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Tax Credits

In this article, George L. Strobel II of the State Tax Credit Exchange discusses historic and other real estate rehabilitation tax credit programs in South Carolina, Alabama, Georgia and North Carolina.

Historic Tax Credit Developments in the Southeast

BY GEORGE L. STROBEL II

Historic and other real estate rehabilitation tax credit programs are gaining momentum in the Southeast. No place better epitomizes this trend than South Carolina. South Carolina was once the center for much of the nation's textile industry and other simple manufacturing. It had a large supply of non-unionized labor and plentiful water, making it ideal for many industries. South Carolina incurred significant economic losses during the 70's and 80's due to globalization. Most of the large textile mills shut down as manufacturing moved abroad. The financial crisis of 2009 also didn't spare South Carolina, bankrupting many real estate developers and banks alike. South Carolina has since aggressively courted auto and aircraft builders, landing both BMW and Boeing. This has resulted in significant job growth. In order to restore numerous abandoned and underutilized textile mills back onto local property tax roles and in order to provide housing to support the new economic growth and growing university student bodies, South Carolina has passed multiple pieces of legislation between 2013 and 2016 creating and/or improving state tax credits to stimulate renovation and restoration of old factories.

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South Carolina

In 2013, South Carolina adopted the South Carolina Abandoned Buildings Revitalization Act. It provided a tax credit equal to 25 percent of qualified renovation expenditures. The credit could be used to offset up to 50 percent of corporate or individual income taxes or corporate franchise taxes. While the credit was earned when the building was placed into service, the credit could only be claimed over a five-year period. The tax credits could also carry forward for five years to the extent a taxpayer had more credits than it could use in the current year. The credit was limited to $250,000 per taxpayer per project and also could not be used to offset premium taxes. In many senses, this was just an exten-

 ISSN 1534-1550

sion of the existing Historic and Mill Revitalization Tax Credits, which both were five year tax credits. The Mill Revitalization Tax Credit use was also limited to 50 percent of the taxpayer's liability, though the Historic Tax Credits could be used to offset 100 percent of a taxpayer's tax liability. Both the Historic and the Mill Revitalization Tax Credits could be used to offset premium taxes. As of the end of 2013, South Carolina had a rather extensive, though inconsistent, series of tax credit incentives for real estate renovation projects. All three of these credits, if earned within an entity taxable as a partnership, can be specially allocated among its members in any manner the partnership desires on an annual basis. South Carolina has another favorable attribute with respect to these three credits: unlike the federal historic tax credit, there are no recapture provisions. So once a taxpayer received these credits, other than from an error in the calculation of the credit itself, there is no risk of subsequently losing the credit. Finally, all three of these credits have no annual statewide caps, so developers don't have to worry about obtaining them if their projects otherwise qualify for them.

A much overlooked, but significant, provision of the 2013 Act is the following:

> To the extent that the taxpayer is a partnership or a limited liability company taxed as a partnership, the credit may be passed through to the partners or members and may be allocated among any of its partners or members including, without limitation, an allocation of the entire credit to one partner or member, without regard to any provision of the Internal Revenue Code or regulations promulgated pursuant thereto, that may be interpreted as contrary to the allocation, including, without limitation, the treatment of the allocation as a disguised sale.[1]

The significance is as follows: In 2011, the Fourth Circuit ruled in *Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*[2] that the allocation of state tax credits to a partner in that partnership would be treated as a sale of property under certain conditions. This was inconsistent with the terms of the partnership documentation which indicated that the credits were to be allocated to the partner in exchange for the partner's capital contribution. The Fourth Circuit held that the tax credits were property. Treating the state tax credits as property makes sense in scenarios where the entity creating the tax credits has the ability to sell or specially allocate the credits to one or more members of such entity regardless of the number of years over which that credit must be claimed. Since the credits were then nominally allocated to one or more partners that received few other economic benefits or detriments, the Fourth Circuit determined that the partner(s) had in effect acquired the credits by sale or exchange for some undetermined portion of the partner's capital contribution to the partnership.

This creates stress with most state tax credit statutes which first adopt the federal code for most purposes in determining a taxpayer's adjusted gross income. Consequently, federal law in most instances will determine whether the contribution to the partnership is treated as a purchase and sale of tax credits or a contribution of capital to the partnership. Then, most state tax credit statutes permit the state historic credits to be freely allocable in any manner determined by the partnership creating the credits. While this provision is necessary, because almost every project with state historic tax credits also has federal historic tax credits, it also causes the state credits to have property-like characteristics, even if they are allocated pro rata to the members of the partnership. Finally, the state statutes specifically provide that the credits must be allocated to one or more partners in the partnership—that is, not "sold" to a partner. While it can be argued that older statutes don't contemplate the *Virginia Historic Tax Credit Fund* decision, the same cannot be said for statutes enacted post 2011.

What this provision of the South Carolina Abandoned Building Tax Credit does is acknowledges the existence of the Fourth Circuit decision and says, South Carolina doesn't care whether the federal treatment is a sale or allocation. Regardless of the federal treatment of the state credit allocation, it is valid for South Carolina income tax purposes as long as it is to a member of the partnership. This should be a model provision of every state tax credit statute going forward in order to potentially keep the *Virginia Historic Tax Credit Fund* decision from invalidating every intended special allocation of state tax credits and eviscerating the efficacy of every new state tax credit program going forward.

However, South Carolina did not stop here. In 2015, it enacted H.B. 3725, which made a number of technical changes to both the South Carolina Historic Tax Credit and the South Carolina Abandoned Building Tax Credit. First, and most significantly, the period of which both credits could be claimed was reduced from five years to three years. Second, the South Carolina Abandoned Building Tax Credit was made eligible to offset South Carolina insurance premium taxes. The thrust of these changes was to make both these credits more valuable to developers. This occurred because syndicators would pay more for the credits because they were spread over three years, except for the Mill Credit, which is still over five years, rather than five years. And since the Abandoned Building Tax Credit could also offset insurance company premium taxes, insurance companies would now be interested in them. By far, the largest buyers of state tax credits are insurance companies because premium taxes are effectively a sales tax. Insurance companies, unlike other corporations, can benefit from these credits even if they have no taxable income.

Finally, on May 23, 2016, South Carolina S.B. 5009 was signed into law. This bill eliminated the 50 percent limitation on the Textile Revitalization Tax Credit. Now, all three South Carolina real estate improvement tax credits have largely comparable terms: the credit is claimed over three years, they can offset up to 100 percent of the taxpayer's tax liability, and they all may offset premium taxes. This series of legislation comes from a state with fiscal challenges and a strong Tea Party contingent within its Legislature. Yet South Carolina was able to push forward this legislation with bipartisan support realizing the long-term potential benefit these credits would have on its workforce and economy.

[1] South Carolina Code Section 12-67-140(B)(6).

[2] *Virginia Historic Tax Credit Fund 2001 LP, v. Commissioner*, 639 F.3d 129 (4th Cir. 2011).

  TM-WSTR ISSN 1534-1550

Alabama

The opposite can be said for Alabama, though that story is still being written. In 2013, it passed Alabama Historic Rehabilitation Tax Credit Act No. 2013-241. This piece of legislation provided a credit equal to 25 percent of qualified expenditures beginning in 2013. The credit was capped statewide at $20 million per year. Moreover, the credit was scheduled to sunset in 2016. Because the statute was poorly written, the Alabama Department of Revenue was unable to ascertain how to administer the credit in 2013, so no credits were issued in its initial year. The unissued credits carried over to the remaining two years of the credit. Clearly, these issues, together with the statewide cap, limited the economic impact of the credit in Alabama. Nevertheless, 2016 saw a fierce political effort to continue the credit. H.B. 62, which would have reinstated the credit for a seven-year period, passed the Alabama House with 91 votes out of a possible 108. Despite a study prepared by Novogradac & Company LLP concluding that for every $1 of the Alabama Historic Rehabilitation Tax Credit that is allocated, $3.90 was returned to state and local tax collections over a 20-year period,[3] the bill was tied up in the Alabama Senate Finance Committee by Senate President Pro Tem Del Marsh, a conservative Republican, due to budget concerns. Developer outrage has been intense. Subsequently, Senator Marsh has indicated that he would reconsider and support the Alabama Historic Tax Credit next year. That change of heart may be attributable to Senator Marsh's indication that he may want to run for Governor of Alabama in the next election cycle. Though too late for this year, there is overwhelming support for the renewal of this credit in 2017.

Georgia

The situation is far more positive in Georgia. Georgia amended its Historic Tax Credit in 2015 with the changes becoming effective in 2016.[4] H.B. 308 amended Article 2 of Chapter 7 of Title 48 of the Official Code of Georgia Annotated in a number of ways but most significantly by raising the per structure cap on the credit from $300,000 to $5 million, and $10 million if certain permanent jobs targets can be met. Unfortunately, there is a $25 million statewide annual cap. Excess credits may now be carried forward by the taxpayer for ten years. The credit can now be fully sold or assigned at the discretion of the entity creating the credit. This avoids any *Virginia Historic Tax Credit Fund* concerns. Another interesting and attractive change is that only the party responsible for creating the credit is subject to recapture on the credit, and any good faith transferee of the credit has no liability for a subsequent recapture of the credit. Georgia's historic tax credit can only offset Georgia income tax.

North Carolina

North Carolina also has a surprisingly positive tale to share. Both the Historic Tax Credit and its Mill Renovation Tax Credit expired in 2014. North Carolina also has a Republican House and Senate with members with strong conservative tendencies. Yet on March 5, 2015, H.B. 152 reinstated the Historic Tax Credit For Income Producing Properties through 2020. In general, H.B. 152 provides a 15 percent tax credit for up to $10 million in qualified expenditures and a 10 percent tax credit for a project costing between $10 million and $20 million in qualified expenditures. The bill also allows an additional 5 percent bonus to developers of historic properties if a qualified development project is located in one of North Carolina's poorer Tier 1 or Tier 2 counties, as well as if a project was considered a ''targeted investment'' site such as an old textile mill or factory that's been vacated, a certified historic structure or a building that has been at least 65 percent vacant for at least two years. The cap for any one project is $4.5 million dollars. Like the old Historic Tax Credit, it can offset 100 percent of a taxpayer's North Carolina income, franchise or premium taxes. Excess credits carry forward for nine years. With respect to credits earned by a pass-through entity, the credits may be allocated in any manner determined by the entity in its sole discretion. Recapture of the credit occurs within five years of receiving the credit to the extent that the taxpayer who ultimately uses the credit has its ownership interest in the project reduced to less than 66 percent of what it was when it received the credit. Recapture is in proportion to the reduction of the ownership interest.

One unfortunate rule has been carried over from the old North Carolina Mill Renovation Tax Credit rules, and it is truly a trap for the unwary. North Carolina Section 105-129.100(b) provides that if a pass-through entity allocates the Historic Credit to a member of that entity, the allocation of the credit is only valid to the extent that the member's adjusted basis in the pass-through entity, as determined under the Code, at the end of the taxable year in which the certified historic structure is placed in service, is at least forty percent (40 percent) of the amount of credit allocated to that owner. Because this statute was enacted after the *Virginia Historic Tax Credit Fund* decision, it specifically references the member's tax basis under the Internal Revenue Code, and the credit must be considered property due to it being specially allocable by the pass-through entity, the transfer/allocation of the credit will be treated as a sale both for federal and North Carolina income tax purposes, and amounts received by the entity for the state credits will not count towards the member's basis in the pass-through entity. Therefore, the state tax credit equity member must either make contributions in addition to those required to receive the North Carolina Historic Tax Credits equal to 40 percent of the credits received, or it must guaranty debt as of the end of the year in which the credits are received sufficient to have basis in the pass-through entity equal to 40 percent of the credits received.

Federal

There is also federal legislation concerning Historic Tax Credits. The Historic Tax Credit Improvement Act of 2015 (S. 2655) was introduced in March of this year. Similar to the House version of the legislation (H.R. 3846), it would increase the Historic Tax Credit for certain small projects, allow credit transfers for certain small projects, lower the rehabilitation expenditure

[3] Alabama Historic Rehabilitation Tax Credit Program Comprehensive Economic Impact Study, by Novogradac & Company, LLP.

[4] Georgia H.B. 308 (2015).

threshold to qualify for the credit from 100 percent to 50 percent of adjusted basis and reduce depreciable basis adjustment for rehabilitation property. One item which differs from the House bill is that the Senate version does not include a provision that would allow functionally related buildings to be treated as separate properties. More importantly from a state tax credit perspective, both the House and Senate bills attempt to address the adverse impact of the *Virginia Historic Tax Credit Fund* decision. The bills would exclude from income the proceeds from the sale of state Historic Tax Credits and instead treat the proceeds as a basis reduction first to land and then to depreciable property.[5] The bills also provide an election to allow the taxpayer to treat the proceeds as income rather than a basis adjustment. The strong implication is that the Fourth Circuit decision will soon be the law of the land, if it isn't already. Whether Congress will ultimately pass the Historic Tax Credit Improvement Act is unclear. There is strong bipartisan support for the measure, but tax credit opponents may still block it in an election year. It's hard to imagine either a Clinton or Trump Presidency not supporting this bill.

Despite strong political undercurrents opposing tax credits, historic tax credit legislation has taken root in the south and is only expected to strengthen. The strong economic and jobs impact of historic tax credits overcomes the political opposition to such credits. State legislation should address issues created by the *Virginia Historic Tax Credit Fund* decision as South Carolina has. Otherwise, this decision could trigger statutory and tax issues which might unintentionally invalidate allocations of state historic tax credits. Federal proposals may soften the ''sales'' treatment of state historic tax credits, but they won't resolve technical issues in state statutes.

[5] Historic Tax Credit Improvement Act (S. 2655—Section 6).

   ISSN 1534-1550