TAX CREDIT DEVELOPMENT IN A TIME OF UNCERTAINTY

I. Historical Background

A. Low-Income Housing Tax Credits (LIHTC)

1. Type of Project – Low-income housing tax credits (9% and 4% per year for 10 years) provide equity for residential rental projects which receive credit allocations through a competitive process. Rent and occupancy requirements apply with residents having incomes of 60% or less of area median income, and frequently lower income requirements apply.

2. Equity Investment – In 2016, equity provided approximately 45% to 70% of the total project cost for 9% deals and approximately 35% to 50% of total project cost for 4% deals, with some geographic diversity around the nation.

B. Historic Tax Credits (HTC)

1. Type of Project – The historic tax credit provides a credit equal to 20% of the qualified rehabilitation expenditure for certain designated historic buildings.

2. Equity Investment – Historic tax credits provide approximately 15% of total project cost, although this can vary greatly. It is important to consider both the initial equity investment and the put price in determining net equity.

C. New Market Tax Credits (NMTC)

1. Type of Project – The NMTC is (39% over 7 years) intended to foster the construction and rehabilitation of properties and the creation of jobs in low-income communities and for low-income persons. There are many different types of NMTC projects, including shelters, arts facilities, hotels, and factories. Credits are based on the financing rather than project ownership.

2. Equity Investment – The equity raised with the NMTC typically provides 15% to 19% of total project cost.

D. Prior Program Disruptions

1. Original year to year renewal of LIHTC and NMTC

2. FNMA withdrawal from market

3. 2008-9 Great Recession: to fill the gap created by loss of equity investors, TCAP Grant funding was available for capital investments in LIHTC projects awarded in LIHTC in 2007, 2008, 2009

4. Reductions in gap financing (HOME and CDBG)

E. Other Important Programs

1. CRA

2. State tax credits

3. HOME and CDBG

II. Possible Tax Changes That Could Impact Market

A. Reduction in corporate tax rate from the current 35% maximum rate would not impact credits, but would impact overall investor IRR by reducing the benefit of losses.

1. Trump proposal – maximum 15% corporate rate

2. Current House proposals – 20 to 25% corporate rate

3. Likely outcome based on economic reality – 25% - 29% corporate rate

B. Elimination of corporate interest deduction

C. Accelerated depreciation – There are a variety of proposals for minor and major changes to depreciation schedules.

D. Elimination or modification of credit

1. LIHTC – probably retained and may be improved

a. Possible revival of Cantwell Hatch LIHTC expansion bill

b. Increase 9% credits by 50% and make 4% rate fixed

2. HTC – more at risk under a "but for test" and not as strong a lobbying group

3. NMTC – authorized through 2020

E. Other Possible Changes

1. Elimination or modification of CRA

2. Changes or elimination in tax-exempt bonds

III. Current Developments

A. Election Outcome – Many investors did not see Republican control of the House, Senate, and the White House concurrently. The anticipated tax plans are having a dramatic effect on investor interest and yield expectation.

B. Early Investor Reaction

1. Close based on LOI prior to year end 2016

2. Renegotiate LOI with significant adjuster

3. Withdraw from market and wait. Pricing will change as a result.

C. Warehouse Lines – For those syndicators that have anticipated receipt of the investor capital and borrowed against warehouse lines of credit, they stand exposed when the investors are not funding. The syndicators cannot hit the rates of return required by the investors if the corporate tax rates are reduced to the 20% or 25% level.

D. 10 Year Treasury Rate – In the meantime, the 10 Year Treasury rate has increased 100 basis points since the election. This benchmark has increased investor yield expectations while simultaneously running counter to the negative effect on yield if the corporate tax rate declines.

IV. Allocator Reaction

A. State Agencies are not thrilled with the adjuster concept.

B. With the use of an upward adjuster, many state agencies believe that deals could be over-funded if the developers receiving capital from the syndicator through an upward adjuster.

C. Once the Form 8609 has been issued, there is little recourse for a state agency.

D. Some states may be requiring developers to pay some type of upward adjuster rebate to the state agency to fund a state trust fund to subsidize future transactions to avoid the windfall that otherwise may occur.

E. Some agencies have delayed application deadlines.

F. Other creative approaches by state agencies.

V. Recent Investor Reaction

A. Current LOIs for applications assume a 20% to 25% corporate tax rate and tend to be at reduced investments (10-20% reduction is common)

B. Adjuster Provisions

1. <u>Downward Adjuster</u>. If the assumptions at the time of investment assume a certain tax rate which later is slashed with tax reform legislation, the syndicator will require the developer to write a check back to the syndicator to make up the difference. Few developers can take that economic risk.

2. <u>Upward Adjuster</u>. Some syndicators will go into a deal presuming a 20% corporate tax rate and provide an adjustment upward if the corporate tax rate increases beyond that level.

VI. NMTC

A. The New Market Tax Credit ("NMTC") program has not been as dramatically affected as the LIHTC. The pricing for New Market Credits focuses on the credits and does not involve losses.

B. Because of uncertainty in LIHTC, NMTC investments are stable or increasing.

VII. HTC – Proposals do not seem to be impacted as much as LIHTC, but unpredictability of HTC investments makes it harder to evaluate.

A. HTC frequently combined with LIHTC or NMTC

B. Small developer transactions have little predictability