Tax Credits as a Planning Tool

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Background:

Tax filing day for 2016 has passed, and with it the opportunity to minimize tax obligations for 2016 may have slipped away, but businesses and their principals should begin to consider — and to plan for — their 2017 tax liabilities.

We encourage taxpayers to include tax credits as one of the tools they deploy in their tax planning arsenal. Taxpayers are aware of the more well-known hedges — such as incurring capital expenditures on equipment or machinery in the current year, deferring asset sales or other profitable transaction closings into 2018 (unless a 1031 like-kind exchange can be achieved), but these are deferral strategies, whereas tax credits which reduce one's tax obligation are less well known and understood to the greater taxpayer population. Tax credits are very well known and deftly utilized by the largest corporations and financial institutions, who, it is well documented have achieved far lower tax rates than we as individual taxpayers have realized.

Business Case:

Tax Reform is a topic that Washington has been actively discussing this year, as the climate for a reform of our tax code has become more probable with a Republican Administration and a Republican-controlled Congress. The Trump Administration has been proposing to outline a major tax reform package during the Administration's first 100 days, the cornerstone of which will include tax cuts. As our tax system is a progressive system, 60% of all taxes are paid by the top 10% of earners, and 25% of all taxes are paid by the top 2%. Most US companies are flow-through entities, those being partnerships, S-Corporations, or limited liability companies. Flow-through entities are not taxed, rather all income flows through to the owners of those entities who pay taxes individually. The tax cuts that are being talked about for the most part are the corporate tax rate, which at 35% is among the highest (if not the highest) in the developed world.

The Administration has stated they will cut tax rates to 15% and replace the 7 brackets for personal taxes with 3 tax brackets, the highest of which will be around 31%, rather than the current 39.6%. As I have said previously, the large corporations have employed strategies, such as tax inversions, hoarding cash overseas, and tax credits to significantly reduce their tax rates in any event. Accordingly, for the tax cuts to stimulate the economy there would need to be a permanence to the tax cuts, which generally is achieved by corresponding spending cuts or elimination of other deductions. It is my belief, therefore, that the tax reform package that moves through Congress will be revenue neutral (i.e. it does not add to the federal deficit over a decade). If the tax plan is revenue neutral, then it can be passed through the Senate with a 51-vote majority making the tax

code changes permanent. If the tax changes produced results that were not revenue neutral, then the tax code changes will expire after nine years, as did the Bush tax cuts.

The Trump Administration seems to be agreeing that the tax code changes need to be permanent to substantially boost business investment, but have suggested that the tax cuts could be offset with increased productivity, which is debatable. Most likely, in a tax reform package that contains major cuts to the tax rates, for those tax changes to be revenue neutral several programs and deductions could face the chopping block. Moreover, the President and his advisors have also proposed a $1 trillion infrastructure spending plan, as well as significant increases in defense spending, all of which will need to be balanced against the tax cuts. The President, when he was on the campaign trail, suggested that the infrastructure plan would comprise a public-private partnership, and he and his advisors have stated that there would be a tax credit for investors in infrastructure spending. In fact, the suggestion seems to be that the $1 trillion infrastructure spending package can be financed with private investment of $167 billion and an 82% tax cut.[1] Interestingly, Congressional Democrats (who have been in favor of an infrastructure spending plan for several years already) support the President's plan, and even agree with his $1 trillion cost estimate, which looks to be a rare opportunity for bipartisan agreement. In fact, it was the Conservative Republicans that stymied Democratic infrastructure spending plans in years past, creating this unholy alliance on infrastructure spending between the Democrats and Congressional Republicans.

The Democrats' objection to the Trump plan is that they would rather see federal investment than a tax credit because they cannot see how a tax credit would pay for the spending. Nevertheless, there is enough common ground such that my sense is that the final plan will have both a federal spending component and a tax credit component. Large private equity firms, such as BlackRock and Blackstone, who are already invested in oil, gas, power production and power infrastructure are raising large pools of money to invest more deeply into infrastructure projects. This is a clear Wall Street indication that directly supports the Administration's theories of a revenue-neutral tax plan and infrastructure tax credits. Furthermore, for those who have been concerned that the future of tax credits may be uncertain, note that it is the Republican Administration that is favoring a tax credit strategy for the infrastructure spending, while it is the Congressional Democrats that are hedging on tax credits. To me this is a good sign that in a Republican-controlled Congress, ***tax credits*** as a general strategy ***will continue to play a role in our economy and be a part of, and not a casualty of tax reform***.

[1] Without the details of the composition of the tax credit for investors in infrastructure, looking at the estimate of $167 billion in investment and an 82% tax credit suggests that it would work in similar fashion to the federal tax credits that are discussed in this paper. Generally, the investor equity of $167 billion would generate $137 billion in tax credits which can be "monetized" by other investors to generate an additional $100 billion in equity. The total equity investment of $267 billion or 26.7% will allow debt financing to be secured with a 73% loan-to-value ratio and allow the $1 trillion in infrastructure financing to be secured.

So, naturally the overriding question is how will tax cuts and increased infrastructure and defense spending be accommodated in a revenue neutral tax plan. Congressional tax "authorities" have mentioned a few possibilities, such as dropping the 1031 like-kind exchange rules, eliminating the federal deduction for payment of state taxes, lowering payroll taxes, or eliminating the deduction for mortgage interest payments as contenders for amendment or elimination.

Clearly, whatever the final form the proposed tax changes take, the result will be an uncertain landscape that will challenge tax professionals because, although the actual tax rate may be lowered, taxpayers' liability as measured in dollar terms will be relatively unaffected, or may even increase.

To mitigate this uncertainty, it is as important now as it has ever been for taxpayers to act on their own to minimize their tax obligations rather than to expect that the government will do so. It's important, therefore, to maximize tax savings within your tax plan and take control over your tax obligations over the upcoming years. What this paper is suggesting is that the addition of *a tax credit strategy will amount to more certainty in the planning for tax obligations*, and that is a good thing!

Tax Credits as a Strategy:

Simply stated, a **tax credit** is a *dollar-for-dollar* offset against taxes that are due to either the state or federal government.[2] Taxpayers can utilize their tax credits to satisfy their own tax obligations or transfer[3] their tax credits to other taxpayers.

Certain taxpayers, such as those holding newly acquired and rehabilitated real estate or newly formed single asset entities, may not have generated sufficient income to be able to utilize their tax credits. For such taxpayers, "selling" their tax credits is a better alternative than anticipating the future usability of those credits. Conversely, for the tax credit transferees — who usually receive the tax credits at a discount — such a transaction invariably results in substantial tax savings.

How do tax credits work, and how can they be effectively used by taxpayers?

Firstly, utilizing a tax credit strategy requires advanced planning, and should be funded with resources that otherwise would be used to pay taxes. It is important to realize that, although you are making an investment in a transaction that generates tax credits, the return is the tax credits

[2] This paper focuses on federal tax credits, as state tax credits are generally fully transferable to taxpayers without a requirement that the taxpayer have participated in the transaction that generated the tax credits. This is an important distinction, which will be made clearer as we delve deeper into this strategy.

[3] State tax credits are certificated and are therefore easily transferable. Federal tax credits are earned by a taxpayer, usually an entity, and are utilized through a partnership that the tax credit equity investor creates. This process, sometimes called a syndication will be described in greater detail later in this paper.

themselves and not the capital invested. With that in mind, the following is an explanation of how a typical tax credit transaction would work.

The tax credits that we reference herein are Investment Tax Credits ("ITC"), which are allowable in Section 38 of the Internal Revenue Code ("IRC"). There are several different ITC's, such as the low-income housing tax credit[4], the historic rehabilitation tax credit[5], and the renewable energy tax credit[6]. As noted above, we speculate that there might also be an infrastructure investment tax credit, which we believe will be structured in a similar fashion to the other federal tax credits mentioned herein. For that reason, the explanation of a federal tax credit transaction will utilize a historic rehabilitation project as an example that can be applied across the various ITC's.

Assume that a developer has acquired an old mill complex in Northern New England for a cost of $5 million. The mill complex was a former loom manufacturer and provided housing for its factory workers, which was one of the origins of the town in which it is located. The mill buildings are eligible for listing on the National Register of Historic Places, and so the proposed rehabilitation of the buildings, which will convert the mill complex into a mix of residential apartments, stores, restaurants, and small offices will qualify the project for the historic rehabilitation tax credit ("HTC"). The rehabilitation budget for the project is $36 million, of which $30 million are deemed to be "qualified rehabilitation expenses" or QRE's, and are thus eligible for the 20% federal HTC. The HTC's that the project expects to be awarded are $6 million (20% of the $30 million QRE's). The developer is also separately able to secure other state tax credits and local incentives totaling $5 million, so his capital stack will be comprised as follows:

Sources

Developer Equity	$ 6,000,000 (includes acquisition cost)
State/Local Incentives	$ 5,000,000

[4] A tax credit generated by the creation of multifamily rental housing that is made affordable to persons with income levels that are less than the Area Median Income ("AMI") as a percentage, e.g. 60% or 80% of the AMI. The tax credit provides additional equity to the project which allows a lower debt service and correspondingly the ability to accept less than market-rate rents.

[5] This is a tax credit that is allowable to those who rehabilitate historic buildings and retain their historic character. The theory behind the tax credit is that our historic structures are important to us as a nation, and are an important part of the fabric of our communities. Restoring a historic building rather than tearing it down and building new is far more expensive, therefore, the tax credit provides equity to the project that is necessary to allow the project to be financially viable.

[6] This tax credit is generated by an investment in the infrastructure that produces renewable energy, such as solar facilities, wind farms, hydro-electric power, biomass, or geothermal technologies to name a few. Renewable energy is an unlimited resource in that it comes from the sun, wind, water, and so forth. This is a positive alternative to fossil-fuel based power generation, and as our natural resources are limited such energy production is key to our survival. Therefore, developing our renewal resources rather than full reliance on our dwindling natural resources is enormously important. Renewable energy production is also less harmful to our environment, which could help us with global warming issues, as well as to reduce our reliance on foreign fuel, which enhances our national security interests. The tax credits are necessary to allow the renewable energy industry to achieve scale and allow the industry time to stabilize while production technologies advance and achieve cost efficiencies which can sustain the industry.

Construction Loan	$25,200,000
Tax Credit Equity	$ 4,800,000
Total Sources	**$41,000,000**
Uses	
Acquisition costs	$ 5,000,000
Project construction costs	$36,000,000
Total Costs	**$41,000,000**

As the numbers demonstrate, the $6 million of tax credits were monetized for $4.8 million, and without the tax credit equity and the state tax credits or local incentives the developer would have needed to have 40% of the project's cost on hand in equity to complete the project. If that were the case, the developer would most likely have elected not to pursue the project, or to tear down the mill complex and engage in ground-up construction, as that is less expensive than the adaptive reuse of historic buildings. In both scenarios, a historic mill complex that represented our country's Industrial Revolution roots and is an important symbol of our country's architectural heritage would be lost.

From the tax credit investor's perspective, you are able to utilize the $6 million tax credit to offset $6 million of federal tax liability (i.e. dollar-for-dollar) at a cost of only $4.8 million, representing a 20% tax savings. Additionally, in a transaction such as this, the tax credit investor receives cash flow of $375,000 for a five-year period and an exit payment of $175,000 for a total of $550,000[7] or an 11.5% return (based upon the $4.8 million investment) for a total ROI of 31.5%[8].

Benefits:

As stated above, the referenced tax credit strategy is only useful to those that otherwise would have needed to pay $6 million to the federal government (as per the above example). In such a case, a taxpayer can look at this transaction as achieving a 31.5% ROI, but most beneficial is that they have reduced their tax rate from 39.6% to 28% with this strategy. Consider also that this tax credit investment has aided in saving a historical mill complex, created a retail/office/dining/residential destination, created hundreds of jobs, and aided in the transformation of a neighborhood. With

[7] Usually a 2%-3% preferred return (calculated upon the tax credit equity investment) annually for 5 years and a 5% exit payment at the end of year 5 (also calculated upon the tax credit equity investment). The 5-year period is because the tax credits flow 100% upfront but can be recaptured at the rate of 20% per year over a 5-year period. It is for that reason that these transactions are structured as a partnership flip at the end of year 5 when the recapture risk has burned off.

[8] There are currently limitations on certain taxpayers' use these tax credits, specifically individuals and closely-held companies need to comply with the passive loss and at-risk rules in their use of these tax credits.

that in mind, the benefits of this strategy are overwhelming and achieve far more than a financial return.

Moreover, the government's benefit in allowing these tax credits can also be measured, but let's look at the infrastructure investment tax credit to illustrate this point.

It is beyond dispute that our national infrastructure is in disrepair. We have airports that are old and tired, crumbling bridges and roads, and aging transportation infrastructure, such as rail lines. These issues are affecting our competitiveness economically, our perception as a world leader, and are dangerous to our citizens. If $167 billion in private investment generates tax credits that cause the government to forgo $100 billion in future taxes, and the sum of the private investment and the tax credits stimulates $1 trillion in infrastructure spending into the economy, we will have utilized our tax dollars in a most efficient and effective manner.

Firstly, the estimated $733 billion in debt financing that the plan requires will stimulate our financial institutions and create thousands of jobs in the financial sector, most of which will be well-paying white-collar jobs such as legal and financial advisors, actuaries, and so forth. Furthermore, there will be tens of thousands of construction jobs that will be created, some of which will last for over a decade. Moreover, there will be manufacturing jobs needed to produce the steel, concrete and technology to implement the infrastructure, and new airports, rail stations, and the like will create service jobs for our economy. These job gains will create additional tax revenue for the government, the owners of the new infrastructure will be paying property taxes to state and local governments, and the private investors in those ownership partnerships will incur tax liabilities on their income. In fact, the combination of all this new economic activity will generate far more tax revenue than the government will forgo.

Generally, studies conducted for some of the other tax credits referenced herein have shown that the federal government receives a return that exceeds the taxes it forgoes in new tax revenue, and that state and local governments receive increased property taxes, and personal income taxes[9]. In any event, even if this were not a net revenue gain for the government it demonstrates how they can inject $1 trillion in infrastructure spending into the economy with only $100 billion in federal spending, which measured over a decade is only $10 billion per year. Coupled with a benefit to taxpayers that represents a 31% return on funds that would have been used to pay taxes in any event (or a tax rate reduction of almost 12%) and it's hard to argue against such a strategy.

[9] The National Trust for Historic Preservation has estimated that the HTC program, which is one of the nation's most successful and cost-effective community revitalization programs to date, returns $1.20-$1.25 to the Treasury for each dollar in taxes that it forgoes. The National Trust estimates that the HTC Program has used $23.1 billion in tax credits to generate more than $28.1 billion in federal tax revenue**,** and has leveraged $120.8 billion in private investment into our communities, creating 2.3 million jobs and saving 41, 270 historic buildings.

The Counter-Argument:

From a tax credit investor's perspective, it has been postulated that a decrease in tax rates will lessen the effectiveness, or even eliminate the need for tax credits. This argument does not hold water because focusing only on the tax rate completely misses the point, and in any event the bulk of the tax cuts will be to the corporate tax rate, which does not affect most taxpayers. From my perspective, individual taxpayers will discover that, although the tax rate may decline, the actual taxes they are obligated to pay will change very little, if at all. There is also a natural tendency to ensure that we are only paying over to the government what they are entitled to, even in a society where you are expected to pay your fair share. The general concept being that we can make better spending decisions with our funds than the federal government would.

Regardless, when April 15th arrives each year the feeling of being overtaxed does not come from the rate at which the government calculates your tax liability, but the actual dollar amount in taxes that you have paid, or will pay. Whatever your tax rate may be, that dollar amount will always be too sizable a portion of your resources. Tax credits will always reduce that taxable obligation; they are a legal and longstanding part of our tax code, and as such they should be utilized by as many taxpayers as are able to do so.

That, however, is not currently the case.

Presently, tax credits are the domain of the largest corporations and financial institutions, and their tax savings have been constant and considerable for decades. There is no reason that tax credits should not be legitimately utilized by a larger portion of the taxpaying public, those being individual taxpayers.

Warren Kirshenbaum is president of the Cherrytree Group, a Newton, Massachusetts firm offering tax credit consulting, brokerage and syndication services. The company assists developers of all sizes, general contractors, engineers, geotechnical scientists, individuals, and investment partnerships in applying for, securing, and monetizing available federal and state tax credits. The group has advised and closed on millions of dollars in state and federal tax credits, including small and large renewable energy projects. Contact him at warren@cherrytree-group.com *or 617-431-2266.*