Federal and state governments make certain tax deductions and credits available, often to encourage businesses and individuals to invest in activities that will benefit the greater good. Many of these incentives are targeted to the real estate industry in hopes of spurring development in certain areas or alternatively, the conservation of other areas. This article outlines some of the federal and state incentives that are available to the real estate industry as well as discusses recent court cases that have impacted the structuring and transferability of tax credits.

**Federal**

*Conservation Easement Deduction*: A deduction against federal taxes is available for landowners that place conservation restrictions on their properties. The restrictions must satisfy certain eligible conservation purposes. To qualify, taxpayers must grant an easement in perpetuity to a qualified charitable organization that is committed to preserving the property for conservation purposes. The amount of the deduction is based on the fair market value of the easement which must be appraised. An additional benefit of the easement is the taxpayer can continue to use the property so long as conservation easement restrictions are not violated.

*New Markets Tax Credit*: The New Markets Tax Credit Program allows taxpayers to receive a credit against federal income taxes for making qualified equity investments in certified Community Development Entities. Substantially, all of the qualified equity investment must in turn be used by the entity to provide investments in low-income communities. These investments are made to qualified businesses in low-income communities in the form of a loan or equity. The credit provided to the investor totals 39% of the cost of the investment and is claimed over a seven year credit allowance period. There are many qualifications and requirements that must be met during setup of the CDE and throughout the seven year credit period, but the tax credit enhances project owners'/developers’ access to affordable capital that may not otherwise be available. Through monetizing the credits, project owners/developers are able to raise equity and/or debt financing at much lower costs and with more favorable terms.

*Rehabilitation Credit*: The federal rehabilitation credit is 20% of rehabilitation expenditures for certified historic buildings or 10% for non-historic buildings placed in service before 1936. Requirements exist regarding the extent of the required rehabilitation and remaining historical elements (walls, etc.) of the historical building. This credit is taken in the year the expenditures are incurred, but must be recaptured (pro rata for each full year not completed) if the building is sold within five years. The credit may not be transferred, but can facilitate equity investments in partnerships.

*Low Income Housing Credit*: This tax credit encourages developers to build affordable housing to meet the needs of the community. The credit is based on an applicable percentage of the total basis of the property and is available over a ten-year period. There are various eligibility and operating requirements that must be maintained during the holding period.
States

State Conservation Easement Credits: Georgia, North Carolina and South Carolina offer income tax credits for taxpayers that make certain conservation easements mentioned above. In Georgia, taxpayers can claim a credit against their state income tax of up to 25% of the fair market value of the donated property. The credit is limited to $250,000 for individuals and $500,000 for corporations. North Carolina’s credit has more restrictive requirements than the federal requirements and is non-transferable. The credit is for 25% of the deduction (limited at $250,000 for an individual). South Carolina allows for a credit of 25% of the federal deduction and is limited to $52,500 per taxpayer per year or $250 per acre. The Georgia and South Carolina credits are transferrable and can be carried over if unused in the initial tax year.

State Rehabilitation Credits: Georgia, North Carolina and South Carolina all both provide state credits in addition to the federal credits mentioned above for the rehabilitation of certain historic buildings. The credit amount is 25% for Georgia, 20% for North Carolina and 10% for South Carolina.

South Carolina Textile Mills Revitalization Credit: This credit provides for state income tax, property tax or license fee credits of 25% of the revitalization costs, recognized over a five year period.

Jobs Tax Credits: Many states (including North and South Carolina) offer state tax credits for increasing employment in their regions. The amounts and eligibility of the credit depend on several factors including industry, location and amount of pay.

Recent Rulings

There have been two recent court cases that impact the tax credit landscape. The first, Historic Boardwalk Hall, LLC v. Comm., addresses partnership allocations of tax credits in rehabilitation developments. The second, Tempel v. Comm., deals with the income tax consequences of selling state tax credits.

In the Boardwalk case, a state agency (who cannot utilize tax credits) formed a partnership with a private business to renovate Boardwalk Hall. The private entity invested equity in exchange for a 99.9% interest in the partnership and planned to receive a preferred return, certain cash flows and the rehabilitation tax credits associated with the project. The Federal Appeals Court overturned a tax court decision that was favorable to the taxpayer and disallowed the structure that allocated tax credits to the private business. The court outlined various flaws with the structure, but based its decision on two factors: 1) the transaction was a sham (economic substance doctrine) and 2) the private business was not subject to any significant downside risk with the investment. This shows the importance of properly structuring a partnership on the front end if specially allocating credits.

The Tempel case addresses the sale of state conservation easement tax credits. In this case, the tax court ruled favorably that the sale of the credit resulted in a capital gain to the taxpayer. However, the court also ruled that the taxpayer’s basis in the credit was zero and that his holding period began at the time the credit was granted as opposed to when the property was purchased. Generally, this may cause a short-term gain on sale of credits as they are typically sold in the same year granted.
Summary

The incentives above and numerous others not mentioned are a great way to assist real estate developers with cash flow in their developments or raising capital. The complex requirements related to utilizing the incentives and recent developments in court cases amplify the need for taxpayers to plan accordingly and follow the right procedures to ensure maximum benefit. Please don’t hesitate to contact us at Elliott Davis if you’d like to hear more about how incentives can help your business.

Matt Madden, CPA, is a senior manager at Elliott Davis, LLC/PLLC. He may be reached at mmadden@elliottdavis.com.