

IRS Info

This information has been prepared by the Internal Revenue Service for use by applicants for the Historic Preservation Tax Incentives. Its purpose is to present an overview of the issues set forth, and it should not be relied upon as definitive tax advice. Applicants are strongly encouraged to consult their tax advisor or the Internal Revenue Service about the tax implications of the Historic Preservation Tax Incentives.

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Frequently Asked Questions

Prepared by Mark Primoli, Internal Revenue Service, October 2000

Claiming the Credit

1. Who can claim a rehabilitation tax credit?

The rehabilitation tax credit is available to the person(s) and/or the entity who holds title to the property.

2. When can a taxpayer claim the rehabilitation tax credit?

The property must be substantially rehabilitated. During a 24-month period selected by the taxpayer, rehabilitation expenditures must exceed the greater of the adjusted basis of the building and its structural components or \$5,000. The basis of the land is not taken into consideration. It is important to note that any expenditure incurred by the taxpayer before the start of the 24-month period will increase the original adjusted basis. See Treasury Regulation 1.48-12(b)(2).

If the rehabilitation is completed in phases, the same rules apply, except that instead of a 24-month period, a 60-month period is substituted. This phase rule is available only if the taxpayer meets three conditions:

1. There is a written set of architectural plans and specifications for all phases of the rehabilitation. (If the written plans outline and describe all phases of the rehabilitation, this will be accepted as written plans and specifications);
2. The written plans must be completed before the physical work on the rehabilitation begins; and It can be reasonably expected that all phases of the rehabilitation will be completed.
3. The property must be placed in service. See Treasury Regulation 1.46-3(d) for definition of "placed in service." The rehabilitation credit is generally allowed in the taxable year the rehabilitated property is placed in service provided that the building has met the "qualified rehabilitated building" requirements for the 24 month period ending in that taxable year. A qualified rehabilitated building is defined as that which has been substantially rehabilitated and was placed in service as a "building" before the beginning of the rehabilitation (as opposed to a ship, airplane, bridge, etc). See Treasury Regulation 1.48-12(b).

If the taxpayer fails to complete the physical work of the rehabilitation prior to the date that is 30 months after the date the taxpayer filed a tax return on which the credit is claimed, the taxpayer

must submit a written statement to the District Director stating such fact and shall be requested to sign an extension to the statute of limitations. See Treasury Regulation 1.48-12(f)(2).

3. What method of depreciation is required when claiming the rehabilitation tax credit?

The rehabilitation credit is available only if the taxpayer uses the straight-line method of depreciation. The current recovery period is 27.5 years for residential rental property and 39 years for non-residential real property. See Treasury Regulation 1.48-12(c)(8).

4. Can the unused portion of the rehabilitation tax credit be carried back and carried forward?

If the credit, or a portion of tax credit, cannot be used, the excess can be carried back one year and forward for 20 years. See Internal Revenue Code Section 39(a).

5. Can a taxpayer incur and claim additional rehabilitation costs in a taxable year after the year in which the rehabilitation credit was originally claimed?

The rehabilitation tax credit is 20% of the qualified rehabilitation expenditures incurred before and during, but not after, a taxable year in which the property, or a portion thereof, was placed in service. Remedial work, or expenses necessary to obtain final approval by the National Park Service, will qualify provided the substantial rehabilitation test period includes these costs. It is possible that an additional rehabilitation credit would be allowable on a new project within the same property as long as that project involves a portion of the building that was not placed in service.

Alternatively, a taxpayer is allowed to perform second rehabilitation tax credit project on the same building provided the substantial rehabilitation test is met.

6. How is the rehabilitation tax credit claimed on a tax return?

The credit is claimed on Form 3468. Attached to the Form 3468 (or by way of a marginal notation), the following information must be provided. See Treasury Regulation 1.48-12(b)(2)(viii).

1. The beginning and ending dates of the measuring period selected by the taxpayer.
2. The adjusted basis of the building as of the beginning of the measuring period.
3. The amount of qualified rehabilitation expenditures incurred or treated as incurred during the measuring period.
4. A copy of the final certification of completed work by the Secretary of Interior.

5. If the adjusted basis is determined in whole or in part by reference to the adjusted basis of a person other than the taxpayer, the taxpayer must attach a statement by such third party as to the first day of the holding period, measuring period and adjusted basis calculation.

7. Are there provisions in the Internal Revenue Code that could prevent a taxpayer from using the rehabilitation tax credit?

Yes, certain provisions within the Internal Revenue Code can impact the full use of the rehabilitation tax credit. These include alternative minimum tax, tentative minimum tax and the passive activity rules. Consequently, taxpayers may not be able to use the entire tax credit available to them in one tax year. In situations where the tax credit can not be used as a result of alternative minimum tax the unused credit can be carried back or forward. The passive activity rules, however, allow unused credit only to be carried forward.

Form 3800, General Business Credit, will guide you through a series of computations to determine how much, if any, of the rehabilitation tax credit can be used in the current year. To alleviate any surprises, tax planning should include a "what if" scenario using Form 3800 as a guide to determine the anticipated tax credit.

8. What is alternative minimum tax?

Taxpayers who are not required to pay tax under the regular tax system may still be liable for tax under alternative minimum tax laws. The purpose of alternative minimum tax (AMT) is to ensure that all taxpayers share the tax burden fairly. It prevents a taxpayer with substantial income from avoiding significant tax liability. Alternative minimum taxable income is computed from regular taxable income with certain adjustments and the addition of all appropriate tax preference items.

9. What will trigger alternative minimum tax?

Common adjustments and tax preferences that could trigger alternative minimum tax include:

- Large Schedule A itemized deductions such as:

- Medical and dental expenses

- Taxes (i.e. tax and local, real estate, personal property)

- Miscellaneous deductions (i.e. unreimbursed employee business expenses, investment expenses, education expenses)

- Tax refunds (i.e. income tax, personal or real property tax)

- Use of accelerated depreciation.

- Gains or losses resulting from the sale of assets in which accelerated depreciation was used.

Other adjustments and preferences that could trigger alternative minimum tax, but are not as common as those described above, include: certain interest on a home mortgage not used to buy, build or improve your home; investment interest; incentive stock options; passive activities; beneficiaries of estates and trusts; tax-exempt interest from private activity bonds; certain charitable contributions; depletion; installment sales; intangible drilling costs; mining costs; tax shelter farm activities.

10. Even if alternative minimum tax applies, can the rehabilitation tax credit still be used to offset regular income tax?

No, the rehabilitation tax credit cannot be used to reduce regular income tax if alternative minimum tax applies - no matter how large or small the alternative minimum tax.

Since the taxpayer has been denied the benefit of the rehabilitation tax credit due to the applicability of alternative minimum tax, the unused credit can be carried back 1 year and forward 20 years.

11. What is tentative minimum tax?

Tentative minimum tax is computed on Form 6251, Alternative Minimum Tax - Individuals. Tentative minimum tax, which affects a great number of taxpayers, will reduce the amount of rehabilitation tax credit that can be used.

Once again, it is important that a taxpayer perform a "what if" computation to determine the effect of tentative minimum tax on the rehabilitation tax credit allowed for the current year.

Tentative minimum tax can exist without alternative minimum tax. Unlike alternative minimum tax, tentative minimum tax reduces the allowable tax credit rather than deny the benefit entirely.

12. What are Passive Activity Restrictions?

The Tax Reform Act of 1986 introduced tax law changes which indirectly impacted the rehabilitation tax credit. One of these changes, the "Passive Activity Provisions," was intended to stop "abusive tax shelters." Although not directly related, these changes have impacted the availability of the rehabilitation tax credit for certain types of investors.

Modifications to the Passive Activity provisions under the Omnibus Budget Reconciliation Act of 1993, (effective for taxable years after December 31, 1993), provides some relief. The Act provides that deductions and credits, from rental real estate in which an eligible taxpayer materially participates, are not subject to limitation under the passive loss rules. An individual taxpayer is eligible if more than one-half of the taxpayer's business services for the taxable year, amounting to more than 750 hours of services, are performed in real property trade or business in which the taxpayer materially participates.

13. How do the passive activity restrictions affect taxpayers with adjusted gross income greater than \$250,000?

Individuals, including limited partners, with adjusted gross income greater than \$250,000 who invest in a rehabilitation tax credit project cannot use the tax credit to offset income tax in that tax year. The credit is suspended and carried forward and will be available when either income falls below \$200,000 (it is partially available when income falls between \$200,000 and \$250,000) or there exists net passive income sufficient to offset the passive losses generated by the rehabilitation project.

A computation is required to figure the regular tax liability allotted to passive activities. In other words, even if a taxpayer has net passive income, they might not be able to utilize all of the rehabilitation tax credit. Please see net passive income example below.

14. If a taxpayer's investment is passive and income is below \$200,000, how is the tax credit affected?

Generally, rental real estate losses up to \$25,000 may be deducted in full by anyone whose modified adjusted gross income is less than \$100,000. For investors in rehabilitation projects, this income level is raised to \$200,000. The rehabilitation tax credit, however, is limited to the credit equivalent of \$25,000. This does not mean that the taxpayer can deduct a credit of \$25,000. Instead a taxpayer is allowed the tax equivalent of \$25,000 for the rehabilitation tax credit. Thus, a taxpayer in the 36% tax bracket could use \$9,000 of tax credits per year ($36\% \times \$25,000 = \$9,000$). Unused credits can be carried forward indefinitely until they can be used.

15. If a taxpayer has net passive income, could the full use of the rehabilitation credit be restricted?

Perhaps, as illustrated in the following example:

John rehabilitates a certified historic structure used in a business in which he does not materially participate and generates a rehabilitation tax credit of \$43,000. He files a joint return in 1996 reflecting \$160,000 in taxable income. Of this total, \$40,000 is from a passive activity (commercial rental).

John's total tax liability on the \$160,000 taxable income is \$42,095.

John's taxable income reduced by net passive activity income is \$120,000 ($\$160,000 - \$40,000$).
Tax on \$120,000 is \$29,080.

Tax liability applicable to the passive activity is \$13,015 ($\$42,095 - \$29,080$).

John can use passive credits up to \$13,015 and carry forward unused credits of \$29,985 ($\$43,000 - \$13,015$). Simply stated, the more passive income, the more tax credit can be used. The less passive income, the less tax credit can be used.

Please note: Credits generated from non-passive rehabilitation projects will not be limited.

16. Under what circumstances would a taxpayer's rehabilitation tax credit not be limited?

Material Participation. Generally if a taxpayer either works more than 500 hours a year or performs substantially all of the work in a business, he or she is deemed to be materially participating, and losses and/or income are non-passive. However, the material participation rules do not apply to long-term rental real estate activities. Real estate rental is passive by definition regardless of the 500-hour test.

Example: John is an architect and rehabilitates a certified historic structure. If John uses the building for his architectural business, the credit is not limited because it is stemming from a non-passive activity. (Non-passive credit)

If John rehabilitates the same building and rents the space to a restaurant, the rehabilitated building is now rental real estate (passive by definition) and will be limited. (Passive credit)

Real Estate Professionals. If more than one half of a taxpayer's personal services in all business are in real property businesses (property development, construction, acquisition, conversion, rental, management, leasing, or brokering) and the taxpayer spends more than 750 hours a year in real property trade or businesses, the taxpayer is a real estate professional. If this is the case, any rehabilitation project the taxpayer is involved with, including rental real estate, will generate non-passive rehabilitation tax credits.

Short-term rentals. If a taxpayer rehabilitates an historic building and uses it for short term rental, such as a Bed & Breakfast or a Hotel/Motel, and materially participates in the operation of the business (i.e. spends more than 500 hours), the rehabilitation tax credit generated from this project is deemed to be non-passive, and the credit will not be restricted.

Corporate entity. While the passive activity loss rules do not generally apply to regular C-Corporations, they do apply to personal service corporations and to closely held corporations in a limited way. For personal service corporations and closely held corporations, material participation is determined based on the level of participation of the shareholders. One or more individuals who hold more than 50% of the outstanding stock must materially participate in the activity in order for the corporation to meet the material participation standard.

17. Can a taxpayer's involvement be non-passive in one year and passive in the next year?

Yes, passive activity rules are applied on a year-by-year basis. A taxpayer could materially participate in a business generating a rehabilitation tax credit in one year, use the rehabilitation tax credit and have a passive interest in the business operation the following year.