

Novogradac Report on Tax Credits
Transcript: January 19, 2010

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(Intro music)

Hello! It's Tax Credit Tuesday and I'm Michael Novogradac.

Today is Tuesday, January 19th, 2010. I'm back in San Francisco this week after attending our low-income housing tax credit last week in Miami.

This week's I will discuss how recent accounting guidance could affect how corporations account for their investments in low-income housing tax credit, new markets tax credit, historic tax credit and renewable energy tax credit investments.

Then I will review the findings of a report that analyzes the impact of the Recovery Act's renewable energy provisions on community wind energy projects.

While on the topic of renewable energy, I will also examine a recently released Treasury Department list of frequently asked questions and answers about the Section 1603 cash grant program.

Then, I will discuss the results of a comprehensive review of Iowa's state tax credits. This ongoing topic has considerable potential significance for other states.

And finally, I will summarize points of interest to the tax credit community that come from an annual congressional estimate of federal tax expenditures.

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But first, I have breaking news about \$23 billion, yes \$23 billion dollars with a B, in housing bond activity that was announced last week.

On January 13th, the U.S. Department of the Treasury the Department of Housing and Urban Development, or HUD, and the Federal Housing Finance Agency announced the completion of all transactions under the recently-introduced state and local Housing Finance Agency Initiative or HFA Initiative.

The initiative was created using authority provided to Treasury by the Housing and Economic Recovery Act of 2008, also known as HERA. As part of the initiative, the New Issue Bond Program provided HFAs with temporary financing to issue new housing bonds.

Treasury reports that more than 90 state and local HFAs representing 49 states in the New Issue Bond Program, for an aggregate total new issuance of \$15.3 billion. Participating HFAs are expected to provide affordable multifamily loans that will help keep rents affordable for tens of thousands of renters. The Treasury Department says that government sponsored enterprises, or GSEs, Fannie Mae and Freddie Mac played a central role in both the program's design and transaction execution.

In announcing the completion of these bond transactions, Susan Dewey, president of the National Council of State Housing Agencies, NCSHA, and executive director of the Virginia Housing Development Authority said that "These bond proceeds," and I quote, "combined with the \$7.7 in retail housing bonds the initiative requires

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state HFAs to issue will allow HFAs to finance more than 200,000 affordable homes while generating jobs and tax revenue for the economy.”

To learn more about this announcement and the New Issue Bond Program, I invite you to pick up a copy of the February issue of the Novogradac Journal of Tax Credits. If you’re not already a subscriber, you can sign up online at www.novoco.com slash journal.

I’d also like to take a moment to congratulate my partner, Annette Stevenson, in our Cleveland, Ohio office.

Annette was honored by Crain’s Cleveland Business as one of the recipients of the publication’s Forty Under 40 award. The recipients, who are chosen from throughout Northeast Ohio, are aged 40 or younger and have established and proven themselves as leaders, actively guiding the region’s business community.

Annette has 15 years of public accounting and business advisory experience with an emphasis on complex financing for community development real estate projects and she has carved out a national reputation as an expert in new markets tax credits. Annette has helped in closing more than \$1 billion of new markets tax credit transactions. She worked recently on the restored historic Capitol Theatre project in Cleveland, Ohio, which we will profile in the next issue of the Novogradac Journal of Tax Credits.

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Now, for our first planned topic, I have a more in-depth discussion of the significance of accounting guidance recently released by the Financial Accounting Standards Board.

In December, the Financial Accounting Standards Board issued guidance about financial reporting by enterprises involved with variable interest entities. The update incorporates FIN 46(R), which was issued in June 2009, to the board's new Accounting Standards Codification.

The adoption of this amendment is not expected to *significantly* alter the majority of conclusions reached previously by various investors in the low-income, new markets, historic and renewable energy tax credit communities; **however**, there are subtle changes that will change an investor's approach and even the timing for reassessing the primary beneficiary.

Through this update, certain guidance was amended for the accounting on consolidation of variable interest entities, or VIEs. Variable interest entities are legal entities in which investors do not have sufficient equity at risk for the legal entity to finance its activities, without additional financial support, **or**, as a group, they lack:

1. the ability to direct the activities of the entity that significantly impacts the entity's economic performance,
2. the obligation to absorb the expected losses, or
3. the right to receive the expected residual returns.

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The legal entity itself may be any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts and other trusts.

The amended guidance changes the approach for making an assessment to determine the primary beneficiary of a VIE. An enterprise is required to perform an analysis to determine whether its variable interest or interests give it a controlling financial interest in a variable interest entity. Included in this assessment is a consideration of whether there is an implicit financial responsibility to ensure that a VIE operates as designed. This assessment should be considered when determining whether the enterprise has the power to direct the activities that most significantly affect the VIE's economic performance.

With this change, those who invest in tax credits may need to consider if future capital contributions may be required to fund operations and preserve future tax credit streams. An investor with a frequent history of providing unanticipated contributions may be more likely identified as a primary beneficiary. Some questions that you should ask are

Will the sponsor of the tax credit investment be able to honor its guarantees?

If unanticipated contributions are required, how will this impact the determination of the primary beneficiary?

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Will the investor require an amendment to the provisions of the partnership or operating agreement?

and

Will the investor require more control and rights in the entity's daily operations or activities?

The amended guidance may increase the frequency of making an assessment to determine the primary beneficiary, because an entity must now perform an ongoing assessment to determine if it remains or has become the primary beneficiary. Previously, an entity did not need to reconsider if it was the primary beneficiary except when certain events occurred. The Financial Accounting Standards Board guidance provides several considerations for when an event may indicate a possible change to the entity's status as a VIE or to an investor's status as the primary beneficiary. Reconsideration may result from changes in facts and circumstances, such as when the equity holders as a group lose their voting rights or similar rights to direct the entity's activities that have a significant impact on the entity's economic performance. An example of this is in circumstances in which a debt holder requires approval or decision rights in the entity's activities in order to defer an acceleration of principal from a loan default.

Additionally, the amended guidance eliminates the qualitative approach and requires enhanced disclosures for special purpose entities.

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So, to summarize, while these changes will not have a substantive effect on the majority of tax credit investors, additional considerations may be required when determining the primary beneficiary. In addition, those who invest in tax credits will need to frequently consider if the facts and circumstances from unanticipated changes to the investment or unforeseen events may warrant a change to the primary beneficiary designations.

If you have questions about how this new Financial Accounting Standards Board guidance may affect your tax credit investment or investments, I encourage you to call my partner Bentley Stanton in our Atlanta office. He can be reached at (678) 867-2333. Once again, that's (678) 867-2333.

Our second topic for this week is a look at the findings of a report that indicate that two of the Recovery Act's renewable energy provisions may be particularly beneficial to shovel-ready community wind projects.

The Department of Energy's Lawrence Berkeley National Laboratory released a report on January 8th that analyzed the impact of the ability for qualifying wind projects to choose either a 30 percent investment tax credit, referred to as the ITC, or a 30 percent cash grant. These two options are in lieu of the production tax credit, also called the PTC.

That analysis showed that community wind development, which has had more difficulty using the PTC than commercial wind, may

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benefit disproportionately from this newfound ability to choose among these two federal incentives. The report defines “community wind power development as wind projects that are locally owned, consist of utility-scale turbines, and are interconnected on either the customer or utility side of the electric meter.

A financial model of community-scale wind power projects developed by the report’s authors indicates that for most community wind projects the ITC and the cash grant will likely be worth more than the PTC. Also, several “ancillary” benefits associated with the ITC, or the cash grant in lieu of the ITC - but not with the PTC - could provide a further boost to these projects. These ancillary benefits include full relief from the alternative minimum tax and the passive credit limitations.

The report’s authors say that a quantitative analysis of these ancillary benefits may also inform the development of a policy agenda for community wind, by revealing which of these benefits are most valuable to the sector. For example, the report examines the relief from passive activity credit limitations for passive activity investors in community wind projects. This examination reveals that choosing the 30 percent ITC over the production tax credit does not provide much value to passive investors, because of the passive credit limitations and those limitations generally require that all the tax credits be carried forward – potentially for many years – until they can be applied against that project’s own tax obligations or tax obligations from other passive activities. This delay reduces the present value of

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these tax benefits. Only if the project elects the 30 percent cash grant, which is not subject to the passive activity credit limitations, does a project realize the full potential of wind's temporary ability to choose among these two incentives.

The report notes that to date, passive investors have not played a significant role in most community wind projects built in the United States – and the authors speculate this could be due to the negative impact of the passive credit limitations on the value of the production tax credit. However, the report says that if community wind is going to penetrate the broader wind market to any significant degree, it may need to look more to passive investors to finance that expansion. In this light, seeking to extend the very limited window of opportunity for the 30 percent cash grant – which singlehandedly removes the largest impediment to the participation of passive investors in community wind projects – may be a logical top policy priority for the community wind sector. Alternatively, and one that we at Novogradac particularly support, the report notes that exempting the PTC and ITC from the passive credit limitations could provide similar relief, though without the other benefits provided by the receipt of cash rather than a tax credit.

A copy of the complete report is available online at www.energytaxcredits.com. More information about the PTC, the ITC and the Recovery Act's renewable energy provisions are also available at that web address. If you have additional questions, I'd

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also encourage you to contact my partner Stephen Tracy in our San Francisco office.

While we're on the subject of renewable energy, let's talk for a moment about the recently released set of frequently asked questions and answers about the Section 1603 cash grant program.

On January 8th the Treasury Department published a list of its Frequently Asked Questions and Answers document for the renewable energy cash grant program.

Commonly referred to as the FAQs, they address topics such as application procedure, applicant eligibility, property eligibility, use of awarded funds and eligible basis. The most recent copy lists a total of 35 questions and answers. There is a lot of good information provided in the document and for the most part the answers provided largely what industry practitioners had expected.

Some points of interest, however, do include question and answer number 9 in which Treasury says it will - that is it will - notify an applicant of a project that has not been placed in service whether or not Treasury has accepted position that construction has actually already started within the required time period of 2009 or 2010.

Also, in question and answer number 10, Treasury clarifies that multiple projects cannot be applied for in a single application. This point is of particular interest, and possibly concern, for developers of solar energy projects.

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To download a copy of the FAQ document, simply go to www.energytaxcredits.com and click on Hot Topics in the News menu. From there, just click on the link for the Section 1603 Grant Program, there you will find a link to this and all other published guidance on the program.

If you have questions about any of the FAQs or about the program in general, please call my partner Dan Smith in our Dover, Ohio office.

Let's shift gears now to an update on the comprehensive review of state tax credits that was completed recently in Iowa.

As most listeners will recall, Iowa's lawmakers and state officials have been conducting an intensive review of state tax credits. On November 19th, 2009, Governor Chet Culver designated a tax credit review panel consisting of agency directors who oversee the state's various tax credit programs.

Each director on the panel conducted an in-depth review of existing tax credit programs. This examination included an analysis of the major provisions, costs and benefits, recent historical information, and oversight and responsibility for each state tax credit. The panel also held public hearings on December 15th in Cedar Rapids and on December 16th in Urbandale. During these forums more than 80 individuals and organizations shared their ideas and concerns related to specific tax credits and to the overall state policy regarding the use of tax credits.

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On January 8th, the panel released a report that includes its key findings and recommendations. The panel's basic conclusion is that prudent stewardship of taxpayers' dollars demands much greater transparency for tax credits. Specifically, the report recommends that all business-related tax credits that are not capped be included under the global budget cap that Governor Culver initiated in his fiscal year 2010 budget recommendations. The report also recommends that a five-year sunset be required for all tax credits in order to provide greater accountability, and that eight tax credit programs be eliminated.

In addition, and this is of particular interest in a more broad sense, the panel concluded that transferability of state tax credits does not contribute to an effective tax credit program. In fact, the panel said that transferability of tax credits in some instances has contributed to abuse. As such, the panel recommends that the state eliminate the ability to transfer all state tax credits. The state's Historic Preservation and Cultural and Entertainment District Tax Credit is among those credits that are transferable. In its recommendation, the panel says that it is mindful of the fact that elimination of transferability could change the economics of certain projects.

Other changes that are recommended for the historic preservation tax credit are

1. for the state to develop a searchable database that would be maintained by the Department of Revenue;

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2. that they should be lowering to 250 the number of required jobs offered for projects in the “jobs projects queue”; and
3. should include a sunset provision.

As a large number of states face the same budgetary pressures as those faced in Iowa, it's quite possible if not likely that similar reviews could be considered.

For example, Missouri Senator Jason Crowell recently renewed his efforts to alter the way tax credits for economic development projects are awarded in Missouri. Senator Crowell tried unsuccessfully last year to submit the amount of tax credits in each program to legislative appropriations.

Senator Crowell introduced similar legislation again last week. Under his proposal, agencies that award tax credits would be required to explain why credits were awarded and show that the expense makes sense for the state.

Regional newspaper the *Southeast Missourian* reports that so far this fiscal year, Governor Jay Nixon has vetoed or withheld \$634 million in spending approved by lawmakers last year. The paper also reports that additional cuts will be required in the next fiscal year as the state faces the impact of the recession.

Against this background, Senator Crowell said in a press release that tax credits reduced state revenue by \$584.7 million in 2009. He says his proposal will ensure that the value of each tax

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credit program will be measured when annual allocations are approved as part of the appropriation process.

Fortunately however, as the next two announcements illustrate, the value of tax credits to a state's economy - rather than their cost - is being acknowledged by lawmakers in these other states. For example, let's consider state tax credit news from Maryland.

On January 8th, Governor Martin O'Malley announced his plans to create the Sustainable Communities Tax Credit program. The new Sustainable Communities Tax Credit program would be designed to propel smart and sustainable growth in historic areas and existing communities well-served by transit and infrastructure. Governor O'Malley says the \$50 million, three-year program will help create construction and rehabilitation jobs, revitalize neighborhoods and spur economic development.

The new program would replace and improve upon the 14-year-old Heritage Structure Rehabilitation Tax Credit program, which is set to expire in June. The existing Heritage Tax Credit is administered by the Maryland Department of Planning, and provides state income tax credits equal to 20 percent of the qualified capital costs expended in the rehabilitation of a certified heritage structure. Through the Heritage Tax Credit Program, the state has invested more than \$347 million in revitalization projects since 1996. Those projects have produced more than \$1.5 billion in total direct rehabilitation

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expenditures by owners and developers. Coupled with wages, construction and new jobs, as well as state and local revenues generated, this equates to more than \$8.50 in economic output for every \$1 invested by state government.

A report last year by the not-for-profit Abell Foundation concluded that over the life of the program commercial projects have employed approximately 15,120 people. Moreover, because the tax credit investment is for relatively labor-intensive building renovation, it has generated 1,850 more jobs than would have been created had the same funds been used for new construction, according to the foundation's report.

Novogradac will track the progress of Governor O'Malley's proposed Sustainable Communities Tax Credit program and update you in future podcasts as well as in the Novogradac Journal of Tax Credits.

Also on the state tax credit front, lawmakers on January 4th introduced legislation in the Wisconsin Assembly to create a state new markets tax credit.

Wisconsin lawmakers will consider a bill to create a state new markets tax credit in their current legislative session. Assembly Bill 642 was introduced on January 4th and a public hearing on the matter was held January 5th. The bill would authorize the Wisconsin Department of Commerce to certify an individual — who applies, has made an investment in a qualified community development entity, and is eligible to receive federal new markets tax credits — to receive

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a credit against state income and franchise taxes and against license fees paid by insurers.

A number of states, as our listeners know, already have state new markets tax credits in place. The NMTC Working Group compiled a list of those states late last year and that list has been posted on our web site. To view a complete list of existing state NMTC programs simply go to www.newmarketscredits.com and click on State NMTCs under the menu headline Application & Allocation. On that page you can see summaries of each state's program as well as links to more detailed information.

A number of states don't have state NMTCs but are or may be considering them in the future. We are compiling a list of proposed NMTC legislation that will be added to the State NMTC web page at newmarketscredits.com.

For example, reports indicate that Michigan may be considering a state NMTC program in the coming legislative session. A bill was introduced last year to create that program but the proposal lacked traction; however, it is expected that lawmakers will try again this year. Novogradac & Company is tracking that proposal and will report on its progress in the March issue of the Journal of Tax Credits.

While we're on the topic of new markets tax credits, it's time for this week's Project Profile segment.

On December 30th, Advantage Capital Partners announced that it provided \$7.1 million in financing to Chicago-based Allen Brothers

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Incorporated, a leading supplier of USDA Prime grade beef. The funds will be used to support the company's growth, with new job creation projected in the coming months. This investment is particularly interesting because it marks the first significant investment that Advantage Capital has made in connection with the Illinois New Markets Development program. Advantage Capital provided the financing in participation with Old Second National Bank of Aurora, Illinois.

Mark Lewis, a principal at Advantage Capital, said Advantage was able to provide this well-established Chicago business with mezzanine financing to fill a financing gap and provide liquidity. He said this level of financing would not have been possible without the New Markets Tax Credit program.

Founded in 1893 in Chicago's historic Union Stockyards, Allen Brothers has built a reputation for providing fine dining restaurants and direct-to-consumer channels with high-quality beef products. The company supplies prime-aged cuts to many of the country's top steakhouses, including Morton's, Lawry's and Delmonico's. However, like many businesses, it has felt the effects of the economic downturn. Robert Hatoff, chairman and CEO of Allen Brothers, says Advantage Capital's investment will provide the company with the necessary working capital to ensure continued growth and profitability.

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Now, for our final topic for today's podcast let's review some of the highlights of the Joint Committee on Taxation's annual estimates of federal tax expenditures.

Each year the Joint Committee staff publishes a report on Tax Expenditures prepared for the House Committee on Ways and Means and the Senate Committee on Finance. The report is also submitted to the House and Senate Committees on Budget.

In general, tax expenditures include any reductions in income tax liabilities that result from special tax provisions or regulations that provide tax benefits to particular taxpayers. Importantly, a tax expenditure estimate is not the same as a revenue estimate. Unlike revenue estimates, tax expenditure estimates do not incorporate any behavioral responses of taxpayers or changes in the timing of tax payments.

The study of tax expenditures is used by policymakers and the public to understand and gauge the actual size of government, the uses to which government puts its resources, and most significantly for our listeners — the tax and economic policy consequences that follow from implicit or explicit choices made in fashioning legislation.

The most recent report, which was released last week, includes a description of the numerous tax provisions enacted by the Recovery Act that were not in place when the committee prepared the last installment of this analysis. It also lists the large number of tax credit provisions that expired at the end of 2009, which were in place for the previous assessment.

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According to the most recent report, the home mortgage interest deduction will cost \$572.9 billion during the five year period between 2009 and 2013. By contrast, when you look at rental housing, the low-income housing tax credit program is expected to cost only \$30 billion dollars during the same period. This represents a federal subsidy for homeownership worth 19 times more than the subsidy for low-income housing tax credit housing.

Included in the \$30 billion estimate for LIHTC expenditures is \$3.4 billion for the LIHTC cash grant election created by the Recovery Act.

The committee's report also includes estimates for other tax credits. The federal expenditure for the historic rehabilitation tax credit between 2009 and 2013 is \$2.6 billion. The expenditure for the new markets tax credit program under Section 45D is estimated at \$3.5 billion.

For renewable energy, the federal expenditure for the production tax credit that will go to wind projects is estimated at \$5.9 billion. The tax credit for investment in advanced energy property under Section 48 cap C that was created by the Recovery Act is expected to cost \$1.3 billion.

A copy of the Joint Committee on Taxation's estimates of federal expenditures can be downloaded from www.novoco.com. Click on Hot Topics and then choose the link that says Tax Expenditures.

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Before I wrap up this week's podcast, let's look at the Tax Credit Calendar.

Next week my colleagues and I will travel to San Diego, California for the New Markets Tax Credit Conference. The conference will take place on January 28th and 29th. It's not too late to join us in San Diego, where we will discuss the future of the NMTC program, including an extension of the tax credit and what practitioners can expect from the next round of tax credit allocations. We already have over 275 registered attendees, which is a true testament to the vitality of the new markets tax credit program.

Also next week:

- on January 24th through the 26th, rural housing providers will convene in San Francisco, for their 2010 Mid-Year Meeting, and
- on January 25th through the 27th the Affordable Housing Tax Credit Coalition will hold its 2010 Annual Meeting in Laguna Beach, California.

Well, that brings me to the end of this week's report.

Please join me again next week for more tax credit breaking news. I will discuss the Financial Crisis Responsibility Fee, or the bank tax, that President Obama proposed last week that would be imposed on the debt of the largest financial firms.

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I will also review the most recent low-income housing tax credit utilization data that released by the National Council of State Housing Agencies. NCSHA publishes annual charts summarize total housing credit allocations and low-income units produced by calendar year for each allocating agency. Next week I will review the results from 2008 and compare them to activity in previous years.

This is Michael Novogradac and I'll be back next Tuesday.
Thanks for listening.

(outro music)

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