Claiming the Historic Tax Credit? Check with Your Tax Advisors Before Pursuing a Cost Segregation Study

2019

The Impact of Cost Segregation Studies on Historic Tax Credit Claims

The federal tax code provides several incentives and strategies that allow commercial building owners to reduce their tax burdens. Among the most powerful of these strategies is Cost Segregation, which enables building owners to claim accelerated depreciation deductions by simply reclassifying certain real property assets as personal property. Another provision called the Historic Tax Credit offers investors and owners of historic buildings a tax deduction of up to 20 percent of the costs of rehabilitation work performed on the building.

While Cost Segregation and the Historic Tax Credit may each offer significant tax savings, benefits stemming from the Historic Tax Credit may be reduced when the credit is claimed in conjunction with a Cost Segregation study. In other cases, using both strategies may yield optimal savings. Therefore, the owners of qualifying historic buildings should consult their tax advisors to determine whether it is more advantageous to pursue one or both opportunities.

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Cost Segregation and the Historic Tax Credit

Understanding Cost Segregation

Nonresidential real property is generally depreciated over a period of 39 years, while tangible personal property is depreciated over 5, 7, or 15 years. Therefore, personal property assets yield more substantial and immediate depreciation deductions. The IRS-approved strategy of Cost Segregation examines a commercial building and reclassifies specific assets—including wall coverings, carpeting, electrical wiring, and more—from real property to personal property. As a result, the building owner can reap the benefits of the shorter depreciation lives by claiming accelerated deductions, thus significantly reducing their tax burden and boosting cash flow.

Cost Segregation studies may be performed retroactively, but the optimal time is during the year that the building is placed into service in order to begin maximizing deductions as soon as possible. Newly constructed buildings, as well as acquisitions and renovations, are eligible. The key to a successful Cost Segregation study is to work with qualified professionals with engineering and tax expertise.

Tax reform changes to the Historic Tax Credit

Created in 1976, the Federal Rehabilitation Tax Credit—commonly known as the Historic Tax Credit—incentivizes investment in the preservation and restoration of historic buildings. According to the National Trust for Historic Preservation, the credit has created more than 2.5 million well-paying local jobs, leveraged nearly $145 billion in private investment, and supported the preservation of more than 43,000 historic buildings across the U.S.

Before the enactment of the Tax Cuts and Jobs Act of 2017 ("tax reform"), there were two incentives available as part of the Historic Tax Credit: a 10 percent credit for the rehabilitation of buildings that are not on the National Register of Historic Places but were built before 1936, and a 20 percent credit for projects that meet the following qualifications:

- The building is listed or eligible for listing on the National Register of Historic Places;
- The building produces income (including residential rental income);
- Renovations were completed in accordance with the Secretary of the Interior's Standards for Rehabilitation, which generally require that updates are consistent with the historic character of the building; and
- The building owner completes a three-part approval process through the state and the National Park Service.

The Tax Cuts and Jobs Act eliminated the 10 percent credit, except for certain taxpayers that owned or leased the building as of January 1, 2018 and continued to own or lease the building after that date. In addition, while tax reform preserved the 20 percent credit, taxpayers must now claim it over a five-year period, at a rate of four percent utilization per year. Previously, the entire 20 percent credit could be used during the year the property was placed into service. Building owners may claim the credit themselves, or allocate it to an investor involved in the project.

The Historic Tax Credit is calculated as 20 percent of qualified rehabilitation expenditures (QREs), which include architectural and engineering fees, legal expenses, site survey fees, building restoration costs, and any other construction-related expenses that may be added to the basis of the building. Costs related to land improvements and personal property assets are not considered QREs.

Cost Segregation and the Historic Tax Credit

To qualify for the Historic Tax Credit, projects must satisfy a "substantial rehabilitation" requirement, which stipulates that the amount spent on the rehabilitation must equal or exceed the original basis of the building at the beginning of the project (excluding personal property, land, and land improvements). For example, if the property was purchased for $1,000,000, and $200,000 of that amount was for the land, the rehabilitation expenses must equal or exceed $800,000.

In addition to the federal Historic Tax Credit, most states offer some form of rehabilitation tax credit. Combined federal and state credits may equal up to 45 percent of QREs.

How might a Cost Segregation study affect the Historic Tax Credit?

In some situations, a Cost Segregation study could have a negative impact on the amount that a building owner may claim through the Historic Tax Credit. The Historic Tax Credit is only available for costs incurred for the renovation of qualifying real property—not personal property. Therefore, because Cost Segregation studies reclassify real property assets within the building as personal property, the building owner would not be able to claim the credit for costs pertaining to those assets. The Historic Tax Credit may be further affected if investors are involved in the transaction or if the taxpayer is also claiming a state-level rehabilitation tax credit, the New Markets Tax Credit, or the Low-Income Housing Tax Credit.

However, Cost Segregation may still be beneficial in many cases. For example, a Cost Segregation study may be used to confirm that the basis of the building is accurate and that the land improvements and personal property have been properly depreciated. This could help to keep the starting basis lower—therefore requiring a lesser investment to meet the substantial rehabilitation requirement. Furthermore, the Historic Tax Credit is not available for additions to the original building, so Cost Segregation may be a valuable tax strategy for added-on sections.

The federal tax code is highly complex, and outcomes are entirely dependent upon each taxpayer's unique circumstances. Therefore, when pursuing the Historic Tax Credit, Cost Segregation, or other incentives, it is important to work with experienced tax professionals in order to navigate the nuances of the tax code and determine the best course of action for optimal savings.

At Capital Review Group, we offer the tax and engineering expertise needed to maximize savings through Cost Segregation, and we can advise building owners on the interaction between the Historic Tax Credit and Cost Segregation. Contact CRG today at 877.666.5539 to schedule a pro bono analysis!

(Sources: https://ascsp.org/quarterly-e-newsletter-spring-2019-the-interplay-of-cost-segregation-with-the-historic-tax-credit/, https://www.irs.gov/newsroom/tax-reform-brings-changes-to-real-estate-rehabilitation-tax-credit, https://savingplaces.org/historic-tax-credits#.XNt5Z5NKiu4

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Our nationally experienced Team Leaders will evaluate your position, identify the opportunities most suited to it, analyze potential results, and then apply for and move forward with implementation.

Do your projects qualify for Cost Segregation or the Historic Tax Deductions?

Find out today with a pro bono analysis

Contact Us

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