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CLIENT ALERT

The Tax Cuts and Jobs Act: Effects on Low-Income Housing Tax Credit Properties and Developments

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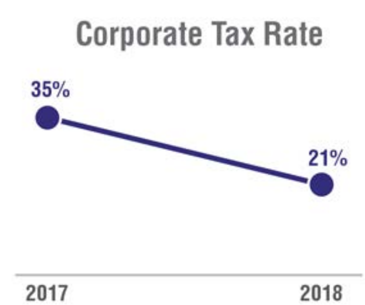
The Tax Cuts and Jobs Act (Act) looks to be on the verge of passage this week, and with the Conference report legislative language released, we can now analyze what the Act means for developing and renovating affordable rental housing with the low-income housing tax credit (LIHTC) and on existing LIHTC properties. The good news is that the low-income housing tax credit and private activity bonds were retained as they existed before tax reform, with the one small exception, a change in the way annual inflation adjustments work. In the future, Chained CPI will be used instead of CPI, which will lead to smaller annual inflation adjustments in tax credit and private activity bond volume cap. That said, there are five changes that will have a notable effect on the LIHTC housing community.

1. Lower Corporate Tax Rate

The corporate tax rate would decline from 35 percent to 21 percent for taxable years beginning after December 31, 2017. This will lead to a reduction in the value of the LIHTC, a value reduction of roughly 14 percent. While the value reduction is greater for tax-exempt bond financed developments, and acquisition/rehabilitation developments, it is slightly lower for 9 percent volume cap new construction developments. Properties receiving additional LIHTC from the basis boost will also have a slightly lower effect than those without basis boost LIHTCs.



2. Base Erosion and Anti-abuse Tax (BEAT)

The Senate bill created a new alternative tax calculation for large corporations – foreign owned and U.S. based with significant foreign operations - in an effort to prevent a corporation from eroding their U.S. tax base through domestic deductions arising from payments to foreign affiliates. The alternative tax calculation subjects companies to a potential base erosion and anti-abuse tax (BEAT). The BEAT tax rate is 5 to 6 percent in 2018, 10 to 11 percent in 2019 to 2025, and 12.5 to 13.5 percent after 2025. The BEAT has the potential to erode a LIHTC's investor's benefit from the LIHTC by up to 20 percent through 2025, and up to 100 percent thereafter. The BEAT also has the potential to erode roughly ½ of an investor's tax benefits from tax losses.

In early 2018 large multinational corporations will be reviewing their exposure to BEAT liability. Existing LIHTC investors may find that they will owe BEAT, and may stop investing in LIHTC, and may also remarket some or all of their existing LIHTC investments.

3. Interest Expense Limitation/Alternative Depreciation System

The Act limits the deductibility of business interest expense, but real estate businesses can elect out. We expect most LIHTC partnerships will elect out. However, to elect out, a partnership needs to agree to depreciate real property over the alternative depreciation system (ADS) life, which is 30 years for residential rental properties as modified under the Act. For properties placed in service in 2018 and beyond, the property will adopt the 30-year life. Properties placed in service before 2018, will need to switch their depreciable life to 30 years. Guidance from the Internal Revenue Service will be needed to confirm the methodology to use in making the change. Also, partnerships currently, or planning on, electing a current law 40-year depreciable life will need to switch to 30 years, which could create capital account issues.

Note at the fund level, it is unclear whether such interest expense is business or nonbusiness interest expense, and if business interest expense, if such interest expense is “properly allocable” to the lower tier real estate activity. The IRS will need to issue guidance regarding tiered partnerships and the deductibility of interest expense, at a minimum, to deal with anti-abuse concerns.

There is a small business exception to the interest expense limitation rules, but most LIHTC partnerships will not qualify for the exception. Partnerships that allocate more than 35 percent of their losses to limited partners are not eligible.

4. 100 Percent Asset Expensing

The Act provides 100 percent asset expensing (otherwise known as 100% bonus depreciation) for personal property and land improvements. LIHTC partnerships should be eligible. Used property acquired from an unrelated party also qualifies, so acquisition of existing property will be eligible, to the extent that a portion of the acquisition cost is allocable to personal property and land improvements. The 100 percent asset expensing rule starts phasing down after December 31, 2022. Also, property placed in service after September 27, 2017 is eligible, subject to a binding contract rule.

Cost segregation analysis will be even more significant in 2018 and beyond.

5. State Tax Credits

With corporate rates declining, the value of state tax credits rises for corporations simply because the value of the state tax deduction that is lost is less. On the individual side, the elimination of all but up to $10,000 in state income tax deductions for individuals should lead state tax credits to be considerably more valuable for individuals. Many state tax laws will need to be revised to facilitate the use of state income tax credits by individuals.

Other Provisions

Other provisions in the Act also will affect LIHTC developments, though the magnitude remains to be assessed.

1. Repeal of Technical Termination Rule

The Act repeals the technical termination rules of Section 708. Under current law, transfers of more than 50 percent of interests in the profits and losses of a partnership cause the deemed termination of the partnership, and the formation of a new partnership. Property held by the partnership is then re-placed in service, and depreciable lives start over, generally reducing annual depreciation deductions. With the repeal of the technical termination rules, depreciable lives will not restart, so annual depreciation expense will not generally be reduced.

2. Accelerated Income Recognition Based on Audited Financial Statements

Under the Act, LIHTC partnerships will generally be required to recognize income no later than the taxable year in which such income is recognized on their audited financial statements. This provision is not expected to affect most LIHTC partnerships directly, although the impact at the investor level needs to be further analyzed.

3. Potential Taxability of Nonshareholder Capital Contributions to C Corporations

Under the Act, nonshareholder capital contributions to corporations will not be excluded from income to the extent they are made by a governmental entity or civic group. They generally will be excludable from taxable income to the extent made by such entity as a shareholder.