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Community Developments
INSIGHTS

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Historic Tax Credits: Bringing New Life to Older Communities

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Abstract

Since 1977, the Federal Historic Preservation Tax Incentives,[1] more commonly known as the Historic Tax Credit (HTC) program, has helped revitalize communities by encouraging private sector investment to facilitate the rehabilitation of historic buildings. The HTC program encourages the rehabilitation of certified historic buildings through the provision of tax credits to property owners equal to 20 percent of the qualified rehabilitation expenditures (QRE) incurred. The rehabilitation tax credit, by itself, cannot be bought or sold. Instead, these HTCs are generally allocated to third parties who become investors in the transaction and make corresponding capital contributions to the partnership that owns, or in some cases, master leases the building. These investors may include national banks and federal savings associations (FSA) (collectively, banks).

This *Community Developments Insights* report describes how this tax credit program operates and outlines the risks and regulatory considerations of participation in the program.

I. What Is the HTC Program?

Since the HTC program's inception in 1977, more than 49,000 projects to rehabilitate historic buildings have been undertaken. The HTC program has generated $131.71 billion in rehabilitation investment and produced 670,468 new and rehabilitated housing units, including more than 199,000 low- and moderate-income (LMI) housing units. In 2023 alone, there were 970 projects completed under the HTC program, with $8.81 billion in private investments.[2]

[1] Refer to Section 47 of the Internal Revenue Code and Treasury Regulations at 26 CFR 1.48-12.

[2] Refer to National Park Service (NPS), "Federal Tax Incentives for Rehabilitating Historic Buildings: Annual Report for Fiscal Year 2023" (March 2024).

The U.S. Departments of the Interior and the U.S. Department of the Treasury jointly administer the HTC program. The National Park Service (NPS) acts on behalf of the Secretary of the Interior, in collaboration with the State Historic Preservation Officer (SHPO) in each state.[3] The Internal Revenue Service (IRS) acts on behalf of the Secretary of the Treasury.

A property must be substantially rehabilitated for a taxpayer to claim the HTC. This requires that during a 24-month period selected by the taxpayer, rehabilitation expenses must exceed the greater of the adjusted basis of the building and its structural components at the start of that period (generally, this is the building's cost) or $5,000. The basis of the land is not taken into consideration.[4]

In the year the rehabilitated property is "placed in service,"[5] an owner (or, with a proper election, a master lessee) of a qualified rehabilitated building is eligible to begin claiming the tax credits. The tax credit of 20 percent of the QREs is claimed ratably over a five-year period, i.e., 4 percent per year for five years.[6]

Some or all of the HTCs may be recaptured if a recapture event occurs in the five years after the date the property is placed in service. Recapture events include the sale of the building or if the building ceases to be a "business use property,"[7] This five-year period when the credits can be recaptured is typically referred to as the "recapture period." The amount of recapture is reduced by 20 percent for each full year that elapses after the property is placed in service.

When the owner of a rehabilitated property is unable to use the tax credits, a limited partnership (LP) or limited liability company (LLC) may be created to allow third-party investors, such as banks that can use the credits, to provide financing for the project.[8] Third-party provision of

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[3] SHPOs carry out the National Historic Preservation Program as delegates of the Secretary of the Interior pursuant to the National Historic Preservation Act of 1966, as amended, 54 USC 300101 et seq. Information about SHPOs' responsibilities is available from the National Conference of State Historic Preservation Officers.

[4] Refer to IRS, Rehabilitation Credit (Historic Preservation) FAQs.

[5] ibid. "Placed in service" refers to the date that the rehabilitation work has been completed and a certificate of occupancy has been issued, provided the minimum 24-month expenditure test has been met. Refer to 26 USC 1.46-3(d). The Interior Department regulations governing the procedures for obtaining historic preservation certification are at 36 CFR 67.

[6] Refer to 26 USC 47(a).

[7] Recapture can also occur if a "qualified rehabilitated building" loses its historic integrity or character such that the NPS removes the building from the National Register of Historic Places or determines that the building no longer contributes to a Registered Historic District within five years from when it was first placed in service. A building that is severely damaged by a casualty (e.g., hurricane, flood, tornado, or earthquake) within five years of first claiming of the credit such that its historic character cannot be restored is also subject to recapture. The recapture provisions are found in 26 CFR 50(a). Also refer to IRS, "Rehabilitation Credit: Recapture" (July 2023).

[8] Banks organized under 26 IRC, subtitle A, chapter 1, subchapter S as "S" corporations pass HTCs and passive losses through to their shareholders. "S" corporation shareholders are subject to the normal limitations on taking those credits or deductions, including the passive activity loss limitations, which limit passive loss deductions. Interested parties should contact their tax adviser for more information.

funding in exchange for the credits being allocated to the investor-partners helps reduce the project's need for additional financing. Under the Internal Revenue Code (IRC), to receive the HTCs, the third-party investor must acquire an interest in the entity that holds the property before the building is placed in service.

Revenue Procedure 2014-12, issued by the IRS, includes compliance guidelines and creates a safe harbor for investors being allocated HTCs.[9] If HTC transactions are structured in accordance with this guidance, the IRS will not challenge the allocation of credits to the investors.[10]

The third-party investor typically holds such an interest during the five-year recapture period and then has the option to sell its interest back to the developer, referred to as a "put." Banks have various sources of legal authority that permit them to provide financing to HTC projects in return for the associated tax credits. A more detailed description of these authorities is included in section IV of this report.

HTCs are available for properties rehabilitated for commercial, industrial, agricultural, or residential rental purposes. The rehabilitated buildings must be depreciable, income producing, and used in businesses. HTCs are not available for properties used exclusively as an owner's private residence.[11]

HTCs have been used in connection with the rehabilitation buildings of nearly every size, style, type, and historic period. Examples of properties include railroad apartments in Mississippi, art deco hotels in Miami, office towers in Chicago, skyscrapers in Michigan, row houses in Baltimore, bungalows in Los Angeles, miners' cottages in Colorado, post offices in rural areas and inner cities, former manufacturing facilities, theaters, and even baseball parks.

HTCs have been used in qualified rehabilitation projects that are also financed using new markets tax credits or low-income housing tax credits.[12] This is often referred to as "twinning" the credits.

[9] Refer to IRS Revenue Procedure 2014-12 (January 2014). This guidance was issued following *Historic Boardwalk Hall, LLC v. Commissioner of Internal Revenue*, 694 F.3d 425 (3d. Cir. 2012), to give investors comfort that their transactions would not be challenged if they complied with the guidance. See also IRS Market Segment Specialization Program.

[10] ibid. Also refer to Historic Tax Credit Coalition, Memorandum on IRS Guidance 2014-12 (January 10, 2014). This guidance only affects HTC transactions, not other federal credits, state credits, or transactions combining HTCs with low-income housing tax credits or new markets tax credits.

[11] Some limitations exist for certain tenants of rehabilitated historic properties. For example, tax-exempt entities cannot lease more than 50 percent of the rentable area in a rehabilitated building unless all of the following are true: the tax-exempt entity did not previously place the building in service, the lease terms are limited to no more than 20 years, the tax-exempt entity did not participate in tax-exempt financing of the building, and the entity does not have a purchase option at the end of the lease term for other than fair market value. In addition, a tax-exempt entity cannot have a varying partnership interest in the owner entity without impairing the amount of the HTC. The tax-exempt user rules are complex and should be analyzed carefully on a project-by-project basis. Refer to 26 USC 47(c)(2)(B)(v) and 168(h); 26 USC 1.48-12(c)(7).

[12] Refer to Novogradac, "Maximizing NMTC Benefit by Using HTC Subsidy as a Source Leverage Stack," (September 2022) and HUD Exchange's "Using the Historic Tax Credit for Affordable Housing."

II. Why Are HTCs of Interest to Banks?

Banks participate in the HTC program for several reasons. Through the program, banks may have opportunities to

- support local economic development strategies, which often include historic preservation.
- earn competitive yields.
- gain opportunities to diversify into other credit products and services.

Support Local Economic Development Strategies

The HTC is an important tool to promote the economic revitalization of older communities in the nation's cities and towns, along Main Streets, and in rural areas.[13] It can also be an effective tool to create affordable housing, including mixed-use developments that have commercial space on the first floor and residences on the upper floors.[14] Combining the HTC with the low-income housing tax credit is very attractive to affordable housing developers because it attracts additional equity to a project.

Loans to or investments in HTC projects may be eligible for Community Reinvestment Act credit. For additional information, please visit the OCC's Community Reinvestment Act web page or contact the OCC's supervisory office.

Earn Competitive Yields

The HTC program is an additional financing opportunity that banks may pursue, depending on their risk tolerance and tax credit appetite.[15] A bank's return on an HTC investment depends on several factors, including the bank's underwriting and management of the investment. As an asset class, historic returns on investments in HTC properties have been competitive with similar alternative investment opportunities.

The Inflation Reduction Act of 2022[16] established a corporate alternative minimum tax (CAMT) of 15 percent on the adjusted financial statement income of large corporations with average annual financial statement income exceeding $1 billion. The CAMT allows adjustments, most notably deductions for accelerated depreciation and amortization, as well as the use of general

[13] Refer to NPS, "Annual Report on the Economic Impact of the Federal Historic Tax Credit for Fiscal Year 2022" supra note 2 (February 2024).

[14] Refer to HUD Exchange, "Using the Historic Tax Credit for Affordable Housing" supra note 13.

[15] Refer to IRC 59A Base Erosion Anti-Abuse Tax Overview, August 9, 2021.

[16] Refer to Pub. L. 117–169, title 1, subchapter A, part 1, section 10101.

business credits, such as the HTC, the low-income housing tax credit, new markets tax credit (NMTC), and renewable energy tax credits, to be used to reduce this minimum tax.[17]

Gain Opportunities to Diversify Into Other Credit Products and Services

HTC projects are essentially commercial real estate transactions undertaken by developers and property owners. The program provides banks with opportunities to expand their existing customer relationships and to develop new ones by offering additional products and services related to a developer's proposed project. Loan products that are often used in conjunction with the development of HTC projects include

- predevelopment and acquisition loans.
- mezzanine loans.
- bridge loans.[18]
- construction loans.
- permanent mortgage financing.
- letters of credit.
- warehouse lines of credit.[19]

III. How Does the HTC Program Work?

As noted previously, to finance rehabilitation projects HTCs are available for property owners of certified historic buildings or, with an election, to long-term master lessees that operate and manage these properties. Taxable lessees may be eligible to claim HTCs provided that the lease term is at least 32 years for nonresidential property or 24 years for rental residential real property, an election is made to transfer the HTCs, and other requirements are met. These "two-tier" or "master lease" transactions are somewhat more complex than owner or "single-tier" HTC transactions, and often require experienced support.[20] Most of the discussion below refers to the single-tier structure, but the two-tier structure is also very common.

When property owners or developers are unable to make use of the HTCs, an owner or developer of a certified property may establish a partnership or LLC with one or more investors, such as a bank. This entity permits a bank to invest in the transaction by making a capital contribution

[17] Refer to Novogradac, "Benefits of Tax Credit Investments Mostly Preserved in Inflation Reduction Act, But Significant Questions Remain" (August 2022).

[18] In general, bridge loans are short-term credit facilities to assist borrowers with funding needs until the borrower receives permanent financing. For example, bridge loans can be used to cover capital calls during the construction period or to allow newly constructed or acquired commercial properties to reach stabilization necessary for either sale or qualification for permanent financing.

[19] Banks can provide warehouse lines of credit, allowing developers to acquire the historic properties. The repayment source is financing from tax credit investors and capital generated by lease payments and rental proceeds.

[20] Refer to 26 USC 168(c) and 26 USC 47(c)(2)(B).

which is then used by the property owner to reduce the cost of financing the rehabilitation project. In return, the investor is allocated a share of the HTCs. HTCs are allocated to members or partners in the entity according to their profits interest[21] in the entity.

The partnership or LLC claims the HTCs over a five-year period (4 percent each year) beginning in the taxable year that the property is placed in service. Members/partners of the owner receive percentage interests in the tax credit benefits, profits, losses, and cash flows associated with the property as provided in the partnership or LLC agreement. HTCs follow a partner's profits interest[22] in the partnership.

The bank (or other investor) typically has a 99 percent interest in the partnership or LLC, and the property owner or developer has a 1 percent interest. Despite this 99-to-1 ratio, reasonable fees enable the developer to receive a satisfactory share of the operating cash flow. After the five-year period during which the credits were being allocated, the investor's interest typically flips to approximately 5 percent of what its interest was during the five-year period.

To avoid tax credit recapture, the partnership or LLC must retain ownership of the property, and members/partners of the partnership or LLC must retain at least 67 percent of their interest, for a five-year period following the year a property is placed in service. HTCs cannot be transferred to subsequent property owners/developers or funding members/partners during the compliance period.[23]

[21] The rule for allocating the rehabilitation tax credit is found in Treas. Reg. section 1.46-3(f)(2).

[22] ibid.

[23] Refer to the IRS's "Rehabilitation Credit (historic preservation) FAQs."

Figure 1: Typical Single-Tier Structure HTCs

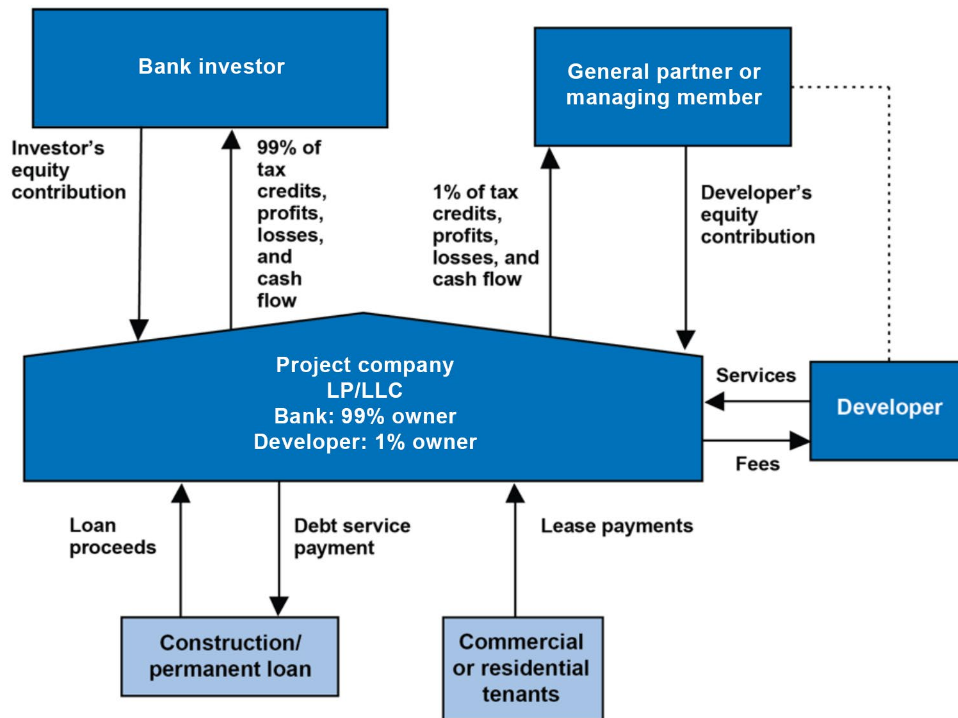

Figure 1 depicts this single-tier structure, a common structure for simpler HTC projects. Tenant lease payments flow to the HTC subsidiary, while the HTC subsidiary makes debt service payments on construction and permanent loans to the lender.

The tax basis of the improved property is reduced by 100 percent of the HTCs. This basis reduction and depreciation deductions taken during the period that the investor was a partner or member in the single-tier structure generally produces a taxable gain upon the investor's exit that should be taken into consideration when calculating the bank's overall return on investment.

Equity pay-ins for the HTC may be performance based. To meet the safe harbor requirements described above, a minimum of 20 percent of the anticipated investment must be paid in before the property is placed in service.[24] Other performance benchmarks may include completion of an independent accountant's "cost certification" of the QREs, NPS part 3 (final) certification of completed work, and a lease-up or debt service coverage threshold. Refer to appendix A of this report for a sample pay-in schedule.

[24] Refer to IRS Revenue Procedure 2014-12 (January 2014). Placed-in-service is discussed in footnote 6.

Figure 2: Master Lease/Credit Pass-Through Structure HTCs

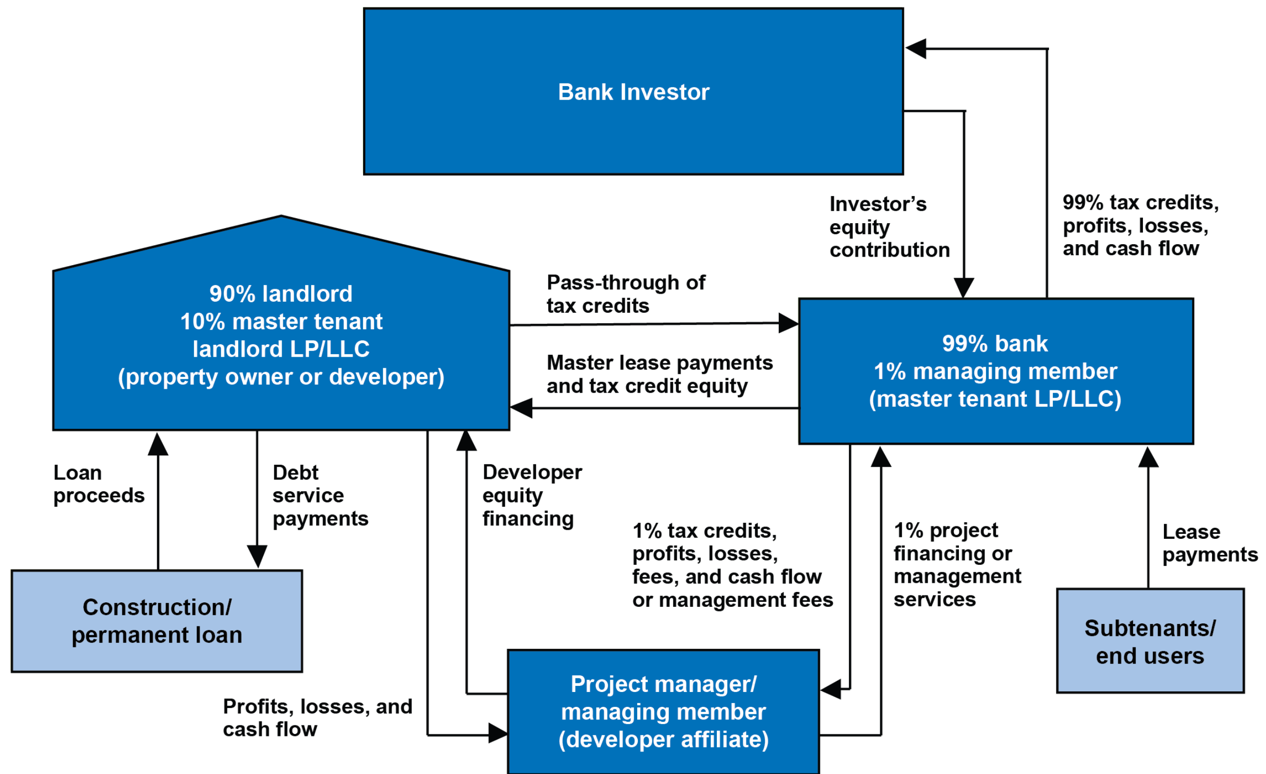

Figure 2 displays a master lease/credit pass-through structure. The developer establishes a landlord LP/LLC (landlord) that holds title to the project and has the responsibility for predevelopment and project completion. The developer and the bank then establish a separate master tenant LP/LLC (master tenant), which will be the lessee and operator of the property. The landlord entity makes an election to "pass-through" the HTCs to the master tenant.[25]

The master tenant often has an ownership interest in the landlord entity. An affiliate of the developer typically manages the master tenant. The bank makes an equity contribution to the master tenant in exchange for 99 percent of the ownership interests and allocation of 99 percent of the HTCs. To get the cash provided by the bank investor to the landlord (where it is needed to help pay the cost of developing the project), the master tenant either (i) becomes a partner/member of the landlord (typically with a 10 percent to 49 percent interest) and makes a capital contribution or (ii) makes a prepayment of rent to the landlord. The general partner/managing member of the master tenant provides management services to the master tenant and has a 1 percent interest in the master tenant.

The master tenant operates the property and pays all operating expenses. The subtenants or users of the property make sublease payments, which are used to cover the property operating expenses and the master lease payments. The landlord uses the master lease payments to make debt service payments on construction and permanent loans, with any excess available to distribute to the developer and affiliates.

[25] Refer to 26 USC 50(d)(5).

The master tenant structure offers developers a way to separate the interests of private equity (non-tax credit) investors and investors motivated by the tax credit. Developers and their private equity partners in this structure control the development process through the landlord entity in which they have a majority interest and have a direct relationship with construction contractors and project lenders. By investing through the master tenant entity, banks can take an interest (usually 99 percent) in the partnership that is operating the property and maximize the value of the credits generated.

IRS guidance clarifies how the property basis adjustment is addressed in the master tenant model.[26] Since the master tenant entity is a lessee, not an owner of the property, the reduction in property basis in the amount of the credits that occurs with the single-tier transaction does not apply to the master tenant investment model. Instead, the credits are amortized ratably over the depreciable life of the property and taken into partnership income annually. This is generally referred to as "50(d) income." The investor pays ordinary income tax on its 99 percent share of this income, although it may use losses allocated by the landlord to the master tenant to offset this income while the investor is still a partner/member. When the investor exits the transaction, either any unamortized portion of this income is accelerated at the investor's option (with all taxes paid upon acceleration) or the investor may elect to recognize the income annually and pay the associated tax over the remaining depreciation period. The IRS has explicitly disallowed the addition of these income tax payments to the investor partner's basis.[27]

Funding for certified historic properties also can be raised from syndication. Typically, syndicators identify potential HTC projects for investors, based on the relationships they have cultivated with property owners, developers, accountants, lawyers, architects, and others in the historic preservation industry. A syndicator creates a fund LP/LLC that is financed by a single investor who provides financing for one or more HTC projects. Syndicators typically are responsible for project underwriting, due diligence, and asset management activities for their investors over the five-year compliance period.

Application Process for Historic Preservation Certification

Property owners complete the application process for historic preservation certification with the NPS. Typically, this process involves developer interaction with an SHPO. This process has three parts:

- Part 1: Certification of the building as a historic structure.
- Part 2: Certification of the proposed rehabilitation plan for the building.
- Part 3: Certification that the rehabilitation has been completed according to the certified rehabilitation plan.

[26] Refer to 26 CFR 1.50-1.

[27] ibid.

A developer's completion of at least parts 1 and 2 of the certification application process is an important consideration for banks contemplating an investment in an HTC project.[28] Without the completion of part 2, a project may not receive the final rehabilitation certification (part 3), thereby putting the tax credit funds at substantial recapture risk.[29]

HTC Calculation and Pricing

The dollar amount of tax credits is calculated by multiplying the value of the QREs[30] by the 20 percent HTC rate. The amount that can be raised is computed by multiplying this amount by the capital contribution per tax credit dollar.[31] Table 1 is an example of how HTCs are calculated for a hypothetical HTC project. The hypothetical project has $40 million in QREs. In this example, a bank with a 99 percent interest paying an estimated $0.85 for each dollar of tax credits would contribute $6,732,000 in financing to the project while receiving $8,000,000 in HTCs.[32]

Table 1: HTC Financing for a Hypothetical HTC Project

QREs	$40,000,000
Tax credit rate	20%
Tax credit dollar amount	**$8,000,000**
Investor tax credit allocation (99% interest in project)	$7,920,000
Contribution per tax credit dollar	$0.85
Tax credit financing raised	**$6,732,000**

Developer Guarantees

Developers typically provide investors with numerous guarantees related to the project, but the "safe harbor" described by the IRS in Revenue Procedure 2014-12 specifies most guarantees must be unfunded. Additionally, the risk of tax credit disallowance cannot be guaranteed by any partner, but the guidance states that investors may obtain third-party insurance to cover this risk.

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[28] The NPS and the IRS strongly encourage owners to apply for rehabilitation certification before starting the rehabilitation process.

[29] More information about the application process for historic preservation certification is available at the NPS website.

[30] QREs include the costs related to walls, partitions, floors, ceilings, windows, doors, air conditioning and heating systems, plumbing and plumbing fixtures, other related building construction, and specific fees. Fees considered as qualified expenditures may include certain payments for developer, architectural, engineering, and legal services. Refer to IRC 47(c)(2).

[31] Although credits are sometimes referred to as being "sold," the proper terminology is to refer to the capital contribution made by the investor.

[32] Pricing variables in a specific transaction include size, structure, location, and market.

Exit Strategy

When a partnership or LLC is established, the partnership or operating agreement specifies optional strategies for the investor exit. In Revenue Procedure 2014-12, the IRS outlines a "safe harbor" governing the structuring of HTC transactions that allows the investor to "put" its interest back to the developer subject to certain strict requirements.[33] Under the HTC safe harbor, although the tax credit investor is permitted to have a put option to sell its interest, the developer cannot have the right to call the tax credit investor's interests. The put price, however, which is generally agreed on at the front-end of the transaction, cannot be greater than the fair market value of the investor's interest at the time the put option is exercised. Note that by using the partnership flip structure described previously, the fair market value will generally be computed on just a 5 percent interest in the partnership or LLC that owns or leases the building. The parties negotiate the flip because tax credit investors do not intend to maintain a sizeable investment in the partnership or LLC for the life of the structure and instead want to exit the partnership after the tax compliance period.

For the life of the transaction, the partners generally must maintain a meaningful upside potential (gains, deductions, and credits) and downside risk (losses). At the end of the compliance period, however, the IRS allows the tax credit investor's interest and the developer partner's ownership interest to flip. For example, the tax credit investor's interest during the compliance period of initially up to 99 percent can "flip down" to no less than 5 percent of the largest pre-flip percentage interest (that is, generally, 5 percent of 99 percent or 4.95 percent), while simultaneously the developer partner's interest increases from a de minimis holding (1 percent) to 95.05 percent.

Figure 3 illustrates the partnership flip for a two-tier lease passthrough structure. The illustration for a single-tier direct ownership structure would be very similar.

Figure 3: Partnership Flip

IV. What Are the Key Risks and Regulatory Issues Associated With HTC Financing?

Banks active in the HTC business typically underwrite project funding requests using their commercial real estate credit guidelines. Project-specific construction budgets, operating income projections, and financial statements are typically analyzed during underwriting. In addition to

[33] Refer to IRS Revenue Procedure 2014-12 (January 2014). The IRS guidance clearly contemplates "flips" to be drafted into the partnership agreement between the developer and the tax credit investor. "Flip" means that the agreement between the developer and the tax credit investor provides that the ownership interests change after the end of the HTC recapture period.

the normal risks of a commercial real estate transaction, there are additional risks to consider with an HTC transaction for the five-year tax compliance period.

As referenced in the previous section, the IRS issued Revenue Procedure 2014-12 on compliance requirements for HTCs.[34] This guidance does not establish substantive law but rather creates a safe harbor for investors in HTCs. If HTC transactions are structured in accordance with this guidance, the IRS will not challenge the allocation of credits to the investors.[35] The guidance affects how current HTC transactions are structured to eliminate the risk of credit disallowance.

Compliance Risk and the Threat of Recapture

HTCs are designed to reduce an investor's tax liability. A primary economic benefit from financing an HTC project is the opportunity to claim the federal tax credits over five years after the building is placed in service. The credits may be carried back one year and forward 20 years. The HTC cannot be used to offset the base erosion and anti-abuse tax (BEAT).[36]

The potential loss of the tax credit and its recapture by the IRS represent a risk to a bank investor. Recapture triggers during the five-year compliance period may include the disposition of property (for example, the sale, foreclosure, or transfer of more than one-third of managing member ownership interest), revocation of the NPS certification, and conversion of the property to tax-exempt status as well as a reduction of an investor's interest to less than 67 percent of its interest in the year the property was placed in service, but only as to the partner or member whose interest is so reduced. Once the five-year compliance period is over, the IRS cannot recapture the tax credit. At this point, investors typically look to exit the LP or LLC.

A 2011 study conducted for the National Trust for Historic Preservation by Novogradac & Company found that the cumulative recapture rate for the HTC program over the 10-year period from 2001 through 2010 was only 0.73 percent. The study period included recapture activity during the 2007–2009 recession.[37] The risk of revocation of NPS certification can arise from any changes to the building during the compliance period that negatively affect character-defining features of the building and includes casualty loss from a natural disaster. Good business practices generally involve syndicators conducting annual site visits during the compliance period to check for architectural changes. Developers typically carry casualty insurance to ensure that damage due to flooding or earthquakes can be repaired or, if that is not possible, to repay the credit amount.

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[34] ibid.

[35] ibid. Also refer to Historic Tax Credit Coalition, Memorandum on IRS Guidance 2014-12 (January 2014). This guidance only affects HTC transactions, not other federal credits, state credits, or transactions combining HTCs with low-income housing tax credits or new markets tax credits.

[36] Refer to 26 USC 59A(a)-(b). See also Godfrey Kahn, National Law Review, "Impact of Final Tax Reform Legislation on the Historic Tax Credit, New Markets Tax Credit, Low-Income Housing Tax Credit, and Renewable Energy Tax Credits" (January 2018).

[37] National Trust for Historic Preservation, Historic Rehabilitation Tax Credit Recapture Study, 2011.

Banks financing HTC projects in syndicated funds rely on the syndicators to aggregate the required tax information. Syndicators are also responsible for monitoring projects and managing the risks associated with the investors' portfolios over the five-year compliance period.

Banks that directly finance HTC projects (that is, through a means other than syndicated funds) are primarily responsible for their own tax compliance activities. This information is typically provided to banks by project managers or managing members. Banks rely on project managers or managing members to maintain the properties in a tax-compliant manner. Banks with large HTC portfolios typically have established property management units within their commercial real estate departments to oversee the management of these properties and to mitigate the risk of recapture. Banks financing their first HTC project should consider working with experienced partners, including syndicators that have proven track records in structuring transactions and assisting with asset management functions.[38]

Credit Risk Management

In conducting due diligence, a bank typically reviews the financial capacity, projected performance, management capacity, and expertise of the developer and the project manager or managing partner. The due diligence typically includes an evaluation of the developer, the organization that will operate the property as the project manager or managing partner, and the syndicator, when applicable. The evaluation allows an assessment of the strength of these development partners by their proven track records and management skills and a determination as to whether these development partners have satisfactory financial, management, and compliance monitoring resources to support the viability and success of the project. Confidence in the development partners' abilities to meet the rehabilitation standards required to complete the historic preservation certification process and to fulfill the other managerial responsibilities is fundamental in determining whether the project will likely generate sufficient cash flow to support the project, repay debt, and meet the bank's targeted rate of return.

Banks typically review HTC projects as commercial real estate transactions. For example, during the construction and lease-up phase (which typically lasts one to three years), banks would typically consider the sources and uses of construction financing and calculate expected costs to be included in the QRE. Because the greatest period of risk in this type of financing is during the construction and lease-up phases of the project, banks also typically consider the experience, strength, and reputation of the general contractors that are responsible for completing the rehabilitation projects on time and on budget while meeting the NPS standards.

Banks investing in HTCs are exposed to the property's business risk. Investors in properties under a master lease structure typically rely on cash flow as a portion of the return. When there are construction delays or cost over-runs, the property is not fully leased, or the property suffers from poor operations, the investors' returns can be affected.

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[38] Refer to OCC Bulletin 2017-43, "New, Modified, or Expanded Bank Products and Services: Risk Management Principles," and OCC Bulletin 2023-17, "Third-Party Relationships: Interagency Guidance on Risk Management" (June 2023).

Other typical underwriting elements include such items as site location in a neighborhood, market demand, rents and expenses, and project financing rates and terms. Additionally, management should understand the project's reserves, debt service coverage, loan to value, and guarantees to confirm the loan structure aligns with the bank's policies. Developers and managing partners or project managers typically provide investors with completion, operating, and tax credit delivery guarantees within the limitations of IRS Revenue Procedure 2014-12 to mitigate the risk associated with this type of real estate financing. Loan agreements may require completion of certain specified amounts of construction at specified costs and allow lenders to monitor against the project's budgets for time and cost. Completion guarantees may cover completion of the project as well as achieving completion on time and on budget.

As a limited partner in a partnership or as a member in an LLC, a bank typically has a 99 percent interest in the entity that owns or leases the rehabilitated real estate assets for at least the duration of the HTC recapture period. Although the HTC investor does not have a lien position, it typically does have the right to vote on removal of a partner or managing member who is not performing in accordance with its duties under the LP or LLC agreement. To the extent that an HTC project includes first-mortgage financing from another source, there is repayment and foreclosure risk. The risk associated with recapture ends, however, when the five-year recapture period ends. A bank that invests in HTC projects relies on underlying properties to generate cash flows as proposed. Banks providing tax credit equity in exchange for the HTCs may require the debt financing source to execute a subordination and non-disturbance agreement to protect the master tenant entity if master lease payments are not being made. By keeping the master lease in place, HTC investors are provided sufficient time to replace a managing member.

Operational and Reputation Risks

HTC projects tend to include unique and complex transactions, requiring compliance with numerous rules and regulations. Project development teams involve many different parties, including developers, syndicators, contractors, architects, preservation consultants, lawyers, accountants, and property managers. Effective operational and reputation risk management programs reduce potential risks with HTC projects. Banks may consider using experienced third parties to help manage risks associated with HTC projects. However, using third parties introduces risks, and banks should deploy sound third-party risk management.[39]

V. Legal Authorities

National Bank Legal Authority

National banks may make investments that are designed to primarily promote the public welfare under the investment authority in 12 USC 24(Eleventh) and the implementing regulation, 12 CFR 24. This authority allows a national bank to make an investment, directly or indirectly, that primarily benefits LMI individuals, LMI census tracts, or other areas targeted by a government entity for redevelopment, or to make an investment that would receive consideration

[39] Refer to OCC Bulletin 2023-17.

under section 25.23 of appendix G to 12 CFR 25 (March 29, 2024) as a "qualified investment."[40] Examples of these investments include supporting affordable housing and other real estate development, providing equity for start-up and small business expansion, and revitalizing or stabilizing a government-designated area. Some public welfare investments may also involve the use of HTCs as long as the projects are designed to primarily promote the public welfare.

National banks seeking to provide financing to tax credit projects under the public welfare investment authority must either request prior OCC approval or submit an after-the-fact notice to the OCC, depending on the bank's safety and soundness profile and CRA performance, the aggregate amount of the bank's public welfare investments, and the nature of the project financing.[41]

Federal Savings Associations Legal Authority

FSAs may make similar public welfare investments, including investments involving HTCs that primarily promote the public welfare. FSAs have a authority[42] under 12 CFR 160.36 to make investments of the type permitted for national banks under 12 CFR 24. FSAs are also authorized under 12 CFR 5.59 to make investments in service corporations engaged in a broad range of activities, including community and economic development investments,[43] that are permissible under 12 CFR 24, provided that applicable filing requirements are satisfied.[44] A third legal authority available to FSAs, under 12 USC 1464(c)(3)(A), implemented by 12 CFR 160.30, involves investments in real estate-related community and economic development activities that promote community, inner city, and community development purposes[45] and that meet certain qualifying standards.[46]

[40] Refer to 12 CFR 24.3.

[41] Refer to 12 CFR 24.

[42] Investments made under 12 CFR 160.36 are limited to the greater of 1 percent of total capital or $250,000.

[43] Under 12 CFR 5.59, the FSA is authorized to make investments in service corporations that engage in community development activities, subject to the regulation's filing requirements. Authorized investments include those that serve primarily community, inner city, or community development purposes, including investments in HTC projects. Pursuant to 12 CFR 5.59(g)(1), the FSA may invest up to 3 percent of its assets in service corporations, but any amount exceeding 2 percent must serve "primarily community, inner city, or community development purposes."

[44] FSAs proposing to invest in a service corporation must comply with the filing requirements in 12 CFR 5.59(h).

[45] Under 12 CFR 160.30, which covers the general lending and investment powers of FSAs, an FSA's aggregate community development loans and equity investments may not exceed 5 percent of its total assets. Within that limitation, an FSA's aggregate equity investments may not exceed 2 percent of its total assets.

[46] The standards are as follows:

(1) The investment must be located either in a Community Development Block Grant entitlement community, in a non-entitlement community that has not been specifically excluded by the state in its statewide submission for Community Development Block Grant funds, or in an area that participates in the Small Cities Program.

(2) The investment must be made in a residential housing project that benefits LMI people. The OCC generally considers an investment that benefits LMI people to mean that over 50 percent of the units are reserved for occupancy by LMI individuals or families.

Tax Equity Finance

Banks may engage in tax equity finance under 12 CFR 7.1025.[47] Under this authority, banks may engage in tax equity finance if the transaction is the functional equivalent of a loan and satisfies the conditions of 12 CFR 7.1025(d). The authority to engage in tax equity finance transactions under 12 CFR 7.1025 is separate from, and does not limit, other investment authorities available to banks.[48]

Conclusion

Since 1977, the federal HTC program has been used to attract new private capital to the historic cores of cities and Main Streets across the nation. These funds have enhanced property values, created jobs, generated local, state, and federal tax revenues, and revitalized communities. For banks, this program offers an opportunity to earn attractive economic rates of return and support local redevelopment and economic development efforts. It is a way for banks to expand existing customer relationships and establish new ones by offering products and services related to HTC projects. Banks can partner with community-based organizations and other developers to encourage economic stability and revitalization, especially in LMI and distressed communities. When carefully implemented, financing historic properties can provide banks with economic and regulatory benefits, while contributing to the stabilization and growth of the communities in which they do business.

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(3) The investment must be safe and sound. Whether an investment is safe and sound depends on the relevant facts and circumstances regarding the business transaction. For example, the OCC does not consider an investment that exposes an FSA to unlimited liability to be safe and sound.
(4) The FSA's investment may not exceed the institution's loan-to-one borrower limit.
(5) If the FSA does not qualify as an eligible savings association pursuant to 12 CFR 5.3(g), the FSA must notify the OCC's Community Affairs Division at least 14 calendar days before making the investment.
(6) The investment must conform to all applicable laws, including the 2 percent aggregate investments cap for all equity investments by the FSA under HOLA 5(c)(3)(A). HOLA stands for Home Owners' Loan Act of 1933.

[47] Refer to OCC Bulletin 2021-15, "Commercial Lending: Tax Equity Finance Transactions Pursuant to 12 CFR 7.1025" (March 2021).

[48] Refer to 12 CFR 7.1025(a). For example, banks may make investments that are designed primarily to promote public welfare. Such investments may include tax equity finance transactions made pursuant to these public welfare investment requirements and procedures. Refer to 12 CFR 24 (national banks) and 12 CFR 160.30 and 160.36 (federal savings associations).

Appendix A: Example of a Pay-In Schedule (for Illustrative Purposes Only)

This schedule illustrates how the financing may be disbursed into an HTC project. The timing of the financing contributions is flexible and negotiable. Frequently used pay-in milestones for an investor include admission into the LP/LLC, placed-in-service date, independent accountant's cost certification, part 3 certification approval date from the NPS, and stabilization[49] of the project. Pay-in schedules reflect the unique circumstances of each project, the requirements of investors (as limited partners), and the needs of the general or managing partner.

Table 2: Hypothetical Pay-In Schedule

Pay-in contribution	Milestone	Amount
25%	Admission to the LP/LLC	$250,000
55%	Placed-in-service/cost certification	550,000
10%	Certified historic rehabilitation approval received (part 3 approval from the NPS)	100,000
10%	Stabilization	100,000
100%	**Total financed**	**$1,000,000**

[49] Stabilization is typically reached when a project achieves a certain level of completion, occupancy, or net income. Upon stabilization, construction financing is often taken out by permanent financing.

Appendix B: Abbreviations

CFR	Code of Federal Regulations
CRA	Community Reinvestment Act
Fed. Reg.	*Federal Register*
FSA	federal savings association
HOLA	Home Owners' Loan Act of 1933
HTC	historic tax credit
IRC	Internal Revenue Code
IRS	Internal Revenue Service
LLC	limited liability company
LMI	low- and moderate-income
LP	limited partnership
NMTC	new markets tax credit
NPS	National Park Service
OCC	Office of the Comptroller of the Currency
Pub. L.	Public Law
QRE	qualified rehabilitation expenditures
SHPO	State Historic Preservation Officer
USC	U.S. Code

Appendix C: Resource Directory

OCC

- *Community Developments Insights,* "Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks"
- *Community Developments Insights,* "New Markets Tax Credits: Unlocking Investment Potential"
- CRA Qualifying Activities Confirmation Request
- Public Welfare Investments Resource Directory

Other

- National Conference of State Historic Preservation Officers
- National Housing & Rehabilitation Association
- National Park Service, U.S. Department of the Interior
- National Trust Community Investment Corporation
- Historic Tax Credit Coalition

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