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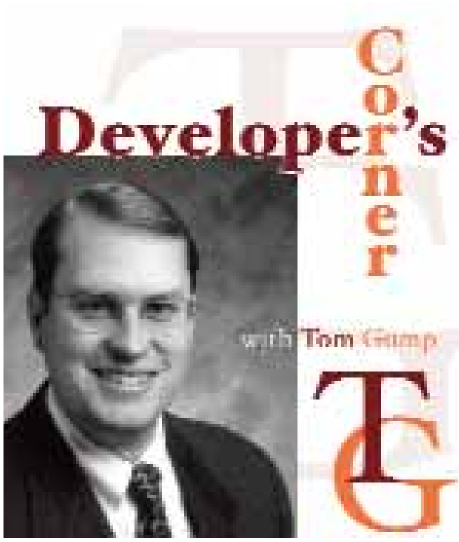
Historic tax credits reap mostly benefits (with some uncertainty) for developments, community



By Tom Gump

George Sherman, Founder, Sherman Associates

Signed into law in 2010, Minnesota's Historic Rehabilitation Tax Credit Program (HRTC) has been a plus for area developers. George Sherman is one of the most experienced, and he shares his insights.

When Gov. Pawlenty signed Minnesota's Jobs Stimulus Bill in 2010, one provision of that statute established the Historic Rehabilitation Tax Credit (HRTC) Program. The HRTC Program gave developers in the state an effective way to revitalize historic properties, help create much-needed jobs, spur on economic development and follow through on their commitments to environmental sustainability. Under the program, which started May 1, 2010, and sunsets in Fiscal Year 2015, developers receive 20 percent of qualified rehabilitation expenditures such as construction costs, and a potential wide array of fees, pertaining to architectural, engineering, survey, legal and development matters.

In addition, the state tax credit can be "twinned" with the Federal Historic Preservation Tax Incentives program, in place since 1976, which provides credits for historic rehabilitation expenses for certified historic structures. Together, the state and federal credits can be combined to cover 40 percent of qualified rehabilitation expenses of a certified historic commercial property. In addition, Minnesota's credit is considered one of the best in the nation for several reasons. The state historic tax credit can be taken as a grant equal to 90 percent of the federal credit allowed. It is transferable, credit is fully refundable, and it may be used by insurance companies as well as other corporations and individuals. There is no annual program cap and no per-project cap.

In order to qualify for the credit, the project must involve rehabilitation of a certified historic building for the purposes of producing income. The rehabilitation must comply with the standards of the U.S. Secretary of the Interior, and receive final approval from the National Park Service.

I had the opportunity to sit down recently with George Sherman, perhaps Minnesota's most experienced user of historic tax credits for development. His firm, Sherman Associates (www.sherman-associates.com), has been a pioneer in successful redevelopment not only here in Minnesota, but has made a name for itself since its beginnings in 1979 as a leader in development using historic tax credits, affordable housing and tax increment financing with projects in other states including Wisconsin, Iowa, Missouri Colorado and California.

Some notable examples of Sherman Associates' redevelopment projects in Minnesota that have incorporated historic tax credits include the $189 million Midtown Exchange Apartments and The Chicago Lofts (formerly the Sears Building) in Minneapolis, the Bottineau Lofts in Minneapolis, the Straus Lofts in St. Paul, Greyolson Plaza in Duluth and, most recently, the $132 million renovation of Riverside Plaza in Minneapolis, one of the largest – if not the largest –

uses of historic tax credits for residential renovation in the United States.

I asked Mr. Sherman to share his insights with us on the benefits of using historic tax credits, the pitfalls and obstacles involved, his top three tips for effectively using them, and the commercial real estate recession's effect on them. Finally, I asked him to tell us what the future may hold.

Tom Gump (TG): What are the biggest benefits of development using historic tax credits?

George Sherman (GS): The historic tax credit is structured so it brings in additional capital to a transaction (or equity) that helps make a project financially feasible. It generates additional capital and that helps historic projects, which usually cost more to meet historic compliance requirements, current building codes and user expectations – simply because you're working with older buildings. It might not be otherwise possible to renovate them, and the credit helps make their redevelopment more possible by bringing in more capital.

TG: And what are the biggest difficulties/risks/impediments?

GS: The historic tax credit involves a lot of complexity – with more and more risk and cost. It can be a complex instrument to structure. It involves financial risk to the developer. You are going to have to rehabilitate the building according to the State Historic Preservation Office and the National Park Service, the governing body on the federal side. The two bodies critique your drawings and concepts, and they have very set ideas. It may cost you more, and you might not like the requirements. There is a time delay in that it could take you anywhere from three months to several years to get through the approval process. Even then, there is not an assurance that you will get your building approved, so you don't want to count your chickens before they're hatched. You have increased costs, you have time delay and there is some uncertainty.

In addition, there has been a legal development in the last few weeks with the Historic Boardwalk Hall case. On Aug. 27, the Third Circuit Court of Appeals decided in a specific case that a tax credit investor was not a partner, saying that they "lack a meaningful stake in the success or failure of the project owner". The appeals court has said that on top of putting in your equity and putting in the credits, you have to be at some financial risk for the project as well. Consequently, that has put everything on hold for several weeks as attorneys and investors try to address these at-risk rules. Most credit buyers have not wanted the real estate risk, saying that the credits are risk enough. The new ruling makes these credits a bit more challenging to sell.

Another difficulty is that you have to keep your building in compliance for five years. You never know when a fire or some other disaster can affect your building. So, this may not be the solution for every building.

TG: Please share with us your top three tips for development using historic tax credits.

GS: First, you need to get a very good historic consultant early on and determine whether the building will be approved, and how much it may cost you to get it approved. A very good historic consultant will help evaluate the risk, time delays and cost of rehab to get your building approved.

Second, you want to discuss early on with tax attorneys and accountants how to structure your transaction in this more constrained environment. What you may have to do in order to sell your credits, you may not be willing to do. You will need to structure your financial and investment criteria in a way that complies with the more conservative investment climate.

Finally, it may be that the potential reuse restrictions may put your building into a use or configuration that may not be its highest and best use. You can do a nice historic rehab, but have a building that doesn't economically work because it has, for example, unusually small windows, or inadequate floor plates. Don't sacrifice the economics simply to get it to be historic.

TG: How have things changed since the commercial real estate recession as far as historic tax credits go?

GS: The recession did not have a dramatic impact on the marketability of the historic tax credits except when the credit markets completely shut down in 2008 when no one was buying any instrument. After that, most historic investors came back fairly quickly. However, one still needed private debt and the recession clearly had an impact on commercial lending. Historic credits may pay for up to 20 percent of a project's cost, but you still need the other 80 percent. The private banks have recently come back to offer financing on commercial real estate. In the last 24 months the lending market has improved, and getting the primary debt has improved. That, and the new Minnesota state historic tax credit, is why you see more historic projects going on.

TG: Finally, can you tell us your thoughts on what the future holds for historic tax credits?

GS: There is some uncertainty on the renewal of the federal and the state historic credits, and because of the Historic Boardwalk court case, there is even more investor uncertainty. On the federal side, in the next six to 18 months, Congress is going to have to address the federal deficit. If they open up the discussion on how to raise taxes, the credit could have some risk. It has been well received at all levels – a generous return on the federal dollar – but if tax law and deductions are changed, there could be some exposure as to the longevity of the federal tax credit. With the upcoming political election and the deficit – those both could affect the federal credit.

Now, this Historic Boardwalk court case says the investor has to be at risk – so there may be some pricing risk, where the investor has to take on more risk. I don't think you could even get an opinion today from a tax attorney at this point on how to deal with this. In about a month, however, the attorneys may have a solution.

On the state side there is a sunset provision for Fiscal Year 2015. It was supported by a Republican governor and a Democratic house, so it had bipartisan support. And it still has bipartisan support, but it has to be renewed, and that will depend on what the state budget looks like. People will look at every project that gets done, and we are hopeful that the projects that have been done are very good examples of the benefits.

We may also be faced in Minnesota with less of a stock of qualified product. Time keeps ticking and when you look at the very good buildings in the state, most of them are under development or have been developed. There is probably going to be a slowdown simply because the decrease in supply of qualified buildings.

TG: George, thank you very much for you invaluable insights on historic tax credits. We will all be watching to see what develops in the next few months.

For more information on Minnesota's historic rehabilitation tax credit, contact the State Historic Preservation Office at the Minnesota Historical Society at 651-259-3000 or visit them online mnhs.org/shop/grants.

George Sherman is the Founder and Principal of Sherman Associates. Mr. Sherman has planned and delivered multi- and single-family housing for more than 30 years. As principal in developing more than 7,000 rental units and more than 1,200 for-sale housing units, the total value of properties for which he has developed exceeds $2 billion. George can be reached at 612-332-3000.

Tom Gump is a real estate developer based in the Minneapolis area. He invites comments and questions about this column, and can be reached at tagump@gmail.com.