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SPECIAL FEATURE

COMMENTARY: Tax Credits, Tax Reform and Individual Investors: A Fresh Look?

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Tax reform is on the horizon. While proponents are cautiously optimistic that investor-based tax credit programs (e.g., the low-income housing tax credit, the historic rehabilitation tax credit, new markets tax credit and renewable energy tax credits) will survive tax reform, there is a question of whether tax reform will negatively impact the amount of available tax credit equity for these highly successful and popular programs. There is also the prospect of a federal infrastructure credit, substantially increasing the amount of credits in the marketplace.

Tax Rates and Corporate Tax Capacity

Tax credit finance is driven almost exclusively by corporate investors that are taxed as "widely-held" C corporations.

President Donald Trump is proposing a reduction in the corporate income tax rate from 35 percent to 15 percent and Republicans in the House of Representatives are proposing a reduction of the corporate income tax rate to 20 percent.

These reductions in the tax rates could result in less overall tax capacity for C corporations. As a result, these "widely-held" C corporations may decide to invest less in tax credits.

The reduction of corporate income tax rates may also make depreciation deductions less attractive to these same investors.

"Significantly lowering the effective corporate tax rate could result in a reduction of corporate tax capacity," said Jeff Whiting, CEO of City Real Estate Advisors, a prominent syndicator of the low-income housing tax credit (LIHTC).

In a supply-and-demand market, the result could be falling tax credit prices, with the prospect of transactions unable to close due to a gap in the transaction's capital stack.

The Tax Equity Marketplace for Individuals

So, what about individual investors?

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While President Trump is proposing an income tax rate reduction from 39.6 percent to 35 percent for individuals, this rate reduction is nowhere near as significant as what is being proposed for C corporations.

In addition, for most of the investor-based tax credit programs, a dollar of tax depreciation will be worth more to an individual than to a C corporation.

Substantial restrictions put in place in the 1980s, however, have posed significant challenges for individuals to participate in the tax equity marketplace. These same restrictions generally do not apply to "widely-held" C corporations.

Restrictions on Individual Investors

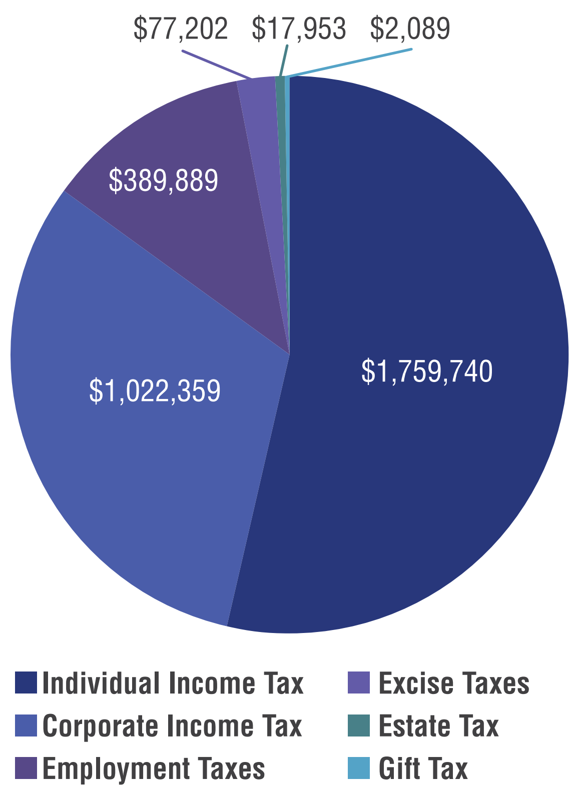
The passive activity loss and credit rules limit the ability of an individual investor engaged in a passive activity to use losses and credits generated from such activity against income (and the tax liabilities) from other non-passive activities, according to Section 469 of the Internal Revenue Code. An activity is generally considered to be passive unless the individual participates in the activity at a certain level. This is generally determined based upon the amount of hours the individual spends on such activity in a taxable year. Certain activities such as leasing are generally considered passive regardless of an individual's level of participation.

For example, a physician not engaged in the hotel business would be unable to use historic tax credits generated from his or her investment in a limited liability company that is operating a hotel which underwent a historic rehabilitation against his or her tax liability from practicing medicine. The physician's income tax credits are considered to be generated from a passive activity and the physician's tax liability from practicing medicine is considered to be generated from a non-passive activity.

Also, at-risk rules may prevent individuals from fully obtaining tax credits and using losses generated from the proceeds of nonrecourse financing where project-level debt is involved. Unless an exception applies, an individual investor would need to personally guarantee the project-level debt to avoid the negative impact of the at-risk rules, a problematic requirement for most transactions.

These rules have created significant barriers for individual investors to participate in the tax equity marketplace.

Federal Tax Revenue in 2015* (in millions)
$3.26 Trillion**



*IRS Statistics of Income 2016, Publication 4198 (Rev. 7-2016) Catalog Number 36580V, Department of the Treasury
**Summary of collections, before refunds

Ripe for Change?

Changes in the tax code to the passive activity loss and credit rules and the at-risk rules would be needed to create a more level playing field for individual investors.

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The passive activity loss and credit rules and the at-risk rules were enacted in the tax code decades ago to combat abusive tax shelters. These exclusively tax-driven transactions were largely devoid of any economic value.

One approach would be for Congress to expand the exceptions to the passive activity loss and credit rules and the at-risk rules so that these limitations would not apply to investor-based tax credit programs. These rules already contain exceptions, most notably for the oil and gas and real estate industry.

An exception for investor-based tax credits would foster a more robust investor base in well-established programs that have been specifically designed by Congress to stimulate the investment of private capital.

Not taking into account the impact of tax reform, the federal government collects more than four times as much income-tax revenue from individuals than from corporations.

As Steven F. Mount, a prominent tax attorney of Squire Patton Boggs observed, "A limited exception from the current restrictions for individuals could provide a controlled means to allow individuals to participate in tax equity, while not opening up the floodgates of abusive tax shelters from the past."

Summary

Tax reform presents a unique opportunity to rethink the strategic direction of the tax code. Why should individuals not enjoy greater parity with C corporations in tax credit investing–particularly where the tax credit programs have been well policed and provide effective investments in important social objectives? A limited exception to the passive activity loss and credit rules and at risk rules would allow an individual market to flourish, and reverse a possible shortage of available tax equity resulting from tax reform.

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