

Reg. Section 1.48-12(b)(2)(iv)

Qualified rehabilitated building; expenditures incurred after December 31, 1981.

(b) Definition of qualified rehabilitated building—

(1) In general. The term "qualified rehabilitated building" means any building and its structural components—

- (i) That has been substantially rehabilitated (within the meaning of paragraph (b)(2) of this section) for the taxable year,
- (ii) That was placed in service (within the meaning of § 1.46-3(d)) as a building by any person before the beginning of the rehabilitation, and
- (iii) That meets the applicable existing external wall retention test or the existing external wall and internal structural framework retention test in accordance with paragraph (b)(3) of this section.

The requirement in paragraph (b)(1)(iii) of this section does not apply to a certified historic structure. See paragraphs (b) (4) and (5) of this section for additional requirements related to the definition of a qualified rehabilitated building.

(2) Substantially rehabilitated building—

(i) Substantial rehabilitation test. A building shall be treated as having been substantially rehabilitated for a taxable year only if the qualified rehabilitation expenditures (as defined in paragraph (c) of this section) incurred during any 24-month period selected by the taxpayer ending with or within the taxable year exceed the greater of—

(A) The adjusted basis of the building (and its structural components), or (B) \$5,000.

(ii) Date to determine adjusted basis of the building—

(A) In general. The adjusted basis of the building (and its structural components) shall be determined as of the beginning of the first day of the 24-month period selected by the taxpayer or the first day of the taxpayer's holding period of the building (within the meaning of section 1250(e)), whichever is later. For purposes of determining the holding period under section 1250(e), any reconstruction that is part of the rehabilitation shall be disregarded.

(B) Special rules. In the event that a building is not owned by the taxpayer, the adjusted basis of the building shall be determined as of the date that would have

been used if the owner had been the taxpayer. The adjusted basis of a building that is being rehabilitated by a taxpayer other than the owner shall thus be determined as of the beginning of the first day of the 24-month period selected by the taxpayer or the first day of the owner's holding period, whichever is later. Therefore, if a building that is being rehabilitated by a lessee is sold subject to the lease prior to the date that the lessee has substantially rehabilitated the building, the lessee's adjusted basis is determined as of the beginning of the first day of the new lessor's holding period or the beginning of the first day of the 24-month period selected by the lessee (the taxpayer), whichever is later. If, therefore, the first day of the new lessor's holding period were later than the first day of the 24-month period selected by the lessee (the taxpayer), the lessee's adjusted basis for purposes of the substantial rehabilitation test would be the same as the adjusted basis of the new lessor as determined under paragraph (b)(2)(vii) of this section. If a building is sold after the date that a lessee has substantially rehabilitated the building with respect to the original lessor's adjusted basis, however, the lessee's basis may be determined as of the first day of the 24-month period selected by the lessee or the first day of the original lessor's holding period, whichever is later, and the transfer of the building will not affect the adjusted basis for purposes of the substantial rehabilitation test. The preceding sentence shall not apply, however, if the building is sold to the lessee or a related party within the meaning of section 267(b) or section 707(b)(1).

(iii) Adjusted basis of the building—

- (A) In general. The term "adjusted basis of the building" means the aggregate adjusted basis (within the meaning of section 1011(a)) in the building (and its structural components) of all the parties who have an interest in the building.
- (B) Special rules. In the case of a building that is leased to one or more tenants in whole or in part, the adjusted basis of the building is determined by adding the adjusted basis of the owner (lessor) in the building to the adjusted basis of the lessee (or lessees) in the leasehold and any leasehold improvements that are structural components of the building. Similarly, in the case of a building that is divided into condominium units, the adjusted basis of the building means the aggregate adjusted basis of all of the respective condominium owners (including the basis of any lessee in the leasehold and leasehold improvements) in the building (and its structural components). If the adjusted basis of a building would be determined in whole or in part by reference to the adjusted basis of a person or persons other than the taxpayer (e.g., a rehabilitation by a lessee) and the taxpayer is unable to obtain the required information, the taxpayer must establish by clear and convincing evidence that the adjusted basis of such person or persons in the building on the date specified in paragraph (b)(2)(ii) of this section is an amount that is less than the amount of qualified rehabilitation expenditures incurred by the taxpayer. If no such amount can be so established, the adjusted basis of the building will be deemed to be the fair market value of the building on the relevant date. For purposes of determining the adjusted basis of a building, the portion of the adjusted basis of a building that is allocable to an addition (within the meaning of paragraph (b)(4)(ii) of this section) to the building that does not meet the age requirement in paragraph (b)(4)(i) of this section shall be disregarded. (See

paragraph (b)(2)(vii) of this section for the rule applicable to the determination of the adjusted basis of a building when qualified rehabilitation expenditures are treated as incurred by the taxpayer.)



- (iv) Rehabilitation. Rehabilitation includes renovation, restoration, or reconstruction of a building, but does not include an enlargement (within the meaning of paragraph (c)(10) of this section) of new construction. The determination of whether expenditures are attributable to the rehabilitation of an existing building or to new construction shall be based upon all the facts and circumstances.
- (v) Special rule for phased rehabilitation. In the case of any rehabilitation that may reasonably be expected to be completed in phases set forth in written architectural plans and specifications completed before the physical work on the rehabilitation begins, paragraphs (b)(2) (i), (ii), and (vii) of this section shall be applied by substituting "60-month period" for "24-month period." A rehabilitation may reasonably be expected to be completed in phases if it consists of two or more distinct stages of development. The determination of whether a rehabilitation consists of distinct stages and therefore may reasonably be expected to be completed in phases shall be made on the basis of all the relevant facts and circumstances in existence before physical work on the rehabilitation begins. For purposes of this paragraph and paragraph (a)(2)(iii) of this section, written plans that describe generally all phases of the rehabilitation process shall be treated as written architectural plans and specifications. Such written plans are not required to contain detailed working drawings or detailed specifications of the materials to be used. In addition, the taxpayer may include a description of work to be done by lessees in the written plans. For example, where the owner of a vacant four story building plans to rehabilitate two floors of the building and plans to require, as a condition of any lease, that tenants of the other two floors must rehabilitate those floors, the requirements of this paragraph (b)(2)(v) shall be met if the owner provides written plans for the rehabilitation work to be done by the owner and a description of the rehabilitation work that the tenants will be required to complete. The work required of the tenants may be described in the written plans in terms of minimum specifications (e.g., as to lighting, wiring, materials, appearance) that must be met by such tenants. See paragraph (b)(6)(i) of this section for the definition of physical work on a rehabilitation.
- (vi) Treatment of expenses incurred by persons who have an interest in the building. For purposes of the substantial rehabilitation test in paragraph (b)(2)(i) of this section, the taxpayer may take into account qualified rehabilitation expenditures incurred during the same rehabilitation process by any other person who has an interest in the building. Thus, for example, to determine whether a building has been substantially rehabilitated, a lessee may include the expenditures of the lessor and of other lessees; a condominium owner may include the expenditures incurred by other condominium owners; and an owner may include the expenditures of the lessees.
- (vii) Special rules when qualified rehabilitation expenditures are treated as incurred by the taxpayer. In the case where qualified rehabilitation expenditures are treated as having been incurred by a taxpayer under paragraph (c)(3)(ii) of this section, the transferee shall be treated as having incurred the expenditures incurred by the transferor on the date that the transferor incurred the expenditures with the meaning

of paragraph (c)(3)(i) of this section. For purposes of the substantial rehabilitation test in paragraph (b)(2)(i) of this section, the transferee's adjusted basis in the building shall be determined as of the beginning of the first day of a 24-month period, or the first day of the transferee's holding period, whichever is later, as provided in paragraph (b)(2)(ii) of this section. The transferee's basis as of the first day of the transferee's holding period for purposes of the substantial rehabilitation test in paragraph (b)(2)(i) of this section, however, shall be considered to be equal to the transferee's basis in the building on such date less—

- (A) The amount of any qualified rehabilitation expenditures incurred (or treated as having been incurred) by the transferor during the 24-month period that are treated as having been incurred by the transferee under paragraph (c)(3)(ii) of this section, and
 - (B) The amount of qualified rehabilitation expenditures incurred before the transfer and during the 24-month period by any other person who has an interest in the building (e.g., a lessee of the transferor). The preceding sentence shall not apply, however, unless the transferee's basis in the building is determined with reference to (1) the transferee's cost of the building (including the rehabilitation expenditures), (2) the transferor's basis in the building (where such basis includes the amount of the expenditures), or (3) any other amount that includes the cost of the rehabilitation expenditures. In the event that the transferee's basis is determined with reference to an amount not described above (e.g., transferee's basis in one building is determined with reference to the transferee's basis in another building under section 1031(d)), the amount of the expenditures incurred by the transferor and treated as having been incurred by the transferee are not deducted from the transferee's basis for purposes of the substantial rehabilitation test. If a transferee's basis is determined under section 1014, any expenditures incurred by the decedent within the measuring period that are treated as having been incurred by the transferee under paragraph (c)(3)(ii) of this section shall decrease the transferee's basis for purposes of the substantial rehabilitation test.
- (viii) Statement of adjusted basis, measuring period, and qualified rehabilitation expenditures. In the case of any tax return filed after August 27, 1985, on which an investment tax credit for property, described in section 48(a)(1)(E) is claimed, the taxpayer shall indicate by way of a marginal notation on, or a supplemental statement attached to, Form 3468—
- (A) The beginning and ending dates for the measuring period selected by the taxpayer under section 48(g)(1)(C)(i) and paragraph (b)(2) of this section,
 - (B) The adjusted basis of the building (within the meaning of paragraph (b)(2) (iii) or (vii) of this section) as of the beginning of such measuring period, and
 - (C) The amount of qualified rehabilitation expenditures incurred, and treated as incurred, respectively, during such measuring period.

Furthermore, for returns filed after August 27, 1985, if the adjusted basis of the building for purposes of the substantial rehabilitation test is determined in whole

or in part by reference to the adjusted basis of a person, or persons, other than the taxpayer (e.g., a rehabilitation by a lessee), the taxpayer must attach to the Form 3468 filed with the tax return on which the credit is claimed a statement addressed to the District Director, signed by such third party, that states the first day of the third party's holding period and the amount of the adjusted basis of such third party in the building at the beginning of the measuring period or the first day of the holding period, whichever is later. If the taxpayer is unable to obtain the required information, that fact should be indicated and the taxpayer should state the manner in which the adjusted basis was determined and, if different, the fair market value of the building on the relevant date.

(ix) Partnerships and S corporations. If a building is owned by a partnership (i.e., the building is partnership property) or an S corporation, the substantial rehabilitation test shall be determined at the entity level. Thus, the entity shall compare the amount of qualified rehabilitation expenditures incurred during the measuring period against its basis in the building at the beginning of its holding period or the beginning of its measuring period, whichever is later. (See section 1223(2) for rules concerning the determination of a partnership's holding period in the case of a contribution of property to the partnership meeting the requirements of section 721.) The adjusted basis of the building to a partnership shall be determined by taking into account any adjustments to the basis of the building made under section 743 and section 734. Any adjustments to the building's basis that are made under section 743 or section 734 after the beginning of the partnership's holding period, but before the end of the measuring period, shall be deemed for purposes of the substantial rehabilitation test to have been made on the first day of the partnership's holding period. However, in such case, the partnership's basis in the building shall be reduced by the amount of qualified rehabilitation expenditures incurred by the partnership. In the case of any tax return filed after January 9, 1989 on which a credit is claimed by a partner or a shareholder of an S corporation for rehabilitation expenditures incurred by a partnership or an S corporation, the partner or shareholder shall indicate on the Form 3468 on which the credit is claimed the name, address, and identification number of the partnership or S corporation that incurred the rehabilitation expenditures, and the partnership or S corporation shall, by way of a marginal notation on or a supplemental statement attached to the entity's return, provide the information required by paragraph (b)(2)(viii) of this section.

(x) Examples. The following examples illustrate the application of the substantial rehabilitation test in this paragraph (b)(2):

Example 1. Assume that A, a calendar year taxpayer, purchases a building for \$140,000 on January 1, 1982, incurs qualified rehabilitation expenditures in the amount of \$48,000 (at the rate of \$4,000 per month) in 1982, \$100,000 in 1983, and \$20,000 (at the rate of \$2,000 per month) in the first ten months of 1984, and places the rehabilitated building in service on October 31, 1984. Assume that A did not have written architectural plans and specifications describing a phased rehabilitation within the meaning of paragraph (b)(2)(v) of this section in existence prior to the beginning of physical work on the rehabilitation. For purposes of the substantial rehabilitation test in paragraph (b)(2) of this section, A may select any 24-consecutive-month measuring period that ends in 1984, the taxable year in which the rehabilitated building was placed in service. Assume that on A's 1984 return, A selects a measuring period beginning on

February 1, 1982, and ending on January 31, 1984, and specifies that A's basis in the building (within the meaning of section 1011(a)) was \$144,000 on February 1, 1982 (\$140,000+\$4,000). (The \$4,000 of rehabilitation expenditures incurred during January 1982 are included in A's basis under section 1011 even though such property has not been placed in service.) The amount of qualified rehabilitation expenditures incurred during the measuring period was \$146,000 (\$44,000 from February 1 to December 31, 1982, plus \$100,000 in 1983, plus \$2,000 in January 1984). The building shall be treated as "substantially rehabilitated" within the meaning of this paragraph (b)(2) for A's 1984 taxable year because the \$146,000 of expenditures incurred by A during the measuring period exceeded A's adjusted basis of \$144,000 at the beginning of the period. If the other requirements of section 48(g)(1) and this paragraph are met, the building is treated as a qualified rehabilitated building, and A can treat as qualified rehabilitation expenditures the amount of \$168,000 (i.e., \$146,000 of expenditures incurred during the measuring period, \$4,000 of expenditures incurred prior to the beginning of the measuring period as part of the rehabilitation process, and \$18,000 of expenditures incurred after the measuring period during the taxable year within which the measuring period ends (See paragraph (c)(6) of this section.)). The result would generally be the same if the property attributable to the rehabilitation expenditures was placed in service as the expenditures were incurred, but A would have \$148,000 of qualified rehabilitation expenditures for 1983 and \$20,000 of qualified rehabilitation expenditures for 1984. (See paragraph (f)(2) of this section).

Example 2. Assume the same facts as in example 1, except that additional rehabilitation expenditures are incurred after the portion of the basis of the building attributable to qualified rehabilitation expenditures was placed in service on October 31, 1984. Such expenditures are incurred through the end of 1984 and in 1985 when the portion of the basis attributable to the additional expenditures is placed in service. The fact that the building qualified as a substantially rehabilitated building for A's 1984 taxable year has no effect on whether the building is a qualified rehabilitated building for property placed in service in A's 1985 taxable year. In order to determine whether the building is a qualified rehabilitated building for A's 1985 taxable year, A must select a measuring period that ends in 1985 and compare the expenditures incurred within that period with the adjusted basis as of the beginning of the period. Solely for the purpose of determining whether the building was substantially rehabilitated for A's 1985 taxable year, expenditures incurred during 1983 and 1984, even though considered in determining whether the building was substantially rehabilitated in 1984, may also be used to determine whether the building was substantially rehabilitated for A's 1985 taxable year, provided the expenditures were incurred during any 24-month measuring period selected by A that ends in 1985.

Example 3.

(i) Assume the B purchases a building for \$100,000 on January 1, 1982, and leases the building to C who rehabilitates the building. Assume that C, a calendar year taxpayer, places the property with respect to which rehabilitation expenditures were made in service in 1982 and selects December 31, 1982, as the end of the measuring period for purposes of the substantial rehabilitation test. The beginning of the measuring period is January 2, 1982, the beginning of B's holding period under section 1250 (e), and the adjusted basis of the building is \$100,000. Accordingly, if C incurred more than \$100,000 of qualified rehabilitation expenditures during 1982, the building would be substantially rehabilitated within the meaning of paragraph (b)(2)(i) of this section.

(ii) Assume the facts of example 3(i), except that after C begins physical work on the rehabilitation, but before C incurs \$100,000 of expenditures, D acquires the building, subject to C's lease, from B for \$200,000. D's holding period under section 1250(e) begins on the day after D acquired the building, and C's adjusted basis for purposes of the substantial rehabilitation test is \$200,000, less the amount of expenditures incurred by C before the transfer. (See paragraph (b)(2) (ii) and (vii) of this section.) Accordingly, if C incurred more than \$200,000 (less the amount of expenditures incurred prior to the transfer) of qualified rehabilitation expenditures during 1982, the building would be substantially rehabilitated within the meaning of paragraph (b)(2) of this section. Under paragraph (b)(2)(ii)(B) of this section, however, C's adjusted basis for purposes of the substantial rehabilitation test would be \$100,000 if C had substantially rehabilitated the building (i.e., incurred more than \$100,000 in rehabilitation expenditures) prior to B's sale to D.

Example 4. E owns a building with a basis of \$10,000 and E incurs \$5,000 of rehabilitation expenditures. Before completing the rehabilitation project, E sells the building to F for \$30,000. Assume that F is treated under paragraph (c)(3)(ii) of this section as having incurred the \$5,000 of rehabilitation expenditures actually incurred by E. Because F's basis in the building is determined under section 1011 with reference to F's \$30,000 cost of the building (which includes the property attributable to E's rehabilitation expenditures), F's basis for purposes of the substantial rehabilitation test is \$25,000 (\$30,000 cost basis less \$5,000 rehabilitation expenditures treated as if incurred by F). (See paragraph (b)(2)(vii) of this section.) F would thus be required to incur more than \$20,000 of rehabilitation expenditures (in addition to the \$5,000 incurred by E and treated as having been incurred by F) during a measuring period selected by F to satisfy the substantial rehabilitation test.

Example 5. G owns Building I with a basis of \$10,000 and a fair market value of \$20,000. H owns Building II with a basis of \$5,000 and a fair market value of \$20,000, with respect to which H has incurred \$1,000 of rehabilitation expenditures. G and H exchange their buildings in a transaction that qualifies for nonrecognition treatment under section 1031. Assume that G is treated under paragraph (c)(3)(ii) of this section as having incurred \$1,000 of rehabilitation expenditures. G's basis in Building II, computed under section 1031(d), is \$10,000. G's basis in Building II is not determined with reference to (A) the cost of Building II, (B) H's basis in Building II (including the cost of the rehabilitation expenditures) or (C) any other amount that includes the cost of expenditures, but is instead determined with reference to G's basis in other property (Building I). Therefore, G's basis in Building II for purposes of the substantial rehabilitation test is not reduced by the \$1,000 of rehabilitation expenditures treated as if incurred by G. (See paragraph (b)(2)(vii) of this section.) Accordingly, G's basis in Building II for purposes of the substantial rehabilitation test is \$10,000, and G must incur additional rehabilitation expenditures in excess of \$9,000 within a measuring period selected by G to satisfy the test.

(3) Retention of existing external walls and internal structural framework—

(i) In general—

(A) Property placed in service after December 31, 1986. Except in the case of property that qualifies for the transition rules in paragraphs (a)(2)(iv) (B) and (C) of this section, in the case of property that is placed in service after December 31,

1986, a building (other than a certified historic structure) meets the requirement in paragraph (b)(1)(iii) of this section only if in the rehabilitation process—

- (1) 50 percent or more of the existing external walls of such building are retained in place as external walls;
- (2) 75 percent or more of the existing external walls of such building are retained in place as internal or external walls, and
- (3) 75 percent or more of the internal structural framework of such building (as defined in paragraph (b)(3)(iii) of this section) is retained in place.

(B) Expenditures incurred before January 1, 1984, for property placed in service before January 1, 1987. With respect to rehabilitation expenditures incurred before January 1, 1984, for property that is either placed in service before January 1, 1987, or that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, a building meets the requirement in paragraph (b)(1)(iii) of this section only if 75 percent or more of the existing external walls of the building are retained in place as external walls in the rehabilitation process. If an addition to a building is not treated as part of a qualified rehabilitated building because it does not meet the 30-year requirement in paragraph (b)(4)(i)(B) of this section, then the external walls of such addition shall not be considered to be existing external walls of the building for purposes of section 48(g)(1)(A)(iii) (as in effect prior to enactment of the Tax Reform Act of 1986), and this section.

(C) Expenditures incurred after December 31, 1983, for property placed in service before January 1, 1987. With respect to expenditures incurred after December 31, 1983, for property that is either placed in service before January 1, 1987, or that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, the requirement of paragraph (b)(1)(iii) of this section is satisfied only if in the rehabilitation process either the existing external wall retention requirement in paragraph (b)(3)(i) (B) of this section is satisfied, or:

- (1) 50 percent or more of the existing external walls of the building are retained in place as external walls,
- (2) 75 percent or more of the existing external walls are retained in place as internal or external walls, and
- (3) 75 percent or more of the existing internal structural framework of such building is retained in place.

(D) Area of external walls and internal structural framework. The determinations required by paragraphs (b)(3)(i) (A), (B), and (C) of this section shall be based upon the area of the external walls or internal structural framework that is retained in place compared to the total area of each prior to the rehabilitation. The area of the existing external walls and internal structural framework of a building shall be determined prior to any destruction, modification, or construction of external

walls or internal structural framework that is undertaken by any party in anticipation of the rehabilitation.

- (ii) Definition of external wall. For purposes of this paragraph (b), a wall includes both the supporting elements of the wall and the nonsupporting elements, (e.g., a curtain, windows or doors) of the wall. Except as otherwise provided in this paragraph (b)(3), the term "external wall" includes any wall that has one face exposed to the weather, earth, or an abutting wall of an adjacent building. The term "external wall" also includes a shared wall (i.e., a single wall shared with an adjacent building), generally referred to as a "party wall," provided that the shared wall has no windows or doors in any portion of the wall that does not have one face exposed to the weather, earth, or an abutting wall. In general, the term "external wall" includes only those external walls that form part of the outline or perimeter of the building or that surround an uncovered courtyard. Therefore, the walls of an uncovered internal shaft, designed solely to bring light or air into the center of a building, which are completely surrounded by external walls of the building and which enclose space not designated for occupancy or other use by people (other than for maintenance or emergency), are not considered external walls. Thus, for example, a wall of a light well in the center of a building is not an external wall. However, walls surrounding an outdoor space which is usable by people, such as a courtyard, are external walls.
- (iii) Definition of internal structural framework. For purposes of this section, the term "internal structural framework" includes all load-bearing internal walls and any other internal structural supports, including the columns, girders, beams, trusses, spandrels, and all other members that are essential to the stability of the building.
- (iv) Retained in place. An existing external wall is retained in place if the supporting elements of the wall are retained in place. An existing external wall is not retained in place if the supporting elements of the wall are replaced by new supporting elements. An external wall is retained in place, however, if the supporting elements are reinforced in the rehabilitation, provided that such supporting elements of the external wall are retained in place. An external wall also is retained in place if it is covered (e.g., with new siding). Moreover, an external wall is retained in place if the existing curtain is replaced with a new curtain, provided that the structural framework that provides for the support of the existing curtain is retained in place. An external wall is retained in place notwithstanding that the existing doors and windows in the wall are modified, eliminated, or replaced. An external wall is retained in place if the wall is disassembled and reassembled, provided the same supporting elements are used when the wall is reassembled and the configuration of the external walls of the building after the rehabilitation is the same as it was before the rehabilitation process commenced. Thus, for example, a brick wall is considered retained in place even though the original bricks are removed (for cleaning, etc.) and replaced to form the wall. The principles of this paragraph (b)(3)(iv) shall also apply to determine whether internal structural framework of the building is retained in place.
- (v) Effect of additions. If an existing external wall is converted into an internal wall (i.e., a wall that is not an external wall), the wall is not retained in place as an external wall for purposes of this section.

(vi) Examples. The provisions of this paragraph (b)(3) may be illustrated by the following examples:

Example 1. Taxpayer A rehabilitated a building all of the walls of which consisted of wood siding attached to gypsum board sheets (which covered the supporting elements of the wall, i.e., studs). A covered the existing wood siding with aluminum siding as part of a rehabilitation that otherwise qualified under this subparagraph. The addition of the aluminum siding does not affect the status of the existing external walls as external walls and they would be considered to have been retained in place.

Example 2. Taxpayer B rehabilitated a building, the external walls of which had a masonry curtain. The masonry on the wall face was replaced with a glass curtain. The steel beam and girders supporting the existing masonry curtain were retained in place. The walls of the building are considered to be retained in place as external walls, notwithstanding the replacement of the curtain.

Example 3. Taxpayer C rehabilitated a building that has two external walls measuring 75 X x 20 X and two other external walls measuring 100 X x 20 X . C demolished one of the larger walls, including its supporting elements and constructed a new wall. Because one of the larger walls represents more than 25 percent of the area of the building's external walls, C has not satisfied the requirements that 75 percent of the existing external walls must be retained in place as either internal or external walls. If however, C had not demolished the wall, but had converted it into an internal wall (e.g., by building a new external wall), the building would satisfy the external wall requirements.

Example 4. The facts are the same as in example 3, except that C does not tear down any walls, but builds an addition that results in one of the smaller walls becoming an internal wall. In addition, C enlarged 8 of the existing windows on one of the larger walls, increasing them from a size of 3 X x 4 X to 6 X x 8 X . Since the smaller wall accounts for less than 25 percent of the total wall area, C has satisfied the requirement that 75 percent of the existing external walls must be retained in place as external walls in the rehabilitation process. The enlargement of the existing windows on the larger wall does not affect its status as an external wall.

Example 5. Taxpayer D rehabilitated a building that was in the center of a row of three buildings. The building being rehabilitated by D shares its side walls with the buildings on either side. The shared walls measure 100 X x 20 X and the rear and front walls measure 75 X x 20 X . As part of a rehabilitation, D tears down and replaces the front wall. Because the shared walls as well as the front and back walls are considered external walls and the front wall accounts for less than 25 percent of the total external wall area (including the shared walls), D has satisfied the requirement that 75 percent of the existing external walls must be retained in place as external walls in the rehabilitation process.

(4) Age requirement –

(i) In general –

(A) Property placed in service after December 31, 1986. Except in the case of property that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, a building other than a certified historic structure shall not be

considered a qualified rehabilitated building unless the building was first placed in service (within the meaning of § 1.46-3(d)) before January 1, 1936.

(B) Property placed in service before January 1, 1987, and property qualifying under a transition rule. In the case of property placed in service before January 1, 1987, and property that qualifies under the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, a building other than a certified historic structure is considered a qualified rehabilitated building only if a period of at least 30 years has elapsed between the date physical work on the rehabilitation of the building began and the date the building was first placed in service (within the meaning of § 1.46-3(d)) as a building by any person.

(ii) Additions. A building that was first placed in service before 1936 in the case described in paragraph (b)(4)(i)(A) of this section, or at least 30 years before physical work on the rehabilitation began in the case described in paragraph (b)(4)(i)(B) of this section, will not be disqualified because additions to such building have been added since 1936 in the case described in paragraph (b)(4)(i)(A) of this section, or are less than 30 years old in the case described in paragraph (b)(4)(i)(B) of this section. Such additions, however, shall not be treated as part of the qualified rehabilitated building. The term "addition" means any construction that resulted in any portion of an external wall becoming an internal wall, that resulted in an increase in the height of the building, or that increased the volume of the building.

(iii) Vacant periods. The determinations required by paragraph (b)(4)(i) of this section include periods during which a building was vacant or devoted to a personal use and is computed without regard to the number of owners or the identify of owners during the period.

(5) Location at which the rehabilitation occurs. A building, other than a certified historic structure is not a qualified rehabilitated building unless it has been located where it is rehabilitated since before 1936 in the case described in paragraph (b)(4)(i)(A) of this section. Similarly, in the case described in paragraph (b)(4)(i)(B) of this section, a building, other than a certified historic structure, is not a qualified rehabilitation building unless it has been located where it is rehabilitated for the thirty-year period immediately preceding the date physical work on the rehabilitation began in the case of a "30-year building" or the forty-year period immediately preceding the date physical work on the rehabilitation began in the case of a "40-year building." (See § 1.46-1(q)(1)(iii) for the definitions of "30-year building" and "40-year building.")

(6) Definition and special rule—

(i) Physical work on a rehabilitation. For purposes of this section, "physical work on a rehabilitation" begins when actual construction, or destruction in preparation for construction, begins. The term "physical work on a rehabilitation," however, does not include preliminary activities such as planning, designing, securing financing, exploring, researching, developing plans and specifications, or stabilizing a building to prevent deterioration (e.g., placing boards over broken windows).

(ii) Special rule for adjoining buildings that are combined. For purposes of this paragraph (b), if as part of a rehabilitation process two or more adjoining buildings are combined and placed in service as a single building after the rehabilitation process, then, at the election of the taxpayer, all of the requirements for a qualified rehabilitated building in section 48(g)(1) and this section may be applied to the constituent adjoining buildings in the aggregate. For example, if such requirements are applied in the aggregate, any shared walls or abutting walls between the constituent buildings that would otherwise be treated as external walls (within the meaning of paragraph (b)(3) of this section) would not be treated as external walls of the building, and the substantial rehabilitation test in paragraph (b)(2) of this section would be applied to the aggregate expenditures with respect to all of the constituent buildings and to the aggregate adjusted basis of all of the constituent buildings. A taxpayer shall elect the special rule of this paragraph (b)(6)(ii) for adjoining buildings by indicating by way of a marginal notation on, or a supplemental statement attached to, the Form 3468 on which a credit is first claimed for qualified rehabilitation expenditures with respect to such buildings that such buildings are a single qualified rehabilitated building because of the application of the special rule in this paragraph (b)(6)(ii).