New Tax Benefits From Old Buildings

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Cattlemen who renovate their old buildings can qualify for major tax benefits. You can reduce your tax bill by 15 percent, 20 percent, or even 25 percent of the amount you spend to fix up your facilities.

This tax incentive is available for a wide array of building rehabilitation activities. The building can be fully or partially renovated, altered or remodeled. Your only limitation is that most of the exterior walls must remain.

Eligible projects include modernizing electrical or plumbing systems, refurbishing walls, upgrading fixtures, reconditioning air conditioning systems, redistribution of space by new interior walls, soundproofing, and installation of insulated doors and windows. These are just a few of the many renovations that qualify for tax benefits. A wide range of fix-up expenditures are eligible.

The tax benefits are available even if you convert the building to a new use. Or, if you wish, you can use the funds to repair dangerous conditions and building code violations plaguing your building.

These tax incentives may make rehabilitation of old buildings even more attractive than new construction. In fact, building rehabilitation may be the most lucrative real estate tax shelter for cattlemen.

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If your building is 30 to 39 years old it qualifies for a tax credit of 15 percent of the amount spent for rehabilitation. Buildings 40 years old or older qualify for a 20 percent credit. Certified historical structures can receive a 25 percent credit, regardless of age. The tax credit is a dollar for dollar reduction of your tax obligation.

Qualifying

To qualify for the tax credit, building renovations must cost at least \$5,000. Also, expenditures must exceed the undepreciated cost of the building (cost less accumulated depreciation). If you spend less than these amounts, your activities do not qualify as building rehabilitation for tax purposes.

Example: In 1964, \$60,000 is paid for a building then 20 years old. Total cost included \$10,000 for the land and \$50,000 for the building. The building was depreciated on a straight line basis over its estimated 25 year remaining useful life, starting in 1964 and providing the owner with a depreciation deduction of \$2,000 per year. By 1984, \$40,000 of the building's \$50,000 cost had been depreciated, leaving an undepreciated cost of \$10,000. Therefore, in 1984 the rehabilitation must cost over \$10,000 to qualify for the tax credit.

The owner can pay wages to family members who help renovate the building, and these wages qualify toward the minimum renovation cost requirement.

Once a building is old enough to qualify for the rehabilitation investment tax credit, it is probable that the building has been sufficiently depreciated so that the minimum expenditure requirement is easily satisfied.

Let's assume $18,750 is spent for rehabilitation in 1984. Several tax benefits are now available.

The tax credit is 20 percent of the $18,750 rehabilitation expenditure or $3,750 because the building is 40 years old. After subtracting the $3,750 tax credit from the $18,750 rehabilitation cost, the remaining $15,000 of renovation costs can be depreciated over the next fifteen years. Depreciation using the straight line depreciation method is $1,000 per year.

If the owner finances the rehabilitation sum with funds borrowed from an external source, interest on the loan is also deductible.

Exterior wall rule

Construction requirements must be met for the rehabilitation of a building to qualify for the tax credit. At least 75 percent of the building's existing exterior walls must stay in place as external walls. If the rehabilitation adds to the square footage of the building, the additional area is considered enlargement or new construction and its cost does not qualify for tax credit. The rehabilitation tax credit is for renovative improvements and not for expansion. Strictly cosmetic repairs alone, such as repainting the building, don't qualify as rehabilitation.

Depreciation and rehabilitation tax credit

To claim the tax credit, the owner must use straight line depreciation for the renovation expenditure. The straight line method allows equal yearly deductions for 15 years.

Accelerated depreciation provides larger deductions in the earlier years after purchase but lower deductions in the waning years. One disadvantage to the accelerated method is that if a building is sold too early, the owner may have to pay back all the depreciation up to the amount of his profit.

Whether accelerated depreciation or straight line depreciation plus rehabilitation tax credit saves more money depends on the facts, and competent tax advice is necessary. Usually, rehabilitation tax credit and straight line depreciation will be preferable.

Keeping all the credit

To keep full benefits from the rehabilitation tax credit, you must own the building for a minimum of five years after renovation. If the building is sold within five years of the credit claim, 20 percent per year will be recaptured for each year less than five that the ownership continues. For example, if the building is sold at the end of the fourth year, 80 percent of the tax credit may be claimed and 20 percent must be paid back to the government.

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Even if you sell or plan to sell the building in one year, the tax credit should still be claimed. The owner has use of the full tax credit amount on an interest free basis for one year and can keep 20 percent of the credit. In addition, since the straight line method of depreciation was used, the year's depreciation is not paid back.

Conclusion

Savings available using rehabilitation tax credit often make it the most lucrative real estate tax shelter. These benefits will vary according to the individual taxpayer's circumstances and tax bracket. However, this tax incentive is likely to be preferable to many tax shelter offerings.

The rehabilitation tax credit is an excellent way to minimize costs of renovating your old building which should generate greater revenue. However, as with many business decisions, your tax adviser should fully explore all alternatives to determine the tax strategy suitable to your needs. AJ