

# CERTIFICATED CREDITS – MORE BANG FOR YOUR STATE CREDIT BUCK

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# Certificated State Housing Tax Credits

- On June 27th, 2016, Governor Brown signed into law important changes to the State Low Income Housing Tax Credit (LIHTC) program that can increase equity pricing for nonprofit developers of LIHTC-financed properties by allowing them to certificate state housing credits and sell them separately from federal LIHTCs.
- California Housing Partnership Corporation and State Treasurer John Chiang co-sponsored and helped draft SB 837, which was authored by Senator Jim Beall. Senator Beall demonstrated great fortitude and tenacity in passing this bill with nearly unanimous support after having his first attempt (SB 377) vetoed last year by the Governor.

## Certificated Credits: The Simple Version

- SB 837 allows the CA Credit to be certificated and sold separately from the federal credit
- Currently, every dollar of allocated state LIHTC increases investor Federal tax liability by ~35%, reducing net value of state LIHTC to \$0.65
- Other states have certificated their credits so that nonprofit organizations can sell them without paying federal taxes due to exemption

# Certificated Credits: The Simple Version (continued)

- Allowing the CA Credit to be certificated effectively increases the net value of the state Credit from it's current \$0.65 to \$0.90's
- This is equivalent to increasing the value of the state credit by more than 40%
- For-profit developers able to use this only if in partnership with a NP developer (consult your tax attorney)

# Current CA Credit Mechanics

- Housing Credit allocated by TCAC to taxpayer and property owner, typically limited partnership or limited liability company
- Housing Credits “sold” via sale of 99.99% interest in tax pass through ownership entity (typically Limited Partnership) to investor
- Investor receiving Housing Credits needs to have ownership interest to claim credits and losses
- State Housing Credits can be sold separately from federal Credits (bifurcated)

# CA Credit Federal Tax Hit

- Allocated state Credits reduce an investor's state tax liability
- State taxes are deductible against federal taxable income under IRC §164(a)(3)
- Allocated state Credits thus effectively reduce an investor's federal tax deductions
- *Net impact is to cap economic value of state tax credit at \$0.65, assuming 35% federal income tax rate*

# Certificating the Credit

- Project sponsor may choose to have Credit “certificated” instead of allocated – FTB issues certificate evidencing right to the credits in connection with development of qualified low-income housing
- Project sponsor must choose to certificate credit at time of TCAC application and sell the credit for minimum of \$0.80. If credit is NOT sold for at least \$0.80, then sponsor may request TCAC to rescind certification.
- Certificated credits sold to investor as if personal property, fully severable from ownership entity, unlike current allocated credit
- Investor does NOT need to have ownership interest in ownership entity (taxpayer) , BUT investor must be a traditional LIHTC investor in at least one LIHTC project in CA

# Certificating the Credit (continued)

- Certificated credit is considered property by IRS, not redeemable as cash, therefore does NOT reduce investor's ability to deduct state tax liability from federal taxable income under IRC §164(a)(3) - *potential economic value of state tax credit closer to \$1.00 for \$1.00*
- Purchaser of certificated credit is NOT liable for CA LIHTC compliance. The taxpayer (i.e. partnership) remains fully liable for compliance and risk of recapture.
- Certificated credit initial purchaser may resell the unused portion of the credit certificate ONCE.
- Taxpayer will need to report sales information to TCAC within 10 days of sale.

# Allocated Housing Credit Math

Assume each investor would owe \$100,000 in state taxes & Investor B allocated \$100,000 state credits.

	<u>Investor A</u>	<u>Investor B</u>
<b>State Tax Credits Allocated:</b>	\$0	\$100,000
Gross Income:	\$1,000,000	\$1,000,000
State Income Taxes Paid:	(\$100,000)	(\$0)
Taxable Income:	\$900,000	\$1,000,000
Corporate Tax Rate:	<u>X 35%</u>	<u>X 35%</u>
<b>Federal Income Tax:</b>	<b>\$315,000</b>	<b>\$350,000</b>
<b>Additional Federal Tax Paid by Investor B =</b>		<b>\$35,000 more</b>

# Certificated Housing Credit Math

Assume each investor would owe \$100,000 in state taxes & Investor B buys \$100,000 in certificated state credits.

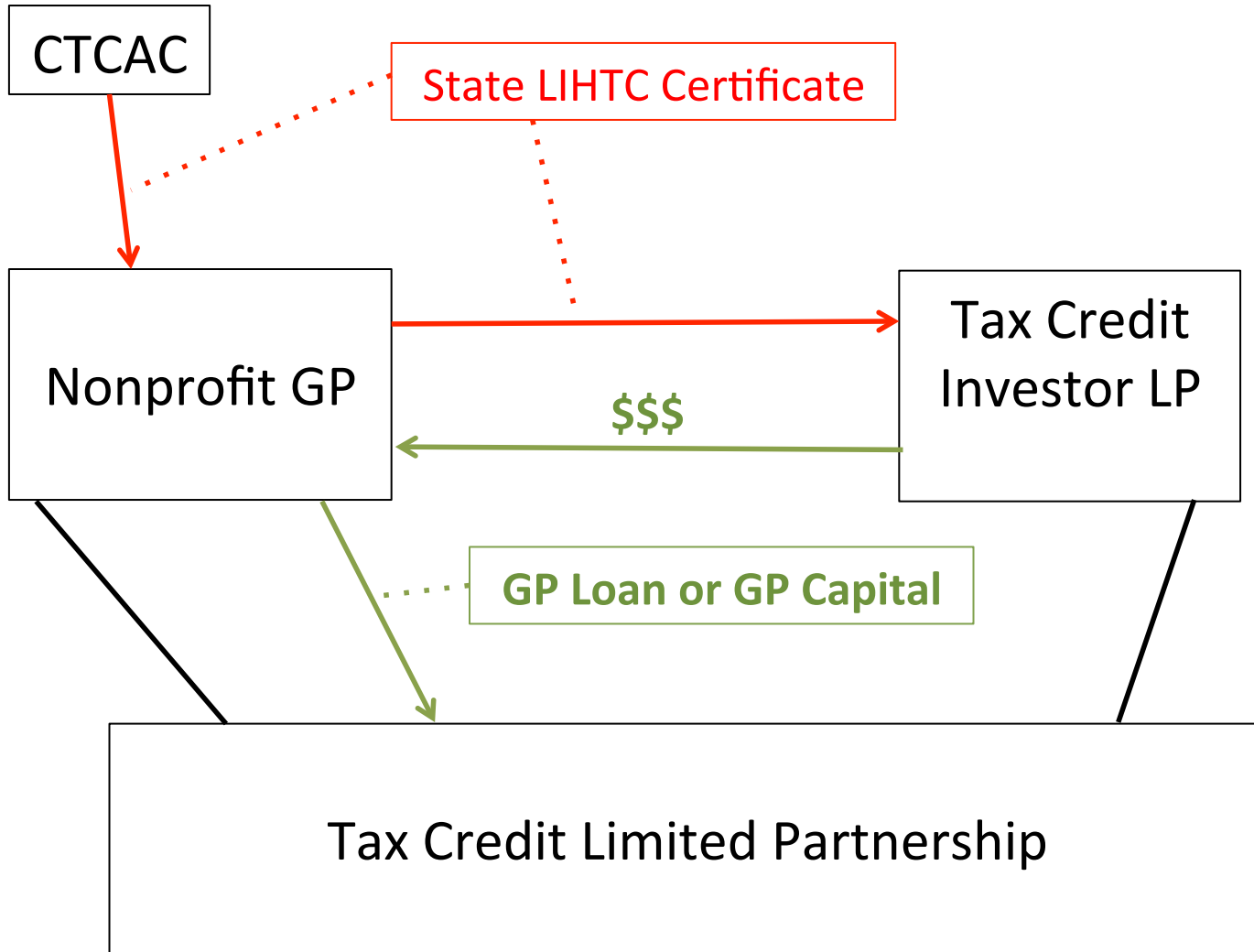
	<u>Investor A</u>	<u>Investor B</u>
<b>State Tax Credits Allocated:</b>	\$0	\$0
Gross Income:	\$1,000,000	\$1,000,000
State Income Taxes:	(\$100,000)	(\$100,000)
Taxable Income:	\$900,000	\$900,000
Corporate Tax Rate:	<u>X 35%</u>	<u>X 35%</u>
<b>Federal Income Tax:</b>	<b>\$315,000</b>	<b>\$315,000</b>
<i>State Credit Certificate:</i>	\$0	\$100,000

Certificated credits treated as property by IRS. Taxpayer B still has a state tax liability. Taxpayer B is “paying” its state taxes with the Housing Credit certificate instead of using cash.

# Structuring Sale: NonProfit GP

- Selling the certificated credits as personal property triggers capital gains tax because initial recipient (sponsor developer) has no tax basis in certificate
- Solution is TCAC awarding 100% of state credit to nonprofit GP as sponsor/applicant. Nonprofit does not have to pay income or capital gains taxes. Nonprofit GP sells certificated credits to the investor.
- Nonprofit GP will then loan or contribute the certificate sale proceeds to the partnership for the benefit of the project
- Investor receives face value of credit
- Given multiyear stream and present value calculation, this could increase price into the \$0.90s

# Sale by NonProfit



# Experience in other States

- 12 states have certificated various types of state credits
- Examples include:
  - Michigan, Missouri, MA and Kansas Historic Preservation Programs
  - North Carolina Renewable Energy Credits
  - Connecticut, Illinois and Georgia film credits

# Potential Issues/Solutions

Q: If nonprofit GP provides equity as capital, won't this trigger 40 year depreciation as "tax exempt use property" (IRC 168(h))?

*A: The enhanced pricing for the state credit is expected to more than offset the cost of using 40 year depreciation. Many LIHTC deals in CA already use 40 year depreciation. It is possible some tax counsels might accept 27.5 year depreciation.*

Q: If nonprofit GP provides equity as debt, will it be bona fide?

*A: GP loan must be structured as true debt to meet 55 year test.*

Q: Won't the debt be treated as partner recourse debt per IRC 704(b) unless the GP is disaffiliated?

*A: Should not be an issue for most deals, but for those where it is, disaffiliation has become more common in deals with related party debt.*

# Potential Issues/Solutions

Q: Will the IRS consider this transaction as disguised ownership?

*A: Generally not an issue in CA as the nonprofit is a substantive Managing GP in these deals but structuring as true debt should resolve this concern if it exists*

Q: Will the IRS treat this as private inurement?

*A: Unlikely since proceeds will be used for the LIHTC deal which furthers the non profit's charitable purpose.*

Q: Has this been done anywhere before?

*A: Massachusetts has a certificated state LIHTC that is typically transferred to a nonprofit which sells the credit and then loans the proceeds to the partnership.*

Q: What if we still can't find a way to use certificated Credits?

*A: You will still be able to obtain allocated state Credits the way you can now; certificating the Credits is at the developer's option.*