NOW + NEXT

COMMUNITY DEVELOPMENT FINANCE ALERT | NIXON PEABODY LLP

AUGUST 14, 2020

NP

IRS extends grandfathering for the one-year historic tax credit

By Forrest Milder

As you know, the Tax Cut and Jobs Act of 2017 (TCJA) converted the one-year historic tax credit to a five-year credit. Instead of getting a 20% credit in the year the qualified rehabilitation expenditures (QREs) are placed in service, a taxpayer qualifies for five years of 4% credits.

There is a transition rule that grandfathers certain projects, enabling them to still qualify for the one-year credit. As originally written, the rule had two requirements:

- The building must be owned or leased by the taxpayer at all times on or after Dec. 31, 2017, and
- The standard 24-month or phased 60-month substantial rehabilitation period must begin no later than June 20, 2018.

Let's consider that second requirement. It requires the taxpayer to spend more on QREs in a 24- or 60-month period selected by the taxpayer than its basis in the building at the start of the period. So, as originally written, the transition rule for a standard (24-month) rehabilitation requires the taxpayer to incur the required QREs in a 24-month period that ended no later than June 20, 2020, and the phased (60-month) rehabilitation test requires the taxpayer to incur the necessary QREs over a 60-month period that ended no later than June 20, 2023. These two dates are the latest possible dates for a 24- or 60-month period to end if it begins no later than June 20, 2018.

The COVID-19 pandemic has delayed many projects, casting doubt on whether the required QREs will be incurred within the 24- or 60-month period. In response, the IRS issued Notice 2020-23. Among many tax extensions, it extended the time limit to preprogrammed "time sensitive acts" to July 15, 2020. Of course, this was not much of an extension if you already had until June 20.

Now, in Notice 2020-58, the IRS has provided a significantly longer extension.

Notice 2020-58 provides, in part, as follows:

> B. DEADLINE FOR TCJA TRANSITION RULE
>
> For purposes of taxpayers subject to the TCJA transition rule, if the 24- or 60-month measuring period in which the requisite amount of QREs have to be paid or incurred in

> order to satisfy the substantial rehabilitation test for a building originally ends on or after April 1, 2020, and before March 31, 2021, the last day of the 24- or 60-month measuring period for a taxpayer to pay or incur the requisite QREs with respect to the building is postponed to March 31, 2021. Thus, if the requisite QREs described in the preceding sentence are paid or incurred by March 31, 2021, the TCJA transition rule allows the rules of former § 47 allowing the 10-percent and 20-percent credits in a single year to apply to QREs paid or incurred with respect to such building in the taxable year in which the 24- or 60-month measuring period (the last day of which is postponed by this notice) ends. In addition, the amendments made by section 13402(a) and (b) of the TCJA, under which only the 20-percent credit is allowed over five years, apply to QREs paid or incurred with respect to such building in succeeding taxable years.

Let’s translate this a bit.

For the most part, the new rule provides a simple extension. If your original 24-month period would have ended on or after April 1, 2020, then you now have until March 31, 2021 to pass the 24-month test. Keep reading for a couple of illustrations of how this works.

There’s also an extension for 60-month projects. These will benefit only if the 60-month period would have otherwise ended between April 1, 2020, and March 31, 2021. Projects whose 60-month period will end beyond that date will continue to be subject to the outside date of March 31, 2023.

A few additional observations:

- **How the extension helps**. Let’s start with the typical case. Here’s an illustration of how most delayed projects will benefit from the notice. Suppose a project with a basis of $1.1M on July 1, 2018, planned to incur $50,000 of QREs per month for the next 24 months, ending in June 2020. The projected QREs, $1.2M, were expected to exceed the $1.1M basis at the start of the 24-month period.

  Suppose the project stopped work in March, leaving it $200,000 short, and causing it to fail the substantial rehabilitation test. Notice 2020-58 will allow this project to incur the final $200,000 of rehabilitation expenditures all the way through March 21, 2021, and still qualify for a one-year credit.
- **How the extension might not help**. Not every project with a 24-month rehabilitation period ending in 2020 will be saved by this rule. Some will still lose their grandfathering, and some will only be grandfathered if they can undertake a larger rehabilitation than originally planned.

  For example, suppose a project had a basis of $4M on March 31, 2018, with a plan to spend $4.2M on QREs over the next 24 months. Suppose it then incurred $1M of QREs in April and another $1M in May 2018. Thereafter, it planned to incur $100,000 per month of QREs for the next 22 months. Thus, the 24-month period was planned to end March 31, 2020, with $4.2M of QREs compared to the $4M basis at the start of the 24-month period.

  Assume that the project was shut down in January 2020, when it was three months short of being completed, i.e., when there were $3.9M of QREs compared to a $4M starting basis, thereby barely failing the substantial rehabilitation test. It only needed another $100,000 of QREs to pass. Nonetheless, with the rehabilitation shut down, the test was failed.

  Suppose that this project now wants to take advantage of Notice 2020-58. Of course, the 24-month period for the Project was originally expected to end on March 31, which is before the

April 1, 2020, date referred to in the notice. So, to even get the notice to apply, the taxpayer has to begin by selecting a ***later*** start to the 24-month period that would end on or after April 1, 2020, thereby bringing the project under the protection of the notice.

But note how selecting a later start date than this affects the computations. If we shift the 24-month period by one month, so that it starts on May 1, 2018, instead of April 1, 2018, then our starting basis will now be increased from the $4M it was on April 1, 2018, to $5M on May 1. This is due to the $1M of QREs incurred in April 2018.

So, to pass the substantial rehabilitation test, the project must now incur $5M of QRE in the period that starts with May 2018. Now, remember our assumptions: the taxpayer incurred $1M of QREs in May 2018, and $100,000 for the next 19 months, a total of $2.9M. When compared to the $5M basis on May 1, 2018, this taxpayer must now incur an additional $2.1M (because $2.9M so far plus another $2.1M going forward is $5M) in order to pass the substantial rehabilitation test. Of course, thanks to Notice 2020-58, it now has until March 31, 2021, to reach that amount. Still, this is far more than the mere $100,000 that would have been required originally, had the project not been shut down.

In other words, this project can qualify for the relief provided by the notice if it significantly increases the overall cost of the rehabilitation by over $2M. Alternatively, such a project ***may*** be able to rely on the 60-month (phased) rehabilitation rule, but, of course, that has its own additional requirements. In particular, it will have to show that before work commenced, the project had plans to be done in phases.

Mostly, this example illustrates that the extension provided by Notice 2020-58 is not a simple "You now have until March 31, 2021." It's important to do the math and make sure that you comply with the substantial rehabilitation test.

— **Non-transition Projects.** The notice also extends the 24- and 60-month periods for non-grandfathered projects. In other words, even if the taxpayer concedes that the five-year HTC applies, the notice may give it more time to pass the required substantial expenditure requirement. The rule is very similar to the grandfathering rule: If the 24-month or 60-month period would have originally ended on or after April 1, 2020, and before March 31, 2021, then the last day of the 24- or 60-month measuring period for a taxpayer to incur the requisite QREs is postponed to March 31, 2021. Accordingly, a taxpayer may have a measuring period that is longer than 24 or 60 months, whichever is applicable.

— **And Don't Forget.** As noted above, in order to qualify for the one-year credit, there's a second test: the building must be owned or leased by the taxpayer at all times on or after December 31, 2017. If you can't meet this requirement, then you won't qualify for the one-year credit, even if you can pass the 24- or 60-month test, as extended by Notice 2020-58.

— **Other Effects.** If a project is finished in 2021 instead of 2020, then the year for claiming the one-year credit will also be pushed back to 2021. So, it can be important to check the partnership agreement to see whether this creates any additional obligation from the developer partner to the investor partner.

As you can readily see, there's a lot of math and calendar review required here. For more information on the content of this alert please contact one of our community development finance attorneys, your usual NP attorney, or:

- Forrest Milder at **fmilder@nixonpeabody.com** or 617-345-1055
- David Schon at **dschon@nixonpeabody.com** or 202-585-8778
- Scott Sergio at **ssergio@nixonpeabody.com** or 202-585-8828
- John Cornell at **jcornell@nixonpeabody.com** or 617-345-1127