Factors Influencing the Tax Credit Market: Demand

While the supply of community development tax incentives is a multi-billion-dollar annual market for tax credits that include the low-income housing tax credit (LIHTC), new markets tax credit (NMTC), historic tax credit (HTC) and various clean/renewable energy tax credits (RETCs), the demand for such credits plays a major role in determining their value. 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 2 of a two-part podcast series on the entire tax credit equity market. They look at how the current state of the economy affects tax credit demand, how recent bank problems affected the market and how new transferability and elective pay mechanisms for clean energy credits might affect demand. They then talk about how proposed global minimum tax, expected Community Reinvestment Act (CRA) reform, a recent change in the proportional amortization accounting method with tax credits and environmental, social and governance (ESG) investing could or do affect demand.

Summaries of each topic:

1. Introduction (0:00-3:58)
5. Global Minimum Tax and Demand (22:01-28:45)
6. Community Reinvestment Act and Demand (28:46-33:35)
7. Proportional Amortization Decision and Demand (33:36-42:19)
8. ESG Investment and Demand (42:20-49:46)
9. Off-Mike Section (49:47-56:59)

Editorial material in this transcript is for informational purposes only and should not be construed otherwise. Advice and interpretation regarding tax credits or any other material covered in this transcript can only be obtained from your tax adviser.

© Novogradac & Company LLP, 2023. All rights reserved. Reproduction of this publication in whole or in part in any form without written permission from the publisher is prohibited by law. For reprint information, please send an email to cpas@novoco.com.
Transcript

Introduction

Michael Novogradac, CPA: Hello, I'm Michael Novogradac and this is Tax Credit Tuesday. This is the August 1st, 2023, podcast.

This is the second part of a special two-part podcast series about the overall community development tax credit equity market. I'd encourage you to listen to Part 1, which was last week, but that is not required to understand what we'll be discussing today.

Last week, we focused on both the micro level, that is project-level equity pricing, and the macro level, the overall supply of various community development tax credits. Today we'll talk about the demand by investors for community development tax credits. Now, when I say community development tax credit equity market, I mean the combined equity market for green energy credits, low-income housing tax credits, new markets tax credits and historic tax credits.

I wrote a column about the various factors that come into play for all those credits and how they interact with each other for the June issue of the Novogradac Journal of Tax credits. I'll share a link to that column in today's show notes. If you're a developer, syndicator, investor or any other stakeholder in any of these areas, this podcast series will give you a better overall picture of the factors to help determine the equity price per credit for various community development tax incentives.

Last week, as I said earlier, we discussed the supply side of the equity market. My guests shared information about the size of the equity markets for various credits. Now that supply of credits could increase if various legislation passes to expand and enhance the existing incentives, as well as create new ones. In terms of creating new ones, we discussed new incentives such as neighborhood homes tax credit and middle-income housing tax credit that could be enacted this year.

This week, we're switching from supply to demand. We'll talk about investor income tax liability, which is perhaps the single most important factor in determining demand, along with the general state of the economy and how my guests see these trending and the impacts they're having on the investor equity markets. We'll also talk about other factors that have the potential to notably influence demand. By that I mean such things as a proposed global minimum tax, upcoming Community Reinvestment Act regulation changes, as well as environmental, social and governmental—or ESG—motivations for investment.

This discussion is intricate, as there are many factors, which is why I am pleased to have all three guests back from last week. They're experts and they can provide great insight. They're partners at the
Novogradac, of course, and they are Dirk Wallace from our office in Dover, Ohio. Tony Grappone from our office in Andover, Massachusetts, and Brad Elphick from our office in the metro Atlanta area.

Dirk heads up both our Low-Income Housing Tax Credit Working Group and a working group for the proposed neighborhood homes tax credit. He works in affordable housing, historic tax credit and opportunity zone spaces and his clients include developers, investors, syndicators and other stakeholders.

Tony helps lead our renewable energy tax credit working group and is one of the highest profile members of Novogradac's clean energy team. Tony also works in affordable housing, historic preservation and community development spheres with a variety of clients.

Turning to Brad, he leads both our New Markets Tax Credit Working Group and our GAAP Working Group, that’s generally accepted accounting principles working group. He also works with historic credits and low-income housing tax credits for a variety of clients. His main focus though, is new markets tax credits, working with community development entities, qualified low-income community businesses and other stakeholders.

With three guests and several community development tax incentives. there’s a lot to cover today. So if you're ready, let's get started.

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

[00:03:56] Brad Elphick, CPA: Thanks for having us back, Mike.

**Federal Income Tax Liability and the Current Economy**

[00:03:59] Michael Novogradac, CPA: So, one of the most significant issues in federal tax credit demand is federal income tax liability, meaning the more taxes a potential investor owes, the more likely they are to consider tax credits as an investment.

Now, if we look back to the 2008-2009 Great Recession, we saw equity pricing plummet as investors saw a drop in taxable income and tax liability, and many companies focused on mere financial survival and investing in tax credits was not high on their list. Later, in 2017, we saw equity pricing for many tax credits drop in anticipation of the ultimately enacted lowering of the corporate tax rate from 35% to 21%. This drop reduced the value of tax losses to investors. The extent to which various tax credits were affected by the drop in the corporate tax rate was a function of the proportion of tax losses to tax credits and the extent of any basis reduction for tax credits. For example, new markets tax credits weren’t affected very much, due to the fact that the new market tax credit investments generally don’t generate large tax losses like we talked about last week and the tax credit does reduce the investors' basis such that their capital account goes negative and upon sale of their interest, the investor generally will
recognize gain approximately equal to the negative capital account. As tax accountants, we all know it doesn't work quite that way, but that's common parlance to frame it that way.

That makes the new market tax credit essentially a taxable credit. So, when tax rates are lowered, the tax on the gain recognizes less than would otherwise have been. Conversely, as many of us know, or all of us on this call know, and many of the listeners know, low-income housing tax credit investments generally have a higher tax loss to tax credit ratio and there is no basis adjustment for the tax credits. As such, a lower corporate tax rate dramatically lowered the value of tax losses and thus lowered equity pricing by about 10-plus percent. Before it was enacted, we predicted it and wanted to be wrong, but unfortunately, we weren't and the pricing was down that amount and that has stabilized and it was that delta based upon the lower corporate tax rate.

However, tax liability isn't the only main factor for demand. Another factor is the state of the economy. So, I'm interested, Tony, Dirk and Brad, your thoughts on how the current state of the economy is affecting demand for investments in tax credits. And when I think about the economy, I think of both the potential for a recession as well as inflation. And with higher inflation, obviously transactions are harder to get to pencil out because of the higher costs and higher interest rates meaning less debt, borrowings all the rest, plus investors wanting higher yields to accommodate a higher inflation rate. With all that as background, I'll start with you Dirk, and if you could maybe share your thoughts on how the current state of the economy is affecting investor demand for low-income housing tax credit investments.

[00:07:01] Dirk Wallace, CPA: Sure. So, on our last podcast, we touched a little bit on who the investors are. And when you look at tax liability, and it's the tax liability of those investors that I think we're really concerned with and you ask yourself, well, are they oil and gas companies? Are they insurance companies? Are they financial companies? And when you really look at it, the big LIHTC investors are your banks and financial institutions as well as the GSEs, which are Fannie Mae, Freddie Mac. So, when looking at that group and looking at the overall economy, that group is still generating quite a bit of taxable income, banks are doing pretty well nowadays.

So, one thing with interest rates going up, banks are collecting more interest and you look at that and say, OK, well we have banks that are investing, banks with tax liability. Will banks continue to invest in low-income housing tax credits? And when looking at that demand, you also have to look at, well, are there other investments that they would invest in besides low-income housing tax credits? And I think that's where rising interest rates, I think also come into play in this economy and say could they invest somewhere else rather than investing in low-income housing tax credits to get a similar return. And we're going to talk about other factors that impact banks later. But so far, the market has still been strong. Banks are still investing. Fannie Mae, Freddie Mac, they're authorized to now invest $850 million each. That's up from $500 million each. So that's $1.7 billion that can come from Fannie Mae
and Freddie Mac. So that’s a significant investor in the low-income housing tax credit market. So still strong market out there for investors.

Michael Novogradac, CPA: Thank you for that, Dirk. So, Brad, let’s now turn to new market tax credits. Maybe just talk about new market tax credits and historic tax credits and how you’re seeing the economy, state of the economy affecting investor demand in those two areas.

Brad Elphick, CPA: Yeah, I think it’s been interesting because we’ve been hearing a lot about what the economy could become and in the near future and as we keep going into the future, it doesn’t, hasn’t really materialized into a recession yet, a big recession like we experienced in 2007-2008, which has been a welcome, I think, outcome for most. And when I think about what does that do for demand, I go and listen to what the actual investors are saying publicly and as Dirk said, a lot of the investors are, I think, pretty bullish right now, in terms of investing in tax credits. And I think that that has a lot to do with what they’re projecting their current tax liability is. But also with the next couple years, tax liability is, I think that something that will be interesting to look at and we’ve seen this in other areas. For example, when the Tax Cut and Jobs Act was being discussed and lowering the corporate tax rate, it started having an impact on pricing and demand before it actually fully was enacted, as investors were preparing for it. And a lot of those provisions expire at the end of 2025 and there will be likely a large tax package at that time and so it will be interesting to see what impact that may have in investor appetite. But I think that’s enough time down the road that it hasn’t had an immediate impact, not yet, as investors are trying to figure out what that may become.

For new market tax credits too, there’s been this discussion of that there’s a remaining $15 billion of allocation after the current round is awarded. And there’s been discussion about getting it back on track and possibly having a double round to help do that. And so that would be a double round would be $10 billion, two $5 billion rounds combined into one. I think that that’s a good litmus test of investor appetite, because generally I think investors have been supportive of that double round, or an increased combination of rounds. And I think that if there was concern about their appetite that you wouldn’t see the support or for that. So in new market tax credits, I think the demand has remained relatively strong and I think most investors at our conferences have projected greater investments this year than the prior year.

Now, historics is a little bit different. I think that those transactions are more impacted by a higher interest rate environment, similar to LIHTC, and so we’ve actually seen some drop-off in activity this year compared to last year and a lot of that has to do with the gap, as being hard is harder to fill in in this current interest rate environment. Also, property values are not coming down so that’s impacting it, as well.

So, because historic tax credits are generated by the projects that are built, if less projects are being built, there’s less tax credits to invest in ultimately. And so I think, as Dirk mentioned, investors
essentially have a menu of tax credits to pick from. And so I think in these types of environments where there's a lot of tax credits, but there's also a lot demand, you may see investors picking and choosing certain ones over others for lower-hanging fruit, for example.

And so I think that for historic tax credits, if the historic tax credit extension or the HTC-GO bill is passed, I think it could generate some more demand for the historic tax credit. But overall, I think we may see a slight decline or same as last year, in 2023.

[00:13:27] Michael Novogradac, CPA: Thank you for that, Brad. And as you guys know, I wrote an article a number of months back or a monthly column on the impact of higher inflation on low-income housing tax credit transactions particularly talking about how it affects the sources side, how it affects the uses side, how it affects operating income and how it affects operating expenses.

And newsflash, it's not net positive. I'll include a link to that article in the show notes because it's a lot. A lot of that also applies to historic credits and new markets and renewables and the rest at least from a conceptual perspective, since it's really an article about project finance. But I also wanted to, before we get to Tony and green energy, get your thoughts, Dirk and/or Brad if you have something you wanted to add, that fear that not too recently was going through the investor community, particularly in the affordable housing area with the collapse of Silicon Valley Bank and a number of other notable investors in tax credits. Certainly in terms of the volume amount that they did, it wasn't that notable. But obviously the question was what effects was that going to have longer term with the collapse of those banks? Obviously, if you're a listener to this and you had a construction loan with Silicon Valley Bank or Silicon Bank was one of the equity investors that fund that was your equity investor, you had deposits at Silicon Valley Bank, it was a very, very tough time for a week or two as you're waiting to see how it was all going to play out. And for the most part, it's played out in a satisfactory way, I think, for most at the transaction level. But in terms of longer-term effects, when I look at the market now, it seems like it was weathered pretty well and there aren't too many real enduring effects.

Effect of Banking Problems on Market

I was wondering, Dirk and Brad, if you had any thoughts on that in terms of the new markets, historic or LIHTC area in terms of the effects of the collapse of a number of large but smaller, relatively, financial institutions.

[00:15:37] Dirk Wallace, CPA: Yeah. I think on the LIHTC market, it really showed the resiliency of the market. Silicon Valley Bank was an investor in multi funds as well as single-investor funds. So, you had a multi investor fund—or for those you may not know, it is what it sounds like. It has more than one investor. So, you may have 6, 7, 8, 9, 10 investors in there and Silicon Valley Bank being one of them. Other investors, we were hearing, were willing to step up and say, OK, we'll take that share, that they were to provide the property and the multi-investor funds, sounded like they were going to be OK. On the single investor side, it was just Silicon Valley Bank, but as we talked about before, one of the impacts
on pricing is how soon your equity goes into the transaction. Well, if Silicon Valley Bank had put in 60, 70, 80% of their equity, but only received 10% of their benefit, that's pretty attractive for another investor to come in and say, I'll, put in that remaining equity and get twice as much benefit. So, when the syndicators were really looking at how we could solve this problem, while they were a big investor, it didn't seem like it would be that big of an issue for other investors to come in and fill that void.

[00:16:54] Michael Novogradac, CPA: Great. Thank you, Dirk. Brad?

[00:16:56] Brad Elphick, CPA: I think for new markets there was very little, if any impact. Neither bank were really involved in investing in new market tax credits. So, I think that, as you said, Mike, it was kind of a week or so that everyone was wondering if these were dominoes falling or if they were one-offs. And I think once the investor community got comfortable that these were more one-offs than the start of dominoes falling, I think it became, pretty quickly went in the rearview mirror and things went back to regular programming when it comes to new markets. And I'd say the same to some degree for historics as well. But I would guess that new markets was probably impacted the least.

[00:17:44] Michael Novogradac, CPA: And Tony, anything you want to add before I get a more focused question for you?

[00:17:49] Tony Grappone, CPA: Yeah, no, similar because Silicon Valley Bank participated in renewable energy in a similar kind of fashion that they did in affordable housing. So we didn't see any major disruptions in the marketplace as a result. Probably a little bit more worry and some short-term panic there. I think people are feeling like the dust has more or less settled. So hopefully that's the case.

Transferability, Elective Pay and the Green Energy Marketplace

[00:18:12] Michael Novogradac, CPA: Thank you for that, Tony. Now, last week we talked about the significant potential increase in the dollar volume of green credits. Now Dirk and Brad have talked about the general state of the economy and the impact that has in LIHTC investing and new markets and historic investing. When I think about that for renewables or clean energy credits, I think about all those same issues, plus, as we touched upon last week, there's transferability that really isn't, as we talked about last week, isn't really available yet. But transferability is not going to reduce demand. It seems like it's only going to increase demand or have no effect. It's not going to have no effect because they've got to have some effect. So there's some ability of that to increase demand.

And then similarly, on the elective pay, it doesn't necessarily increase demand, it really could potentially reduce supply, which is an indirect way, I guess of increasing demand, I guess because now they're using their own credits, if you will. They have demand for their own credits for having to resyndicate them. When you think about the equity markets in the economy and renewables, what are some of your observations?
[00:19:25] **Tony Grappone, CPA:** Great. So, the IRA allows for the transferability option, which basically means you don't have to be an owner of the tax credit-generating property to use the credits that is unique in the federal tax credit game, right? So as a result, the appeal for renewable energy tax credits, it's safe to say, has gone through the roof. Becoming a partner in a partnership takes time. If you're a potential investor, you have to go through a vetting process. There's all kinds of issues you have to sort through there, tax, accounting, etc., business, you name it. And so if you don't have to be a partner in the partnership or an owner of the property, you could just buy the credits, well, you can imagine that really opens up the playing field to such a wider mix of potential buyers and investors, etc. And so it makes sense that the demand for renewable energy tax credits is really going to take off in ways we've never seen. Which I think is fantastic, right? It allows corporations or taxpayers to be able to more efficiently manage their tax liability, while at the same time, be a good corporate citizen by helping to put their money into socially minded causes like clean energy projects.

Now in terms of elective pay, that's where you're, that's really available for tax-exempt, nonprofit types of organizations where they can now own a tax credit-qualifying renewable energy facility and put the credit on their tax-exempt return and essentially file the return and get a refund of that credit. So that supply credits goes up there, but really they're just going to use the money themselves. I don't really see that as having, I don't anticipate that's going to be huge impact on the whole demand side of things because I think those nonprofits are, they generally do small deals, small facilities and so I think it allows, I think the benefit of elective pay really allows small tax exempts to participate in clean energy. Whereas previously they were shut out.

[00:21:33] **Michael Novogradac, CPA:** And that's when my similar sort of experience you get that a smaller nonprofit may have put solar panels on a facility or something of that nature and the cost of syndicating didn't make it worthwhile. So, they ended up having to come up with other ways of financing it so it'll allow more of, or not be able to move forward because they couldn't finance it because of that gap and this allow them to have that refundability/elective pay that allow them to move forward.

**Global Minimum Tax and Demand**

So, I wanted to talk about some of the other more global issues that affect demand across investors. And the one that we've been fearful of as of late in that it's one of those issues that has potential to have no effect or completely eliminate a very significant investor in the tax credit market. It was one of those where I'm certainly hopeful that it ends up having no effect, given the potential binary nature of having a major investor choose to stop investing. And of course, I'm talking about the global minimum tax. So Brad, you're one of Novogradac in-house experts on the global minimum tax and thanks for all the work that you've done in this area to try to help navigate us to a place where the global minimum tax won't cause some major investors to pull out of investing in community development tax credits.
But if you could please provide our listeners a very high-level description and then just share some of the conclusions you think right now in terms of how it could affect demand. And I'll just caveat all of that by saying the global minimum tax is still kind of years in the full implementation if it does get fully implemented, so whatever we're talking about here, we know can be changing rapidly. So it's only as good as the time we're recording it. But with that as background, if you could share some of your thoughts with our listeners.

Brad Elphick, CPA: Sure. And I think it's important to note, as you said, it's a minimum tax, right? And the goal is to ensure that these multinational corporations are paying a minimum tax rate. It's currently 15% is what the global minimum tax is. And so, as you mentioned, there are certain investors that may be impacted by this. I think it's important to know that this may not impact directly all investors. Obviously if they're U.S.-based and only U.S.-based they wouldn't be impacted by this. But for the multinational corporations and financial institutions that are, this could become a real issue for them. As you said, nothing is final, nothing has been enacted to date and there's been a lot of news lately about certain lawmakers pushing back on the U.S.'s participation in this global minimum tax. But it's also worth noting that whether we participate or not, there still may be an impact on these corporations.

And, so what we've been concerned with is the treatment of tax credits. As we've talked about, the usability of tax credits, it really impacts the demand for them as well. That's why we see a lot of individuals not invest in certain tax credits due to certain restrictions. Well, the same would be the case here is that if a corporation is impacted by the global minimum tax, and there the tax credits were not essentially allowed to be carved out of that calculation, then there would be concern about, "well, if I use tax credits and I go down below 15% and have got to pay a tax to get me back up to 15%, why would I make that investment?" And that's been something that we've been concerned with for a while and unfortunately, the initial guidance, it only referred to tax credits as refundable tax credits. And, in the U.S. tax structure, we use tax credits, not necessarily refundable tax credits. And so that's much more of a kind of a tax scheme in other parts of the world.

And so there was a lot of concern of whether or not our tax credits could also be excluded, could be carved out. And so there was a lot of effort in the negotiations to get some additional guidance. There was some guidance released in February that reduced some of the concern. But I will say that it did not eliminate that concern of the impact that the global minimum tax may have. It looks to the accounting treatment and I think that investors would prefer there to be a specific mention of tax credits, similar to refundable tax credits to really alleviate the concern that they have of the impact of the global minimum tax reducing the value of these tax credits.

And so we continue to monitor the progress. And it's an exercise in herding a lot of countries together to agree to it. But there's been changes in terms and so forth, it seems like every month on this issue. So, we'll continue to monitor it, but in terms of its impact now, I don't think that we've seen an impact in
the marketplace in terms of tax equity pricing. But there are definitely those who believe that they may be impacted looking at ensuring that there's ways to be able to take advantage of some of the carve-outs that are being proposed in the guidance.

[00:27:52] **Michael Novogradac, CPA:** So thank you for that, Brad. I appreciate the overview there. And I just generally think of it as the guidance that has been released so far basically says, for most structures, you'll do the calculation of effective tax rate before taking into account the credits, which means you'll get the benefit, because you won't be taking a reduction of that in your tax liability before you do the calculation.

And then earlier and then recently guidance came out saying transferable green energy credits are treated equivalent for refundable credits. And we've not had time to dive through and think of all the ramifications of that, but that was a good ruling if you will, or good guidance. But we'll obviously be staying very, we'll be monitoring it closely and fearful that there's some shoe that's going to drop that would've an adverse effect.

**Community Reinvestment Act and Demand**

So I wanted to move to another issue that's been front and center once again, particularly for low-income housing tax credits and new markets tax credits, and that's the Community Reinvestment Act. We expect the Office of the Comptroller of the Currency, the FDIC and the Federal Reserve to issue updated guidance for CRA regulations this year. And the low-income housing tax credit and new market tax credit does provide Community Reinvestment Credit, not a tax credit, but credit toward their obligations to reinvest in certain communities. And there's concerns about the CRA regulations being changed in a way that makes investing in new markets and low-income housing tax credits less attractive. I will also note that there's been efforts to expand the ability of the historic tax credit, renewable energy tax rates to qualify for Community Reinvestment Act credit. It's not that they can't, it's just they don't universally qualify. And with that as background, Dirk, if you could maybe once again briefly discuss the status of regulations and expand on some of the concerns about tax credit demand from financial institutions.

[00:29:58] **Dirk Wallace, CPA:** Sure. And for those of you that might know too much about CRA or Community Reinvestment Act, the last major change was back in the mid-'90s. So if you think about banking in the mid-'90s versus banking in 2023, it's a much different landscape now.

So especially when you're talking about banks investing where they take deposits. Mobile banking didn't really exist back in 1995. So, that kind of being one thing that they're looking at saying where do you need to invest? What is your geographic area? And will those geographic areas change and therefore demand in certain what we would call a high CRA market, which is where a lot of banks have this incentive to invest, demand may decrease in those areas. Now it may increase in other areas, but would there be a net benefit there? And most think that it would be more of a negative benefit than a positive
benefit. There’s various tests that banks go through with CRA and meeting that CRA requirement. One of them is looking at lending to low-income communities or investing in low-income communities and when you look at that as a whole, lending, if a bank lends to these economic development areas, they don’t have to set aside as much capital as if they were to invest in those areas. So if you look at these smaller, maybe regional banks and looking at how much capital they need to put aside to make a loan or do an investment, that could impact their demand on making an investment versus making a loan. So we talk a lot about large banks being the investors, but there are a lot of regional and smaller banks too that also invest in more regional funds or more local developments and there’s going to be impact there if there is CRA reform. So as far as the status, you talk to some people, they say any day and you talk to some people and say it’ll never happen.

So, not sure what to say about the status, but I know a lot of people are talking about it and I don’t think it will be tomorrow, but it’s definitely something that has been proposed. There is a proposal out there. So I think anytime something has been officially proposed then, that kind of creates, I don’t know if I’m going to use the word fear, but just creates a sense of urgency to dive in and see what’s in that proposal to see how that might impact the industry.

[00:32:32] Michael Novogradac, CPA: Thank you for that, Dirk. One that I’d heard is by snowfall they’d be out, they didn’t say which state. And the other thing I would just note is that generally banks have a three-year cycle where they’re evaluated based upon CRA and if we expect that the rules coming out will kick in over that three-year period so that the impact it would have on bank investing would be based upon that sort of three-year period for the most part. Obviously, that could change, depending on what the regulations actually say. So, the first thing I’ll be looking at is the effective date when the rules come out. And I would just emphasize that there is a concern that banks would make fewer equity investments and make more loans. So that’s been the area of most of the comments from the tax credit equity investing communities is to ensure that the incentives to make equity investments as opposed to loans is preserved.

Proportional Amortization Decision and Demand

I did want to now turn to you, Brad, about our favorite topic at Novogradac, GAAP accounting. The Financial Accounting Standards Board, FASB, this year released expanded guidance for the use of the proportional amortization method of accounting. I say expanded guidance and that it’s investments beyond the low-income housing tax credit are eligible proportional amortization accounting. And we’ve discussed this issue on another podcast, but if you could just briefly share where we are with respect to that guidance and what impact in the near term you expect it might have in the tax credit investing community.

[00:34:18] Brad Elphick, CPA: Sure. This was a project that we were involved in when proportional amortization was created originally.

[00:34:26] Brad Elphick, CPA: Yeah. And there was a lot of effort to make sure it was available to all tax credits, but unfortunately that didn’t happen then. And next thing almost 10 years go by and another project to expand it to all tax credits was put on the agenda. And ultimately, as Mike said, new accounting standard update was released. It expanded, it removed the limitation to only LIHTC investments, which is a very positive thing. However, there are some additional hurdles that certain types of investments have to overcome to be able to use proportional amortization accounting when applying it to their tax credit equity investments.

And so each of those new markets, historics and renewable energy all have different ways that these investments are structured. And so, for example, for new market tax credits, a lot of those investments are consolidated. And the new guidance specifically says that if you use the consolidation method, you can’t use the proportion amortization method for your tax equity investments. And so new markets was probably the one that was going to be able to most quickly and easily use the new accounting guidance, until that hurdle was, that that wrench was thrown in. So we haven’t, we’ve been working with clients and a lot of clients have been talking about how can we change the structure of different types of tax credit investments to be able to fall within the parameters that currently exist.

The GAAP Working Group has also been working on kind of a separate effort to potentially have FASB take up another project to examine some of the parameters that currently exist and changing those so that it’s easier for transactions as they’re structured now to be able to qualify to use the proportional amortization method. So, I think that while it was a big win for the tax credit industry, I think it was somewhat short-lived so far in terms of the impact. I don’t think we’ve really seen the impact yet until we start seeing potential changes in tax credit structures that qualify. But assuming that that those things happen, that tax credit structures change so that they qualify, I think that it will be a tremendous impact on the demand for the tax credit. You have a lot of tax credit-eligible investors who look at the accounting for certain tax credits not called low-income housing tax credits, and don’t like the accounting treatment that they have to use and so they would much rather use the proportional amortization method. So if they’re now able to do that, I think you would see much more appetite from those types of investors.

So I think that there’s still work to be done. That’s why the GAAP Working Group still exists. It didn’t, obviously it wasn’t only focused on this issue, but here's still definitely some work in order for it to have, I think, the impact that most of the different investors in the different tax credits we’re hoping it would.

[00:38:15] Michael Novogradac, CPA: Thank you for that, Brad. And we'll include a link to the GAAP Working Group in the show notes. I encourage the listeners to get involved in that effort because as you point out, there’s much work still to be done. I don’t know, Tony, if you had any comments on the renewables community and their response to the GAAP change?
Tony Grappone, CPA: Sure. So, with renewable energy investments, the way those are structured, most tax equity partners use the equity method of accounting. But when you read through the GAAP rules on how those equity method investments are structured, they’re required to apply what’s called the hypothetical liquidation at book value accounting method to their equity method investment. And so hypothetical liquidation at book value or, simply referred to as HLBV, is considered a very complicated area of accounting guidance in terms of how you read it, interpret it and apply it. There isn’t a ton of consistency in the marketplace in terms of how the guidance is interpreted and applied and so it can be a barrier. HLBV, the accounting guidance for equity method investments for renewable energy tax equity investors can be, has been a barrier to entry. And it has actually been a reason that some investors cite as to why they decided not to invest in it in the program. So I think the fact that proportional amortization now can be considered for renewable energy investments, I think is fantastic.

But there are still barriers there even in terms of qualifying for proportional amortization. So even though technically renewable energy investments can consider proportional amortization, you have to meet certain other criteria before you can just say you can use it, right? And so PTC investments just, and the biggest criteria you have to work through to qualify for proportional amortization on these renewable energy investments really boils down to the pricing on the investment. And ITC investments have proven to be, they’re priced high enough where it makes it difficult for them to qualify for proportional amortization based on current market conditions that impact pricing. Where we’ve worked with investors and syndicators to try to come up with alternative structures that work there, but they sort of bring some of their other challenges as well. So I think it’s great that it’s very well received. It provides an opportunity for investors to get out of HLBV accounting, which most investors in renewable energy really don’t like, allows them to use proportional amortization, which they perceive as much simpler and easy to implement. It provides much more predictable results, puts the results below the line, which most tax equity investors prefer. These are tax investments after all, so to them it just intuitively makes sense that the GAAP results would show up below the line. So, we’ll see. I think there’s some still, like there is with new markets and some of the other programs, there’s still some work to be done there with proportional amortization so that it can be used more widely by all renewable energy investors. But I’m somewhat confident that eventually that’s where the industry’s headed.

Michael Novogradac, CPA: And do you think the key change would be to relax the rule that you have to have a positive yield from your tax incentives alone?

Tony Grappone, CPA: That would be fantastic if that rule could be relaxed a bit, that would really solve a lot of problems here. I think though investors, I think renewable energy investors are more determined to find workarounds in terms of how they structure the deal so that they can meet the current positive yield criteria without having to wait to go back to FASB and open a new project, because that can take time and it’s uncertain. So I think they’d rather explore structure alternatives.
ESG Investment and Demand

So, there’s one final area I’d like to specifically discuss before bringing this second part of our two-part episode to a close. That’s your overall view from each of you on the motivation of investors to invest in these various community development tax credits to achieve various environmental, social, governance or ESG-type goals to engage in impact investing as well as to meet various public commitments that many large institutions have made. And maybe I’ll start with you, Tony, if you can share your thoughts there. And then Dirk, share your thoughts in the affordable housing area. And then Brad, you can discuss your thoughts with respect to new markets and historics. Tony?

Tony Grappone, CPA: Great. Yeah, so big public companies, they invest in these types of renewable energy projects. Being good corporate citizens is a top priority for big companies and they want to show that they’re leaders when it comes to making an impact on environmental and social issues. And so they’ve been very focused on trying to find ways that they can invest or participate in renewable energy projects.

One of the attributes that a renewable energy project generates is something called renewable energy certificates or referred to as RECs. And so if you’re a company and you purchase RECs from a clean energy facility, well that helps improve your ESG reporting and that’s an important initiative that publicly traded companies have taken on is try to really ramp up and improve their ESG reporting.

And so how does that play out in the market? Well, if you’re a sponsor of a project or a developer of a project and you’re trying to raise a tax equity investor, one of the things that you’ve got to help make your project more attractive to the investors is being able to also offer them RECs. And so that’s been a difference-maker to attracting tax equity investors is where you can say to that investor, look, I know ESG reporting is really important to you, our project also qualifies for RECs, if you come in as our tax equity partner, we’ll also give you an opportunity to buy the RECs from the project as well. And so it’s helped lift the ESG reporting needs and companies desire to get that deeper social environmental impact going, have been more attracted to some of these projects for not just the tax equity investment piece, but also to get the RECs from these projects.

Michael Novogradac, CPA: Thank you for that, Tony. Dirk, your thoughts.

Dirk Wallace, CPA: Yeah. So, I would say 10, 15 years ago, or even just five to 10 years ago, we were really only seeing funds that were just focused on the credit itself and the low-income housing tax credit. And every now and then we may see a distressed property fund or something a little unique. But the general structure in properties that we’re invested in were generally the same. We’re seeing more and more types of funds that are looking at social impact. We’re looking at, we have a few
syndicators that have minority developer funds and where they’re bringing in some first-time developers just to get more developers into the industry. We have a lot of preservation funds. We have clients that are looking at, I guess properties where they’re not necessarily requiring what they would on a typical fund and lowering some of those benchmarks to put a property into a fund just because it’s in a good location where the investor wants to invest socially. So we didn’t see that five years ago and I think now we’re seeing a lot more of that, a lot more different types of funds. And it’s definitely something that investors are considering when they’re making these investments.

[00:46:24] **Michael Novogradac, CPA:** Thank you, Dirk. Brad, how about effects for new markets and or historics?

[00:46:30] **Brad Elphick, CPA:** Yeah, I’ve seen a very direct impact on investors and how they have looked at new market tax credit investments in particular. As you mentioned, there’s been a lot of investors who have made these public commitments and a lot of those public commitments didn’t say tax credit investments specifically, but they’re an obvious landing place for filling those commitments. And I think for some new market tax credit transactions, I’ve seen an investor come in and say, we have this commitment that we need to make, so we’re actually going to increase the pricing on this transaction by several pennies on the dollar, merely because of the desire to use that investment to meet some of their public commitments. And so obviously those transactions benefit from that commitment. And I think we’ve seen a lot, a good amount of that. Some investors are more specific about these commitments and so depending on the specificity of those commitments, we’ve seen different investors take different approaches. But, similar to CRA or any of these other things that kind of drive investors and they can take this approach where it checks more than one box. Investors are willing to pay a little bit more for the more boxes it checks and so these types of investments often will check the ESG or the social impact investing requirements. So I think in that case, we see an increase in pricing. And so that I’ve seen that more so in new markets.

[00:48:13] **Michael Novogradac, CPA:** OK so thank you for that, Brad. So, Dirk, Tony and Brad, let me say again, thank you for being on the podcast the past two weeks. I think you’ve given the podcast listeners a good big-picture view as how community development has for equity markets work, both in supply and demand, and most importantly, how that flows down to individual equity pricing at the project level. I am certain that you’ve given listeners many things to consider. For our listeners, if you have any questions for Dirk, Tony, or Brad, I will share their email addresses in today’s show notes and I’ll also share a link to the column I wrote about this topic along with the other matters that I’ve mentioned I include in the course of this podcast today.

I will ask the three of you to stick around for our Off-Mike section, where I’ll get to ask you a fun off-topic question to get your words of wisdom.
Back to our listeners. Be sure to tune in next week when we shift gears and talk about HUD compliance issues. My partner Susan Wilson will join me to talk about various regulatory agreements and other issues involved in HUD programs. That’s the Department of Housing and Urban Development programs. Often these programs are used at low-income housing tax credit properties, so if you’re a property owner, manager or investor, next week’s podcast is for you. We’ll discuss a number of compliance issues that listeners should be knowledgeable about. We’ll discuss some common pitfalls and more importantly, how to avoid them, as well as several recommended practices. Please be sure to tune in next week.

**Off-Mike Section**

Now we turn to the Off-Mike section, where I get to ask each of you questions unrelated to tax credit equity markets. Since there’s three of you, I’m only going to ask one question and that one question for each of you to answer. What lesson have you learned in your career that you think would be helpful for everyone to learn? And I randomly chose and you got first, Dirk.

[00:50:13] **Dirk Wallace, CPA:** Well, I’ll set the bar pretty low for the rest of you. Yeah, so thinking about this, a long time ago when I started my career, I think we were working on tight schedules, lots of deadlines and you start thinking, I just want to get this done as fast as possible. And you’re thinking quantity, quantity, quantity. You’re not thinking quality over quantity. But I think the older you get and you start getting some gray in our beards and things like that, you definitely want the quality you want quantity quality, but you definitely want the quality there. So, I would say take your time. I know we work on tight schedules and lots of deadlines, but as somebody with a lot of staff, a lot of interns, we’d rather have that quality product and you to take a couple extra minutes and make sure it’s done right than just to see how many you can get through in a day.

[00:51:15] **Michael Novogradac, CPA:** Yeah. And if you don’t get it done right, you get to do it over again.

[00:51:18] **Dirk Wallace, CPA:** That’s right.

[00:51:19] **Michael Novogradac, CPA:** It kind of reminds me of painting. Whenever I’m painting a room or something, I always want to just start painting and if I don’t do all the prep work and everything else in advance, that painting takes a lot longer. So good tip, Dirk. Next Brad. What would be your tip here?

[00:51:41] **Brad Elphick, CPA:** Yeah, so when I was thinking about this question, I thought, what would I say to one of my kids as they’re getting older? And, I’ve got one that just is going to be starting college here shortly and hopefully will be in the workplace soon after that. And so, I think it’s easy for someone to look at someone who’s been doing it for a long time and go, “I want to be there. Why am I not there yet?” And I think, for me, patience was a hard lesson to learn. And I can see I haven’t been the
best at teaching it too my children either. It takes time to be successful. You’ve got to chop the wood. You have to, as Dirk said, focus on the quality. And I think you have to do things above and beyond what’s being asked for you, right? And you may not always get the reward immediately for doing that and I think if you look at the reward is cumulative, not just immediate, I think that that allows you to stick around for a lot longer and be happy in what you do. And I just celebrated my 24th anniversary here at Novogradac, so that's worked out well for me, obviously, being patient with that and the rewards that I’ve seen. So I would just kind of I always tell new staff to take the long-term picture of what you want and the long-term approach. And so that's what lesson I think I've had to learn. And, I'm still learning.

[00:53:30] Michael Novogradac, CPA: Well, thank you for that, Brad. It kind of reminds me of, I'm a fan of Naval Ravikant and he gives lots of great advice and one of the bits of advice that he has is you have to believe in the power of compounding. And all the things that you do in life and your example is really all about compounding by investing in yourself over those 24 years. The power of compounding in terms of your own personal growth has been quite remarkable and that's something that at the time is like investing in that and realizing the power of compounding can be obviously mathematically it’s quite obvious, but to invest in it individually can be challenging. And then there's lots of diversions along the way. But let's turn to you, Tony. They took away the two you were going to say, I bet you're going to tell me.

[00:54:23] Tony Grappone, CPA: It's a good thing. I had a backup. OK, so look, we're living in a time of unprecedented changes and significant changes, all right? And, these days you hear a lot of people kind of lament about how much change we're experiencing and throughout the world and longing for the good old days. I think what I would tell people is, I would discourage people from embracing that sort of mindset and instead practice the mindset of looking at change as opportunities. Because I have a feeling we're going to continue to see a lot of changes going forward. And I think you want to see this changing world that we're living in as providing opportunities for ways to better ourselves. And so I would say, one of the lessons I've learned is, and I think I learned it maybe from you, Mike, a little bit, I mean, you learned this lesson from a lot of people, but you've kind of exemplified this yourself. And that is don't be an old dog that can't learn new tricks. Change is going to happen. Look at the bright side of change and see the opportunities in it and embrace it because there'll be more coming.

[00:55:36] Michael Novogradac, CPA: Yes, indeed. And that reminds me of the book "Growth Mindset." And you really need, everyone needs to have a growth mindset because change hopefully is inevitable and growth is inevitable. Not just change, but positive change and growth. So having a growth mindset's certainly key in any profession and life in general.

[00:56:04] Brad Elphick, CPA: Tony, I can't help but think that this is somewhat related to the Inflation Reduction Act.
Michael Novogradac, CPA: There could be leaps at times in terms of–

Tony Grappone, CPA: Well, the Inflation Reduction Act is almost a little bit like the '86 Reform Act and I've heard Mike talk about how the '86 Reform Act, how transformative that was for his career, and how there were some old dogs that couldn't learn new tricks back in the day and so–

Michael Novogradac, CPA: There definitely were some old dogs that were choosing not to learn new tricks. And they weren't quite open about it. And, I was fine with that.

Tony Grappone, CPA: You could say that growth mindset that you had back then is a big part of how Novogradac came to be and what it is today.

Michael Novogradac, CPA: Indeed. So, thank you Tony. Thank you, Brad. Thank you, Dirk. And to our listeners, I'm Mike Novogradac. Thanks for listening.
Additional Resources

Emails

Brad Elphick
Tony Grappone
Dirk Wallace

Novogradac Journal of Tax Credits Columns

Tax Credit Equity Pricing–A Supply-and-Demand Analysis
Effects of High Inflation on Development, Financing and Operation of Tax Credit-Financed Housing

Generally Accepted Accounting Practices Working Group

More about GAAP Accounting for Tax Credits Working Group