

Historic Tax Credits: Bringing New Life to Older Communities

Abstract

For more than 35 years, the federal Historic Tax Credit (HTC) program has helped revitalize communities by encouraging the flow of private funds to facilitate the rehabilitation of historic buildings. Under the program, the costs of rehabilitation and restoration of certified historic properties are subsidized by transferring HTCs¹ from project sponsors to third parties, which may include national banks and federal savings associations (FSA) (collectively, banks).

This 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).

This report was originally published in 2008. Since then, the Internal Revenue Service (IRS) has issued significant regulatory changes and guidance, which are described in this updated report and are important for banks to consider when they contemplate investing in HTCs.²

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

I. What Is the HTC Program?

Since the Tax Reform Act was enacted in 1976, over 42,000 projects to rehabilitate historic buildings have been undertaken. The HTC has generated over \$84 billion in rehabilitation investment, produced 153,255 low- and moderate-income housing units, and generated 2.44 million jobs.³ In 2016 alone, the HTC program completed 1,039

¹ The Historic Rehabilitation Tax Credit Program, which involves the rehabilitation of real property (buildings), is also referred to as the Historic Tax Credit program in Treasury Regulation Section 1.48-12, 26 CFR 1.48-12. For simplicity, this report refers to the HTC program. Facts about the performance of the HTC program are available from the National Park Service in "[Federal Tax Incentives for Rehabilitating Historic Buildings: Annual Report for Fiscal Year 2016](#)."

² See [IRS Revenue Procedure 2014-12](#), issued on December 30, 2013, and clarified on January 8, 2014, and IRS, Treasury, Final and Temporary Regulations, [81 FR 47701 \(July 22, 2016\)](#).

³ See NPS, "[Federal Tax Incentives for Rehabilitating Historic Buildings: Statistical Report and Analysis for Fiscal Year 2016](#)," March 2017.

projects, which created more than 108,000 jobs, and developed more than 21,000 new or renovated housing units.⁴ 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.⁵ 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).⁶

In the year a property is “placed in service,” an owner of a certified rehabilitated historic property is eligible to receive the tax credits. 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,” occurs in the five years after the date the property is placed in service.⁷ This five-year period during which the credits can be recaptured is typically referred to as the “compliance period.”

When the owner of a rehabilitated property is unable to use the tax credits, a limited partnership (LP) or limited liability company (LLC) is created to allow third-party investors, such as banks that can use the credits, to provide financing for the project.⁸ 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.⁹ 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.¹⁰

The HTC program has rehabilitated buildings of nearly every size, style, type, and

⁴ Ibid.

⁵ 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 an SHPO’s responsibilities is available from the [National Conference of State Historic Preservation Officers](#).

⁶ 26 USC 47 also provides for a 10 percent tax credit for the rehabilitation of non-historic, older (pre-1936) non-residential properties. Unlike the 20 percent HTC, the 10 percent tax credit is used primarily by building owners for personal tax purposes and does not typically include financial contributions from investors. This *Insights* report focuses only on the 20 percent HTC. A detailed description of the 20 percent HTC and 10 percent HTC is provided by the [NPS](#).

⁷ “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.

⁸ HTCs may be taken by property owners who have the benefits and burdens of ownership, such as through LPs and LLCs. See, e.g., *Historic Boardwalk Hall, Inc. v. Comm’r of Internal Revenue*, 694 F.3d 425 (3d Cir. 2012).

⁹ 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, however, 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 additional information.

¹⁰ Some limitations also exist for certain tenants of rehabilitated historic properties. For example, tax-exempt entities cannot lease more than 35 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. See IRC 47(c)(2)(B)(v) and 168(h); 26 CFR 1.48-12(c)(7).

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, and churches and theaters across the country.¹¹

II. Why Are HTCs of Interest to Banks?

Banks participate in the HTC program for a number of reasons. Through the program, banks

- 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 located in low- and moderate-income (LMI) geographies, designated disaster areas, or designated distressed or underserved nonmetropolitan middle-income geographies.¹²
- gain opportunities to diversify into other credit products and services.
- earn protection from alternative minimum tax (AMT) loss of credit value.¹³

Competitive Yields

The HTC program is an additional financing opportunity banks may pursue, depending on their risk tolerance and tax credit appetite. According to interviews conducted by the OCC, historically, the returns on HTC financing arrangements have been consistently above after-tax, five-year Treasury yields.

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.

¹¹ "Federal Incentives for Preserving Historic Properties," NPS.

¹² See "Annual Report on the Economic Impact of the Federal Historic Tax Credit for FY 2015," NPS (August 2016).

¹³ Credit can be applied against an investor's AMT liability. See IRC 55. The AMT is the minimum tax that a taxpayer must pay if this tax is greater than the taxpayer's regular income tax. The AMT is a method of determining a taxpayer's tax liability that runs parallel to the taxpayer's regular income tax liability computation. The Housing and Economic Recovery Act of 2008 allows HTCs claimed for QREs placed in service after December 31, 2007, to be used to reduce a taxpayer's AMT.

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.

- letters of credit.
- warehouse lines of credit.¹⁵

CRA Consideration

Some loans or investments in projects that receive HTCs may also meet the definition of community development in the CRA regulations and, therefore, 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. Activities are considered to promote economic development when they, for example, 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.¹⁶

Because approximately 50 percent of all HTC properties are commercial in nature, HTC investments are notable for their track record of producing a high number of permanent jobs. Based on NPS statistics, an average of 60 percent of all HTC investments are made in LMI census tracts. Due to their location in older downtown commercial areas of cities and towns, a very high percentage of HTC projects are located in areas targeted for redevelopment and contribute to the stabilization or revitalization of these areas. In addition to HTC properties that provide direct benefits to LMI individuals, many provide space for small businesses.

A bank that finances HTC properties located within its assessment area or a broader statewide or regional area that includes the bank’s assessment area receives CRA consideration for those 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 institution’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 areas 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).¹⁷

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.¹⁸ 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)

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 12 CFR 25.12(g) and 12 CFR 195.12(g) and the Interagency Questions and Answers Regarding Community Reinvestment, 81 FR 48506, 48526 (Q&A § __.12(g)(3) – 1) (July 25, 2016).

¹⁷ See the “[Community Reinvestment Act; Interagency Questions and Answers Regarding Community Reinvestment; Guidance](#),” 81 FR 48506, 48529-48530, Q&A § __.12(h)-6 (July 25, 2016) for more information about the geographic considerations for meeting community development needs.

¹⁸ Taxable lessees may be eligible to claim HTCs provided that the lease term is as long as the recovery period, currently 39 years for non-residential real property and 27.5 years for rental residential real property. See IRC 168(c) and IRC 47(c)(2)(B).

in the subsidiary and the property owner or developer has a de minimis interest (for example, 1 percent).¹⁹

The subsidiary, typically an LP or LLC, receives the full value of HTC's the year that a 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. 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.²⁰

Figure 1: Single-Entity Structure

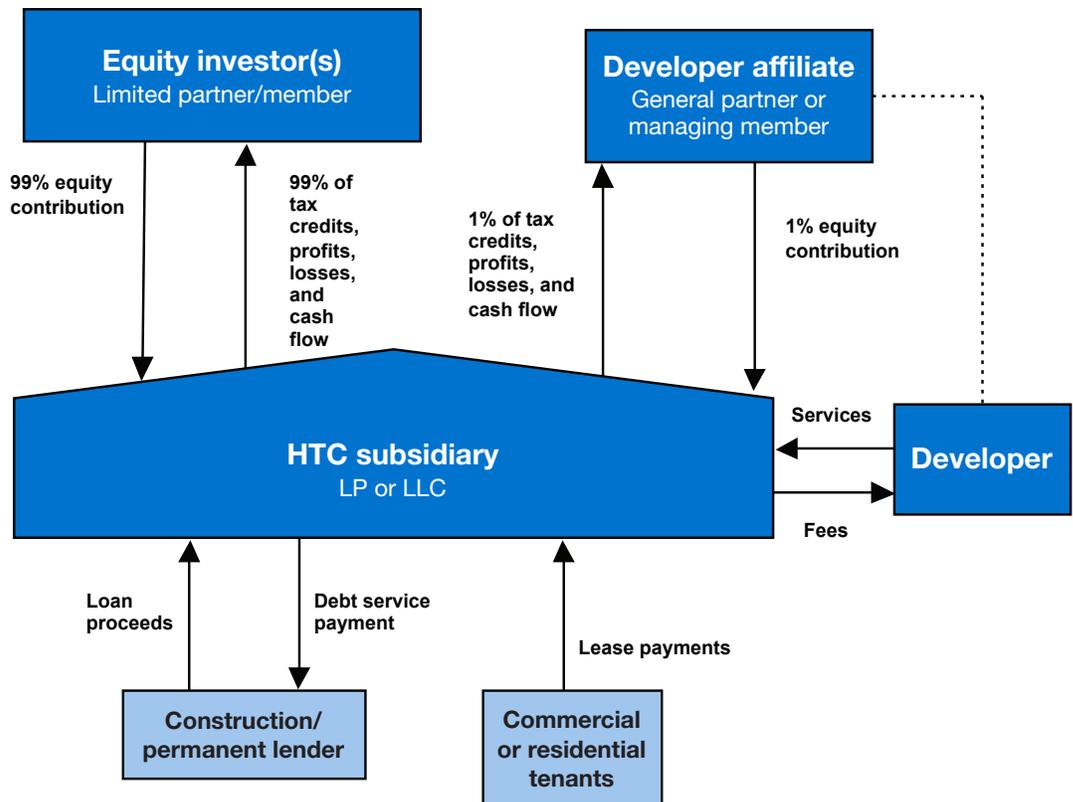


Figure 1 depicts a typical single-entity structure, a common structure for simpler HTC projects. A property owner or developer and a bank establish an HTC subsidiary, typically an LP or LLC. The bank makes an equity contribution to finance the project's rehabilitation through the purchase of the HTCs. 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 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, fees, 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.

¹⁹ These percentage interests may be subject to a flip that would reduce the bank's interest as discussed later in this paper.

²⁰ See "Tax Aspects of Historic Preservation," by Mark Primoli, Internal Revenue Service (October 2000), for more information about tax credit recapture and ownership requirements.

The tax basis of the improved property is reduced by 100 percent of credits and associated fees. 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 traditionally are performance based. A minimum of 20 percent of the investment must be paid in before placement in service. Other typical benchmarks 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 2: Master Lease/Credit Pass-Through Structure

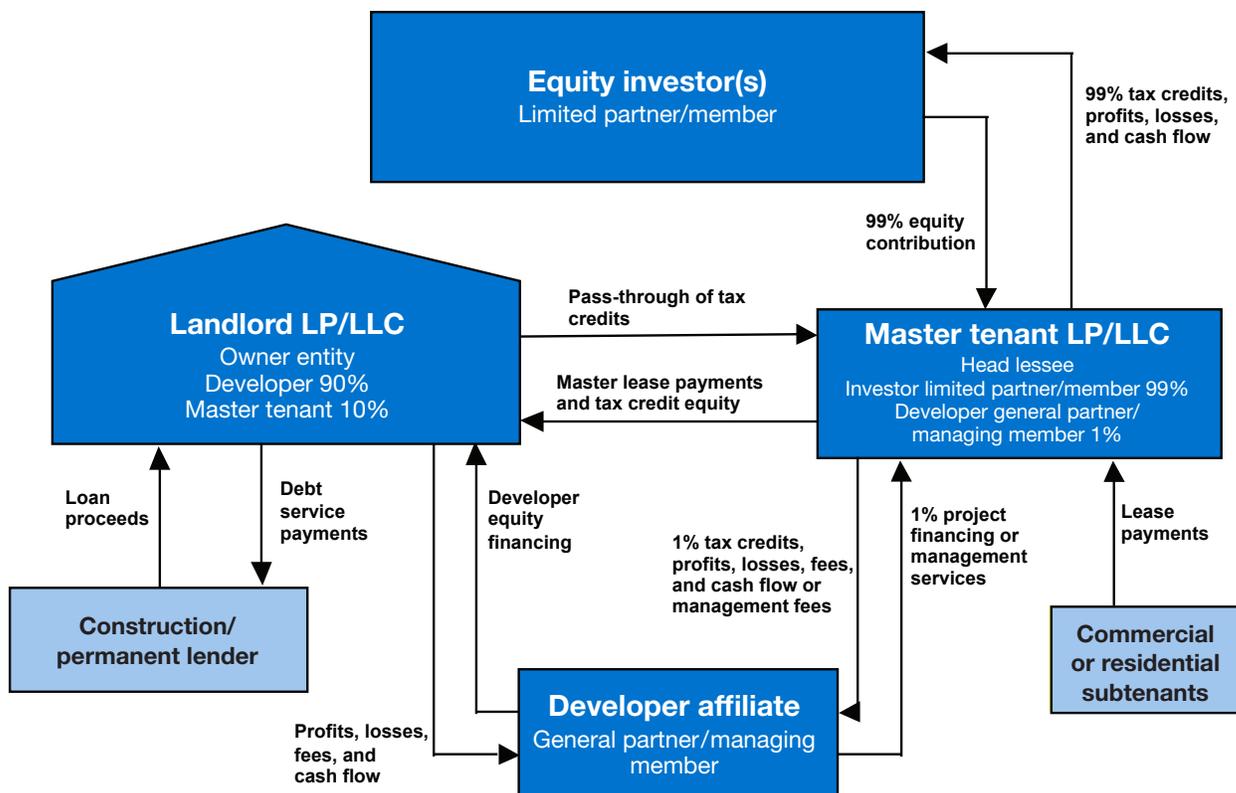


Figure 2 displays a master lease/credit pass-through structure. The property owner or developer establishes a landlord LP/LLC (landlord) that holds title to the project and has the responsibility for predevelopment and project completion. The property owner or developer and the bank then establish a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

The master tenant typically has at least a 10 percent 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 one percent) in the master tenant LP/LLC. The landlord passes through the tax credits to the master tenant (permitted under IRC 50(d)) 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.²¹ 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, any unamortized portion of this income is either 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.²²

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.

Application Process for Historic Preservation Certification

To receive HTCs, property owners must complete the application process for historic preservation certification with the NPS. Typically, this process involves developer interaction with a 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.

²¹ “Income Inclusion When Lessee Treated as Having Acquired Investment Credit Property,” 81 FR 47739 (July 22, 2016).

²² Ibid.

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.²³ 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.²⁴

HTC Calculation and Pricing

A certified historic building must be depreciable and held for the production of income from a trade or business. The QREs include the development costs for which HTCs can be claimed.²⁵ The dollar value of tax credits is calculated by multiplying the value of the QREs 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 \$0.93 for each dollar of tax credits would contribute \$7,365,600 in financing to the project while receiving \$8,000,000 in HTCs.²⁶

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	\$0.93
Tax credit financing raised	\$7,365,600

A primary economic benefit of HTC financing is the opportunity to claim the full amount of federal tax credits in the year that the property is placed in service (compared to the seven- and 10-year vesting of the New Markets Tax Credits and Low-Income Housing Tax Credits, respectively). The compliance period, however, follows for five years thereafter, during which there is risk of recapture. This risk decreases at a rate of 20 percent per year until the entire recapture amount expires after five years.

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 may want to exit the partnership

²³ The NPS and the IRS strongly encourage owners to apply for rehabilitation certification before starting the rehabilitation process.

²⁴ More information about the application process for historic preservation certification is available at the [NPS](#) website.

²⁵ QREs include, but are not limited to, the costs related to walls, partitions, floors, ceilings, windows, doors, air conditioning/heating systems, plumbing and plumbing fixtures, other related building construction, and specific fees. Fees considered as qualified expenditures may include, but are not limited to, certain payments for developer, architectural, engineering, and legal services. See IRC 47(c)(2).

²⁶ Pricing variables in a specific transaction include, but are not limited to, size, structure, location, and market.

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.²⁷ 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 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.

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

Banks active in the HTC business typically underwrite project funding requests under commercial real estate credit guidelines. Developers and syndicators provide banks with project-specific construction budgets, operating income projections, and financial statements. Once banks have completed normal due diligence, they need to 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.²⁸ 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 guidance, the IRS respects the allocation of credits to the investors.²⁹ As such, banks considering investing in HTCs should become familiar with this guidance since it affects how current HTCs transactions are structured to eliminate the risk of credit disallowance.

Tax Planning, 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 full amount of federal tax credits in the year that the building is placed in service. The credits may be carried back one year and forward 20 years. In addition, it is important to note that the HTC can be used to offset the AMT.

The potential loss of the tax credit and its recapture by the IRS, however, represent a risk to a bank. Recapture triggers, which can occur 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

²⁷ See [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.

²⁸ *Ibid.*

²⁹ *Ibid.* See also [Memorandum](#) to Historic Tax Credit Coalition (HTCC) members from the HTCC 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.

NPS certification, and conversion by the property owner to tax-exempt status.³⁰ Table 2 indicates the recapture rates over the five- year compliance period. 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 would 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.

Table 2: Recapture Rates

If the building is disposed of...	Recapture rate (%)
... less than 1 year from placement into service	100
... after year 1 but before end of year 2 from placement into service	80
... after year 2 but before end of year 3 from placement into service	60
... after year 3 but before end of year 4 from placement into service	40
... after year 4 but before end of year 5 from placement into service	20
... after year 5	0

Source: IRC Section 50(a).

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 also 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 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 is 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. Highlights of Revenue Procedure 2014-12 include the following:

- The principals (developer affiliate) must have a minimum partnership interest of 1 percent.

³⁰ Ibid.

- The investor must have, at all times during the period it owns an interest in the partnership, a minimum interest in each material item of partnership income, gain, loss, deduction, and credit equal to at least five percent of the investor's percentage interest in each such item for the taxable year for which the investor's percentage share of that item is the largest. This requirement allows for a "partnership flip" for the investor from 99 percent down to a minimum of 4.95 percent after the expiration of the five-year compliance period.
- Principals and partnerships no longer have a right to "call" an investor's interest. IRS Revenue Procedure 2014-12 allows investors to "put" their interest back to the developer as long as the put payment is at or below fair market value.
- The value of an investor's interest may not be reduced by fees, lease terms, or other arrangements that are materially different from practices on non-section 47³¹ transactions.
- The investor must receive net project cash flow commensurate with its ownership interest. In other words, the investor must participate in the upside potential profits of the partnership's activities.
- Investors must contribute a minimum equity contribution of 20 percent of the investor's total expected capital contributions before the building is placed in service. This minimum contribution must be maintained throughout the investor's ownership of its partnership interest and must not be protected against loss through any direct or indirect arrangement, although certain "permissible guarantees" are allowed.
- At least 75 percent of the investor's expected pay-ins must be fixed in amount before the project is placed in service, but timing of contributions may be contingent on performance benchmarks.
- Investors may receive permissible guarantees, which are limited and do not result in the investor being protected from the structural risk of the transaction. For example, unfunded guarantees can be provided to assure the performance of acts to claim the section 47 credits, or the avoidance of acts (or omissions) that would result in recapture of the section 47 credits. This permits unfunded guarantees, such as completion guarantees, operating deficit guarantees, environmental indemnities, and financial covenants. These guarantees must be unfunded with the exception of operating deficit reserves that may be funded up to a maximum of 12 months of operating expenses including debt service. No party in the partnership may guarantee recapture or disallowance based on the transactional structure.

Credit Risk Management

Good risk management practices dictate that a bank should perform due diligence to determine the financial capacity, performance, management capacity, and expertise of the developer and the project manager or managing partner. These practices should include evaluation of 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 ensure that these development partners have adequate 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 needed to minimize uncertainties about whether the project will meet the bank's targeted rate of return.

³¹ IRC 47.

Real Estate Underwriting

Banks 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 consider all of the sources and uses of construction financing and calculate expected costs to be included in the eligible basis. Because all HTC projects involve construction, banks will also need to evaluate 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 also exposed to the property's business risk. Investors in properties under a master lease structure typically rely on the cash flow as a portion of the return. When 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 within a neighborhood, market demand, rents and expenses, and project financing rates and terms. Additionally, banks should understand the project's reserves, debt service coverage, and guarantees. 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.

Collateral and Repayment Risk

A bank, as a limited partner in a partnership or as a member in an LLC, 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 remove a 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 these underlying properties to perform and produce 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 in the event that master lease payments are not being made. By keeping the master lease in place, HTC investors can allow sufficient time to replace a managing member.

Operational and Reputation Risks

The NPS administers the HTC program in partnership with the IRS and the SHPOs. To receive a 20 percent HTC, property owners must complete the application process for historic preservation certification administered by the NPS and the SHPO in their state and follow applicable laws and IRS regulations.

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.

National Bank Legal Authority

The first source of authority is 12 USC 24(Eleventh).³² 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).

Under this authority, a national bank may be authorized to provide financing for historic property rehabilitation projects and related HTC's 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 25.23.³³

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.

A national bank may not make an investment under this part that would expose the bank to unlimited liability.

The second source of authority 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 HTC's 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.³⁴

Federal Savings Association Legal Authority

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

- De minimis investments, which are less than or equal to the greater of 1 percent of capital or \$250,000.³⁵

³² 12 CFR 24 implements this statutory authority. Part 24 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. This regulation also contains requirements for investment limits, which provide that, with OCC written permission, a national bank's aggregate public welfare investments may total 15 percent of its capital and surplus. Further, a national bank may not make an investment that would expose it to unlimited liability.

³³ See [Community Development Investment Letter 2000-3](#) (August 2004).

³⁴ See [OCC Corporate Decision 99-07](#) (April 1999). See also [OCC Interpretive Letter 1139, footnote 6](#) (November 2013) (when the economic characteristics of a lease are substantially similar to a loan, the lease is deemed to be an exercise of the bank's lending powers—*M&M Leasing Corp. v. Seattle First Nat'l Bank*, 563 F.2d 1377 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978)); and [OCC Interpretive Letter](#) (November 4, 1994) (available in LexisNexis) (bank provided financing to owners of natural gas leases by acquiring interest in business trust that owned working interests in the leases; acquisition of interest in trust that held leases necessary for the bank to be eligible to receive federal tax credits).

³⁵ 12 CFR 160.36. Under the de minimis authority, the FSA may invest, in the aggregate, less than or equal to the greater of 1 percent of capital or \$250,000 in community development investments of the type permitted for a national bank under 12 CFR 24. HTC's may be one such type of investment.

- Community development-related equity investments in real estate.³⁶
- Investments in service corporations for community development investments.³⁷

Generally, an FSA is not required to seek approval for or provide notice to the OCC for de minimis public welfare investments. An FSA that proposes to make a community development-related equity investment in real estate that cannot comply with the standards relating to expedited treatment of applications in the May 10, 1995 Letter but otherwise complies with the standards of that Letter³⁸ is required to provide notice to the OCC's Community Affairs Department at least 14 calendar days before investing.³⁹ If the proposed community development-related equity investment does not meet the standards of the May 10, 1995 Letter, but is consistent with the HOLA, the FSA may seek a no-action letter from the OCC, if the FSA wants to make the investment. Lastly, investments in service corporations for community development activities are generally subject to prior notice to, and approval by, the OCC. FSAs proposing to invest in a service corporation should follow the filing requirements outlined in 12 CFR 5.59(h).

Volcker Rule Exemption

It should be noted that these authorities are generally not affected by section 619 of the Dodd–Frank Wall Street Reform and Consumer Protection Act, known as the Volcker rule and codified at 12 USC 1851, which prohibits banking entities, including national banks, FSAs, and federal branches of foreign banks, from owning, sponsoring, or having certain relationships with covered funds. The final regulations implementing section 619⁴⁰ exclude from the definition of covered fund those investments that are (1) designed primarily to promote the public welfare of the type permitted under 12 USC 24(Eleventh), including the welfare of LMI communities or families (such as providing housing, services, or jobs), and (2) QREs with respect to a qualified rehabilitated building or certified historic structure, as such terms are defined in section 47 of the IRC or a similar state HTC program.⁴¹ Accordingly, the regulations implementing the Volcker rule would not prohibit or otherwise limit the ability of banks to sponsor or invest in entities qualifying for these exclusions to provide funding and assistance to LMI communities

³⁶ Under the Home Owners' Loan Act (HOLA) (12 USC 1464(c)(3)(A)), the 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 (including projects receiving HTCs) must be located within a geographic area or neighborhood that receives assistance or is covered by, for example, the U.S. Department of Housing and Urban Development's Community Development Block Grant program. Under 12 USC 1464(c)(3)(A) and 12 CFR 160.30, the FSA's aggregate community development loans and equity investments may not exceed 5 percent of its total assets, provided that its equity investments do not exceed 2 percent of total assets. The standards for such loans and investments are explained in an opinion of the Office of Thrift Supervision Chief Counsel, dated May 10, 1995 (May 10, 1995 Letter). If the investment meets all of the standards, then the FSA would not need to provide notice to the OCC.

³⁷ 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."

³⁸ The FSA should maintain appropriate documentation to ensure that its community development investments conform to the statutory and regulatory requirements governing those investment authorities.

³⁹ Please refer to the OCC's [Public Welfare Investments Web Resource Directory](#).

⁴⁰ On December 10, 2013, the OCC, together with other agencies, adopted [final rules](#) implementing the requirements of section 619. See 79 FR 5536 (January 31, 2014).

⁴¹ See 12 CFR 44.10(c)(11)(ii). These exclusions cover any issuer that engages in the business of making tax credit investments (for example, low-income housing tax credit, new markets tax credit, renewable energy tax credit, rural business investment company) that are either designed to promote the public welfare of the type permitted under 12 USC 24(Eleventh) or are QREs with respect to a qualified rehabilitated building or certified historic structure.

and certain community-improving projects.⁴²

Accounting Considerations

HTC projects financed directly or through syndicated funds with conduit LPs or LLCs may be accounted for under the cost or equity method of accounting or may result in consolidation, depending on the structure of the transaction.⁴³ Banks should seek advice from their external accountants regarding the appropriate accounting for their HTC projects.

V. Who Is in the HTC Business Today?

Numerous parties are involved in the process of rehabilitating certified historic properties.

Developers

HTC developers may be for-profit or nonprofit organizations, joint ventures, partnerships, LPs, trusts, corporations, and LLCs. Some developers (or their affiliates) will also participate in HTC transactions as general partners (in LPs) or managing members (in LLCs) for property owners or master tenants that sublease the buildings. In addition, some developers may create joint ventures with nonprofit or for-profit organizations that manage the HTC properties after the projects have been placed in service.

Financing Sources

HTC investors can be persons, corporations (for example, banks), LP/LLC, public entities, and nonprofit organizations.

Syndicators

Syndicators are usually for-profit organizations that identify HTC financing opportunities for investors and property owners. They are generally responsible for project underwriting, due diligence, and asset management activities over the five-year compliance period. Banks, however, remain responsible for their fund or project-level financing due diligence. Typically, syndicators create proprietary funds or provide services for one-off transactions.

Banks

As equity investors in HTC transactions, in addition to acquiring an interest in an HTC project for the right to be allocated HTCs, some banks offer numerous other types of financing to developers of historic properties. Among the types of credit facilities provided are predevelopment and acquisition loans, bridge financing, construction loans, permanent mortgage financing, letters of credit, and warehouse lines of credit.

Third-Party Experts

Financing HTCs involves a complex set of transactions. Real estate lawyers, tax accountants, architects, historic rehabilitation consultants, appraisers, real estate management companies, and HTC compliance specialists are among the numerous professionals that bring important expertise and experience to organizing, financing, and managing HTC projects.

⁴² To the extent that an entity is a covered fund under 12 CFR 44.10, a bank would need to consider whether its investment in the entity is permissible under 12 CFR 44.10 and, if so, what additional requirements, including investment limits and activity restrictions, may apply under the final regulations.

⁴³ See *Accounting Standards Codification 810*, “Consolidation.”

VI. How Does the Cost and Pricing Structure of HTCs Work?

To determine the risk-adjusted return on a prospective transaction, most banks have established an internal hurdle rate for HTC projects that is above the rate on a five-year U.S. Treasury note. Understanding that U.S. Treasury securities preserve principal and earn a risk-free rate of return, banks will expect to obtain a return in excess of the current yield on a five-year U.S. Treasury note.

Banks use a number of variables to determine the returns associated with proposed HTC transactions. These variables include

- yield factors:
 - amount paid per dollar of tax credit and timing of capital disbursements into the project.
 - associated losses from depreciation, cash flow, potential for capital gains and losses, and value of ownership interests upon disposition.
 - timeline for the project to be placed in service and receipt of NPS part 3 certification.
- risk factors:
 - risks typically associated with commercial real estate development, such as developer strength, guarantees, operations, cash flow, and property management.
 - tax planning, compliance, and recapture risk.
 - project placed in service and receipt of NPS part 3 certification.

Ideally, a bank would finance an HTC project with an experienced developer that has a strong balance sheet and a well-regarded general contractor who has a proven track record. The bank would purchase partnership interest on the low-end of the price range and disburse funds into the transaction in accordance with the partnership agreement. An example of a pay-in schedule for funds disbursed into an HTC project is shown in appendix A. Variations on this type of financing are negotiated between a bank, as a limited partner, and a project manager or managing partner, or, in the case of a proprietary fund, a syndicator. Banks may obtain higher “all in” returns from HTC project transactions when they also provide construction and permanent financing.

Yields

Yields are a function of the amount paid per dollar of tax credits, the transaction ownership structure, the pay-in schedule, the annual cash flow, and the exit strategy selected by the investor.

Calculating estimated yields for financing HTC projects involves sophisticated modeling of tax benefits and cash flow and differs for each transaction and investor. Each transaction represents different financing elements and bases. Likewise, each investor has its own tax liability profile and risk-adjusted return expectations. The primary elements in the calculation of estimated returns from HTC projects include a bank’s federal income tax rate, the price paid for transaction ownership interest, the net value of the tax credits, and the timing of capital contributions. In addition, passive losses, such as those generated by depreciation and interest expenses, are considered for the yield projections.

Fees

The HTC rehabilitation business involves many interested parties and service providers. There may be fees for market and environmental analyses, architectural consulting, historical rehabilitation and NPS certification consulting, appraisals, tax accounting,

syndication, legal services, and real estate management that can involve substantial initial costs and ongoing expenses. Syndicators may earn acquisition fees based on a percentage of the net capital brought to projects as well as annual asset management fees. Syndication fees typically are paid directly by the bank investor to the syndicator from gross HTC proceeds. Many of the aforementioned fees are typical for bank-financed commercial real estate transactions.

Asset Management

Banks actively involved in HTC projects have found it useful to establish asset management units within their real estate departments. Asset management units work with the project manager or managing partner to ensure that the properties are well managed, operate as proposed, and comply with all HTC program requirements. Banks with large HTC portfolios also use these asset management units to monitor activities. HTC fund portfolios typically rely on the property management expertise of the developer or third-party property manager to provide this oversight.

VII. What Barriers Have Constrained the Growth of HTCs?

Application Process for Historic Preservation Certification

Eligibility for HTCs depends on the property owner's ability to complete the application process for NPS certification. Successful financing opportunities are contingent on the experience and expertise of the property owner and developer to navigate through the NPS process promptly. Not every historic building can be adapted to a new use.

Complexity of the Project

The HTC marketplace is characterized by a substantial number of highly customized projects with associated regulatory, financial, and tax reporting issues.

VIII. 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 also is a way for banks to expand existing customer relationships and establish new ones by offering products and services related to HTC projects. In addition, 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 stabilization⁴⁴ 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
20%	Admission to the LP/LLC	\$200,000
50%	Placed-in-service/cost certification	500,000
20%	Certified historic rehabilitation approval received (part 3 approval from the NPS)	200,000
10%	Stabilization	100,000
100%	Total financed	\$1,000,000

⁴⁴ 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”

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 Housing Trust

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

National Trust Community Investment Corporation

Historic Tax Credit Coalition

Rutgers University Historic Tax Credits Report

David Black is the primary author of this update. Sherrie L.W. Rhine was the primary author of the original 2008 report. *Community Developments Insights* reports differ from OCC advisory letters, bulletins, and regulations in that they do not reflect agency policy and should not be considered as regulatory or supervisory guidance. Some of the information used in the preparation of this paper was obtained from publicly available sources that are considered reliable and believed to be current as of June 1, 2017. The use of this information, however, does not constitute an endorsement of its accuracy by the OCC.

The Tax Cuts and Jobs Act (Pub. L. No. 115-97), signed into law on December 22, 2017, made numerous changes to the Internal Revenue Code. This document has NOT been updated to reflect these changes. Banks or other entities considering a tax credit equity transaction should consult with a tax professional with knowledge of how the changes in the tax code may affect specific tax credit equity transactions.