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The Transferability and Monetization of State Tax Credits-Part II

The sale, transferability, or monetization of state tax incentives is a vital necessity to the success of incentive programs.

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More and more states are offering transferable state income tax credits as incentives for businesses to expand or locate within their boundaries or otherwise engage in state-supported economic development or other projects. When taxpayers "earn" transferable state income tax credits that they cannot utilize, states will permit them to sell these credits to other taxpayers who can utilize them in order to realize and recognize (or "monetize") such benefits.

In a previous issue of the Journal (25 JMT 18 March/April 2015), one of the present authors (Jennifer Zimmerman) discussed the evolution of state tax credits, the common activities that are incentivized by state tax credits that are transferable, the basic methods of monetization of tax credits and federal income tax consequences of monetizing tax credits. In this second part, along with Danny Bigel (CEO & Co-Founder of the Online Incentives Exchange (OIX)), we are going to discuss in depth the types and treatments of transferable tax credits, and the process, considerations and risks of purchasing tax credits.

Monetizeable State Tax Credits 101

State tax credits are enacted into law by authorizing legislation and considered to be the most effective economic development tool for government to "surgically incent" growth in a given industry. The focus in most cases is on incentivizing specific economic activity and job creation. Generally speaking, the state tax credits are earned by businesses that make an enterprise investment and create jobs within a jurisdiction by following the statutory and regulatory guidelines. Examples of industry focus for monetizeable tax credits include: entertainment & media, renewable energy, job creation, historic rehabilitations, and brownfields.

The provisions of the authorizing legislation design the credit to be transferable or refundable, allowing a generator of a credit that does not have sufficient liability to utilize all of the credits to trade/sell the credit to a taxpayer who can use the credit, and/or borrow against the state IOU (in the case of refundable credits).

Federal Tax Credits (high level overview)

Even though tax credits originated on the federal level, there are many more options for monetization of tax credits on the state level. However, there are four primary monetizable federal tax credits:

1. Historic rehabilitation tax credit (single year, 20% credit)
2. Renewable energy investment tax credit (single year, 30% credit)
3. New Markets tax credit (7 year, 39% credit)
4. Low-Income Housing tax credit (10 year, up to 90% credit)

Credits often are priced over $1.00 when factoring in the corresponding losses, depreciation, and other tax benefits associated with the investment (5 years Modified Accelerated Cost Recovery System (MACRS) with the renewable energy investment tax credit or 27.5 or 39-year depreciation schedule with historic rehabilitation tax credits depending on building use). Low-Income Housing tax credits and New Markets tax credits generally are syndicated to banks and insurance companies for Community Reinvestment Act (CRA) needs yielding 6-8% returns (effective yield accounting treatment).

Types and Treatment of Monetizeable Transferable State Tax Credits

There are several different types of monetizeable state tax credits: (1) transferrable/certifiable credits; (2) refundable/rebate credits; (3) de facto transferable partnership credits; and (4) true partnership allocated credits.

Obviously, if an investor or purchaser wants to acquire tax credits, the easiest way to do that is to just purchase the tax credits directly from the owner of a credit, if that is an option. Not all transferable tax credits have the same type of transferability provisions. Accordingly, investors and purchasers must determine transferability requirements of each credit on a program-by-program basis.

There are some basics with respect to transferable credits. Transferable credits have a $1.00 face value and can be used to offset $1.00 of tax that the respective credit can offset. Transferable credits generally offset a variety of taxes: personal income taxes, corporate income taxes, franchise taxes, insurance premium taxes, and other types of state taxes. The type of taxes for which the credits can be offset is outlined in the relevant authorizing legislation.

Some tax credits are freely transferable an unlimited number of times by the project owner to a transferee, and by a transferee to a subsequent transferee. Generally, tax credit programs are not freely transferable unless the statute provides for this. Examples of freely transferable credits include: Kansas Credit for Historic Structure Rehabilitation Expenditures (Kan. Stat. Ann. § 79-32,211(c)), the Massachusetts Historic Rehabilitation Tax Credit (Mass. Gen. Laws ch. 63, § 38R(b)(2)(ii)), the Missouri Historic Preservation Credit (Mo. Rev. Stat. § 253.557), and the Louisiana Motion Picture Investor Tax Credit (La. Rev. Stat. Ann. § 47:6007).

Other tax credit programs offer tax credits that can only be transferred a limited number of times. Examples of tax credit programs with limited numbers of permissible transfers include the Georgia Entertainment Industry Investment Credit (Ga. Code Ann. § 48-7-40.26(g)) and the Illinois Film Production Services Credit (35 Ill. Comp. Stat. 5/213).

Transferable credits can generally be carried forward anywhere from 5 to 20 years (depending on the authorizing legislation) to be used in subsequent years. Transferable credits are purchased and sold at a discount to the face value of the credit. Transferable credits can be bought and sold with a simple purchase and sale agreement making it the easiest and most commonly purchased type of credit. Transferable credits are generally the most expensive credits to purchase at an average of approximately $0.85-$0.90 per credit dollar.

Refundable credits have a $1.00 face value and can be used to offset $1.00 of tax that the respective credit can offset. In some cases, refundable credits can offset different taxes and such offsets are statutorily sanctioned. Carryforward provisions also prevail, and unused credits (credits that exceed liabilities) are "refunded" by the state. Refunds may be claimed (and paid) once a year when filing returns, or in some cases may be spread out over multiple years-thus creating a market for borrowing and lending against refundable credits. Credits are often leveraged (factored) at a discount to the face value of the credit, pledging (and in certain cases assigning) the state "IOU" as loan collateral.

For states, the advantage "transferrable credits" has over "refundable credits" is that the cash paid to qualifying companies does not come from state coffers. Examples of refundable credits include New York film credits, Louisiana digital animation credits, Minnesota Credit for Historic Structure Rehabilitation (Minn. Stat. § 290.0681, at 90% of the face value of the credits) and Missouri's Enhanced Enterprise Zone Credit (Mo. Rev. Stat § 135.967, at 100% of the face value of the credits).

De facto transferable partnership credits are treated for tax purposes as a transferable tax credit, but the taxpayer must be a member of a partnership for the credits to flow-through to the taxpayer. To the extent that bifurcation is not made possible in the relevant tax credit statutes, investors in qualifying projects receive their proportionate share of tax credits equal to their profits interest in the project. Generally, most states that provide the bifurcation feature require that the special allocation must be spelled out in the project's operating, corporate or partnership agreement.

These type of credits are becoming more widely accepted in the marketplace. Transferable partnership credits are generally priced around $0.80 on the dollar. Examples of transferable partnership credits include the Georgia Low-Income Housing Credit and the South Carolina Textile Mill Credit.

Finally, for true partnership allocated credits, the taxpayer must be a true partner in a partnership in order to receive an allocation of the tax credits (similar to federal tax credit transactions). While the structure is more complicated, this structure for state credits does not have any of the accounting or tax issues associated with federal credits and has become of more interest to taxpayers given the attractive returns. Allocated credits are often priced around $0.70 on the dollar. Examples of allocated credits include the North Carolina renewable energy credit, federal historic tax credits, and federal renewable energy tax credits.

Transferable and Refundable State Tax Credit Markets

Technology coupled with market demand is changing the landscape making it even easier for taxpayers (businesses and individuals) to purchase credits. Demand for credits is increasing as more taxpayers learn about the opportunity to purchase transferable tax credits and as existing taxpayers become more comfortable with the process.

There was little market demand in the 1990s, but the market started to expand in the early 2000s. Now, approximately $3 billion of transferable state tax credits are issued each year by more than 30 states. In addition, approximately $3 billion of refundable state tax credits are issued each year by more than 40 states.

New technologies-innovated by entrepreneurs, pioneers and thought leaders-introduced to the transferable tax credit markets in the form of online tax credit exchanges (such as the OIX) are shape-shifting the decades-old opaque and fragmented nature of how tax credits have previously transacted, and are bringing traditional market dynamics to the space. All modern financial assets transact through a transparent and efficient process-which is only where true price discovery is possible-and the tax credit markets will certainly not be immune. Technology is also playing a role to level the landscape where new entrants (including individuals) can now participate.

Open-market platforms are also enabling businesses to leverage refundable tax credits (where monetization is often only possible once a year, or longer, based on statutory guidelines) through a borrower-lender dynamic. Companies that earn refundable tax credits can obtain the necessary capital to expand even further (plant and equipment, new hires, etc.) in a competitive environment, once again, enabling the maximization of the value of credits earned by job-creating enterprises.

Process of Purchasing Credits

The process of purchasing credits starts with a taxpayer identifying tax credits to purchase. There are several ways to identify available tax credits including online tax credit exchanges, reputable brokers or clearinghouses (e.g., large financial institutions), state agencies (that offer information on issuers of credits), advisory firms representing sellers (CPA, tax advisory firms, etc.), and word-of-mouth and corporate relationships.

Next, a taxpayer (purchaser) conducts due diligence and underwrites the credits the taxpayer is considering purchasing. Then, a purchase and sale agreement/transfer agreement is negotiated between the seller and the taxpayer. Finally, the taxpayer funds the purchase price once the credits have been transferred, and then the credits can be utilized by the taxpayer. In some instances, a taxpayer will fund into an escrow prior to the credits being transferred, but taxpayers usually *do not* fund the purchase price to the seller prior to the transfer for the reasons outlined here.

Considerations when Purchasing State Credits

When purchasing tax credits, taxpayers must keep in mind the following considerations:

- Institute a *formal* due diligence process.
- *Only* transact with trusted entities (online exchanges, directly B/S, top-tier brokers, etc.)
- *Only* purchase transferable credits or provide tax credit equity through a properly documented transaction.
- Ensure your statutory ability to utilize purchased credits.
- Plan ahead when forecasting future liabilities to effectively reduce liabilities.
- Whether buying or selling ensure that you're getting the right price!
- Eliminate the need for estimated payments (which is jurisdiction specific) and eliminate penalties and interest in the event of an underpayment.

Proper Underwriting and Due Diligence Summary

For the due diligence and underwriting process, purchasers should take the following steps. First, review the initial certification (or other governmental statement) of project/production eligibility provided by the government agency that issues the certification. Then, review the final certification (or the equivalent governmental statement) provided by the government agency that issues the certification.

Next, review the auditor's report and/or comfort letter provided by a licensed CPA firm and run a UCC search to identify any liens or encumbrances on credit. Then, confirm that individual credit owners entering into the agreement have the right and authority to sell the credit and enter into a purchase and sale agreement.

Based on the due diligence and underwriting process, draft a comprehensive purchase and sale agreement (which may be jurisdiction specific). As a purchaser of a credit, if possible, it is advisable that the purchaser's legal counsel draft the purchase and sale agreement in order to ensure it contains all the relevant provisions. Finally, it is essential to obtain recapture guarantee from the credit owner or credit owners' parent company depending on whose balance sheet supports the guarantee.

What is recapture? Recapture provisions, also referred to as "clawbacks," can occur if certain detrimental events either occur or are discovered after the credits have been issued, and sometimes after the credits have been claimed. For instance, if a program requires a company to maintain at least 100 new jobs for a five-year period, and the company's job count drops below 100 during the compliance period, this could trigger total or partial recapture.

Generally, recapture provisions are contained in the authorizing statutes, but they can also be found in the credit applicant's agreements with the issuing agencies. Sometimes, the recapture provisions are only against the original applicants. Other times, the recapture provisions apply to both the original applicants and the transferees, or just to the transferees (i.e., the taxpayer who actually claimed the credits).

To the extent that recapture applies to transferees, the purchaser or investor should ensure that the seller provides an indemnification against potential recapture in the relevant tax credit purchase agreement or provides a third party guarantee to make the purchaser whole in case recapture occurs. Often, too, the risk of recapture is mitigated by pre-issuance audit requirements or independent cost certification requirements.

Risks Associated with Purchase of Transferable Tax Credits and How to Mitigate Those Risks

Although purchasing tax credits is an excellent way to turn your tax department into a profit center, potential purchasers should be keenly aware of the risks involved in the process and how best to mitigate them. The following is a list of risks associated with the purchase of tax credits and suggestions as to how to mitigate those risks.

(1) Potential Risk: *Purchases of credits directly from sellers or through brokers with no indemnification or (recapture) guarantee from seller and parent company of seller (if applicable).* To avoid this potential issue, it is vital to ensure an independent review of costs by reviewing an audit report or cost report; ensure any necessary tax credit certificates have been issued (and review the corresponding application for accuracy); and ensure a creditworthy guarantor provides recapture indemnity.

Seller's indemnities are only as good as the net worth of the seller. If the seller is a shell company or otherwise has no assets, investors and purchasers should consider requiring an entity with assets to guarantee the seller's performance. Indemnities and guarantees should be for the face amount of the credits (not the purchase price), plus all costs and expenses of enforcement, including reasonable attorney's fees and consulting fees (including costs of collection).

(2) Potential Risk: *Credit doesn't offset the specific type of taxes that the taxpayer owes.* To prevent this issue, the investor or purchaser needs to ensure that the type of tax that it pays can be offset by the tax credit that it is purchasing. For instance, most tax credit programs offset the corporate income tax, but if the entity is subject to a particular type of specialized tax (e.g., financial institutions taxes or insurance premiums taxes), the purchaser or investor needs to ensure that the statute permits offsetting the credit against those particular types of tax credits.

(3) Potential Risk: *Ineffective transfers which are the fault of the broker/facilitator.* To escape this potential risk, it is important to ensure that the purchase price isn't funded until the credits are transferred, that a new transfer notice is timely submitted, and that the purchase price isn't funded until a new tax credit certificate is issued to the buyer. Another solution to this issue is to have an independent third party clear the trade.

(4) Potential Risk: *Limitations on carryforward provisions.* Sometimes when tax credits are sold during the carryforward period, the purchaser may only use the credits in the year purchased, plus any remaining carryforward years. For example, a 2010 tax credit purchased in 2012 with a five-year carryforward period might be restricted for use in only the 2012-2015 tax years. If this restriction exists, the purchaser would not be permitted to amend its 2010 return to claim the credits. This is true of the Massachusetts Low-Income Housing Tax Credit Program.

In addition, some states may have rules that require taxpayers who are claiming more than one tax credit in a particular year to apply those tax credits in a particular order (e.g., refundable credits might be required to be utilized before other credits). Furthermore, carryforwards are not income-producing assets and do not generate interest while the taxpayer is holding them for future years.

To avoid these potential issues, it is advisable to purchase only the amount of credits that the taxpayer can utilize in the immediate year because if, for whatever reason, the taxpayer does not generate a liability in subsequent years, the tax credits may exhaust the carryforward period and expire.

(5) Potential Risk: *If purchased through a "loss partner," risk to partnership of "disguised sale" treatment with negative federal and state income tax consequences.* To mitigate this risk, the developer should retain legal counsel with subject matter expertise in tax credit transactions and the counsel should structure the transaction in a manner that is consistent with any safe harbor guidance issued with respect to the particular tax credit and or transaction structure. Furthermore, transaction participants should consider obtaining a legal opinion from counsel blessing the transaction structure.

Other ways to mitigate this risk would be for the project partnership to represent and warrant to its members that the project will be treated as a partnership for federal tax purposes and the proceeds from the investors are considered capital and not a purchase price. Additionally, any re-characterization of capital contributions as income should be specially allocated to the developer/sponsor and not to the federal or state tax credit investors.

(6) Potential Risk: *Changes in the law.* Although instances of this are rare, governments always have the option to retroactively revoke tax credit programs or disqualify projects that were once qualified and have already been sold. To avoid this issue, purchasers and investors should always shift the liability for changes in the law to the seller, until such credits are vested and issued.

(7) Potential Risk: *Seller's fraud (not following guidelines, selling credit twice, etc.)* To alleviate this risk, it is wise to ensure that these types of actions are clearly spelled out as a breach of contract with specified damages to ensure that the developer who has sold you the credits does not shop around for someone else who is willing to pay more for them.

(8) Potential Risk: *Agency that issues the credits might not be the agency that audits the credits when claimed.* To allay this risk, carefully examine and understand the recapture or clawback provisions of the specific program.

(9) Potential Risk: *Ongoing operational/compliance requirements not followed by the seller.* If tax credits can be recaptured in future years, ensure a strong recapture indemnity is provided for the entire compliance period and consider escrowing the funds in a separate account until the compliance period is over or as the recapture risk steps down.

(10) Potential Risk: *Project is never completed.* If the purchase price is required to be funded before the tax credits are generated, it is essential to require the purchase price to be funded into an escrow account. If the project is not completed for some reason and the credits are not earned, the money is escrowed and can be returned to the taxpayer.

(11) Potential Risk: *Acceptance of credits as collateral.* Purchasers should never accept unissued tax credits as collateral for something else. Until a state has actually issued the tax credits to the applicant, they do not exist. Unissued tax credits used as collateral are, in general, very high risk because they do not exist until they are issued.

(12) Potential Risk: *Late credits and underpayment penalties.* Purchasers should never apply the credits they are purchasing against their tax liability before they have actually received the credits and should also ensure that their tax credit purchase agreements have strong penalties to compensate them for underpayment penalties and other costs and expenses if the credits are not delivered to them on a timely basis.

(13) Potential Risk: *Purchaser responsible for issuances costs.* These are costs that should be paid by the seller. Purchasers should ensure that the entity generating the credits pays them or that the purchaser has the right to offset them from the purchase price.

Please keep in mind that a relatively new product known as "tax credit insurance" (which can be obtained from major carriers) can protect against many or all of these risks.

The Pricing of Tax Credits

There are many factors that contribute to the pricing of transferable tax credits and only an efficient and transparent market-enabled by technology and open access-can provide true price discovery, which is the foundation of traditional market dynamics. In an efficient market, tax credit prices would be determined primarily by fundamentals, which, at the basic level, refer to combinations of many factors, which may include:

- Supply/demand dynamics
- Program attributes and use of credit
- Seasonal components

In addition, other factors might be involved:

- Does the purchaser play other roles in the project (e.g., construction loan lender, permanent financier, purchaser of related federal credits)?
- Does state law set the pricing or floors for the pricing?
- Does the seller (borrower) have the balance sheet to support potential risks? (i.e. "recapture

guarantees")

Before a modern tax credit exchange (which now exists) pricing was often an arbitrary function which never allowed for price elasticity. Excess surplus (supply or demand) did not cause price fluctuation or adjustment, but rather resulted in denying either the buyer or seller the maximum value of the tax credit. Price discovery has been absent for decades and only traditional market dynamics can truly provide clarity around pricing-let the market determine fair value.

Unlike a traditional security-where an investor purchases an asset with the intent of realizing an increase in value-taxpayers *must* pay the tax, and as such the decision to purchase tax credits (at a discount to face value to apply against tax liabilities) is *not* an investment (as the value of a credit remains $1.00), but rather it offers an opportunity (for buyers and tax credit equity investors) to enjoy immediate yield and above average returns. Speculators can, of course, play a role in the pricing of tax credits, and risk/reward dynamics will create opportunities and often provide valuable liquidity.

The State Tax Credit Crystal Ball

States are constantly coming up with new and creative policies to incentivize economic development, job creation, affordable housing, etc., as tax incentives provide the most effective solution. Despite headwinds in some states, tax credit programs as a whole are flourishing, such as renewable energy, digital animation/gaming/software, historic rehabilitation, affordable housing, and various job creation credits (New Markets, CAPCO, hybrid programs).

Efforts to make credits 100% refundable/rebatable have received some pushback, which we suspect will continue given the overall review of credits by the states. This pushback marginalizes taxpayers support of the program as they do not get to benefit from purchasing credits. In addition, such pushback effects isolate a jurisdiction's base of support as taxpayers are no longer incentivized to support the program. The public/private partnership between the state, taxpayers, sellers, intermediaries and other involved parties erodes significantly and often the programs do not achieve their intended goal and/or fraud/abuse tends to increase as the program can be less efficient when normal market forces of supply and demand are not present.

There are still many questions regarding the viability and effectiveness of government sponsored economic development programs (known as tax incentives) that remain, including:

- What is the distinction between tax incentives that are actually beneficial to a jurisdiction's economy vs.

incentives that are business giveaways?

- Do tax credits actually help business (large and small) grow, and produce tangible results for the states (and the country) in the form of positive economic impact and quality job creation?

Taxpayers in every jurisdiction need to be able to see clearly who is eligible for these incentives, who is receiving them, who is using them and what the impact on the local and regional economy is-both in terms of job creation and the gain/loss of taxable revenues. Further, some commentators have stated that the most effective use of tax incentives involves the credits that are earned by a company after expenditures are made and once jobs are created-not those based on the "promise" of job creation. This is one of the primary distinctions between *statutory* and *negotiated* incentives.

With respect to negotiated incentives, one remedy for jurisdictions to consider may be to require that if companies fail to deliver on employment expectations they not be able to simply pack up and move away. Rather, jurisdictions ought to take an equity position in the company (as the federal government does and, of course, as is standard operating procedure in the capital markets businesses) if/when businesses fail to meet their obligations under the terms of the credit grants. Jurisdictions may then be in a position to convert that equity into valuable resources which can be used to remedy already burdened state treasuries.

Conclusion

Despite the attractive nature of tax credits, they are not without controversy. Critics argue that states spend too much money to incentivize businesses and enterprise growth and that the money could be better spent in other arenas, such as education or healthcare, and that the economic impact of tax incentives programs do not yield sufficient returns. Others argue that states should completely eliminate all tax incentives and simply lower tax rates for everyone. Others view the elimination of tax incentives as a direct tax increase.

However, it is important to note that the ultimate goal of state tax credits is not in all cases to generate income for the state. Instead, state and federal tax incentives are still seen as perhaps the most effective economic development tool that government has to attract new and expanding businesses, and to encourage certain activities in specific industries or investment within a jurisdiction. And at their core, of course, tax incentive programs are intended to create new, high-quality jobs.

Those businesses that earn tax credits (by following the statutory rules and regulations of an incentive program) often do not have any, or sufficient, tax liability to which the total credits received may apply. As such, without a means for a business to monetize those excess credits the economic impact of the incentive would serve no purpose, the business may not survive or thrive, or the activity or investment deemed necessary may not be achieved. Therefore, to the extent state tax incentives exist, the sale, transferability, or monetization of these incentives is arguably still a vital necessity to the success of tax incentive programs. What is also apparent is that the businesses/taxpayers who purchase tax credits (at a discount) unearth additional capital (through the reduction of liabilities) which are inevitably re-invested in the economy in one form or another, while simultaneously providing invaluable equity to growth industries and the job-creators.

Perhaps through a standard of best practice, a level playing field and transparency in the monetization of tax credits-which modern technology brings to bear in an efficient tax credit exchange-governments should consider developing more innovative economic development strategies to create programs that have the most effective impact on job creation and make *all* tax incentives transferable (and/or monetizable in one way or another). This would provide the strongest catalyst for businesses to invest capital and create new jobs given an efficient means to source necessary expansion equity.