January 1996

Using Tax Incentives Reduces Construction Costs

John M. Tarras

Michigan State University, shbsirc@msu.edu
Using Tax Incentives Reduces Construction Costs

Abstract
Rehabilitation tax credits can save developers a significant amount of money. The author discusses the tests used to lower overall tax liability by renovating older structures.

This article is available in Hospitality Review: https://digitalcommons.fiu.edu/hospitalityreview/vol14/iss1/7
Using Tax Incentives Reduces Construction Costs

by

John M. Tarras

Rehabilitation tax credits can save developers a significant amount of money. The author discusses the tests used to lower overall tax liability by renovating older structures.

Stiff competition is a reality in the hospitality industry. Developers and entrepreneurs are constantly looking for ways to cut costs and gain an edge. This is especially important in the construction phase of a hospitality project. One of the best ways to save money is to minimize construction costs by rehabilitating an existing structure, and one of the first places to look for savings is in the Internal Revenue Code.

Congress has decided it's better to save buildings, rather than tear them down for new construction. Therefore, financial incentives have been provided in the Internal Revenue Code to encourage developers to renovate, rather than build new structures.

Under the rehabilitation section of the Internal Revenue Code', developers receive tax credits for all qualified expenditures incurred in rehabilitating a qualified property. These credits are especially advantageous because they are deducted directly from actual taxes owed, rather than from taxable income. A developer is entitled to these credits to the limit of his taxable income, regardless of his tax bracket.

There are two ways in which a hospitality developer can obtain a rehabilitation tax credit. One allows credit in the amount of 10 percent of all qualified expenditures to developers rehabilitating certain qualified buildings built before 1936. The other allows credits equal to 20 percent of all qualified expenditures to developers who rehabilitate certified historical structures.

Qualified Rehabilitation Expenditures Are Covered by Law

Basically, the law requires that a taxpayer satisfy four conditions in order to take advantage of the rehabilitation credit: the expenditure...
must be properly chargeable to a capital account; the expenditure must be for property for which the depreciation deduction is allowable; the expenditure must be for property that meets the property type requirements; and the expenditure must be made in connection with the rehabilitation of a qualified rehabilitated building.

Under the first requirement, rehabilitation expenditures are usually charged to a capital account and are not considered an expense item, so in most cases this requirement is easily met. The second requirement that the expenditures be depreciable is almost always met, because in most cases the hospitality firm is considered a business entity entitled to depreciation expense. The third requirement maintains that the property be primarily used as non-residential real property. The majority of hospitality properties certainly meet this requirement.

The fourth requirement sets out what is considered a proper rehabilitation expenditure. For example, a qualified rehabilitation expenditure would be for the renovation of the property. It, however, does not include the purchase of the building, nor does it include the costs of acquiring a building, or any interest in a building. It also does not include expenditures attributable to the enlargement of an existing building.

**Substantive Rehabilitation Test Is Specific**

Another requirement is that the building must be substantially rehabilitated. The test is whether the expenditures during the rehabilitation period exceed the greater of the adjusted basis of the building and its structural components or $5,000. The rehabilitation period is the 24-month period selected by the taxpayer that ends within or with the taxable year.

A developer or taxpayer is not allowed to simply go in and gut a building and then claim a rehabilitation credit. There are three specific conditions that must first be met, in addition to the four requirements enumerated above: 50 percent or more of the existing external walls of the building must be retained in place as external walls; 75 percent or more of the existing external walls of the building must be retained in place as external or internal walls, and 75 percent or more of the existing internal structural framework of the building must be retained in place.

A developer can obtain the higher 20 percent credit if the following additional two conditions are met: the building is listed in the National Register, or the building is located in a registered historic district and is certified by the Secretary of the Interior as being of historic significance to the district.

A registered historical district is any district that satisfies one of two conditions. The first condition is satisfied if the district is listed in the National Register. The second is satisfied if two tests are met: Is the district designated under a statute of an appropriate state or local government, and the statute certified by the Secretary of the Interior.
or the IRS as containing criteria which will substantially achieve the purpose of preserving and rehabilitating buildings of historic significance to the district, or, is the district certified by the Secretary of the Interior or the IRS as meeting substantially all the requirements for listing of districts in the National Register.

Many hospitality developers would rather take the straight rehabilitation credit rather than try to meet the often complicated historical preservation rules. For example, the developer may be required to use slate roofing in his improvements that match the slate roofing of the period the building was originally built. This can be rather expensive and may not justify the extra credit allowed.

It is also important to remember that no rehabilitation credit is allowable with respect to property used predominantly outside the United States.

Also no rehabilitation credit is allowable with respect to any property that is used predominantly to furnish lodging or in connection with the furnishing of lodging. The lodging exception does not apply to property used by a hotel or motel in connection with the trade or business of furnishing lodging if the predominant portion of the accommodation is used by transients. This lodging exception does not apply to a certified historic structure, so if a developer was to rehabilitate a hotel as a residential hotel, then he would need to qualify it as a historical structure to qualify for a rehabilitation credit.

Finally, what the IRS gives, it also takes away, at least in part. Under the law, the adjusted basis of property for which a rehabilitation credit is allowed must be reduced by the amount of the credit. The basis is increased to the extent the credit is subsequently recaptured. For example, if all qualified rehabilitation expenditures equal $100,000, the credit allowed would be $10,000. The $100,000 minus the credit of $10,000, or $90,000, would be the basis for which depreciation could be taken on the improvements. This dilutes the value of the credit somewhat, but only to the extent of the hospitality developer's marginal tax rate.

The rehabilitation tax credit is one of the most lucrative planning tools at the disposal of anyone thinking of developing a hospitality property. This credit can reduce the high cost of rehabilitation and help the hospitality firm maintain its competitive advantage by lowering its overall tax liability. Location of the property is irrelevant. As long as the property qualifies under the tests listed above, the developer will qualify for the rehabilitation tax credit. For example, many restaurateurs have been able to convert charming older, but run-down properties into beautiful theme restaurants at a fraction of the cost of building new structures. In addition, they have been able to obtain a rehabilitation tax credit that further reduced their cost.

The rehabilitation tax credit is a very real planning device that should be considered by anyone contemplating opening a hospitality property. The old saying "an old brick is cheaper than new brick" is a valid concept to which the IRS gives additional support.
References

1IRC Sec. 47.
2IRC Sec. 47(a)(1).
3IRC Sec. 47(a)(2).
4IRC Sec. 47(c)(2)(A).
5IRC Sec. 47(c)(2)(A)(I).
6IRC Sec. 47(c)(2)(A)(I)(I).
7IRC Sec. 47(c)(2)(A)(ii).
8IRC Sec. 47(c)(2)(B)(ii).
9IRC Sec. 47(c)(2)(B)(iii).
10IRC Sec. 47(c)(1)(A)(I).
11IRC Sec. 47(c)(1)(A)(I)(I).
12IRC Sec. 47(c)(1)(A)(I)(II).
13IRC Sec. 47(c)(1)(A)(iii)(I).
14IRC Sec. 47(c)(1)(A)(iii)(II).
15IRC Sec. 47(c)(3)(A)(I).
16IRC Sec. 47(c)(3)(A)(II).
17IRC Sec. 47(c)(3)(B)(I).
18IRC Sec. 47(c)(3)(B)(II).
19IRC Sec. 47(c)(3)(B)(iii)(I).
20IRC Sec. 47(c)(3)(B)(iii)(II).
21IRC Sec. 50(b)(1)(A).
22IRC Sec. 50(b)(2).
23IRC Sec. 50(b)(2)(B).
24IRC Sec. 50(b)(2)(C).
25IRC Sec. 50(c)(1).
26IRC Sec. 50(c)(2).

John M. Tarras is associate professor in the School of Hotel, Restaurant and Institutional Management, Michigan State University.