

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

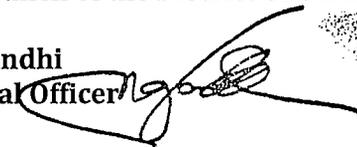


Natwar M. Gandhi
Chief Financial Officer

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**

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,¹ 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.

¹ 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,² 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.

² 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
Amount of Possessory Interest Tax to be Exempted	\$200,464	\$279,581	\$287,968	\$295,455	\$304,319	\$1,367,787
Amount of Recordation and Transfer Taxes to be Exempted	\$ 16,261	\$ -	\$ -	\$ -	\$ -	\$ 16,261
Total	\$216,725	\$279,581	\$287,968	\$295,455	\$304,319	\$1,384,048

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:

Sources	
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
Total Financing Sources	\$ 10,180,800
Uses	
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)
Total Financing Uses	\$ (10,180,800)

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.

**Information in Support of a Request for Tax
Abatement or Exemption
for the Old Naval Hospital Foundation and the
Hill Center**

Submitted to the District of Columbia Chief Financial Officer

By the

Old Naval Hospital Association

October 27, 2011

\$959,220 or about 80% of the returns from the federal historic tax credit, leaving only \$254,000 for the ONHF and the Hill Center. If ONHF were required to pay those taxes, the levies would nullify over 80% of the value of the tax credit that DC encouraged the ONHF to include in its financing, and together with the legal and accounting fees and other expenses of the transaction, virtually render it meaningless as a financial benefit to the ONHF or the Hill Center.

5. Community Benefits Provided By the Recipient of the Abatement or Exemption

The District of Columbia is the principal investor in the Hill Center Project. It is the fee owner of the Old Naval Hospital and the ultimate beneficiary of any historic and other improvements to the entire site, which was in severely deteriorated condition at the time of the lease to the ONHF, and was continuing to deteriorate at an alarming pace. These improvements, particularly the restoration of this landmark historic building its outbuilding and its fence and landscaping on Capitol Hill, is of substantial value to the District. The quality of the historic restoration that has been carried out at the ONH is already being recognized nationally in publications such as *American Heritage Magazine*, *The National Trust for Historic Preservation's Preservation Magazine* and on National Public Radio, among others. Likewise, the adoption of green technology throughout the building, such as the use of a geothermal system for all heating and cooling, is well noted and exemplary. These physical benefits of the District's role are only the beginning of the benefits to be realized by the District and its people from the Hill Center. Most importantly, the investments of the District will be repaid in a vibrant community program stretching into the future in a neighborhood which currently has no such community center. See also the attached Hill Center DVD which clearly shows the "before and after" condition of the Old Naval Hospital.

Details of these community, economic, and social benefits to the District and Capitol Hill will include:

Revitalizing the Neighborhood. We are taking a derelict property and turning it into an arts and cultural destination, enhancing the neighborhood quality of life, increasing property values and bringing new audiences and visitors to patronize the retail establishments in the community. In addition, the Center will hire up to six part-time staff in addition to its full-time employees.

Building and Strengthening Community. The Center will create a welcoming gathering place for a broad range of individuals and organizations that might not normally intersect. The Center's programming, firmly rooted in arts and

humanities offerings, will be designed to bring these diverse groups together, providing myriad opportunities for new interactions among the citizens of various ages and backgrounds. Our community has never had a center for educational and cultural life with programming so richly connected to the arts and humanities disciplines. The result will strengthen the fabric of our community and foster relationships, understanding and collaboration. Its proximity to the seat of government makes the Center a natural place to convene conversations and discussions of civic import.

Encouraging Volunteerism. Hill Center will have a robust volunteer corps of individuals to serve as docents for interpretive historical exhibits, ushers for performances and staffers for openings of rotating exhibits. Already over 200 individuals have filled out applications committing thousands of hours over the upcoming year.

Opening Doors to Culture. Hill Center will provide training in the demonstration kitchen to teenagers and adults, computer literacy and training to underserved members of the community, financial literacy training, English as a Second Language and literacy classes. These and other programs and courses will enhance the skills of local residents to improve their employment and earnings prospects.

Increasing Employment and Local Business Revenues. The operations of the Hill Center will create 6 full time positions [an executive director, programming manager, operations manager, administrative assistant, and two building custodians] and 8 part time positions, involving a total wage and benefits bill of about \$650,000. Annual salaries and wages range from \$15,000 to \$100,000. During the construction phase of the project, 38.5% of funds disbursed went to District Certified Business Enterprises. About 25 positions were created for District Residents as part of the construction phase

The operation of the Center will attract paying customers to the Capitol Hill area who will spend money on courses and programs, event rentals, office rentals, event catering and supplies, room rental for conferences, meetings and other events, meals and other supplies and services in the area. The estimated annual expenditures for all of these will reach over \$5 million. This will create employment among area profit-making businesses and non-profit organizations, including course and program providers, caterers and restaurants, and a variety of local retail outlets. The indirect employment created by these expenditures will provide economic benefits to the DC community, and create at least 100 jobs. The

DC government will also benefit from the receipt of related sales and other taxes resulting from this increased economic activity.

Expanding Opportunities for Artists and Arts Organizations. Teaching art to students of all ages, we are giving teaching artists the opportunity to reach out by offering the opportunity for emerging and established artists to exhibit and sell their works. We are offering the opportunity for existing organizations like Capitol Hill Arts Workshop and other established nonprofits to expand their reach. We will enable programs and organizations such as the Capitol Hill Art League to reach wider audiences with expanded exhibit space for group and single artist shows. We are making space available for other nonprofit organizations to use Hill Center to create art and cultural events and activities that serve a particular demographic or ethnic interest group.

6. Existing Buildings and 7. Development Projects

Sections 6 and 7 are not clearly relevant to the situation of the ONHF and the Hill Center. It is an existing building, of course, that is not being acquired but rather restored and redeveloped under the terms of a long term ground lease from the DC government. Answers to the questions in Section 6, the better fitting of the two sections, and as they apply to this project, are as follows:

a. Month by month financial projections for the ONH/Hill Center Project for 2011 and 2011 are attached along with a less detailed five year annual projection.

Notes on a. - The pro forma financial projections for the Hill Center (ONHF) clearly illustrate that the exemption of the organization from DC recordation and property taxation is critical to its financial performance. The receipt of the historic tax credit proceeds is essential to the successful startup and operation of the operation, including completion of payments for the construction costs. The ONHF financial statements show that the organization has no reserves to cover the remaining expenditures and startup costs, and it has been unable to secure a line of credit given its lack of assets for security and the risks still present regarding the completion of the tax credit transaction. The principal remaining risk to the Project is the possibility of DC levying recordation and property taxes. This is offset by the possibility that the City Council conferring exemption from the recordation and property taxes.