Historic Rehabilitation:
An Important Economic Development Tool for North Carolina

Robynn E. Moraites, J.D., M.R.P.

Tax incentives for historic rehabilitation can promote central-city economic development around legacy sites that otherwise would go neglected under inexorable and institutionalized suburbanization. North Carolina has had some success with its historic rehabilitation tax credit, but it could learn from other states’ experiences in improving this program.

A combination of social and economic forces, assisted in no small measure by government policies and programs, has produced a steady outmigration of population and business activity from urban areas, regardless of their size. Left behind in the “surge to the suburbs” is a vast inventory of housing, commercial buildings, and, particularly in North Carolina, abandoned mills. A strong argument can be made that in an efficient capital market, uninfluenced by government subsidy, investment would naturally flow into the rehabilitation, reuse, and adaptation of these buildings. Such is not the case, and demographic trends demonstrate that, for the most part, flight to the suburbs continues, as does continuing destruction of these properties. The pattern is well documented, and some North Carolina cities and towns resort to annexation as they struggle to maintain a viable tax base.

Tax incentives for the rehabilitation of income-producing historic properties cannot completely reverse demographic trends or restore fiscal solvency to abandoned cities. What they can do is provide, at the margin, a useful means to counterbalance the institutionalized policy bias toward complete and total suburbanization. In addition, there are economic benefits of reclaiming these buildings and the infrastructure that supports them.

Estimates vary, but according to Don Rypkema, an expert urban renewal economist, the numbers are convincing. He reports that since 1976, and by the end of 1998, developers and business people in North Carolina used federal tax incentives for the rehabilitation of designated historic structures to rehabilitate 733 historic income-producing properties or projects, representing an estimated $325 million in private investment. Downtown revitalization in the context of historic preservation during the same time period has led to 676 business expansions, 3,400 new businesses, 1,500 building rehabilitations, and (most importantly for the purposes

Robynn E. Moraites is a recent graduate of the joint law and planning program at UNC-Chapel Hill. She is a practicing attorney at the law firm of Helms Mulliss & Wicker, PLLC in its Charlotte, NC office. Her practice focuses primarily on environmental law, including brownfield redevelopment and adaptive reuse of mills. She has particular interest in state-wide historic preservation and urban renewal efforts including downtown revitalizations.
of discussion here) 7,200 new jobs—representing $450 million in new investment.\(^5\) Tourism is the second largest industry in North Carolina, employing 161,000 people and providing $2.5 billion in annual payroll; the number one reported reason tourists visit North Carolina is the state’s historic resources.\(^6\) In addition, historic preservation impacts related industries such as the crafts industry primarily in Western North Carolina, as well as the film industry.\(^7\)

North Carolina’s Historic Preservation Office (NCHPO) reports slightly different numbers. NCHPO reports that at least 4,162 housing units have been created or rehabilitated using the historic tax credit, and that many of the units are for low to moderate-income families.\(^8\) In 1997, the last year before the implementation of the new North Carolina tax credits, 23 projects were complete with rehabilitation expenditures totaling $6,062,428. During the last three years (2000-02), the annual number of projects has averaged 115 (a 500 percent increase), with the annual investment averaging $46.9 million (a 774 percent increase). Since 1976, 1,088 completed “certified rehabilitation” projects have been reviewed by the NCHPO involving $483.3 million dollars in construction costs. NCHPO staff estimate that North Carolina’s rehabilitation expenditures on income- and non-income-producing projects have created 20,000 new full-time jobs, have added $1.06 billion dollars to the state’s economy, and have added $387.1 million dollars to the household incomes of North Carolina residents. Over 5,000 rental-housing units have been created or rehabilitated—many for low- to moderate-income families. It is critical to note that NCHPO reports that developers involved in these rehabilitation projects have indicated that the majority of projects completed under the income-producing tax credit program would not have been completed without it.\(^9\)

Another critical benefit stemming from historic restoration is the cost savings realized by utilizing abandoned or under-used infrastructure. Federal tax incentives such as depreciation encourage new construction. Potential environmental liability issues with older, existing sites encourage development on untouched suburban greenfields. Substantial government subsidies for expensive and increased highway construction make traveling to untouched suburban greenfields unproblematic. As a consequence of the interaction of these and other factors, sprawl has become a monolithic problem across the nation. While developers may initially invest in infrastructure, cities and counties are left to maintain new infrastructure, while existing infrastructure lays idle in central cities and business districts. Such infrastructure is called a “stranded investment.”\(^10\) Companies like Carolina Power & Light have huge investments in powerlines and equipment already in place to serve existing buildings in downtowns and neighborhoods. When those facilities are used at a rate less than their capacity, the investment is considered stranded, that is, not able to provide a return commensurate to the capital initially invested in the equipment.

Abandoned buildings from a wide array of industries sit idle, unused, and draining local economies of tax revenue, as new development on the suburban fringe requires significant capital investment for new infrastructure. Historic areas have infrastructure already in place since they are primarily located in close proximity to travel arteries and central business districts.\(^11\) In addition to generating revenue through increased job creation and promotion of tourism, historic rehabilitation curbs additional infrastructure costs to undeveloped greenfields, utilizes existing infrastructure, and increases potential future tax revenue from currently idle and unproductive properties.

As the economic studies illustrate, historic preservation, particularly when combined with the use of historic income-producing tax credits, can be a very efficient mechanism to spur North Carolina’s economic growth. North Carolina policy makers were on the front end of the curve when they adopted the current historic tax credit program in 1997. Several states, including South Carolina and Missouri, initially modeled their programs
after North Carolina’s program. North Carolina’s program was considered the best, or one of the best, and it has had notable success with its program. Now is an ideal time to implement refinements or targeted incentives that have been implemented elsewhere in order to build on this initial success and carry forward the momentum.

North Carolina has its own particular profile for rehabilitation investment tax credit projects. North Carolina’s projects tend to be smaller than those occurring in other states. The type of project is overwhelmingly residential, not commercial. The average estimated construction cost is $430,000. The smallest projects, of which there are several, total $6,000 and the largest project, Holly Inn in Pinehurst, totaled more than $12.7 million. Only a few developers have rehabilitated more than one building. In North Carolina, the tax credit program has been largely a program for small and moderate business people and investors. Larger projects, however, have been completed in the last few years, and the average size is increasing steadily. Of the total rehabilitation projects existing as of December 31, 1999, 41 percent of the after-rehabilitation uses were residential, 35 percent office and commercial, and 24 percent mixed-use or other uses.

Most of the rehabilitation investment tax credit activity in North Carolina has occurred where historic resources are concentrated: in older settlements on the coast, in Piedmont cities, and in early 20th century growth towns of the western region. Despite this concentration, however, tax credit projects have been located in 69 counties, distributing the benefits across the state.

The purpose of this paper is to examine possible initiatives or modification to the current statutory scheme that would facilitate more effective use of the state historic rehabilitation income-producing tax credit and encourage increased numbers of historic rehabilitation projects, thereby positively impacting North Carolina’s economy. It is assumed that the reader is already familiar with the operation of the federal tax credit program.

Overview of North Carolina’s Historic Tax Credit Program

North Carolina’s historic tax credit is available to offset against North Carolina income tax to taxpayers that are allowed a federal income tax credit under the federal Code for the Federal tax credit program. Like the federal program, the credit is allowed for qualified rehabilitation expenditures for a certified historic structure located in North Carolina. The amount of the credit is 20 percent of the expenditures that qualify for the federal credit. The credits are allocated in five equal installments beginning with the taxable year in which the property is placed in service. Any unused credit may be carried forward for the succeeding five years and the tax may not exceed the amount of taxpayer’s North Carolina income tax liability reduced by all other credits allowed.

Effective for taxable years since January 1, 1999, a “pass through” entity (a limited partnership or limited liability company for purposes of discussion here) that qualifies for the credit may allocate it among any of its owners at its discretion as long as an owner’s adjusted basis in the pass-through entity (as determined under the Code, at the end of the taxable year in which the certified historic structure is placed in service) is at least 40 percent of the amount of credit allocated to that owner. There are recapture and forfeiture provisions in place to facilitate long-term investment in rehabilitation projects.

North Carolina modeled its historic tax credit program after the federal program. As a result, developers and investors have an easier time with extensive paperwork and record-keeping requirements for rehabilitation projects that meet both the federal and state certification criteria since the federal and state programs mirror each other. The opportunity to recoup additional costs through the state program for projects that qualify for both the federal and state credit provides a significant
Historic Rehabilitation 33

incentive for both developers and investors.

In North Carolina, investors and developers can opt to disaggregate the federal credits from the state credits. Accordingly, a developer may find two separate investors for a project: a national investor for the federal credit and a local investor for the state credit. A national investor that does not have significant tax liability in North Carolina would probably only be interested in the federal credits, leaving the state credits available for a local investor.20 Because local investors can invest in state credits alone, the structure of the state historic credit program, standing apart from the federal scheme, can have a significant impact on the type, amount, and size of historic rehabilitation projects.

As stated previously, the primary purpose of this paper is to examine possible initiatives or changes in the current statutory scheme that would facilitate greater and more effective utilization of the state credit program and encourage increased numbers of historic rehabilitation projects. In order to effectively analyze possible changes in the current scheme, it is important to understand how these deals are structured, since there is technically no market exchange in place.

Primary Investors and the Structure of a Historic Rehabilitation Tax Credit Deal21

In order to understand why historic rehabilitation tax credit deals are structured as they are, it is important to first acknowledge the impact certain tax code provisions have on taxpayers that could serve as potential investors in these deals.22 For example, the historic rehabilitation credit cannot be used to reduce liability for the alternative minimum tax; it is also subject to the passive activity loss prevention rules of Section 469 of the Code and the at-risk rules of Section 49 of the Code.

The alternative minimum tax (“AMT”) is an additional tax over and above regular income tax.23 The idea underlying the AMT is to prevent taxpayers from avoiding tax liability by using special tax benefits, tax shelters, or tax credits. The AMT rules determine the minimum amount of tax that a taxpayer within a certain income bracket should be required to pay. Many of the credits that are allowed when calculating regular income tax, such as historic tax credits, are not allowed when calculating AMT. The more credits claimed for regular income tax, the more likely it is that AMT payment will be required.

At-risk limitations limit an investor’s deductions to the amount at-risk—that is, money an investor stands to lose should an investment turn sour.24 The initial sum considered at risk is the amount of cash and the adjusted basis of property contributed to the activity and/or amounts borrowed for which an investor is personally liable. An investor may not claim deductions for losses greater than these amounts invested.

The passive activity loss rules force an investor to segregate all income and losses into three categories: active, passive and portfolio.25 Generally, these rules disallow deducting passive losses against active or portfolio income, even when an investor is at risk to the extent of the loss. Deductions for passive activity or related expenses may be claimed only to the extent that they offset income from all passive activities.

In order to avoid the passive activity loss rule and to claim any investment losses against active income, an investor must have “material participation” in an endeavor. Material participants must participate on a continuous and substantial basis. The material participation standard is difficult to determine, and the IRS provides several tests to help taxpayers determine their current participation levels.26

Therefore, when stepping back to consider the Code provisions combined, in order for an investor in a historic rehabilitation tax credit deal to successfully use the credits, the investor must first meet a minimum tax threshold (after application of any credits), and then
may deduct only up to the amount directly at risk, provided the investor participates in the deal materially, not just passively. It is a rather tall order and restricts who can effectively claim the credit. Accordingly, in North Carolina, a typical investor is a major corporate entity, although, in some cases, investors may be syndicated funds. Current purchasers of historic rehabilitation credit transactions are primarily financial services companies, particularly banks.

Usually, the on-the-ground developer of a historic project wants to utilize the historic rehabilitation credit as a source of financing for the project. In order to do this, the developer would want to sell the credit to an outside investor while simultaneously retaining all of the economic benefits from the project. To accomplish this within the restrictions of the tax code and historic tax credit programs, the entity that has evolved for ownership of buildings eligible for the credit is either the limited partnership (LP) or the limited liability company (LLC) (hereinafter “partnership”). The changes recommended here are based in part on the structure of these deals and the allocation of profits and tax credits in these entities.

Comparative Analysis: Strategies Used in Other States that Promote Redevelopment

North Carolina has typically been on the forefront of innovative policy initiatives encouraging development. North Carolina policy-makers led the pack in 1997 when they enacted the current historic tax credit program. One of the ways to assess the effectiveness of North Carolina’s current tax credit program is to examine programs offered in other states. Such a comparative analysis offers differing perspectives as well as benchmarks to measure adequacy and areas for improvement. The analysis here will assume rational market actors who wish primarily to maximize profit. The further assumptions are: 1) the less the risk, 2) the easier it is to turn a property, and 3) the easier it is to enter and exit a deal, then the greater the program’s overall effectiveness and efficiency in reaching the goal of promoting redevelopment.

A comprehensive survey using several sources revealed that 22 states have programs designed to encourage historic preservation and redevelopment of older abandoned properties that do not involve state income tax credits, but instead involve property tax abatements. Of the remaining 28 states, 10 do not have any type of financial or tax incentive for historic rehabilitation at all. Of the remaining 18 states, 7 use some combination of property tax abatement and tax credit, and the remaining 11 states use some form of tax credit standing alone. The following analysis will focus on differing aspects of those 18 states that utilize some form of tax credit. The purpose is not to exhaustively compare those 18 states’ programs, but to select statutory provisions from among them that promote redevelopment, and to utilize economic data from those states where available. Greater focus is placed on southeastern states since North Carolina competes with southeastern states to attract business as well as tourism revenue.

States use varying strategies to promote redevelopment of historic properties and several factors influence how policy makers develop a program. As expected, the greater the positive economic impact that can be shown, as well as the greater number of historic resources within a state, the more willing policy-makers will be not only to support a tax credit program, but also to strengthen it once it is clear that the program is successful and effectuating policy goals. Indeed, North Carolina’s historic tax credit program has positively impacted the state’s economy. The critical inquiry for policy makers now is how best to build upon the successful foundation of the program to strengthen it and generate even more revenue for the state. The following five provisions are elements of statutory schemes from other states that North Carolina’s policy makers should consider implementing for the reasons given.
1) Allow developers to realize the entire historic tax credit in the year the structure is placed in service

In North Carolina, the current tax credit program restricts a developer to apply for historic tax credits in equal installments over a five-year period once the building is placed in service. Investors must then also wait for the credit to pass through. As a result of the five-year restriction, developers in North Carolina wishing to finance a project can only obtain $0.50 on the dollar for each tax dollar of credit.

North Carolina’s five-year restriction is very unusual. Other states do not provide for a credit realization time restriction but rather allow the entire credit to be claimed either the year the building is placed in service or as the rehabilitation is carried out. In Virginia, for example, the entire tax credit may all be applied in the year the building is placed in service. As a result, developers in Virginia receive $0.65 on the dollar for each tax dollar of credit.

The fact that Virginia does not place a time restriction on when the credits may be claimed puts North Carolina at a competitive disadvantage.

National investors with substantial tax liability in both North Carolina and Virginia, if forced to select only one market for investment, would likely choose to invest in Virginia projects in order to receive the greater immediate tax benefit. In addition, developers in Virginia would likely be willing to undertake larger scale projects or take on riskier properties because they can secure greater up-front financing. The evidence indicates that North Carolina’s historic rehabilitation projects are smaller than those in other states, and the timing of credit realization is part of the reason why. Eliminating the restriction would bring North Carolina into alignment with a majority of other states.

2) Allow investors to use the historic rehabilitation credit to offset against other significant taxes in lieu of state income tax

Some companies and certain types of business entities do not pay state income tax, per se. Instead, they pay some other form of tax. For example, premium tax is the tax that insurance companies pay for the premiums they receive. Insurance companies are not subject to franchise or income taxes once the premium tax is levied against them. But North Carolina’s historic tax credit is restricted to state income tax. Insurance companies have enormous state tax liability in North Carolina, but the liability is premium tax, not income tax, so they are precluded from investing in historic tax credits.

While an investor can always offset federal tax liability, the appeal of investing in a rehabilitation project within North Carolina is greater for companies that have North Carolina tax liability. Currently in North Carolina, banks are the primary investors in historic rehabilitation credits because they have enough of the “right kind” of North Carolina tax liability to make investing worthwhile. Bank of America and the Community Affordable Housing Equity Corporation (CAHEC) are the primary investors in historic rehabilitation credit projects in North Carolina. Bank of America has enormous tax liability and passive income from its Charlotte headquarters. CAHEC is a non-profit corporation that specializes in organizing and managing low-income housing tax credit equity funds, and it has a historic credit program. BB&T and Wachovia have limited state tax liability and rarely invest in these deals. Thus, the universe of potential investors is small.

Unlike the situation with the five-year credit timing allocation, North Carolina is not in the minority as to the income tax restriction for offset purposes; many states allow offsets only for personal or corporate state income tax. Several states with highly successful programs, however, allow historic credits to offset several other forms of tax in addition to state income tax. By allow-
ing offsets to various forms of income from various types of industries, states open up entirely new markets of potential investors in rehabilitation projects. Developers in North Carolina experience difficulty in finding investors for projects because the current market is so restricted. By allowing credit offsets against one or two additional forms of tax liability, North Carolina policy-makers would open North Carolina’s market considerably and put North Carolina in a competitive position for attracting private investment.

Virginia, North Carolina’s economic competitor to the north, provides an exemplary model that promotes not only historic rehabilitation, but also business in general. Investors in Virginia’s tax credits are not restricted to state income tax liability. Investors may apply the credit against not only individual income tax, but also against estate and trust tax, corporate tax, bank franchise tax, insurance company tax (like a premium tax), and any licensing taxes for telegraph, telephone, water, heat, light, power or pipeline companies. Such a scheme allows companies with enormous state tax liability in various forms, like insurance companies and utility companies, to partner in historic rehabilitation deals.

Several states in addition to Virginia provide investors the option to offset against other taxes. For example, Rhode Island allows offsets against personal income tax, business corporate tax, franchise tax, public service corporation tax, bank tax, and insurance company tax. Missouri offers offsets against income tax for individuals, corporations, partnerships, estates and trusts, as well as taxes of financial institutions including banks, credit unions, savings and loans, insurance companies, and farmers’ cooperative credit associations.

It becomes apparent at once that the pool of potential investors in historic rehabilitation projects in states like Virginia, Rhode Island, and Missouri far exceeds those in North Carolina. In order to increase the pool of potential investors, North Carolina policy makers can simply include additional forms of tax liability in the current statute.

Some may become concerned that these credits deplete the state’s treasury in a time when the state budget is already in bad shape, and allowing additional investors will deplete the treasury even further. However, double dipping is not allowed under any state scheme; only one person, household, or entity may claim a historic tax credit. By allowing additional investors to enter the market, policy-makers will lay the foundation for more historic rehabilitation projects, which has been shown to increase revenue and jobs.

In the short-term, some may predict that state revenues will drop if North Carolina allows additional industries to capitalize on the credits. While a credit is a credit, regardless of who claims it, opening the market will pave the way for increased use of credits in amounts not currently contemplated. Evidence consistently shows, however, that the tax revenue generated from the reuse of once unproductive property far outweighs any short-term revenue losses.

Policy-makers in Missouri had such a concern, and the St. Louis Regional Chamber and Growth Association commissioned a study of the short-term and long-term economic impact of historic preservation. The study showed that the historic tax credit program generated $1.78 for every $1.00 of tax credit issued. Moreover, the study found that developers must raise $4.00 in private equity financing for each $1.00 of tax credit issued. Researchers also noted that short-term losses are virtually irrelevant because the equity and financing must be raised and the rehabilitation of the property complete before a single credit is issued. Essentially, the building begins generating tax revenue once it is placed in service, and only when it is placed in service may a developer apply for the credits, thereby minimizing state revenue losses from issuing the credits.
While there is no published cost-benefit data on the North Carolina historic tax credit program, the federal program may prove a useful parallel for illustrative purposes. In fiscal year 1995, there were 529 historic rehabilitation projects representing investment of $467 million.\(^6\) The cost to the federal treasury was $93.4 million.\(^4\) Yet the increased revenue totaled $124.25 million—significantly more than the revenue cost.\(^5\) North Carolina’s credit program is modeled closely after the federal credit program, so it is reasonable to assume a similar ratio or percentage of return. By allowing offsets to additional forms of tax liability, policy makers will strategically position North Carolina’s program among the elite, encouraging business investment that the state might not otherwise realize.

Also important to this discussion is the idea of cost and benefit allocation. Many argue that these types of programs have costs that exceed benefits. Those that oppose these programs argue that economic analyses are flawed because they weigh assumptions too heavily to accurately predict revenue or economic impacts. Assuming \textit{arguendo} that such is the case, there is still a strong argument for promoting these programs because of the benefit allocation.

In the example of the federal tax credit program, the federal government foregoes certain tax revenue in order to promote redevelopment. That redevelopment in turn directly benefits both state and local governments through increased local property tax revenue. Whether the federal government acts for the precise purpose of enriching state and local government is questionable but nevertheless irrelevant. The fact remains that state and local governments receive revenue from properties put back into service and on the tax roles as a result of the federal credit. Such is also the case with a state credit. A state will temporarily forego revenue in the short term while local governments benefit almost immediately from economic stimulation in a once economically stagnant area.

Policy-makers should consider allowing offsets against other forms of income to diversify the historic tax credit investor base in order to stimulate and increase state and local tax revenue.

3) Eliminate or shorten the credit recapture period

Recapture provisions generally anticipate and are triggered by very different scenarios. For example, failure or closure of a property within five years of receiving a credit will trigger the recapture provisions. Modifications to a property that do not comply with the historic rehabilitation standards set by the Department of the Interior (“Interior”) will also trigger recapture provisions if the non-complying modifications occur within five years of receiving a credit. Finally, sale of a property or sale of a certain percentage of interest in a property triggers recapture as well.

Recapture provisions can provide an efficient mechanism for risk allocation. On one hand, recapture provisions can promote more careful selection of projects in terms of market strength, since loss of tenants can lead to project failure, resulting in a loss of credits. Under such a scenario, the developer carries the risk of project failure and society is not left with a string of failed, abandoned projects and only a lack of revenue to show for it. On the other hand, developers currently cannot sell redeveloped projects because sale or transfer of a rehabilitated property during the five-year period after it is placed in service and the credits are claimed qualifies for recapture. In addition, developers currently carry an additional risk in the way the deals are structured.

Because investors in historic rehabilitation projects acquire interests in partnerships to obtain the historic rehabilitation credits, investors, as opposed to developers, are not concerned with receiving significant cash flow from a project.\(^6\) An investor’s principal concern is that projects remain viable for a period of at least five years in order to avoid recapture. Accordingly, a typical investor requires both a credit guaranty and a guaranty of
Eliminating, shortening, or modifying the recapture period would greatly reduce risk for investors, thereby making it easier for developers to obtain capital investment. It would also reduce a developer’s personal risk in guaranty agreements. With reference to the assumptions outlined previously, the easier it is to enter and exit a deal, the easier it is to obtain credit, and the easier it is to turn a property, the more successful the reinvestment will be.

There is a split among the states regarding recapture with a majority including it. For example, New Mexico, Virginia, Missouri, Kansas, and Rhode Island, to name a few, do not include a recapture provision as part of their programs. Colorado, Indiana, Michigan, Maine, and Vermont, however, all incorporate some form of the federal five-year recapture provision. Those states that include a recapture provision do not distinguish between scenarios triggering recapture, such as sale versus failure, when determining whether a developer is subject to recapture of credits.

As a general rule, property law and economics do not favor excessive restraints on sale and transfer of property. Neither do developers. Allowing developers to turn property easily and quickly frees up capital and enables them to delve into subsequent projects. Eliminating recapture gives developers greater flexibility in determining when to divest from a partnership after a completed rehabilitation. There is no evidence of abuse in those states that do not have a recapture provision. There is also no evidence that avoiding a recapture provision somehow encourages rehabilitated buildings to later be modified in unacceptable ways or shortens a rehabilitated building’s useful life. It seems that once buildings are put back into productive use, they continue to be productive.

Recapture provisions also affect the value of the tax credit. The difference in price between the federal credit and the state credit occurs because state taxes are deductible for federal tax purposes. Assuming the investor is in the 35 percent bracket, the tax credit at par is worth $0.65. The NC credit is worth $0.50 for two reasons. The first reason involves the five-year credit claim restriction, as discussed previously. The other key reason is that a recapture provision serves as a five-year holding period. Investors often hold the credits until the credits vest and are free from the possibility of recapture. Once again, the time value of money dictates that the longer an investor is required to wait to claim a credit, the less the credit is worth to that investor in terms of current dollar value.

North Carolina would encourage greater private investment and accelerate the productive reuse of numbers of blighted buildings by shortening, modifying, or eliminating the five-year recapture provision. For example, policy-makers could limit the scenarios that trigger recapture to situations where a project fails or where a developer made modifications that did not meet the standards set by Interior and, at the same time, eliminate recapture for transfer or sale of property. Under such a framework, developers still shoulder the majority of risk, but they have greater flexibility to sell a project than they do presently. In another modification example, policy-makers could reduce the recapture provision to three years, thereby maintaining the current risk allocation scheme, with developers shouldering the majority of risk, but reducing the risk slightly. Reducing the recapture period would also increase the current value of the tax credit.

The point is not to eliminate risk for developers or to shift the inherent risk completely to society, but rather to even the scales a bit to encourage development where it is not otherwise occurring. Policy-makers can be creative in crafting a recapture provision in order to maintain an acceptable risk allocation between society and developers. Shortening, modifying or eliminating the recapture provision is yet another tool available to strengthen the current historic tax credit program.
4) **Create a market for historic rehabilitation credits and make them fully transferable**

Rhode Island, Missouri, and Delaware lead the way as far as free market transferability of credits. They each permit taxpayers eligible for historic tax credits to assign, transfer, or convey the credits, in whole or in part, by sale or otherwise to any individual or entity. The assignee then steps into the shoes of the original taxpayer and acquires the same offset rights; assignees are not limited in any way by the mere fact that they are assignees.

There are several benefits to adopting such a scheme. To begin, the greatest benefit would be that the structure of historic rehabilitation deals would change. Developers could develop a project without needing to partner with another institution to claim the state credit. Because the credits would be transferable in whole or in part, developers could sell the credits in smaller blocks to smaller investors who do not have enormous tax liability. In the alternative, a large investor, such as Bank of America, could sell smaller blocks of credits to smaller taxpayers. Investors would not be precluded from investing in these types of projects because of tax liability limits. In addition, because developers would have greater flexibility as to how to allocate credits, they may consider larger rehabilitation projects that at one time would have been out of reach due to the large burden of risk on a single investor.

Adopting such a transferability scheme in addition to some of the other recommendations would make North Carolina’s historic rehabilitation tax credit program one of the most competitive in the nation. For example, combing transferability with immediate realization and no recapture provisions would allow developers to undertake larger, previously riskier projects and would attract a variety of small to medium size investors that had previously been excluded from the investment process. Businesses would be drawn to invest in these programs, creating a positive cash flow for the state stemming from new tax revenue from rehabilitated buildings.

5) **Provide targeted incentives for abandoned mills**

North Carolina has a vast number of abandoned mills—mills that were once the heart of the now defunct North American textile industry. Almost every small town in North Carolina, and elsewhere in the South, had at least one cotton mill. Most are now abandoned and dilapidated. Two hundred and thirty six mills closed in North Carolina between 1997 and 2002. While some are being put to alternative uses such as museums and concert halls, many are being destroyed, or their building materials sold off at premium prices. These mills represent the heritage of North Carolina, and many serve as a town’s central architectural feature.

As discussed previously, but for the many governmental policies encouraging development elsewhere, private development would focus on reuse of these buildings and their supporting infrastructure. Policy-makers can use the historic tax credit as an effective means to target abandoned mills and promote their redevelopment and reuse. The current historic tax credit program does not target any one particular historic resource. If policy-makers want to target mill redevelopment, the low-income housing tax credit could serve as a good model for how to modify the historic tax credit to target mills.

Section 42 of the Code outlines the low income housing tax credit. Congress allocated special provisions for determining eligible basis in an attempt to provide incentives to target certain areas. Developers using the low-income housing tax credit are eligible for a 130 percent increase in eligible basis of a qualifying property provided that the building is located in either a qualified census tract (an area with a high concentration of low-income residents) or in a difficult to develop area (an area where development costs are exceptionally high). By providing a 30 percent booster to basis in difficult to develop areas, Congress encourages development of low-income housing where it would otherwise never
Many policy-makers are already familiar with the low-income housing tax credit structure. Application by analogy to the historic tax credit program would not be difficult. For example, North Carolina could provide a 30 percent (or some other percentage) boost in eligible basis for the redevelopment of historic textile mills. Such an incentive would direct commercial development to these particular resources. The potential economic benefits of such a program would be widespread and would impact most small towns across the state, since mills are not concentrated in one area of the state. However, if applied as suggested, this approach would be complicated to implement because the basis determination would differ for federal and state tax credit programs.

Another simpler approach might be to increase the state income-producing credit from its current 20 percent of qualified expenditures for historic properties in general to 40 percent for adaptive redevelopment of mills. Such a change to the current scheme would create a greater incentive for private developers to specifically target abandoned mills. Moreover, for ease of use, the operational approach to claiming the credits would remain the same as is currently utilized.

One of the major economic challenges facing North Carolina is the growing economic disparity between rural and urban areas. While North Carolina’s major cities continue to experience an economic boom that bring high-paying jobs and a range of social and cultural amenities, most rural areas are in a state of economic stagnation or decline. Rural economic development in North Carolina is a critical goal, and since most small towns have at least one mill, targeting mills for reuse likely would provide an economic boost to rural areas. A mill incentive would provide an equitable distribution of tax incentives and would not result in a concentration of rehabilitation only in larger cities.

**Conclusion**

Sprawl is on the rise. New construction continues at a staggering pace. Government policies encourage new construction on the suburban fringe and central cities are left depleted of tax revenue, supporting vast idle and under-used infrastructure. Historic resources are ignored, abandoned, and usually destroyed. While the numbers vary, economists have shown that historic preservation creates jobs, attracts tourists, increases governmental revenue, and brings in private investment at a 4:1 ratio. Policy-makers across the nation have awakened to the possibilities historic preservation may offer for curbing sprawl, maximizing stranded infrastructure investments, and promoting and maintaining livable, attractive cities and towns for both residents and tourists.

While North Carolina currently offers a historic rehabilitation tax credit that has received use, the tax credit can be stronger and can be structured to attract greater investment. Virginia is one of North Carolina’s primary economic competitors and has a program that attracts greater private investment. Rhode Island and Missouri also have model programs that promote business and encourage private investment by making it easier for developers to solicit investors to rehabilitate historic properties. Some of those strategies could be employed in North Carolina to make its program more competitive today and encourage greater reinvestment.

The suggestions put forth are not intended to be used carte blanche. Doing so would shift the allocation of risk completely and unacceptably from developers to society. In fact, it would be unwise to adopt all suggestions together. Adopting all suggestions would not ensure the outcome espoused at the outset of this discussion, which is to promote greater historic rehabilitation as an effective and efficient economic development tool. While adopting all measures would promote greater historic rehabilitation, it also could encourage potential abuse, which would, in turn, likely drain the economy, creating an inefficient outcome. State and lo-
cal governments would forego revenue and likely have little to show in terms of percentage of overall success. Such a scenario does not serve the public interest.

Instead, the provisions outlined are meant to serve as benchmarks for ideas that could be incorporated selectively or partially. The adoption of just two or three suggestions would significantly alter the historic tax credit program as it currently stands and promote greater redevelopment without simultaneously shifting risk. Allowing the credit to offset against a wider array of taxes than just income tax is a highly recommended change, regardless of the other measures adopted. For example, increasing the amount of credit allowed for mill redevelopment and a transferability provision would likely revolutionize the projects undertaken throughout the state without shifting unreasonable risk to state and local governments.

Incorporation of some variety of these changes would benefit historic rehabilitation developers as well. Developers currently familiar with the system and involved in historic rehabilitation projects will likely expand their rehabilitation activities. As discussed earlier, North Carolina’s projects tend to be smaller than those in other states. Developers may be willing to approach larger projects that they would have avoided otherwise. In addition, the greatest amount of rehabilitation has been residential. Modifying the program will shift the focus and encourage greater commercial redevelopment, which is at the heart of economic development. In the process, developers will receive tax benefits, but more importantly, they will be able to solicit a diverse pool of investors that bring needed private investment to the table. Developers who at one time were not interested in the historic rehabilitation market may become so, once risk is hedged and return marginally increased. Historic rehabilitation tax credit deals are sophisticated and highly risky; any changes that can be adopted to make deals easier and somewhat safer will further open the market.

It is time for North Carolina’s policy makers to consider strengthening the historic tax credit program. Policy makers should study the effectiveness of historic rehabilitation tax credit programs in other states that have model programs, such as Virginia, Missouri, and Rhode Island. A close look at other states will reveal the advantages and disadvantages of incorporating the various modifications suggested here. These suggested modifications could be used individually or in tandem. The more they are strategically and thoughtfully combined together, however, the stronger and more competitive North Carolina’s historic tax credit program will be. The stronger the program, the greater the private investment will be. The greater the private investment, the greater the economic benefit to the state and local governments and their residents.

Endnotes


2. Id.

3. This discussion focuses entirely on the income-producing tax credit and does not speak to the historic homeowner tax credit program also employed in North Carolina for rehabilitation of residential property.


5. Id.

6. Id.

7. Id. Rypkema reports that the craft industry employed 4,000 workers and artists in 1996 and added $48 million annually to those household incomes. Consistently, the most effective sites from which to sell those crafts are western North Carolina’s historic
buildings in downtowns and on main streets. Rypkema also reports that the film industry has spent over $4.6 billion in North Carolina since 1980 and that North Carolina’s historic commercial areas and historic neighborhoods are a significant draw for that industry.


9. Id.


13. Id.

14. Id.

15. See N.C. Gen. Stat. § 105-129.35(a). North Carolina also offers a credit for rehabilitating non-income producing historic structures (i.e. residences), but that provision is irrelevant for the purposes of discussion here. See N.C. Gen. Stat. § 105-129.36.


17. How these deals are structured is detailed in Section III.

18. See N.C. Gen. Stat. § 105-129.37(c) and (d).

19. Developers will still, however, have to deal with both federal and state agencies and departments for official historic designations and certifications in addition to both the IRS and the NC Department of Revenue.

20. BB&T and Wachovia are two institutions that fall within this category of investors because they have limited state tax liability.

21. A great deal of the following section has been excerpted and paraphrased from Kenneth A. Alperin, “Historic Rehabilitation Tax Credit—An Overview,” Historic Preservation Law, sponsored by American Law Institute – American Bar Association Continuing legal Education and the National Trust for Historic Preservation (October 15, 2001).

22. All potential investors in a deal involving historic rehabilitation tax credits are taxpayers. As such, the terms investor and taxpayer are used interchangeably throughout this section as needed.


28. The outside investor is obligated to make capital contributions to the partnership that owns the project. These capital contributions are typically based upon the amount historic rehabilitation credits anticipated to be available, with current prices for federal credits equal to approximately $.90 per dollar of credit. So, for example, if a $5,000,000 rehabilitation were conducted, the 20 percent historic rehabilitation credit would be $1,000,000 and the capital contribution attributable to those credits would be approximately $900,000.

29. Sources include: Constance E. Beaumont, Smart States, Better Communities, How State Governments Can Help Citizens Preserve Their Communities, 114-23, National Trust for Historic Preservation (1996); State Tax Central available at www.statetaxcentral.com (a search engine designed to assist in identifying specific tax statutes in all fifty states); and searches for individual state statutes us-
30. There has been an increasing trend toward states adopting tax credit programs and some states are in transition. One report estimates that 45 states have some form of financial incentive for historic rehabilitation.

31. North Carolina is one of the states that combine both property tax abatement and a tax credit. North Carolina’s property tax abatement applies only to locally designated landmarks. However, it is beyond the scope of this discussion to analyze the interplay between the two types of incentives.

32. The discussion here will not refer to Maryland’s Historic Tax Credit. At the time this paper was written and researched there was a question as to whether Maryland would keep its historic tax credit program, which was slated to sunset in June of 2004. The Maryland credit program provides an excellent example of many of the ideas that will be discussed here.

33. See N.C. Gen. Stat. § 105-129.37(b).

34. There is no indication that the five year restriction increases the pool of potential investors given the AMT limitations because anecdotally it is known that there is a very small pool of investors in North Carolina. See Section IV(a)(ii) infra.

35. Examples of states include: Colorado, see Colo. Rev. Stat. Ann. § 39-22-514(7); Indiana, see Ind. Code Ann. § 6-3.1-16-13; Missouri, see Mo. Ann. Stat. § 253.557; New Mexico, see N.M. Stat. Ann. § 7-2-18.2; Rhode Island, see R.I. Gen. Laws § 44-33.2-3; Wisconsin, see Wis. Stat. § 71.07 (9m) and Wis. Stat. § 71.07 (9r).


37. The difference in price between the federal credit (estimated by Kenneth Alperin to be $.90 for every dollar of credit) and the state credit (a maximum value of $.65 for every dollar of credit) occurs because state taxes are deductible for federal tax purposes. Assuming the investor is in the 35 percent bracket, the tax credit at par is worth $.65.

38. The NC credit is discounted more than Virginia’s for two reasons. First is the fact that the credit may only be claimed over a five year term. The other is that the VA credit has no recapture period, so there is no five-year holding period as there is with the NC credit. See discussion, Section IV(a)(iii) infra.


42. See, e.g., Colo. Rev. Stat. Ann. § 39-22-514 (limited to income or corporate franchise tax); Ind. Code Ann. § 6-3.1-16-6 (limited to adjusted gross income tax); Wis. Stat. § 71.07 (9m) and Wis. Stat. § 71.07 (9r) (limited to income tax); Utah Code Ann. § 59-7-609 (limited to income or corporate franchise tax).


50. R.I. Gen. Laws § 44-30-1 et seq.

51. R.I. Gen. Laws § 44-11-1 et seq.

52. R.I. Gen. Laws § 44-12-1 et seq.


54. R.I. Gen. Laws § 44-14-1 et seq.

55. R.I. Gen. Laws § 44-17-1 et seq.


58. This could be an argument to continue to require the realization of the credit to be allocated in equal installments over five years.


60. Id.

61. Id.
62. Id.
64. Id.
65. Id.
66. Much of the following section has been excerpted and paraphrased from Kenneth A. Alperin, “Historic Rehabilitation Tax Credit—An Overview,” *Historic Preservation Law*, sponsored by American Law Institute – American Bar Association Continuing legal Education and the National Trust for Historic Preservation (October 15, 2001).
67. Rhode Island will revoke credits and recapture them if there is a material misrepresentation or if within 24 months after completion of the rehabilitation a taxpayer applies for tax-exempt status for the property. Applying for tax-exempt status after receiving a tax credit is essentially double dipping into tax incentives, of which Rhode Island makes tax payers elect and allows only one at a time under R.I. Gen. Laws § 44-33.2-6. See R.I. Gen. Laws § 44-33.2-3(d)(2) and § 44-33.2-3(e).
68. For a very interesting discussion on an alternative means of transferability of property to avoid recapture using mortgage credit certificates and developer pass-thru techniques, see Schwartz, supra, note 1.
71. Id.
75. Id.
76. Typically historic rehabilitation projects are concentrated in urban areas, and such has been the case in North Carolina. North Carolina, however, is in a unique position because it has mills across the state. Despite a concentration in urban areas, tax credit projects in North Carolina have taken place in 69 counties and in all twelve congressional districts, spreading the benefits across the state. See North Carolina State Historic Preservation Office, *The Economic Impact of the Rehabilitation Investment Tax Credit Program in North Carolina*, available at www.hpo.dcr.state.nc.us/ta90nc.htm (December 31, 1999). Targeting mills for special redevelopment would continue to spread the economic benefits across the state.