Rehabilitation Credit:
Recapture

The Internal Revenue Code and Department of the Treasury Regulations provide rules for the rehabilitation credit and recapture of the investment credit, which includes the rehabilitation credit.

This information is intended to provide a basic understanding of the rules concerning recapture as it relates to the rehabilitation credit.

The information presented does not constitute legal authority and may not be relied upon as such. The information does not amend, modify or add to the Income Tax Regulations or any other legal authority.

Most of the Department of the Treasury regulations governing the rehabilitation credit are contained in Treasury Regulation § 1.47-7 and § 1.48-12. Furthermore, the provisions of the Internal Revenue Code including the investment credit, general business credit, at-risk rules, passive activity limitation, and alternative minimum tax can affect a taxpayer's ability to claim the rehabilitation credit.

The rehabilitation credit under Internal Revenue Code § 47 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 § 50(a).

The amount of 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, but less than five years. Internal Revenue Code § 50(a)(1)(B)(i)-(v).

Treasury Regulation § 1.47-7, Example 3, illustrates the interaction of the rehabilitation credit, as amended by the Tax Cuts and Jobs Act, Pub. L. 115-97, 131 Stat. 2054, enacted on December 22, 2017, with the recapture provisions:

Between February 1, 2021 and October 1, 2021, X, a calendar year C corporation, incurred qualified rehabilitation expenditures of $200,000 with respect to a qualified rehabilitated building. X placed the building in service on October 15, 2021. X's rehabilitation credit determined in 2021 under Treas. Reg. 1.47-7(c) is $40,000 ($200,000 x 0.20). For purposes of section 46, for each taxable year during the 5-year period beginning in 2021, the ratable share allocated under Treas. Reg. 1.47-7(b) for the year is $8,000 ($40,000 x 0.20). In 2021 and 2022, X claimed the full amount of the ratable share allowed under section 46, or $8,000 per taxable year. X's total allowable ratable share for 2023 through 2025 is $24,000 ($8,000 allowable per taxable year). On November 1, 2023, X disposes of the qualified rehabilitated building. Under Internal Revenue Code § 50(a)(1)(B)(iii), because the period of time between when the qualified rehabilitated building was placed in service is more than two, but less than three full years, the applicable recapture percentage is 60%. Based on these facts, X has an increase in tax of $9,600 under section 50(a) ($16,000 of credit claimed in 2021 and 2022 × 0.60) and has $3,200 of credits remaining in each of 2023 through 2025, after forgoing $4,800 in credits in each of the years 2023 through 2025 ($8,000 × 0.60).

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, recapture may be required. Applying Treasury Regulation § 1.47-6(a)(2), 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 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, LP, has an 80% interest in a limited partnership that rehabilitated a historic structure and placed it in service on January 1, 2016. LP's share of the rehabilitation tax credit amounted to $100,000. If LP's interest is reduced to 50% on February 1, 2019, which is more than three years from when the property was first placed in service, credit recapture is required. This is because the LP's remaining 50% interest is less than two thirds of what it was when the property for which the rehabilitation credit was claimed was placed in service (i.e. the 50% interest is only 62.5% (50/80) of the original 80% interest). LP is considered to have disposed of an amount of the property proportional to the percentage that LP's interest was reduced, which in this case is 37.5% (30/80). This means that the applicable recapture percentage of 40% should be applied to $37,500 of the rehabilitation tax credit (i.e. 37.5% of the partner's share of the $100,000 rehabilitation tax credit). Based on these facts, LP has an increase in tax under Internal Revenue Code § 50(a) in the amount of $15,000 in 2019.

When a Building is Removed from the National Register or its Certification as a "Certified Historic Structure" (NPS Part 1 – Evaluation of Significance) is Revoked

If, after qualifying for this investment tax credit, 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, then the building would cease to be investment credit property and the recapture provisions would apply.

This could happen for a variety of reasons, including when a building loses its historic integrity and/or character. For example, if the building owner materially alters the building's facade or a new building addition overshadows the historic structure or if the building is destroyed and cannot be rebuilt.

Recapture when Property is Destroyed by Casualty

When a building that qualified for the rehabilitation credit is destroyed by a casualty (i.e. hurricane, flood, tornado, earthquake), within five years of placing the property in service, the recapture provisions of Internal Revenue Code § 50(a) apply.

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

Partially damaged property would not trigger recapture if the owner makes the necessary repairs and places the property back in service. For example, see Notice 2006-38, 2006-16 I.R.B. 777, 2006-1 C.B. 777 (Section II of the notice describes the legal background surrounding casualties under Internal Revenue Code § 47). As long as the statute of limitations remains open the Service may adjust this credit through the normal audit and deficiency procedures.

If a building on which the rehabilitation 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 transfer of interest between spouses, or former spouses if the transfer is incident to a divorce. The transferee, in these cases, steps into the shoes of the transferor with respect to the transferred property for purposes of rehabilitation credit recapture. See Internal Revenue Code § 50(a)(5)(B).

The recapture rules will not apply when property is transferred by reason of death. See Internal Revenue Code § 50(a)(4)(A).

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

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 investment credit property and the taxpayer retains a substantial interest in the trade or business. Internal Revenue Code § 50(a)(4) flush language.

Basis Adjustment upon Recapture

When applicable, Internal Revenue Code § 50(c)(1) and Treasury Regulation § 1.48-12(e)(1) require the basis of rehabilitated buildings, including certified historic structures, be reduced by 100% of the rehabilitation credit determined. If the rehabilitated property is disposed of or ceases to be investment credit property within the five-year recapture period, the recapture amount of the credit is added back to the building's basis. Treasury Regulation § 1.48-12(e)(3).

For questions about use of the rehabilitation credit by lessees, see *Rehabilitation Credit: Lessee's Ability to Claim the Rehabilitation Credit.*

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