Federal, State, and Local Real Estate-Based Financial Incentives

Provided by Bartlesville Redevelopment Trust Authority

Historic Tax Credits

The HTC has its roots in the National Historic Preservation Act of 1966, which created the National Register of Historic Places, which helped coordinate and support public and private efforts to identify, evaluate and protect historic and archeological resources. A decade later, in 1976, the federal government began providing tax incentives for historic building renovations in the form of accelerated depreciation.

During the 1986 federal tax reform, the credit became a 20 percent credit for structures deemed historic by the National Park Service. It is administered jointly by the Department of the Interior and the Department of the Treasury.

The Tax Cuts and Jobs Act (P.L. 115-97) was signed on Dec. 22, 2017 and the new tax legislation went into effect Jan. 1, 2018. There are some key amendments to the HTC program. The new rules are applicable for qualified rehabilitation expenditures (QREs) paid or incurred after Dec. 31, 2017, subject to certain transition rules. Under the new law, the 20 percent tax credit for certified historic structures is retained and modified, requiring the 20 percent HTC to be claimed "ratably" over the five-year period beginning in the taxable year in which the building is placed in service. The new tax law does provide for a transition rule. Under that rule, rehabilitation tax credits will be claimed under the provisions that existed prior to P.L. 115-97. To qualify for the transition rule, two criteria must be met: the building must be owned or leased by the taxpayer during the entirety of the period after Dec. 31, 2017 and, the 24-month (or 60-month) substantial rehabilitation measurement period must begin no later than 180 days after the enactment of P.L. 115-97. Previously, qualified rehabilitation expenditures with respect to any qualified rehabilitated building were taken into account for the taxable year in which such building is placed in service.

Federal 20% Historic Tax Credit

To qualify for the 20 percent credit, a building must be a certified historic structure (buildings individually listed on the National Register of Historic Places or listed as a contributing building in a National Register or state or local historic district certified by the Secretary of the Interior. The National Park Service (NPS) determines if a building is a certified historic structure by approving Part 1 of the application. A Part II application shows the NPS what renovations will adhere to the Secretary of Interior's Standards for Rehabilitation. A Part III application verifies the work in the Part II. Only after receiving the approval of Part III will the credit be issued by the IRS. The credit can be sold to an investors for cash under certain criteria.

Oklahoma 20% Historic Tax Credit

The Oklahoma Historic Tax Credit mirrors the national program providing an additional 20% credit with no additional requirements. If the project qualifies for the federal tax credit it automatically qualifies for the State Credit. A building owner generates credits by completing a certified rehabilitation on a qualified rehabilitation building. The State credit is also fully transferable.

Opportunity Zones

(Bartlesville's TIF I and TIF II are located in a Qualified Opportunity Zone)

The Opportunity Zone (OZ) incentive provides certain tax benefits to taxpayers with capital gains by enabling them to invest the amount of the gain into Qualified Opportunity Funds (QOFs) generally within 180 days from the date of the sale triggering such gain. The OZ investment allows taxpayers to defer paying the tax on these capital gains until the earlier of the sale of the investment in the QOF or Dec. 31, 2026. At that time, the capital gain must be recognized and the taxpayer must pay tax on the lesser of the original deferral (less basis adjustments–discussed below) or the fair market value of the investment. Investors that hold the equity interest in the QOF for seven years will realize an additional benefit in which 15 percent of the original capital gain (10 percent after a five-year hold and an additional 5 percent after a seven-year hold) may be permanently forgiven. This added incentive is accomplished through an upward basis adjustment in the investment after the five- and seven-year time periods. At the time of the initial investment, the investor's basis in the capital gain deferred investment is zero. Further, an investor may realize significant additional benefit if it holds the investment for 10 years or more whereby any gain on the sale of the investment in the QOF is permanently eliminated.

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QOFs generally must hold at least 90 percent of their assets in qualified OZ property, which consists of any combination of the following:

1. Qualified OZ stock in a Qualified OZ Business (QOZB),
2. Qualified OZ partnership interest in a QOZB, and
3. Qualified OZ Business Property (QOZBP).

QOZBP is generally defined as tangible property acquired by purchase from an unrelated party after Dec. 31, 2017; has its original use in an opportunity zone by the QOF or QOZB or is substantially improved; and during substantially all of the QOF's or QOZB's holding period, substantially all of the use of such property is in an opportunity zone. Special rules apply to leased property.

Other rules exist related to the qualification of an entity as a QOZB, including that substantially all of the tangible property (70 percent) of such entity is QOZBP and at least 50 percent of the gross income of the entity is derived from the active conduct of business in the OZ. Certain trades or businesses often referred to as the "sin" businesses are also disqualified.

The OZ incentive is governed by Internal Revenue Code Section (IRC) 1400Z-2.

Pairing HTC and OZ

Considering the rules described above related to a QOZB and QOZBP, it is clear to see why developers of historic properties are looking at this incentive as a potential opportunity to raise capital for their HTC projects. Traditional HTC investors are exploring the ability to receive both HTCs and OZ benefits in a single investment. Project developers are also raising outside capital separate from HTC investment equity either through their own capital gain deferrals or from outside economic investors, recognizing the synergies of the two incentives.

One point of compatibility is that the HTC requires a substantial rehabilitation of the historic property, which aligns well with the OZ requirement to substantially improve the property. In fact, in both cases, developers generally must spend more than the basis of the property to meet these similar (not identical) tests. In addition, rental real estate activities can generally qualify as the active conduct of a trade or business whose gross income is essentially 100 percent derived in the OZ in which the property is located. However, as with any tax credit or incentive, depending on the transaction structure, the OZ rules pose numerous structuring and compliance challenges when combined with HTCs. The following discussion highlights a selected few issues that arise in contemplating these combined incentives.

Basis Adjustment–HTC

In a traditional direct HTC investment, the developer or project sponsor and the investor form a partnership in which the investor member typically owns 99 percent of the partnership and the developer/project sponsor owns a 1 percent interest. An important aspect of the direct investment structure is the requirement of a reduction in basis of the building and the owners' bases in the partnership interests by the amount of HTCs claimed. As noted earlier, an investor's initial basis in its OZ investment in a QOF is zero. With the required basis adjustment of HTC property equal to the amount of HTCs, the zero basis of an OZ investment is likely to cause significant tax issues for an investor looking to use a capital gain deferral to make an HTC investment directly into a landlord entity.

QOF or QOZB?

The landlord entity in a HTC transaction could possibly qualify as a QOF or a QOZB. In addition, it may be possible for a master tenant entity in a lease pass-through structure to qualify as a QOF or QOZB. The 90 percent test for a QOF and various qualification tests for a QOZB will need to be considered in determining how best to structure an OZ investment into a HTC transaction. For example, if the master tenant is the QOF and the HTC investor owns 99 percent and elects to defer capital gain as an OZ investment (which also serves as an HTC investment), the master tenant must hold 90 percent of its assets in QOZP. An equity interest in the landlord could potentially qualify as QOZP (assuming the landlord is a QOZB), as could the purchase of certain tangible property (equipment or furniture and fixtures).

However, a prepaid lease or loan to the landlord (structures often used in a pass-through lease transaction) would generally not qualify as QOZP, and such assets are likely to cause the master tenant to fail the 90 percent test. In a similar vein, to qualify as a QOZB, the entity may not hold more than 5 percent of its assets in nonqualified financial property. Nonqualified financial property is defined in IRC Section 1397C and includes assets such as partnership interests and debt instruments. Thus, a master tenant that holds an equity interest in a landlord, makes a loan or prepays rent to a landlord is likely to hold more than five percent of its assets in nonqualified financial property, and therefore not qualify as a QOZB.

Active Conduct of a Trade or Business

The QOZB must derive more than 50 percent of its gross income from the active conduct of a trade or business in an OZ. While these types of businesses have very little risk of deriving income outside of their physical locations, developers must still ensure that the rental of real property meets the "active conduct of a trade or business" part of the test. Treas. Reg. 1.1400Z2(d)-1(d)(5)(ii)(B)(2) explicitly states that the "ownership and operation (including leasing) of real property is the active conduct of a trade or business."

However, the provision goes on to state "merely entering into a triple-net lease with respect to real property… is not the active conduct of a trade or business by such taxpayer." In a traditional lease pass-through HTC structure, the landlord entity enters into a triple net master lease with a master tenant. Whether such an arrangement would constitute an entity "merely entering into a triple-net lease" is unclear. Consideration should be given to the provisions within the master lease and the level of operational activity performed by the landlord with respect to the property in determining whether the entity will qualify as a QOZB.

HTC Transition rules

The tax reform bill brought significant changes to the manner in which HTCs are claimed by investors. A detailed discussion on HTC transition rules can be found in this issue of the Novogradac Journal of Tax Credits on page 65 , but here's a summary on how the HTC transition rules raise questions for QOZBPs. In order to protect the more lucrative benefits of the prior law and meet the grandfathering provisions of the HTC rules, many developers rushed to acquire historic properties before the end of 2017. To qualify as QOZBP, tangible property must be acquired after Dec. 31, 2017. Questions remain as to whether the mere acquisition of a historic building would taint the entire rehabilitation for purposes of qualifying the subsequent qualified rehabilitation expenditures as QOZBP. Numerous comments have been submitted to the IRS with respect to this and similar issues, and the final regulations may provide additional guidance.

Other structuring considerations

Numerous additional compliance and tax issues exist when considering the pursuit of OZ and HTC. One consideration is the timing of the equity investments. Given the 180-day window for investing capital gains into QOFs, HTC investors looking to take advantage of OZ incentives may have to adjust their typical pay-in schedules in order to meet the OZ requirements. Another relates to the typical holding period of a HTC investment and whether the OZ incentives align with the anticipated holding period of the HTC investor. Longer holding periods structured to maximize OZ benefits may be costly to developers in the form of higher than expected priority and cash flow returns to be paid to HTC investors. In addition, developers question whether investors will provide a premium in equity pricing for investments that combine both incentives. Finally, in a typical HTC pass-through structure, a developer affiliate serves as the managing member of the master tenant and is responsible for managing the operations and administrative activities. The additional compliance requirements of a QOF may increase the burden to developers.

While layering the OZ incentive into a HTC transaction may be complicated, HTC developers are no strangers to complex financing structures, and the OZ incentive may offer an additional incentive to attract much needed capital into difficult projects in low-income communities. For further questions regarding the potential to use OZ investments in HTC transactions, please consult your tax advisor.

What are some structuring challenges when using the opportunity zones (OZ) incentive in a historic tax credit (HTC) development?

Answer: The OZ incentive and HTC have a number of compatible attributes that make pairing the two benefits an attractive option. While there are a number of possible structures that can combine the benefits of the two incentives, the OZ regulations create significant compliance and structuring challenges. The primary challenges facing investors and developers when pairing the two incentives under common structures are summarized below.

Direct Investment

In a direct-investment structure, the investor member and the project sponsor form a partnership that owns the historic building. The partnership is typically structured such that the investor member owns 99% of the partnership and the project sponsor owns the remaining 1%. When the building is placed in service and the HTCs are earned, there is a required reduction to the basis of the building. Each member must also reduce their bases in the partnership interest by the amount of HTCs claimed. In a structure where either member funds their equity contribution with eligible capital gains under the OZ incentive, the member's beginning basis in the OZ investment is zero. The required basis reduction for HTCs paired with zero beginning basis under the OZ rules may cause the HTCs to be delayed until the member has sufficient basis to absorb the required partnership interest basis reduction.

HTC Lease Passthrough

As required in the OZ regulations, investors must hold at least 90% of their assets in qualified OZ property. When pairing the OZ incentive with HTC financing, investors commonly use the indirect investment structure where the eligible capital gains are contributed into a qualified opportunity fund (QOF). In the indirect OZ structure, the QOF then makes an equity contribution to a qualified OZ business, which is required to be held for substantially all (at least 70%) of its tangible real and personal property within census tracts designated as OZs. A qualified OZ business is also required to derive at least 50% of its gross income from the conduct of an active trade or business in a qualified census tract.

Treasury Regulation (Treas. Reg.) Section 1.1400Z2(d)-1(d)(3)(iii)(A) states that ownership and operation of real property is the active conduct of a trade or business. The provision also states that a "mere triple-net-lease" is not active conduct of trade or business. An example is included in the regulations where a company leases a portion of its building under a triple net lease and provides managerial and operational activities for the remaining portion of its under lease. Although a portion of the building is merely under a triple net lease, the statute says that employees of the company conduct meaningful managerial and operational activities in carrying out the overall leasing business of the company. As a result, the company conducts an active trade or business.

Typical HTC pass-through structures include a triple net lease of the historic building between the landlord entity and the HTC tenant. It seems clear that a single triple net lease will disqualify the landlord as a qualified OZ business under the active business requirement. While it remains unclear what level of participation constitutes "meaningful managerial and operational activities," consideration should be given to the level of managerial and operational responsibilities required of the landlord in the HTC lease agreement.

OZ Investment in HTC Tenant

As discussed above, the landlord entity in an HTC passthrough structure can qualify as a QOF or qualified OZ business. Assuming that the HTC tenant owns qualified opportunity zone business property (as defined in Treasury Reg. Section 1400Z-2(d)(2)(D)(i)), it can also qualify as a QOF or qualified OZ business, but doing so comes with a separate set of hurdles. In typical HTC passthrough structures, the HTC tenant will receive HTC equity contributions from the investor and in turn make equity contributions, loans or HTC lease prepayments to the landlord.

In addition to the qualified OZ business requirements discussed previously, a qualified OZ business cannot hold nonqualified financial property exceeding 5% of the average aggregate unadjusted bases of the entity's property. As defined in IRC Section 1397C(e), nonqualified financial property includes debt and partnership interests. The investments or loans from the master tenant to the landlord as outlined above results in nonqualified financial property that likely exceeds the 5% threshold and disqualify the HTC tenant as a qualified OZ business.

Pairing HTCs with the OZ incentive comes with a certain set of programmatic hurdles, but the additional benefit has proven to help potential projects. Novogradac is highly experienced in structuring areas of program compliance. Please contact Novogradac with any related questions or any other historic rehabilitation questions.

Links to more information:

https://www.law.cornell.edu/cfr/text/26/1.1400Z2(d)-1

https://www.irs.gov/pub/irs-wd/202223012.pdf

https://www.mmmlaw.com/files/documents/Redline---First-Set-of-Proposed-Regulations---as-modified-by-second-with-security.pdf

https://www.greenbergglusker.com/content/uploads/2020/01/eBook-The-Tax-Joys-of-Opportunity-Zones.pdf

New Market Tax Credits

The New Market Tax Credit (NMTC) Program incentivizes community development and economic growth through the use of tax credits that attract private investment to distressed communities. NMTCs are used to fund job creation, business expansion and new construction.

Historically, low-income communities experience a lack of investment, as evidenced by vacant commercial properties, outdated manufacturing facilities, and inadequate access to education and healthcare service providers. The New Market Tax Credit Program (NMTC Program) aims to break this cycle of disinvestment by attracting the private investment necessary to reinvigorate struggling local economies.

The NMTC Program attracts private capital into low-income communities by permitting individual and corporate investors to receive a tax credit against their federal income tax in exchange for making equity investments in specialized financial intermediaries called Community Development Entities (CDEs). The credit totals 39% of the original investment amount and is claimed (5 percent in each of the first three years, then 6 percent in the final four years, for 39 percent) over seven years.

New Markets Tax Credits and Historic Rehabilitation

NMTCs can be used in the rehabilitation of historic buildings, combined with both the federal historic tax credit (HTC) and where applicable, state HTCs or other incentives. Combining the credits does however add significant complications to the organizational structure; it is essential to have a solid and experienced team of historic consultants, accountants, and attorneys. This complication translates directly to noticeably higher project soft costs for administration and professional services. In practical terms, a smaller project becomes more challenging. Unlike federal and most state HTCs, which are available by right and have no volume cap, the NMTC program is competitive and requires securing an allocation from a CDE that has received an award and has available credits. Finally, it is important to note that while the recapture period for the HTC is five years, the recapture period for NMTC is seven years; recapture for both is triggered by transferring the property to new ownership.

Combining Investments in QOZs and NMTCs

The two programs share many synergies, and there is a great deal of overlap in the geographical location of QOZs and NMTCs.

As currently written, there are no statutes in the Opportunity Zone literature that exclude NMTC investors from also capitalizing on Opportunity Zone benefits.[3] In fact, the seven-year holding period for NMTC investments matches up perfectly with the seven-year deferral for QOZ investments.

If a qualified Community Development Entity also gained status as a qualified Opportunity Zone Fund (making it a CDE/QOF), it could potentially reward investors with new market tax credits as well as tax deferral through the Opportunity Zone investment program since the programs provide different incentives. The Opportunity Zone program focuses exclusively on investment gain, so tax-deferral benefits are generated solely on equity. New Market Tax Credits, meanwhile, are generated from both equity and debt. Lastly, many businesses located in QOZs are typically eligible for NMTCs, so pairing the two programs when there's overlap could potentially benefit investors through greater yield.

The Bottom Line

There are many considerations to ponder before attempting to twin these two programs. NMTCs are claimed over seven years, so investors who want to reap the reward of a step-up in basis through the Opportunity Zone program may choose to opt for the latter since it's a 10-year holding period.

Investors considering blending Opportunity Zone and New Market Tax Credit investments should have a deep discussion with their tax professionals to determine the proper structure for such an investment since it's likely to be

quite complicated.

Energy Efficiency Tax Incentives:

179D Energy Efficiency Tax Deduction

The 179D commercial buildings energy efficiency tax deduction primarily enables building owners to claim a tax deduction for installing qualifying systems in buildings. Tenants may be eligible if they make construction expenditures. If the system or building is installed on federal, state, or local government property, the 179D tax deduction may be taken by the person primarily responsible for the system's design. The 179D tax deduction does not apply to other non-tax paying entities, including but not limited to NGOs or churches, unless there exists an energy-as-a-service agreement that is owned by a tax paying company. Please see IRS Notice 2008-40 or FAQs for additional information. The 179D tax deduction has been in effect since January 1, 2006, and is now a permanent program enacted as part of the Consolidated Appropriations Act of 2021 signed into law on December 27, 2020.

The following information is still applicable for properties placed into service on or before December 31, 2020. Updated information will be made available for properties placed into service on or after January 1, 2021, upon anticipated IRS Notice release.

A tax deduction shown in the table below (up to $1.88 per square foot) is available to owners of new or existing buildings who install (1) interior lighting; (2) a building envelope; or (3) heating, cooling, ventilation, or hot water systems that reduce the energy and power cost of the interior lighting, HVAC, and service hot water systems by 50% or more in comparison to a building meeting minimum requirements set by ASHRAE Standard 90.1. Cost savings must be calculated using qualified computer software, which we link to below.

For properties placed into service on or before December 31, 2020, the energy and power cost shall be compared with the minimum requirements of ASHRAE Standard 90.1-2007. Projects placed into service on or after January 1, 2021, shall use the most recent Standard 90.1 affirmed no later than the date that is 2 years before the date that construction of the qualifying property begins, or the date the construction permit of the qualifying property is issued. Details and associated updates to this webpage are awaiting an anticipated IRS Notice.

Deductions shown in the table below (up to $0.63 per square foot) are also available to owners of buildings in which individual lighting, building envelope, or heating and cooling systems partially qualify by meeting certain target levels or through the interim lighting rule. For properties placed into service on or before December 31, 2020, following IRS Notice 2012-26, choose the appropriate compliance pathway shown in the table below. Updates for properties placed into service on or after January 1, 2021, will be made available upon anticipated IRS Notice release.

Commercial - Property Assessed Clean Energy (C-PACE)

Washington County could set up a C-PACE program

C-PACE is a form of long-term financing enabled by state and local law. C-PACE drives private sector investment in local communities, improves commercial property values, reduces energy and water expenses, creates jobs, and provides environmental benefits by conserving natural resources, C-PACE is used to lower the upfront costs of energy-efficiency, water conservation, or resiliency improvements to commercial properties and allows the full cost of these improvements to be amortized over an extended repayment period.

Enabled through the Oklahoma Energy Independence Act, 19 O.S. §§ 460.1 – 460.7, specifically, 19 O.S. § 460.5 (the “Act”), counties may establish a C-PACE program within the boundaries of their jurisdiction and allow qualifying property owners to voluntarily request that the county impose and levy an assessment on their property to secure private financing from a private capital provider to fund eligible improvements. In the C-PACE financing structure, private capital providers finance up to 100% of all direct and indirect costs associated with eligible improvements, which include permanently affixed energy sources or energy-efficiency, water conservation, or resiliency improvements made to an eligible property. Financing is repaid over the full useful life of the improvements, typically fifteen years or longer.

The terms of C-PACE financing are set between the property owner and the capital provider. Unpaid assessment payments constitute a lien that runs with the property and has the same priority and status as a lien for unpaid ad valorem property taxes. The C-PACE lien is not extinguished by virtue of a sale by the county for delinquent property taxes or other special assessments. As a result, the C-PACE repayment obligation can transfer smoothly to the next owner if the property is sold. In the event of default, only the payments in arrears come due.

With C-PACE, property owners renovating their building can immediately enjoy the operating savings from C-PACE projects and spread the costs of installation over an extended period. For developers, C-PACE can provide a lower cost of funds and help close financing gaps. For landlords whose tenants have a triple-net lease, certain leases allow the pass through of assessments, solving the issue of split-incentives between tenants and landlords. Finally, while C-PACE assessments are transferable to future owners, they are viewed as secure investments by private capital providers because the payment is tied to the property as an assessment, a secure payment stream.

Benefits of C-PACE for Property Owners

C-PACE is a reliable source of affordable financing for property owners to make money-saving and energy-saving improvements to their buildings. For example, C-PACE financing can be used to procure and install energy-efficient, triple-glazed windows for their storefronts that reduce heat transmission, high-efficiency HVAC models, interrelated systems that synergize temperature control and lighting, and much more. C-PACE is an effective tool for defraying upfront cash expenses. Fixed interest rates for C-PACE financing are competitively set by the market, typically requiring no down payment. No personal or corporate guarantees are required for C-PACE financing.

Tax Increment Financing (TIF)

The Bartlesville Redevelopment Trusts Authority (BRTA) administers a TIF District called the Capitol Hill Increment District in which the property at 412 SE Frank Phillips Blvd. is a part. The district provides financial incentives, such as low-interest loans and grants, for properties undergoing significant renovations. The size of the incentives is $5,000 and up. The lower grants and based on specific programs while larger projects of $150,000 or more in costs are based on a percentage of the amount spent on the renovation and in some cases can be combined with the purchase amount. These funds are derived from the increment generated from real property and person property tax increases in the district.

Combining TIF with other forms of financing

BRTA highly encourages the use of all forms of financing including financial incentives, but in no way do they preclude a project from using TIF. We will normally base our participation on the gap in financing.

Resources:

New Market Tax Credits

Opportunity Zones

Consultants / CPAs:

Novogradac
The Novogradac organization consists of affiliates and divisions providing professional services that include certified public accounting, valuation, and consulting. They specialize is financial incentives as mentioned above. Their website has many resources.

Energy Efficiency Tax Incentives

179D

Local Consultant: Legacy Energy Solutions – Travis Yoder, 895-797-3975

C-PACE

Historic Tax Credit Consultants:

Rosin Preservation

Preservation and Design Studio

TIF:

Chris Wilson
Executive Director
Bartlesville Redevelopment Trust Authority
401 South Dewey Avenue, Suite 812
Bartlesville, OK 74003
(918) 214.8501 (office)
(918) 766.4847 (cell)
chris@brta-ok.org (email)