EXCERPT

NOVOGRADAC
Journal of Tax Credits™

June 2023 • Volume XIV • Issue VI
Published by Novogradac

Debt and Equity Market Updates

Insights on Affordable Housing, Community Development, Historic Preservation and Renewable Energy

Tax Credit Equity Pricing–A Supply-and-Demand Analysis

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When I've spoken about tax credit equity pricing over the past year or so, I've said that I believe we are facing an unprecedented number of factors that have the potential to materially affect tax credit equity pricing over the coming years. On balance, these factors tilt slightly downward.

At conferences, I have limited time to drill down and discuss key factors that affect tax credit equity pricing. This column is an effort to specify some critical supply-and-demand factors that directly and indirectly influence equity pricing. We welcome reader comments on these as well as other considerations. Send comments to cpas@novoco.com.

This discussion focuses on those federal income tax credits that are traditionally used to raise tax credit equity to close financing gaps and make projects and businesses financially feasible. Ranked by relative projected market size in calendar year 2023, they are renewable energy tax credits (RETCs), low-income housing tax credits (LIHTCs), new markets tax credits (NMTCs) and historic tax credits (HTCs).

We will start with an analysis and estimates of the 2023 calendar year supply of tax credits, then turn to factors that affect investor demand for tax credits and close with some additional observations about tax credit equity pricing.

Supply

On the supply side of the federal income tax credit market, there is the authorized supply of newly minted tax credits, there are legislative and advocacy efforts to expand the authorization of existing credits and create new tax credits, and there is the potential for existing equity investments with on-the-run tax credits to be remarketed. Near and longer-term estimates of the anticipated size of these supply elements affects the current and future market equity price.

Existing Enacted Incentives

Following are estimates of the size of the 2023 market for major enacted community development tax incentives:

- RETCs: The size of the RETC market in 2023 is very difficult to estimate due to the enactment of the Inflation Reduction Act (IRA), which contained the largest environmental expenditures in U.S. history. The IRA increased and extended many existing energy credits, as well as created new climate tax credits. The speed at which these additional tax credits hit the market will be highly correlated to the release of much-needed IRS guidance. Looking back to 2020, Norton Rose Fulbright estimated the *equity* market (not total credits) for the renewable energy investment tax credit and production tax credit was $17 billion to $18 billion. A Joint Committee on Taxation report on 2023 legislation to repeal the IRA estimates that clean energy and climate tax incentives will add up to $550 billion over 10 years, a figure that accounts for multiyear tax credits. Put this in the ballpark of $50 billion annually in equity (more than that in allocation, since the median price per credit is less than $1), with pending regulatory guidance playing a major role. The RETC market will take time to ramp up from the authorized levels in the IRA, given industry and regulatory constraints. Expect a notable year-over-year increase in these credits during the near term.

Adding to the challenge in estimating the additional RETCs expected to hit the market because of the IRA is the issue of **refundability**. The IRA allows direct pay for certain clean energy credits for entities including nonprofits, state and local governments, tribal governments, and a few others. It is currently unclear how many newly minted RETCs will go the refundability route, which would keep those credits from adding to the supply of tax credits in need of equity investors.

- LIHTC: Novogradac estimates the overall 2023 allocation for allocated 9% LIHTCs will be approximately $9.5 billion, while the 4% private-activity bond (PAB) LIHTCs will be around $15.5 billion. That's a combined $25 billion in newly minted credits and the amount will grow annually, based on population increases, inflation adjustments and more PAB cap being used for affordable rental housing.
- NMTC: The Community Development Financial Institutions (CDFI) Fund issues $5 billion in allocation authority each year through 2025, which translates into just shy of $2 billion in newly minted credits annually.
- HTC: The HTC is a 20% credit, so it's instructive to look at annual figures for federal HTC investment released by the National Park Service. In 2022, that was $6.6 billion. The $6.6 billion translates to about $1.3 billion in tax credits (20% of $6.6 billion). This $1.3 billion estimate is consistent with recent tax return data releases by the Internal Revenue Service.

There's a wide possible range for the total annual newly minted tax credit equity market–about $60 billion to $90 billion, with 2023 likely to be on the lower end of that range and the amount increasing over time as more guidance is released by Treasury and RETC developments reach the tax equity raising stage.

Sales of Existing Portfolios

Income tax credits don't need to be newly minted to influence the tax credit equity market, as the sale of existing portfolios–particularly in affordable housing, but also in other areas–can bring in the potential of more credits in need of equity investors.

Proposed Incentives

Several proposals–new incentives or expansions of existing incentives–could add to the tax credit equity market in coming years. Some (or all or none) of these could be enacted, which would affect the market:

- Neighborhood Homes Tax Credit (NHTC). A tax credit for the construction and renovation of single-family homes in distressed neighborhoods was proposed in the past two sessions of Congress with a per-capita allocation amount and a small-state minimum. Novogradac estimates there would be $2.4 billion in allocation for 2024, growing to $3.1 billion in 2033, so this would add $2 billion to $3 billion in annual allocation.
- Middle-Income Housing Tax Credit (MIHTC). This credit was part of the Decent Affordable Safe Housing for All (DASH) Act introduced in March. The MIHTC would create $5.3 billion in 2023 to $7 billion in 2032 in tax credit allocation.
- Affordable Housing Credit Improvement (AHCIA) provisions. The AHCIA was reintroduced in May and includes several provisions that would affect the overall market:
    - Restoring the expired annual 12.5% increase in 9% LIHTC allocations and further increasing that allocation by 50% over two years would add an additional $2 billion to $4 billion to the overall LIHTC annual tax credits.
    - Reducing the financed-by test for PAB-financed affordable housing from 50% to 25% would result in more LIHTC-financed housing and would significantly increase the amount of allocation

- ◇ for 4% LIHTCs. Novogradac estimates that this change would increase the amount of LIHTCs by $8 billion annually.
- ◇ Providing a 30% basis boost for rural properties. Novogradac estimates this would create about $360 million per year in additional tax credits.

- The New Markets Tax Credit Extension Act. This bill, reintroduced in February, contains two provisions that could affect the market. One is being able to use credits against the alternative minimum tax (AMT), which we address in the next section. The other is an inflation adjustment for the $5 billion annual allocation, which would mean more allocation in coming years.
- Historic Tax Credit Growth and Opportunity (HTC-GO) Act. This legislation, also reintroduced in February, would increase the HTC percentage for small projects, eliminate the HTC basis adjustment (addressed later) and make other changes to the rehabilitation credit. The magnitude of the increase is unclear, but this legislation would increase tax credit supply.

The overall change in the total annual allocation by these proposals varies greatly, depending on which, if any, are enacted. If *all* were enacted, the overall tax credit allocation would grow by up to $20 billion annually–a jump of more than 25% in the overall market.

Demand

Demand for tax credits is determined by many factors. For starters, investors must have projected income tax liability and current (and anticipated changes to) tax law must allow them to use the credits to offset that tax liability. Demand for tax credit equity is also affected by the comparative yields of competing tax credit investments and non-tax-credit investments. Several nonpecuniary incentives affect investment demand as well.

Tax Liability

The most obvious factor in assessing demand by investors for tax credits is their anticipated federal income tax liability. The IRA created a 15% minimum tax on corporate book earnings, which could boost demand for tax credits since some public companies will have larger income tax bills due to the corporate minimum tax and may seek to offset a portion of that tax liability with federal income tax credits.

Estimates of future income tax liability are heavily impacted by the anticipated state of the economy. Should the economy slide into a recession–whether it's a major economic downturn like the Great Recession or a momentary blip like the COVID-19 mini-recession of 2020–there will be downward pressure on investor demand, with a derivative downward pressure on equity pricing.

Ability to Use Credits

Another demand factor is the *ability* of taxpayers to use credits. Having a significant tax liability does not mean that a taxpayer can benefit from a tax credit and tax losses.

Widely held corporations dominate the tax credit equity markets for two major reasons: First, they have large tax liabilities and can make large equity investments, minimizing transaction costs per dollar of equity invested. Second, and perhaps more importantly, they have considerably fewer limitations on their ability to use tax credits.

Individual taxpayers, on the other hand, are notably minor tax equity investors by dollar volume, as most individuals are locked out of many community development tax incentives due to passive activity and at-risk limitation rules. That is not a factor for the NMTC, but that credit is largely unavailable to individual taxpayers because under existing law the NMTC does not reduce the AMT, a restriction that does not apply to the other community development tax credits discussed in this article. As mentioned earlier, a provision in the NMTC Extension Act would allow the NMTC to reduce the AMT, which would increase demand for credits by individual investors.

Another factor in the *ability* to use credits is **transferability**. Transferrable tax credits create the potential for many new investors, including individuals. A provision in the IRA makes some energy credits transferrable, which presumably will increase demand. The extent to which this provision will affect the market is unclear, with IRS guidance (expected this summer) critical in determining the logistics of transferability and how it will affect the tax credit equity market.

Efforts to enact a **global minimum tax (GMT),** which would create a minimum effective tax rate of 15% in each country for large multinational corporations, is another "ability to use" factor. The GMT has the potential to reduce or eliminate the value of some or all of a company's community development tax credit investments, depending on how the use of such credits affects the assessment of an entity's minimum effective tax rate on U.S. income. While guidance released in February lessened concern among many community development stakeholders, notable apprehension remains. The GMT could yet cool demand for tax credits for some of the larger investors.

Nonpecuniary Incentives

Beyond the purely financial assessment of the demand for tax credit investments, several non- pecuniary factors affect investor demand.

Community Reinvestment Act (CRA) regulations provide banks with motivation to invest in community development. With the three main bank regulatory agencies finalizing the first major update to CRA regulations since 1995, we could see a major effect on community development tax incentives. Provisions in the proposed rule released in May 2022 were seen as having a negative effect on demand for tax credits, but there is hope that revisions will be made before the updated regulations are released later this year. Stakeholders are urging tax-credit-friendly regulations, but what happens will ultimately affect the market.

The financial accounting treatment of tax credits affects the desire to invest in tax credits and the relative attractiveness of individual incentives. The **Financial Accounting Standards Board** (FASB) released guidance in March to extend the proportional amortization method of accounting beyond LIHTCs, which will likely marginally increase existing investor appetite for other credits and bring some new investors into the market. The full extent of that change on demand is unknown.

There is a growing interest in **environmental, social and governance (ESG) or impact investing** that is positively affecting investor demand. In recent years, these efforts have been a greater benefit to RETCs than other community development tax credits, but there are indications that that could be changing, especially for LIHTC.

Investor Yield

The ultimate per-tax-credit pricing of tax credit equity investments is heavily influenced by the comparative pricing of investment alternatives, both those motivated by taxes and those not motivated by taxes.

The yield from a tax credit investment is often calculated on an after-tax rate of return or present value net equity, although many investors also have a more elaborate internal model that calculates a return on book equity or other internal analytical metric.

In calculating after-tax internal rates of returns, the tax losses and estimates of cash flow must also be valued in addition to the tax credits. The value of tax losses is directly correlated to the federal income tax rate. A decrease in the federal corporate income tax rate, such as happened in late 2017, can depress equity pricing for credit investments with notable tax losses, such as the LIHTC.

The value of tax losses is also negatively affected if an investor's tax basis must be reduced by tax credit claimed. The LIHTC does not have a basis adjustment, but the renewable energy investment tax credit (ITC) has a 50% adjustment and the NMTC and HTC have a full (100%) basis adjustment. A provision in the HTC-GO Act would eliminate the basis adjustment for HTCs, which would make those credits more attractive to investors.

The term of the credit is also a factor. For investors, the period over which you claim credits (LIHTCs are taken over 10 years, NMTCs over seven years, HTCs over five years and RETCs have varied time frames) affects the desirability of the tax credits and the assessment of hurdle rates and comparative yields.

Conclusion

Amid the current uncertainty around tax credit equity pricing, it is important to remember that the rise and fall of equity pricing, the volatility therein, is inherent in any market of a good or service. Project developers, investors, government officials, underwriters and the many others involved in community development finance should stay aware of the potential for notable shifts in the supply of and/or demand for tax credit equity investments and create flexible and antifragile tax credit financing plans that will readily respond to ever changing equity pricing.

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ISSN 2152-646X