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Missouri State Auditor

Economic Development

Historic Preservation Tax Credit Program

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CITIZENS SUMMARY

Findings in the audit of the Historic Preservation Tax Credit Program

Background

The Department of Economic Development (DED) Missouri Historic Preservation Tax Credit (HPTC) program was established in 1998 to provide an incentive for the redevelopment of commercial and residential historic structures statewide. In fiscal year 2013, the HPTC had approximately $79 million in redemptions, making it the state's third largest tax credit program. The HPTC provides state tax credits (which may be used to offset tax liability) equal to 25 percent of eligible costs and expenses of the rehabilitation of approved historic structures. The HPTC credit can be transferred, sold or assigned, but is not refundable. Missouri is one of at least 30 states that have established state tax credits for historic preservation. Eighteen of these 30 states have established an overall annual program limit, of which Missouri has the highest. As part of our audit, we interviewed DED and State Historic Preservation Office officials and staff and various external parties. We obtained information from the National Trust for Historic Preservation and contacted applicable state agency representatives from several other states. We also reviewed ten tax credit project files, reviewed historical trends, and visited several completed HPTC projects.

Program Cost

With redemptions of over $1.1 billion in the past decade, Missouri's historic preservation program is the largest in the nation. Missouri leads the nation in qualified rehabilitation expenses for historic preservation purposes and program redemptions have exceeded fiscal note estimates. The General Assembly imposed a $140 million annual program limit, which went into effect in 2010, but Missouri could reduce this limit to $75 million, as recommended by the Governor's Tax Credit Review Commission November 2010 report, and still have the largest state historic preservation program in the nation.

Program Efficiency and Effectiveness

While the goals of the program are laudable in some respects, the state's HPTC program is an inefficient use of state resources. Only 49 cents to 85 cents of every tax credit dollar issued actually goes toward rehabilitation costs. The remainder goes to investors, tax credit brokers or syndicators, and the federal and state government in the form of income taxes. HPTC applicants generally sell the credit to third parties and use the proceeds to reduce construction-related debt, but the sale of a HPTC certificate creates taxable income, resulting in additional income tax due by the seller. Our audit identified several options to improve the efficiency of the current HPTC program, including making the HPTC refundable to make the credit more attractive to investors and reduce the incentive to sell the certificates at a discount; requiring credits be assigned to a state agency, local political subdivision or other not-for-profit organization that would sell the credits in the market and grant the proceeds to the project; or eliminating the use of the state tax credits in favor of direct appropriations through a state agency to fund historical rehabilitation projects.

Too much time passes between project completion and the tax credit certificate issuance, which increases interest costs incurred by developers and reduces equity going toward construction.

The use of HPTC on owner-occupied residences may not be a needed, reasonable, or effective use of taxpayer dollars. The audit noted several instances where the credit was used for renovations to homes with high property values and high renovation costs. Because the tax credits represented a small percentage of total renovation costs, the credits may not have been a significant determining factor in the decision to redevelop the properties. The Governor's Tax Credit Review Commission December 2012 report recommended limiting the maximum tax credit allowed for owner-occupied residences to $50,000 and prohibiting the tax credit for owner-occupied residences if the home was purchased for more than $150,000.

The HPTC program is not subject to a sunset provision, and state law does not prohibit claiming the same project costs under two or more tax credit programs. This "stacking" of tax credits allows additional tax credits to be issued while no additional economic activity or state benefit is generated.

Program Administration

The DED could improve its oversight. State agency personnel do not conduct site visits, and the DED's cost certification work is inefficient and redundant. The DED does not monitor project approval time to ensure compliance with state law, and program activity projections appear to overstate the economic impact of the HPTC program. The DED's economic activity projections contain several flawed assumptions, and the DED does not verify or review the accuracy of the number of jobs reported on the preliminary application. The DED is not consistent with respect to the eligibility of certain costs, which often leads to disputes.

In the areas audited, the overall performance of this program was **Fair***

***The rating(s) cover only audited areas and do not reflect an opinion on the overall operation of the entity. Within that context, the rating scale indicates the following:

Excellent: The audit results indicate this entity is very well managed. The report contains no findings. In addition, if applicable, prior recommendations have been implemented.

Good: The audit results indicate this entity is well managed. The report contains few findings, and the entity has indicated most or all recommendations have already been, or will be, implemented. In addition, if applicable, many of the prior recommendations have been implemented.

Fair: The audit results indicate this entity needs to improve operations in several areas. The report contains several findings, or one or more findings that require management's immediate attention, and/or the entity has indicated several recommendations will not be implemented. In addition, if applicable, several prior recommendations have not been implemented.

Poor: The audit results indicate this entity needs to significantly improve operations. The report contains numerous findings that require management's immediate attention, and/or the entity has indicated most recommendations will not be implemented. In addition, if applicable, most prior recommendations have not been implemented.

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Missouri State Auditor

Honorable Jeremiah W. (Jay) Nixon, Governor
and
Sara Parker Pauley, Director
Department of Natural Resources
and
Mike Downing, Director
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Jefferson City, Missouri

We have audited certain operations of the Historic Preservation Tax Credit Program in fulfillment of our duties under Chapter 29, RSMo and Section 620.1300, RSMo. The scope of our audit included, but was not limited to, the 2 years ended June 30, 2013. The objectives of our audit were to:

1. Analyze the costs and benefits of the program to determine if it is an effective and efficient use of state resources.

2. Evaluate the internal controls over significant management and financial functions related to the program.

3. Evaluate compliance with certain legal requirements related to the program.

4. Evaluate the economy and efficiency of certain management practices and operations.

For the areas audited, we (1) determined the current program structure is an inefficient method of funding preservation activities, but due to weaknesses in program data, other aspects of program effectiveness and efficiency could not be adequately determined, (2) identified deficiencies in internal controls, (3) identified no significant instances of noncompliance with legal provisions, and (4) identified the need for improvement in management practices and procedures.

Except for the matter discussed in the last paragraph of the Scope and Methodology Section, we conducted our audit in accordance with the standards applicable to performance audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform our audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides such a basis.

The accompanying Management Advisory Report presents our findings arising from our audit of the Missouri Historic Preservation Tax Credit Program.

Thomas A. Schweich
State Auditor

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Historic Preservation Tax Credit Program Introduction

Background

The Missouri Historic Preservation Tax Credit (HPTC) program was established in 1998 under Sections 253.545 to 253.559, RSMo, and has no sunset or expiration date. The program was designed to supplement the federal HPTC program, which began in 1976. The purpose of the credit is to provide an incentive for the redevelopment of commercial and residential historic structures statewide. The Department of Economic Development (DED) administers the program and is responsible for the issuance of all tax credits based upon final certification of the rehabilitation project by the Missouri Department of Natural Resources, State Historic Preservation Office (SHPO). With approximately $79 million in redemptions in fiscal year 2013, the HPTC is the state's third largest tax credit program. See Appendix B for redemption information on all state tax credits.

The HPTC provides state tax credits equal to 25 percent of eligible costs and expenses of the rehabilitation of approved historic structures. An eligible property must be (i) listed individually on the National Register of Historic Places, or (ii) certified by the Missouri Department of Natural Resources as contributing to the historical significance of a certified historic district listed on the National Register, or located within a local historic district that has been certified by the U.S. Department of the Interior. Eligible costs include, but are not limited to, qualified rehabilitation expenses (QRE) as defined under the federal program. Generally QRE are limited to rehabilitation expenses of the original historic structure, while expenses for additions to the property, acquisition costs, and personal property are generally unqualified. To qualify for credits, QRE associated with the rehabilitation must exceed 50 percent of the acquisition cost.

The HPTC credit can be freely transferred, sold, or assigned, but is not refundable.[1] Section 253.557.1, RSMo, allows the credits to be carried back 3 years to offset prior tax liability or carried forward for 10 years to offset future tax liability. The tax credits can be applied against the taxes imposed pursuant to Chapter 143 and Chapter 148, RSMo, except for Sections 143.191 to 143.265 for the succeeding ten years, including the insurance company premium tax, and the financial institution tax. Any taxpayer is eligible to participate but nonprofit entities are ineligible.

Legislative changes

In 2009, the General Assembly passed legislation imposing new annual limits on the amount of tax credits authorized by the DED and established a more detailed, multi-step application and approval process. Effective July 1, 2010, the General Assembly imposed an annual program limit of $140 million. Prior to 2010 there was no annual limit for the HPTC program.

[1] The taxpayer must have a tax liability the credit can be offset against.

Approval process

Applicants submit a preliminary application to the DED detailing the project and its expected costs. The DED reviews the application for completeness and forwards the application to the SHPO for approval. After the SHPO approves the project, the DED notifies applicants of the authorization of a specific amount of tax credits. These authorizations of tax credits are the basis for calculating the annual dollar limit for the program.

Applicants have 2 years from the date of preliminary authorization to begin rehabilitation. When the rehabilitation project is completed, applicants are required to obtain a cost certification prepared by a Certified Public Accountant (CPA) licensed in Missouri. If total project costs are less than $250,000 the CPA must compile a schedule of project expenses. If total project costs are $250,000 or greater the CPA must perform a 100 percent examination of expenses and issue an opinion as to the eligibility of the expenses. The applicant then submits a final application and the CPA cost certification to the DED. After the SHPO performs a final review of the technical project work, the DED performs a review of the cost certification and issues a tax credit certificate equal to 25 percent of QRE.

Credits in other states

According to a December 2011 report issued by the National Parks Service, Missouri is one of at least 30 states that have established state tax credits for historic preservation. The following table summarizes statistics on state credit programs, including Missouri.

State Historic Tax Credit Programs

	Commercial Buildings	Owner-Occupied / Residential
States with credit programs	30	25
Credit percentage[1]	5 - 50%	20 - 50%
States with per-project cap	17	15
Per-project cap (minimum)	$25,000	$25,000
Per-project cap (maximum)	$5 million	$5 million

[1] Percent of QRE awarded in state tax credit.

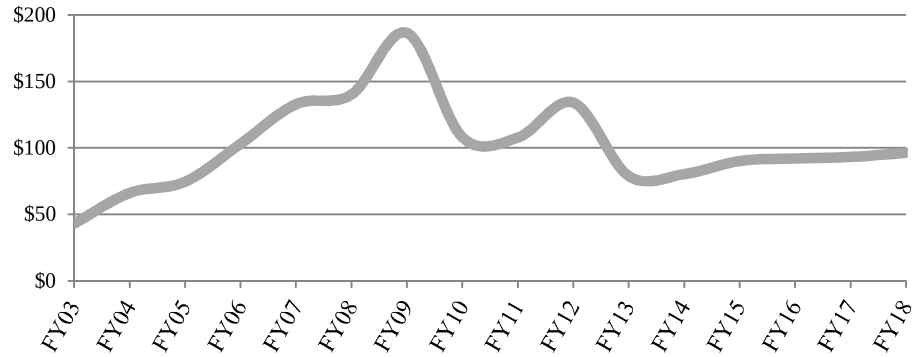
Source: National Trust for Historic Preservation and SAO analysis

Eighteen of 30 states, including Missouri, have established an overall annual program credit limit. The lowest annual limit we identified is $700,000, while Missouri's limit ranks highest among the states with an overall limit. In addition, 14 states (including Missouri) allow credits to be transferred or sold to third parties.

Projection of future credit activity

Based on actual tax credits awarded in recent years, we projected tax credit redemptions through 2018. The chart on the next page shows actual credits redeemed annually for fiscal years 2003 through 2013, and projected redemptions for 2014 through 2018. Based on our projections, redemptions are expected to stay below $100 million through fiscal year 2018.

Actual and Estimated Tax Credits Redeemed - Fiscal Years 2003 to 2018 (in millions)



Source: DOR data and SAO analysis.

Reporting

The DED provides the General Assembly and the public key program information for the HPTC program through the tax credit activity report.

Agencies administering tax credit programs are required under Section 33.282, RSMo, to submit the estimated amount of tax credit activity for the next fiscal year to the State Budget Director for submission to the Chairmen of the Senate Appropriations and House Budget Committees. In addition to the estimates of tax credit activity, the agencies must also include a cost-benefit analysis of the program for the preceding fiscal year. The annual estimates and cost-benefit analyses are submitted on forms called tax credit activity reports. State law requires the tax credit activity report be submitted to the State Budget Director by October of each year and to the Chairmen of the Senate Appropriation and House Budget Committees by January 1 each year.

Scope and Methodology

To gain an understanding of the performance of the HPTC program, we interviewed DED and SHPO officials involved in the application and approval process. We interviewed various external parties involved in all aspects of the program, including five developers and their representatives; three tax attorneys; an architect; two historic preservation consultants; and representatives of two syndication firms who specialize in buying and selling tax credit certificates, three CPA firms involved in the cost certification process, and a city development agency. Our review also included visits to several completed HPTC projects.

To determine whether required procedures were followed, we reviewed ten tax credit project files, interviewed DED staff, and reviewed documentation submitted by the applicants. The DED issued a total of $8.7 million in credits for these 10 projects. The projects included three owner-occupied residences and seven commercial buildings, including buildings used for residential purposes such as loft apartments.

To understand how the economic impact of the HPTC program is calculated, we met with representatives of the DED responsible for generating the economic impact estimates. We interviewed DED staff regarding assumptions provided by the companies to calculate the economic impact of the tax credit. We also interviewed a representative of a county assessor's office to understand the impact of rehabilitation on property values, and the lead researcher on a third-party study[2] of the economic impact of the Missouri HPTC.

To understand how Missouri's HPTC program compares to programs in other states, we obtained information from various sources, including the National Trust for Historic Preservation, and contacted applicable state agency representatives in Arkansas, Iowa, Kansas, Kentucky, Oklahoma, Illinois, Minnesota, Ohio, and Virginia. We also contacted a tax attorney familiar with the program in Minnesota.

To develop projections of future tax credit activity and liability, we reviewed historical trends in tax credits authorized, issued, and redeemed including data presented in Appendix A. We based projections for future years on historical trends, with an emphasis on recent history. Future activity is dependent on trends in the overall economy and is difficult to project.

To evaluate potential improvements to the program, we reviewed reports from the Tax Credit Review Commission. The commission was created by the Governor in July 2010 and charged with reviewing the state's tax credit programs and making recommendations for greater efficiency and enhanced return on investment. The commission released reports in November 2010 and December 2012.[3]

We obtained aggregate totals of annual tax credit redemptions from the DOR. In accordance with the Missouri Supreme Court decision in the case of *Director of Revenue v. State Auditor* 511 S.W.2d 779 (Mo. 1974), auditors are not provided individual tax returns. As a result, auditors were not able to verify the completeness and accuracy of redemption data provided.

[2] Saint Louis University, " An Observation of the Missouri Historic Preservation Tax Credit Program's Impact on Job Creation and Economic Activity Across the State," March 2010.
[3] The December 2012 report included a supplemental report that we also reviewed.

1. Program Cost

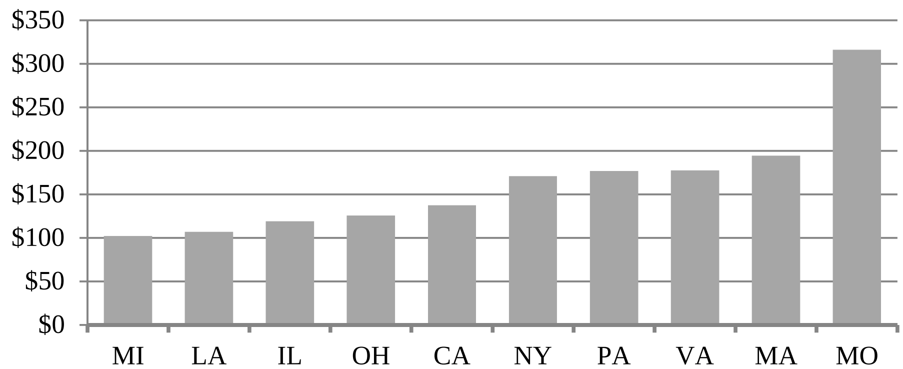
There is no dispute the Historic Preservation Tax Credit (HPTC) has been a significant factor in helping rehabilitate hundreds of the state's historic properties. However, with redemptions of over $1.1 billion in the past decade, Missouri's historic preservation program is the largest in the nation, has exceeded fiscal estimates provided to the legislature at its passage, and has a statutory annual limit that is so high that it does not contain actual spending.

Program activity

Missouri leads the nation in qualified rehabilitation expenses (QRE) for historic preservation purposes. Program redemptions have averaged $123 million per year for the past 5 fiscal years, and have totaled over $1.1 billion in the past decade. To compare Missouri's historic preservation program relative to other states we relied on federal historic preservation data. According to the National Park Service (NPS), an average of $316 million of QRE was reported in Missouri from 2001 through 2012. In contrast, the next highest state averaged $194.4 million (38.5 percent less).

The chart below shows the average annual federal QRE reported to the NPS for the period 2001 through 2012 for the top ten states nationally.[4]

Average Annual Federal QRE for Top Ten States - Years 2001 to 2012 (in millions)



Source: National Park Service data

As noted in Report No. 2010-47, *Tax Credit Cost Controls*, issued in April 2010, the HPTC program has greatly exceeded the original fiscal note estimates. The original fiscal note for Senate Bill 1 in 1997, when the program was established, estimated an annual cost of $14.3 million. Program redemptions have significantly exceeded this estimate since 2002.

Several historic preservation consultants we spoke with attributed the level of historic preservation activity in Missouri to the large supply of historic

[4] California, Michigan, and Pennsylvania do not have state credit programs. The remaining states shown have state credit programs with varying credit percentages as a percentage of QRE as noted above.

buildings in the state, particularly in the metropolitan areas, and the existence of the state credit, which makes the rehabilitations more financially feasible.

Program limits and exemptions

Missouri's program limit is the highest among the 18 states that have established annual limits. Under state law the program is limited to $140 million in authorizations each year, but projects receiving less than $275,000 in tax credits are exempted from the annual program limit. As a result, owner-occupied residential projects that have project limits of $250,000, are exempted when calculating the program limit. For fiscal year 2013, the DED authorized approximately $93.9 million in credits, of which $86.5 million was subject to the statutory cap. Tax credit authorizations have remained well below the $140 million statutory cap since the annual program limit was established in 2010, averaging about $91 million for the 3 fiscal years ended June 30, 2013. While 12 of 30 states with HPTC programs have not established an annual limit, those states have a significantly lower level of activity than Missouri.

Based on our review of other state's programs, if the General Assembly reduced the current $140 million annual statutory cap to $75 million, as recommended in the November 2010 report of the Tax Credit Review Commission, Missouri would still have the largest state historic preservation program in the nation.

Recommendation

The General Assembly re-evaluate the annual program limit for appropriateness.

2. Program Efficiency and Effectiveness

While the goals of the program are laudable in some respects, the HPTC program is an inefficient use of state resources. Only 49 cents to 85 cents of every tax credit dollar issued goes toward rehabilitation costs, with the remainder going to investors, tax credit brokers or syndicators, and the federal and state government in the form of income taxes. Several options exist to improve the efficiency and effectiveness of the credit. In addition, the program has no sunset provision and applicants can receive multiple tax credits for the same expenditures.

2.1 Inefficiency of credit

The HPTC program structure is inefficient in part because only a portion of each dollar of tax credit goes toward historic preservation. Based on information provided by tax attorneys, while the final user of the HPTC certificate typically pays a price in the low 90-cent range, for every dollar of HPTC issued, only 49 cents[5] up to 85 cents,[6] goes toward project costs. The

[5] Assumes credit is sold to a third-party for 90 cents on the dollar and the seller(s) is in the highest state and federal tax brackets applicable to tax year 2013.

remaining portion of each dollar is lost to the federal and state government in the form of income taxes generated from selling the credit, investors who demand a return, and tax credit brokers or syndicators who sell the credits.

Tax implications

HPTC applicants generally sell the credit to third parties and use proceeds from the sale to reduce construction related debt. The sale of a HPTC certificate creates taxable income, requiring the payment of additional income taxes by the seller. Attorneys we spoke with said several factors impact the net amount of equity going toward the project, including the current tax bracket of the individual(s) selling the credit, how long the credit was held before sale, and the selling price.

According to our interviews, it is relatively common for developers to use a loss partner, which allows developers to receive approximately 80 to 85 cents in equity for every dollar of credit. A loss partner has losses from other businesses that allows them to apply the taxable gains from selling the tax credit certificates without incurring a tax liability. Tax attorneys estimated over half of projects in Missouri were using the loss partner structure in recent years. However, recent IRS rulings have made the use of the loss partner structure more risky, reduced the number of developers using this structure, and increased the rate of return demanded by loss partners, resulting in reduced equity applied to projects. In the event a loss partner is not available or not used, developers typically receive approximately 49 cents for each dollar of state tax credit awarded after income taxes.

2.2 Options to improve efficiency

Our research identified several options to improve the efficiency of the HPTC model in place, including making the credit refundable, and allowing not-for-profit organizations to be involved in the process.

Refundable credit

Legislative changes to make the HPTC refundable would increase the attractiveness of the credit by allowing the holder of the certificate to receive the full value of the credit in the first year, regardless of their tax liability. According to tax attorneys interviewed, in addition to improving the overall attractiveness of the certificates to investors, a refundable credit reduces the necessity to sell the certificates, and would help increase the amount of equity going toward project expenses. Nine of 30 states (30 percent) offer a refundable provision with their state credit program. Attorneys indicated timing is a significant consideration because applicants prefer not to hold the credit until they file a tax return; thus, credits are often sold to third parties, if allowed, even if the state has a refundable provision.

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[6] Assumes the use of a loss partner and assumes credit is first allocated to a partner, usually a limited partner investor entity, who has operating losses to offset the taxable gain generated when the credit is sold to a third party. The partner provides a capital contribution to the partnership in exchange for the credits, but the capital contribution is less than the market rate of the credit that is assumed to be 90 cents on the dollar.

Credit to government entities or not-for-profit organizations

Several tax attorneys suggested an alternative model to the tax law committee of the Tax Credit Review Commission. These alternatives are discussed in an October 2012 committee report. The model would require credits to be assigned to a state agency, local political subdivision, or other not-for-profit organization that would then sell the credits in the market and grant the proceeds to the project. Based on our discussions with the co-chair of the commission, this option further increases the complexity of partnership structuring and would not result in a significant increase in equity for developers who are already using a for-profit loss partner, though it would increase equity for others. Several developers told us this option would increase the supply of loss partner entities, which would subsequently increase equity to projects. Given the reduced usage of for-profit loss partners, this model appears to be a viable option to increase the amount of equity to projects.

Direct appropriation

Eliminating the use of state tax credits and utilizing direct appropriations through a state agency to fund historic rehabilitation projects would be the simplest and the most administratively efficient means of improving the efficiency of the state's historic preservation program. According to interviews with tax attorneys, not-for-profit organizations would need to be involved in a direct appropriation model to avoid federal tax consequences and for 100 percent of the state's money to go towards preservation. We identified one state, Minnesota, that offers a grant in lieu of credit option.[7] Minnesota officials indicated legislators primarily included this provision because it helps ensure a minimum price floor, not to minimize taxation, though it has been popular with not-for-profit organizations.

Conclusion

Improvements to the efficiency of the tax credit model are possible, however, state law would have to be modified. The various changes proposed would result in more tax credit dollars being used for the preservation of historic buildings, giving the state significantly higher return on its HPTC investment. If Missouri wishes to continue to make significant investments in the preservation of historic buildings, steps need to be taken to ensure state funds are invested as efficiently as possible.

2.3 Program design

Because the General Assembly established the HPTC program as an entitlement up to the current authorization limit; the DED is not allowed to limit tax credits to projects that represent a good investment for taxpayers, or to only projects that need tax credits to be financially feasible.

[7] The grant amount is equal to 90 percent of the value of what the tax credits would be, if that option is elected. This helps ensure minimum equity of at least 90 cents, ignoring potential tax consequences.

Some other state tax credits, including the Low Income Housing Tax Credit, are established statutorily as discretionary programs. While most states have established their historic credit program as an entitlement program to mirror the federal program, we identified at least two states that have a competitive project selection process. These two states require the administrative agency to review the merits of each proposed project and select the projects that are most beneficial.

Ohio distributes credits through a biannual competitive application process, ranking proposals based on economic benefit and regional distributive balance. Ohio officials indicated the competitive process ensures the limited amount of annual funding is distributed to the historic rehabilitation projects with the best merits. Additionally, they indicated this type of process allows agency officials and legislators to establish priorities for historic preservation activities. The priorities can be updated periodically based on need and market conditions. Arkansas also ranks applications according to various objective criteria.

A competitive award process coupled with a reduced program funding cap would help ensure only projects that represent a good investment receive funding.

2.4 Timeliness of credit issuance

The amount of time between project completion and the issuance of tax credit certificates is excessive, and results in increased project costs due to accrued interest costs. Additional interest costs incurred after completion of the CPA cost certification are not a qualified expense and do not result in any additional credits being issued; however, increased interest costs result in more equity going toward borrowing costs and less tax credit equity going toward the project, which further reduces the efficiency of the credit.

Average issuance time

The DED has established an informal benchmark that indicates the final review should take no longer than 60 business days. Based on our review of a sample of projects, the DED does not meet this benchmark. For the 10 projects we reviewed the final review took the DED between 3 and 12 months, with an average of 6 months. A portion of this time represents time to obtain the SHPO's final approval and time for the applicant and/or CPA to answer questions or submit additional documentation.

A statutory change to allow a partial issuance of tax credits upon the completion of the CPA cost certification would help reduce project interest costs, allowing more of the tax credit to go toward project costs. The Tax Credit Review Commission's December 2010 report recommended the use of a partial tax credit certificate after the applicant submits a complete application and the SHPO provides final approval of the completed work. The recommended partial issuance would be calculated as a percentage of the total amount of credits for which the applicant is eligible as reported in the CPA cost certification. The DED could then issue the remaining credit amount after the final review of the cost certification.

By adopting provisions that would require a partial issuance of credits, the General Assembly can help ensure more equity goes toward projects, ensure projects are not put at risk of failure due to financial constraints, and make the program more attractive to developers.

2.5 Owner-occupied residences

The use of the HPTC on owner-occupied residences does not always appear to be a needed, reasonable, or effective use of taxpayer dollars. We reviewed two owner-occupied projects that received credits for rehabilitating lavish and expensive private residences. These two projects resulted in a minimal economic impact and, based on the level of rehabilitation expenses, the tax credit was likely not a dispositive factor in the applicants' decision to perform the rehabilitation.

In 2010, the DED issued $250,000 in credits to an applicant who rehabilitated the top portion of a 35-story building to create a private luxury residence. A different applicant previously received credits for rehabilitating the building's exterior, including windows, and remaining floors of the building. The applicant purchased the upper four floors of the building for $2 million and reported about $1.2 million in qualified rehabilitation expenditures. The residence is approximately 6,100 square feet and includes a private elevator, rooftop garden, movie theatre, and various other amenities. Total rehabilitation costs, including expenditures not eligible for tax credits, averaged about $251 per square foot, which is extremely costly as compared to other projects reviewed. The total credits awarded on this project represent approximately 8 percent of the final cost of the residence and renovation and, therefore, do not appear to have been a significant cost driver on the project.

In 2011, the DED issued about $296,000 in credits to an applicant who renovated a 3-story, 5,400 square foot home in an affluent neighborhood in a metropolitan area. The applicant purchased the home in 1993 for nearly $300,000 and reported about $1.2 million in qualified rehabilitation expenditures. The home has a fair market value of approximately $434,000. The majority of qualified expenditures consisted of upgrades to the electrical, mechanical, and plumbing systems to comply with current building codes, replacement of a heavily damaged slate roof, and repair of extensive fire damage to the third floor of the home. Total rehabilitation costs, including expenditures not eligible for tax credits, averaged about $238 per square foot, which is extremely costly as compared to other projects reviewed. Due to the high level of rehabilitation costs the owner invested in the property, the tax credit does not appear to have been a significant cost driver on the project.

Officials with a city development agency and several developers indicated the option to use this credit for owner-occupied residences is critical to the continued success of the program. While there are significant benefits to using the credit as an incentive to revitalize historic neighborhoods, particularly those with a high percentage of vacant or dilapidated homes, it does not appear the two projects discussed above fit within that category.

Other states

Although owner-occupied residences do not qualify for federal historic tax credits, six of the nine other states we obtained information from issue state rehabilitation credits for owner-occupied residences. Oklahoma, Illinois, and Minnesota do not issue credits for owner-occupied residences.

Per-Project Cap (Owner-Occupied)

State	Tax Credit Per-Project Limit
Arkansas	$25,000
Kentucky	$60,000
Missouri	$250,000
Ohio	$5,000,000
Iowa	No limit
Kansas	No limit
Virginia	No limit

The Tax Credit Review Commission's December 2010 report recommended the General Assembly reduce the maximum tax credits allowed for owner-occupied residences to $50,000 per residence, a significant reduction from the current $250,000 limit. Additionally, the Commission recommended the General Assembly prohibit tax credits for owner-occupied residences if the home was purchased for more than $150,000. If enacted these changes would help ensure the credit is used to revitalize historic neighborhoods, particularly those with a high percentage of vacant homes, rather than be used to rehabilitate homes with high market values.

2.6 Sunset provision

As noted in Report No. 2010-47, *Tax Credit Cost Controls*, issued in April 2010, state law does not include a sunset provision for many tax credits, including the HPTC program. The Sunset Act, passed in 2003, provides for new programs to sunset after a period of not more than 6 years unless reauthorized by the General Assembly or the program is exempted from the Sunset Act. The Act requires the Committee on Legislative Research to review applicable programs before the sunset dates and present a report to the General Assembly regarding the sunset, continuation, or reorganization of each affected program. However, the HPTC program was created prior to the Sunset Act and is exempted.

By adopting a sunset provision for the HPTC program, the General Assembly can better determine whether the program is achieving its intended purpose and whether program funding should be increased, decreased, or eliminated.

2.7 Use of multiple incentives

As noted in Report No. 2012-117, *Division of Business and Community Services*, issued in September 2012, state law does not prohibit claiming the same project costs under two or more tax credit programs. This "stacking" of tax credits can be lucrative for developers and additional tax credits are issued while no additional economic activity or state benefit is generated.

Companies may claim certain project costs under the Historic Preservation, Low Income Housing, Brownfield Remediation, and the Neighborhood Preservation Tax Credit programs. Between fiscal years 2000 and 2011, the state issued tax credits totaling approximately $738 million for 117 projects that received funding from two or more of these tax programs.

The Tax Credit Review Commission's December 2010 report recommended changes when Brownfield, Historic Preservation, and Low Income Housing Tax Credits or any combination thereof are awarded to a single project. The Commission recommended a specific ordering process and Brownfield credits would be calculated first based on eligible remediation expenditures. Next, the eligible Historic Preservation credit expenditures would be reduced by the amount of Brownfield credits. Finally, the Brownfield and Historic Preservation credits would be deducted from the total expenditures eligible for the Low Income Housing Tax Credit. The DED should work with the General Assembly to establish cost containment provisions regarding project costs claimed under multiple tax credit programs.

Recommendations

The General Assembly:

2.1&
2.2 Consider modifying state law to improve the efficiency of the current tax credit model.

2.3 Require the DED to evaluate the merits of potential projects before credits are authorized.

2.4 Require the DED to issue partial credits upon submission of a completed cost certification and confirmation of SHPO approval.

2.5 Establish more strict eligibility criteria for owner-occupied residences receiving historic credits.

2.6 Establish a sunset provision for the HPTC program.

2.7 Establish cost containment provisions regarding project costs claimed under multiple tax credit programs.

3. Program Administration

Opportunities exist to improve the administration of the HPTC program. Oversight of projects could be improved, the DED does not have adequate controls to ensure reported costs are reasonable, and the DED needs to ensure cost eligibility criteria are applied consistently. In addition, the economic impact of the HPTC being reported to the General Assembly does not accurately measure the economic impact of the program.

3.1 Project oversight

The DED's oversight of projects could be improved. State agency personnel do not conduct site visits to verify work has been completed, and the cost certification work performed by DED is inefficient and redundant.

At the completion of the project the SHPO and DED review before and after photographs and floor plans, and determine whether the completed work is consistent with the applicant's rehabilitation plan and the Secretary of the Interior's Standards for Rehabilitation. The DED then reviews the CPA's cost certification and determines the final qualified expenditures and the allowable tax credit amount. The DED's review of the cost certification includes reviewing selected invoices for projects with total costs of $250,000 or greater and all invoices for projects with total costs of less than $250,000.

Site visits and square footage cost analysis

Neither DED nor SHPO personnel typically perform site visits of completed projects to verify the planned work has been completed, or perform square footage cost analysis to determine if costs claimed appear reasonable. Officials from both agencies said they typically do not perform site visits, though SHPO officials stated they will perform a site visit if they have concerns regarding the completed work. DED officials indicated they do not analyze costs on a square foot basis or compare categories of costs with past projects of similar size. DED officials also indicated the cost of historic rehabilitations can vary greatly and there is no industry standard regarding cost per square foot for a historic building.

Virginia fraud

Officials in Virginia indicated they recently discovered several large cases of developer fraud involving at least three developers that resulted in millions of dollars in tax credits issued for fraudulently reported expenditures. These developers had submitted cost certifications prepared by independent CPA firms; however, the CPA firms did not detect the falsified invoices and are not required to assess the reasonableness of costs or perform independent confirmations of the invoiced amounts. Virginia officials indicated the majority of fraudulent expenditures consisted of items that would not be readily identifiable in the photographs submitted such as mechanical, electrical, and plumbing repairs or upgrades. Virginia officials indicated the fraudulent projects were identified when they calculated a cost per square foot for the projects that was significantly more than expected based on past rehabilitations of similar size.

Virginia now requires a site visit by a state construction inspector prior to the issuance of the state tax credits. The inspector meets with the developer to discuss the work completed on the project and then reviews the project costs as reported by the CPA to determine if there are any obvious discrepancies and whether reported costs appear to be reasonable given the scope of the rehabilitation, age of the building, size of the building, and other factors. Additionally, Virginia officials now calculate the cost per square foot for every project and will perform additional review if this calculation exceeds a certain threshold, which may include additional review of invoices or confirmation of invoiced amounts directly with the contractor or vendor.

Utilizing a risk-based approach to project oversight and performing site visits to verify project costs, and reducing the amount of cost certification work performed, would allow the DED to increase the efficiency and timeliness of the review process. Keeping a database of previous costs and calculating average costs by type and size of project would help the DED identify projects with potentially inflated costs, and would help determine if project costs are reasonable, or whether a project should be subject to additional review. Current DED procedures that duplicate a significant portion of the CPA cost certification process do not appear to be an efficient use of DED resources.

3.2 Average approval time

The DED does not currently monitor project approval time to ensure compliance with state law. Statutory changes in 2009 included provisions mandating timely issuance of credits. Section 253.559.8, RSMo, requires the DED to issue credits within 12 months of project completion. This standard was not met for two of ten projects reviewed; however, these applicants did not submit the final application and cost certification until 4 months and 9 months after project completion. The DED analyzed approval time during 2011 and found the average approval time, which includes the time from when the applicant submits the final application and cost certification to when credits are issued, had decreased from 6.8 months to 6.4 months in fiscal year 2010 and decreased again to 5 months in fiscal year 2011. In 2012, the DED increased the number of cost reviewers and modified procedures in an effort to reduce the time necessary for the final review, but because the DED has not continued to monitor approval time, it is not clear if the increased staffing has improved approval time by any significant measure.

Officials stated it is not always feasible for the DED to meet the statutory deadline due to delays in the applicant's submission of the cost certification or significant delay by the applicant in responding to questions or additional requests. Several CPA firms indicated it generally takes them several months to complete the cost certification, though one firm indicated the larger projects can take up to a year to complete.

Monitoring approval time on an ongoing basis would allow the DED to assess compliance with state law and help ensure projects are approved in a timely manner.

3.3 Program activity projections

Program activity projections reported to the General Assembly annually on the tax activity report appear to overstate the economic impact of the HPTC program. While the primary purpose of the HPTC program is to redevelop state historic structures, reliable and reasonable economic projections should be reported to the General Assembly.

The fiscal year 2012 tax activity report for the HPTC indicates that over the next 10 years the projects authorized for credits in fiscal year 2012 will return $0.41 in state revenue for every dollar of tax credit authorized, create $2.2 billion in new economic output, and create approximately 2,400 new jobs. The economic activity projections reported are based on data provided in the preliminary project applications. Applicants must report the estimated project construction expenditures and estimated number of permanent jobs that will be created as a result of the project.

Level of activity

The economic activity projections provided by DED contain several flawed assumptions regarding the level of activity. DED projections assume *no* historic preservation activity would take place if not for the state credit, and also assume 100 percent of authorizations will be utilized.

With the existence of the federal historic credit, the assumption of zero historic preservation activity in the absence of the state program is unreasonable. While there is little doubt the existence of a state program increases the amount of preservation activity in a given state, some level of activity would occur without a state program. Several states including Michigan, California, and Pennsylvania have no state tax credit program but still ranked among the top ten states nationally for average federal QRE. Moreover, while there were 14 projects completed in the first year of Minnesota's recently implemented historic preservation program, there were 4 projects completed in the previous year when no state credits were available.

DED projections assume 100 percent of authorizations will be utilized; however, our review of HPTC program data shows a small portion of original authorizations are not utilized since some projects require less tax credits than planned or do not proceed with construction. It is unreasonable to assume all applicants will complete their projects because some applicants voluntarily withdraw or fail to proceed with construction for various reasons such as lack of financing, changes in economic conditions, or discovery of additional damages to the building.

Number of jobs

The DED does not verify or review the accuracy of the number of jobs reported on the preliminary application. While the number of jobs used for economic impact purposes is intended to represent only new, permanent jobs, it is not clear whether applicants may be reporting jobs that existed in the same building prior to the rehabilitation or reporting jobs for businesses that move from a nearby location. For example, the preliminary application for one project reviewed reported 30 new jobs would be created; however, this amount included jobs of a business that moved into the renovated space from its existing location across the street. In addition, while the DED report included 30 jobs based on the preliminary application, the applicant reported only 17 jobs on the final application submitted after the project was completed, a decrease of about 43 percent.

3.4 Cost eligibility

Several developers, historic preservation consultants, and representatives of CPA firms indicated they commonly observe disagreements between applicants and the DED regarding eligibility of certain costs. These parties indicated it is common for applicants to report higher QRE when applying for the federal credit than the state credit because the DED is inconsistent in what it considers QRE. Minor differences between the federal and state QRE are expected because the DED has chosen to apply percentage limits to certain types of soft costs; however, parties we spoke to said other differences including types of costs eligible are not reasonably explained by the DED.

Missouri's definition of QRE uses the federal definition as a baseline, and permits certain other expenses to qualify. The federal rehabilitation tax credit program defines qualified rehabilitation expenditures in 26 USC 47(c)(2)(A) of the Internal Revenue Code of 1986. Generally, permanent improvements made within the footprint of a building are considered eligible costs and soft costs, such as architect's fees, that are directly related to the rehabilitation also qualify. The DED publishes a list of potentially qualifying and non-qualifying expenditures in application materials, though this information is not intended to be a comprehensive list.

DED officials indicated they allow the developer and CPA firm to submit additional documentation to support why disputed expenditures should be considered QRE, but the DED retains the right to make the final decision. The SHPO indicated disagreements with applicants involving approval of proposed or completed rehabilitation work are somewhat rare.

To ensure developers are treated fairly and to eliminate future disagreements, the DED should review procedures currently in place to ensure cost eligibility decisions are consistent.

Recommendations

The DED:

3.1 Implement procedures requiring mandatory site visits and square footage cost analysis.

3.2 Monitor approval time on an ongoing basis to assess compliance with timeframes required by state law.

3.3 Establish procedures to ensure the economic benefit projections reported to the General Assembly reflect the most realistic assessment of program performance.

3.4 Review procedures to ensure decisions regarding the eligibility of costs are consistent.

Auditee's Response

3.1 DED and SHPO oversight of the Missouri Historic Preservation Tax Credit Program is designed to ensure that tax credits are issued only for eligible costs and expenses, including through independent verification of cost certification documentation, review of extensive photographic evidence of completed work, and periodic site visits by SHPO. DED will work with SHPO to evaluate additional opportunities to employ site visits in the oversight process. However, there is currently no legal authority to deny tax credits based on a mandatory cost per square foot limit, making the value of such an analysis is unclear in light of the numerous other oversight techniques employed to detect fraud and refer any such fraud for prosecution.

*One such example is the independent verification of documentation supporting the cost certification submitted by a tax credit applicant's CPA. DED disagrees with the audit's statement that such verification is "inefficient and redundant" and the suggestion that DED should instead rely on the applicant's CPA in determining the amount of tax credits to issue. Indeed, DED is required to independently verify all costs and expenses in order to faithfully discharge its duties under Section 253.559.7, RSMo (requiring that "the approval of all applications and the issuing of certifications of eligible credits to taxpayers **shall be performed by the department of economic development**.") (emphasis added).*

*3.2 DED issues Historic Preservation Tax Credits in compliance with state law and will continue to monitor approval time on an ongoing basis to assess compliance. Section 253.559.8, RSMo, provides that tax credits "shall be issued in the final year that cost and expenses of rehabilitation of the project are incurred **or** within the twelve-month period immediately following the conclusion of such* *rehabilitation." (emphasis added). Pursuant to this provision, DED issues tax credit certificates for the year of project completion following review of a complete application and supporting documentation. Approval times are directly impacted by the completeness of the application and supporting documentation submitted by the applicant to substantiate the eligibility of costs and expenses of rehabilitation. For example, as pointed out in the audit, it can take CPAs up to a year to submit the necessary documentation to DED, which directly impacts the time in which tax credits are issued.*

3.3 The economic benefit projections performed by DED related to the Missouri Historic Tax Credit Program are performed in accordance with Section 33.282.2, RSMo and based on information submitted by tax credit applicants pursuant to Sections 253.550 to 253.559, RSMo and the Tax Credit Accountability Act of 2004, Sections 135.800 to 135.830, RSMo.

3.4 DED administers the Missouri Historic Preservation Tax Credit Program in accordance with state law to ensure that tax credits are only issued for costs and expenses that are actually eligible for tax credits and not simply for all costs and expenses an applicant claims for tax credits. The State Auditor is correct that developers will occasionally try to claim tax credits for costs and expenses that are not eligible for tax credits under state law, which does create disagreements between DED and developers when such claims are denied. Based on a review of files from the past two years, some of the most common reasons for a portion of claimed tax credits being denied include that the credits were claimed for non-qualifying purchases such as supplies and equipment (i.e. tangible personal property) or that the applicant failed to provide proofs of payment for the costs and expenses claimed. As indicated in the audit, DED affords applicants every opportunity to provide documentation substantiating the claimed costs and expenses and will continue to do so in order to ensure consistency.

Auditor's Comment

3.1 We are not suggesting the DED should "deny tax credits based on a mandatory cost per square foot limit," but that the DED could improve the efficiency of program oversight by implementing a more risk-based approach by making site visits and reviewing costs analytically. In addition, the DED's contention that Section 253.559, RSMo, requires it to independently verify all costs and expenses is not accurate as the statute requires the DED to determine the amount of eligible costs but does not specify the procedures the DED must utilize to make that determination.

Missouri Historic Preservation Tax Credit Activity

The following table lists the Missouri Historic Preservation tax credits authorized, issued, and redeemed for fiscal years 2003 through 2013. The figures presented reflect amounts provided as of our fieldwork completion and may not reflect amounts reported by DED on past or future tax credit activity reports.

Fiscal Year	Amount Authorized	Amount Issued	Amount Redeemed
2003	$ 106,928,335	96,906,086	43,153,986
2004	107,245,788	76,348,131	66,089,980
2005	94,161,535	80,192,409	74,532,355
2006	208,213,201	107,470,280	103,134,226
2007	142,714,495	172,693,813	132,841,728
2008	133,125,322	161,621,537	140,111,002
2009	181,629,134	119,914,948	186,426,164
2010	55,579,398	107,196,640	107,973,542
2011	80,108,743	116,244,410	107,767,393
2012	98,542,596	105,272,651	133,937,747
2013	93,923,652	71,495,994	78,814,711
Totals	$ 1,302,172,199	1,215,356,899	1,174,782,834

Source: Reports obtained from the DED Customer Management System and the Department of Revenue.

Tax Credit Redemptions

The following table shows redeemed tax credits for fiscal years 2010 through 2013 for all state tax credit programs. We did not audit the information.

Program	Year Ended June 30, 2010	2011	2012	2013
Adoption (Special Needs)	$ 1,894,187	1,346,454	1,036,226	744,155
Affordable Housing Assistance	11,647,956	4,880,797	5,629,466	7,406,988
Agricultural Product Utilization Contributor	114,674	466,048	1,468,156	1,267,239
Alternative Fuel Vehicle Refueling Property[1]	0	23,365	45,690	69,454
Bank Franchise	2,013,584	4,233,673	2,333,619	2,559,444
Bank Tax Credit for S Corporation Shareholders	1,823,612	2,787,708	5,523,276	4,533,837
Brownfield Jobs/Investment	1,650,222	1,620,384	1,660,626	68,693
Brownfield Remediation	17,590,273	11,432,109	16,967,400	6,378,613
Business Use Incentives for Large-Scale Development (BUILD)	8,306,413	10,976,914	6,591,948	8,212,533
Business Facility	2,883,729	5,682,965	4,867,041	4,572,711
Certified Capital Business[2]	495,459	586,135	411,014	590,235
Charcoal Producers[1]	14,642	521,380	59,595	0
Children in Crisis	420,857	587,137	629,456	792,368
Community Development Corporation[2]	5,915	22,703	224	231
Development	1,589,618	1,001,142	3,856,648	3,863,814
Developmental Disability Care Program	n/a	n/a	0	7,819
Disabled Access	12,526	26,273	24,791	14,603
Distressed Areas Land Assemblage	6,731,635	13,534,347	7,558,203	1,651,415
Domestic Violence	789,233	757,609	988,996	851,517
Dry Fire Hydrant[1]	2,634	7,715	3,124	0
Enhanced Enterprise Zone	2,916,392	4,000,689	7,324,093	6,451,698
Enterprise Zone	1,479,702	1,128,432	232,990	557,312
Examination Fees and Other Fees	5,227,134	4,974,981	4,926,191	5,886,105
Family Development Account	3,000	25,000	10,616	95
Family Farms Act	104,798	49,825	53,948	32,032
Film Production	1,925,158	1,563,218	4,839,217	56,665
Food Pantry	793,734	1,081,076	796,156	72,822
Health Care Access Fund	0	0	0	0
Historic Preservation	107,973,542	107,767,393	133,937,747	78,814,711
Homestead Preservation[1]	2,478,624	773,465	0	0
Life and Health Guarantee Association	0	3,260,829	3,306,409	5,664,124
Low Income Housing	142,141,458	143,055,387	164,208,547	144,082,976
Maternity Home	762,701	726,355	1,354,431	1,138,969
MDFB Bond Guarantee	0	0	0	0
MDFB Infrastructure Development	13,970,215	25,597,348	33,444,754	14,804,416

Appendix B
Tax Credit Redemptions

Program	Year Ended June 30, 2010	2011	2012	2013
Missouri Automotive Manufacturing Jobs Act	n/a	0	0	0
Missouri Health Insurance Pool	7,896,391	10,931,565	14,318,218	16,874,865
Missouri Property and Casualty Guarantee Association	592,308	(53)	0	0
Missouri Quality Jobs	14,238,179	27,936,799	35,431,828	39,278,156
Neighborhood Assistance	10,065,993	8,513,472	9,757,095	7,392,113
Neighborhood Preservation	6,739,123	4,427,639	2,159,654	1,232,214
New Enterprise Creation[2]	77,098	11,499	25,000	0
New Generation Cooperative Incentive	3,287,882	1,984,424	826,953	2,100,091
New Jobs Training	3,228,601	3,175,559	4,090,193	3,081,261
New Market	0	1,199,285	15,385,989	12,934,464
Pregnancy Resource	1,198,394	1,103,384	1,892,183	1,194,477
Property Tax	118,594,589	114,886,668	117,603,638	113,962,551
Public Safety Officer Surviving Spouse	11,910	16,861	32,793	78,249
Qualified Beef	0	9,447	219,062	522,858
Rebuilding Communities	1,553,894	1,277,135	1,388,190	1,430,329
Qualified Research Expense[1]	890,135	n/a	n/a	n/a
Residential Dwelling Accessibility	23,040	20,086	6,501	10,258
Residential Treatment Agency	47,599	323,376	283,501	292,396
Retain Jobs	8,145,996	5,758,163	2,403,687	1,960,931
Self-Employed Health Insurance	652,850	1,428,143	1,847,045	1,811,060
Shared Care	159,222	44,152	70,004	41,645
Small Business Incubator	219,014	107,549	166,336	68,441
Small Business Investment (Capital)[1]	0	1,701	(19,395)	0
Transportation Development[1]	9,176	52,124	9,342	12,510
Wine and Grape Production	112,057	29,411	61,598	15,301
Wood Energy	1,546,453	3,818,378	2,282,401	3,563,209
Youth Opportunities	4,405,158	3,589,991	4,979,138	3,906,263
Total	$ 521,458,689	545,145,614	629,311,552	512,911,236

n/a - Tax credit did not exist in this fiscal year.

[1] The tax credit has expired or has been repealed. Redemptions may be reported due to carry forward provisions.
[2] The tax credit program has met the cumulative program cap.

Source: Office of Administration, Department of Revenue, and tax credit administering agencies