April 25, 2017

Tax Credits as a Planning Tool

Background:

The tax filing deadline for 2016 has passed, and with it any opportunity to minimize tax obligations for 2016, But now is the time when businesses and their principals should begin to consider — and to plan for — their 2017 tax liabilities.

We encourage our clients to include tax credits as one of the tools of their financial planning arsenal. Taxpayers are already 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. Tax credits which ***directly*** reduce the tax obligation are deftly utilized by the largest corporations and financial institutions, but far less known and understood by the greater population — even though they could also be of great benefit to many individual taxpayers.

Business Case:

Tax Reform is a topic which 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 suggested a major tax reform package will be one of its earliest initiatives — the cornerstone of which will include tax cuts.

For background: as our tax system is a progressive one, 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, and limited liability companies. Flow-through entities are not directly taxed; rather all income flows through to the owners who pay taxes as individuals. Large corporations not structured for flow-through have employed numerous strategies, such as tax inversions, hoarding cash overseas, and tax credits to significantly reduce their tax rates. We've all read stories of corporations like GE and Apple paying little — if anything — in income taxes.

The proposed tax cut most talked about lately is the corporate tax rate, which at its current 35% level is among the highest (if not the highest) in the world. The new administration has stated they will cut that rate to 15% and take away the seven tax brackets for personal taxes (including flow-through income) and replace them with three brackets — the highest of which will be around 31% rather than the current 39.6%.

For the tax cuts to stimulate the economy there would need to be corresponding spending cuts or elimination of other deductions. It is my belief the tax reform package that moves through Congress likely will be "revenue-neutral" (i.e. it does not add to the federal deficit). As revenue-neutral, the plan can be passed through the Senate with only a 51-vote majority needed to make 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 suggesting the tax code changes need to be permanent to substantially boost business investment. Therefore, in a tax reform package that contains major cuts to the tax rates, for those tax changes to be revenue neutral there need to be several programs and deductions facing 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 and the failed passage of health care reform (which had included tax savings).

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 years) 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 instead of a tax credit because they cannot envision how a tax credit would pay for the spending.

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[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 addition $100 billion in equity. The total equity investment of $267 billion or 26.7% will allow debt financing to be secured with a little more than a 73% loan-to-value ratio and allow the $1 trillion in infrastructure financing to be secured.

Nevertheless, there is enough common ground 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, as well as other infrastructure projects — 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 who 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***.

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: 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.

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 their government will do so. With good planning, one can take control over his or her tax obligations overfed years to come. 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?

Using 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 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 will largely reference here 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 cred*it[4], the *historic rehabilitation tax credit*[5], and the

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[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.

[4] A tax credit generated by the creation of multi-family 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 provided 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.

renewable energy tax credit[6]. As noted earlier, we speculate that there might also be an infrastructure investment tax credit, which we believe will be structured in a similar fashion to existing federal tax credits. For that reason, our explanation of a federal tax credit transaction will use 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 complex was once a textile factory, and provided housing for the loom operators and factory workers — which was the genesis 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
Construction Loan	$25,200,000
Tax Credit Equity	$ 4,800,000
Total Sources	**$41,000,000**

Uses

Acquisition costs	$ 5,000,000

[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. Renewable energy is an unlimited resource in that it comes from the sun, wind and water. This is a positive alternative to fossil-fuel based power generation, as our natural resources are limited, and energy production is key to our survival. Therefore, developing our renewal resources rather than full reliance on our dwindling natural resources is considered important by our Federal and state governments. Renewable energy production is also less harmful to our environment, which could help mitigate 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.

Project construction costs	$36,000,000
Total Costs	**$41,000,000**

As the numbers demonstrate, the $6 million in 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 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 would prefer to tear down the mill complex and engage in ground-up construction — far 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, he or she is 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 mentioned earlier, such a 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%***. Consider also: this 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 that in mind, the benefits of this strategy can often be overwhelming.

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:

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[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 necessary because while the tax credits flow 100% upfront they 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 of 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.

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 century-old rail lines and terminals. These issues are affecting our country's competitiveness economically, our perception as a world leader, and are at times an outright danger 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.

First, 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 — many of which will be well-paying white collar jobs such as legal and financial advisors, actuaries, project managers and so forth.

Next, there will be tens of thousands of construction jobs which will be created —some 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.

All of these job gains will create additional tax revenue for the government, and the owners of the new infrastructure will be paying property taxes to state and local governments 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 outlined earlier have shown that the Federal government receives a return that exceeds the taxes it forgoes in new tax revenue,. State and local governments receive increased property taxes and personal income taxes[9]. Even if this were not a net revenue gain for the government it demonstrates how these programs can cause $1 trillion in infrastructure spending to take place while only spending $100 billion — which measured over a decade is only $10 billion per year. One can couple that with a benefit to

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[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.

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.

The counter-argument:

From a tax credit investor's perspective, it has been postulated that a decrease in tax rates will lessen the effectiveness of — or even eliminate the need for — tax credits. From a reasoned perspective this argument does not hold water. 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 their 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. Many understandably believe that they can make better spending decisions with their 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. It emanates from the actual dollar amount in taxes that you have paid — or will need to 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. However, that is not currently the case. Tax credits remain 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: our nation's individual taxpayers.

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