CRITICAL ISSUE: Historic Tax Credits & Nonprofit Sales

One-Page Brief for Developer

Date: November 2025
Re: 5-Year Holding Period Requirement for Historic Tax Credit Projects

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THE PROBLEM

If you plan to sell or transfer the rehabilitated building to a nonprofit organization before 5 years, you will face potentially large recapture penalties that will destroy the project's financial viability.

THE NUMBERS

What You Stand to Lose

Project Investment:

- Estimated rehabilitation: $1,000,000 (**number has been chosen for ease of calculation**)
- Federal historic tax credit (20%): $200,000
- NC state historic tax credit (20%): $200,000
- **Total tax credits: $400,000**
- Credits sold for cash (at $0.90/dollar): **$360,000**

Recapture Penalties If You Sell Early

When You Sell	% Recaptured	Amount You Owe Back	Net Loss
Year 1	100%	$400,000	$760,000
Year 2	80%	$320,000	$680,000
Year 3	60%	$240,000	$600,000
Year 4	40%	$160,000	$520,000
Year 5	20%	$80,000	$440,000
After Year 5	0%	$0	**$360,000 (you keep)**

Net Loss includes both repaying recaptured credits AND losing the upfront cash you received from selling the credits.

WHY THIS MATTERS FOR YOUR PROJECT

The IRS requires you to hold the property for 5 full years after it's "placed in service" (completed and occupied). This is non-negotiable.

- ❌ **You CANNOT sell to a nonprofit in years 1-3** without losing $600K-$760K*
- ❌ **You CANNOT gift the property** - IRS treats gifts same as sales
- ❌ **You CANNOT transfer majority ownership** without triggering recapture
- ✅ **You CAN lease to a nonprofit** while maintaining ownership
- ✅ **You CAN sell after 5 years** with no penalty

*Actual number will be based on rehab costs, this is estimate based on $1 million investment

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THE SOLUTION: LEASE-TO-OWN STRUCTURE

Recommended Approach

Year 1:

- Complete rehabilitation using historic tax credits
- Receive cash from selling credits
- Nonprofit signs long-term lease with purchase option

Years 1-5:

- Nonprofit occupies and uses building as tenant
- Pays monthly rent (property taxes + insurance + minimal return)
- You maintain ownership - satisfies IRS holding period
- Purchase price locked in today

Year 6 (or later):

- Nonprofit exercises purchase option
- You sell with ZERO recapture penalty
- You keep all tax credit proceeds
- Nonprofit becomes owner

Why This Works

✅ **Nonprofit gets immediate occupancy** - they can move in right after rehab
✅ **You satisfy IRS requirements** - 5-year holding period maintained
✅ **No recapture penalties** - you keep all $360,000 in tax credit proceeds

✅ **Everyone wins** - nonprofit gets their space, you exit successfully
✅ **Proven structure** - used successfully on hundreds of similar projects nationwide

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WHAT DOESN'T WORK

Common Mistakes That Trigger Recapture

❌ **"I'll just sell quickly to the nonprofit"**
→ Result: Owe potentially significant dollars back to IRS

❌ **"I'll gift it to avoid the sale"**
→ Result: IRS treats gifts same as sales - full recapture

❌ **"I'll form a nonprofit to own it"**
→ Result: Nonprofits can't claim tax credits (tax-exempt)

❌ **"I'll make the nonprofit a 50% partner"**
→ Result: Transfer of majority control triggers recapture

❌ **"We can figure this out later"**
→ Result: Once structure is set up wrong, very difficult to fix

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ALTERNATIVE STRUCTURES

Option A: You Remain Permanent Owner

- Nonprofit leases long-term (10-20 years)
- You become "mission-aligned landlord"
- Nonprofit never owns, which many actually prefer
- No building management burden for nonprofit
- You have stable long-term asset

Option B: Delayed Purchase Agreement

- Sign purchase contract NOW with nonprofit
- Closing date set for 5+ years in future
- Nonprofit leases in the interim
- Purchase price locked in today
- Both parties have certainty

Option C: Forget Tax Credits Entirely

If nonprofit MUST own immediately:

- Don't use historic tax credits
- Pursue traditional financing + grants
- Seek CDBG, USDA, foundation funding
- Takes more time and money, but possible

IMMEDIATE ACTION REQUIRED

What We Need to Do NOW (Before Any Applications)

1. **Ask the Nonprofit Key Questions**
    - Do they need ownership or just space to operate?
    - Can they wait 5 years to purchase?
    - Are they open to long-term lease?
    - Many nonprofits prefer leasing over ownership burden
2. **Make Go/No-Go Decision**
    - If 5-year timeline works: Proceed with tax credits
    - If nonprofit needs immediate ownership: Pursue alternative financing
    - If uncertain: DO NOT submit applications yet

THE BOTTOM LINE

OPTION 1: Use Tax Credits + Lease to Nonprofit

- Receive potentially significant dollars in tax credit proceeds based on rehabilitation costs
- Reduce financing needs through credits
- Lease to nonprofit for 5 years
- Sell after year 5, keep all proceeds
- **Timeline: Year 6 exit**

OPTION 2: Sell to Nonprofit Immediately

- Don't use historic tax credits

- Need 100% traditional financing
- Pursue grants and alternative funding
- Can transfer to nonprofit anytime
- **Timeline: Year 1-2 exit**

You cannot do both. Trying to use tax credits AND sell quickly to a nonprofit will cost you $240,000-$400,000 in recapture penalties.

NEXT STEPS

Do not:

- Submit any tax credit applications
- Start any work on the building
- Make any commitments to the nonprofit
- Spend money on consultants

Until we determine:

- Can the nonprofit wait 5 years to purchase?
- Is lease-to-own structure acceptable?
- Should we pursue tax credits or alternative financing?

QUESTIONS?

Remember: This 5-year rule is federal law. There are no exceptions, waivers, or workarounds. The only question is whether your exit timeline can accommodate it.

This document summarizes IRS requirements for historic tax credits. For legal or tax advice specific to your situation, consult qualified professionals.