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Community Development Tax Credits: Damaged, but not Devastated

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President Donald Trump's signing of the Tax Cuts and Jobs Act Dec. 22 brought the yearlong drama concerning tax reform–and its effect on community development tax credits–to a conclusion, leaving community development advocates rejoicing in the survival of the low-income housing tax credit (LIHTC), private activity bonds (PABs), new markets tax credit (NMTC), historic rehabilitation tax credit (HTC) and renewable energy investment tax credit (ITC) and production tax credit (PTC), but also wounded as they assessed the damage done to these tools.

The year began with optimism in many areas about possible expansion and compensating proposals, but ended with a fierce battle for survival.

The Republican legislation ultimately is more of a *tax cut* than *tax reform*, especially compared to comprehensive tax reform in 1986. As evidence, 1986 saw a change in the name of the tax code–from the 1954 Internal Revenue Code to the 1986 Internal Revenue Code–while the 2017 tax changes won't necessitate such alterations.

Now comes more work for those involved in the LIHTC, NMTC, HTC, ITC and PTC worlds, who must:

- Get into the trenches and assess and adjust to the many changes brought by the tax cuts and reforms.
- Help legislators craft the inevitable clean up legislation containing technical corrections.
- Work to expand and improve the tax credits in the wake of 2017.

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Here's a look at where we stand after H.R.1 became law:

Overall Picture

The headline provision of the Tax Cuts and Jobs Act was a reduction in the top corporate tax rate from 35 percent to 21 percent and move to a territorial international tax system. The rate reduction–which went into effect Jan. 1–directly and adversely affects LIHTC equity pricing. Novogradac & Company estimates a roughly 14 percent reduction in the value generated as compared to a 35 percent corporate rate. Recent market pricing had been at about a 25 percent corporate rate, so going to 21 percent will lead to an additional 3 percent to 4 percent drop, all other things being equal. The other credits, HTC, NMTC, ITC and PTC, shouldn't generally see dramatic pricing changes solely as a result of the corporate tax rate reduction.

The movement to a territorial international tax system brought with it a new tax, designed to limit the ability of multinational corporations to engage in inter-company transactions that erode the U.S. tax base, a tax that is aptly named the Base Erosion and Anti-abuse Tax (BEAT). The BEAT is an alternative tax calculation that generally starts with a corporation's regular taxable income and adds back certain base erosion payments. The BEAT tax rate starts at 5-6 percent in 2018, then goes to 10-11 percent in 2019-2025, and to 12.5-13.5 percent in 2026 and beyond. Tax credit investments are generally limited in their ability to effectively reduce a corporation's BEAT liability.

But what is even worse is the calculation of BEAT can result in corporations permanently losing up to 20 percent of the benefit of their LIHTCs, ITCs and PTCs every year through 2026 and up to 100 percent after that. The NMTC and HTC are in a worse position, as investors could lose up to 100 percent of their value starting in 2018. The credits are lost because even though they may not generate a tax benefit, there is no carryforward. To add insult to injury, investors could also lose up to about 50 percent of the value of tax losses every year. As you can quickly discern, the BEAT is likely to lead many multinationals to reconsider investing in tax credits and potentially remarketing all or a portion of their existing tax credit investment portfolio.

Two other central provisions in the tax reform legislation affecting tax credit investing relate to the calculation of taxable income. One provision limits interest expense deductions and the other allows asset expensing. There is now, generally, a limit on business interest expense deduction: 30 percent of business adjustable taxable income, although real estate businesses can opt out. On the asset expensing side, the former 50 percent bonus depreciation provision that was being phased down is reset to 100 percent for new property investments from Sept. 27, 2017, through the end of 2022, then starting another phasedown.

LIHTC

Of all the tax credit provisions, the LIHTC (at least the 9 percent credit) was in the least danger of repeal, although it faced significant difficulties–particularly when the House version of H.R. 1 included a repeal of the tax exemption for all PABs at the end of 2017. That threat caused shockwaves in the affordable housing world, prompting a report by Novogradac & Company LLP illustrating that the House provisions (including the lower corporate rate and other issues) would result in nearly 1 million fewer affordable housing units over the next decade. Fortunately, the Senate bill and final version of the legislation retained tax-exempt status for PABs without any changes, such as a limitation on carrying unused PAB cap forward.

The biggest challenge to affordable housing is the fact that the lower corporate tax rate, combined with the effects of the BEAT on investor demand, will result

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in less affordable housing being built in the next few years. Expect a push for the Affordable Housing Credit Improvement Act–which includes a provision to increase the LIHTC allocation–to be launched to offset that decrease and a fix to the BEAT.

NMTC

The House bill included a provision to repeal the NMTC after the 2017 round (which is scheduled to be awarded in the first quarter of 2018), but the final legislation retained the 2018 and 2019 rounds of the NMTC, which were approved in the Protecting Americans from Tax Hikes (PATH) Act at the end of 2015.

That means we're exactly where we were before tax legislation was discussed: With $3.5 billion allocation rounds for 2018 and 2019. NMTC supporters must now push for an extension–hopefully permanent–for 2020 and beyond and a fix to the BEAT.

Community development did, in one bright light in the bill, receive a boost with the inclusion of the Investing in Opportunity Act in H.R. 1. That legislation was introduced in each of the past two sessions of Congress by Rep. Pat Tiberi, R-Ohio, and Sen. Tim Scott, R-S.C., to allow investors to defer capital gains on investments benefitting low-income communities that are eligible for the NMTC. Now it will complement the NMTC by encouraging the investment of private capital in economically distressed areas.

HTC

The House bill would have repealed both iterations of the HTC—the 20 percent credit for certified historic properties and 10 percent rehabilitation credit for non-historic properties placed in service before 1936–but the Senate version of the legislation carried the day in the final bill, albeit with two significant changes.

Most importantly, the 20 percent HTC will now be claimed ratably over five years, rather than at the time the property is placed in service. That will have a minor, but meaningful, adverse effect on the present value of the credit. The other major change was the repeal of the non-historic credit for buildings placed in service before 1936.

Again, expect those involved in historic preservation to push for the Historic Tax Credit Improvement Act, which has been introduced in each of the past two sessions of Congress, as well as guidance on a number of transition rule questions, elimination of the basis adjustment and a fix to the BEAT.

RETCs

But for the BEAT, the ITC and PTC emerged surprising unscathed from tax reform. Both the House and Senate version of H.R. 1 included provisions that were seen as unfavorable to renewables–the House bill would have repealed the 10 percent ITC and reduced the PTC phasedown value, while extending the ITC for orphaned technologies; the Senate bill retained current provisions without extending the orphaned technologies.

The Senate bill carried the day, meaning there is no extension for the orphaned technologies and the ITC and PTC phasedown remain in place.

Going Forward

With a tax cut bill now enacted, tax credit advocates now have two major tasks, work through the existing changes as best they can, seek guidance and suggest technical corrections as needed; and get back to work to improve and expand the credits. The Affordable Housing Credit Improvement Act is still before Congress, as are the Historic Tax Credit Improvement Act and New Markets Tax Credit Improvement Act. Watch for them to become a focus again as a new year starts.

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Comparison of Major Provisions Before, After Passage of Tax Cuts and Jobs Act		
	PREVIOUS LAW	**NEW LAW**
Volume Cap Low-Income Housing Tax Credits (LIHTC)	$2.35 per capita/$2.71 million small state minimum (2017)	Retained
Private Activity Bonds (PAB)	$100 per capita/$305 million small state minimum (2017)	All PAB, including residential rental, retained
4 Percent PAB LIHTC	$3-4 billion a year 4 percent PAB LIHTC	4 percent PAB LIHTC retained
LIHTC Basis	Maximum basis boost = 30 percent	No changes
LIHTC-General Public Use Requirement	No changes	No changes
New Markets Tax Credit (NMTC)	$3.5 billion annual allocation for 2018 and 2019, 39 percent credit, slated to expire after 2019	2017, 2018 and 2019 rounds retained
Investing in Opportunity Act	No provision	Creates new incentive to invest capital gains in low-income communities
Historic Rehabilitation Tax Credit (HTC)	20 percent credit claimed when certified historic property is placed in service	20 percent credit retained, but claimed over 5 years, after 2017, subject to transition rules
Non-Historic Rehabilitation Tax Credit	10 percent credit, for nonresidential buildings placed in service before 1936	REPEALED after 2017 subject to transition rules
Renewable Energy Investment Tax Credit (ITC)	30 percent ITC, phases down after 2019, 10 percent ITC - “Permanent”	30 percent ITC, phase down after 2019 retained, 10 percent ITC retained
Orphan Renewable Energy Technologies	ITC “Orphan” Renewable Energy Technologies expired after 2016	ITC “orphan” renewable energy technologies remain expired
Renewable Energy Production Tax Credit (PTC)	PTC phase down starting after 2016, PTC @ 2.4 cents per kWh	PTC phase down starting after 2016, PTC at 2.4 cents per kWh retained
PTC Continuous Construction Requirement	No continuous construction requirement for projects completed by 2020	Retained
Corporate Rate	Top corporate rate of 35 percent	Top corporate rate of 21 percent tax years beginning after Dec. 31, 2017
Business Income Taxation (Individuals) (Pass-throughs and Schedule C)	Subject to individual income tax rates	Individuals may generally deduct 20 percent of qualified business income (until Dec. 31, 2025)
Business Interest Expense Deduction	No limit	Limited to 30 percent of business adjusted taxable income, real estate businesses can elect out
Expensing	50 percent bonus depreciation, phased down through 2019 for new property	100 percent expensing for new and used property investments made after Sept. 27, 2017, through Dec. 31, 2022, phases down through Dec. 31, 2026, buildings not eligible, real estate businesses are eligible
Property Depreciation	Modified Accelerated Cost Recovery System (MACRS): residential rental real property - 27.5 years, site improvements – 15 years, personal property – 5 years, Alternative Depreciation System (ADS): real property – 40 years	MACRS – Residential and nonresidential real property depreciation life unchanged. ADS 30 year for residential and 40 year for nonresidential real property if elect out of business interest expense deduction limitations
Interest Deductibility	No limit ADS – 40-year cost recovery for real property	Real estate businesses can elect out of limitation on interest deductibility. But, ADS as modified to 30-year cost recovery for residential real property and 40-year cost recovery for nonresidential real property would apply
Inflation Factor	Consumer Price Index for all Urban Consumers (CPI-U)	Changes to “chained CPI,” future 9 percent LIHTC allocations and volume cap for tax-exempt private activity bonds REDUCED
Base Erosion and Anti-Abuse Tax (BEAT)	N/A	5-6 percent - 2018, 10-11 percent – 2019-2025, then 12.5-13.5 percent tax rate after 2025 Corporations generally benefit from at least 80 percent of LIHTC, ITC, and PTC until 2026. NMTC and HTC cannot offset BEAT liability
Alternative Minimum Tax	20 percent for corporations 28 percent for individuals	Repealed for corporations; Increased exemption and phase-out thresholds for individuals until Dec. 31, 2025 Note: LIHTC, HTC and ITC can be taken against AMT liability, but NMTC and years 5 through 10 of PTC cannot

Source: Novogradac & Company LLP

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Supporters of affordable housing, community development, historic rehabilitation and renewable energy should also continue their quest to remind legislators of the good done by their industries–not only in achieving their fundamental purposes, but in creating economic benefit to communities that need it.

Those looking for a way to get further involved should consider joining Novogradac's working groups for the LIHTC, NMTC, ITC and PTC, and the Investing in Opportunity Act. Information is available on www.novoco.com. If there is a bright side to the tax reform battle–other than the fact that the major tax credits survived–it is in how the communities were energized and successfully advocated to Congress for the continuation of the tax credits.

The tax reform battle of 2017 appears over, but the war to increase and improve the tools to create affordable housing, community development, historic preservation and renewable energy continues.❖

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