



OPPORTUNITIES AND CHALLENGES IN THE NEW ADMINISTRATION

Tax Reform and Its Consequences for Affordable Rental Housing

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I. Introduction

The 2017 tax reform legislation (Pub. L. No. 115-97), initially titled the “Tax Cuts and Jobs Act” (Act), was responsible for the most sweeping changes to the Internal Revenue Code (Code) in a generation. Unlike the experience in 1986, which included the creation of the low-income housing tax credit (LIHTC), nothing in the Act directly addressed affordable rental housing. Nevertheless, the new law has very important consequences for the production and preservation of affordable rental housing.

This article begins with a review of several proposals that were initially included in, or subsequently added to, the draft legislation, but ultimately were not retained in the final bill. This article then reviews the tax changes included in the final bill that are particularly relevant to the use of the LIHTC for the production and preservation of affordable rental housing. These are provisions that: (1) have a direct effect on financial returns to investors, (2) affect investor demand for the federal LIHTC and corollary state tax credits, (3) affect the future supply of the LIHTC and private activity bonds, and (4) make other technical changes.

The discussion presumes readers have a basic knowledge of the LIHTC program. More importantly, by necessity the article is only a summary. Other aspects not addressed may be consequential to particular situations. The development and operation of LIHTC properties require advice from knowledgeable accountants and attorneys. The Act makes this need even more acute. If readers take only one message from this article, it should be to seek out assistance from tax experts.

II. Provisions Considered but Not Enacted

Although the 2017 tax reform process was rapid by historical standards, several ideas came and went along the way. The following section

describes some of the provisions that were considered but ultimately not enacted. This historical background illustrates how the process worked and provides a context for understanding the ultimate outcome. It also is worth understanding the concepts that were added, and then removed, as they could resurface in the future.

*A. Elimination of Private Activity Bonds and Accompanying
4 Percent LIHTCs*

The tax bill initially passed by the House of Representatives left the 9 percent allocated LIHTC untouched.¹ However, the tax bill eliminated the ability of government agencies to issue tax-exempt private activity bonds (PABs), which under the Code are needed to generate 4 percent PAB LIHTCs.² Buildings are eligible for 4 percent PAB LIHTCs only if 50 percent or more of the building is financed with tax-exempt bonds subject to a volume cap. (Any 4 percent LIHTC received for acquisition costs in an allocated 9 percent LIHTC rehabilitation property would have remained unchanged.) The repeal of PABs would have cut LIHTC housing production and preservation by more than half.³ The elimination of PABs was seen as a way to help pay for other tax cuts, as well as a consequence of the concerns by some Members of Congress about some of the many uses of PABs.⁴

The affordable housing community mobilized in response to this prospect.⁵ Through these efforts and long-standing support for the program among key senators, the Senate passed tax legislation that retained PABs.⁶ The House consented to retaining PABs in the final bill.

As of the writing of this article, the future of PABs remains a hot topic. How the tool will fit in the upcoming plans for infrastructure spending is very much at issue.⁷ There is a very real possibility that the program will

1. The historic rehabilitation and new markets tax credits were slated for elimination.

2. Code Section 42(h)(4).

3. Michael Novogradac, *Tax Reform Bill Would Eliminate Future Supply of Nearly 1 Million Affordable Rental Housing Units*, TAX REFORM RESOURCE CENTER (Nov. 3, 2017, 12:00 A.M.), <https://www.novoco.com/notes-from-novogradac/tax-reform-bill-would-eliminate-future-supply-nearly-1-million-affordable-rental-housing-units>.

4. Brian Tumulty, *Brady open to keeping PABs, limiting their uses*, BOND BUYER (Nov. 30, 2017, 9:56 A.M.), <https://www.bondbuyer.com/news/21-in-house-gop-lobby-for-pabs-advance-refundings>.

5. *House GOP Tax Reform Bill Retains Housing Credit, But Repeals Housing Bonds*, AFFORDABLE RENTAL HOUSING ACT BLOG (Nov. 3, 2017), <http://rentalhousingaction.org/blog/2017/11/3/house-gop-tax-reform-bill-retains-housing-credit-but-repeals-housing-bonds>. Multiple interest groups representing other activities utilizing PABs (e.g., hospitals) also made their views known.

6. *Senate Approves Tax Cuts and Jobs Act, Conference with House Next*, NOVOGRADAC & COMPANY, LLP NEWS AND ANALYSIS (Dec. 2, 2017, 11:45 A.M.), <https://www.novoco.com/news/senate-approves-tax-cuts-and-jobs-act-conference-house-next>.

7. Mark Niquette & Alan Levin, *Trump's Draft Infrastructure Plan Asks Cities, States to Pony Up*, BLOOMBERG POLITICS (Jan. 22, 2018, 2:52 PM), <https://www>.

see a substantial expansion, perhaps in part because of the goodwill and support generated by last year's advocacy efforts. However, House Ways and Means Committee Chairman Kevin Brady (R-Tex.) continues to express concerns about some of the eligible uses of PABs, as well as the need to allow unused PABs to be carried forward and be available to be issued in a subsequent year.

B. Affordable Housing Credit Improvement Act

The Affordable Housing Credit Improvement Act (AHCIA) was introduced in Congress initially in 2016 during the 114th Congress and then reintroduced in 2017 (S. 548, H.R. 1661). The legislation contains two dozen revisions to the LIHTC program.⁸ Early versions of tax reform included the following no- or low-cost improvements from the legislation:⁹

- *Reconstruction or Replacement Period After Casualty Loss*: This provision would allow owners up to 25 months to restore a property after experiencing a casualty loss that occurred outside a presidentially declared disaster area before being either at risk of recapture or unable to claim LIHTCs. The current requirement is to restore such a property within the same calendar year.
- *Modification of Rights Relating to Building Purchase*: This provision would replace the ability to allow a non-profit to possess a right of first refusal to acquire a LIHTC property at a price equal to existing debt and exit taxes with a purchase option on such terms. A purchase option is seen as less prone to conflict over what triggers a nonprofit's ability to exercise its right of first refusal and acquire a LIHTC property.
- *Determination of Community Revitalization Plan to Be Made by Housing Credit Agency*: This provision would add criteria for credit allocating agencies' review of plans, including being geographically specific and commitments of non-housing infrastructure.
- *Prohibition of Local Approval and Contribution Requirements*: This provision would preclude credit allocating agencies from requiring that LIHTC allocation applications have local support.

[bloomberg.com/news/articles/2018-01-22/trump-s-draft-public-works-plan-asks-cities-states-to-pony-up](https://www.bloomberg.com/news/articles/2018-01-22/trump-s-draft-public-works-plan-asks-cities-states-to-pony-up).

8. *Modified Chairman's Mark to Senate Tax Reform Bill Includes Changes to LIHTC*, NOVOGRADAC & COMPANY, LLP NEWS AND ANALYSIS (Nov. 15, 2017, 11:30 A.M.), <https://www.novoco.com/news/modified-chairmans-mark-senate-tax-reform-bill-includes-changes-lihtc>.

9. Mark Shelburne & Peter Lawrence, *Modified Chairman's Mark Includes Provisions to Strengthen LIHTC*, TAX REFORM RESOURCE CENTER (Dec. 1, 2017, 12:00 A.M.), <https://www.novoco.com/notes-from-novogradac/modified-chairmans-mark-includes-provisions-strengthen-lihtc>.

- *Native American Housing*: This provision would require Qualified Allocation Plan selection criteria include consideration of the needs of those living on tribal lands.
- *Renaming to the Affordable Housing Tax Credit*.

None of the above-enumerated provisions made it into the final version, as they failed to meet the requirement under budget reconciliation rules that they have a revenue impact.

The AHClA could still be enacted in its entirety. And if not, the fact that the items above were included in the Senate Finance Committee-reported version of tax reform legislation will likely enhance their prospects for being attached to other tax legislation not subject to budget reconciliation rules.

C. Basis Boost and General Public Use

Proposed changes to the basis boost and general public use requirements were problematic provisions that were introduced together in an amendment from Sen. Roberts (R-Kan.) and were included in the final Senate-passed version of tax reform legislation.¹⁰ The provisions were not included in the final tax bill.

1. Basis Boost

The Roberts amendment would have allowed all 9 percent LIHTC properties in rural areas, as defined by the U.S. Department of Agriculture,¹¹ to be automatically eligible for a 25 percent increase in eligible basis, similar to properties located in difficult development areas and qualified census tracts. Congressional staff considered this allowance to have a fiscal impact, despite coming out of a jurisdiction's limited LIHTC ceiling. The amendment also reduced the current maximum boost of 30 percent to 25 percent for all LIHTC properties eligible for a basis boost under current law if placed in service after the date of enactment. The loss of up to a 5 percent boost in LIHTC equity would have created significant gaps for developments in the pipeline.

2. General Public Use

In 2008, Congress overruled an IRS interpretation of the law by adding a general public use exception to Section 42. The new exception made explicit that a property's occupational preference for certain groups, including artists, did not violate the general public use requirement.¹² The other

10. Michael Novogradac, *Senate Approves Tax Cuts and Jobs Act With Some Changes from Committee-passed Version*, TAX REFORM RESOURCE CENTER (Dec. 2, 2017, 12:00 A.M.), <https://www.novoco.com/notes-from-novogradac/senate-approves-tax-cuts-and-jobs-act-some-changes-committee-passed-version>.

11. U.S. Dep't of Agriculture, Rural Housing Services, Eligibility, <https://eligibility.sc.egov.usda.gov/eligibility/welcomeAction.do?pageAction=sfp>.

12. Code Section 42(g)(9).

half of Senator Roberts' proposal would have removed artists¹³ from this protection and replaced them with veterans. The amendment did not apply only to future properties; it also applied to existing properties. Eliminating artist housing from the general public use exception raised serious concerns from many, particularly considering its retroactive effect. Developers and investors involved in hundreds of existing artists' properties were potentially at risk.

D. Offsetting Loss of Equity at Property and Program Levels

As further described *infra*, changes resulting from the Act will reduce what otherwise would have been the number of LIHTC rental homes produced, renovated, and preserved. The drop in the number of units occurs principally because of the drop in the corporate tax rate and resulting decline in the value of tax losses to investors, leading investors to invest less equity per dollar of tax credits.¹⁴

In consultation with other LIHTC stakeholders, Novogradac & Company assisted in the preparation of draft legislative text to counteract these effects. The proposal adopted a two-step approach to respond to the drop in corporate tax rates, which is the primary but not sole cause of the estimated reduction in future units. The two steps operate together but are not interdependent, such that one step could be enacted separately from the other. The proposal remains in consideration and may yet be enacted.

1. Modernization of Tax Credit Rate

The first step was to modernize the calculation of the annual tax credit rate or percentage.¹⁵ This change would increase the amount of LIHTCs for which a property could qualify. While many properties are allocated fewer LIHTCs than the maximum allowed, some properties are limited by the maximum allocation rules. Increasing the maximum allocation available to a LIHTC property is often needed for a variety of underwriting reasons, such as properties serving tenants at very low income levels (e.g., permanent supportive housing).

The changes included in the modernization proposal respond to the fact that the current tax credit percentage formula does not accurately reflect LIHTC investors' cost of capital because the current formula is based

13. Mark Shelburne, *Why Tax Reform Caused a Concern for LIHTC Artists' Properties*, TAX REFORM RESOURCE CENTER (Dec. 21, 2017, 12:00 A.M.), <https://www.novoco.com/notes-from-novogradac/why-tax-reform-caused-concern-lihtc-artists-properties>.

14. Dirk Wallace, Michael Novogradac & Peter Lawrence, *How Congress Could Offset the Effects on Affordable Housing Production from a Reduced Corporate Rate*, AFFORDABLE HOUSING RESOURCE CENTER (Apr. 17, 2017, 12:00 A.M.), <https://www.novoco.com/notes-from-novogradac/how-congress-could-offset-effects-affordable-housing-production-reduced-corporate-rate>.

15. Code Section 42(b).

on after-tax federal government borrowing rates. Congress partially addressed this problem by establishing a 9 percent floor. However, the mismatch would manifest with a rise in interest rates and associated investor yield hurdles, which is made worse with a lower corporate rate. Furthermore, Congress did not establish a similar tax credit percentage floor for PAB LIHTCs, so the mismatch for properties using such financing remains unaddressed.

The proposed amendment addresses this mismatch. Under current law, the annual tax credit percentage formula is based on the average of the mid-term and long-term applicable federal rates (AFR), reduced by 28 percent and discounted on a present value basis over a 10-year period designed to cover either 70 percent or 30 percent of eligible costs. The present value calculation assumes an investor receives the first year's tax credit on the same day the entire investment is made.

The revised formula makes three key changes:

- eliminates the 28 percent discount and adds 150 basis points to the average of the mid-term and long-term AFRs to represent the spread between federal government borrowing rates and private investor borrowing rates;
- delays the present value discount by two years to incorporate the fact that investors invest capital much earlier than the point at which they have received the benefit of a full year of LIHTCs; and
- adjusts the LIHTC rate based on the change in corporate tax rates.

If enacted, and based on the newly established corporate tax rate, the tax credit percentage would need to increase by 16 percent to restore the financial feasibility of developments to pre-tax reform levels.

2. Increase of Agency Annual Volume Cap

The other proposal increases credit allocating agencies' annual volume cap based on the degree to which the corporate tax rate is reduced below the level (35 percent) when the LIHTC was made an indefinite part of the Code. Furthermore, to incorporate the effect of changing the annual inflation adjustment in the IRC to the Chained Consumer Price Index (see section III.C. below), a further increase would be needed. A hypothetical allocating agency with a current \$20 million volume cap would require an increase of 19 percent, or \$3.8 million, enabling the agency to allocate \$23.8 million in LIHTCs to restore production to pre-tax reform levels.

E. Summary

The preceding discussion enumerated some of the provisions considered during the tax reform legislative process that would have fairly directly affected the LIHTC program—some negatively, some positively. These provisions ultimately were not enacted. As we follow the machinations of congressional deliberation, we expect to see many of these provisions continue to be discussed, considered, and potentially enacted.

III. Enacted Provisions

The following is a review of the tax changes included in the final bill that are particularly relevant to the use of the LIHTC for the production, renovation, and preservation of affordable rental housing. These are provisions that: (1) have a direct effect on the financial returns to investors, (2) affect investor demand for the federal LIHTC and corollary state tax credits, (3) affect the future supply of the LIHTC and private activity bonds, and (4) make other technical changes.

A. Direct Impact on Financial Returns for Federal LIHTC

Four enacted provisions have a direct impact on financial rates of return for federal LIHTC investors: (1) the lower corporate tax rate, (2) limitations on the deductibility of interest expense, (3) 100 percent asset expensing, and (4) Opportunity Zones.

1. Lower Corporate Rate

Novogradac & Company has determined that the Act will reduce the supply of LIHTC rental homes by nearly 235,000 and support 262,000 fewer jobs over the next 10 years.¹⁶ The conclusions are based on the lower corporate tax rate and on the change to the method of determining inflation (the latter is discussed further *infra*). The analysis uses after-tax rates of return prevalent in the LIHTC equity market and does not take into account:

- adverse effects on investor demand from other provisions, such as the base erosion and anti-abuse tax;
- widely anticipated rising interest rates;
- the post-tax reform increase in after tax return on taxable investments;
- an anticipated increase in secondary market transactions;
- Fannie Mae's and Freddie Mac's return to LIHTC investing;¹⁷ or
- the anticipated reduced size of the annual aggregate supply of tax credit equity investments.

These factors are difficult to quantify but taken together, in the aggregate, likely will further reduce the production and preservation of affordable rental housing.

16. Michael Novogradac, *Final Tax Reform Bill Would Reduce Affordable Rental Housing by Nearly 235,000 Homes*, TAX REFORM RESOURCE CENTER (Dec. 19, 2017, 12:00 A.M.), <https://www.novoco.com/notes-from-novogradac/final-tax-reform-bill-would-reduce-affordable-rental-housing-production-nearly-235000-homes>.

17. *FHFA Allows Fannie, Freddie Limited Re-Entry into LIHTC Investment Market*, NOVOGRADAC & COMPANY, LLP NEWS AND ANALYSIS (Nov. 16, 2017, 11:45 A.M.), <https://www.novoco.com/news/fhfa-allows-fannie-freddie-limited-re-entry-lihtc-investment-market>.

The lowering of the corporate tax rate percentage does not directly affect the value of LIHTCs. As long as a corporation is paying income taxes, a dollar of credit against tax liability is worth a dollar.¹⁸ The corporate tax rate affects the amount of tax credit equity generated by federal LIHTCs because part of an investor's tax benefits are derived from losses and depreciation. A LIHTC investor is generally a direct or indirect partner in the entity that owns and operates the LIHTC property and, as such, is allocated a proportionate share of LIHTC property deductions.

The corporate tax rate determines the amount of taxes an investor saves when allocated losses and depreciation from a LIHTC partnership. Using an overly simplified explanation:

- In 2017 and before, a corporation with \$10,000,000 in taxable income owed \$3,500,000 in taxes (applying the then-applicable marginal tax rate of 35 percent).
- Having \$1,000,000 in additional deductions (reducing taxable income to \$9,000,000) reduced that liability to \$3,150,000, saving the corporation \$350,000 in taxes.
- In 2018, the corporation owes \$2,100,000 on \$10,000,000 in taxable income (applying the current marginal tax rate of 21 percent).
- The same \$1,000,000 in additional deductions reduces the corporation's tax bill to \$1,890,000, a corporate tax savings of \$210,000.

When this corporation decides to invest in LIHTCs, it will see less income tax savings per dollar of allocated tax losses.

The enacted 21 percent corporate rate will result in approximately 14 percent less equity for a total of about \$1.7 billion each year.¹⁹ Per our calculations, this reduction will translate into the loss of 200,500 to 212,400 rental homes, or more, over the next 10 years. Other analysis supports these conclusions.²⁰

Evidence of this reduction in tax credit pricing was observed in the post-election anticipation of tax reform, which caused a drop in equity pricing starting at the end of 2016.²¹ Novogradac & Company compared tax credit

18. Less time value of money and other investment considerations.

19. *Id.*

20. Michael Novogradac, *Observational Study Corroborates Lower LIHTC Unit Production Due to Lower Corporate Tax Rate*, AFFORDABLE HOUSING RESOURCE CENTER (Jan. 24, 2018, 12:00 A.M.), <https://www.novoco.com/notes-from-novogradac/observational-study-corroborates-lower-lihtc-unit-production-due-lower-corporate-tax-rate>.

21. Dirk Wallace & Michael Novogradac, *Tax Reform Could Significantly Affect LIHTC Equity Market*, AFFORDABLE HOUSING RESOURCE CENTER (Dec. 29, 2016, 12:00 A.M.), <https://www.novoco.com/notes-from-novogradac/tax-reform-could-significantly-affect-lihtc-equity-market>.

allocations made in 2015 to those made in 2017 allocations in select states and found this market shift led to fewer rental homes produced.²²

2. Interest Expense and Depreciation

A key value component for LIHTC equity investors is the ability to deduct their allocable share of a LIHTC partnership's interest expense and depreciation expense with residential rental real property depreciation generally claimed straight line over a 27.5-year life. For taxable years beginning after December 31, 2017, the deductibility of interest expense may be limited, and if not, real property depreciable lives generally will be lengthened. As such, after 2017, LIHTC investors will likely see lower than expected annual tax losses from LIHTC investments placed in service before 2018.

a. Limitation on Interest Expense

The Act limits annual business interest expense deductions; the limit applies at the taxpayer level, with partnerships being treated as taxpayers. The limitation is applied by first netting any business interest income against business interest expense to arrive at net interest expense.²³ This net is then limited to 30 percent of adjusted taxable income.²⁴ Adjusted taxable income is taxable income computed without regard to any item of income, gain, deduction, or loss that is not properly allocable to a trade or business; any business interest or business interest income; the amount of any net operating loss deduction; the amount of any deduction allowed under section 199A (Qualified Business Income deduction); and, in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion.²⁵

Because of depreciation expense, LIHTC rental real estate partnerships' taxable income, before interest expense deductions, is generally low or negative. As such, a limitation of interest expense deductions equal to 30 percent of taxable income generally would be a severe reduction in annual tax benefits from tax losses from LIHTC partnerships. However, the last adjustment to the calculation of adjusted taxable income, as noted above, in the case of taxable years beginning before January 1, 2022, moderates the impact of the interest expense limit until the year 2022. More specifically, the deduction for interest expense before the year 2022 generally would be limited to 30 percent of taxable income before depreciation expense. After 2021, the limitation would be more severe.

22. *Observational Study Corroborates Lower LIHTC Unit Production*, *supra* note 20.

23. Code Section 163(j)(1) as amended by Act Section 13301(a).

24. *Id.* These terms have more specific definitions.

25. J. William Callison, article to be published in CCH JOURNAL OF PASSTHROUGH ENTITIES, Spring 2018.

b. Exceptions from Interest Expense Limitations

There is an exemption from the interest deduction limitation for entities with less than \$25 million in average annual gross receipts, but not for partnerships where more than 35 percent of losses are allocable to limited partners.²⁶ This 35 percent of losses limitation means this option is not generally available to LIHTC partnerships because LIHTC partnerships generate tax losses and 99.99 percent of these tax losses are typically allocated to limited partners.

The good news for LIHTC partnerships is an exception to the interest expense limitation rule for real property trade or businesses. LIHTC property partnerships can avoid a limitation on the deductibility of interest expense by electing to be treated as a real property trade or business.²⁷ There is no statutory deadline for making the election, but once the election is made, the election is irrevocable. The election does come at a cost—the partnership must depreciate residential real property using the alternative depreciation system (ADS). Before the tax bill, ADS was 40 years for residential rental property; under the new tax bill, it is 30 years for properties placed in service after 2017.²⁸ Adding two-and-a-half years to the depreciation recovery period should not have an appreciable consequence on depreciation losses for LIHTC transactions involving properties placed in service in 2018 and later years.

However, it is unclear how properties placed in service in 2017 and before are treated if the real property trade or business election is made. There is a pending question of whether, after switching to ADS, owners of properties placed in service before 2018 will be allowed to use the new 30-year ADS life or will be forced to revert to the prior law ADS life of 40 years.²⁹ Absent federal guidance to the contrary, the more likely answer under existing regulatory guidance is that the net remaining basis is depreciated over the remaining 40-year ADS recovery period. Exactly what this new treatment means for investors' returns (and possible adjusters³⁰) will vary, but overall it is generally not positive.

For properties placed in service in 2018 and later, we anticipate most investors will require LIHTC partnerships to elect to be a real property trade or business. The longer depreciation life of 30 years versus 27.5 years generally reduces depreciation expense much less than the amount of interest expense deductions that would be deferred if interest expense

26. Code Section 163(j), as amended by Act Section 13312. Certain regulated public utilities and electric cooperatives also are exempt.

27. Code Section 168(g)(1)(F), as amended by Act Section 13301(a).

28. Code Section 168(c) as amended by Act Section 13301(a).

29. Callison, *supra* note 25.

30. This term describes a provision in the partnership agreement whereby the general partner is obligated to make the investor whole because of not realizing identified anticipated tax benefits.

limitations applied. However, the answer is likely different for properties placed in service before 2018. Since, as noted above, until the year 2022, the adjusted taxable income limit excludes depreciation expense, many LIHTC partnership with properties placed in service before 2018 will find that extending the depreciable life of partnership residential real property to 40 years has a greater reduction in tax deductions than the 30 percent limit on interest expense. We at Novogradac & Company are running calculations for clients, and one bright line test is that if a property has a debt service coverage ratio of over 1.15 percent, they likely will defer the election until 2022. Note: Treasury has not issued guidance as to when such an election needs to be made, and this analysis presumes that a partnership with a property placed in service before 2018 can make such an election in any future year.

c. 100 Percent Asset Expensing

The Act extends the additional first-year depreciation deduction for qualified property³¹ and allows for a temporary 100 percent expensing in lieu of 50 percent through December 31, 2022.³² As was the case with the 50 percent expensing, the 100 percent expensing allows for an alternative to the commonly used fixed asset depreciation recovery periods of 15 and 5 years for site improvements and furniture, fixtures, and equipment, respectively. For tax years after December 31, 2022, there is a 20 percent annual phase down ending on December 31, 2026. Electing real property trades or businesses are eligible for this provision.

A LIHTC partnership using 30-year (instead of 27.5) depreciation on buildings because of electing out of the interest limitation could use 100 percent expensing to help maintain an investor's desired rate of return. Owners have the option to expense on an asset class basis.³³

The Act also expands the type of property eligible to include used property. This expansion will notably affect tax losses generated by LIHTC acquisition/rehabilitation/preservation properties.

3. Opportunity Zones

The most innovative concept in the Act is not specifically connected to LIHTCs, but it may provide a benefit to investors in LIHTC properties located in qualifying areas. The provision is the tax reform act's only explicitly helpful addition to the field of community development: namely, the enactment of the Opportunity Zones tax incentive.³⁴ In short, the concept

31. Generally includes any depreciable asset with a recovery period of 20 years or less, such as furniture, fixtures, equipment, and site improvements; buildings are specifically excluded.

32. Code Section 168(k), as amended by Act Section 13201.

33. Classes include personal property and site improvements.

34. Michael Novogradac & John Sciarretti, *Opportunity Zones, A New Tool for Community Development*, CLIENT ALERT, NOVGRADAC & COMPANY, LLP, <https://>

is using tax law to promote private sector equity investment in certain geographically defined distressed communities.

a. Qualified Opportunity Zones

Becoming a qualified opportunity zone (QOZ) involves meeting several criteria. Eligibility starts with being a Low Income Community (LIC), as defined in the new markets tax credit (NMTC) program,³⁵ or a contiguous census tract.³⁶ LICs are census tracts with either a poverty rate of at least 20 percent or a median income that does not exceed the highest of 80 percent of the median income of the metropolitan area or of the statewide median income.³⁷ Contiguous tracts are eligible if they do not exceed 125 percent of the median family income of the adjacent LIC and may be no more than 5 percent of a state's total QOZs. Together, QOZs may not exceed 25 percent of a state's total number of low-income communities.³⁸ We estimate that approximately 10 percent of the country may be designated as an Opportunity Zone.

Meeting the above parameters alone does not result in being designated a QOZ. Rather, governors had until March 21, 2018, to nominate tracts or ask for a 30-day extension.³⁹ The Act is silent on the consequences of failure to do so. Treasury has 30 days to certify the nominated tracts. Designations remain in effect for 10 years.

b. Reasons for Participating

The Act creates three major benefits to investors who invest recognized gains in a qualified opportunity fund (QOF):

- deferral of recognition of taxable gain;⁴⁰
- one or more step-ups in basis for long term holds;⁴¹ and
- no tax on gains, in excess of initially deferred gains, for investments held at least 10 years.

With respect to the first benefit, taxpayers may temporarily defer an unlimited amount of gains from the sale of property to an unrelated party⁴² to

www.novoco.com/sites/default/files/atoms/files/client_alert_opportunity_zone_updated_011118.pdf.

35. *NMTC Mapping Tool*, NEW MARKETS TAX CREDIT RESOURCE CENTER, <https://www.novoco.com/resource-centers/new-markets-tax-credits/data-tools/nmtc-mapping-tool>.

36. Code Section 1400Z-1(c)(1).

37. Code Section 1400Z-1(c)(1).

38. Code Section 1400Z-1(d). Unless the state has less than 100, in which case the total may be 25 tracts.

39. Code Section 1400Z-1(c)(2)(B).

40. Code Section 1400Z-1(e).

41. Code Section 1400Z-2(b)(2)(B).

42. The definition of "unrelated" refers to Code Sections 267(b) and 707(b)(1), as modified by Code Section 1400Z-2(e)(2).

the extent such gains are invested in a QOF within 180 days.⁴³ Each sale may be deferred only once.⁴⁴ The deferral period ends no later than December 31, 2026.⁴⁵ Generally, any gain deferred under this provision must be included in the taxpayer's income on the earlier of the date of a sale or exchange of a QOF investment, or December 31, 2026.⁴⁶

Regarding the second benefit, holding an investment for at least 5 years allows for an upward basis adjustment of 10 percent of the original gain deferred. After 7 years, there is an additional 5 percent upward adjustment.⁴⁷ In other words, 10 percent or 15 percent of the tax on the deferred gain is permanently eliminated.

Finally, with respect to the third major benefit, taxpayers holding investments in QOFs for at least 10 years are exempt from any gain recognition above on the sale of their QOF investment that which was previously deferred.⁴⁸

c. Qualified Opportunity Funds

In order for gain to be deferred, the investment must be in a QOF certified by Treasury.⁴⁹ These entities must take the form of a corporation or a partnership.⁵⁰ As of the writing of this article, rules regarding the QOF certification process have not been announced.

QOFs have an ongoing obligation to ensure at least 90 percent of the fund's assets are in QOZ Property (as defined below).⁵¹ The percentage is determined by averaging the fund's QOZ Property on the last day of the first six-month period of the taxable year and on the last day of the taxable year.⁵² Failure to meet the 90 percent threshold without being able to show reasonable cause will result in a penalty.

d. Qualified Opportunity Zone Property

QOZ Property may be:

- QOZ stock,
- QOZ partnership interests, or
- QOZ business property.⁵³

43. Code Section 1400Z-2(a)(1)(A).

44. Code Section 1400Z-2(a)(2)(A).

45. Code Section 1400Z-2(a)(2)(B).

46. Code Section 1400Z-2(b)(1).

47. *Id.* at 41.

48. Code Section 1400Z-2(c).

49. Code Section 1400Z-2(d)(1).

50. *Id.*

51. *Id.*

52. *Id.*

53. Code Section 1400Z-2(d)(2).

QOZ Property must be acquired after December 31, 2017. QOZ stock and partnership interests must be in a QOZ Business (defined below). QOZ business property is tangible property used in a trade or business in a QOZ; the QOF must either be the original user of the property or make a substantial improvement to the property; and substantially all of the property's use must take place in a QOZ.⁵⁴

e. Qualified Opportunity Zone Business

An entity may be a QOZ Business if substantially all of its tangible assets qualify as QOZ Property and at least 50 percent of its total gross income is derived from the active conduct of such business, which cannot include activities described in Code Section 144(c)(6)(B), such as private or commercial golf courses, country clubs, racetracks or other facilities used for gambling, and so on.⁵⁵

There is no restriction against residential rental real estate businesses as is the case for the new markets tax credit. As noted above, substantially all of a QOZ Business's tangible property must be purchased after December 31, 2017, and be new, or substantially improved.

B. Investor Demand

In addition to provisions that have a direct effect on the financial returns to investors, the Act also contains provisions that affect investor demand for the federal LIHTC and corollary state tax credits. In particular, the Act creates the Base Erosion and Anti-Abuse Tax, a provision that adversely affects the demand of some tax credit investors for tax credit investments. By contrast, the Act also enhances the value of state tax credits for tax credit investors.

1. Base Erosion and Anti-Abuse Tax

The Base Erosion and Anti-Abuse Tax (BEAT) has garnered a great deal of interest and attention by the tax credit community. The corporate alternative minimum tax (AMT) was repealed by the Act, but the BEAT was created. The BEAT is similar to the AMT, in that it is a parallel calculation of income tax liability.⁵⁶ Similar to the AMT, international entities must pay the larger of their tentative BEAT liability or their regular income tax amount. BEAT imposes a minimum tax on international corporations that generate U.S. tax benefits from payments to foreign subsidiaries and other foreign related parties. Congress expects BEAT to limit the ability of international corporations to lower their U.S. tax liability by shifting income to foreign jurisdictions. This provision was triggered by Congress's decision to change international taxation from a global basis to a territorial one, where profits earned abroad do not trigger U.S. tax liability.

54. *Id.*

55. Code Section 1400Z-2(d)(3)(A).

56. Act Section 14401.

a. Covered Entities

The BEAT applies to businesses that:

- generated at least \$500 million in average annual gross receipts for the last three years;
- are not regulated investment companies, real estate investment trusts, or S corporations; and
- have more than a certain de minimis percentage of base erosion payments.⁵⁷

Although the number is unknown, it is likely that at least some current LIHTC investors will pay the BEAT. The situation is fluid, as international corporations are in the midst of adjusting their international tax planning strategies in response to the Act.

b. Consequence for LIHTCs

The vast complexity of the BEAT math is beyond the scope of this article.⁵⁸ In the context of tax credits, the main issue is how much of the reduction in an entity's regular tax liability counts before making the comparison to what is owed under the BEAT. The extent varies based on the credit. For LIHTCs, through the year 2025, 80 percent of LIHTCs are disregarded before determining whether regular tax liability is more or less than BEAT.⁵⁹ After 2025, no portion is disregarded.

Stated differently, for the next eight years investors will take into account only 20 percent of the reduction from their LIHTCs before checking if they owe BEAT. If the alternative calculation results in effectively not being able to take the benefit of the LIHTC, there is no provision for carrying forward tax credits for which a benefit was not received. Such amounts are permanently lost.

The prospect of this potential loss of credits will force corporate taxpayers to carefully evaluate and manage their exposure to the BEAT. In situations where tentative BEAT liability is projected to exceed regular tax liability, investors may choose to adjust their future plans and may also decide to sell some portion of their existing portfolios. Either a drop in demand for, or increase in supply on the secondary market of, LIHTCs will cause a further reduction in equity pricing beyond what is already projected due to the lower corporate tax rate.

57. Code Section 59A(e)(1)(A), as amended by Act Section 14401.

58. For a description, see Michael Novogradac, Nicolo Pinoli, Charles A. Rhuda III & Peter Lawrence, *BEAT: Who is affected? How calculated? Implications to tax credit communities?*, CLIENT ALERT, NOVogradac & COMPANY, LLP, https://www.novoco.com/sites/default/files/atoms/files/novogradac_client_alert_beat_011718.pdf.

59. Code Section 59A(b)(1)(B)(ii)(II) and (b)(4), as amended by Act Section 14401.

2. State Tax Credits

State tax credits across the country generally share a limitation: every dollar not paid in state taxes is a dollar less to deduct from taxable income for federal income tax purposes. As a result, investors generally must adjust the value of the state tax credit for the effect on their federal tax liability. For corporations, in 2017 this generally meant sending the IRS an additional \$0.35 for every dollar saved in state taxes. The reduction in the corporate tax rate generally means there is now a lower \$0.21 reduction.

On the individual taxpayer side, the elimination of all but up to \$10,000 in state and local tax deductions for individuals⁶⁰ should considerably increase the appeal of state tax credits. However, many state laws will need to be revised to better facilitate the process by which individual taxpayers can avail themselves of state income tax credits.

The effect of the Act on market pricing is as yet uncertain but should be positive. States should consider program revisions to increase the market value investment of state tax credit.

C. Supply of Tax Credits and Bonds: Chained Consumer Price Index

Credit allocating agencies have either a per-capita or small state minimum for 9 percent LIHTCs and PABs. In October 2017, the Internal Revenue Service tentatively said the LIHTC ceiling in 2018 would be the greater of \$2.40 multiplied by the population, or \$2,765,000. A state with 8,333,333 residents would have approximately \$20 million to allocate. The tentative PAB volume cap was the greater of \$105 times the population or \$311,375,000.⁶¹

These amounts change year to year with population and inflation.⁶² Previously, the Code used the “Consumer Price Index for all Urban Consumers” (CPI), but the Act switched to “Chained Consumer Price Index for all Urban Consumers” (Chained CPI).⁶³ CPI does not take into account consumers making substitutions in response to rising prices. By contrast, chained CPI captures substitutions by averaging prices before and after variations each month (creating a “chained” index from month to month).⁶⁴ Chained CPI has been consistently lower. Since 2000, it has grown 39.7 percent, as opposed to 45.7 percent for CPI.⁶⁵

60. Act Section 11042, amending Code Section 164(b).

61. Rev. Proc. 2017-58, <https://www.irs.gov/pub/irs-drop/rp-17-58.pdf>.

62. Code Section 42(h)(3)(C). A jurisdiction could have less to allocate over time if its population decreases.

63. Code Section 1(f)(3), as amended by Act Section 11002(a). This change also applies to other Code sections with CPI adjustments.

64. Rob McClelland, *Differences Between the Traditional CPI and the Chained CPI*, CONGRESSIONAL BUDGET OFFICE (Apr. 19, 2013), <https://www.cbo.gov/publication/44088>.

65. Sho Chandra, *What You Need to Know About ‘Chained CPI’*, BLOOMBERG POLITICS (Nov. 19, 2017, 11:00 PM), <https://www.bloomberg.com/news/articles/2017-11-20/why-chained-cpi-has-links-to-u-s-tax-debate-quicktake-q-a>.

In early March 2018, the IRS announced the LIHTC and PAB per-capita amounts remained the same (\$2.40 and \$105, respectively). The small state minimum for LIHTCs decreased by \$5,000 (\$2,760,000) and the PAB amount went down by \$665,000 (\$310,710,000).⁶⁶

The shift will mean less inflationary growth, which is particularly consequential when considering how inflation compounds over time. Novogradac & Company estimates 18,700 to 19,900 fewer LIHTC rental homes will be produced over the next decade because of chained CPI.⁶⁷

D. Other Technical Tax Changes

The Act also contains some technical tax changes that will affect the LIHTC community and the tax consequences of certain transactions: (1) the repeal of the technical termination rules, (2) the tax treatment of non-shareholder capital contributions, and (3) the accelerated taxable income of certain items based on book income treatment.

1. Repeal of Technical Termination

The Act repeals technical termination under Code Section 708(b)(1)(B).⁶⁸ Previously, these terminations occurred upon transferring 50 percent or more of a partnership's interests in profits and capital during any rolling 12-month period. Doing so caused a restart of depreciation.

The change is mostly positive because improperly characterizing transactions no longer creates a risk of unintentional terminations. A downside is the elimination of what had been an option to address a problem with capital accounts when a property's performance differed notably from the original projections. If the extent of losses claimed over time is larger than planned, the investor may not be able to fully realize expected tax benefits. Triggering a technical termination restarted and slowed depreciation, which sometimes was enough to correct the issue.

2. Non-Shareholder Contributions

Before the Act, generally any contribution from a shareholder to a corporation in the form of money or property to the capital of the taxpaying corporation was excluded from gross income for tax purposes.⁶⁹ This exemption also applied when a governmental entity or civic unit contributed land or other property to a corporation for the purposes of encouraging the corporation to relocate its business in a particular community or to enable the corporation to expand its operating facilities.

66 Rev. Proc. 2018-18, https://www.novoco.com/sites/default/files/atoms/files/proc_2018-18.pdf.

67. *Id.* at 16

68. Act Section 13504

69. Code Section 118.

Now any contribution made to aid construction or any other contribution to a customer or potential customer, as well as any contribution made by any governmental entity civic group, is no longer excluded from the taxable income of the recipient corporation.⁷⁰

3. Accelerated Income Recognition Based on Audited Financial Statements

Under the Act, LIHTC partnerships generally will be required to recognize income no later than the taxable year in which such income is recognized on their audited financial statements.⁷¹ This provision is not expected to affect most LIHTC partnerships directly, although the impact at the investor level needs to be further analyzed.

IV. Conclusion and Lessons Learned

To the extent outcomes are known, from legal and accounting perspectives the Act produced mixed results, which on balance are likely negative. While increased asset expensing is beneficial, and state tax credit programs are stronger, the other changes create challenges. Most importantly, almost all LIHTC owners will need to change their depreciation, and at least some investors have a new potential limitation on reducing their tax liability.

The results also are mixed, and overall negative, when considering the Act's effect on programs. Of greatest concern is the indirect consequence of limiting future LIHTC production. The reduction could hardly have come at a worse time. America is in the midst of an increasing affordable housing crisis. By any measure, the nation needs more, not fewer, options for low-income individuals and families. For example, seven in ten households earning less than 30 percent of their area median income spend more than half of their income on rent and utilities.⁷² The consequences span from increased homelessness⁷³ to changing neighborhood characteristics.⁷⁴

However, the outcome for housing could have been much worse. Advocacy by the LIHTC community was crucial to saving private activity bonds and convincing Congress not to advance several proposals negatively affecting the LIHTC. Such advocacy efforts must continue to advance legislation that could help address the negative impact on affordable housing

70. Act Section 13312.

71. Code Section 451, as amended by Act Section 13221

72. National Low-Income Housing Coalition, *The Gap: A Shortage of Affordable Homes*, <http://nlihc.org/research/gap-report>.

73. Damien Sharkov, *Affordable Housing Crisis Forces U.S. Homeless Numbers Up for First Time Since Great Recession*, NEWSWEEK (Dec. 6, 2017, 4:36 A.M.), <http://www.newsweek.com/affordable-housing-crisis-forces-us-homeless-numbers-first-time-great-739333>.

74. Tanza Loudenback, *America's future depends on the death of the single-family home*, BUS. INSIDER (Dec. 4, 2017, 1:50 P.M.), <http://www.businessinsider.com/us-housing-crisis-homeownership-single-family-home-2017-12>.

production. The pending AHCA legislation that may be able to advance this year not only could increase production to status quo ante, but also could go beyond that to help address the large unmet need for affordable housing nationwide.

Contrasting the loss of affordability is the bright spot of Opportunity Zones. This innovative concept has great potential to improve low-income neighborhoods. According to the Economic Innovation Group, there are over \$2 trillion in unrealized capital gains held by U.S. investors,⁷⁵ and Opportunity Zones have the potential to deploy some of those gains for community development in low-income communities. Housing and community development professionals should learn how to implement the law to its maximum potential.

Last but not least, as noted in the Introduction, LIHTC developers and investors should consult with expert tax professionals immediately to better understand all relevant implications of the recent tax reform law.

V. Epilogue

As this article went to press, changes to section 42 were enacted. The fiscal year (FY) 2018 omnibus appropriations law⁷⁶ (Omnibus) includes several tax provisions, including an expansion of the low-income housing tax credit (LIHTC), and income averaging, a new income election option for owners of LIHTC properties.

The LIHTC provisions were included in the Omnibus along with a top priority for congressional Republicans, a correction to Section 199A previously enacted by the Act to address the tax advantage that cooperatives were inadvertently given as compared to other competing businesses.

A. Allocation Cap Increase

The Omnibus provides a 12.5 percent increase in LIHTC allocations, starting in 2018 and lasting until 2021.⁷⁷ The new 2018 per capita amount should be \$2.70 and the new small state minimum should be \$3,105,000. For 2019–2021, annual inflation adjustments would be applied to the new 2018 allocation amounts. Barring an extension, the LIHTC annual allocation in 2022 would revert to current law, adjusted for inflation. Novogradac estimates that this provision will increase production by approximately 28,400 affordable rental homes compared to current law.⁷⁸

75. Jared Bernstein & Kevin A. Hassett, *Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas*, ECONOMIC INNOVATION GROUP (Apr. 2015), <https://eig.org/wp-content/uploads/2015/04/Unlocking-Private-Capital-to-Facilitate-Growth.pdf>.

76. Consolidated Appropriations Act, 2017.

77. *Id.*, Section 102.

78. Michael Novogradac & Peter Lawrence, *Omnibus Spending Bill Contains Affordable Housing Credit Improvement Act Provision*, AFFORDABLE HOUSING RESOURCE CENTER, Mar. 21, 2018 (12:00 A.M.), <https://www.novoco.com/notes-from->

B. Income Averaging

In addition to an allocation cap increase, the Omnibus includes a provision from the Affordable Housing Credit Improvement Act (AHCIA) to create an income-averaging option in addition to the existing low-income requirements.⁷⁹ Prior to the enactment, household incomes in LIHTC properties could not exceed 60 percent of the area median (AMI) at move-in.⁸⁰ The maximum housing expense (rent, utilities, and required fees) was correspondingly restricted.⁸¹

This new provision, at the election of the taxpayer, allows certain apartments in a LIHTC property to be available to residents with incomes up to 80 percent of AMI, as long as the development-wide average income is 60 percent or less.⁸²

Allowing income averaging permits a broader mix of incomes and makes developing LIHTC properties more attractive in places where it now is difficult, such as:

- high housing cost areas;
- sparsely populated low-income areas, where finding enough renters earning less than 60 percent of the AMI to justify construction of new property is difficult;
- low-income neighborhoods in need of revitalization; and
- existing developments in need of preservation, but where tenant incomes have risen over the years.

C. Conclusion

While these LIHTC provisions together could increase affordable rental housing provision by more than 28,400 homes, they would not offset the 235,000 affordable rental home deficit because of tax reform.⁸³ Nevertheless, the proposal represents the first expansion of the LIHTC in 10 years. And, if the temporary allocation increase is made permanent, it would bring the 9 percent allocated LIHTC program to production levels close to pre-tax reform.

novogradac/omnibus-spending-bill-contains-affordable-housing-credit-improvement-act-provisions.

79. Consolidated Appropriations Act, 2017, Section 103.

80. Code Section 42(g)(1)(B).

81. *Id.*

82. Code Section 42(g)(1)(C).

83. *Final Tax Reform Bill Would Reduce Affordable Rental Housing by Nearly 235,000 Homes*, *supra* note 16.

