

Rehabilitation Tax Credit Recapture

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The rehabilitation tax credit is subject to recapture if the building on which it was claimed is sold or ceases to be business use property within five years from the date it was first placed in service. The recapture provisions are found under Internal Revenue Code Section 50(a)

The amount of such recapture is reduced by 20% for each full year that elapses after the rehabilitated property is placed in service. Thus there is a 100% recapture if the property is disposed of less than one year after the property is first placed in service; an 80% recapture after one year, a 60% recapture after two years; a 40% recapture after three years; and a 20% recapture after four years.

Disposition of Partnership Interests

When rehabilitated property is owned by a partnership and a partner sells or disposes of all or a part of his partnership interest tax credit recapture may be required. Treasury Regulation 1.47-6(a)(2) states that if a partner's interest in the partnership is reduced to less than two-thirds of what it was when the property for which the rehabilitation tax credit is claimed was placed in service, the reduction is treated as a proportional disposition of the property.

This is illustrated in the following example:

A limited partner has an 80% interest in a limited partnership that rehabilitated an historic structure in 1996. This limited partner's share of the rehabilitation tax credit amounted to \$100,000. If the limited partner's interest is reduced to 50% in 1999, three years from when the property was first placed in service, credit recapture is required. Since the limited partner's interest was reduced below two thirds (62.5%), the partner is considered to have disposed of 30/80 or 37.5% of the property. Recapture is computed as follows:

$$\begin{aligned} \$100,000 \times 37.5\% &= \$37,500 \\ \$37,500 \times 40\% \text{ (recapture \%)} &= \$15,000 \end{aligned}$$

When a Building is Removed from the National Register

If the National Park Service removes a "qualified rehabilitated building" from the National Register or determines the building no longer contributes to a Registered Historic District within five years from when it was first placed in service, the recapture provisions apply.

Revocation of a building's status as a certified historic structure can occur when a building loses its historic integrity and/or character. This could happen, for example, if the building owner materially alters the building's façade or a new building addition overshadows the historic structure or if the building is destroyed and can not be rebuilt. In each of these situations, the alteration to the historic structure would be irreversible and would result in its deletion from the National Register.

Recapture when Property is Destroyed by Casualty

When a building that qualified for the rehabilitation tax credit is destroyed by a casualty (i.e. hurricane, flood, tornado, earthquake), within five years of first claiming the credit, the recapture provisions of Internal Revenue Code Section 50(a) apply.

Unlike the provisions set forth in Internal Revenue Code Section 42(j)(4)(E) which does not require recapture of low income housing tax credit property when it is completely destroyed but replaced within a reasonable amount of time, rehabilitation tax credit property would be subject to full recapture.

Partially damaged property would not trigger recapture if the owner makes the necessary repairs and places the property back in service.

If historic property in which the rehabilitation tax credit was claimed is destroyed and it is beyond the recapture period (five years from when building was placed in service), no recapture of rehabilitation credit would be required.

When Recapture is not Required

The recapture rules do not apply when there is a simple transfer of interest between spouses or when there is a transfer of interest due to divorce. The transferee, in these cases, steps into the shoes of the transferor with respect to the transferred property for purposes of tax credit recapture. See Internal Revenue Code Section 50(a)(5).

The recapture rules will not apply when property is transferred by reason of

death. See Internal Revenue Code Section 50(a)(4).

The recapture rules will not apply when property is transferred in certain tax-free liquidations and reorganizations pursuant to Internal Revenue Code Section 381(a). Also see Internal Revenue Code Section 50(a)(4).

Recapture will not apply in situations where there is a mere change in the form of conducting a trade or business provided the property is retained in the trade or business as Internal Revenue Code Section 38 property and the taxpayer retains a substantial interest in the trade or business. See Internal Revenue Code Section 50(a)(4).

Basis Adjustment upon Recapture

Treasury Regulation 1.48-12(e) requires that the basis of rehabilitated buildings, including certified historic structures, must be reduced by 100% of the rehabilitation credit earned regardless of whether the credit is used or carried forward. If the rehabilitated property is disposed of or ceases to be business use property within the five-year recapture period, the amount of the recaptured credit is added back to the building's basis.