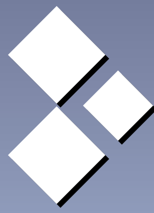
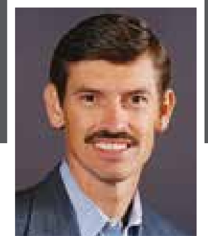

Novogradac
Journal of Tax Credits
News, Analysis and Commentary On Affordable Housing, Community Development and Renewable Energy Tax Credits

September 2014 • Volume V • Issue IX

Published by Novogradac & Company LLP

WASHINGTON WIRE



Better by Design: Tax Credits' Structure Provides Superior Results

MICHAEL J. NOVOGRADAC, CPA

Despite their proven track records promoting capital investment in affordable housing, community development, historic preservation and renewable energy, some tax credit critics continue to suggest capital grants may be a better alternative. For example, in response to criticism of the new markets tax credit (NMTC), the U.S. Government Accountability Office (GAO) in 2010 recommended a pilot capital grant program to compare with the NMTC. Similar suggestions have been made regarding the solar investment tax credit (ITC) and the low-income housing tax credit (LIHTC).

Capital grants do have some attractive features that make them the appropriate to incentivize certain kinds of activity. But many arguments in favor of capital grants in place of tax credits for the creation of affordable rental housing, community development in low-income communities, rehabilitating historic property or developing renewable energy facilities — where long term low-cost capital is crucial — either understate or fail to account for other factors that offset those attractive features to the point of rendering them moot.

For the purposes of providing enduring investment in affordable housing, community development, historic preservation and renewable energy, and ensuring actual benefits for the nation's citizens and communities, tax credits have been successful because of the many structural features they boast that are not offered by capital grants.

Transaction Costs

One of the most common assertions in favor of capital grants is that they don't entail the transaction costs that tax credits do, and as such can more directly provide economic benefit to end users. It's true that some tax credit subsidy is consumed by third parties via administrative costs, but capital grant programs involve up-front and ongoing administrative costs as well. It is also important to note that tax credits do not have a separate stream of funding for administrative costs, while many capital grant programs, such as the U.S. Department of Housing and Urban Development's (HUD's) Community Development Block Grants (CDBG), do.

To administer a hypothetical capital grant program to encourage the development of low-income rental housing, an entity would be required to initially underwrite the development and dispense the capital grant during development. Not to mention the ongoing oversight required to monitor and enforce income, rent and other

continued on page 2

continued from page 1

restrictions for the resulting properties. A Harvard Kennedy School of Government study, "Investable Tax Credits: The Case of the Low-Income Housing Tax Credit," found that that shifting from tax credits to capital grants would "entail greater complexity and potentially higher costs when these programs are reconstituted as direct spending programs." What is sometimes misunderstood about the design of tax credit programs like the LIHTC, is that they leverage market-based incentives and delegated monitoring to shift the administrative burden from government officials to the private sector, reducing the cost to taxpayers while providing important safeguards.

Actual Cost and Realization of Planned Benefits

Unlike tax credit programs, capital grant programs are limited in their abilities to enforce a correlation between actual government costs and realization of planned benefits. When designing and funding programs to incentivize activity such as historic preservation or community development, it is important to measure more than just the direct cost to the government against the amount of subsidy received by the intended recipient. A key consideration must be a measure of the direct cost to the government against the realized benefit.

A crucial aspect of tax credit programs' design is the ability to terminate future tax credits and recapture some or all of tax credits already claimed if the subsidized goals aren't attained. This integral "pay for performance" feature of tax credits is a key component to long-term success. Once deployed to actual developments, the funds provided through existing capital grant programs are difficult to recapture and often the only recoverable asset is the property funded by the capital grant. And in the case of affordable rental housing funded with such a grant, recovering a capital grant from a property that had been completed and placed in service would put at risk the low-income residents, the very population the grant was meant to help.

But if you look at the track records of the LIHTC, NTMC, historic tax credit (HTC) and ITC, the benefits they've created for the economy and communities across the United States are a testament to the effectiveness of the power of tax credits' design to effect real results.

Low-Income Housing Tax Credit

The LIHTC has incentivized the construction, rehabilitation and/or preservation of more than 2.6 million affordable housing units between 1986 and 2012, according to the National Council of State Housing Agencies. The GAO and New York University report that this housing has helped some of this country's most vulnerable citizens. Surveys indicate that approximately three quarters of households living in LIHTC properties have incomes below 50 percent of the area's median. What's more, LIHTC properties have an extremely low rate of failure and recapture. According to a report, Low-Income Housing Tax Credit Assessment of Program Performance and Comparison to Other Federal Affordable Housing Subsidies," authored by Novogradac & Company on behalf of the Housing Advisory Group, between 1991 and 2006, LIHTC properties experienced foreclosure at roughly 30 percent the rate of all multifamily rental non-LIHTC properties. And that rate was well below that of single family housing and many other types of real estate.

New Markets Tax Credit

Between 2003 and 2007, the NMTC created or retained 135,970 permanent jobs and 151,304 construction jobs according to a 2013 evaluation of the program by the Urban Institute. The same report found that 80 percent of NMTC funded projects contributed to some form of increased city or county tax revenues. The flexibility of the NMTC means it has supported the creation of businesses including shopping centers, youth clubs, community centers, charter schools, food processing plants, lumber mills and neighborhood centers in low-income communities where this kind of development would not be possible without a program like the NMTC.

Historic Tax Credit

The HTC program has led to the rehabilitation of more than 39,600 properties and generated more than $69 billion worth of rehabilitation activity, according to the National Park Service (NPS). The program is also credited by the NPS with creating the 2.4 million jobs and generating $106 billion in private investment as of 2012. Perhaps one of the HTC program's most remarkable accomplishments is that it does all this at a very low cost. If fact, the HTC has generated $26 billion in federal taxes by creating jobs and spurring on economic activity, while reducing revenues by $20.5 billion, effectively more than paying for itself.

continued on page 3

continued from page 2

Solar Investment Tax Credit

The solar ITC has assisted in increasing annual solar installations by more than 3,000 percent since its inception, according to survey results from the Solar Foundation. Meanwhile, the ITC is also supporting a growing industry; according to the Solar Energy Industry Association, the solar industry has expanded from approximately 15,000 employees in 2005 to almost 143,000 today. Moreover, the solar ITC is also highly cost effective. The U.S. Partnership for Renewable Finance found that when the increased tax revenues from ITC-incentivized business activity was compared to the costs of the tax credits, government earned a 10 percent nominal internal rate of return on its investment.

Tax Credits' True Cost

The true cost of tax credits is often overstated in comparison to the costs of capital grants. Converting many tax credit programs to capital grants would actually decrease government revenues. Furthermore, to the extent that tax credits reduce basis, they make certain tax credits a partially or fully "taxable credit."

Tax issues aside, cost comparisons between tax credits and capital grants tend to ignore that alternative capital grants would be provided upfront at full cost to the government, while tax credits are deferred over a period of time. As noted in the Novogradac special report, "Low-Income Housing Tax Credit Assessment of Program Performance and Comparison to Other Federal Affordable Rental Housing Subsidies," using a 3.5 percent discount rate (to represent the government's long term cost of borrowing) puts the cost of providing $1 million worth of tax credits for 10 years every year at $7.5 million.

Tax Credits' Structural Advantages

Perhaps because they are complex, and complexity can breed distrust, tax credits' many structural advantages are often misunderstood or overlooked.

For example, private investors assume the risks not only during the compliance period but also during the development phase, which is generally the riskiest phase of an investment. Under many tax credit programs, the government isn't subject to construction or lease-up risk, because the tax credits usually only begin to accrue when the property is placed in service. Thus the government finances only properties that have been successfully developed.

In addition, private markets provide ongoing oversight. The combination of collectible recapture over time and delayed claiming of tax credits provide a strong incentive to remain compliant and as such investors provide intense oversight. Capital grant programs remove this extra layer of investor due diligence that is embedded in tax credit programs.

Also, upfront third party financing means government only pays for performance. Where many government capital grant programs have high failure rates with little ability to recover the grant, tax credit programs' recapture allows the federal government to limit its losses by terminating future credits and collecting at least a portion of previously claimed tax credits via recapture.

Another strength of tax credits is their ability to introduce other sources of capital into low-income areas. Tax credits such as the LIHTC or NMTC often introduce investors with access to and debt and other equity capital to communities and low-income populations they would not otherwise be involved in, and pave the way for future collaborations and investments.

Finally, private competition produces efficiency. Government agencies aren't subject to the competitive incentive that private companies are to limit administration and compliance monitoring costs while still adhering to property performance.

Reform Rather than Replace

Because tax credit programs for affordable housing, community development, historic preservation, and renewable energy have been effective, it would be much wiser for policymakers to work together to reform tax credits rather than attempting to replace them with less efficient tools such as capital grants.

There are modifications that would make each of the LIHTC, NMTC, HTC and ITC even more effective. For example, providing a 9 percent floor for the LIHTC rate would ensure a more predictable and stable market, thus reducing the premium paid to investors for uncertainty. Allowing for gradual recapture of the NMTC would reduce

continued on page 4

continued from page 3

the risk of the investment, raising the price of credits and increasing efficiency. The HTC and ITC would each be more effective if casualty recapture rules were altered in a manner to better allow project owners to rebuild after disasters.

When it comes to encouraging lasting capital investment and ensuring measurable benefits for the nation's citizens and communities, tax credits are the better tool. Research has borne this out repeatedly, as discussed in much greater detail in Rel. 66 of the University of Southern California's journal, Major Tax Planning. ❖

This article first appeared in the September 2014 issue of the Novogradac Journal of Tax Credits.

© Novogradac & Company LLP 2014 - All Rights Reserved

Notice pursuant to IRS regulations: Any U.S. federal tax advice contained in this article is not intended to be used, and cannot be used, by any taxpayer for the purpose of avoiding penalties under the Internal Revenue Code; nor is any such advice intended to be used to support the promotion or marketing of a transaction. Any advice expressed in this article is limited to the federal tax issues addressed in it. Additional issues may exist outside the limited scope of any advice provided – any such advice does not consider or provide a conclusion with respect to any additional issues. Taxpayers contemplating undertaking a transaction should seek advice based on their particular circumstances.

This editorial material is for informational purposes only and should not be construed otherwise. Advice and interpretation regarding property compliance or any other material covered in this article can only be obtained from your tax advisor. For further information visit www.novoco.com.

Novogradac
Journal of Tax Credits

EDITORIAL BOARD

PUBLISHER
Michael J. Novogradac, CPA

EDITORIAL DIRECTOR
Alex Ruiz

TECHNICAL EDITORS
Michael G. Morrison, CPA
James R. Kroger, CPA
Owen P. Gray, CPA
Thomas Boccia, CPA
Daniel J. Smith, CPA

COPY

ASSOCIATE EDITOR
Jennifer Dockery

STAFF WRITERS
Teresa Garcia
Mark O'Meara

EDITORIAL ASSISTANT
Elizabeth Orfin

CONTRIBUTING WRITERS
Scott Michael Dunn
Kyle Zochert
Thomas Stagg
Michael Reardon
Ryan Rieger
Cyle Reissig
John M. Tess
Forrest Milder

ART

CARTOGRAPHER
David R. Grubman

PRODUCTION
Alexandra Louie
Jesse Barredo

CONTACT

CORRESPONDENCE AND EDITORIAL SUBMISSIONS
Alex Ruiz
alex.ruiz@novoco.com
415.356.8088

ADVERTISING INQUIRIES
Tyler Perrotta
tyler.perrotta@novoco.com
415.356.8062

EDITORIAL MATERIAL IN THIS PUBLICATION IS FOR INFORMATIONAL PURPOSES ONLY AND SHOULD NOT BE CONSTRUED OTHERWISE.

ADVICE AND INTERPRETATION REGARDING THE LOW-INCOME HOUSING TAX CREDIT OR ANY OTHER MATERIAL COVERED IN THIS PUBLICATION CAN ONLY BE OBTAINED FROM YOUR TAX ADVISOR.

ADVISORY BOARD

LOW-INCOME HOUSING TAX CREDITS

Bud Clarke — BOSTON FINANCIAL INVESTMENT MANAGEMENT
Jana Cohen Barbe — DENTONS
Tom Dixon — BOSTON CAPITAL
Rick Edson — HOUSING CAPITAL ADVISORS INC.
Richard Gerwitz — CITI COMMUNITY CAPITAL
Rochelle Lento — DYKEMA GOSSETT PLLC
John Lisella — U.S. BANCORP COMMUNITY DEV. CORP.
Philip Melton — CENTERLINE CAPITAL GROUP
Thomas Morton — PILLSBURY WINTHROP SHAW PITTMAN LLP
Mary Tingerthal — MINNESOTA HOUSING FINANCE AGENCY
Rob Wasserman — U.S. BANCORP COMMUNITY DEV. CORP.

PROPERTY COMPLIANCE

Michael Kotin — KAY KAY REALTY
Michael Snowdon — HIGHRIDGE COSTA HOUSING PARTNERS
Gianna Solari — SOLARI ENTERPRISES INC.
Kimberly Taylor — HOUSING DEVELOPMENT CENTER

HOUSING AND URBAN DEVELOPMENT

Flynann Janisse — RAINBOW HOUSING
Ray Landry — DAVIS-PENN MORTGAGE CO.
Denise Muha — NATIONAL LEASED HOUSING ASSOCIATION
Monica Sussman — NIXON PEABODY LLP

NEW MARKETS TAX CREDITS

Frank Altman — COMMUNITY REINVESTMENT FUND
Merrill Hoopengardner — ADVANTAGE CAPITAL
Scott Lindquist — DENTONS
Matthew Philpott — U.S. BANCORP COMMUNITY DEV. CORP.
Matthew Reilein — JPMORGAN CHASE BANK NA
Ruth Sparrow — FUTURES UNLIMITED LAW PC
Elaine DiPietro — ENTERPRISE COMMUNITY INVESTMENT INC.

HISTORIC TAX CREDITS

Jason Korb — CAPSTONE COMMUNITIES
John Leith-Tetrault — NATIONAL TRUST COMM. INVESTMENT CORP.
Bill MacRostie — MACROSTIE HISTORIC ADVISORS LLC
John Tess — HERITAGE CONSULTING GROUP

RENEWABLE ENERGY TAX CREDITS

Bill Bush — BORREGO SOLAR
Ben Cook — SOLARCITY CORPORATION
Jim Howard — DUDLEY VENTURES
Forrest Milder — NIXON PEABODY LLP

© Novogradac & Company LLP
2014 All rights reserved.
ISSN 2152-646X

Reproduction of this publication in whole or in part in any form without written permission from the publisher is prohibited by law.