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How the New U.S. Tax Law Affects Community Development Projects.

As Congress cobbled together the biggest tax overhaul since 1986, they nearly wiped out the essential sources of funding for large-scale community development projects—namely, three federal tax credit programs that attract private investment for neighborhood revitalization. Developers, financiers, and municipalities pushed back and managed to keep most of what they wanted intact. But now they are dealing with what some of them describe as the new tax law's unintended consequences.

One of those unintended consequences: a signature component of the tax act—the reduction of the tax rate on corporations to 21 percent from 35 percent—threatens to diminish the relative value of tax credits. Developers qualify for tax credits from the federal government to help raise equity for their projects. Corporations typically invest in the projects and use the tax credits to offset their federal tax liability. But with the lower tax rate now in place, developers fear that investor appetite for the tax credits may wane.

At issue are the low-income housing tax credits (LIHTCs) that help finance the construction and upkeep of affordable rental units, the federal historic tax credits (HTCs) that preserve historic properties, and the New Markets Tax Credits (NMTCs) that support economic growth in impoverished communities. Early drafts of the tax bill would have scaled back or eliminated all of these tax incentives; when they survived, many developers were relieved—but then braced themselves for more setbacks, says Phillip Kash, a principal at HR&A Advisors, a Washington, D.C.–based consulting firm that specializes in real estate services. "Nobody died, but everybody got hurt," says Kash, a leader of the firm's affordable housing team. "We are just so relieved that we're willing to swallow the pain and find ways to deal with it."

While the three tax credit programs are not the sole source of funding for any one project, they are widely viewed as the pillars of massive community development projects, often used in combination with other financing tools, says Aaron Seybert, social investment officer at the Kresge Foundation in Troy, Michigan. That is why the industry is closely watching how these public/private partnerships will fare. "When you cut a few inches off the leg of a table, you can never be sure how things will calibrate," says Seybert, a former JPMorgan Chase community development banker. "Right now, we just don't know how the market will settle."

Low-Income Housing Tax Credits

In the affordable housing arena, LIHTCs are crucial because they enable developers to build homes with less debt and thereby offer lower rents. But the industry almost lost a key portion of the program late last year when the House version of the tax bill called for eliminating private activity bonds, which more than half of affordable housing projects have been using recently to qualify for the LIHTC. Scrapping the bonds would have effectively wiped out as much as two-thirds of affordable housing production—a loss of roughly 788,000 to 881,000 rental units over ten years, according to Novogradac & Company, an accounting firm based in San Francisco, California, that specializes in real estate services.

Even before Congress took up its tax bills, some real estate projects were affected by the anticipation of lowered tax rates. Rodger L. Brown Jr., managing director of real estate development at Preservation of Affordable Housing Inc. in Boston, says a bank that planned to invest in one of his projects pulled its letter of intent off the table just a few days after Donald Trump was elected president. The bank expected that he would soon make good on his campaign promise to slash the corporate tax rate, and the bank wanted Brown's firm to lower the price of the low-income housing tax credits in the deal.

"By then, it was too late in the process for us to rearrange our capital stack," Brown notes. "The pricing risk suddenly was shifted from the investor to us. To quote them, they said: 'We want you to share in our pain.'" To make the deal work, Brown says his nonprofit firm agreed to reduce the tax credit pricing if the corporate tax rate went down. It honored that commitment, which has left little room to pay for construction change orders and may cut into the firm's development fee by hundreds of thousands of dollars by the time the project is completed, Brown says.

Many developers say they were already struggling to deal with the shortage of federal urban development funds, high land costs, and other challenges before the lower corporate tax rate exacerbated matters. They are forced to lean more heavily on mayors and county executives for financing help at a time when many localities are cash-strapped, and they are looking for possible workarounds.

Stan Wall, a partner at HR&A Advisors, says his firm is advising housing authority officials in D.C. on a plan to redevelop Greenleaf Gardens, an aging public housing complex that spans several blocks in the city's southwest quadrant. The goal is to integrate about 1,200 new market-rate units with 500 new low-rent public housing units for the complex's current residents. Revenue from the market-rate units would help subsidize the public housing so that those tenants' rents do not rise. To fully finance the deal, tax credits must be used along with other funds. But now the tax credits will bring less to the table, Wall says, so developers and housing officials must search for other ways to close the funding gap—something that is easier to do in the District, where land values are high, than in communities where land values are low. "You'll be seeing more frequent use of public land value writedowns, property tax abatements, tax increment financing [TIF], and other funding tools in D.C. and across the nation," Wall says.

The scope of any potential impact to tax credit equity pricing requires insight into the long-term tax positions of current investors, says Peter Nichol, managing director of Pillar Finance, an affordable housing lender in San Francisco. Investors receive LIHTCs over a ten-year period, "so if they planned on using previously acquired tax credits to offset a tax liability of $100 million over ten years, but their tax liability goes down to $60 million, they're sitting on extra tax credits and might decide to put their current investing on hold," Nichol says.

Michael Novogradac, managing partner in the San Francisco office of Novogradac & Company, projects that the supply of affordable housing will shrink by 235,000 homes over the next decade with the lower corporate tax rate in place. But, many factors could affect that baseline projection for better or worse, he notes. On the plus side, housing regulators recently announced that Fannie Mae and Freddie Mac will reenter the LIHTC market in a limited way as equity investors. Affordable housing may also get a boost from a provision in the new tax law that creates tax advantages for private investment in low-income "Opportunity Zones," a program that has yet to take shape. But other provisions in the tax law that are not directly tied to tax credits could nonetheless tilt investment dollars away from such credits. "My general belief is that the headwinds are going to overwhelm the tailwinds," Novogradac says. "But that has yet to be seen."

Historic Tax Credits

While the corporate tax rate change could hurt federal historic tax credits, disruption in that market is more directly tied to changes in that program's prized 20 percent tax credit, which helps finance the rehabilitation of historic properties that will be used for commercial purposes.

Through this Reagan-era program, the federal government awards to developers historic tax credits that cover 20 percent of eligible renovation costs for a historic property. For instance, if a developer buys a historic building for $1 million and spends $1 million renovating it, the government would issue $200,000 in tax credits to the developer for renovation costs. Previously, the credits would fully vest during the year the project opened its doors. But starting January 1, 2018, under the new tax law, the credits will fully vest in installments over five years.

That structure threatens to diminish the value of the credits for impatient investors, who may not be interested in a five-year commitment. With the change pending in November 2017, developers rushed to close on as many deals as possible by year's end. (Developers were scrambling to get deals done since September, when Republicans released their tax reform framework, which would have cut the entire historic tax credit program. On November 12, the Senate Finance Committee's version of the tax bill kept the 20 percent program but parceled it out over five years. The worst-case scenario disappeared, but developers were still rushing to close by December 31, 2017, to get the more favorable one-year tax credit.)

Jonathan D. Shaver, a commercial real estate broker in New Orleans who specializes in the brokerage of historic properties, says that one of his clients put a building in New Orleans under contract the evening of December 27 and closed the deal early December 29, which he says was the fastest turnaround he has been involved in during his eight years on the job. By then—the end of 2017—industry experts were projecting a 7 percent to 15 percent shrinkage in equity raised through the tax credit after the five-year structure is in place. "That loss has to come from somewhere, whether it's the seller taking less, the investor or developer taking a lower rate of return, or the tenant paying a higher rate," Shaver says. "For the majority of projects, it just makes it harder to bring them to fruition."

The pace of purchases has slowed down as the deals that closed last year are now entering the construction phase, says Robert Lay, a partner in Atlanta at Sixty West, which develops commercial historic properties and syndicates federal and state tax credits. It may take a year or so for activity to pick up again. Investors are taking a step back to assess their next move, Lay says. They are trying to wrap their minds around how the new tax law in general—and the tax credits in particular—will affect their tax liability. They also are waiting for regulatory guidance to clarify technical questions as they decide which tax credits to invest in, if any.

Given that investors will have roughly a one-year window to think through their strategy as existing projects make their way through the pipeline, Lay says he is hopeful that there will be a relatively smooth transition. "I'm not saying it's going to be effortless or painless or without its headaches," Lay says. "But it won't be a sky-is-falling scenario."

That scenario unfolded late last year, when the House of Representatives adopted a version of the tax bill that scrapped the federal historic tax credit program, including a seldom-used 10 percent tax credit for the renovation of historic buildings erected before 1936. The National Trust for Historic Preservation and other industry stakeholders coordinated a massive letter-writing blitz to Congress and a social media campaign to save the program. Key lawmakers rallied to their side, and Congress ultimately kept the 20 percent program alive, but not its 10 percent counterpart.

New Markets Tax Credit

The New Markets Tax Credit, which lures private investment to some of the nation's poorest communities, faced a similar fate. While the affordable housing and historic properties tax credit programs were codified into law in 1986, the NMTC must be reauthorized by Congress every few years. It was set to expire in December 2019, but its supporters believed it would be extended again as it has been several times before with wide bipartisan support since its creation in 2000.

Instead, the House version of the tax bill called for a repeal of the remaining two years of the program. That proposal made no sense, says Bob Rapoza, spokesman for the New Markets Tax Credit Coalition in Washington, D.C. Between 2003 and 2015, the program had helped finance nearly 2,000 community services and facilities, such as hospitals, schools, daycare centers, and grocery stores. It had generated more than 1 million jobs during that time and lured about $82 billion in public and private investments to credit-starved areas.

The cost of this program to the federal government is more than offset by the tax revenue and economic activity it spurred, Rapoza says. Getting rid of it would not have reaped big savings, only $1.7 billion over a decade in the $1.5 trillion tax package.

The program's repeal did not make its way into the new tax law, and supporters of the NMTC are now rallying behind two measures in Congress that would make the tax credit program permanent, possibly within the next two years. A permanent authorization would help bring certainty for investors and developers, who often combine the NMTC with other sources of capital, including tax-exempt bonds and community development block grants (CDBGs) funded by the federal government. As the federal funds continue to shrink, the tax credits emerge as more critical than ever, supporters say.

"The community development world has been working in this moment of constrained federal resources for the past three decades," Rapoza says. "Tax credits have served to fill at least some of the hole created by the cuts to federal grant programs."

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