Office of the Comptroller of the Currency
Washington, DC 20219

Community Developments

October 2019 www.occ.gov/capublications

Insights

Historic Tax Credits: Bringing New Life to Older Communities

This report reflects the Office of the Comptroller of the Currency's (OCC) understanding of U.S. federal income tax laws and regulations as of this report's publication date. The report does not constitute tax or legal advice. Banks should consult their own tax and legal advisors about tax treatments and the consequences that may apply to their transactions.

Abstract

For more than 42 years, the Federal Historic Preservation Tax Incentives[1] Program, more commonly known as the Historic Tax Credit (HTC) program, has helped revitalize communities by encouraging private sector investment to facilitate the rehabilitation of historic buildings. Under the program, the costs of rehabilitation and restoration of certified historic properties are subsidized by transferring HTCs from project sponsors to third parties, which may include national banks and federal savings associations (FSA) (collectively, banks).

This *Community Developments Insights* report describes how this tax credit program operates, outlines the risks and regulatory considerations of participation in the program, and discusses how investments in these tax credit transactions by banks may be considered under the Community Reinvestment Act (CRA). The *Community Developments Fact Sheet* that accompanies this report provides a high-level summary of the HTC program.

This report was originally published in 2008. Since then, Congress has modified the program and the Internal Revenue Service (IRS) has issued significant regulatory changes and guidance, which are described in this updated report.[2]

I. What Is the HTC Program?

Since the HTC program's inception in 1977, more than 44,000 projects to rehabilitate historic buildings have been undertaken. The HTC program has generated over $96 billion in

[1] Refer to 26 CFR 1.48-12.

[2] Refer to IRS Revenue Procedure 2014-12, issued on December 30, 2013, and clarified on January 8, 2014; "Income Inclusion When Lessee Treated as Having Acquired Investment Credit Property," 81 Fed. Reg. 47701 (July 22, 2016); Tax Cuts and Jobs Act, Pub. L. 115-97, 131 Stat. 2134–35 (December 22, 2017); and IRS Tax Reform Tax Tip 2018-161, "Tax Reform Brings Changes to Real Estate Rehabilitation Tax Credit" (October 17, 2018).

rehabilitation investment and produced approximately 600,000 new and rehabilitated housing units, including more than 166,000 low- and moderate-income housing units. In 2018 alone, there were 1,013 projects completed under the HTC program, which developed 19,521 new and renovated housing units.[3]

The U.S. Departments of the Interior and the Treasury jointly administer the HTC program. The National Park Service (NPS) acts on behalf of the Secretary of the Interior, in collaboration with the State Historic Preservation Officer (SHPO) in each state.[4] The IRS acts on behalf of the Secretary of the Treasury. The HTC program encourages the rehabilitation of certified historic buildings through the provision of tax credits to property owners equal to 20 percent of the qualified rehabilitation expenditures (QRE).

A property must be substantially rehabilitated for a taxpayer to claim the HTC. During a 24-month period selected by the taxpayer, rehabilitation expenses must exceed the greater of the adjusted basis of the building and its structural components or $5,000. The basis of the land is not taken into consideration.[5]

In the year a property is "placed in service,"[6] an owner of a qualified rehabilitated building is eligible to begin receiving the tax credits. The tax credit of 20 percent of the QREs is allocated ratably over a five-year period.[7]

Some or all of those tax credits may be recaptured if a recapture event, such as when the building is sold or ceases to be a "business use property,"[8] occurs in the five years after the date the property is placed in service. This five-year period when the credits can be recaptured is typically

[3] Refer to NPS, "Federal Tax Incentives for Rehabilitating Historic Buildings: Annual Report for Fiscal Year 2018," March 2019.

[4] SHPOs carry out the National Historic Preservation Program as delegates of the Secretary of the Interior pursuant to the National Historic Preservation Act of 1966, as amended, 54 USC 300101 et seq. Information about SHPOs' responsibilities is available from the National Conference of State Historic Preservation Officers.

[5] Refer to the IRS's "Tax Aspects of the Historic Preservation Tax Incentives-FAQs."

[6] "Placed in service" refers to the date that the rehabilitation work has been completed and a certificate of occupancy has been issued. The Interior Department regulations governing the procedures for obtaining historic preservation certification are at 36 CFR 67.

[7] Refer to 26 USC 47(a). The Tax Cuts and Jobs Act includes a transition rule relating to QREs that allows a taxpayer to use the prior law to claim 100 percent of the tax credit in the year in which the building is placed in service if (1) the taxpayer owned or leased a building during the entirety of the period after December 31, 2017; and (2) the 24- or 60-month period selected by the taxpayer began not later than June 20, 2018. Refer to Tax Cuts and Jobs Act, Pub. L. 115-97, 131 Stat. 2134-35.

[8] Recapture can also occur if a "qualified rehabilitated building" loses its historic integrity or character such that the NPS removes the building from the National Register of Historic Places or determines that the building no longer contributes to a Registered Historic District within five years from when it was first placed in service. A building that is severely damaged by a casualty (e.g., hurricane, flood, tornado, or earthquake) within five years of first claiming of the credit such that its historic character cannot be restored is also subject to recapture. The recapture provisions are found in Internal Revenue Code 50(a). Also refer to IRS Brief, Mark Primoli, "Rehabilitation Tax Credit Recapture."

referred to as the "compliance period." The amount of recapture is reduced by 20 percent for each full year that elapses after the property is placed in service.

When the owner of a rehabilitated property is unable to use the tax credits, a limited partnership (LP) or limited liability company (LLC) is often created to allow third-party investors, such as banks that can use the credits, to provide financing for the project.[9] Third-party provision of funding in exchange for the credits helps reduce the project's need for additional financing. Under the Internal Revenue Code (IRC), to receive the HTCs, the third-party investor must acquire an interest in the entity that holds the property before the building is placed in service. The third-party investor typically holds such an interest during the five-year compliance period and then has the option to sell its interest back to the developer.[10] Banks have various sources of legal authority that permit them to provide financing to HTC projects in return for the associated tax credits. A more detailed description of these authorities is included in section IV of this report.

HTCs are available for properties rehabilitated for commercial, industrial, agricultural, or residential rental purposes. The rehabilitated buildings must be depreciable, income producing, and used in businesses. HTCs are not available for properties used exclusively as an owner's private residence.[11]

HTCs have been used in connection with the rehabilitation buildings of nearly every size, style, type, and historic period. Examples of properties include railroad apartments in Mississippi, art deco hotels in Miami, office towers in Chicago, skyscrapers in Michigan, row houses in Baltimore, bungalows in Los Angeles, miners' cottages in Colorado, post offices in rural areas and inner cities, former manufacturing facilities, and theaters across the country.

HTCs have been used in qualified rehabilitation projects that are also financed using new markets tax credits or low-income housing tax credits.[12]

[9] The rehabilitation tax credit, by itself, cannot be bought or sold. The rehabilitation tax credit is available only to the person or entity who holds title to the property. HTCs may be taken by property owners who have the benefits and burdens of ownership, such as through LPs and LLCs. For example, refer to *Historic Boardwalk Hall, LLC v. Commissioner of Internal Revenue*, 694 F.3d 425 (3d. Cir. 2012).

[10] Banks organized under IRC title 26, subtitle A, chapter 1, subchapter S as "S" corporations pass HTCs and passive losses through to their shareholders. "S" corporation shareholders are subject to the normal limitations on taking those credits or deductions, including the passive activity loss limitations, which limit passive loss deductions. Interested parties should contact their tax adviser for more information.

[11] Some limitations exist for certain tenants of rehabilitated historic properties. For example, tax-exempt entities cannot lease more than 50 percent of the rentable area in a rehabilitated building unless the lease terms are limited in length, and there are no purchase options at the end of the lease term. There are also restrictions on the sale and leaseback arrangements with tax-exempt entities. The tax-exempt user rules are complex and should be analyzed carefully on a project-by-project basis. Refer to IRC 47(c)(2)(B)(v) and 168(h); 26 CFR 1.48-12(c)(7).

[12] Novogradac & Co., Brad Stanhope, "NMTC-HTC Twinning Back After HBH Slowdown," (December 5, 2017); HUD Exchange, "Using the Historic Tax Credit for Affordable Housing."

II. Why Are HTCs of Interest to Banks?

Banks participate in the HTC program for a number of reasons. Through the program, banks may have opportunities to

- earn competitive yields.
- invest in certain community development-oriented projects that may qualify for positive consideration in the bank's CRA evaluation.
- support local economic development strategies, which often include historic preservation.
- contribute to the stabilization or revitalization of historic communities, many of which are in low- and moderate-income (LMI) geographies, designated disaster areas, or designated distressed or underserved nonmetropolitan middle-income geographies.[13]
- gain opportunities to diversify into other credit products and services.

Competitive Yields

The HTC program is an additional financing opportunity that banks may pursue, depending on their risk tolerance and tax credit appetite. A bank's return on an HTC investment depends on a number of factors, including the bank's underwriting and management of the investment. As an asset class, historic returns on investments in HTC properties have been competitive with similar alternative investment opportunities.

Additional Commercial Lending Opportunities

HTC projects are essentially commercial real estate transactions undertaken by developers and property owners. The program provides banks with opportunities to expand their existing customer relationships and to develop new ones by offering additional products and services related to a developer's proposed project. Loan products that are often required in conjunction with the development of HTC projects include

- predevelopment and acquisition loans.
- bridge loans.[14]
- construction loans.
- permanent mortgage financing.
- letters of credit.

[13] Refer to NPS, "Annual Report on the Economic Impact of the Federal Historic Tax Credit for FY 2017" (September 2018).

[14] Bridge loans are short-term loan credit facilities provided by banks to cover capital calls during the construction period. Also known as "subscription obligation financing," these credit facilities are usually secured by the unconditional commitment of investors. These credit facilities are typically used to generate the higher internal rates of return required to attract capital, as well as to better manage the capital call process.

- warehouse lines of credit.[15]

CRA Consideration

Some loans or investments in projects that receive HTCs may meet the definition of community development in the CRA regulations and may receive CRA consideration. Community development includes affordable housing (including multifamily rental housing) for LMI individuals, community services targeted to LMI individuals, and activities that promote economic development by financing small businesses and small farms.[16] Activities are considered to promote economic development when, for example, they support permanent job creation, retention, or improvement for LMI individuals, in LMI areas, or in areas targeted for redevelopment by federal, state, local, or tribal governments. Community development also includes activities that revitalize or stabilize LMI geographies, designated disaster areas, or designated distressed or underserved non-metropolitan, middle-income geographies.[17]

A bank that finances HTC properties located within its assessment area(s) or a broader statewide or regional area that includes the bank's assessment area(s) receives CRA consideration for activities that meet the definition of community development as long as the purpose, mandate, or function of the activity includes serving geographies or individuals located within the bank's assessment area(s). Further, the bank's community development activities that benefit geographies or individuals located somewhere within a broader statewide or regional area that includes the bank's assessment area(s) will be considered even if the bank's assessment area(s) do not receive an immediate or direct benefit from the bank's participation in the activity, if the bank has been responsive to credit and community development needs in its assessment area(s).[18]

The NPS has noted that the HTC is designed not only to preserve and rehabilitate historic buildings but also to promote the economic revitalization of older communities. While the HTC is not targeted to low-income communities by statute, a 2018 study found that 50 percent of the certified rehabilitation projects in fiscal year (FY) 2017 were located in LMI census tracts and

---

[15] Banks can provide warehouse lines of credit, allowing developers to acquire the historic properties. The repayment source is financing from tax credit investors and capital generated by lease payments and rental proceeds.

[16] For purposes of the CRA, small businesses or small farms are those that have gross annual revenues of $1 million or less or that meet the size eligibility requirements of the U.S. Small Business Administration's Small Business Development Company or Small Business Investment Company programs. Refer to "Community Reinvestment Act; Interagency Questions and Answers Regarding Community Reinvestment; Guidance" (CRA Guidance), 81 Fed. Reg. 48506, 48526, Q&A § __.12(g)(3) – 1 (July 25, 2016).

[17] Refer to 12 CFR 25.12(g)(4) and 195.12(g)(4) and CRA Guidance, 81 Fed. Reg. 48506, 48526, and Q&A § __.12(g)(4)(i) – (iii) (July 25,2016).

[18] Refer to CRA Guidance, 81 Fed. Reg. 48506, 48529–48530, and Q&A § __.12(h)-6, for more information about the geographic considerations for meeting community development needs.

over 79 percent were located in economically distressed areas.[19] HTC projects may be located in areas targeted for redevelopment and contribute to the stabilization or revitalization of those areas. HTC investments may provide space leased to small businesses that provide permanent jobs to low-income persons, are located in LMI communities, or are in areas designated for economic development. In addition, HTC properties may provide direct benefits to LMI individuals, such as affordable housing or job training centers.

III. How Does the HTC Program Work?

HTCs are available for property owners of certified historic buildings, or long-term master lessees that operate and manage these properties, to finance rehabilitation projects.[20] When property owners or developers are unable to make use of the HTCs, an owner or developer of a certified property establishes a subsidiary entity with investors, such as a bank. This entity permits a bank to invest in the transaction, which reduces the cost to the owner/developer of financing the rehabilitation project, and in return receive its share of the HTCs. A bank typically has a substantial interest (for example, 99 percent) in the subsidiary and the property owner or developer has a de minimis interest (for example, 1 percent).[21]

The subsidiary, typically an LP or LLC, receives the value of HTCs over a five-year period beginning in the taxable year that the property is placed in service. Members/partners of the subsidiary receive a pro rata interest share of tax credit benefits, profits, losses, and cash flows associated with the property. HTCs follow a partner's profits interest[22] in the partnership. To stay in compliance (and avoid tax credit recapture), the members/partners of the subsidiary must retain ownership of the property for a five-year period following the year a property is placed in service. HTCs cannot be transferred to subsequent property owners/developers or funding members/partners during the compliance period.[23]

Figure 1 depicts a single-entity structure, a common structure for simpler HTC projects. A property owner or developer and a bank establish an HTC subsidiary, typically an LP or LLC. The bank makes an equity contribution to finance the project's rehabilitation and receives the HTCs that correspond to its profits interest in the entity. In return, the bank investor has a substantial interest (for example, 99 percent) in the HTC subsidiary. The project manager/managing partner, a developer affiliate, provides the remaining equity to the HTC

[19] Refer to NPS, "Annual Report on Economic Impact of the Federal Historic Tax Credit for FY 2017" (September 2018).

[20] Taxable lessees may be eligible to claim HTCs provided that the lease term is as long as the recovery period, currently 39 years for nonresidential real property and 27.5 years for rental residential real property. Refer to IRC 68(c) and IRC 47(c)(2)(B).

[21] These percentage interests may be subject to a flip that would reduce the bank's interest as discussed later in this paper.

[22] The rule for allocating the rehabilitation tax credit is found in Treas. Reg. section 1.46-3(f)(2). Refer to IRS, Dianne Adelberg, "Allocations of Tax Credits."

[23] Refer to IRS, Mark Primoli, "Tax Aspects of Historic Preservation" (October 2000), for more information about tax credit recapture and ownership requirements.

subsidiary and has a de minimis interest (for example, 1 percent) in the HTC subsidiary. The bank and the project manager/managing partner receive their interest shares (99 percent and 1 percent, respectively) of tax credits, profits, losses, and cash flow from the HTC subsidiary. Tenant lease payments flow to the HTC subsidiary, while the HTC subsidiary makes debt service payments on construction and permanent loans to the lender.

The tax basis of the improved property is reduced by 100 percent of credits. This basis reduction in the single-tier structure produces a capital gain upon the investor's exit that should be taken into consideration when calculating the bank's overall return on investment.

Equity pay-ins for the HTC may be performance based. A minimum of 20 percent of the investment must be paid in before placement of the property in service.[24] Other performance benchmarks may include completion of an independent accountant's "cost certification," NPS part 3 (final) certification of completed work, and a lease-up or debt service coverage threshold.

Figure 1: Typical Single-Entity Structure HTCs

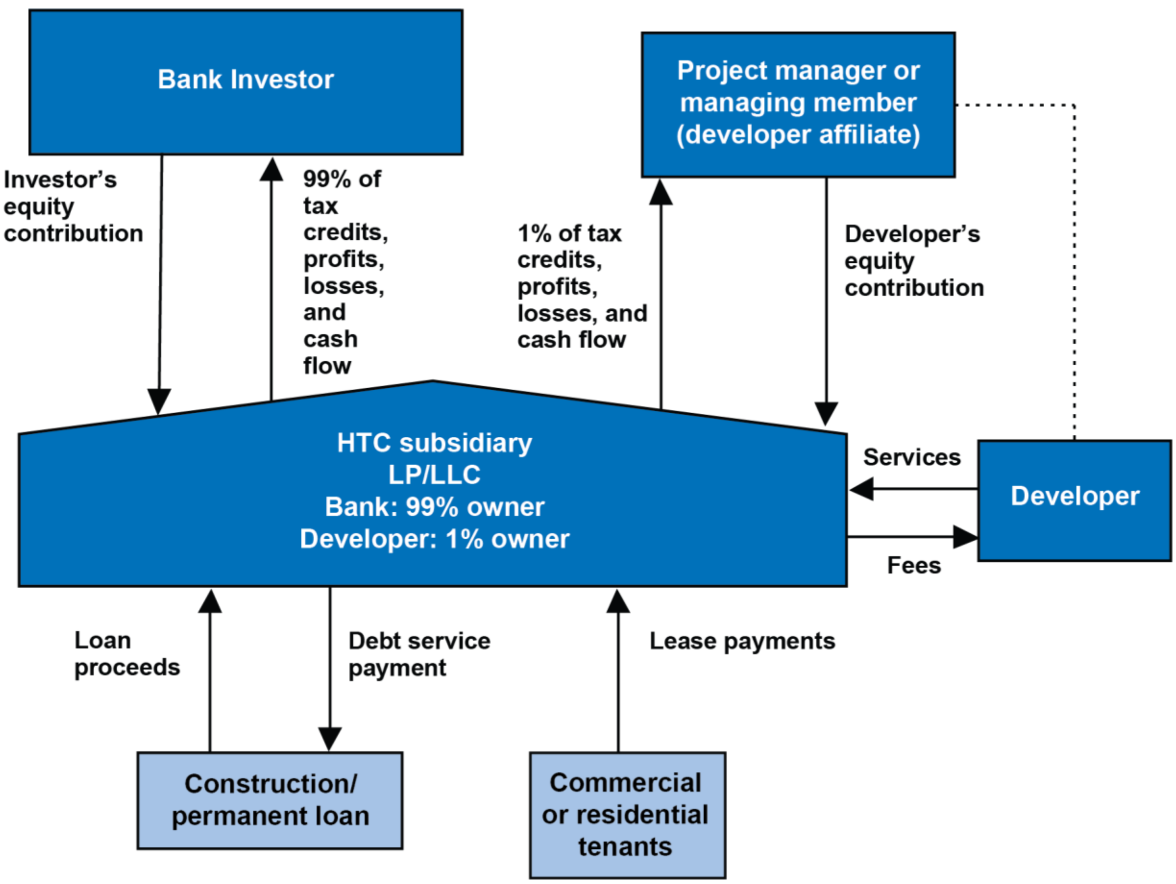


Figure 2 displays a master lease/credit pass-through structure. The property owner or developer establishes a landlord LP/LLC (landlord) that holds title to the project and has the responsibility for predevelopment and project completion. The property owner or developer and the bank then

[24] Refer to IRS Revenue Procedure 2014-12. The placed-in-service date for a property is the date the property is ready and available for a specific use.

establish a separate master tenant LP/LLC (master tenant), which will lease and operate the property.

The master tenant often has an ownership interest in the landlord entity. An affiliate of the developer typically manages the master tenant. The bank makes an equity contribution to the master tenant in exchange for 99 percent of the ownership interests and the use of 99 percent of the HTCs. The general partner/managing member of the master tenant LP/LLC provides management services to the master tenant LP/LLC and has a de minimis interest (no less than 1 percent) in the master tenant LP/LLC. The landlord passes through the tax credits to the master tenant[25] in exchange for the cash provided by the bank for the use of those credits.

A market rate master lease payment is made by the master tenant to the landlord. The master tenant operates the property and pays all operating expenses. The subtenants or users of the property make sublease payments, which are used to cover the property operating expenses and the master lease payment. The bank receives its interest share (for example, 99 percent) of the tax credits, profits, losses, and cash flow from the master tenant. The general partner/managing member receives its interest share (for example, 1 percent) of the tax credits, profits, losses, and cash flow from the master tenant, which may be increased by the payment of deferred developer fees, as negotiated. The landlord makes the debt service payments on construction and permanent loans to the lender.

The master tenant structure offers developers a way to separate the interests of private equity (non-tax credit) investors and investors motivated by the tax credit. Developers and their private equity partners in this structure control the development process through the landlord entity in which they have a majority interest and have a direct relationship with construction contractors and project lenders. By investing through the master tenant entity, banks can take a controlling interest (usually 99 percent) in the partnership that is operating the property and maximize the value of the credits generated.

IRS guidance clarifies how the property basis adjustment is addressed in the master tenant model.[26] Since the master tenant entity is a lessee, not an owner of the property, the reduction in property basis in the amount of the credits that occurs with the single-tier transaction does not apply to the master tenant investment model. Instead, the credits are amortized ratably over the depreciable life of the property and taken into partnership income annually. The IRC refers to this as "50(d) income." The investor pays ordinary income tax on its 99 percent share of this income. When the investor exits the transaction, either any unamortized portion of this income is accelerated at the investor's option (with all taxes paid upon acceleration) or the investor may elect to recognize the income annually and pay the associated tax over the remaining depreciation period. The IRS has explicitly disallowed the addition of these income tax payments to the investor partner's basis.[27]

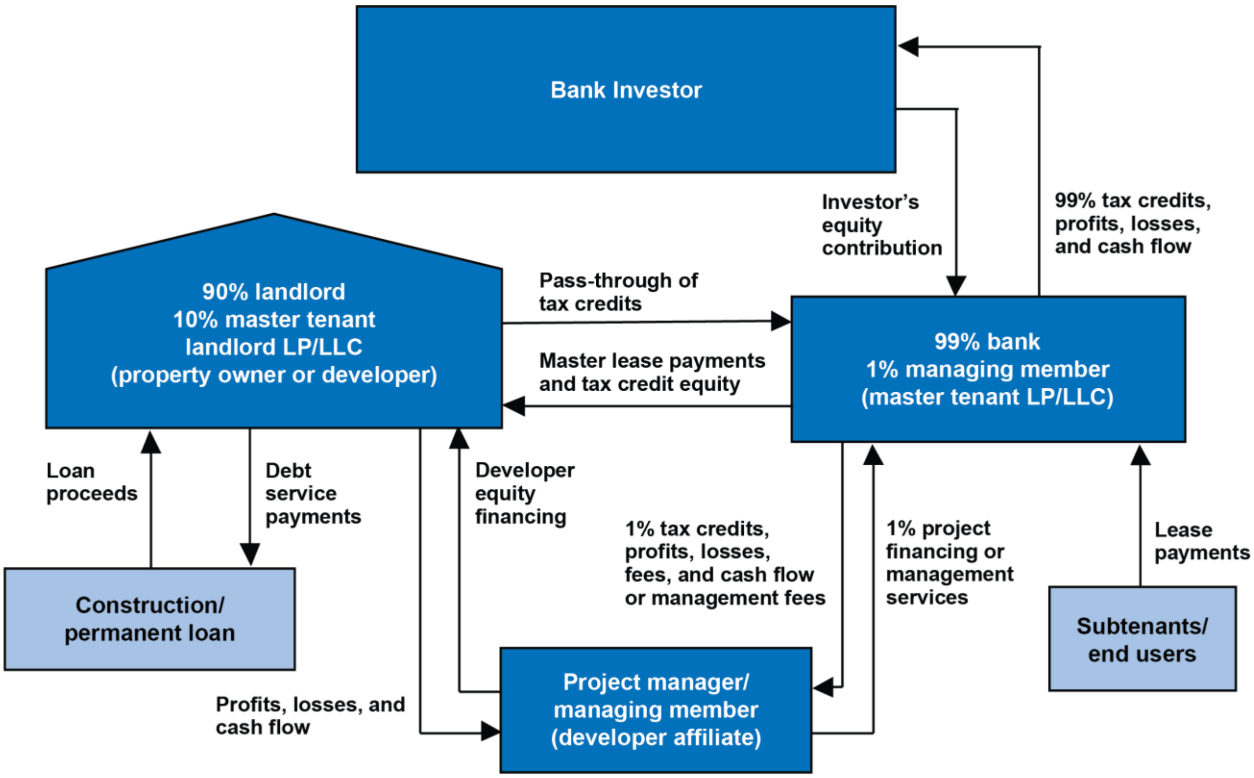
[25] Refer to IRC 50(d).

[26] Refer to IRS, "Income Inclusion When Lessee Treated as Having Acquired Investment Credit Property," 81 Fed. Reg. 47739 (July 22, 2016).

[27] Ibid.

Funding for certified historic properties also can be raised from syndication. Typically, syndicators identify potential HTC projects for investors, based on the relationships they have cultivated with property owners, developers, accountants, lawyers, architects, and others in the historic preservation industry. A syndicator creates a fund LP/LLC that is financed by a single investor who provides financing for one or more HTC projects. Syndicators typically are responsible for project underwriting, due diligence, and asset management activities for their investors over the five-year compliance period.

Figure 2: Master Lease/Credit Pass-Through Structure HTCs



Application Process for Historic Preservation Certification

Property owners complete the application process for historic preservation certification with the NPS. Typically, this process involves developer interaction with an SHPO. This process has three parts:

- Part 1: Certification of the building as a historic structure.
- Part 2: Certification of the proposed rehabilitation plan for the building.
- Part 3: Certification that the rehabilitation has been completed according to the certified rehabilitation plan.

A developer's completion of at least parts 1 and 2 of the certification application process is an important consideration for banks contemplating an investment in an HTC project.[28] Without the completion of part 2, a project may not receive the final rehabilitation certification (part 3), thereby putting the tax credit funds at substantial recapture risk.[29]

HTC Calculation and Pricing

The dollar value of tax credits is calculated by multiplying the value of the QREs[30] by the 20 percent HTC rate. Table 1 is an example of how HTCs are calculated for a hypothetical HTC project. It shows the financing generated from HTCs for the project. The hypothetical project has $40 million in QREs. In this example, a bank with a 99 percent interest paying an estimated $0.85 for each dollar of tax credits would contribute $6,732,000 in financing to the project while receiving $8,000,000 in HTCs.[31]

Table 1: HTC Financing for a Hypothetical HTC Project

QREs	$40,000,000
Tax credit rate	20%
Tax credit dollar amount	**$8,000,000**
Investor tax credit allocation (99% interest in project)	$7,920,000
Price per tax credit dollar	$0.85
Tax credit financing raised	**$6,732,000**

Developer Guarantees

Developers typically provide investors with numerous guarantees related to the project, but guidance provided by the IRS in Revenue Procedure 2014-12 specifies that most guarantees must be unfunded. Additionally, the risk of tax credit disallowance cannot be guaranteed by any partner, but the guidance states that investors may obtain third-party insurance to cover this risk.

Exit Strategy

When a partnership is established, the operating agreement specifies optional strategies for the investor exit. One such strategy is what is referred to as a "partnership flip." The parties negotiate the flip because tax credit investors do not intend to maintain a sizeable investment in

[28] The NPS and the IRS strongly encourage owners to apply for rehabilitation certification before starting the rehabilitation process.

[29] More information about the application process for historic preservation certification is available at the NPS website.

[30] QREs include the costs related to walls, partitions, floors, ceilings, windows, doors, air conditioning and heating systems, plumbing and plumbing fixtures, other related building construction, and specific fees. Fees considered as qualified expenditures may include certain payments for developer, architectural, engineering, and legal services. Refer to IRC 47(c)(2).

[31] Pricing variables in a specific transaction include size, structure, location, and market.

the partnership for the life of the structure, and instead want to exit the partnership after the tax compliance period. The IRS in Revenue Procedure 2014-12 outlines a “safe harbor” governing the structuring of HTC transactions that allows the investor to “put” its interest back to the developer subject to certain strict requirements.[32] Under the HTC safe harbor, although the tax credit investor is permitted to have a put option to sell its interest, the developer cannot have the right to call the tax credit investor’s interests. The put price, however, which is generally agreed on at the front-end of the transaction, cannot be greater than the fair market value of the investor’s interest at the time the put option is exercised.

For the life of the transaction, the partners generally must maintain a meaningful upside potential (gains, deductions, and credits) and downside risk (losses). At the end of the compliance period, however, the IRS allows the tax credit investor’s interest and the developer partner’s ownership interest to flip. For example, the tax credit investor’s interest during the compliance period of initially up to 99 percent can “flip down” to no less than 5 percent of the largest pre-flip percentage interest (that is, generally, 5 percent of 99 percent or 4.95 percent), while simultaneously the developer partner’s interest increases from a de minimis holding (1 percent) to 95.05 percent.

Figure 3: Partnership Flip

IV. What Are the Key Risks and Regulatory Issues Associated With HTC Financing?

Banks active in the HTC business typically underwrite project funding requests using their commercial real estate credit guidelines. Project-specific construction budgets, operating income projections, and financial statements are typically analyzed during underwriting. Once banks have completed their normal due diligence, they should understand and accept the risks associated with this transaction for the five-year compliance period.

As referenced in the previous section, the IRS issued Revenue Procedure 2014-12 on compliance requirements for HTCs.[33] This guidance does not establish substantive law but rather creates a safe harbor for investors in HTCs. If HTC transactions are structured in accordance with this

[32] Refer to IRS Revenue Procedure 2014-12, issued on December 30, 2013, and clarified on January 8, 2014. The IRS guidance clearly contemplates “flips” to be drafted into the partnership agreement between the developer and the tax credit investor. “Flip” means that the agreement between the developer and the tax credit investor provides that the ownership interests change after the end of the HTC recapture period.

[33] Ibid.

guidance, the IRS respects the allocation of credits to the investors.[34] Banks considering investing in HTCs should become familiar with this guidance since it affects how current HTC transactions are structured to eliminate the risk of credit disallowance.

Strategic, Compliance, and Recapture Risk

HTCs are designed to reduce an investor's tax liability. A primary economic benefit from financing an HTC project is the opportunity to claim the federal tax credits over five years after the building is placed in service. The credits may be carried back one year and forward 20 years. The HTC cannot be used to offset the base erosion and anti-abuse tax.[35]

The potential loss of the tax credit and its recapture by the IRS represent a risk to a bank. Recapture triggers during the five-year compliance period may include the disposition of property (for example, the sale, foreclosure, or transfer of more than one-third of managing member ownership interest), revocation of the NPS certification, and conversion by the property owner to tax-exempt status.[36] Once the five-year compliance period is over, the IRS cannot recapture the tax credit. At this point, investors typically look to exit the LP or LLC.

A study conducted for the National Trust for Historic Preservation by Novogradac & Company, in 2011, found that the cumulative recapture rate for the HTC program over the 10-year period from 2001 through 2010 was only 0.73 percent. The study period included recapture activity during the 2007–2009 recession. The risk of revocation of NPS certification can arise from any changes to the building during the compliance period that negatively affect character-defining features of the building and includes casualty loss from a natural disaster. Under good business practices, banks generally should require syndicators to conduct annual site visits during the compliance period to check for architectural changes. Banks should also require developers to carry casualty insurance to ensure that damage due to flooding or earthquakes can be repaired or, if that is not possible, to repay the credit amount.

Banks financing HTC projects in syndicated funds rely on the syndicators to aggregate all of the required tax information. Syndicators are also responsible for monitoring projects and managing the risks associated with the investors' portfolios over the five-year compliance period.

Banks that directly finance HTC projects (that is, through a means other than syndicated funds) are primarily responsible for their own tax compliance activities. This information is typically provided to banks by project managers or managing members. Banks rely on project managers or managing members to maintain the properties in a tax-compliant manner. Banks with large HTC portfolios typically have established property management units within their commercial real

---

[34] Ibid. Also Refer to Memorandum to Historic Tax Credit Coalition (HTCC) members from the HTTC IRS Guidance Committee (January 10, 2014). This guidance only affects HTC transactions, not other federal credits, state credits, or transactions combining HTCs with low-income housing tax credits or new markets tax credits.

[35] 26 USC 59A(a)-(b). See also National Law Review, "Impact of Final Tax Reform Legislation on the Historic Tax Credit, New Markets Tax Credit, Low-Income Housing Tax Credit, and Renewable Energy Tax Credits" (January 15, 2018).

[36] Ibid.

estate departments to oversee the management of these properties and to mitigate the risk of recapture. Banks financing their first HTC project should consider working with experienced partners, including syndicators that have proven track records in structuring transactions and assisting with asset management functions.

Structure Risk and the IRS Safe Harbor Guidance

IRS Revenue Procedure 2014-12 provides a safe harbor that assures investors that if HTC transactions are structured in accordance with its guidelines, the IRS will respect the allocation of tax credits to investors. For more information, refer to IRS Revenue Procedure 2014-12 or your tax adviser.[37]

Credit Risk Management

A bank should perform due diligence to determine the financial capacity, projected performance, management capacity, and expertise of the developer and the project manager or managing partner. The due diligence should evaluate the developer, the organization that will operate the property as the project manager or managing partner, and the syndicator, when applicable. The evaluation measures the strength of these development partners by their proven track records and management skills. A bank should determine whether these development partners have satisfactory financial, management, and compliance monitoring resources to support the viability and success of the project. Confidence in the development partners' abilities to meet the rehabilitation standards required to complete the historic preservation certification process and to fulfill the other managerial responsibilities is fundamental in determining whether the project will generate sufficient cash flow to support the project, repay debt, and meet the bank's targeted rate of return.

Banks typically review HTC projects as commercial real estate transactions. For example, during the construction and lease-up phase (which typically lasts one to three years), banks should consider the sources and uses of construction financing and calculate expected costs to be included in the qualified rehabilitation expenditures. Because the greatest period of risk in this type of financing is during the construction and lease-up phases of the project, banks also should consider the experience, strength, and reputation of the general contractors that are responsible for completing the rehabilitation projects on time and on budget while meeting the NPS standards.

Banks investing in HTCs are exposed to the property's business risk. Investors in properties under a master lease structure typically rely on cash flow as a portion of the return. When there are construction delays or cost over-runs, the property is not fully leased, or the property suffers from poor operations, the investors' returns can be affected.

Other typical underwriting elements include such items as site location in a neighborhood, market demand, rents and expenses, and project financing rates and terms. Additionally, management should understand the project's reserves, debt service coverage, loan to value, and

---

[37] Refer to IRS Rev. Proc. 2014-12. For an overview, refer to Q&A: Breaking Down Revenue Procedure 2014-12, Thomas Boccia, February 1, 2014.

guarantees to confirm the loan structure aligns with the bank's policies. Developers and managing partners or project managers typically provide investors with completion, operating, and tax credit delivery guarantees within the limitations of IRS Revenue Procedure 2014-12 to mitigate the risk associated with this type of real estate financing. Loan agreements may require completion of certain specified amounts of construction at specified costs and allow lenders to monitor against the project's budgets for time and cost. Completion guarantees may cover completion of the project as well as achieving completion on time and on budget.

As a limited partner in a partnership or as a member in an LLC, a bank typically has a 99 percent interest in the subsidiary entity that owns or leases the underlying real estate assets of the partnership for at least the duration of the HTC compliance period. Although the HTC investor does not have a lien position, it typically does have the right to vote on removal of a partner or managing member who is not performing in accordance with its duties under the LP or LLC agreement. To the extent that an HTC project includes first-mortgage financing from another source, there is repayment and foreclosure risk. The risk associated with recapture ends, however, when the five-year compliance period ends. A bank that invests in HTC projects relies on underlying properties to generate cash flows as proposed. Banks providing tax credit equity in exchange for the HTCs may require the debt financing source to execute a subordination and non-disturbance agreement to protect the master tenant entity if master lease payments are not being made. By keeping the master lease in place, HTC investors are provided sufficient time to replace a managing member.

Operational and Reputation Risks

HTC projects tend to include unique and complex transactions, requiring compliance with numerous rules and regulations. Project development teams involve many different players, including developers, syndicators, contractors, architects, preservation consultants, lawyers, accountants, and property managers. A bank can reduce operational and reputation risk by having a team of experienced and independent third-party consultants. Using third parties also introduces risks that banks should manage.[38]

V. Legal Authorities

National Bank Legal Authority

The first source of authority for national banks to make investments in HTC projects is 12 USC 24(Eleventh).[39] This provision authorizes national banks to make investments, each of which is designed primarily to promote the public welfare, including the welfare of LMI communities or families (such as by providing housing, services, or jobs).

[38] Refer to OCC Bulletin 2013-29, "Third-Party Relationships: Risk Management Guidance," and OCC Bulletin 2017-21, "Frequently Asked Questions to Supplement OCC Bulletin 2013-29."

[39] 12 CFR 24 implements this statutory authority. It contains the OCC's standards for determining whether an investment is designed to promote the public welfare and the procedures that apply to those investments.

Under this authority, a national bank may be authorized to provide financing for historic property rehabilitation projects and related HTCs by taking an ownership interest in an entity that holds such properties. An HTC investment is generally permissible if the bank's investment primarily benefits LMI individuals, LMI areas, or other areas targeted by a governmental entity for redevelopment, or if the investment would receive consideration as a "qualified investment" under 12 CFR 25.23 for purposes of the CRA.[40] In addition, a national bank may not make an investment under this part that would expose the bank to unlimited liability.[41]

A national bank's aggregate outstanding investments under this part may not exceed 5 percent of its capital and surplus, unless the bank is at least adequately capitalized and the OCC determines, by written approval of a written request by the bank to exceed the 5 percent limit, that a higher amount of investments will not pose a significant risk to the deposit insurance fund. In no case may a bank's aggregate outstanding investments under this part exceed 15 percent of its capital and surplus.[42]

The second source of authority that national banks may consider is 12 USC 24(Seventh). Under this provision, national banks may arrange financing for an HTC project in such a manner as to make the bank eligible to receive the federal HTCs by acquiring an interest in the entities that hold the properties for rehabilitation. The substance of the transaction must remain the provision of financing for the rehabilitation of historic property.[43]

Federal Savings Association Legal Authority

An FSA may make a public welfare investment in an entity that receives HTCs under one of several investment authorities:

- De minimis investments, which are less than or equal to the greater of 1 percent of capital or $250,000.[44]

[40] Refer to Community Development Investment Letter 2000-3 (August 2004).

[41] Refer to 12 CFR 24.4(b).

[42] Refer to 12 CFR 24.4(a).

[43] Refer to OCC Corporate Decision 99-07 (April 1999). Refer to also OCC Interpretive Letter 1139, footnote 6 (November 2013).

[44] Refer to 12 CFR 160.36. Under the de minimis authority, the FSA may invest, in the aggregate, up to the greater of 1 percent of its total capital or $250,000 in community development investments of the type permitted for a national bank under 12 CFR 24. HTCs may be one such type of investment as long as the investment primarily promotes the public welfare, consistent with 12 CFR 24.3.

- Community development-related equity investments in real estate.[45]
- Investments in service corporations for community development investments.[46]

Generally, an FSA is not required to seek approval for or provide notice to the OCC for investments in HTCs under the de minimis authority. The FSA should, however, maintain records that document the investment's permissibility consistent with the public welfare requirements for a national bank investment in 12 CFR 24.

An FSA that proposes to make a community development-related equity investment in real estate that meets certain OCC standards[47] would not need to provide prior notice to the OCC, but the FSA should maintain records that document the investment's compliance with these standards. If an FSA wishes to make a community development investment that is consistent with section 5(c)(3)(A) of HOLA, but the investment does not meet all of the OCC's standards, the FSA may seek a case-by-case review by the OCC's Community Affairs Division before making the investment.

Lastly, investments in service corporations for community development activities are generally subject to prior notice to, and approval by, the OCC. The FSA may, through one or more service corporations, make investments in community and economic development or public welfare

[45] Under section 5(c)(3)(A) of the Home Owners' Loan Act (HOLA), an FSA may make investments in real property and obligations secured by liens on real property located in areas "receiving concentrated development assistance by a local government under title I of the Housing and Community Development Act of 1974." To be permissible for investment, the real estate must be located within a geographic area or neighborhood that receives assistance under or is covered by, for example, the U.S. Department of Housing and Urban Development's Community Development Block Grant (CDBG) program. Under section 5(c)(3)(A) of HOLA and under 12 CFR 160.30, which covers the general lending and investment powers of FSAs, an FSA's aggregate community development loans and equity investments may not exceed 5 percent of its total assets. Further, within that limitation, an FSA's aggregate equity investments may not exceed 2 percent of its total assets.

[46] Under 12 CFR 5.59, the FSA is authorized to make investments in service corporations that engage in community development activities, subject to the regulation's filing requirements. Authorized investments include, among others, those that serve primarily community, inner city, or community development purposes, including investments in HTC projects. The FSA may invest up to 3 percent of its assets in service corporations, but any amount exceeding 2 percent must serve "primarily community, inner city, or community development purposes."

[47] The standards are as follows:

(1) The investment must be located either in a CDBG entitlement community, in a non-entitlement community that has not been specifically excluded by the state in its statewide submission for CDBG funds, or in an area that participates in the Small Cities Program.
(2) The investment must be made in a residential housing project that benefits LMI people. The OCC generally considers an investment that benefits LMI people to mean that over 50 percent of the units are reserved for occupancy by LMI individuals or families.
(3) The investment must be safe and sound. Whether an investment is safe and sound depends on the relevant facts and circumstances regarding the business transaction. For example, the OCC does not consider an investment that exposes an FSA to unlimited liability to be safe and sound.
(4) The FSA's investment may not exceed the institution's loan-to-one borrower limit.
(5) If the FSA does not qualify as an eligible savings association pursuant to 12 CFR 5.3(g), it must provide notice to the OCC's Community Affairs Division at least 14 calendar days before making the investment.
(6) The investment must conform to all applicable laws, including the 2 percent aggregate investments cap for all equity investments by the FSA under HOLA 5(c)(3)(A).

investments that are permissible for a national bank under 12 CFR 24, provided that any applicable filing requirements are satisfied. An FSA may invest up to 3 percent of its assets in service corporations, but any amount exceeding 2 percent must serve “primarily community, inner-city, or community development purposes.” FSAs proposing to invest in a service corporation should follow the filing requirements outlined in 12 CFR 5.59(h).

Conclusion

For more than 40 years, the federal HTC program has been used to attract new private capital to the historic cores of cities and Main Streets across the nation. These funds have enhanced property values; created jobs; generated local, state, and federal tax revenues; and revitalized communities. For banks, this program offers an opportunity to earn attractive economic rates of return and potentially receive favorable CRA consideration. It is a way for banks to expand existing customer relationships and establish new ones by offering products and services related to HTC projects. Banks can partner with community-based organizations and other developers to encourage economic stability and revitalization, especially in LMI and distressed communities. When carefully implemented, financing historic properties can provide banks with economic and regulatory benefits, while contributing to the stabilization and growth of the communities in which they do business.

Appendix A: Example of a Pay-In Schedule (for Illustrative Purposes Only)

This schedule illustrates how the financing may be disbursed into an HTC project. The timing of the financing contributions is flexible and negotiable. Frequently used pay-in milestones for an investor include admission into the LP/LLC, placed-in-service date, independent accountant's cost certification, part 3 certification approval date from the NPS, and stabilization[48] of the project. Pay-in schedules reflect the unique circumstances of each project, the requirements of investors (as limited partners), and the needs of the general or managing partner.

Table 3: Hypothetical Pay-In Schedule

Pay-in contribution	Milestone	Amount
25%	Admission to the LP/LLC	$250,000
55%	Placed-in-service/cost certification	550,000
10%	Certified historic rehabilitation approval received (part 3 approval from the NPS)	100,000
10%	Stabilization	100,000
100%	**Total financed**	**$1,000,000**

[48] Stabilization is typically reached when a project achieves a certain level of completion, occupancy, or net income. Upon stabilization, construction financing is often taken out by permanent financing.

Appendix B: Resource Directory

OCC

Community Developments Insights, "Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks"

Community Developments Insights, "New Markets Tax Credits: Unlocking Investment Potential"

Community Developments Fact Sheet, "Historic Tax Credits"

Public Welfare Investments Resource Directory

Other

Institute for Professional and Executive Development

Internal Revenue Service, "Rehabilitation Tax Credit—Real Estate Tax Tips"

National Conference of State Historic Preservation Officers

National Housing & Rehabilitation Association

National Park Service, U.S. Department of the Interior

National Trust Community Investment Corporation

Historic Tax Credit Coalition