Historic Preservation Tax Incentives Program

Technical Preservation Services
National Park Service

Topical Tax Brief – Rehabilitation Tax Credit Recapture

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Here we review the circumstances under which a lessee can claim the rehabilitation tax credit.

Expenditures Made by Lessee

Internal Revenue Code Section 47(c)(2)(B)(vi) provides that a lessee is eligible to claim a rehabilitation tax credit when the lessee incurs the cost of rehabilitation and the lease term is greater than the recovery period determined under Internal Revenue Code Section 168(c) - currently 39 years for non-residential real property and 27.5 years for residential rental. The lessee, under these conditions, can claim the rehabilitation tax credit on qualified rehabilitation expenditures provided the "substantial rehabilitation test" is met.

Substantial Rehabilitation Test

Treasury Regulation 1.48-12(b)(2)(ii) and (vi) imposes a special substantial rehabilitation test on lessees seeking to utilize the rehabilitation tax credit. Under this test, the aggregate of qualified rehabilitation expenditures incurred by the lessor and any lessees must exceed the aggregate adjusted basis of all parties who have an interest in the building (i.e., the adjusted basis of the lessor in the building and the adjusted bases of the lessees in the leasehold and any leasehold improvements that are structural components of the building).

As a result, the property owner (lessor) and several lessees could all qualify for the rehabilitation tax credit as long as the aggregate rehabilitation expenditures of all parties are considered when determining if the project meets the substantial rehabilitation test. The amount of credit each party would claim would be based on the amount each party expended during the rehabilitation.

This can be illustrated in the following example:

> Taxpayer X owns a building and leases space in the building to Taxpayer A, Taxpayer B and Taxpayer C. Each lessee has a lease term is in excess of 39 years. The adjusted basis of the building before rehabilitation is $75,000. Taxpayers X, B and C spend a total of $80,000 to substantially rehabilitate the building. A $16,000 ($80,000 x 20%) rehabilitation tax credit has been generated. If Taxpayer X spent $25,000, Taxpayer B spent $10,000 and Taxpayer C spent $45,000, they will each be entitled to claim a portion of the allowable rehabilitation tax credit - $5,000 for Taxpayer X, $2,000 for Taxpayer B and $9,000 for Taxpayer C.

The lessee is responsible for establishing the lessor's basis when determining if the substantial rehabilitation test has been met. Generally, the lessor will provide the lessee with this information. In the event the lessor does not provide the required basis information, the lessee must show that their qualified rehabilitation expenditures incurred during the 24-month test period exceeded the fair market value of the building on the relevant date. See Treasury Regulation 1.48-12(b)(2)(iii)(B).

In the event a lessee has undertaken the expense of a rehabilitation project and the lessor sells the building before the lessee met the substantial rehabilitation test, the lessee would be forced to use the purchase price of the new owner when determining if the project was substantially rehabilitated. This is illustrated in the following example:

> Taxpayer X owns property and leases it to taxpayer A for 40 years. Taxpayer X has an adjusted basis of $500,000 in the property and does not wish to spend any money on rehabilitating the building. Taxpayer A must spend more than $500,000 during a 24-month measuring period to be eligible for the rehabilitation tax credit. If during the rehabilitation project, but before Taxpayer A spends more than $500,000, Taxpayer X sells the building to Taxpayer Z for $750,000, Taxpayer A must now spend more than $750,000 to be eligible for the rehabilitation tax credit.

Pass-through Election by Lessor

A building owner, who incurs the cost of rehabilitating an historic structure, can elect to pass the rehabilitation tax credit to its lessee(s) provided the owner is not a tax-exempt entity. See Internal Revenue Code Section 48(d) and 50(d)(5).

A tax-exempt entity cannot pass the rehabilitation tax credit to its lessee(s) because Treasury Regulation 1.48-4(a)(1) requires that the property must be Section 38 property in the hands of the lessor; that is, it must be property with respect to which depreciation is allowable to the lessor.

Internal Revenue Code Section 48(d) permitted a lessor and lessee to agree to treat the lessee as having incurred all or a portion of the rehabilitation expenditures incurred by the lessor. This "pass-through" election, under Internal Revenue Code Section 48(d) was repealed in 1990, but its content was re-enacted under Internal Revenue Code Section 50(d)(5).

In order for a lessee to qualify for the pass-through rehabilitation tax credit under Internal Revenue Code Section 48(d), the following conditions must be satisfied:

1. The property must be "Section 38 property" in the hands of the lessor; that is, it must be property with respect to which depreciation is allowable to the lessor and it must satisfy the other requirements set forth under Section 1.48-1 of the Treasury Regulations, "Definition of section 38 property"

2. The property must be "new section 38 property" in the hands of the lessor, and the original use of such property must commence with the lessor.

3. The property must be such that it would have constituted "new section 38 property" to the lessee if such lessee had actually purchased the property.

4. A statement of election to treat the lessee as a purchaser must be made. See Treasury Regulation 1.48-4.

5. The lessor cannot be a mutual savings bank, cooperative bank, or an entity described in Treasury Regulation 1.48-4(a)(1)(v).

As stated above, the property must be new section 38 property in the hands of the lessor and the pass-through election is not available unless the lessee is the "original user of the property". This means that as long as the lessee is the first person to use the property for its intended function (i.e., placed in service by the lessee) the lessee will be treated as the original user of the property.

Basis and Income Implications

Treasury Regulation 1.48-12(e) requires that the depreciable basis of a rehabilitated building be reduced by the amount of rehabilitation tax credit allowed.

In the case of an election to pass-through the rehabilitation tax credit to a lessee, the basis adjustment required under Treasury Regulation 1.48-12(e) and Internal Revenue Code Section 48(q) does not apply. Consequently, the property owner (lessor) would not reduce its depreciable basis by the amount of rehabilitation tax credit allowed.

However, in lieu of such basis adjustment, Internal Revenue Code Section 48(d)(5)(B) requires the lessee to include in gross income an amount equal to the allowable rehabilitation tax credit spread over the recovery period (currently 39 years for non-residential rental and 27.5 years for residential rental). This is illustrated as follows:

> Taxpayer X incurs qualified rehabilitation expenditures of $500,000 and elects to pass-through his allowable $100,000 rehabilitation tax credit to his lessee. The lessee is entitled to claim the $100,000 rehabilitation tax credit, but must include in income an amount equal to $2,564 each year for the balance of the 39-year recovery period.

Short-term Lease Election

If a lessor elects to pass-through the rehabilitation tax credit to its lessee and the lease term is less than 80% of the class life of such property (currently 39 years for non-residential rental and 27.5 years for residential rental), the amount of the allowable credit is reduced. Accordingly, if the lease term is at least 31.2 years for non-residential rental property or 22 years for residential rental property, the short-term lease election rules do not apply.

In the case of a short-term lease, the rehabilitation tax credit is determined by the fair market value of the leased premises multiplied by a fraction, "the numerator of which is the term of the lease and the denominator of which is the class life of the property leased". See Treasury Regulation 1.48-4(c)(3). This is illustrated in the following example:

Taxpayer X agrees to lease its entire property to Taxpayer A for 10 years. Taxpayer X rehabilitates his property and elects to pass-through its allowable rehabilitation tax credit to Taxpayer A. The fair market value of the property after rehabilitation is $120,000. Taxpayer A is allowed a rehabilitation tax credit in the amount of $6,154. [20% x ($120,000 x 10/39)]

Net Lease

If the lease term is less than 80% of the class life of the property (i.e., less than 31.2 years for non-residential rental), the lease will not be considered short term if the lease constitutes a "net lease" within the meaning of Internal Revenue Code Section 57(c)(1)(B). See Internal Revenue Code Section 48(d)(4)(D).

A "net lease" is one where the lessor is either guaranteed a specified return or is guaranteed in whole or in part against loss of income.