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The Tax Cuts and Jobs Act Revises Certain Federal Tax Credits

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On December 22, 2017, President Trump signed into law tax legislation formally known as the Tax Cuts and Jobs Act (the "Act"). This comprehensive tax overhaul revised several tax credit provisions but largely kept the same overall tax credit framework that already existed in the U.S. Internal Revenue Code of 1986, as amended (the "Code"). Set forth below are some of the key tax credit provisions of the Act:

Low Income Housing Tax Credit

The low-income housing tax credit under Section 42 of the Code ("LIHTC") provides a credit for the cost of building or rehabilitating rental housing that provides the requisite amount of rent restricted units to tenants having incomes below specified levels. The LIHTC allows for a 70% present value credit for new buildings that are not federally subsidized and a 30% present value credit for all other qualified low-income buildings. The 30% present value credit applies to rehabilitations of existing buildings that are financed by private activity bonds that qualify as tax-exempt under Section 103 of the Code. The House proposed to repeal the exemption of interest paid on qualified private activity bonds for those issued after December 31, 2017, which would have drastically affected the amount of investments made in the LIHTC rehabilitation projects that utilize the 30% present value credit. The Senate's tax plan kept private activity bonds as tax-exempt, which the Conference Agreement between the House and Senate followed (the "Conference Agreement"), so the 30% present value credit for LIHTCs was not affected.

Historic Tax Credit

The historic tax credit under Section 47 of the Code ("HTC") originally provided for two credits: (1) a 20% credit for qualified rehabilitation expenditures with respect to a certified historic structure that is either listed in the National Register or located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to that district and (2) a 10% credit for qualified rehabilitated buildings which were first placed in service before 1936. The House proposed to repeal the entire provision for the HTC. The Senate repealed the 10% credit for pre-1936 buildings but retained the 20% credit, providing that the 20% credit must be taken ratably over 5 years. The Senate allowed for a transition rule for qualified rehabilitation expenditures for pre-1936 buildings where a taxpayer owning or leasing such a building on and after January 1, 2018, could select a 24-month period to continue using the 10% credit. The Conference Agreement followed the Senate's version that repeals the 10% credit for pre-1936 buildings and retains the 20% credit that must be taken over 5 years, but the Conference Agreement added that a taxpayer may select a 60-month (instead of 24-month) phased rehabilitation period for the 10% credit applicable to pre-1936 buildings.

New Markets Tax Credit

The new markets tax credit under Section 45D of the Code ("NMTC") provides a credit for qualified equity investments in a corporation or a partnership that is a qualified community development entity ("CDE"). A qualified CDE is any domestic corporation or partnership (1) whose primary mission is serving, or providing investment capital for, low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities through their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE. The NMTC allows for a credit to be taken over seven years determined by applying the following percentages to the amount the investor paid to the CDE (1) 5% for the year in which the equity interest is purchased from the CDE and for each of the following two years and (2) 6% for each of the following four years. No qualified equity investments are allowed after calendar year 2019, and no amount of unused allocation limitation may be carried to any calendar year after 2024. The House proposed that the NMTC credit limitation for calendar year 2018 be zero and that no amount of unused allocation limitation may be carried to any calendar year after 2022. The Conference Agreement did not follow the House's provision; therefore, the NMTC remains intact as it was prior to the Act.

Qualified Opportunity Zones

The Senate proposed new tax incentives for "qualified opportunity zones" in new Sections 1400Z-1 and 1400Z-2 of the Code that were included in the Conference Agreement. Each U.S. possession that is a low-income community (as defined in Section 45D(e) of the Code) is deemed certified and designated as a "qualified opportunity zone." The chief executive officer of each State (including the mayor of the District of Columbia) may submit nominations for additional opportunity zones to the Secretary for certification and designation. If a State has less than 100 low-income communities, the chief executive officer of the State may designate up to 25 tracts as "qualified opportunity zones." If a State has 100 or more low-income communities, the chief executive officer of the State may designate additional tracts as "qualified opportunity zones" not exceeding 25% of the total number of low-income communities in the State. The provision provides two main tax incentives for investment in "qualified opportunity zones": (1) temporary deferral of inclusion in gross income for capital gains that are reinvested in a qualified opportunity fund and (2) exclusion from gross income of the post-acquisition capital gains on investments in opportunity zone funds that are held for at least 10 years. A qualified opportunity fund is similar to the structure for the NMTC as it is an investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property that holds at least 90% of its assets in qualified opportunity zone property (which includes qualified opportunity zone stock, qualified opportunity zone partnership interests, and qualified opportunity zone business property).

With regard to the first incentive, the maximum amount of the deferred gain is equal to the amount invested in a qualified opportunity fund by the taxpayer during the 180-day period beginning on the date of sale of the asset to which the deferral pertains. Any amounts of capital gains in excess of the deferral amount will be recognized and included in gross income. If the taxpayer holds its investment in the qualified opportunity zone for at least 5 years, the basis on the original gain is increased by 10% of the original gain. If the taxpayer holds its investment in the qualified opportunity zone for at least 7 years, the basis on the original gain is increased by an additional 5% of the original gain (for a total increase of 15%). The taxpayer will recognize the deferred gain on the earlier of the date on which the qualified opportunity zone investment is disposed of or on December 31, 2026. The basis of the taxpayer's investment is also increased by the same percentages, 10% and an additional 5%, when the investment is held at least 5 years or 7 years, respectively. If the taxpayer holds its investment until at least December 31, 2026, the basis in the investment increases by the remaining 85% of the deferred gain. If the taxpayer sells or exchanges its investment in a qualified opportunity zone fund after holding it for more than 10 years, the second incentive allows for the taxpayer to elect that the basis of its investment shall be the fair market value of the investment at the date of sale or exchange.

Details are still to come for this new incentive as the Secretary has been tasked with providing regulations to address rules for the certification of qualified opportunity funds. These rules will ensure a qualified opportunity fund has a reasonable period of time to reinvest the return of capital from investments in qualified opportunity zone stock and qualified opportunity zone partnership interests and will provide guidance on how to reinvest proceeds received from the sale or disposition of qualified opportunity zone property. These rules will also prevent abuse of this new provision.

Conclusion

Overall, the Act kept most of the business tax credit incentives intact. The biggest changes to these credits are related to the HTC where the 10% HTC for pre-1936 buildings was removed, and the 20% HTC must now be taken over 5 years. The Act did not make any changes to the LIHTC and NMTC, but provides for a new "qualified opportunity zone" concept that seems to be a replacement for the NMTC when it expires after December 31, 2019. Please contact our investment tax credit expert, Michael Haun, if you would like to discuss the Act further.

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If you have any questions concerning these developing issues, please do not hesitate to contact the following Paul Hastings Los Angeles lawyers:

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