm’n, Definitions); *see also* TEX. TAX CODE § 171.909 (authorizing the Commission and the Comptroller to adopt administrative rules necessary to implement subchapter S).⁶ Thus, a lessee

⁴“The burden of establishing eligibility for and the value of the credit is on the entity” applying for the tax credit. *Id.* § 171.907(c).

⁵Briefing sent to this office on behalf of the nonprofit applicant states that the nonprofit “will incur the costs related to the rehabilitation of” the school. Memorandum attached to letter from Mr. Patrick J. Kennedy, Jr., Kennedy Sutherland LLP, to Honorable Ken Paxton at 1 (Oct. 17, 2019) (on file with the Op. Comm.). The opinion process cannot resolve disputed questions of fact. Tex. Att’y Gen. Op. No. GA-1061 (2014) at 2 n.3.

⁶The Comptroller’s rules do not address criteria for establishing ownership. *See generally* 34 TEX. ADMIN. CODE § 3.598 (Comptroller of Pub. Accounts, Margin: Tax Credit for Certified Rehabilitation of Certified Historic Structures).

applicant may establish the requisite ownership interest if its lease term in the year during which the structure is placed in service after the rehabilitation is at least 39 years for nonresidential real property.⁷

The heart of your inquiry centers on the eligibility requirement pertaining to the incurrence of eligible costs and expenses and how the relevant statutory provision affects nonprofit lessee applicants. *See* TEX. TAX CODE § 171.903(3) (requiring the applicant entity to incur eligible costs and expenses exceeding \$5,000). The definition of “eligible costs and expenses” under state law is based on the definition of “qualified rehabilitation expenditures” in federal law, but the Legislature established two exceptions for specified state tax credit applicants. As stated in subsection 171.901(4),

“[e]ligible costs and expenses” means qualified rehabilitation expenditures as defined by Section 47(c)(2), Internal Revenue Code, except that the depreciation and tax-exempt use provisions of that section do not apply to costs and expenses incurred by an entity exempt from the tax imposed under this chapter by Section 171.063 or by an institution of higher education or university system . . . , and those costs and expenses are eligible costs and expenses if the other provisions of Section 47(c)(2), Internal Revenue Code, are satisfied.

Id. § 171.901(4). To understand how this complex definition affects nonprofit lessee applicants, we first examine (1) the referenced federal law; (2) the two provisions from it the Legislature made inapplicable; and (3) to whom the provisions are inapplicable.

Subsection 47(c)(2) of the Internal Revenue Code (the “Code”) defines a “qualified rehabilitation expenditure” in terms of its capital account chargeability, its connection to a qualified rehabilitated building, the property’s category, and the property’s eligibility for depreciation allowances. *See* 26 U.S.C. § 47(c)(2)(A). Subsection 47(c)(2) further provides that certain expenditures are not included in the definition. Relevant here, subsection 47(c)(2)(B)(i) excludes expenses not using a particular method of depreciation, and subsection 47(c)(2)(B)(v) excludes expenses tied to property with a “tax-exempt use.” *See id.* §§ 47(c)(2)(B)(i) (referring to straight line depreciation), 47(c)(2)(B)(v)(I) (incorporating the definition of “tax-exempt use

⁷The Comptroller tells us it would require additional information regarding lease arrangements by a nonprofit to determine ownership, such as whether payments are made at fair market value and whether a nonprofit’s occupancy continues for the duration of the lease term. *See* Letter from Ms. Teresa Bostick, Dir., Tax Policy Div., Office of the Tex. Comptroller, to Virginia K. Hoelscher, Chair, Op. Comm. at 2 (Oct. 24, 2019) (on file with the Op. Comm.) The Comptroller’s office asserts this information is relevant to determine whether the lease serves a valid business purpose, stating that the Comptroller “may disregard a transaction with no purpose other than to create a tax benefit.” *Id.* The statutory and regulatory framework governing ownership for the state tax credit makes no reference to payment of market value or occupancy beyond the year in which the structure is placed in service following rehabilitation. *See* 26 U.S.C. § 47(c)(2)(B)(vi). Whether a particular nonprofit arrangement serves a valid business purpose is thus an issue separate from ownership and would depend on specific facts that cannot be determined in an attorney general opinion.

property” in subsection 168(h) of the Code).⁸ Ordinarily, a statute’s incorporation of another statute’s definition incorporates the definition in full, including any exclusions. But the Legislature made two exceptions in subsection 171.901(4) to the incorporation of the federal definition. It provided that “the depreciation and tax-exempt use provisions of [subsection 47(c)(2)] do not apply” with respect to certain applicants. TEX. TAX CODE § 171.901(4). Just as two mathematical negatives make a positive, subsection 171.901(4) thus negates the effect of those federal provisions, resulting in the inclusion—not the exclusion—of expenditures on tax-exempt use properties and non-depreciable properties as “eligible costs and expenses” under state law for those applicants so long as other provisions in subsection 47(c)(2) of the Code are satisfied. *See id.* The Legislature also designated the applicants to which the depreciation and tax-exempt use provisions do not apply as either entities exempt from state franchise taxes under section 171.063, or higher education institutions or university systems. *See id.* Section 171.063 exempts from franchise taxes nonprofit corporations exempt from federal income tax, such as 501(c)(3) organizations. *See id.* § 171.063(a)(1). Thus, for those nonprofits and higher education entities only, the definition of “eligible costs and expenses” in the Texas Tax Code incorporates a modified version of the federal definition of “qualified rehabilitation expenses” in the Internal Revenue Code.

With this framework in mind, we consider how the eligibility requirements pertaining to the incurrence of eligible costs and expenses generally affect nonprofit lessee applicants. *See id.* § 171.903(3) (requiring the applicant entity to incur eligible costs and expenses exceeding \$5,000). As discussed above, the definition of “eligible costs and expenses” under subsection 171.901(4) as applied to nonprofit entities does not include the federal provisions relating to depreciation or tax-exempt use “if the other provisions of [sub]section 47(c)(2) [of the Code] are satisfied.” *Id.* § 171.901(4). One such “other provision” in subsection 47(c)(2) with particular relevance to lessee applicants concerns the time remaining on the lease when the rehabilitation is completed. Subsection 47(c)(2) excludes from the term “qualified rehabilitation expenditure” an expenditure by a lessee of a building if the time remaining on the lease on the date the rehabilitation is completed “is less than the recovery period determined under section 168(c)” of the Code. 26 U.S.C. § 47(c)(2)(B)(vi). Subsection 168(c) of the Code sets the recovery period for nonresidential real property at 39 years. *Id.* § 168(c). Thus, provided the time remaining on a lease of nonresidential real property equals or surpasses 39 years on the date the rehabilitation is complete, a tax credit applicant’s costs and expenditures will not be excluded from subsection 47(c)(2)’s definition of “qualified rehabilitation expenditure”—and thereby subsection 171.901(4)’s definition of “eligible costs and expenses”—due to the applicant’s status as a lessee.

Finally, the eligibility requirement related to costs and expenses expressly refers to the “total amount of the eligible costs and expenses *incurred*.” TEX. TAX CODE § 171.903(3) (emphasis added). Subchapter S as a whole plainly requires any entity applying for the tax credit to have directly incurred the requisite amount of costs and expenses. *See id.* § 171.904(b), (c)(3) (providing that the Commission issues a certificate of eligibility “to an entity *that has incurred eligible costs and expenses*” and requiring the applicant to include “an attestation of the total

⁸Subsection 168(h)(1)(B)(i) of the Code defines “tax-exempt use property” in the case of nonresidential real property as the “portion of the property leased to a tax-exempt entity in a disqualified lease.” 26 U.S.C. § 168(h)(1)(B)(i); *see also id.* § 168(h)(1)(B)(ii) (describing circumstances under which a property lease to a tax-exempt entity becomes a “disqualified lease”).

eligible costs and expenses *incurred by the entity*” in the documentation it forwards to the Comptroller in order to claim the tax credit (emphasis added)). Accordingly, to the extent costs and expenses of a rehabilitation project are directly borne by an entity other than the applicant, the applicant may not apply those costs toward the \$5,000 threshold amount required for eligibility.

S U M M A R Y

A nonprofit lessee applicant may generally qualify for and obtain a state tax credit for certified rehabilitation of certified historic structures pursuant to chapter 171, subchapter S, of the Tax Code, but the qualifying costs and expenses must be borne directly by the applicant. An applicant's status as a nonprofit tax-exempt entity and a lessee does not generally disqualify the applicant from eligibility for the tax credit pursuant to sections 171.901(4) and 171.903, provided the applicant meets certain requirements, including the length of time remaining on the lease when the rehabilitation is completed.

Very truly yours,



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