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PRODUCT & SERVICE GUIDE

New Law Modifies Tax Credits for Building Renovations

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Ken Berry • Jun. 20, 2018

The new tax law enacted late last year – the Tax Cuts and Jobs Act (TCJA) – includes a couple of key changes for real estate investors who are planning to renovate their properties. For one thing, the TCJA completely eliminates the rehabilitation credit, often called the "rehab credit" for short. For another, it reduces the tax benefit of the historic structures credit, although this credit will still be around.

First, here's some background information about both credits.

1. Rehabilitation credit: The rehab credit was equal to 10% of the cost of qualified expenses of renovating a building placed in service before 1936. To qualify for the 10% credit, the work must have been "substantial" in nature (i.e., expenses over a two-year period exceeded the greater of $5,000 or the adjusted basis of the building and its structural components). Furthermore, the rehabilitation work must have met specific wall retention requirements. Finally, the building had to have been placed in service by the taxpayer before the rehabilitation work was commenced.

For this purpose, "qualified expenses" includes architectural and engineering fees, site survey and development fees, legal expenses, and other construction related costs, as long as they are added to the property's basis, reasonable in amount and related to services performed.

2. Historic structures credit: With this credit for renovating a building with historic significance, equal to 20% of the cost of qualified expenses, you don't have to meet strict wall retention rules, as was needed for the rehab credit. However, there are two other key requirements.

- The building must be listed on the National Register of Historic Places or located in a registered historic district and certified by the Secretary of the Interior as being historically significant.
- The rehabilitation work must also be certified. This means the finished product must retain the original historic character (but not necessarily the original use) of the building.

Despite these obstacles, more buildings may qualify for the credit than you might think. It's not limited to birthplaces or childhood homes of presidents or mansions owned by the rich-and-famous. At last check, more than 92,000 buildings were listed on the national register.

New law changes: The TCJA repeals the 10% rehab credit for expenses incurred after 2017. (Note that certain complex transitional rules may apply.) At the same time, the

20% historic structures credit is retained, but now it must be claimed ratably over five years. This dilutes the tax payoff for real estate investors.

For example, suppose a taxpayer spends $1 million in 2018 to update a brownstone or row house in an historic part of a downtown area. As a result, the taxpayer is eligible for a $200,000 credit overall, but a $40,000 credit must be claimed in each of five successive years. In effect, the 20% credit is reduced to a 4% credit that is taken each year over a five-year period.

Undoubtedly, your clients may be less inclined to sink a boatload of money into building renovations if it will take half a decade to fully recoup the tax benefits, instead of receiving instant tax gratification. What's more, the repeal of the 10% rehab credit will further discourage upgrades of buildings that don't qualify as historic structures. Discuss the pros and cons with clients before they proceed with their plans.

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