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Virginia historic tax credits

More oversight on the way for critical financing tool

by Tim Loughran

For nearly 15 years, Virginia's program for historic preservation tax credits (HTCs) has been a financial godsend to communities. The credits — in conjunction with an older federal program — help cities rebuild tax bases, enable real estate developers to launch projects and assist Virginia in preserving one of its main calling cards: historical buildings. From Alexandria to Danville, Norfolk to Blacksburg and points in between, the HTC incentive also creates jobs — lots of them.

Most recently, HTCs have served as a critical lifeline for developers who have managed to survive the worst building slump in decades. "In the last few years it's been very hard for people to get traditional construction loans, and historic tax credits have been the only game in town," says Brian Wishneff, the founder of Brian Wishneff & Associates, a Roanoke-based consultancy that specializes in advising companies on how to use historic- and new-market development credits. "These projects are the only way to get anything done."

In Staunton, officials can't say enough good things about HTCs. Amanda Glover, the city's assistant director of economic development, says the combined federal-state HTC incentives have attracted $65 million in private and public investments to renovate more than one million square feet of previously vacant space. "It's a triple-win: Downtown's historic anchors have been re-purposed; we've retained our architectural legacy; and we're attracting new businesses as a result."

Overall, the economic impact of the credits has been huge. A 2010 study by Virginia Commonwealth University's Center for Urban Development found that during the program's first 12 years, dozens of developers collected about $650 million in income tax credits (calculated in 2009 dollars) in exchange for more than $2.6 billion in spending on nearly 1,800 commercial and residential projects — creating more than 13,000 full-time jobs.

It's no wonder then that the commercial real estate industry is closely following changes to the state's program in the wake of a tax credit scandal in Richmond. What had been considered a national model suffered a black eye last year when federal prosecutors arrested and charged developer Justin French. The former commercial real estate wunderkind was accused of inflating building costs of more than 30 historic tax credit projects, commiting a combined fraud against contractors, banks, private investors and taxpayers of between $7 million and $20 million. Investigators are still trying to unravel all the numbers.

With the full scope of his crimes still under investigation, French pleaded guilty in late January to two federal charges of wrongdoing: wire fraud and engaging in unlawful monetary transactions. First, he admitted he illegally claimed expenses of $1.6 million on a single property that actually cost only $336,000 to rehabilitate. Plus, he confessed to illegally collecting nearly $229,000 from private investors for state and federal historic tax credits that he obtained under false pretenses.

French faces up to 30 years in prison and an initial fine of $500,000 for the federal offenses. Scheduled for sentencing in early May, he faces additional state and possibly more federal charges related to the allegedly fraudulent tax credits he collected on dozens of other properties. "Whenever someone gets caught trying to stretch the limits of a program or system, everyone suffers," says Steven E. Farrar, a specialist in tax credits in the Danville office of the Dixon Hughes Goodman accounting firm. "In difficult times, people try to do deals maybe they should not be doing."

To prevent any repeat of French's crimes, the state Department of Historic Resources (DHR) is ramping up its oversight on HTC projects. Building experts and engineers from the state's Department of General Services plan to visit job sites more frequently to scrutinize work being performed and materials being used. They also will interview subcontractors and compare midstream costs with accepted industry standards. Additionally, the DHR is finalizing new regulations for accounting firms that work with developers applying for HTCs. CPAs will play a much bigger watchdog role in the validation of relevant building expenses and have much greater responsibilities in the eyes of state auditors. CPA firms won't be able to claim they're innocent of any wrongdoing if fraud is discovered.

While Virginia developers will have to pay CPAs more to abide by the DHR's new audit procedures, that shouldn't discourage use of HTC credits by developers, says Kathleen S. Kilpatrick, director of the DHR and Virginia's historic preservation officer. "We have been one of the only states that required the extra step of CPA certification for phase 3 [the total expense section of HTC] applications," she says. "We are working closely with the CPA community to raise the bar on what is submitted to us."

What hasn't changed, though, is the effectiveness of the credits as a financing tool. Even with the economy on the rebound, banks continue to take a hard look at commercial construction projects until they see private investors cover most of the costs upfront. The attractive combination of the 20 percent HTC available from the federal government and Virginia's 25 percent credit helps developers attract enough private equity to make it less risky for one or more banks to fund the balance.

"These credits help developers get the upfront capital they need to make the deal possible ... and get the necessary additional funding that they normally would not have access to," says Marion Werkheiser, a principal in the Alexandria-based Cultural Heritage Partners LLC consultancy.

In the years after the program's launch in 1997 — when the economy was expanding by the month, bank credit was cheap and building prices rose almost weekly — HTCs were considered almost an afterthought by developers and investors, according to Elizabeth Tune, manager of DHR's Office of Preservation Incentives. This is the office that approves the three-part application developers must submit for every historic preservation, rehabilitation, restoration or rebuilding project in the state.

Virginia's successful HTC program has served as a national model, industry experts say, because it encourages private investment in historic preservation projects in multiple ways the federal government and similar programs in 30 other states do not. Virginia has no annual cap in the state budget that limits the amount of credits awarded to developers; in contrast to other states, developers in Virginia can syndicate federal historic tax credits to one set of investors and package the state's credits to another; and, unlike the federal government, which requires a five-year holding period by the owner on any property awarded HTCs, Virginia has no recapture provision on tax credits even if the historic building is sold immediately after completion.

"Every other state has some sort of blemish; Virginia does not," claims Wishneff, whose firm has guided historic building projects in Florida, Iowa, Arizona, Michigan, New York, Pennsylvania, Maryland, Nebraska and California.

To get tax credits, a property must be listed on the Virginia Landmarks Register or the National Register of Historic Places or it must be considered a contributing structure to a certified historic district. The credits can be applied to owner-occupied and income-producing buildings.

The proven ability of Virginia's HTC program to create new jobs in every corner of the commonwealth appears to be the main reason that any mention of trimming the availability, scope or size of HTC benefits is usually absent from annual budget debates in Capitol Square. "We have good data that shows this program is a boost for Virginia's economy," says Kilpatrick. "It's labor intensive rather than materials intensive." A 1996 economic study cited by the Virginia Department of Historic Resources showed that for each $1 million spent on rehabilitation projects, 15.6 jobs are created in the construction industry — 3.4 more jobs than for new construction.

Fortunately, the HTC program has enjoyed bipartisan support, notes Wishneff. He doesn't expect that to change. After all, the rehabilitation of historic buildings in downtown areas boosts retail and business activity and property values. Why would anyone want to mess with that?

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