

# Tax Credit Survivor Story

By Dennis S. Sankovich



So you think you want to restore the historic theatre that will bring energy back to your community, and all you need is a little help raising the money?

Making a viable center of social interaction successful in any given community takes some thought and talent. Above all, it is a **carefully planned process** of investigating, communicating, listening, re-investigating, and engaging with other community leaders.

**Lesson #1: it is NOT fundamentally about the building.** As much as we love the classic beauty of historic theatres, it's really about OPERATING said community center as a fiscally and socially responsible business. It's about what is going to happen on stage to make people want to sit in the seats that are screwed to the floor facing the big gaping hole. What are you going to do to fill this space and touch people enough to pay money to financially support the ongoing success of the business and keep the building from being vacant again?

It's not good enough to say, "I'm restoring this building to present Broadway and have a resident company." It's about exactly where the risk capital will come from to allow you to bring in those shows; how many tickets you'll sell at what prices to pay for all of that; where you'll get the money to cover losses on shows that don't sell as well as expected; what else you can sell and how much more you can and will raise, and from whom, in order to pay the basic staff, supply, and maintenance costs; and where you're going to get the restoration capital, carrying costs, and monthly capital amortization expenses.

Nothing makes this clearer than entering a tax credit program and running that business through the recapture period. That's what I did successfully while leading the Ritz Theatre in Tiffin, Ohio. The Ritz was among the first theatres to lease the building to a for-profit entity to take advantage of historic tax credits, operate profitably for the five year recapture period, then exit the investment partners from the development partnership and returning the building again to the not-for-profit entity that operates it today.

Why did we sell or lease the building twice? That's the way these tax credit deals usually happen, since tax credits are of no worldly value to not-for-profit companies, and non-profits are often the most efficient operators of community-benefit real estate. By the way, you should also take some time to understand all the types of for-profit and non-profit organizations and what makes them different.

**Lesson #2: tax credits are not a grant. They are an "equity investment deal,"** a real estate deal made primarily for a for-profit corporation to save money on taxes, a risk taken for gain by an investor and the government in your real estate development.

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There are severe financial penalties if it doesn't work out! Before selling your tax credits, the "developer" (theatre owner) must present an operating *Pro Forma* that shows it will be successful and remain solvent for seven years, to convince the investors that they should buy the credits. If the operation becomes insolvent or changes in any way over the time of the deal, all the money has to be returned to the investor, including any developer fees. In fact, it is possible for the "developer" – you the theatre operator -- to be sued by the investor, because the government exacts big penalties on the investor, too. And just to make it more fun, the owner and operator/developer can't be the same entity except maybe just a little.

There should be lots of concern and education going on prior to a non-profit group undertaking a tax credit project. The first call is definitely not to an architect, but to a tax attorney expert in tax credit equity investments and/or a CPA who specializes in real estate investing and development if you are considering a tax credit deal for your development. You should also have a good handle on you operation and what business are you planning to be in to cash flow the operation of the theatre. For what business purpose are you developing this theatre and how do you know you are going to survive financially over the next five to seven years. Then, how can you prove it. You need a well thought out business plan with five to seven year financials to show the investor this is a solvent project to be involved with. Then, you have to live by it for that period as a professionally run business.

**Lesson #3: all operating decisions during the recapture period must reflect the tax credit deal.** I can tell you my personal experience with doing a tax credit deal at the Ritz. Our theatre was owned by a for-profit c-corp holding company, leased to a Limited partnership, and operated by a for-profit partnership which was professionally managed by the non-profit corporation. It was necessary for us to run two sets of books and have an audit on the nonprofit and for-profit operations, as well as tax accounting for the nonprofit, the c-corp holding company and the Limited partnership. This increased annual operating costs and we had to develop an exit strategy for the Partners to leave without a major buyout.

The operations had to remain solvent with no changes in ownership during the period and no substantial change in business position. The operation must also have competent management and a steady board to understand the working of the deal in order to survive it. The Ritz's operations were under the for-profit partnership for five years, which meant many advantages of tax exempt organizations was not possible for operations any longer and this had to be figured into the budgeting. There were many issues with raising funds for the nonprofit after the deal, surrounding who actually operates the theatre and determines how to maximize profit versus serving the public good, not to mention trying not to jeopardizing the non-profit status of the managing organization who would eventually take over the theatre again after the deal. And finally, you must protect the nonprofit's 501-c-3 status from being challenged after the

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deal as well by the IRS, depending on how things are set up. These are both management and legal issues that need to be addressed throughout the planning and implementation process of a tax credit real estate deal.

**Lesson #4: planning before the deal is critical to getting out.** It's my understanding that a tax credit equity investment deal can't include a negotiated exit strategy, because then it would be an illegal tax shelter. At the "end of the day," after the recapture period, the partners have to agree to sell or donate their partnership shares and sell their ownership rights back to the developer/operator/community servant.

There are also professional fees before, during and after the deal that need to be discussed and planned for up front. The operating organization must plan ahead to cover these costs. All of these costs need to be a part of the total construction budget along with all of the other capital campaign costs. Everyone should remember two very important standard adages, "It takes money to raise money" and "construction can spend your money faster than you can raise it."

I think that, ideally, the tax credit real estate deal should not come at the beginning of fund raising, but at the end, once an organization has raised enough funds to make the deal work. In some states, bond funds cause some sticky situations in selling the tax credits and this needs to be understood and planned around. For example, in Ohio, the state takes ownership of the property in order to use bond funds, which negates the tax credit deal. I know there are lots of creative ways around all of this, but an organization needs to understand how it all works to make it operate after being creative. At the Ritz, I separated the historic theatre from the new construction addition behind the stage house by a property line at the stage wall. Since most of the new construction did not qualify for the credit, I kept the Studio Theatre and new addition in the ownership of the Non-profit. Then, by timing I was able to receive state funds by the non-profit to finish the new construction.

At the end of the day at the Ritz, I had one partner who didn't want to leave the investment because they liked the "paper losses" from operation & depreciation and we could not afford to buy them out. We were offering a charitable donation plan which helped cover most of their tax situation but it still took some negotiation. I had bankers who were in on the creation of the deal and very supportive, but at the end of the day they had moved on and I was dealing with entirely new people in charge who had no clue about the deal. This was true on my board as well, new players on the board who could not appreciate the corporate history even though they were briefed. A tax credit real estate deal is a long term partnership that must be managed throughout all phases of the deal. As a partnership with your investors, you need to keep them involved with your organization and how the business is going. This has many benefits as well beyond the deal because you are a close partner with an investor who may also be charitable in years to come.

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**The bottom line** is that tax credit equity investment is an excellent way to finance part of a successful theatre restoration or rehabilitation, but is a complicated tool for sophisticated real estate developers.

**For a deal to be wildly successful** for you and your community you should:

- Plan it carefully, knowing exactly why you are making each choice;
- Budget carefully, not only immediate costs but carrying costs, exit costs, and contingency funds;
- Focus on operations, including spending your construction money to help and support your immediate and future operational needs;
- Choose experienced consultants for the feasibility studies as well as the architectural components, accountants and attorneys;
- Choose experienced investors who know why they (and you) are doing the deal and are doing more than one. Keep them informed.

The League of Historic American Theatres provides excellent, helpful resources. Their on-line "Historic Theatre Restoration and Rehabilitation Manual" is of special value, as is LHAT Chat and the member directory. I have gained much knowledge and information from my association with the League over the past nineteen years, and all of my LHAT colleagues and friends have always freely helped me a great deal. Please contact me if I can do the same for you.

Best of luck with your project! -- Dennis S. Sankovich

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**Dennis Sankovich is currently the founding Executive Director of the Riley Center in Meridian, Mississippi. This multi-theater facility in meticulously restored historic buildings opens in September, 2006. It is part of Mississippi State University.** Formerly the longtime head of the historic Ritz Theatre in Tiffin, Ohio, Dennis has a twenty-five year career in the performing arts business including twenty years managing and operating theatres. As the executive director of the Ritz Theatre, Mr. Sankovich managed a major renovation/restoration project for the theatre and grew the theatre's programming to present over 128 days a year with a total annual operating budget of over \$1.4 million. Mr. Sankovich has served as board member and treasurer of the League of Historic Theatres and provided consulting services for the League. In addition, he has significant experience in governmental relations, grant writing and box office management. Mr. Sankovich received a Bachelor of Arts degree in performing arts management and a Master of Public Administration with a major in nonprofit organization management, as well as continuing education work in fundraising, arts advocacy and public relations through the Ohio Arts Council and New York Foundation for the Arts.