Community and Economic Development in North Carolina and Beyond Blog: Local Government Owners of Historic Property Asked to Convey Property by End of 2017: What Public Officials Should Know

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Federal tax reform is likely to be enacted before the end of the year. While the final form of the bill has not been determined, it is nearly certain that federal historic preservation tax credits—an important financing mechanism for preservation of historic properties—will be significantly affected. In fact, most observers anticipate that the value of the tax credits will be diminished by tax reform, thereby making historic preservation projects more difficult to finance and complete. For that reason, some real estate developers have asked local government owners of historic properties to convey those properties to new ownership before the end of the 2017 tax year (December 31, 2017) in order to "grandfather" those projects under the older, more favorable rules. This post briefly describes how federal tax reform could affect historic rehabilitation projects and offers some guidance for North Carolina public officials who wish to respond (on a *very* tight deadline) to a request to transfer historic properties owned by local governments.

How the House and Senate Tax Reform Bills Would Change Historic Preservation Tax Credits

Under current law (pre-2018), a taxpayer who invests in restoring a historic building can receive a tax credit equal to 20% of the expenses incurred to restore the building for an income-producing purpose. Only qualified expenses for historic components (not land acquisition or non-historic elements) count for this purpose. Large projects—such as historic mills in the center of many small downtowns—can potentially generate huge sums of tax credits.

Most real estate developers cannot use all of those tax credits themselves, so they sell investment interests in their projects (through a tax credit intermediary or "syndicator") to persons or companies with large tax liabilities that can use the credits to reduce their tax bill. The investment by entities with large tax liabilities provides an infusion of investment capital (or equity) into the project, thereby financing the rehabilitation. When tax credits are valuable, a developer can get more equity for a project, making the project more financially feasible. When tax credit value is reduced, developers cannot obtain as much equity for the project, thereby making it more difficult to finance the rehabilitation.

The tax reform bills before Congress would make important changes to the tax credit that would reduce the credit's value. The House Bill would eliminate the historic tax credit altogether. The Senate Bill would retain the historic tax credit but cause the 20% credit to be taken over a period of five years rather than, as currently allowed, in the first year after rehabilitation is complete. Due to the time value of money, a credit taken over five years is less valuable than a credit taken entirely in year one. The House and Senate will adopt a compromise, but right now it is not clear which version or variation will be adopted. Whichever version is ultimately enacted, it seems almost certain that the credit will be worth less

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in 2018 than in 2017.

How to “grandfather” a building under the pre-2018 rules

Due to the near certainty that the credit will be worth less after tax reform, there is an advantage to be gained by taking steps to “grandfather” properties under the pre-2018 rules. Unfortunately, neither the House nor Senate tax reform bills provide much detail on how to “grandfather” a building effectively, but they provide some clues.

Both bills say that a historic building is eligible for the pre-2018 tax credit (and is therefore “grandfathered”) if it is “owned or leased by the taxpayer” by December 31, 2017, and remains under that taxpayer’s ownership at all times thereafter. The historic rehabilitation must begin within 180 days of enactment of tax reform and must be completed within two years of commencement.

Unfortunately, the terms used in both bills are not precisely defined. For example, both bills require the “taxpayer” to own or lease the property at all times after December 31, 2017. This raises an important question. Must that owning or leasing “taxpayer” be the entity that ultimately claims the tax credit on its tax return? Or can the property be owned by a holding company as of December 31, 2017, and then an investor who needs tax credits can invest in the holding company later in 2018 and still take the tax credit, so long as the original holding company can trace its ownership back to December 31, 2017? The competing bills don’t provide answers to those questions, so everything discussed below entails uncertainty and risk.

How can local governments create a holding company to hold a historic property?

Local governments with ownership of historic properties probably cannot serve as the “taxpayer” for grandfathering purposes for several reasons. First, local governments typically cannot participate in ownership of an income-producing historic property. (Of course, governments can own a non-income-producing museum, but it won’t be eligible for federal historic tax credits.) Second, local governments would have a difficult time arguing that they are a “taxpayer” for tax credit purposes because they are entirely exempt from paying taxes.

Accordingly, some developers have recommended for local governments to convey property into another entity, such as a limited liability partnership or company (a “holding company”) owned by (1) a government-controlled nonprofit and (2) a second member. The addition of a second member before December 31, 2017, is helpful because adding a second member to a single member LLC may cause the holding company to be considered by the IRS as a new taxpayer at the time the second member is admitted (and hence, if the holding company is considered to be a new “taxpayer,” then it will not have owned the property since December 31, 2017). It would be expected that the multi-member holding company would continue to own some part of the project continuously from December 31, 2017, through the required five year holding period for taking the historic tax credit. This plan might work under either of the following two scenarios:

1. **Government-alone, less certainty scenario**: The local government conveys the historic property to a holding company owned by a local government controlled affiliate (such as a nonprofit) by December 31, 2017. This establishes that the government affiliate “owned or leased” the property continuously since December 31, 2017. A nonprofit is a “taxpayer” because it must file a return and it can be taxed for unrelated business income. Then, later in 2018, an investor taxpayer invests in the affiliate-owned holding company and receives a sizeable ownership stake. Thus, the holding company will have two owners at that point: an investor taxpayer who intends to use the tax credits (typically a 99% owner) and the original government controlled affiliate (typically a 1% owner). [A leasing structure is also possible but will not be discussed here.] The hope is that tax reform rules would evolve to define “taxpayer” flexibly, allowing the 99% owner (investor taxpayer) who invested in 2018 to gain the benefit of the pre-2018 tax credits by relying on the fact that the 1% owner has owned the company continuously since December 31, 2017. This scenario is described as having “less certainty” because it is not clear that an investor who enters the picture in 2018 will be able to take advantage of pre-2018 tax credits solely on the basis that the 1% owner has owned the property since December 31, 2017. [As explained above, the holding company may be considered a new taxpayer at the time the second member is admitted, so admitting that second member after December 31, 2017, may not result in successful grandfathering of the project.]

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2. **Investor-involved, greater certainty scenario**. In this scenario, an investor taxpayer is willing to invest in the project by December 31, 2017. The local government conveys the historic property to a holding company owned by a local government controlled affiliate (such as a nonprofit) by December 31, 2017, as described in the previous scenario. However, rather than waiting until 2018 to accept an investor taxpayer, the identified investor makes a capital contribution to the holding company and becomes a second member by December 31, 2017. Thus, the investor taxpayer will be able to claim that it has "owned or leased" the building since December 31, 2017, and the holding company will already have two members and therefore can itself serve as the "taxpayer" for tax credit purposes. Accordingly, this method offers greater certainty of retaining the pre-2018 tax credit rules. This method requires the local government to admit a second member before the end of 2017. The second member admitted to the holding company should be subject to some form of redemption clause in case the rehabilitation is not able to commence on time for grandfathering purposes; a redemption clause would allow the local government to redeem the second member's capital contribution and require the second member to exit, leaving the local government as the sole controlling owner of the property.

It should be pointed out that some historic property developers have asked local governments to convey property directly to them. This is not advisable unless the following conditions are met:

1. **The developer intends to use all of the tax credits itself to offset the developer's tax liability.** If a local government conveys property to a developer that does not use all of the tax credits itself, then the government has essentially engaged in the "government alone, less certainty" scenario above, because the actual investor taxpayer won't invest in the project until 2018. (It isn't certain, but it is hoped, that the 2018 investor will be able to take advantage of pre-2018 tax credits.) However, this transaction carries an additional drawback: if something goes wrong, the property is no longer controlled by the local government.
2. **The conveyance is subject to a reverter clause, to revert ownership of the property back to the local government, in the event the developer does not commence rehabilitation within 180 days of enactment of tax reform**. If the developer is unable to commence rehabilitation within 180 days, then the attempted "grandfathering" has failed, and the purpose for conveying the property to the developer evaporates. The government should regain control over the property (to ensure it does not languish under the ownership of a private owner who has lost access to tax credits) and start the process of identifying a new developer who can proceed under the new tax credit rules.
3. **The local government receives fair market value consideration for the property, after taking into account any historic preservation conditions on the sale.** Historic properties are valuable because newly renovated historic properties command a rent premium, and properties that are properly "grandfathered" will be even more valuable. The cost of historic rehabilitation, while significant, is offset by federal and state tax credits, and is amortized over many years through debt and equity financing. Don't be fooled by a developer who tells you that a historic property has no value. The developer wouldn't be talking to the local government owner if the property had no value.

Statutory authority for North Carolina local governments to form a holding company and convey historic property to the holding company

In North Carolina, the following approaches can be utilized by a local government in an attempt to "grandfather" historic property, depending on the organizational partners that are available to the local government. With so little certainty around tax reform, local governments are advised not to over-invest in any of these approaches.

1. **Historic preservation commission**. If a local government has established a historic preservation commission pursuant to G.S. 160A-400.7, and the local government has granted the commission the power to acquire and sell historic properties under G.S. 160A-400.8, then presumably the commission's power to acquire and sell historic properties includes an implied authority to create holding companies for those properties.
    - **Form the holding company**: Form a commission-controlled nonprofit corporation and create a subsidiary LLC under the nonprofit corporation. It must be noted that commissions typically don't create nonprofits to hold property. Typically, local governments hold historic property directly or work with an independent (not commission-controlled) historic preservation society. See approach #2 below if the local government is working with an independent historic preservation organization.
    - **Convey the property to the holding company**: Property may be conveyed to a historic preservation

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commission with or without consideration under G.S. 160A-274. Then the historic commission can convey property, subject to historic preservation restrictions, to the holding company pursuant to G.S. 160A-400.8(3). However, the holding company is not a government entity, and therefore the holding company must pay fair market value to the government conveyor of the property (as explained in a blog post here).

- **Finance the conveyance as necessary**. It is unlikely that the holding company will have cash to pay fair market value for the historic property it acquires from the commission. There does not appear to be any legal authority for the commission to offer financing to the holding company. However, the local government (not the commission) may have authority to provide a loan to the holding company pursuant to G.S. 158-7.1(a), provided the historic property will be marketed and used, in part, as commercial (nonresidential) space. The loan must be offered at an appropriate, risk-adjusted rate of interest, depending on the security for the loan. No subsidized loan or below-market interest rate is permitted, as discussed in blog posts here, here, and here. There appears to be no authority for a local government to provide seller financing for a purely residential use (unless it involves affordable housing for low- and moderate-income persons as described here).
- **Timeline for approvals**. Historic preservation commissions are entitled to acquire and sell property without first seeking governing board approval. Accordingly the commission can act quickly. However, if a loan from the local government to the holding company is made pursuant to G.S. 158-7.1(a), then a G.S. 158-7.1(c) public hearing must be held prior to approving the loan. **Notice of the hearing about the loan must be published at least ten days prior to the hearing (weekends and holidays are counted)**. The notice requirements are described in a blog post here.

2. **Independent historic preservation nonprofit organization (not controlled by the local government).**
   - **The holding company is created by the historic preservation organization without government involvement**. The historic preservation organization will form its own holding company to receive the historic property.
   - **Convey the property to the holding company**: Local government conveys property by private sale to historic preservation organization at fair market value pursuant to G.S. 160A-266 and -267, provided a preservation agreement or conservation agreement as defined in G.S. 121-35 is placed in the deed. See a blog post on this topic here.
   - **Finance the conveyance as necessary**. If the historic preservation organization does not have the cash to pay fair market value for the property, then the local government could provide seller financing to the organization pursuant to G.S. 158-7.1(a), provided the property will be marketed and used for a commercial (not solely residential) use. The loan must be offered at an appropriate, risk-adjusted rate of interest, depending on the security for the loan. No subsidized loan or below-market interest rate is permitted, as discussed in blog posts here, here, and here. As noted above, there appears to be no authority for a local government to provide seller financing for a purely residential use unless it involves affordable housing for low- and moderate-income persons.
   - **Timeline for approvals**. The sale of property by private sale pursuant to G.S. 160A-266 and -267 must be approved at a regular meeting, notice must be published after such approval, and the sale shall not be consummated until ten days after publication.
3. **Economic development nonprofit corporation**. If a local government has established an economic development nonprofit corporation pursuant to G.S. 158-7.1(a), and *the historic property will be redeveloped into commercial (nonresidential) space*, then the economic development nonprofit could create the holding company to receive the historic property.
   - **Form the holding company**: Create a subsidiary LLC under the economic development nonprofit corporation.
   - **Convey the property to the holding company**: The local government can convey historic property to be developed into commercial (nonresidential) space pursuant to G.S. 158-7.1 (b) and (d). The holding company must pay fair market value for the property, and restrictions should be placed on the property to ensure that redevelopment commences in a timely manner, that some portion of the property will be marketed for commercial use, and that historic preservation is achieved. A properly noticed public hearing must be held prior to approving the conveyance.
   - **Finance the conveyance as necessary**. It is unlikely that the holding company will have cash to pay fair market value for the historic property it acquires from the local government. If necessary, the local government could provide a loan to the holding company pursuant to G.S. 158-7.1(a). The loan must be offered at an appropriate, risk-adjusted rate of interest, depending on the security for the loan. No subsidized loan or below-market interest rate is permitted as discussed here. A properly noticed public

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hearing pursuant to G.S. 158-7.1(c) must be held prior to approving the appropriation for the loan.
  - **Timeline for approvals**. G.S. 158-7.1 requires a public hearing to be held prior to approving a conveyance or an appropriation for a loan. **Notice of the hearing must be published at least ten days prior to the hearing**. The notice requirements are described in a blog post here.

What if a local government doesn't have the time, resources, or desire to attempt to "grandfather" a historic property it owns? It isn't the end of the project. It just means that the project will be subject to new rules (assuming tax reform is enacted), and the local government will simply reevaluate the various development options for the project based on the new rules.

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