The historic tax credit (HTC) substantial rehabilitation test may seem simple on the surface, but there are some important nuances that even experienced developers may not be fully aware of. In this episode of Tax Credit Tuesday, Michael Novogradac, CPA, and Roy Chou, CPA, discuss what developers need to know about meeting the substantial rehabilitation test and planning their qualified rehabilitation expenditures so they can optimize the amount of HTC equity they can raise.

Summaries of each topic:

Transcript

[00:00:11] **Michael Novogradac, CPA:** Hello, I'm Michael Novogradac. And this is Tax Credit Tuesday. This is the May 17, 2022, podcast. Welcome to the first episode in a two-part series for historic tax credit developers. In this episode, we'll discuss what developers need to know about meeting the substantial rehabilitation test and optimizing their qualified rehabilitation expenditures so they can optimize the amount of historic tax credit equity they can raise. Now, next week we'll have part two, which will be a deeper dive on what is and is not included in qualified rehabilitation expenditures. These two related topics are crucial for developers to understand and we'll cover concepts in both episodes that will be useful for both newer and experienced developers alike.

Turning to today's topic is the substantial rehabilitation test. What is the substantial rehabilitation test? We'll go into the definition in more detail during our discussion today, but essentially to qualify for the federal historic tax credit a historic rehabilitation project must undergo a substantial rehabilitation. That means that the eligible cost of the rehabilitation has to exceed the greater of $5,000 or the adjusted basis of the building and its structural improvements within a given measurement period. Now, the test may seem simple on the surface, but there are some important nuances that even some experienced developers are not fully aware of.

In today's podcast, we're going to discuss some commonly misunderstood or overlooked aspects of the substantial rehabilitation test. Understanding these finer points can help developers not only qualify for the historic tax credit, but also help inform their strategy so they can maximize their historic tax credits, which in turn allows them to maximize the amount of historic tax credit equity that they can raise.

Joining me in today's discussion is my partner Roy Chou from Novogradac’s San Francisco office. Roy has extensive experience with a multitude of tax incentives, including, of course, the historic tax credit, as well as the new markets tax credit and the opportunities zones incentive. Roy also offers numerous accounting consulting services, including audit and tax work, structuring, tax planning and more. Roy is also a frequent contributor to the Novogradac Journal of Tax Credits. We're very fortunate to have him on the podcast today to share his insight and some useful examples he's seen while working with historic tax credit developers. We have a lot of ground to cover. If you're ready, let's get started.

So Roy, welcome to Tax Credit Tuesday.

[00:02:44] **Roy Chou, CPA:** Thanks, Mike, happy to be here.

[00:02:46] **Michael Novogradac, CPA:** Yeah, before we get into the various nuances of the substantial rehabilitation test, I wanted you to take a moment and explain why the substantial rehabilitation test matters and why developers who are listening to this podcast should pay attention.

[00:03:02] **Roy Chou, CPA:** Oh, sure. I can think of a few reasons why this test matters and why developers should care. Whether, you're a seasoned developer or a new developer, whether you know how the historic tax credit program works or not, there are a few reasons why you should understand how the substantial rehab test works. One is if you have a certified structure, a property that is eligible for historic tax credits, you need to understand that you have to meet the substantial rehabilitation test in order to be eligible to claim credits. So that's one.

Second, even knowing the test there's ways where we can help developers maximize the amount of tax credits they can claim by kind of understanding their strategy and helping them with the strategy in terms of construction timing, and how they can plan to meet the substantial rehab test.

And lastly, I think even for those that are familiar with the tax credit program there's certain nuanced rules that they might not know of particularly. For those that might be identifying a property to purchase that might be eligible for tax credits, you can still meet the substantial rehab test and take credits on the qualified expenditures even if the property is already in construction and you have not purchased the property. So, those are some of the reasons I think it's important for developers to kind of understand this test and know how to go about measuring this testing period.

[00:04:35] **Michael Novogradac, CPA:** So in my intro, I gave an overview of the substantial rehabilitation test, basically saying that you have to incur costs in excess of the acquisition cost or the basis in the building and its structural improvements that you own. That sounds simple enough, but it's a little more complicated than that. So, maybe you could share with our listeners some of the more detailed aspects of how you go about the measurement test and sharing some of the aspects of the tests that listeners may not be aware of.

[00:05:13] **Roy Chou, CPA:** So, Mike, as you pointed out earlier at the beginning of this podcast, in order to meet the substantial rehab test, a taxpayer needs to incur qualified rehab expenditures incurred within any 24-month period. That needs to exceed the greater of $5,000 or the adjusted basis of the building at the start of this 24-month period. And I'm going to stop there and take a deeper dive into this. So, within that 24-month period the taxpayer needs to incur qualified rehab expenditures. So, next week we're going to do, do a deeper dive in terms of what are considered eligible versus non-eligible costs for the purposes of the qualified rehab expenditures that you can include in this 24-month test.

Also, I think a couple of misconceptions about the 24-month test that a lot of developers are not aware of is the fact that this test is any 24-month period that the developer chooses. Oftentimes, developers think that the beginning of this 24-month measurement period needs to start with either the property acquisition date or construction start date.

And that's not the case. The developer can choose any 24-month period. But also the 24-month period needs to end within the taxable year in which the expenditures are placed in service, but essentially it's up to the developer to choose this 24-month period that they can use to not only meet the test, but potentially maximize tax credits.

And lastly, once that test is met, meaning within that 24-month period, the developer incurs qualified rehab expenditures that exceed the beginning adjusted building basis at the beginning of the 24-month period, then they're able to claim credits not only on the qualified rehab expenditures within those 24 months, but they can also claim credits on any qualified expenditures incurred prior to the 24-month period and also at the end of the period through the end of the calendar taxable year, they can also claim credits on those expenditures.

[00:07:32] **Michael Novogradac, CPA:** So, another way of looking at this is the 24-month period is just the measure period within which you need to incur sufficient costs to exceed your adjusted basis in the building. Then, you're saying that once you meet that test, whatever tax year that that 24-month test ends, you can have all the expenditures qualified rehabilitation expenditures after the end of the 24-month period through the end of that tax year, or you can include as well those expenditures before the 24 months start.

So, thank you for that. Now I, one thing I'm going to think about this historic rehabilitation test is, how often is that even much of an issue? Because obviously if you're buying an existing building that's quite dilapidated and you're doing an exhaustive historic renovation, the substantial rehabilitation test isn't a significant test to pass.

And I know that you get a lot of calls from potential clients that are considering using historic tax credit equity to fund a renovation of a building. So, I was wondering of those sort of potential client calls when you have that initial discussion with the client, how often when you have that initial discussion, is there a concern that the renovation costs may not be sufficient to meet the substantial test?

[00:08:48] **Roy Chou, CPA:** Yeah. I think typically when we have clients contacting us or me specifically, when clients contact me and they have a planned historic tax credit rehab typically they have enough renovation costs that would meet this test, meaning that they would incur enough qualifying rehab expenditures to meet the adjusted basis of the building.

But there have been times where we've helped clients that are unsure because based on their construction budget, they're very close and I'll use a recent example of a hotel project that I helped a client with recently. So, the client reached out. It was their first historic tax credit project. They have not done a historic tax credit deal before. They were working with an attorney that referred us because, obviously we're one of the leading firms out there in terms of tax credits tax incentives. So, they were referred over to us and they really weren't sure if their project would qualify and based on their construction budget and based on their acquisition costs of the hotel, they were very close.

If I remember the numbers correctly, it was approximately $20 million of acquisition costs and $18 million of hard cost. So, they were thinking they wouldn't qualify, but they weren't aware of whether the costs were eligible or not to include into this substantial rehab test.

And we mentioned it a couple of times, next week of this two-part podcast, we're going to go into more in terms of what are eligible versus noneligible costs. But you know, I was able to communicate with them that, "Hey, there's certain costs that you're not taking into consideration, specifically soft costs, that are capitalized during the construction period. Construction period interests on a construction loan."

They didn't take that into consideration and certain costs that were capitalizable that just were soft costs. And so after a thorough analysis they hired us to do the consulting engagement. We determined that they actually would pass the test. And it sounds like we're going to be signed up to help them with the cost certification process as well.

[00:11:12] **Michael Novogradac, CPA:** I was also going to say, I also think this question also arises when you're combining the historic credit with other tax incentives, so if you're doing a low-income housing tax credit acquisition rehab particularly if it's an in-place renovation, then your acquisition costs will be sort of notably higher and you'll be a little bit closer on some of these tests. So, it definitely is sort of development specific, but it does come up. It does occur as an issue more often than initially you might think it would.

So, now that we've set the foundation as to what the substantial rotation test is and why it matters, I thought it'd be good to dive into some of the more common issues that you have clients resolve with respect to the test. So, I was wondering if maybe you could, when you're thinking about this test, if there are certain main categories or troubleshooting areas that you help clients address?

[00:12:09] **Roy Chou, CPA:** Yeah, I think there are certain areas in which I help clients address it's really, once we figure out that they have a certified historic structure and that they're confident that they're able to meet the substantial rehab test. I think the next step the clients hire us is to find out how they can maximize the amount of credits that they can claim based on the historic tax credit project that they're working on. And again, we mentioned that the 24-month measurement period, it's a flexible test where you the tax credit developer can choose this specific 24-month window to meet the test and based on the window that they choose, as I mentioned earlier, once you meet the test you're able to claim qualified rehab expenditures for tax credit purposes that are incurred prior to the period and after the end of the period through the end of the taxable year. So, really where you start and end this period can potentially really impact the amount of credits that the taxpayer or developer can claim.

[00:13:17] **Michael Novogradac, CPA:** I remember that. Remember reading the regs over 30 years ago, I got started then the tax credits back then at a big eight accounting firm. And we spent a lot of time around measuring the 24-month period and paying a lot of attention to that being just a measuring period and then get a new include the cost before and after, but let's actually turn to a different type of development.

Historic tax credit developments do vary in size and scale. And some projects are constructed in multiple phases. So, what if you have someone that comes to you and says, this is great. There's the 24-month rule, but I actually have, a development that's going to be done in phases. And it's going to take, 30 months or 40 months or 50 months, maybe you could describe for our listeners how the 24-month test, isn't always a 24-month test.

[00:14:11] **Roy Chou, CPA:** Yep. No, certainly Mike for those projects the historic tax credit program specifically carves out an exception for projects that would take longer to complete. And we call those phase rehabilitations. So, for a phase rehab project, you get to use a 60-month measurement period, a five-year measurement period versus the 24-months standard measurement period.

But the caveat is that the rehab must be reasonably expected to be completed in phases that are set forth in the architectural plans and specifications before the rehab. And also, it's important to understand that this 60-month exception is not a fallback provision, just in case a developer fails a 24-month test. It needs to be clear in your plans that this is a phase rehab it's completed in phases prior to the construction commencement. So, I think that's important to note.

[00:15:12] **Michael Novogradac, CPA:** And have you, I mean, how many, how often is it that you end up working on a phased project where you're using the 60 months versus the standard 24?

[00:15:23] **Roy Chou, CPA:** I think, I think a lot of times. So, maybe I'll say it this way. We actually have a lot of clients that we work with that ask us, “Hey, Roy, should we choose the 60-month period, if we're able to demonstrate that our project will be completed in phases, even though we think that the project will be done within 24-months or the project can be done using the 24-month measurement period?”

And my response is yes, 100% of the time. If you can demonstrate that your project is completed in phases and you can use that 60-month exception. You should always do that. And so a lot of times, it takes working with the architects. A lot of times they work with historic tax credit consultants or we work with them as well, to make sure that they're able to support the use of the 60-month exception.

[00:16:24] **Michael Novogradac, CPA:** Right. Thank you. That's a very good advice. So one other area that I thought was worth us touching base on, has to do with the developer acquiring a historic property after the previous owner has started making some improvements to the property and some listeners may not be aware of the effect of those in process improvements to the new owner, the benefits of the new owner. So, maybe you could touch on what I like to refer to as the step-into-the-shoes rule.

[00:17:02] **Roy Chou, CPA:** Yeah. And, and, and that's exactly what a purchaser is doing and able to do. They're stepping into the shoes of a developer with a tax credit project that they're selling so the purchaser, they're able to still claim credits on qualifying costs that have been incurred by the previous owner. And they're still able to meet the substantial rehab test for a property that has commenced construction. Certain items that's important to point out is their adjusted basis in the building will be determined as of the beginning of a 24-month period that's being used, the 24-month period that's being used by the seller of the property they can use the adjusted basis as of that date or as of the first date of their holding period.

In other words, the purchase. Whichever is later. So if they decide to use the holding period date or the purchase date, then the basis in the purchaser's building is essentially the purchase price of the building, less any qualified rehab expenditures incurred by the seller during the 24-month. So, I think that's important to note that I'm a purchaser of a property that's eligible for tax credits that started construction. They're still able to claim credits there. They can still meet the test. And the substantial rehab test is actually a little more flexible in that sense as well.

[00:18:37] **Michael Novogradac, CPA:** And you made the reference to start of construction, which I think you're using somewhat loosely. Because I think what you mean is to the extent that they have started a renovation, which could be soft costs, it could be a number of costs that hasn't started like physical construction of the property that the buyer can step into the shoes of those costs, which as you pointed out does sort of double duty in the sense that it lowers the portion of the purchase price that gets treated into the building because a portion of the purchase price ends up being allocated to the step-into-the-shoes expenditures, but it also ends up increasing the amount of tax credits. Those expenditures end up becoming eligible for tax credits for the buyer. So, it seems like every buyer of historic property should make sure that they're discussing with the seller what work they might have done, renovation work that they might've done or have in, I should say, have in progress so they can allocate some portion of the purchase price to those costs.

Would you agree with that?

[00:19:40] **Roy Chou, CPA:** I completely agree and I couldn't have said that better. And I think it's important for the purchaser to also understand that of the costs that have been incurred by the seller that none of these costs have been previously, I'm going to say used or place in service, because if, if those costs have been previously placed in service, it would just simply be part of the acquisition price and they will not be able to claim credits on those otherwise qualifying costs.

[00:20:09] **Michael Novogradac, CPA:** So, Roy, I think that's a good overview of this tax credit rehabilitation test and I'm looking forward to the podcast next week to go into a deeper dive on what is in qualified rehabilitation expenditures versus what isn't. But I know many listeners won't want to wait until next week. They'll have some specific questions for you.

So, if you could share your email address and I'll also be sure to include in today's show notes.

[00:20:38] **Roy Chou, CPA:** Yep. Sure. Any listeners that wants to reach out for clarity on today's podcast or any questions related to historic tax credit deal, feel free to email me at Roy.Chou@novoco.com. That's spelled Roy.Chou@novoco.com.

[00:21:03] **Michael Novogradac, CPA:** Great. Thank you, Roy. Please stick around for the Off Mic section of the podcast. I get to ask you some fun off-topic questions. For our listeners please, be sure to tune into next week's episode of Tax Credit Tuesday where I noted we're going to have part two of this two-part series in historic tax credits.

Joining me next week, we're going to have my partner Tom Fantin from Novogradac's Dover, Ohio, office. He'll be on the podcast with me to discuss what you need to know about what is included in qualified rehabilitation expenditures, which is also part of the process whereby most historic tax credit developments will get a historic tax credit cost certification, where an accountant will go in and review what costs are included for purchase of the historic tax credit. And then Tom will also discuss updated IRS guidance on qualified rehabilitation expenditures. It'll be a must-listen for all the historic tax credit developers, as well as investors. You can make sure that you're notified of that episode and each week's episode, by following or subscribing to the Tax Credit Tuesday podcast, go to www.novoco.com/podcast to subscribe to and stream the show on our website.

You can also follow subscribe to Tax Credit Tuesday on iTunes, Spotify, Google Podcast, Stitcher and Radio Public.

So, Roy now I'm pleased to reach our Off Mic section where listeners get some off-topic advice, and words of wisdom from podcast guests. And I'll start with one of my favorite questions I like to ask, which is what's the best career advice you've ever gotten?

[00:22:33] **Roy Chou, CPA:** The best career advice that I've ever gotten I think as a public accountant, the best advice is that busy season is a marathon and not a sprint. So that's a very good advice, I think, for any public accounts out there. But I think in general in terms of career advice, I think I would say the best advice that I've gotten is be genuine in terms of what you're doing.

Don't try to do something in a manner that others do it, do it your own way. As long as you put in the hard work and dedication and you're ambitious, you want to be successful, you will be. Just make sure that you stay true to yourself and just kind of, do it your way.

[00:23:16] **Michael Novogradac, CPA:** Great. Thank you for that. And then the second question, which is another favorite is do you have any favorite or it's always hard to say the favorite, but maybe you could share a useful work-life balance tip?

[00:23:30] **Roy Chou, CPA:** I think a useful work-life balance tip at least for me is exercising regularly. I truly think that but you know, at least for me, when I exercise regularly, I feel good. When I feel good, I perform well. And also working out, I think it helps with a lot of the mental stress too.

When I'm working out, I'm less angry and I feel like I have more clarity. So, my wife is happy when I'm working out.

[00:23:59] **Michael Novogradac, CPA:** That's good to hear. So, this is one where I'm always curious, what's a skill or talent someone will share. But what's a skill or talent that most people don't know you have. And how, or why did you develop that skill or talent?

[00:24:13] **Roy Chou, CPA:** I laugh at that question because this is going to go a long way back when I was a staff accountant starting at Novogradac & Company, Mike, there was a question we used to have, we used to share statements from our incoming staff.

So others get to know them a little better. And one of the questions asked was, why did you become an accountant? And to tie into this question, my response was like, well, I don't have the skills or talent to become a rock star. So I decided to be an accountant, but I would say a skill or talent that most people don't know I have: I actually really enjoy cooking and, I have to toot my horn a little bit, I would say I'm a pretty good chef. And that's something that probably a lot of folks won't know about me.

[00:25:05] **Michael Novogradac, CPA:** I did not know that. So, now I need to finagle an invitation.

[00:25:10] **Roy Chou, CPA:** And that's why I don't share this, Mike.

[00:25:14] **Michael Novogradac, CPA:** I'm sure your friends get to learn about that skill that you have and love to take you up on it or watch you practice it.

[00:25:23] **Roy Chou, CPA:** Yeah. Exactly.

[00:25:26] **Michael Novogradac, CPA:** So, this is great. So, I do appreciate you joining me the podcast this week, Roy, and to our listeners, I’m Mike Novogradac. Thanks for listening.

Additional Resources

Email

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