

Government of the District of Columbia  
Office of the Chief Financial Officer

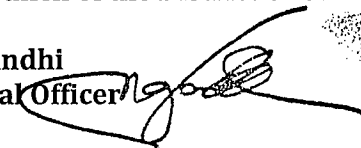


**Natwar M. Gandhi**  
Chief Financial Officer

**TAX ABATEMENT FINANCIAL ANALYSIS**

**TO:**                   **The Honorable Vincent C. Gray**  
                              **Mayor, District of Columbia**

**The Honorable Kwame R. Brown**  
                              **Chairman, Council of the District of Columbia**

**FROM:**               **Natwar M. Gandhi**  
                              **Chief Financial Officer** 

**DATE:**               **November 22, 2011**

**SUBJECT:**           **"Old Naval Hospital Real Property Tax Assistance Act of 2011"**

**REFERENCE:**       **Bill Number 19-503 - Draft Committee Print**

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**Findings**

The property tax exemptions proposed by Bill 19-503 are necessary if the District would like the Old Naval Hospital to be operated as the Hill Center, in accordance with the restrictions in the ground lease entered into between the District of Columbia and the Old Naval Hospital Foundation in December 2010 (Ground Lease).

Because this community center project has obtained federal subsidies in the form of federal tax credits, the nonprofit developer and operator, who would otherwise be eligible for tax exemptions under existing District law, is now required to pay possessory interest and deed recordation and transfer taxes. The proposed legislation would exempt the property from real property, possessory interest,<sup>1</sup> and deed recordation and transfer taxes. This exemption is needed during the five-year period that the tax credit structure is expected to be used for the project.

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<sup>1</sup> The bill, as currently drafted, does not include an exemption from possessory interest tax and transfer tax. It is the understanding of the Office of the Chief Financial Officer, based on conversations with Council staff, that the bill will be marked up to include an exemption from possessory interest tax and transfer tax. Because the Property is ground leased from the District to the Foundation and not owned by the Foundation, the Foundation is subject to possessory interest tax rather than real property tax.

## **Background**

The proposed legislation would exempt the Old Naval Hospital Foundation (Foundation) from real property, possessory interest, and deed recordation and transfer taxes for the property located in Square 948, Lot 5 (Property). The Office of Property Management (now the Office of General Services) selected the Foundation through a competitive Request for Proposal process to rehabilitate the dilapidated Civil War Era Old Naval Hospital (Old Naval Hospital), which is located on the Property. In 2010, the Foundation entered into a grant agreement with the District, which authorized up to \$5.5 million in District funds for the rehabilitation of the Old Naval Hospital (Grant Agreement). Also in 2010, the Foundation signed a 65-year ground lease with the District (Ground Lease), which required the Foundation to rehabilitate the Old Naval Hospital and to operate it as the Hill Center, offering various community amenities.

The construction on the Hill Center is complete, and it opened to the public this fall. Although the construction is complete, the Foundation is relying upon the use of the Federal Historic Preservation Tax Incentives Program (Historic Tax Credit) to reimburse the Foundation for private donations that were used to rehabilitate the Old Naval Hospital. The Historic Tax Credit equity will allow the Foundation to use a portion of the private donations to offset operating losses during the start-up years of the Hill Center. The Foundation expects to close on the Historic Tax Credit equity structure before the end of the calendar year.

To comply with the IRS Historic Tax Credit requirements,<sup>2</sup> the Foundation created a number of for-profit entities, including one to which the Foundation has leased the Property. The Property has therefore become subject to possessory interest and deed recordation and transfer taxes. However, the Hill Center will continue to be managed by the Foundation through an agreement with the for-profit entity and will continue to be subject to the use restrictions found in the Ground Lease. In the absence of the federal subsidy, the nonprofit Foundation would be eligible for tax exemptions under existing District law. The Historic Tax Credit structure is intended to be in place for five years. After five years, it is expected that the for-profit entities will be removed from the ownership structure and the Foundation will return to being the single operator and owner of the Property.

## **Financial Analysis**

The Exemptions and Abatements Information Requirements Act of 2011 requires the analysis provided by the Office of the Chief Financial Officer (OCFO) to contain certain information. The required information is included below.

A separate fiscal impact statement will be prepared on the proposed legislation.

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<sup>2</sup> The Historic Tax Credit program allows taxpayers who are rehabilitating historic buildings to claim a credit against federal income tax based on the certified cost of the rehabilitation. The tax credit can only be claimed by the for-profit owners of a building. Therefore, it is standard practice for nonprofit owners to admit an historic tax credit investor into the ownership structure and to allocate to them the tax credits in exchange for a cash contribution. To comply with law and IRS regulations, nonprofit owners must sub-lease their property to a for-profit entity.

Terms of the Exemption or Abatement

The legislation states that the Property shall be shall be exempt from taxation so long as it continues to be leased by the Foundation and operated as the Hill Center in accordance with the restrictions in the Ground Lease. The OCFO understands that the exemption granted by the legislation be limited to the five-year time period in which the Historic Tax Credit structure is in place.

1. Annual Proposed Value of the Exemption or Abatement

Based on the expected five-year timeframe of the Historic Tax Credit structure, if the Foundation was required to pay possessory interest and deed recordation and transfer taxes, the OCFO estimates the proposed value of the exemptions to be:

	FY2012	FY2013	FY2014	FY2015	FY2016	Total
<b>Amount of Possessory Interest Tax to be Exempted</b>	\$200,464	\$279,581	\$287,968	\$295,455	\$304,319	\$1,367,787
<b>Amount of Recordation and Transfer Taxes to be Exempted</b>	\$ 16,261	\$ -	\$ -	\$ -	\$ -	\$ 16,261
<b>Total</b>	<b>\$216,725</b>	<b>\$279,581</b>	<b>\$287,968</b>	<b>\$295,455</b>	<b>\$304,319</b>	<b>\$1,384,048</b>

2. Summary of the Proposed Community Benefits

A summary of the proposed community benefits as submitted by the Old Naval Hospital Foundation is attached to this analysis.

3. Financial Analysis for Development Projects

*A. Review and Analysis of the Financing Proposal Including Advisory Opinion Stating Whether or Not It is Likely that the Project Could Be Financed Without the Proposed Exemption or Abatement*

The Foundation provided the OCFO with their financing sources and uses as well as projections for five years of cash flows. Based on the OCFO's analysis of the information provided, it is not likely that the project could be financed without the proposed exemptions.

If the for-profit entity created by the Foundation for Historic Tax Credit purposes was required to pay deed recordation and possessory interest taxes, the annual cash flow is estimated to be negative until at least 2016. As a result, the proposed tax exemptions are necessary for the Foundation to close on the Historic Tax Credit equity and to operate the Hill Center without an ongoing deficit.

*B. Estimate of the Amount of Exemption or Abatement Necessary to Enable the Project to Be Financed*

The proposed exemptions from deed recordation and possessory interest tax are likely to be necessary during the period of time that the tax credit structure is in place. The analysis assumes that the structure will remain in place for five years. During the five-year period, the OCFO estimates the value of the exemptions to be approximately \$1.4 million. At the end of this period, the Foundation could terminate the sublease to its for profit subsidiary, and apply for an exemption with the Office of Tax and Revenue.

*C. Assessment of the Developer's Documentation of Efforts to Seek Alternate Financing and the Factors that Limit the Developer's Ability to Obtain Adequate Financing*

The Foundation has sought various forms of alternative financing. It has secured approximately \$2.2 million in federal grants, a \$150,000 Save America's Treasures grant, and \$1.2 million in net equity through the use of the Historic Tax Credit Program. The Foundation has raised approximately \$440,000 in private donations for the financing of the project, in addition to private donations for the ongoing operations of the Hill Center. The project financing sources and uses are below:

<b>Sources</b>	
DC Government Grant	\$ 5,400,000
US Government Grant	\$ 2,186,000
Proceeds from Sale of Federal Tax Credit (net of legal and accounting fees)	\$ 1,202,000
DC Arts and Humanities Grant	\$ 485,000
Private Donations	\$ 438,931
Interest/Dividend Income	\$ 318,869
Save America's Treasures Grant	\$ 150,000
<b>Total Financing Sources</b>	<b>\$ 10,180,800</b>
<b>Uses</b>	
Historic Renovation of Building (including Equipment and Furnishings)	\$ (9,924,000)
Revenue Sharing Reserves Required by Tax Credit Investor	\$ (6,800)
Operating Reserve Required by Tax Credit Investor	\$ (250,000)
<b>Total Financing Uses</b>	<b>\$ (10,180,800)</b>

It is unlikely that the Foundation would be able to secure traditional debt or equity because its nonprofit business model does not create sufficient net operating income to make debt service or equity payments. The Foundation plans to continue to rely upon private donations to bolster its revenue over the next five years.