Comments on Your Government

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Reauthorization of the Historic Structures Tax Credit

Introduction

There are many intangible benefits of historic preservation, such as preservation of culture and community and the aesthetic sensibilities of preserving architecturally-significant buildings. Historic preservation conveys economic benefits as well. For example, preservation costs may be lower than replacement costs and designation as a historic place may increase property values. However, historic rehabilitation also carries costs, particularly with regard to the rehabilitation of industrial or commercial spaces. In order to mitigate these costs, historic structures tax credits provide an economic incentive for private-sector investment in the rehabilitation of historic properties.

There is evidence that these programs are not only successful at incentivizing historic preservation, they are additional economic benefits, such as job creation, as well as less direct benefits, so-called "spillover" effects, that generate additional economic returns. The federal program, which has been in place since 1976, has played a role in the rehabilitation of almost 40,000 projects with a net investment of $62.9 billion. In federal fiscal year (FFY) 2011, the National Park Service estimates that the credits leveraged $4.0 billion in investment across 937 projects, and that these projects created an estimated 55,458 jobs.

Rhode Island's Historic Preservation Investment Tax Credit (HPITC) has been in place since 2001; however, in 2008, the General Assembly passed legislation that effectively ended the program, barring new applications and modifying rules for projects that were not placed in service as of January 1, 2008. Legislation has been introduced to reinstate the credits in a modified form. In evaluating whether to restore the credits, the General Assembly must take into consideration the relative costs and benefits of the credits. This RIPEC Comments provides an overview of the credits, at the federal and state levels, as well as a summary of the potential costs and benefits of reinstating the credits.

Overview of Historic Structures Tax Credits

Historic structures tax credits – dollar-for-dollar reductions in tax liability – provide an economic incentive for investor participation in historic rehabilitation projects, either through resale or syndication of the credits. Currently, 29 states, along with the federal government offer a tax credit incentive for the rehabilitation of historic property. States and the federal government vary on the structure and applicable uses of historic tax credits, including the amount of the credit, the minimum investment that must be made to qualify for the credits and whether the credits can be resold.

Federal Historic Preservation Tax Incentives

The federal Historic Preservation Tax Incentive program is administered by the National Park Service and state historic preservation offices, with cooperation from federal and state tax administrations. The federal program began in 1976 and has been amended twice: in 1981 as part of the Economic Recovery Act, and in 1986 under the Tax Reform Act. Currently, the federal credit is 20.0 percent of qualified rehabilitation expenses (QREs) for certified historic structures for

commercial, industrial and rental residential purposes. There is also a 10.0 percent credit for nonresidential buildings built before 1936 but are not certified historic structures. To qualify for a credit, an owner must:

- Have a structure that is listed on the National Historic Register of Historic Places or is a contributing part of a historic district listed on the Historic Register;
- Use the building for income-producing purposes;
- Expend an amount greater than the building's adjusted basis[1], or $5,000, whichever is greater;
- Rehabilitate the building in a manner that meets the Secretary of the Interior's Standards for Rehabilitation; and
- Complete the rehabilitation, which must be substantial, within a 24-month period, unless the rehabilitation is completed in phases in which a 60-month period is applicable.

By itself, the federal credit cannot be resold and is only available to the person or entity that holds the title to the property; however, the credits can be syndicated. Syndication is the process of allowing additional investors to enter into legal entities such as limited liability corporations (LLCs), allowing the investor to take advantage of the credit in exchange for providing equity to the project. In the case of syndication, the investor generally acts as a limited partner or investor, while the owner acts as the general partner or managing member. The majority of credit syndication is to third-party corporate investors due the Passive Activity Rules in the Internal Revenue Code, which limit the use of tax credits by individuals.

The credit may be claimed when the property is placed in service, and after property owners have obtained final approval from the National Park Service.[2] Credits may be carried back one year, and carried forward up to 20 years. Recapture rules apply if the building is sold or is no longer used for income-producing purposes. The recapture is reduced by 20.0 percent each year the building is in service, so the recapture provisions do not apply after five years. In the event that a partner sells their interest, or reduces their interest to less than two-thirds of what it was when the credit was claimed, recapture provisions apply. Rehabilitation credits may be combined with other federal credits, such as the low-income housing credit.

Table 1
Historic Preservation Tax Incentives by State, FFY 2011

	Part 3 Approval	Certified Expense	Rank	Average Expense	Rank
United States	711	$3,472,840,678	-	$4,884,445	-
Connecticut	5	$92,561,630	12	$18,512,326	3
Maine	6	28,459,790	27	4,743,298	21
Massachusetts	20	104,222,495	11	5,211,125	20
New Hampshire	-	-	-	-	-
Rhode Island	**16**	**110,540,998**	**10**	**6,908,812**	12
Vermont	7	4,347,804	43	621,115	43

SOURCE: "Federal Tax Incentives for Rehabilitating Historic Buildings, Statistical Report and Analysis for FY 2011", RIPEC calculations

In FFY 2011, there were 711 Part 3 approvals nationally, and certified expenses totaled $3.5 billion. Across New England, 54 projects generated $340.1 million in certified expenses. New Hampshire was the only New England state in which there were no Part 3 approvals. Total certified expenses in Rhode Island of $110.5 million were the 10th highest in the country, while the average expense in the Ocean State of $6.9 million was the 12th highest nationally. Connecticut and Massachusetts also saw significant investment and use of the federal credit in FFY 2011.

[1] Generally, the structure's purchase price, minus the value of the land, plus the value of any capital improvements made since the purchase, minus any depreciation already claimed.

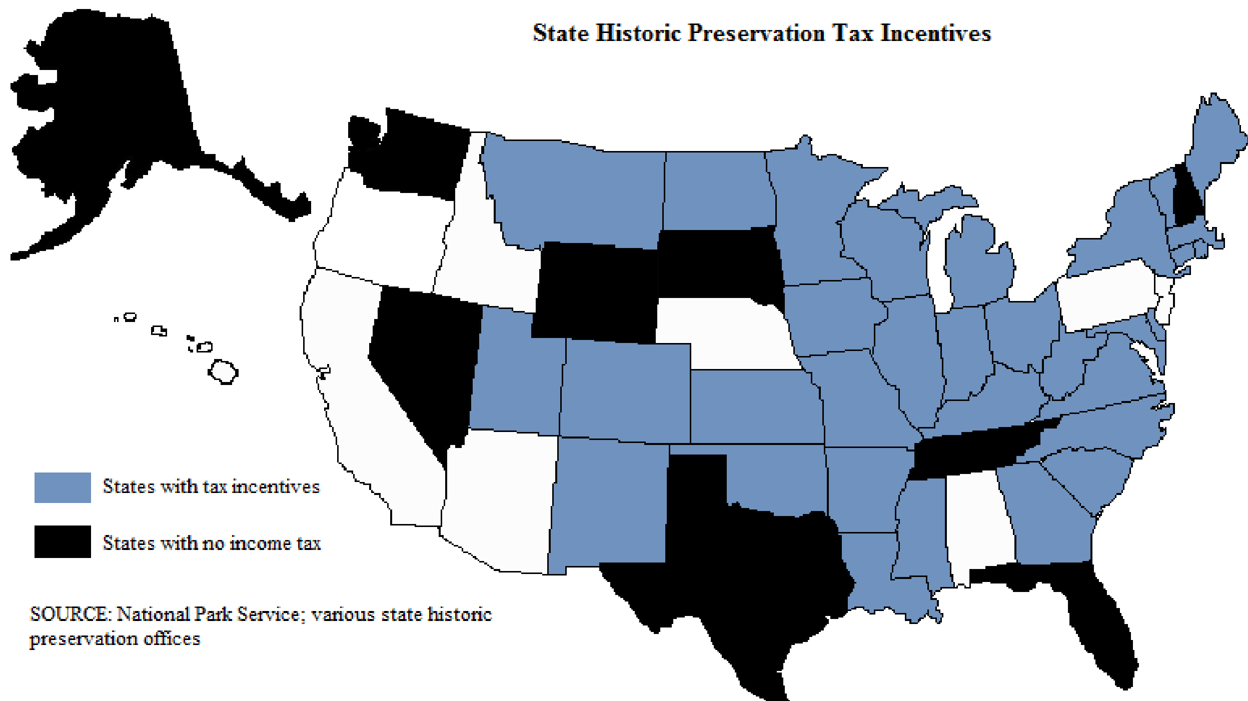
[2] The Historic Preservation Certification Application is a three-part form. Part 1 determines the historic significance of the building, Part 2 is the description of rehabilitation, and Part 3 certifies the work was done consistent with Part 2 of the application and meets rehabilitation standards.

State Credits

Of the 41 states that tax income, 32 states, including Rhode Island, offer some form of state tax credit for historic rehabilitation and preservation. Of these states, 23 offer credits for both commercial (income-producing) and residential projects. Utah is the only state that offers a credit for residential projects but not for commercial projects. The structure of the program varies across states with regard to: the value of the credit; whether the program is capped – either by project or statewide; the minimum investment level; qualifications for the program; and the use and transferability of the credit.

Commercial credits range from a minimum of 5.0 percent in Montana and Wisconsin to a maximum of 50.0 percent in New Mexico. However, the value of the credit in some states is capped. For example, projects in New Mexico are subject to a cap of $50,000 or five years of tax liability, whichever is lower. Conversely, projects in Delaware are eligible for a 20.0 percent credit with an additional 10.0 percent credit for low-income housing, for a total of 30.0 percent with no cap. Thirteen states have caps on the maximum credit for a project, while nine states also have statewide caps. In states that allow credits for residential projects, credits range from a minimum of 20.0 percent in seven states, to a high of 50.0 percent in New Mexico. As with commercial credits, 13 states have a per project cap on residential credits while eight states cap total statewide credits.

As shown on table 2, all New England states, with the exception of New Hampshire, which does not have a personal income tax, have some form of historic preservation credits. Connecticut is the only state that allows credits for residential restoration activities; however, until 2011, Rhode Island had a 20.0 percent rehabilitation credit for properties that were on the State Historic Register. Due to recent changes to the state's personal income tax code, historic homeowner credits may not be applied against an individual's income tax liability in Rhode Island, effective in the 2011 tax year; any unused credits were forfeit as of that date.



Both Connecticut and Maine allow for an additional 5.0 percent add-on to the credit if the project includes low-income housing. All New England states that have a credit, with the exception of Rhode Island, have a cap of some form (per project or statewide). Massachusetts is the only state that does not require a minimum project investment, while requirements in other states range from $5,000 to $25,000 or the adjusted basis.

Most states, with the exception of Maine, allow for a carry-forward of credits. In Maine, the credits must be used in 25.0 percent increments beginning the year the property is placed in service. Connecticut, Massachusetts and Rhode Island have fully-transferable credits. Only C-corporations may take advantage of the credits in Connecticut.

Rhode Island

The Historic Preservation Investment Tax Credit (HPITC) in Rhode Island was originally enacted in 2001 and allowed for a 30.0 percent credit for substantial rehabilitation of historic commercial property. Credits were fully transferable, could be carried forward up to 10 years, and could be applied to personal income, corporate income, franchise, public service corporate, financial institution, and insurance taxes. In 2005, the General Assembly required a processing fee of 2.25 percent of QRE, effectively reducing the value of the credit to 27.75 percent of QRE.

In 2008, the General Assembly passed legislation that effectively ended the program. All projects placed in service before January 1, 2008 were eligible to receive the 30.0 percent credit, as long as processing fees were paid in full by May 15,

Table 2
State Historic Preservation Tax Credits

	Commercial	Residential	Cap	Min Invest	Carry Forward/Back	Transferable	Other
Connecticut	25% for rehabilitation for residential/mixed-use*	30% owner-occupied including apartments up to 4 units	For commercial: $2.7 million per project, $15 million statewide. For residential: $30,000 per project and $3 million statewide.	Commercial: 25% of assessed value**. Residential: $25,000	Comm/Indust forward 5 years; residential forward 4 years	Direct sale or disproportionate allocation through syndication; only usable by C-Corps	5-year recapture period for owner-occupied credit
Maine	25% for properties that qualify for federal credit*	No	$5 million per project	Greater of adjusted basis or $5,000	Not allowed	Owner or lessee	Credit must be taken in 25%/year increments beginning the year property is placed in service
Massachusetts	20% for properties older than 50 years	No	$50 million statewide	None	Forward 5 years	Yes	
New Hampshire	No state income tax; state does have tax incentives to preserve barns and other agricultural structures						
Rhode Island	30% for projects that received approval prior to January 1, 2008	No	None	50% of adjusted basis	Forward 10 years	Yes	Projects must have received initial certification by January 1, 2008
Vermont	10% if received federal credit; must be in a "downtown" or "village center"	No	$50,000 per project, $1.5 million statewide; no more than 30% of allocation may be made to a single municipality	$5,000	Forward 10 years	State may issue a bank credit certificate which may be sold to a bank for cash or other terms	Also have a 25% façade credit; 50% credit to bring buildings to code compliance

* CT: Partial credits for mixed-use; as of July 1, 2008, the state allows a 5% add-on credit for affordable housing. ME: 5% add-on for affordable housing; the state also has a "small project rehabilitation credit" in which projects do not have to qualify for the federal credit.

** Excluding land value

SOURCE: "State Tax Credits for Historic Preservation: A State-by-State Summary", National Trust for Historic Preservation; State preservation websites

2008. Projects in progress, with applications submitted prior to January 1, 2008, had the option of continuing under the new rules which included:

- An effective credit reduction to 22.0 percent, through a combination of credits and processing fees as follows:
  - 27.0 percent credit and 5.0 percent fee
  - 26.0 percent credit and 4.0 percent fee
  - 25.0 percent credit and 3.0 percent fee
- Payment of a portion of the processing fee (2.25 percent QRE, or between 45.0 and 75.0 percent of the full processing fee) by May 15, 2008.
- Full final payment of the processing fee on or before March 5, 2009.
- A contractual agreement with the Division of Taxation stating estimated QRE, tax credit and fees, guaranteeing the state's commitment to honor the stated tax credits. Credits may not be increased if QRE are higher-than-anticipated; however, in the event that QRE are lower, overpayment of fees will be refunded.
- Expenditures of at least 10.0 percent of estimated QRE or its first phase of a phased project on or before May 5, 2013.

Table 3 shows assigned credits by user for the year in which they were taken, as well as the total unused amount as of FY 2012. Since the program's inception, the state has assigned a total of $296.1 million in credits. The majority of credits (71.3 percent) were used to offset personal income tax liability. Although the credits were not used against insurance-HMO tax liability until FY 2009, usage by insurance-HMO entities now accounts for the second-largest share of total credits (10.7 percent). Across all users, there are $14.2 million in assigned, but unused, credits.

Data from the Division of Taxation indicates that there are currently 67 projects or phases outstanding under the HPITC program and two projects that are under review by the Division for a net credit issuance of $3.1 million. Since the program has been revised, 15 projects have been abandoned with a total estimated QRE of $103.6 million and total credit value of $25.9 million. Based on the revisions, outstanding projects must have expended at least 10.0 percent of their estimated QRE on or before May 5, 2013 to continue to qualify for the program.

Table 3
Historic Preservation Credits by FY and User, FY 2003-FY 2012

FY	Personal Income	Corporate	Financial	Insurance	Insurance - HMO	Total
2003	$ 63,718	$ -	$ -	$ -	$ -	$ 63,718
2004	5,065,224	35,293	-	1,455,756	-	6,556,273
2005	16,219,343	748,257	25,000	4,227,536	-	21,220,136
2006	41,613,618	1,214,939	-	1,050,000	-	43,878,557
2007	35,146,514	744,903	4,988,818	2,628,124	-	43,508,359
2008	36,196,887	443,889	2,439,669	948,294	-	40,028,739
2009	43,196,638	1,256,015	2,987,384	6,475,782	5,800,000	59,715,819
2010	19,117,060	669,379	188,525	10,178,103	16,283,209	46,436,276
2011	6,722,204	818,010	-	1,029,825	5,619,604	14,189,643
2012	1,105,318	913,855	-	323,151	3,958,906	6,301,230
Unused	6,777,098	1,586,063	5,112,177	601,708	80,670	14,157,716
Total	**$211,223,622**	**$ 8,430,603**	**$ 15,741,573**	**$ 28,918,279**	**$ 31,742,389**	**$296,056,466**

SOURCE: RI Division of Taxation testimony at May 2012 REC

RIPEC Comments

Historic preservation brings with it a set of intangible benefits, such as a sense of place, community and shared history, and enhancement of an area's cultural landscape. At the same time, a growing number of studies have shown that historic preservation also has an economic benefit, creating jobs, boosting tourism, and generating additional tax revenue for state and local governments. Studies have also identified a number of positive social impacts of preservation, among them, the rehabilitation of buildings into affordable housing and urban revitalization. At the same time, credits are costly to states, and may be unaffordable in difficult economic circumstances. Similarly, given current revenue constraints, should the state be in the business of "picking winners" and investing resources into the construction industry, or are there alternative methods of spurring the same investment that are less expensive and more direct?

Senate bills 2269 (Goodwin, Ruggerio, Jabour, Miller, Pichardo) and 2313 (Miller, Goodwin, Ruggerio, Jabour, Pichardo) and House bill 7732 (O'Grady, O'Neill, Martin, Reilly, Edwards) would reinstate the HPITC structures at a rate of 20.0 percent of QRE or 25.0 percent of QRE if at least 25.0 percent of the rentable area, or the first floor, of the structure is made available to trade or business. RIPEC believes the following two questions should be taken into consideration when evaluating the merits of these bills, or the restoration of the HPITC in general:

- Do the economic benefits outweigh the costs, both in the long- and short-term?
- Does the state have the capacity to support these credits?

Economic Viability

Recently, there has been a significant increase in the number of studies evaluating the economic impact of historic preservation tax credits, particularly as states look to ensure that investment of scarce resources is generating a return for the state. The majority of the studies have found that tax credits have a net positive effect:

- A May 2011 study by Rutgers University and the National Trust Community Investment Corporation on the federal tax credit found that the $17.5 billion (adjusted) federal investment resulted in an increase in federal tax collections of $22.3 million and a total tax collection increase of $30.5 million. Over the life of the program, the credits have leveraged $90.4 million (adjusted), which resulted in over 2.0 million jobs and a net total economic output of $201.2 billion.

Table 4
Summary of Federal Historic Tax Credit Impact ($ billions)

	Cumulative 1978-2010	FY 2009-FY 2010
Certified Rehabilitation*	$81.4	$7.9
Total Rehabilitation*	$90.4	$8.8
Total Federal Credit*	$17.5	$1.6
Jobs	2,020,800	145,100
Income	$76.3	$6.2
GDP	$103.8	$8.4
Output	$201.2	$16.6
Taxes - Federal	$22.3	$1.5
Taxes - State	$4.2	$0.4
Taxes - Local	$4.1	$0.4

* $ adjusted for inflation
SOURCE: Second Annual Report on the Economic Impact of the Federal Historic Tax Credit, The Historic Tax Credit Coalition, May 2011

- As part of Minnesota's recently-enacted tax credit program, the Minnesota State Historic Preservation Office is required to produce an annual report on the economic impact of the credits. The report found that the 14 projects included in the study had a total cost to the state of $49.1 million, resulting in a net economic impact (direct, indirect and induced) of $450.7 million; effectively,

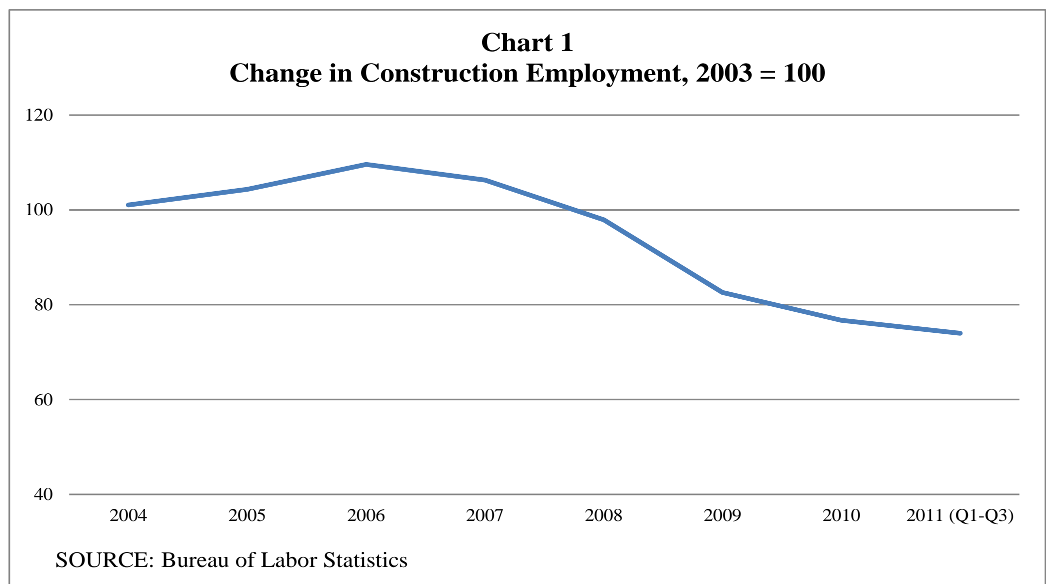
every dollar of state investment generates $9.20 in economic activity.

- In 2009, a study conducted by the Iowa Department of Revenue found that, between 2000 and 2006, the average rate of return for historic preservation projects in the City of Dubuque was 51 percent, compared to five percent for all other properties.
- A 2007 analysis of the Rhode Island credits for Grow Smart estimated total state expenditures of $460.2 million for 277 projects, roughly $300 million of which was slated to be completed between 2007 and 2012. These projects were projected to generate a total of $2.5 billion in economic activity throughout the state, or $5.35 per dollar of state investment.

State and federal historic preservation tax credits also encourage private investment in historic rehabilitation that may be prohibitively costly, as in the case of brownfields redevelopment. Similarly, tax credits may provide an incentive to invest in blighted areas that may otherwise not be considered suitable for development or investment. The analysis of Rhode Island's credit found that cash flow for the tax-credit supported projects only supported 50.0 to 60.0 percent of project costs on average, and that the projects would likely have not happened without the credits.

While the credits have a demonstrable positive impact on state and local economies, the availability of alternate financing mechanisms, such as the federal credit, the Low Income Housing Tax Credit (LIHTC) and the federal New Markets Tax Credit (NMTC) may reduce the need for state historic tax credits. Further, recently-abandoned projects raise questions regarding the economic viability of the credit; specifically, whether the economy in Rhode Island, and the availability of financing for these projects, is robust enough to support reinstituting the credit. The state's high commercial vacancy rates and the foreclosure crisis may have reduced the value of projects designed to create additional housing or rental space.

At the same time, unemployment data indicate that the construction industry continues to shed jobs, even as other industries are recovering. Since 2003, employment in the private-sector construction industry has contracted by roughly 25 percent. When compared to peak employment in 2006, the private-sector construction industry has seen employment fall by 32.5 percent. Additionally, testimony and materials presented by the Rhode Island Department of Labor and Training (DLT) at the May 2012 consensus economic forecast indicates that only "arts, entertainment and recreation" and "other services" saw a greater loss of jobs from March 2011 to March 2012. As data indicate that historic tax credits have been successful at creating construction industry jobs, the credit may serve as a means to stimulate this particular area of the state's economy.



State Capacity

The "Great Recession" resulted in some of the largest revenue declines on record, and revenues have been slow to recover. In response the state has made structural adjustments to certain programs such as Medicaid, reduced the size of its workforce, and significantly reduced state aid to local governments. In recognition of the state's fiscal situation, the HPITC were effectively eliminated in 2008. No new projects were allowed to apply for the credits, owners were required to enter a contract setting a maximum QRE for which they would receive credits, and the state borrowed to secure funding for the outstanding value of the credits.

Although revenues are beginning to stabilize, growth has been modest, particularly in the state's income and sales tax collections. The State Budget Office continues to project out-year deficits as growth in expenditures continues to outstrip growth in revenues. Moreover, Rhode Island's tax burden is one of the highest in the country, and is recognized as being a barrier to attracting and retaining businesses. RIPEC believes that increasing taxes to support restoration of expenditure cuts, particularly as the economy is just beginning to recover, is not in the state's best interest.

Given these constraints, the state must carefully consider how to allocate its scarce resources. Although the HPITC is a relatively small program at the federal level, Rhode Island's credit was among the most generous nationally, costing the state $59.7 million in FY 2009 at the height of the program. Fundamentally, the state must consider whether reinvesting in the program will generate enough economic activity to justify the expense. There is evidence that credits may be a good investment for the state: as recent studies have indicated, the return on investment for historic rehabilitation tax credits is significant and, at the federal level, the credits have generated greater tax revenue than their cost. Moreover, the credits may specifically serve to stimulate the struggling construction industry, which may provide a much-needed boost to the state's economy. However, there may be alternate – and less expensive – means to provide the same stimulus and the state must carefully consider whether it has the capacity to support a tax expenditure of this magnitude.

An additional consideration is how the credits fit into the state's overall tax structure. The flat tax, which disallowed any credits, reduced the popularity of the credits by individual users, shifting the majority of the credits to corporations and insurance-HMOs. The dollar-for-dollar reduction in tax liability effectively reduces the state's corporate/insurance tax rate; however, lowering the state's tax rates may prove to be a more practical long-term response compared to reauthorizing the credits. Notably, this would reduce the uncertainty regarding when credits are taken, creating a measure of stability in the state's tax system. However, the uncertainty could be mitigated by reducing the number of years the credits may be carried forward. At the same time, the multiplier effect of the HPITC should be considered and weighed against the possible economic benefits of a lower tax rate.

Summary

After five years of facing significant deficits, largely due to historic revenue declines, Rhode Island's fiscal situation is showing signs of stabilizing. Based on the State Budget Office's third quarter report, Rhode Island appears likely to end the current fiscal year with a surplus of approximately $100 million. As the economy – and revenues – begins to recover, the state will be faced with two choices: undo structural changes that were made in response to the economic downturn, or take an investment-based approach to the budget.

RIPEC believes that the state should not take any actions that will contribute to its structural deficit.

However, historic credits from abandoned projects – that is, projects that applied for the credit, but were not completed – may allow for a targeted, short-term economic stimulus. Allowing new developers to apply for the abandoned credits may provide a much-needed boost to the state's economy, particularly as the current economy may not be robust enough to support development – particularly commercial development – without the credit. Importantly, a temporary reinstatement also allows for a comprehensive evaluation of the credit's efficacy in stimulating economic activity and job creation.

Based on testimony by the Division of Taxation, there are currently $25.9 million in credits attached to projects that are no longer active and are considered abandoned. As the state has already planned on issuing these credits, they would not add to out-year imbalances. It should be noted that there are currently 84 projects that have qualified under the new program that have not completed construction, but are not considered abandoned. While some of these projects are in progress, a large number are pending and may not meet the "substantial construction" test by the May 15, 2013 deadline and will, therefore, be considered abandoned. Effectively, this means there is a potential for a significant increase in the number of abandoned credits that may be used to support the program going forward.

In the long-term, Rhode Island may benefit from full reinstatement of the credits; however, this decision should be a part of an overall review of the state's tax policy. For example, are the credits, which effectively lower corporate tax burdens, more effective at generating economic activity than lowering the corporate tax rate, particularly given the state's high marginal tax rate? Similarly, are there alternate methods of spurring investment in development projects that generate the same economic returns? The state has taken steps to revise its tax structure and the ultimate impact of these changes has yet to be seen. Any further revisions must take into account the impact these – and future – changes will have on the state's business climate and ability to support government operations.

A final consideration must be given to the structure of the credit itself – both in the long- and short term. Specifically:

- Should the credit be capped, either by project or statewide and, if so, how should the state allocate the credits?
- Is the current effective 22.0 percent credit the right size, or should the credit value and fee structure be revisited?
- Should the credit sunset?
- Would a direct buyback program, in which the state buys back the credits at a discount, help address the issue of the value of the credit being diminished through the resale process?
- Should legislation include incentives to file only when developers have financing in place, such as requiring a certain percentage of expenditures within a specified time frame?
- Are there negative implications – such as reducing the marketability and value of the credit – if the state were to adopt a shorter carry-forward period in order to provide more stability in tax revenues?

Full restoration of the HPITC must be done in a thoughtful manner, based on an evaluation of the efficacy of the credits, whether they generate a return to the state, and how they fit into the state's overall tax system. However, a temporary reinstitution of the credits – allowing new developers to apply for the roughly $26 million in outstanding credits – may provide both a solid economic stimulus in an area of particular weakness in the state's economy, and an opportunity to systematically evaluate the economic value of the credits.