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Making a Case for the Five-Year Carryback

By Michael J. Novogradac, CPA

Last year in August I wrote in this space about the affordable housing industry's efforts to coalesce around its response to the steep decline in equity prices for low-income housing tax credits (LIHTC). In their effort to build consensus, industry leaders met to discuss several options and the political realities of getting their proposals approved by Congress. Industry leaders ultimately agreed on three proposals they felt were most crucial to the success of the LIHTC community and which stood the best chance of getting approved by Congress: an extension of the housing credit exchange program, including expanding it to include 4 percent credits; increasing the housing credit carryback for up to five years, and permitting pass-through entities – limited liability companies (LLCs), and Subchapter S corporations – to use the housing credit program.

Unfortunately, neither the LIHTC five-year carryback nor any changes to passive activity rules to benefit investment in the LIHTC program were included in the President's FY 2011 budget, although a five-year carryback was introduced in the House (H.R. 4109) and Senate (S. 3141). On the other hand, an extension of the exchange provision was included in the President's FY 2011 budget and is included as an amendment to the American Workers, State and Business Relief Act of 2010 (AWSBRA 2010). AWSBRA 2010 was introduced by Finance Committee Chairman Max Baucus and Majority Leader Harry Reid and the Senate approved it by a vote of 62-36. At press time, next steps for the bill were undecided. If enacted, the bill would extend for one-year the 9 percent LIHTC cash grant exchange program that was created by the American Reinvestment and Recovery Act of

2009.

Among the Senate-passed provisions of AWSBRA 2010 is the placed-in-service deadline extension, which will allow developers an additional two years to use Gulf Opportunity Zone (GO Zone) LIHTCs. These tax credits represent more than 6,000 affordable homes and \$1 billion in construction activity that have been stalled and are at risk of not being built. This legislation would shift by two years a congressionally mandated deadline of December 2010 for completing construction, providing more time for state governments, developers and investors to overcome financial challenges and enable the use of previously allocated housing credits.

While acknowledging that the exchange program and the Tax Credit Assistance Program (TCAP) have been instrumental in moving some projects forward, there remains a critical need to provide incentives for investors, who left the industry, to return. Many of those investors whose profits had allowed them to claim tax credits against their tax liability found in 2008 and 2009 that they could no longer use tax credits, and demand for LIHTCs fell dramatically.

A domino effect followed: tax credit prices fell, funding gaps were created in LIHTC projects that had received tax credits, and thousands of units were stalled or abandoned.



continued on page 2

continued from page 1

TCAP and the exchange program did not help the investor appetite aspect of the LIHTC downturn; they were not intended nor have they revived investor demand for LIHTCs.

Studies by Ernst & Young (E&Y) and the Joint Center for Housing Studies of Harvard University were undertaken to gain a better understanding of the LIHTC investment market and to analyze investor response to certain legislative proposals, including the five-year carryback. Their results pointed to a critical need for Congress to address and pass a measure that would provide incentives for LIHTC investors to re-enter the industry.

The E&Y study, commissioned by Enterprise Community Partners Inc. and Local Initiatives Support Corporation (LISC), confirmed that LIHTC investment activity had fallen dramatically in the last two years but noted that such activity would increase significantly in the near term if Congress enacted legislation allowing a five-year carryback of LIHTCs instead of the current one-year carryback, providing \$5 billion more of investment nationally through 2011.

The Harvard study reported that one solution to bringing back demand would be legislative solutions to one or both of two aspects of the tax code — passive activity rules and the 10-year use and 15-year compliance period of the tax credit that inhibit demand and result in lower tax credit pricing, and/or an expansion of the Community Reinvestment Act (CRA) that provides regulator and financial motivation for financial institutions to invest in tax credits.

Making a Case for the Five-Year Carryback

Under present law, if a taxpayer has insufficient current year income tax liability to fully use current year LIHTCs, then the excess LIHTCs can be carried back one year, and carried forward 20 years. Rep. Bill Pascrell, D-N.J., has introduced HR 4109 that allows a five-year carryback of LIHTCs, provided the taxpayer agrees to reinvest the proceeds from the carryback in additional LIHTC developments. Sen. Jeff Bingaman, D-NM, has also introduced a similar bill (S. 3141), that would include the 9 percent exchange and the five-year LIHTC carryback for new investments.

My partner Dan Smith and I have studied the cost to the government of the five-year carryback and, as the following examples illustrate, concluded that over a 10-year revenue projection period, this provision should have negligible net cost to the government. If a taxpayer is currently not able to use the credits by carrying back one year, then the taxpayer would likely use the credits to offset tax liability in future years, most likely within the following 10 years. As such, the carryback of the credits accelerates the use of the credits, but over 10 years does not generate a net cost.

continued on page 3

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Novogradac Journal of Tax Credits Information

Address all correspondence and editorial submissions to:
Jane Bowar Zastrow / 415.356.8034

Address inquiries regarding advertising opportunities to:
Emil Bagalso / 415.356.8037

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continued from page 2

Example One

Assume ABC Corp has \$8.5 million in unused LIHTC at the end of 2010. ABC Corp projects that, if carried forward, it could use those credits fully within 10 years. A five-year carryback is enacted into law during 2010 and ABC Corp makes an election to amend the last five years tax returns to carry back and use the unused LIHTC. Consistent with the requirement, ABC Corp invests \$8.5 million in new LIHTCs. ABC Corp purchases the LIHTCs at a price of 85 cents a credit, acquiring a total of \$10 million of LIHTCs that are available at a rate of \$1 million per year for 10 years. Between the years 2011 and 2019, ABC Corp has a tax liability of \$3 million each year and is therefore able to use the credits as they are earned over the next 10 years, resulting in no net cost to the government when compared to ABC Corp's situation had the five-year carryback not been enacted into law and ABC Corp carried forward the unused credits using them within 10 years.

In the unlikely event that a taxpayer was not able to use those credits within the following 10 years, then the requirement to reinvest in additional tax credits ensures that the provision has negligible net cost over 10 years.

Example Two

Assume XYZ Corp has \$8.5 million in unused LIHTC at the end of 2010. XYZ Corp projects that if carried forward over the next 10 years it could only use \$4.5 million of LIHTCs. H.R. 4109 is enacted into law during 2010 and XYZ Corp makes an election to amend the last five years tax returns to carry back and use the unused LIHTC. Consistent with the requirement, XYZ Corp invests \$8.5 million in new LIHTCs. XYZ Corp purchases the LIHTCs at a price of 85 cents a credit, acquiring a total of \$10 million of LIHTCs that are available at a rate of \$1 million per year for 10 years. Between the years 2011 and 2019, XYZ Corp has a tax liability of \$500,000 each year and is therefore able to use only \$4.5 million of credits over the next 10 years. The resulting net cost to the government is still zero, as XYZ Corp, by virtue of the reinvestment requirement is accumulating additional LIHTC to carry forward.

The conclusions in Examples 1 and 2 on the following pages are consistent with that of the Joint Committee on Taxation's (JCT) February 12, 2009 conclusion on the net cost of the five-year carryback of net operating losses for businesses with gross receipts of \$15 million or less. See accompanying charts. The JCT found that the cost to the government for a five-year carry back of net operating losses was about 20 percent of the initial refund amount; however, the net operating loss carryback provision differs from the LIHTC carryback provision in two key ways:

- The LIHTC carryback provision has a reinvestment requirement, and
- The LIHTC annual volume of credits is capped.

continued on page 4

continued from page 3

(Figure 1) JOINT COMMITTEE ON TAXATION (JCX19-09)

Provision	Effective	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2009-13	2009-14	2009-18	2009-19
5-year carryback of 2008 NOLs for businesses with gross receipts of \$15 million or less	[8]	-4,741	708	753	648	486	365	274	205	154	115	87	-2,146	-1,781	-1,033	-947

Source: Joint Committee on Taxation, Novogradac & Company LLP.

It is the interaction between these two features that serves to minimize the net tax cost over 10 years. If this carryback provision were applied to non-capped tax credits, the revenue cost would be much higher. Similarly, if the reinvestment requirement were omitted the revenue cost would be much higher.

Conclusion

In an editorial on AolNews, Sen. Jeff Merkley, D. Ore., and David Abromowitz, of the Center for American Progress, write that while foreclosures dominate the news, “there’s a larger and more worrisome housing crisis ahead: a looming shortage of affordable rental housing.” They cite the Harvard study’s finding that a critical need already exists for at least five million more rental housing units affordable to working families — a situation, they say, that is worsening due to foreclosures that are forcing families back into the rental market and boomers in search of “lower-stress multifamily settings.” The Affordable Rental Housing A.C.T.I.O.N. campaign says that with congressional action on all three of the industry’s action items, 138,000 new affordable apartments could be constructed or rehabilitated through 2011.

Merkley and Abromowitz note in their article that the LIHTC program has been a model for public/private partnerships since its creation in 1986, that it has produced more than 1.5 million units of quality housing for families, seniors and individuals; been an economic engine, creating hundreds of thousands of construction jobs each year; and added \$1.5 billion in taxes and other revenues. They then cite the industry’s three consensus proposals, saying, “if Congress enacts these proposals, capital should begin to again flow back to the production of desperately needed rental housing. And while even returning to normal will fall short of what is needed to avoid the coming housing crunch, it is an essential first step toward addressing this next chapter in America’s housing challenge.”

We thank the Senate for its passage of the tax extenders and join the more than 170 national, state and local LIHTC stakeholder organizations in calling on Congress to include in upcoming tax legislation several other of the LIHTC industry’s important consensus proposals, including the five-year LIHTC carryback period for new housing and qualifying existing housing. ❖

Example One (in thousands) Cost of Five-Year Carry Back

	Year										Total
	1	2	3	4	5	6	7	8	9	10	
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	
Current Credit Usage (ABC Corp)	\$ -	\$ (3,000)	\$ (2,000)	\$ (2,000)	\$ (1,500)	\$ -	\$ -	\$ -	\$ -	\$ -	(8,500)
Existing Credits (Other Investors)	-	(500)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(8,500)
Tax Cost Existing Law	-	(3,500)	(3,000)	(3,000)	(2,500)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(17,000)
Carryback (ABC Corp)	(8,500)	-	-	-	-	-	-	-	-	-	(8,500)
Reinvest. in New Credits (ABC Corp)	-	(500)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(8,500)
Tax Cost New Law	(8,500)	(500)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(17,000)
Net Tax Cost	\$ (8,500)	\$ 3,000	\$ 2,000	\$ 2,000	\$ 1,500	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -

continued on page 5

continued from page 4

Example Two (in thousands) Cost of Five-Year Carryback

	Year										Total
	1	2	3	4	5	6	7	8	9	10	
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	
Current Credit Usage (XYZ Corp)	\$ -	\$ (500)	\$ (500)	\$ (500)	\$ (500)	\$ (500)	\$ (500)	\$ (500)	\$ (500)	\$ (500)	(4,500)
Existing Credits (Other Investors)	-	(500)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(8,500)
Tax Cost Existing Law	-	(1,000)	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)	(13,000)
Carryback (XYZ Corp)	(8,500)	-	-	-	-	-	-	-	-	-	(8,500)
Reinvest. in New Credits (XYZ Corp)	-	(500)	(500)	(500)	(500)	(500)	(500)	(500)	(500)	(500)	(4,500)
Tax Cost New Law	(8,500)	(500)	(500)	(500)	(500)	(500)	(500)	(500)	(500)	(500)	(13,000)
Net Tax Cost	\$(8,500)	\$ 500	\$ 1,000	\$ 1,000	\$ 1,000	\$ 1,000	\$ 1,000	\$ 1,000	\$ 1,000	\$ 1,000	\$ -
Cumulative Carryforward (XYZ Corp)		(500)	(1,500)	(2,500)	(3,500)	(4,500)	(5,500)	(6,500)	(7,500)	(8,500)	

Source: Novogradac & Company LLP.

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