Using tax credits as an effective tax rate management tool
Renewed focus on effective tax rate management

In the 1990s, corporate tax departments were focusing on driving shareholder value in many different ways but most notably through helping reduce a company’s effective tax rate. By lowering the effective tax rate, a company was able to reduce the amount of cash paid for taxes and increase the GAAP earnings, as a company was charged less income tax expense. With the occurrence of Sarbanes-Oxley, the role of the tax department shifted to a focus on risk management. The onset of the financial crisis caused an increased focus on expense management, including reducing taxes.

Some of the most underutilized effective tax rate management tools are tax credit investments. The government has created a number of targeted tax credit programs to incentivize and subsidize certain desired activities, such as the creation of affordable housing and investments in low-income communities. These credits offer investors a dollar-for-dollar reduction in federal tax liability in exchange for providing capital to the project. The investors’ return on capital comes mainly from the tax credit and the depreciation deductions to which they are entitled.

The chart below outlines a number of the main monetizable tax credits and some of their key attributes:

**Various tax equity investment options**

<table>
<thead>
<tr>
<th>Program</th>
<th>Low Income Housing Tax Credit</th>
<th>Historic Rehabilitation Tax Credit</th>
<th>New Markets Tax Credit</th>
<th>Renewable energy: wind</th>
<th>Renewable energy: solar</th>
<th>Refined coal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sector</td>
<td>Rental real estate</td>
<td>Real estate</td>
<td>Various but mainly real estate</td>
<td>Electricity production from wind</td>
<td>Electricity production from solar</td>
<td>Non-conventional fuels</td>
</tr>
<tr>
<td>IRC section</td>
<td>42</td>
<td>47</td>
<td>45D</td>
<td>45</td>
<td>48</td>
<td>45</td>
</tr>
<tr>
<td>Expiration</td>
<td>Permanent</td>
<td>Permanent</td>
<td>Annually</td>
<td>2012</td>
<td>2016</td>
<td>2012</td>
</tr>
<tr>
<td>Credit period</td>
<td>10 years</td>
<td>1 year</td>
<td>7 years</td>
<td>10 years</td>
<td>1 year</td>
<td>10 years</td>
</tr>
<tr>
<td>Recapture period</td>
<td>15 years</td>
<td>5 years</td>
<td>7 years</td>
<td>None</td>
<td>5 years</td>
<td>None</td>
</tr>
<tr>
<td>Main risk(s)</td>
<td>Tax structuring, foreclosure of real estate, asset management</td>
<td>Tax structuring, foreclosure of real estate</td>
<td>Tax structuring, project operations</td>
<td>Tax structuring, project operations</td>
<td>Tax structuring, project operations</td>
<td>Tax structuring, project operations</td>
</tr>
<tr>
<td>Primary return components</td>
<td>Tax credits, deduction</td>
<td>Tax credits, deductions, priority returns, put proceeds</td>
<td>Tax credits, priority returns, put proceeds</td>
<td>Tax credits, deductions, cash flow</td>
<td>Tax credits, deductions, cash flow</td>
<td>Tax credits, deductions</td>
</tr>
<tr>
<td>Range of returns (after tax)</td>
<td>6%</td>
<td>Varies</td>
<td>12% - 18%</td>
<td>9% - 11%</td>
<td>9% - 20%</td>
<td>Varies</td>
</tr>
<tr>
<td>Annual market size (2011)</td>
<td>$7 - $9 billion</td>
<td>Less than $1 billion</td>
<td>Less than $1 billion</td>
<td>$5 - $6 billion</td>
<td>$1 - $3 billion</td>
<td>$1 - $3 million</td>
</tr>
</tbody>
</table>
Low Income Housing Tax Credit

Congress enacted the Low Income Housing Tax Credit program as part of the Tax Reform Act of 1986 to encourage private sector investment in the development of affordable rental housing. The Low Income Housing Tax Credits have been part of the tax and investment strategies of many Fortune 1000 corporations, in addition to their social missions. These investments also provide benefits to financial institutions under the Community Reinvestment Act of 1977.

Since the program’s enactment, federal housing credits have financed the development of more than two million apartment units for low-income households across the country. The program is administered by the state housing agencies who allocate tax credits to owners of housing developments on a competitive basis. The Internal Revenue Service is responsible for monitoring state performance and compliance with program requirements under Section 42 of the Internal Revenue Code.

Certain events can have an adverse impact on expected tax credit delivery, including construction and lease-up delays, foreclosures and property audits by the Internal Revenue Service, requiring close monitoring of these investments by fund syndicators. As a result, selection of a syndicator is very important, particularly given the length of these investments.

Historic Rehabilitation Tax Credit

The Historic Rehabilitation Tax Credit program is a federal tax incentive designed to encourage the preservation and reuse of historic buildings. In a recent five-year period, rehabilitation credits attracted more than $4.7 billion in equity to these properties, helping to finance the redevelopment of 3,000 projects including more than 44,000 apartment units as well as commercial and retail space. Over half of all states have also passed legislation providing tax incentives for historic building preservation. The federal rehabilitation credit program was originally established in 1976. It was modified to its current form in 1986 under Section 47 of the Internal Revenue Code.

New Markets Tax Credit

The New Markets Tax Credit (NMTC) is designed to encourage private sector equity investments for business creation and growth in both low- and moderate-income rural and urban communities. The objective of the legislation is to provide a vehicle for the low-income communities to gain access to patient investment and capital. Section 45D of the Internal Revenue Code allows for a tax credit by virtue of making an investment in a Community Development Entity (CDE), which in turn directs investment capital to businesses located in low-income communities. The NMTC program was originally established in 2000. After the seventh round of funding in October 2010, a total of $32 billion in NMTCs have been awarded.

Renewable Energy Production Tax Credit

The Renewable Energy Production Tax Credit (PTC) program is a federal tax incentive designed to encourage the production of electricity from renewable resources, such as clean coal and wind. The program was established under Section 45 of the Internal Revenue Code. The general business income tax credit is currently 2.2 cents or 1.1 cents (depending on the resource), multiplied by the kilowatt hours of electricity produced by the taxpayer during the 10-year period beginning on the date the facility was originally placed in service. Other less popular renewable energy resources that are eligible for this credit include biomass, geothermal, landfill gas, hydropower and waste to energy. The American Recovery and Reinvestment Act allows projects that generate PTCs to elect to take a 30% investment tax credit in lieu of the PTC.

Renewable Energy Investment Tax Credit

The Renewable Energy Investment Tax Credit (ITC) program is a federal tax incentive designed to encourage the purchase of equipment that uses renewable energy to generate electricity, most notably solar. The ITC was originally established in 1976. The ITC is earned as a function of eligible basis. Business purchasers earn either a 10% or 30% tax credit on the basis of energy property installed after January 1, 2006 but before January 1, 2017.

State tax credit

Many states have programs that mirror federal programs like the low-income housing tax credit and the rehabilitation tax credit. There are also targeted programs that may fit activities desired by that state but that have no federal counterpart. For example, film credits are utilized by numerous states to incent filming to take place in their states but no federal counterpart exists. State tax credits come in a number of different forms and the rules for each credit vary from state to state, however, many of these tax credits can be monetized. Ernst & Young LLP’s knowledgeable state tax professionals are available to discuss details about a particular state tax credit.

Tax Credit Investment Advisory Services

When considering investing in ventures eligible for federal income tax credits, corporate decision-makers should employ the same strategies and disciplines utilized by traditional debt and equity investors, the foundation of which is diversification. There are a myriad of tax credit investment opportunities to achieve almost any tax-motivated investment strategy. The challenge is to understand the various tax credits available and analyze whether they meet a corporate investor’s objectives.

Using tax credits as an effective tax rate management tool
The most common objectives for tax credit investing include:

- Reducing tax liability
- Managing the corporate effective tax rate
- Increasing after-tax cash flow
- Enhancing earnings per share
- Improving regulatory or public relations

The Tax Credit Investment Advisory Services (TClAS) group of Ernst & Young LLP helps clients to identify and analyze the issues surrounding the acquisition and management of various tax credit investments including the Low Income Housing Tax Credit, Historic Rehabilitation Tax Credit, New Markets Tax Credit, Renewable Energy Production Tax Credits and other emerging tax credit opportunities.

Our services include:

- Investment structuring
- Tax credit investment services
- Investment strategy
- Investment due diligence
- Investment implementation
- Tax credit disposition strategy
- General advisory services

**Ernst & Young Capital Advisors, LLC**

Ernst & Young Capital Advisors, LLC (EYCA), Ernst & Young LLP’s broker-dealer affiliate, provides tax equity placement for companies seeking to monetize federal renewable energy tax credits. Utilizing a broad network of investors, EYCA provides clients with independent analysis, transaction advice and execution assistance.

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