Factors Influencing the Tax Credit Market: Supply

Community development tax incentives create a multi-billion-dollar annual market for tax credits, including the low-income housing tax credit, new markets tax credit, historic tax credit and various clean energy tax credits. On this week’s Tax Credit Tuesday, Michael Novogradac, CPA, is joined by Novogradac partners Tony Grappone, CPA; Dirk Wallace, CPA; and Brad Elphick, CPA; for Part 1 of a two-part podcast series on the entire tax credit equity market. In this podcast, the focus on the supply of tax credits, beginning with a look at the state of the current tax credit equity market in each of the four major areas, including the typical tax credit price. After that, they look at the overall size of the tax credit equity market and describe the primary investors. They wrap up with a look at legislative proposals and what effect they could have on the various tax credit equity markets, then preview next week’s podcast, which will focus on the demand side of the economic equation.

Summaries of each topic:

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Transcript

Introduction

Michael Novogradac, CPA: Hello, I’m Michael Novogradac and this is Tax Credit Tuesday. This is the July 25th, 2023, podcast.

At Novogradac, our clients consistently ask us about the current state of the tax credit equity markets and what the future might hold, and advising clients would generally start by discussing some of the key factors in determining the equity pricing for various community development tax credits. To that end today, marks Part 1 of a special two-part podcast series about the community development tax credit equity market.

Now, broadly speaking, the current community development tax credit equity market for purposes of the next two podcasts consists of green energy credits, low-income housing tax credits, new markets tax credits and historic tax credits.

Now I say current community development tax credit equity market because many, many bills have been introduced in Congress to further expand the aforementioned tax credits as well as create additional community development tax credits. Later in today’s podcast, we will discuss some of these proposals.

Today's podcast was inspired by my June column in the Novogradac Journal of Tax Credits, when I wrote about various factors that affect equity pricing of community development tax credits. Now let me start by level setting and providing an overview of some of the key factors that affect the equity pricing for individual community development tax credits at the micro or project finance level.

Please note there are many factors that affect equity pricing, and as a listener, you might quickly identify a factor or two that I’m not mentioning here. But for purposes of this discussion, I’ve identified six basic factors.

They are first, over what time period are the credits claimed? Are the credits claimed all at once, say when a project is placed in service, or over five years, seven years or 10 years? The shorter of the period of time before which the credits are claimed, the higher the equity pricing.

Second factor, do the tax credits reduce federal income tax basis? Tax credits that don't reduce tax basis are generally more valuable than those that do.

Third, what are the projected federal tax losses and when will they accrue? The larger and earlier the tax losses are, the more valuable that tax for equity investment is to investors.
Fourth, what are the investors' expectations regarding timing and amount of cash distributions? No surprise here. The larger and earlier the projected cash flow, the higher the tax credit equity pricing.

Fifth, when is investor planning to exit from the equity investment? Generally speaking, the farther out the projected exit, equity pricing is higher.

And sixth, when are the investors' capital contributions actually made? The farther out the capital contributions are relative to when they claim the tax credits, the higher the equity pricing.

Now, these six factors are useful in comparing pricing across various community development tax credits. You can see wide range in cents per dollar equity pricing, and in a large measure, those differences are attributable.

And let me say again, these are six key factors, but not all the factors. In the course of today's and next week's podcast, we'll discuss other factors, such as the status of the Community Reinvestment Act regulatory environment. As we look beyond the aforementioned six factors, in some sense, we move from a microeconomic analysis to larger macroeconomic factors, such as the aggregate supply of tax credits, the aggregate demand for tax credits and the condition of the broader economy with particular emphasis on inflation and interest rates.

Now the impetus for my Washington Wire column and this podcast was in part the many questions coming from clients, particularly related to the effect that the vast increase in clean energy tax credits created by last summer's passage at the Inflation Reduction Act will have on per-dollar equity pricing of all tax credits.

To discuss these topics, I have three experts from Novogradac. Each of them is a frequent guest on this podcast. Now to focus on new markets tax credits and historic tax credits, I have Brad Elphick from our metro Atlanta office. Brad leads Novogradac’s New Markets Tax Working Group, our GAAP Working Group—that’s generally accepted accounting principles working group—and is the chair of one of our annual new markets tax credit conferences. He also works with historic tax credits and low-income housing tax credits for a variety of clients.

To discuss the low-income housing tax credit, I have Dirk Wallace from our office in Dover, Ohio. Dirk heads up our Low-income Housing Tax Credit Working Group and our working group for the proposed neighborhood homes tax credit. Dirk's clients include developers, investors and all stakeholders in affordable housing properties, and he also works in the historic tax credit and opportunity zones areas.

Now to review green energy tax credits, I have Tony Grappone from our Andover, Massachusetts, office. Tony is one of the leaders of our renewable energy tax credit working group and has been at the forefront of Novogradac's clean energy practice. Like Brad and Dirk, he's a frequent contributor to the
Novogradac Journal of Tax Credits and is a sought-after speaker at various conferences. Tony also works in affordable housing, historic preservation and community development spheres.

Suffice it to say we have a lot of experience and expertise on this call today. This is the largest podcast we've ever had in terms of the number of guests and the breadth of tax credit matters we're covering. So if you're ready, let's get started.

Tony, Brad and Dirk, welcome to Tax Credit Tuesday.

[00:05:49] Brad Elphick, CPA: Appreciate it, Mike.


State of Current Tax Credit Equity Markets

[00:05:54] Michael Novogradac, CPA: So I would like to start with the current state of the tax credit equity markets at the micro or project level for each of the equivalent tax credit areas that I discussed in my intro, and I figured, Tony, since the greater, there are more abundant green energy credits than the other areas we're going to discuss, so if you could give a sense of sort of per-dollar equity pricing for various green energy credits. I think our listeners would appreciate that.

[00:06:19] Tony Grappone, CPA: Sure, sure. Great question. You know, with renewable energy of a variety of different tax credits generate, qualified by different types of technologies and so the pricing, you can see a wide variety of sort of pricing due to the type of technology, the type of tax credit, the sponsor and just the overall demand for credits at that time in the market. So, with renewable energy, you have two types of tax credits, right? You’ve got the investment tax credit, which is a one-time tax credit that’s claimed when the facility's placed in service. And then you’ve got the production tax credit, which is a 10-year tax credit stream based on the amount of clean energy produced and sold.

So, the pricing for those two type two different types of tax credits can vary dramatically. For example, because the ITC, it gets generated and claimed in the year you place it in service, that pricing tends to be higher. The PTC, because it’s generated over a 10-year period, that pricing, generally speaking, is lower. Because you got credits that are being claimed much further out. With the PTC as well, you could get different shapes and sizes to the actual contribution schedule from your investor. So for PTCs, sometimes those are priced out where the investor contributes all of their equity in the year the facility's more or less placed in service or right around that time. But you can also see PTC transactions where they contribute substantially all of their equity in the year around when the facility's placed in service, but then they might have the balance is paid in over that 10-year period as actual tax credits are generated. That's referred to as what I call a pay-go structure. And so for the pay-go structure, because those equity contributions are spaced out over such a long period of time, the pricing on the pay-go portion is typically higher, and that sort of more guaranteed upfront equity contribution is priced lower.
And so these days with PTC transactions, I'd probably say you're more apt to see those types of pay-go structures where you've got equity contributed in sort of two different timelines. Right? Most upfront with the balance over time. But if we're now the ITC market tends to be much more active just in terms of the shared number of volume of deals. So, I'll try to unpack the pricing a little bit more on ITC transactions. An investor in an ITC transaction, they might contribute anywhere from, call it 90 cents all the way up to maybe $1.30, right? And when you see that kind of pricing range, it's an indication again of the type of technology, how nascent it is, how emerging it is, versus how you know how much of a track record and sturdy it is, right? But it can also indicate how much the tax losses are going to be and how those are valued. It can also indicate how much cash flow the investors are expecting to get out of the deal. You know, if you're talking about tax pricing in that 90-cent range, you're talking about a deal where the investors expected to get very little, if any, cash flow out of the transaction and in that type of a transaction, they really are what I like to refer to as a pure play tax credit equity investor, where their benefits are primarily made up of the credits and depreciation benefits, and then like some de minimis cash flow at best. When you see pricing in that $1.30 range, that's a situation where that partner is not just a pure play tax equity investor, but they are intending on being a real economic partner in the deal where they're getting a noticeable part of their return from the underlying cash flow from the investment.

Now what's the typical sort of, what's probably your better sweet range? Sweet spot range? I'd say these days your sweet spot range for ITC deals is somewhere in that $1.05 to $1.20 range. Now let me unpack that dollar, we'll call it a $1.10, for example, right? What, how do you get to that $1.10? I'll help you. I'll build that pricing up for you so you can see how it gets derived.

First off, you value the tax credit itself. That tax credit might monetize out for, say, might be valued by the investor, at sort of 90, 95 cents on the dollar. OK? So that's how you come up with the amount of the equity associated with just the credit itself. Then you've got the cash flow. The cash flow. You know, in a lot of ITC deals, the investor gets a priority return distribution, right? A classic priority distribution is usually 2% per year for call it five years. What's that add up to? Basically, a dime. So, say you start off with your tax credit value that's, call it 92.5 cents. Add a dime for the pref. So now you're at a $1.02.5, right? Most in, in a classic partnership flip structure, the investor usually stays in the deal for, call it five years. At the end of the five-year investment period is usually some sort of call option where the investor with a sponsor has the right to exit the investor at the end of the five-year investment period and that investor is paid a call option amount. Those call option values approximate somewhere in the range of 5 cents. OK, so now you've gone from 92.5 cents to a dime for the pref to now you're at a $1.07.5, including the call.

Now, the last benefit stream there is the tax depreciation benefits. You know, different investors place different values on this, depreciation benefits, but rough and tough, when we analyze the marketplace, my sense is that depreciation benefits price out net present value, somewhere in the range of six, six-ish
cents on the dollar. So you get so, so there quickly. Now you're up to roughly $1.13.5. Okay. You see how I, so those, and those are your benefits. So investors contribute their equity for their equity investment. In ITC deals, they usually put in up to 20, 25% of their investment, before the facility's placed in service, they put the balance, their 75% of the remaining amount goes in sometime right after placement in service. The credit is generated on the date the facility is placed in service. For ITC transactions, they have to reduce their investment tax basis by 50% of the tax credit they claimed. And then they get their pref, they get their exit. Once you take their contribution, you minus out their ITC basis reduction. Take out how much cash flow they’re expected to get and their call that sort of backs into what their maximum possible loss benefits are. And you take their adjusted tax basis, multiply that by their effective tax rate, call that 21% for corporate investors and that tells you how much they can get in depreciation benefits.

That was a lot. I just gave you a lot there, but I wanted some investors often or sponsors oftentimes want to know how the investors value the different benefit streams, which again, the credits, the losses and the cash. And so I wanted to unpack that a bit so they can see how much each one of those benefit streams is valued and sort of, and that's how the investor gets to that sort of dollar $1.10, $1.15 pricing.

Michael Novogradac, CPA: Well, thank you for that. It was also a good refresher for my intro. I talked about the six key factors you helped lay out an example around those, factors. So thank you for that. Dirk, let's turn to affordable housing and the low-income tax credit equity market at the project level, how you're seeing it today.

Dirk Wallace, CPA: Well, it's not a $1.10 to $1.30. I guess I can start with that. Tony's stealing all the thunder here in the equity pricing market. But no. So the LIHTC equity pricing market's a little, a little different. We don't have the pref payments, cash flow's not a big deal for low-income housing tax credit properties. Most of the focus is going to be pretty much on the tax credits themselves and then the losses that are generated. So, when you kind of unpack that, we have two types of credits. We have a 9% credit and we have a 4% credit and 9% credits, which are allocated, and 4% credits, which come with tax-exempt bond financing, really do have different structures and it ultimately does lead to some differences in pricing. When you look at those key factors, losses being a big factor, in a tax-exempt bond transaction, you typically do have more losses. And losses are a bigger component of tax credit equity pricing, I’ll put it that way. So when we look at things like bonus depreciation, that used to be a 100% and now bonus depreciation is phasing down. So if losses are a big deal for your equity pricing and now all of a sudden you're not getting those losses as quickly, a tax-exempt bond transaction may not be as attractive as it used to be. So we are seeing a little bit of decrease in those tax-exempt bond transaction equity pricing. And there is starting to be a little bit of a spread between what we call a 9% transaction and a 4% tax-exempt bond transaction.

Now, that's not to say that if you have a 4% transaction, that you're not going to get, say, a higher credit price than maybe a rural 9% LIHTC property. So, there's just so many factors that go into LIHTC
pricing that's not even quantitative. You have strength of developer, you have leverage on the property. Is there HUD subsidies? Is it soft financing? All of these components are really going into the pricing, that it’s hard to say, it's 90 cents or 92 cents. So, really when we look to the LIHTC equity market, we’re seeing prices maybe as low as in the mid-70s but then as high as mid-90s to maybe in some big CRA markets, maybe even still approaching that dollar a credit.

So we kind of have the supply and demand, which I’m not an economist and we have one on the call, so I’m not going to pretend to be an economist. But, you have supply and demand, but then you also have those quantitative factors where, or sorry, qualitative factors where you're really just looking at all the other parts of the transaction when you come up with an equity price. So equity pricing, you're still getting multiple bidders. You're still getting multiple syndicators that are looking at all aspects of that and in coming up with a price per credit.

[00:16:34] Michael Novogradac, CPA: So, thank you for that, Dirk. And I do find the low-income housing tax credit equity market unique in the importance that Community Reinvestment Act can play with respect to divergent equity pricing. It obviously plays a notable role in new market tax credits as well, but with low-income housing tax credits, you can see notable difference in pricing based upon that CRA benefit. I would also, for the benefit of our listeners, we do track equity pricing for low-income housing tax credit transactions, and I'll include a link to that in the show notes so you can go and check it out. And then I would also just, Dirk, you mentioned the losses being greater on a 4% bond deal. And just to unpack that a bit for our listeners, because sometimes I'll get questions at conferences where people will say to me, why do 4% transactions have more losses? If I have a 200-unit 4% transaction versus a 200-unit 9% transaction, why there more losses with the 4%? And the answer is, there aren't. So we talk about more losses, we're talking about the ratio of losses to tax credits. So the 4% credits are obviously lower, there are fewer tax credits on a 4%, 200-unit transaction than the 9%, 200-unit transactions because the credit percentage is lower. So the ratio of those losses of the credits is higher and that's why when you think about bond deals, you think about having more losses, but it's really, as Dirk mentioned, it's really the loss ratio to the credits, not the absolute number of losses.

With that, let's now, Brad, let's talk about new market tax credit equity pricing and if you could talk about equity price for new market tax credits. Then also touch on historic tax credit equity pricing.

[00:18:22] Brad Elphick, CPA: Yeah, I'd be happy to and I, lucked out here. New market tax credit pricing is a lot less nuanced than the clean energy pricing and the low-income housing tax credit pricing. Because the investment by the investor into the CDE is what triggers the tax credits, the amount of tax credits, it is much more of a commodity and the investors are really, as Tony said, pure play tax credit investors. Through the use of the leverage structure, they've really been able to bifurcate the economic benefits and the tax credit benefits. So we don't, in new market tax credit transactions don't have really a stream of losses from depreciation, interest expense and and so forth like you do at the property level.
But at the investment level, really it's just based upon the stream of tax credits over a seven-year period. And so, we see pricing for new market tax credits be a lot more stable over time. And right now, I would say pricing is kind of in that high 70-cent, low 80-cent range. But Mike, as you mentioned, there are other factors. CRA does play a big part with new market tax credit investors. So you may see, based upon their need for CRA credit and the location of the investment, you may definitely see higher pricing. And we see that. But for the most part, it has been fairly stable, over the last year and a half. And so we’re seeing a slight trend up. But as we’ll talk about throughout this podcast, I’m sure, there’s other factors that may impact that, that are hard to predict at this time. But that’s typically where we’re seeing the price range.

Historic tax credits is probably more like low-income housing tax credit in terms of the way that investors look at it. The investment is in the project and so there's a stream of tax credits, there's a stream of losses that will impact their pricing. The tax credits are over five years, so a shorter period, but still not, like an ITC that is at placed in service.

And so similar to LIHTC, where you're looking at the contribution schedules, the amount of losses, the amount of credits over that five-year period is really what's going to impact the pricing again here. And so what we're seeing on most historic tax credit transactions is probably in the low to mid 80 cent range on those types of transactions. So, similar to LIHTC, it has different components to it based upon how the deal is structured. But that's where we’re seeing the pricing for those two credits.

Michael Novogradac, CPA: Great. Thank you for that, Brad. I appreciate, each of you giving that micro or project finance pricing range level, and I’m sure listeners going, what? I got more than that. Oh, I got less than that. So as we said multiple times, the whole host of factors at play in determining the nominal equity price. And I’m sure there’s an explanation for the equity price you did or didn’t see if you’re listening to this podcast right now.

Size of Entire Markets, Typical Investors

But now I’d like to go beyond what we’re seeing at the micro project level and move to the macro level. And I’d like for each of you to describe for our listeners the size and investor makeup of each tax credit equity market. I know that any sort of specific answer is difficult here, but I wanted you just to provide a reasonable range of the size of the tax equity market for the area you discuss and you either talk about the size, the number of tax credits, or you can talk about what you see as the equity market. You know, either one of those. And I’d also like you, in addition to talking about the size of the equity market, discuss who, what the typical investor is that makes up that market. Is a primarily large financial institutions or there other groups of investors that are coming into the various transactions?

And I’ll start maybe with you, Tony. If you could discuss green energy credits and describe the size of the overall market or maybe the sub-markets, and who some of the current investors are. Maybe if you anticipate they’re being expanded investors as the credits ramp up.
Tony Grappone, CPA: Yeah. Great. Thanks Mike. So, as far as the renewable energy tax equity market goes, you know, for 2023, again, it’s hard to really project now that you’ve got transferability as an option which allows basically non-owners of facilities to participate in the tax credit program, the market could ultimately end up being significantly larger this year, but right now I think we’re estimating that equity market, not the credits per se, but the size of equity investments in renewable energy for this year to be somewhere around the $18 billion range. And most of those substantially, or the lion’s share of those equity dollars typically come from household family name banks, insurance companies, large publicly traded companies and then, a much smaller share of the tax equity investment dollars come from, say, small companies and high-net-worth individuals.

And there are reasons for that, right? So, the tax rules, the way the tax rules are written, it just allows widely held corporations to use those tax credits and depreciation benefits in a way that is very difficult for individual investors and small companies. And so that sort of speaks to why you see the investor makeup the way that you do.

Now with transferability, right? So transferability is a key provision of the Inflation Reduction Act, right? And so what transferability means is most of your renewable energy credits can now be bought and sold, whereas previously, like most federal tax credits, in order to claim federal tax credits, you have to be an owner in the project that qualifies for the tax credits. So usually that means being a partner in a partnership. But the transferability rules basically allow an investor to purchase the credits without being an owner in the facility. And so that’s game-changing legislation, obviously, and should result in just a real significant increase in the number of tax credit buyers in the marketplace and industry participants.

So now just because you have a lot of new interested buyers doesn't mean there are credits to claim. So you have a supply side of credits as well that you have to deal with. I think maybe in the short run you might see, you actually might see a scenario, it’s very uncommon in the tax credit equity markets, where the demand might, outpace the supply of tax credits. So it’d be really interesting to see how that dynamic kind of shapes pricing in the near term.

Michael Novogradac, CPA: And you mentioned transferability and I was hopeful that when you purchased a tax credit under the transferability feature of, most of the green energy credits, that the individual investor wouldn't have to materially participate in the transaction and that in the transferability, the participation by the generator, the credits would carry over to the buyer. Could you share the big reveal on where the IRS ruled on that?

Tony Grappone, CPA: Right. Thanks for bringing that up. So, yeah, and the most recently issued kind of new guidance update that we got from the IRS and Treasury on transferability, they made it clear that buyers of these transferred tax credits are subject to those passive activity rules and at-risk
rules. So that's going to continue to limit the number of individuals and small corps that you see participating in the program.

[00:26:24] **Michael Novogradac, CPA:** So being subject to activities of the party that generate the credits don't carry over to the buyers, so the buyer has to materially participate in the activity, which unfortunately means you won't see large numbers of individuals investing.

[00:26:40] **Tony Grappone, CPA:** Probably not.

[00:26:41] **Michael Novogradac, CPA:** Right. And then one of the other questions that comes up a lot with green energy credits. Yes, there’s this increased volume of credits, but there’s also now an elective pay option for some types of users of tax credits or generators of tax credits. If you could discuss the elective pay and the impact that could have on credits getting generated, but not actually making it to the equity market.

[00:27:06] **Tony Grappone, CPA:** That’s right. Great. So when Mike, when you refer to elective pay, really what you’re talking about is it’s almost like a, it almost turns it into a refundable tax credit of sorts. Right? So, for those of you who remember the 1603 cash grant program, that was a temporary sort of program that allowed credits to be converted to cash grants. And so elective pay is kind of similar to that in the sense that, well first of all, elective pay is only available to nonprofits, tax-exempt organizations and certain other types of defined eligible entities. It's really game changing. Tax-exempt organizations and nonprofits have largely been shut out of the renewable energy game because previously, if you were a tax-exempt organization, if you wanted to monetize renewable energy tax credits, you’d have to do some pretty complicated structuring of your organization in order to really qualify efficiently for those tax credits.

Elective pay now allows tax exempts to qualify to get cash equal to those tax credits without having to create really sophisticated complicated tax structures. And so the way that would work would be if you’re a tax exempt, you could build, own, place in service your own, call it solar facility if you will. And then you calculate the amount of the tax credit and then you report that tax credit on your tax return. Call it your 990 because that’s the type of tax return that most tax exempts file. You’d report that on your 990 as a credit against no tax, right? And then so when you file your return, that would essentially result in a refund back to you. And so now I don't think that’s going to really disrupt the existing tax equity market, because again, tax exempts were really shut out of the tax equity market previously. And so I don’t think that’s going to disrupt the amount of tax credits that are being monetized by investors. I think what it really does is gives tax exempts an opportunity to finally participate in the renewable energy program in a way that they’ve never been able to previously.

[00:29:04] **Michael Novogradac, CPA:** Those that were participating before through the structures, not only would they monetize the credits, they would also monetize the tax losses. So it seems like those that are looking at elective pay now have to be thinking about, OK, I’ll get the refund, but I won’t get the
monetization of the tax losses. So what extent do you think the elective pay will be used as opposed to the other structures continue to play out?

[00:29:33] Tony Grappone, CPA: Right. So if you were a tax-exempt organization that has a large facility or multiple facilities where the tax benefits start to really matter, then you may consider still using some, you may consider still going through some of those complicated tax structuring processes to benefit from the value that the losses drive as well. If you’ve got, if you’re a nonprofit, I’m thinking, a small church or whatever, and you’ve got just a one-off kind of solar facility, you’re probably just going to opt to go the elective pay route. Another interesting part about elective pay, though, that I think is worth noting in the most recently issued new guidance on elective pay, they indicated that the timing of when you get your elective payment is after you file your tax return. Many in the industry were hoping that the IRS and Treasury provided some sort of new tax form that would allow the elective pay candidate to get the payment closer to when the facility is placed in service as opposed to waiting until they file their return. As we all know, nonprofits typically file their return on extension. And so if you place a facility in service in the first quarter of your tax year, but you don’t file your tax return until the extended due date in the next year after the close of your tax year, then you could be talking, anywhere from, you could be talking approximately 18 months of carried interest on the construction loan of your deal and so that obviously erodes at the value of the elective payment. So that’s another reason why you might see some nonprofits continue to try to set up tax structures to monetize the credits in a more timely fashion.


[00:31:18] Michael Novogradac, CPA: So, you mentioned $18 billion in terms of the sort of equity market roughly this year. There was obviously a great expansion with the Inflation Reduction Act of the potential for green energy credits. And I say potential because many of those credits weren’t really achievable until you or could be accessed until the IRS provided sufficient guidance. A lot of guidance has come out so far. A lot of guidance still remains.

How do you see the equity market ramping up over the next couple of years as more guidance comes out and a sense develops as to how the various credits work, such that investors are confident to invest equity to acquire the equity interests and tax credit generation activities, as well as buy credits on the transfer market?

[00:32:17] Tony Grappone, CPA: Definitely a ramp up. Right? So, let’s see. So the Inflation Reduction Act was passed in August of 2022. And at point, when they passed that law, they made it clear that more guidance would be forthcoming. It takes time to put out that guidance. So the law was passed in August of 2022, we just got new guidance on transferability, for example, earlier this month. And even that didn’t complete the guidance process for transferability. So even though it answered a lot
of the questions, there’s a pre-filing registration requirement for transferability and they made it clear in this most recently issued guidance that that pre-filing registration process isn’t going to be made available until later this year. So, although this new guidance we got was extremely helpful, it’s allowed term sheets to really firm up and you can start to see some, you’re starting to see more term sheets get signed. But you still can’t actually, like if you had an eligible project that got placed in service today, you couldn’t actually execute on that transfer bill transfer right now because there’s still a process that hasn’t really been even made available. And that same process also applies to elective pay. So I think because of this sort of like the timeline that guidance is coming out, you’re just going to see this kind of continued ramp up of the IRA. And the IRA isn’t just limited to, the issues aren’t just limited to transferability and direct pay. You know, the IRA when they passed that, they also made available a significant number of adders to the tax credits. And there’s guidance on each one of these separate adders, each set as new guidance rolls out. It's common where the IRS offers the public an opportunity to further comment so you can get like additional guidance. And so I think it’ll probably take, as you hinted at, it'll probably take a couple years for all this guidance to really get absorbed until you’re seeing all the benefits of the IRA really working as intended. So I think obviously, I think 2024, you could still have some guidance that you're waiting for, but I think a lot of your low-hanging fruit will be put into motion.

I think you see a lot of transfer tax credit transactions in 2024 for sure. And, but then again, your harder-to-interpret areas of the guidance probably won’t get sorted out for probably another year or two.

Michael Novogradac, CPA: Great. Thank you for that, Tony. So Dirk, let's turn to you and talk about affordable housing, specifically low-income housing tax credits. If you could share with our listeners Novogradac's current estimates of the marketplace for low-income housing tax credits annually.

Dirk Wallace, CPA: Yeah, so the 9% credits I think are a little bit easier to estimate. When you look at 9% credits, they're allocated. So you’re looking at per-capita allocations and when you do the math, you get about $9.5 billion of 9% allocations for 2023. When you look at 4% tax-exempt bond transactions, that’s where the project gets allocated tax-exempt bonds and in some states that’s oversubscribed and in some states that’s undersubscribed. So just looking at the volume cap of tax-exempt bonds isn’t really going to give you a clear picture of what the total credits are. It’s what the total credits I guess could be. But not all that is being utilized. So, looking at bond issuance data and, you know, other data that we have available, the estimate for 2023 is around $15.5 billion of 4% tax credits. So adding that to the 9% allocation, you get about $25 billion of low-income housing tax credits. Now one thing that's interesting and is in a low-income housing tax credit transaction, normally you just have the low-income housing tax credits, but as Tony mentioned, there's various adders for renewable energy and we're starting to see a lot more solar tax credits and 45L tax credits that are making their
way into our transactions. So that $25 billion would just be the LIHTC portion. Then we haven’t really quantified what the solar and 45L portion might be but, you know, that’s going to add more tax credits to a LIHTC transaction that the LIHTC investor will either pay for or in the case of the 45L maybe somebody else will pay for. But, yeah, really the market I think is going to be more than just the LIHTC market when you're looking at a LIHTC transaction.

[00:37:02] Michael Novogradac, CPA: Thank you for that, Dirk. And I would just note to our listeners that when you think about the private-activity bond estimate or the tax-exempt bond estimate LIHTC, you’re looking at the volume cap of bond issuance by state and different states allocate a different percentage of for affordable housing. So your first step is trying to estimate how much of that goes affordable housing. And then as Dirk mentioned, with that subset, you have to identify when that it’s oversubscribed or not. And then you have to look at that and think there’s a 50% financed-by test. So you can kind of reverse engineer that and then you have to think about what portion are Difficult Development Areas or not. And that’s why it’s difficult to get a good estimate on the actual 4% credits every year. But we definitely get a reasonable range.

I’d also just note that in the course of this podcast, I probably should have mentioned it in the intro, we’re not discussing state credits and a large number of states have state low-income housing tax credits, just like there could be equivalents for the other tax credits at the state level. But we’re focused here on the federal credits only.

So with that, let's turn Brad to you and focus on the new markets tax credit. And since it also is an allocated credit, it makes a bit easier to estimate the size of the market. If you could discuss the size of the market and maybe if you have any comments on the types of investors.

[00:38:24] Brad Elphick, CPA: Sure. Yeah. So as you mentioned, because it's an allocated credit, it's easy to estimate, but there is often some confusion when people hear that there’s a $5 billion new market tax credit authority. A lot of people may think that that means that’s how many tax credits there are. However, that $5 billion is the maximum amount of investments that can qualify for a 39% new markets tax credit. So when you see $5 billion in authority to multiply that by 39% and it's just short of $2 billion of tax credits. Now, a full round of $5 billion, or $3.5, whatever it is, typically takes about 18 months to get in invested into projects. So when we go to some schedules that we keep on our website, the cumulative QEI issuance schedules that the CDFI Fund prepares, we can see how many transactions, how many investments were actually made within a time period.

For example, in 2022, just north of $3.5 billion in investments were made. And so when you multiply that by the 39%, there were about $1.37 billion worth of tax credits in 2022. For 2023 we're already, year-to-date, so half the year, at $3 billion of investments. So based upon things, what we see already year-to-date and what we're hearing from investors and CDEs and projects, we expect that number to probably be closer to $5 billion for 2023. So you'll see an increase in the market compared to the prior
So, and then, I also like to think about how much equity that might mean in the marketplace. And so in 2022, if you use an average price of 78 cents for the tax credit equity, it’s just about $1.08 billion of tax credit equity.

As I mentioned, we’re close to that amount of investment already this year. So we’re just short of a billion dollars of equity being invested this year. And if it reaches all the way up to the $5 billion or more, it’s going to be over $1.5 billion dollars of equity in the market going into these investments. So very strong for new market tax credits. And as I mentioned, there’s accumulative QEI issuance schedules that are put out almost monthly by the CDFI Fund on our website that people can look at some of these numbers as well. In terms of—

Michael Novogradac, CPA: Let me just interject there quickly for purposes of the equity issuance, we do track it as you mentioned, Brad, on our website and I’ll include a link to that in the show notes. But please, do you want to move on to historic tax credits?

Brad Elphick, CPA: Well, I was going to just describe really the investor types, I think as you mentioned for new market tax credits and what we typically see are large financial institutions as the primary investors in new market tax credits. A lot of that has to do with the size of new market tax credit investments, generally, and the ability for the financial institutions to use the tax credits, as we have alluded to and is included in Mike’s article, the new market tax credit as is currently legislated, does not allow it to offset alternative minimum tax. So we don’t typically see a lot of individual investors in the new market tax credit space, but what we are seeing is a growing syndication market. And so it is the investor landscape is changing a little bit in terms of the types of entities, going from just financial institutions to financial institutions and other widely held C-corporations with significant tax liability to offset. So that’s what we’ve been seeing, I think primarily and over the life of the program really, in terms of what the investor makeup looks like.

Michael Novogradac, CPA: Thanks for that. I’m glad we didn’t move on to historics just yet because I did want to note that if the new markets was allowed to offset the alternative minimum tax and as Brad mentioned, the legislation would actually have to be enacted to allow that, you would see a great increase in the number of individual investors because it’s not considered a passive credit. If you want to know more about that, send an email to Brad, because I will include the email addresses for Dirk, Brad and Tony in the show notes.

So now let’s move on to the historic tax credit. If you could estimate for our listeners the size of the historic tax credit equity market. And this is not a capped or allocated credit. This is an as-of-right credit, so it can be a little bit more challenging to predict the annual amounts.

Brad Elphick, CPA: Yeah, and think it’s, as you mentioned, there are some resources that IRS publishes information about the number of qualified rehab expenditures claimed on tax returns in a calendar year period. And I believe in 2022, it was about $6.6 billion of qualified rehab expenditures.
You multiply that by 20% to get the tax credit market. The amount of tax credits available in the market are claimed in the market that year. And so you're at $1.3, let's call it, $1.3 billion worth of tax credits and using that low-80-cent range, that's about just over a billion dollars of tax credit equity. So it’s about the same size, in 2022 with new market tax credits in terms of total tax credit equity. It will be interesting to see what happens in 2023 in terms of the size of the market. As you mentioned, it’s based upon how many historic tax credit transactions are actually completed and invested in and the current interest rate environment has impacts a lot of construction deals. It’s impacting historic deals. So there may be some decrease or staying the same for 2023. So that’s essentially what I would probably predict at this point is it to be roughly the same. And then looking at investors, investors are similar here. A lot of large, widely held C-corporations, not just financial institutions. And it’s a little bit more varied. Now there are when you look at all historic tax credits, there are a number of individual investors, but they typically tend to be on smaller transactions, smaller size, so proportionate to the overall tax equity market for historics, they're a smaller piece of that than your widely held C-corporations.

Proposed Community Development Tax Legislation

[00:45:42] **Michael Novogradac, CPA:** Great. Thank you for that, Brad. We’re running a little bit long, but I did want to talk about the some of the legislation out there to increase or expand existing credits, as well as create new ones. And Dirk, I thought if you could somewhat briefly discuss the Affordable Housing Credit Improvement Act. It’s been introduced in Congress again this year and it contains many provisions that would increase the supply of low-income housing tax credits. So if you could share with our listeners how you think these changes could affect the overall supply.

[00:46:17] **Dirk Wallace, CPA:** Yeah, and I'll focus on the two main provisions that I think would have the most dramatic impact on supply. That would be the increase in the 9% allocations. The Affordable Housing Credit Improvement Act would look to restore the 12.5% increase that we had for a number of years there that expired and was not renewed. So step one is to get the 12.5% increase restored, and then there is a 50% phase-in that is being proposed that would increase the overall allocation by 50% over a two-year period. So that would dramatically increase the supply of 9% credits that are out there. On the tax-exempt bond side, Mike mentioned before that there's this 50% test where 50% of your project has to be financed by tax-exempt bonds. And for those states where they're oversubscribed, one solution could be to lower that 50% test to 25%. So you are essentially freeing up tax-exempt bond allocation, to be used for more projects. So by freeing up that bond allocation, you'd be able to close more 4% transactions, which in turn would generate more 4% low-income housing tax credits. So those are really the two big provisions. There's other provisions we won't get into, but those would have the biggest impact on LIHTC supply.

[00:47:46] **Michael Novogradac, CPA:** Great. Thank you for that, Dirk. I would also note one of the other provisions is a 30% basis boost for all bond deals. That would be pretty notable in a lot of rural areas, or at least the potential for a 30% basis boost for all bond deals.
Let's now move on to new legislation. Dirk, since I have you for the moment, then we'll get to Brad to talk about historics and new markets. Could you discuss the neighborhood homes tax credit, middle-income housing tax credit? Briefly at a very high level what they would do and roughly what they, what it means in terms of annual tax credit supply.

Dirk Wallace, CPA: Sure. So for the neighborhood homes tax credit, this is going to be a single-family tax credit. And it's single-family homes. And it's a for-sale tax credit. So it would be a one-time credit that would be earned when the home is sold and the credit would be the difference between the purchase price and the amount that it took to, or the cost of the home. So the amount it took to build the home. So that difference would be a credit that would then be passed on to the investor. And kind of looking at that structure, now I do think there is going to be some difference in investors there just because our investors now are looking at credits and losses on the LIHTC side, but looking at the neighborhood homes, you have the credit and then you may have a capital loss and not to get into all the tax issues, but a capital loss is different than the losses that are generated on a low-income housing tax credit structures. So, you know, we may see different investors there, but, really I think it’s a one-time credit, so that's attractive. One of the characteristics is how early can you get the credit? So it's a one-time credit when the property's sold. The recapture is not to the investor, but the recapture is actually to the owner. And the owner may have a portion of the credit recapture if they don't remain in compliance. So I look at this as very attractive for a lot of investors that are looking to purchase tax credits.

Michael Novogradac, CPA: And then the middle-income housing tax credit.

Dirk Wallace, CPA: Yes. The, so the middle-income housing tax credit, that really is going to function similar to the low-income housing tax credit. And from the investor side, I really see the same investors or similar investors investing in the middle-income housing tax credit as the low-income housing tax credit.

Anytime you have a new tax credit, there's a learning curve and I think the learning curve on the neighborhood homes is going to be more than the neighborhood homes on the middle, or is going to be more than learning curve on the middle-income tax credit. Because the middle-income housing tax credit will be expenditure based, like LIHTC. It’ll have a similar compliance period. And really the middle-income housing tax credit is really just focused on income levels and it goes up to a 100% of area median income. So, when you really get into the details of how the credit functions, it functions a lot like the low-income housing tax credit.

And I really do think that the investors will be similar in both of those credits.

Michael Novogradac, CPA: Brad, let's turn to you. The main piece of new markets tax credit legislation is the New Markets Tax Credit Extension Act, which would make the new market tax credit a permanent part of the tax code and introduce an inflation adjustment. We basically take the
existing $5 billion a year and just make it indefinite and then start to adjust it for inflation. Those two provisions wouldn't have a dramatic effect on the actual, current pace, obviously instead of going to zero, it continues. But it also would allow the credit to be taken against alternative minimum tax. And as I noted earlier, it seems like claiming the credit against alternative minimum tax would be pretty notable in terms of the investor mix potentially. If you could maybe expand on that and share any additional comments you might have.

[00:51:46] **Brad Elphick, CPA:** Yeah. So as you mentioned, the main part about the act is that it would take a credit that is expiring at the end of 2025 and make it permanent. Whether we get permanency or extension, I think that either would obviously be at similar levels as you mentioned. So, in terms of supply, from right now, it would take 2026 from zero to five. So that, that by my math, that's what the impact on the supply would be. And then obviously with inflation adjustment.

But really, you know, I think that there, as you mentioned, is probably more focus on the investor makeup and the potential that permanent tax credit could have on that. I think if you get permanency, it will likely bring in other investors that may have not focused on new market tax credits due to its size, and also with it not being permanent. And so anytime we have a permanent tax credit, it's a lot easier for investors to bring that into their tax planning.

So I think ultimately that would be an important aspect of how it would impact the investor market, but as you also mentioned, the alternative minimum tax has essentially the prohibition from being able to use it currently against alternative minimum tax has really meant that in individuals haven't been able to use it to any great extent. And so by allowing it to offset that alternative minimum tax, we would think that there would be a lot more individual investors, brought in, I would guess too, a lot of those would happen on the syndication market. And so I think that it would definitely change the landscape there as well. And so, I think ultimately, those are some of the bigger changes in that, in that tax credit extension act.

[00:53:48] **Michael Novogradac, CPA:** Great. Brad, thank you for that. And now let's move to historic tax credits. The Historic Tax Credit Growth and Opportunity Act, or often referred to as the HTC-GO Act, is another bill before Congress. If you could share with our listeners your sense how that bill would affect the historic tax credit equity marketplace.

[00:54:07] **Brad Elphick, CPA:** So the bill would create a 30% tax credit for projects, certain projects, less than $3.75 million. And so there would be definitely an increase in supply on those smaller projects. Whether or not those smaller projects end up into the tax sector equity market like we think about it, traditionally, it may not have as much of an impact because they are smaller deals. So you may not see as many of the credits going to larger institutional tax credit investors. The bill does eliminate the basis adjustment requirement, which would obviously make it a more attractive tax credit. The basis adjustment, meaning that the historic tax credits don't reduce the investors' capital account. And so we
think that that would also increase investor interest in the historic tax credit, in terms of the equity market, removal of the basis adjustment, the 30% boost, some other provisions I think all are positive in terms of leading to possibly higher equity pricing. And which increases the tax equity market, if investors are willing to pay more for those tax credits.

So I think it would, by eliminating the basis adjustment, it makes it a lot more similar to a low-income housing tax credit in that regard. New market tax credit still has a basis adjustment. We didn't talk about that previously, but that's been talked about in other bills, but it's not in the current extension act. So that wouldn't change for there. So, and then the bill decreases the substantial rehab test threshold to 50%, which, obviously would increase the eligibility of historic properties. So I think that's a positive as well. So all of these things, I think, will increase the tax equity market for historic tax credits by how much, it's kind of hard to put a number on, but they're all additive for sure.

[00:56:23] Michael Novogradac, CPA: Thank you for that. I mean, it's sort of like there's the provisions that increase the supply of credits to the 30% or more projects available from the rest and as you point out, there's the basis adjustment provisions that would increase the value of each individual tax credit combining to increase the tax credit equity market amounts invested.

So thank you for that, Brad. Thanks Also, Dirk and Tony. I think we can take a break now. We've done a good job of discussing the supply side of the community development tax credit equity market. So we're at a point where we can close this week's podcast.

Next week, we'll discuss the demand side of the community development tax credit equity markets. That discussion will cover a broad swath of issues and topics, including how the state of the economy affects tax credit demand and how such policy matters as Community Reinvestment Act regulations and a potential global minimum tax have the potential to adversely affect demand for investment in tax credits.

To our listeners, we hope you enjoyed this week's podcast, and we hope you're looking forward to next week. I'm Mike Novogradac. Thanks for listening.
Additional Resources

**Emails**

Brad Elphick

Tony Grappone

Dirk Wallace

**Novogradac Journal of Tax Credits Column**

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

**Novogradac Resources**

LIHTC Equity Pricing Trends

Monthly CDFI Fund QEI Reports