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REHAB INVESTMENT TAX CREDIT

What It Is and How It Works

Section 315 of the Revenue Act of 1978 provides an investment tax credit to encourage the rehabilitation of older buildings. In most cases, the credit is computed at the rate of 10% of the costs of rehabilitating a qualifying building. Unlike the tax incentives of Section 2124 of the Tax Reform Act of 1976, which are deductions from gross income to reach taxable income before figuring actual taxes owed, the credit is deducted from the income tax that normally is due the federal government. While the credit has a number of limitations, it can be a useful tool in encouraging the rehabilitation of older buildings.

The following explanation of the investment tax credit is excerpted from the "General Explanation of the Revenue Act of 1978" prepared by the staff of the Joint Committee on Taxation and issued on March 12, 1979.

Investment Credit for Certain Rehabilitated Structures (sec. 315 of the Act and sec. 48 of the Code)

Prior Law

Property eligible for the investment tax credit has included tangible personal property (such as machinery and equipment) which is used in a trade or business or for the production of income. The investment credit has been allowed for other tangible property which is used in manufacturing, production, extraction, or as an integral part of furnishing transportation, communications, or electrical, gas or other utility services, even though such tangible property may otherwise be considered real (and not personal) property under local law. Buildings and their structural components have not been eligible for the credit nor have expenditures for the purposes of rehabilitating or renovating existing buildings or structures.

Reasons for Change

Buildings and their structural components have not been eligible for the investment tax credit since it was enacted in 1962. At that time, the Congress was primarily concerned about the substantially greater average age and lower efficiency of machinery and equipment in domestic manufacturing facilities in comparison with the facilities of major foreign producers of the same products.

Presently, there is a similar concern about the declining usefulness of existing, older buildings throughout the country, primarily in central cities and older neighborhoods of all communities. This situation, in part, reflects basic demographic and economic trends. It also is a response to changing architectural and engineering designs of buildings and the internal placement and flow of activities in manufacturing and commercial enterprise.

The Congress believed that it was appropriate now to extend the initial policy objective of the investment credit to enable business to rehabilitate and modernize existing structures. This change in the investment credit should promote greater stability in the economic vitality of areas that have been deteriorating.

Explanation of Provisions

Qualifying expenditures

The Act extends the investment credit to rehabilitation expenditures incurred in connection with existing buildings used in all types of business or productive activities except those, such as apartments, which are used for residential purposes. Eligible buildings include factories, warehouses, office buildings, hotels, and retail and wholesale stores. The type of eligible building is to be determined on the basis of its use when placed in service after the rehabilitation, e.g., an apartment building rehabilitated for use as an office building would be treated as an eligible office building.

In order to qualify as a rehabilitation expenditure, the expenditure must be incurred after October 31, 1978, in connection with the rehabilitation or reconstruction of a building which has been in use for a period of at least 20 years before the commencement of the rehabilitation. For this purpose, the determination of the 20-year period would be unaffected by periods during which a building was vacant or devoted to a personal use. In addition, the 20-year test is to be applied to the building without regard to the number of owners. The running of the 20-year period would commence at the earlier of the time depreciation deductions were first allowable with respect to the building or when it was first placed in use for any purpose (Treas. Reg. sec. 1.463(d).)

A rehabilitation of a building, or a major portion thereof, which had previously been rehabilitated would not be eligible for the credit until 20 years after the building was placed in service following completion of a prior rehabilitation for which a credit was allowed. (However, this latter limitation should not be interpreted to require continuous rehabilitation activity and preclude allowing the credit where there are delays between phases of a rehabilitation plan.) In addition, in order to exclude minor repairs or improvements, the costs must be of the type which must be capitalized under existing law (and not expensed) and must be incurred for property which has a useful life of at least five years.

In situations where a part of a building is rehabilitated, the rehabilitation costs will qualify for the credit only if the rehabilitated part constitutes a "major portion" of the building. In determining whether a part of a building constitutes a major portion, such factors as volume, floor space, and functional differences between the rehabilitated and unrehabilitated parts of the building should be taken into consideration. For example, where a substantial part of a building is used for commercial activities (such as retail stores) and another part is used for warehousing, each part will usually consitute a major portion of the building for purposes of these provisions. In addition, a rehabilitation of leased premises, by either the lessor or the lessee, of the entire leasehold interest of a major portion of a building will be considered an eligible rehabilitation.

Under these rules and existing law, qualifying expenditures will be eligible for a two-thirds investment credit if the improvements attributable to the expenditures have a useful life of 5 or 6 years, and a full credit where the useful life is 7 years or more. Useful life for this purpose is the useful life used by the taxpayer for depreciation purposes. In addition, the existing rules concerning the recapture of investment credits will apply so that, if the property is disposed of or ceases to be a qualifying property before the end of the appropriate useful life for which the credit was allowed, all or part of the credit will be recaptured.

Qualified rehabilitation costs will be considered as incurred for new property and, therefore, not subject to the $100,000 used property limitation, except to the extent such costs are for property (such as used elevators) which otherwise qualify for the investment credit. In these latter cases, the costs will not be considered as rehabilitation expenditures.

For purposes of this provision, the rehabilitation of a building will include the renovation, restoration, and reconstruction of an existing building. Thus, interior or exterior renovation or restoration to materially extend the useful life of the building, to significantly upgrade its usefulness, or to preserve it will normally qualify. Capital expenditures for the replacement of plumbing, electrical wiring, flooring, permanent interior partitions and walls, and the heating or air conditioning systems (including temperature control systems) could qualify as qualified rehabilitation expenditures when incurred in connection with a rehabilitation. In addition, expenditures for the removal of existing interior walls, plumbing, electrical wiring, flooring, etc., would qualify if the expenditures were incurred in connection with the rehabilitation of a building and treated as capital expenditures for property with a useful life of at least 5 years.

If a rehabilitation is undertaken by a lessee, the lessee is eligible for the investment credit for qualified rehabilitation costs incurred by him, to the extent these costs are required to be capitalized by him and are not treated under other provisions of the law as payments in lieu of rent. Costs for which a lessee is entitled to reimbursement from the lessor would be taken into account for credit purposes by the lessor rather than the lessee. In determining qualified investment by a lessee, the useful life of a lessee's rehabilitation costs will be the useful life allowed to the lessee for purposes of depreciation or amortization of these costs under code sections 167 and 178.

In the case of a rehabilitation by a lessor, the investment credit may be flowed through to a lessee under regulations prescribed by the Secretary of the Treasury under code section 48(d).

Nonqualifying expenditures

The costs of acquiring a building or an interest in a building (such as a leasehold interest) will not be considered as qualifying expenditures nor will costs that are incurred in connection with facilities, such as parking lots, which are related to an existing building. In addition, construction costs for a new building, or for completing a new building after it has been placed in service, will not qualify.

Limitations are also provided to exclude costs incurred for new construction or enlargement of an existing building. In the case of an enlargement, costs will not be considered qualifying expenditures to the extent incurred to expand the total volume of the existing building. However, an increase in floor space resulting from interior remodeling will not be considered an enlargement. In addition, construction costs will be considered for new construction rather than for the rehabilitation of a building if more than 25 percent of the existing external walls of the building are replaced. This latter restriction, however, is not intended to be interpreted to cover situations where existing walls are covered (e.g., the outer walls are covered by new siding in connection with the rehabilitation) or reinforced.

Certified Historic Structures

In the case where expenditures are eligible for 5-year rapid amortization as rehabilitation expenditures for a certified historic structure, a taxpayer must choose between the benefits of 5-year rapid amortization for the rehabilitation expenditures or the investment tax credit on the expenditures. If rapid amortization is chosen, the expenditures will not be eligible for the investment tax credit. In addition, rehabilitation expenditures in connection with a certified historic structure must themselves be certified as appropriate by the Secretary of the Interior in order to qualify for the investment credit in those situations where the taxpayer elects to claim the credit rather than 5-year amortization.

Effective Date

These amendments are effective for taxable years ending after October 31, 1978, with respect to qualifying rehabilitation expenditures incurred after that date. The amendment relating to rehabilitated certified historic structures applies to property placed in service after October 31, 1978.

Revenue Effect

This provision will reduce budget receipts by $67 million in FY 1979, $181 million in 1980, and $238 million in FY 1983.

A Hypothetical Case Study

The following simplified case study illustrates the possible effect of the investment tax credit on one taxpayer's financial situation. The reader should keep in mind that the conclusions concerning the best course of action for a taxpayer will vary with each person. This example computes the tax savings for the first year only.

Mr. Johnson buys a mill building that is individually listed on the National Register. Because the building is a "certified historic structure" Mr. Johnson must complete Part 2 of a Historic Preservation Certification Application to obtain certification of his rehabilitation. The building is purchased for $20,000 with a $5,000 down payment. Financing is obtained for the balance of $15,000 as well as the $30,000 in rehabilitation expenses Mr. Johnson plans to spend in converting the small mill into office space. The total building cost is $50,000.

Because the rehabilitation qualifies as substantial, Mr. Johnson is able to use the investment tax credit with the accelerated depreciation provision provided by Section 2124 of the Tax Reform Act of 1976. Mr. Johnson, who is in a 50% tax bracket, established a new useful life of 25 years for the building.

Building cost	$20,000
Improvements	30,000
Total adjusted basis	$50,000
Depreciation ($50,000 ÷ 25 years × 150%)	$3,000
Building purchase:	
Cash down	$5,000
Finance	15,000
Improvements	30,000
Total	$50,000
Tax savings:	
Investment tax credit (10% × $30,000)	$3,000
Accelerated depreciation (50% × $3,000)	1,500
Total tax savings, first year	$4,500

From the preceding example, we can see that if one were to buy a building with $5,000 down payment and finance the balance of the purchase price and the improvement costs at the end of the first year, there would be $4,500 in cash generated from tax savings. This is equal to 90% of the cash that was originally paid down on the purchase of the property.

— H. Ward Jandl
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