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Technically Speaking:

A Policy Wonk's Guide to Recent Tax Credit Proposals

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Since the election, there has been much discussion about the Investment Tax Credit (ITC) proposal of Professor Peter Navarro of UC Irvine and Wilbur Ross, along with critiques of it in the press. This article summarizes technical aspects of the ITC proposal along with another application of tax credits—the Tax Credit Bond (TCB).

Tax credits are a deeper (and more expensive) form of financial subsidy than other tax-preferred investments such as tax-exempt bonds (private activity bonds, including the Qualified Public Infrastructure Bonds proposed by the Obama Administration) or partially-subsidized taxable bonds (Build America Bonds, or BABs).

Tax credit incentives for infrastructure can be structured in one of two basic ways:

- Equity-based ITCs, where the credits typically are set at a fixed percentage of private equity invested; or
- Debt-based TCBs, where annual credits attached to bonds reduce or eliminate the need for interest payments on the long-term debt.

Investment Tax Credits

ITCs can be paid either upfront (Navarro-Ross assumed credits equal to 82% of invested equity that would be paid upon project delivery) or over time (Wyden-Hoeven Move America credits could equal up to 50% of invested equity and would be paid out over the 10-year period following project completion). The higher 82% ratio used by Navarro-Ross appears to be the level the authors calculate would make the proposal “break even” from a federal fiscal viewpoint.

However, the Navarro-Ross fiscal impact calculation is predicated upon two key assumptions. First, it assumes the average equity share of P3 projects is about 17% of total project costs. We note that the actual equity contribution on 10 recent revenue-risk highway projects has averaged about 25%. A larger average equity share would increase the size and cost of the proposed ITC.

Second, their analysis depends on “dynamic scoring” in which the estimated taxes generated by the resultant investment activity (federal income taxes collected from construction workers’ wages and corporate income tax from the P3 developer) offset the ITC’s fiscal cost (tax expenditures). The potential use of dynamic scoring is much-debated; under current budget rules the ITC—claimable upfront—would be fully scored. Other variants of the ITC, such as the Move America credits, spread the cost out over several years. This would have the dual benefit of helping ensure assisted projects comply with policy conditions over time and placing a portion of the fiscal cost beyond the 10-year “budget window.”

Some critics claim the ITC is simply a tax break scheme to “fatten the pockets” of equity investors. Yet a well-structured ITC—especially one paid out over a multi-year period—should generate incremental tax-oriented equity augmenting (not displacing) the level of financial equity justified by project cash flows. In fact, the equity could be derived from a completely different set of investors than those making financial equity contributions.

Further, it is worth noting that those 10 recent highway P3 projects on average received 19% of their fund-

ing through governmental grants. The tax-oriented equity generated by an ITC could reduce the need for such contributions, freeing them up for other local projects.

Tax Credit Bonds

The other approach attaches the credits to bonds where the federal government would pay most or all of the “interest” in the form of annual tax credits. The tax credit rate is set at issuance by Treasury based on corporate bond yields (at present about 4.50%). This effectively results in a 50% present-value benefit to the project sponsor/borrower.

It is assumed any future TCB program will require the tax credits to be both volume-capped (for fiscal control purposes) and “nonrefundable” (for political purposes)—that is, the issuer or investor could not present the credits to Treasury for cash payment (as with the BABs). Rather, they could only be used to offset other tax liability of the bondholder.

Nonrefundable TCBs have been criticized by bond industry groups as illiquid and less-marketable than interest-bearing bonds, and to date that has been correct. Part of the problem has been lack of sufficient authorized volume, but another reason is that bondholders don’t know whether they will have tax liability in the out-years to apply against the credits. And up until now, TCBs haven’t been suitable for a non-taxpaying investor such as a public pension fund.

These obstacles might be largely overcome by: (1) authorizing a robust volume (\$50+ billion); and (2) expanding the list of “creditable” taxes beyond regular income tax and the AMT to include non-FICA federal withholding tax, as proposed by Los Angeles County MTA with its “America Fast Forward” bonds.

Pension plans generally withhold up to 10 percent of the benefits they pay out to retirees and remit such amounts to Treasury on the retirees’ behalf. If the pension funds could apply the tax credits against these very predictable withholding payments, they effectively could be monetized with very little out-year risk. On this basis, nonrefundable credits on TCBs should appeal to both public pension funds and life insurance companies (which similarly are long-term bond investors that withhold taxes on retirement payments to annuitants).

The Devil is in the Details

TCBs provide a PV benefit equal to about 50% of the amount borrowed and typically score at 20%-30% of the

authorized volume, since most of the tax credits are paid beyond the budget window. The ITC as proposed would provide a PV benefit of about 15%-20% on total project costs (82% of the equity share) but likely would be fully scored. Another difference: A TCB could be used by both P3 and governmental projects while the ITC would be limited to P3s. It is worth noting that P3 projects constitute only about three percent of

the total capital invested annually in highways.

In short, both ITC and TCB could attract at-risk private capital for public infrastructure. Federal policy makers will need to calibrate their priorities with technical features in determining a feasible path forward. ■

\$5bn Private Equity Invested In 26 Transportation DBFOM Deals

(Source: FHWA, *Public Works Financing Major Projects Database 11/16*)

	PUBLIC FINANCE (\$mill.)		PRIVATE PROJECT FINANCE (\$mill.)			Financial Equity	%	Total Capital	Financial Close Date
	State/Local* Equity	TIFIA	Priv. Activity ■	Bonds	Bank Debt				
91 Express Lanes, CA (TR)	0	0	0		100	30	23	130	7/93
Dulles Greenway, VA (TR)	0	0	0		298	80	21	378	9/93
So. Bay Express, CA (TR)	0	140	0		340	130	21	610	5/03
I-495 Express, VA (TR)	495	589	589		0	630**	27	2,303	12/07
SH 130 seg. 5+6, TX (TR)	0	430	0		686	210	16	1,326	3/08
I-595, FL (AP)	0	603	0		781	208	13	1,592	3/09
Port of Miami Tunnel, FL (AP)	100	341	0		342	80	9	863	10/09
No. Tarrant Express TX (TR)	594	650	398		0	426	21	2,068	12/09
LBJ Expressway, TX (TR)	490	850	606		0	682	26	2,628	6/10
Denver Eagle rail, CO (AP)	1,312	280	396		0	54	3	2,042	8/10
Jordan Bridge, VA (TR)	0	0	0		0	120	100	120	1/12
Downtown/Midtown Tunnel, VA (TR)	582!	422	675		0	272	14	1,951	4/12
Presidio Parkway ph. 2, CA (AP)	0	60+90	0		167	45	12	362	6/12
I-95 HOT Lanes, VA (TR)	83	300	253		0	280	31	916	7/12
East End Bridge, IN (AP)	526	162	508		0	78	6	1,274	3/13
No. Tarrant Exp. 3A/B, TX (TR)	379	531	274		0	442	27	1,626	9/13
Goethals Bridge, NY (AP)	125	474	453		0	107	9	1,159	11/13
US 36 ph. 2, CO (TR)	75	60	21		0	41	21	197	2/14
I-69 Managed Lanes, IN (AP)	80	0	244		0	41	11	365	7/14
I-4 Ultimate, FL (AP)	1,035	950	0		484	103	4	2,572	9/14
Pennsylvania Rapid Bridges (AP)	225	0	721		0	59	6	1,005	1/15
Portsmouth Bypass, OH (AP)	178	209	227		0	49	7	663	4/15
I-77 Managed Lanes, NC (TR)	95	189	100		0	248	39	632	5/15
SH 288, TX (TR)	17	357	299		0	375	36	1,048	5/16
Purple Line transit, MD (AP)	1,599	875	313		0	139	5	2,925	6/16
LaGuardia Central Term., NY (AP)	1,200	0	2,400		0	200	5	3,800	6/16
Total	9,190	8,562	8,477		3,198	5,128	avg. 15%	34,555	
Of the total 26 projects:									
14 are toll revenue risk concessions	2,810	4,518	3,215		1,424	3,966	avg. 25%	15,933	
12 are availability payment P3s	6,380	4,044	5,262		1,774	1,162	avg. 6%	18,622	

(TR) Toll revenue financing (demand risk)
 (AP) Availability payment financing (sovereign risk)

* excludes public sunk predevelopment costs
 **deal restructured in 2014; original equity invested was \$348m in 2007
 ! additional public funding invested after financial close to reduce tolls