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Tax Credit Investments are ESG Investments

Use corporate tax liability to generate environmental and social impact with competitive after-tax returns.

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Overview

Once a niche investment approach thought to come at the expense of returns, ESG investing – or strategies that align with a company's environmental, social, and governance values – has grown into a $30 trillion market as of 2019. Issues like energy consumption, greenhouse gas emissions, climate change, resource scarcity, health and safety, diversity and inclusion, and effective board oversight are all having a greater effect on the financial performance of companies and investors have taken notice. The 2019 Global Impact Investing Network (GIIN) Annual Impact Investor Survey results show the increasing scale and maturity of the impact investing industry. This most recent report includes responses from 266 leading impact investing organizations worldwide that manage $239 billion of the more than $502 billion U.S. market.

One major underutilized strategy that could enable companies to significantly boost their ESG performance and mitigate ESG related risks is ***tax credit investments***. By repurposing and redirecting a company's estimated tax payments into qualified tax advantaged investments, companies can achieve triple bottom line results and fulfill their ESG commitments.

> *Speaking to Reuters Events, BNP Paribas states it "has been successfully investing in renewable energy tax credits for years, which has significantly contributed to our ESG goals and objectives."*

Tax Credits Explained

A tax credit is a type of government sponsored tax incentive that can reduce a company's tax liability dollar-for-dollar. The U.S. government uses tax credits to incentivize corporate taxpayers to invest in certain types of projects that produce economic, environmental, or social benefits. For these projects, the tax credit is an important source of capital, but many project developers do not have enough taxable income to take advantage of the tax credits themselves. In such cases, the developer may monetize the tax credit by attracting a "tax equity" investor, usually a corporate tax paying investor partner.

Tax equity is a term that is used to describe a passive equity ownership interest in a qualified project, where an investor receives a return, based not only on cash flow from the project, but also on tax benefits. In such a transaction, a partnership is typically formed among the parties to facilitate the investment and the allocation of tax credits, deductions, and distributions. The specifics of each partnership vary by project, tax credit type, and transaction structure.

In practice, a tax equity investment uses the same dollars that are earmarked to satisfy a company's tax liability. The funds are repurposed and then invested into qualified projects that generate tax credits, such as a solar farm or an affordable housing project. The tax benefits generated from the project flow back to the investor, eliminating a corresponding amount of tax liability. Typically, the investor also receives a cash return generated through earnings from the project.

Corporate and institutional investors inject well over $25 billion per year into the allocated tax credit market. While the amount is significant, it also suggests there are billions of dollars of tax capacity available that could be deployed for ESG impact in addition to financial performance.

> *"Tax credit investments are really about taking responsibility and being intentional with your tax dollars. Instead of wiring estimated tax payments into The General Fund, corporate taxpayers can direct their dollars to worthy projects that match their sustainability goals."*
> *Bryen Alperin, Vice President of Foss & Company's Sustainability Practice*

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The Benefits of Tax Credits

Federal and state governments offer tax credits to promote public private partnerships, incentivizing investment capital to flow to domestic programs that benefit society, the nation and communities, such as:

- Building affordable housing for our nation's ever-increasing population in need of affordability; (Tax Credit Program: LIHTC, IRC Section 42)
- Preserving America's historical buildings and repurposing those facilities to the benefit of communities; (Tax Credit Program: HTC, IRC Section 47)
- Building sustainable energy infrastructure through solar, wind, fuel cell, and biogas projects; and, (Tax Credit Program: ITC/PTC, IRC Sections 48 and 45)
- Carbon sequestration activities that reduce greenhouse gas emissions from U.S. industries. (Tax Credit Program: PTC, IRC Section 45Q)

A common thread connecting federal, state, and local tax credit programs is the positive intent and long-term environmental and social impacts on society as a whole. Tax credits are a sustainable source of financing for addressing market failures, such as the lack of affordable housing in low-income communities.

> *"History has shown tax policy to be a highly effective mechanism to drive behavior," says Mike Minihan, tax expert and managing partner at business advisory firm BX3. "We have seen it before with credits for solar and R&D."*
>
> *In a report for HSBC, consultancy East & Partners reports that globally, financial returns and tax incentives are the top two drivers of ESG decision making across all issuers and the majority of investors.*

Incentives, Not Tax Avoidance

Tax equity investments are not tax loopholes or tax avoidance. Rather, when a business chooses to make a tax equity investment, they are simply repurposing their estimated tax payments to invest in qualified projects that also meet their ESG goals. In place of taxes paid to the U.S. Treasury, the investor is able to put their money to work even more efficiently and effectively to benefit underserved communities and the environment.

> *Indeed, according to one global bank, with over $1 Trillion AUM, that invests in tax credits, "Congress created the tax credit regimes to motivate investment in these sectors and the IRS has provided guidance which allows taxpayers to be comfortable that transactions will be structured in such a way that the taxpayer will qualify for the tax credits and the transactions will not be deemed abusive of the Tax Code."*

The outcome appears as a reduced effective tax rate on financial reports, but, in either case, real money 'goes out the door.' Instead of paying taxes to the federal government, the investor shows good corporate citizenship by taking the time and effort to underwrite the opportunity, and then deliver meaningful capital to high impact projects on the federal government's behalf. The taxpayer effectively invests their tax payments in socially responsible projects, and can earn a cash return on that investment while generating ESG benefits.

There is a natural overlap between tax equity and ESG, says Phil Graves, head of corporate development at clothing company Patagonia. "It is a way of leveraging our ESG investments to increase the environmental returns.

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ESG Investing Explained

ESG investing is the integration of environmental, social, and governance factors into the investment process. Using ESG criteria, corporate investors and fund sponsors are able to select companies and projects with suitable attributes that align with the investor's voluntary ESG commitments.

Tax equity investments are an underutilized strategy for boosting ESG performance and reducing ESG risk exposure. Transactions that pair the tax credits generated by a qualifying investment with the financing associated with that investment enables corporate investors to put their capital to work in funds, organizations, companies, or projects that generate a positive, measurable social or environmental impact alongside a financial return.

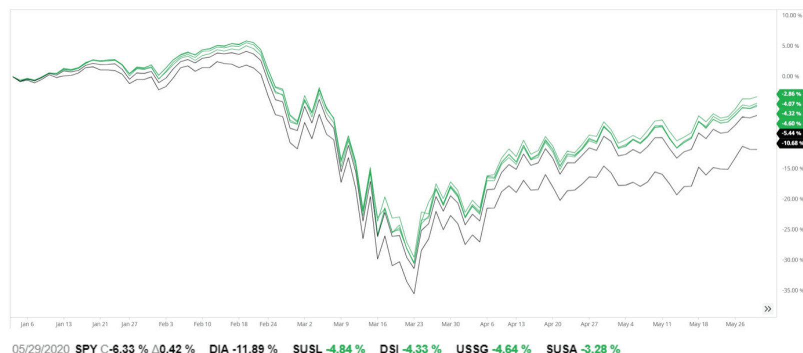
In August 2019, the Business Roundtable, a group representing the nation's 192 most powerful chief executives of the largest companies issued a statement on the purpose of corporations. While the American corporate community has long held that companies must maximize profits for shareholders as a top priority, detractors have contended that this practice creates increased inequity. The new approach delineates the belief that the needs of shareholders should be balanced with the needs of stakeholders, including customers, employees, supply chains, and local communities. Investors like BlackRock have added increasing credibility to incorporating ESG factors into the investment process. In his 2020 annual letter to CEO's and the broader market, BlackRock's CEO Larry Fink vowed to place sustainability at the core of its asset management fiduciary duty to investors, and pushed corporations to do the same or to be judged accordingly.

The Benefits of ESG Investing

ESG issues have become financially material over time. As social and environmental factors become more tangible, a strong ESG proposition can safeguard a company's long-term success. According to global consulting firm McKinsey & Company, a strong ESG proposition creates company value in five essential ways:

1. Top-line growth – achieve higher valuations than competitors with lower social capital
2. Cost reductions – help combat rising operating costs
3. Reduced regulatory & legal interventions – achieve greater strategic freedom, easing regulatory pressure
4. Employee productivity uplift – help companies enhance employee motivation and increase productivity
5. Investment & asset optimization – enhance returns by allocating capital to more sustainable opportunities.

Figure 1: ESG funds continue to outperform during coronavirus downturn.



Source: barchart.com

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The largest asset managers in the world, including BlackRock, JP Morgan, Vanguard Group, and Goldman Sachs, have all announced a variety of initiatives to place sustainability at the center of their investment strategy for their institutional and retail investors. In the absence of strong ESG practices and voluntary disclosures, investors will increasingly conclude companies are not adequately managing risk and invest elsewhere. While this whitepaper focuses on project-centric tax equity investments, Figure 1 demonstrates the resilience and performance of four leading ESG ETF's relative to the Dow Jones Industrial and S&P 500 before and throughout the Q1/Q2 2020 COVID19 pandemic. The iShares ESG MSCI USA Leaders ETF (SUSL), iShares MSCI KLD Social 400 ETF (DSI), Xtrackers MSCI USA ESG leaders equity ETF (USSG), and iShares MSCI ESG USA Select ETF (SUSA), are the four largest ESG focused ETFs by AUM and are represented by the green trend lines over the same period.

> *"When you think about investing through an ESG lens, you are focused on long-term sustainability," says Steve Norcini, senior equity portfolio manager at Wilmington Trust.*

Tax Credit & ESG Investing Options

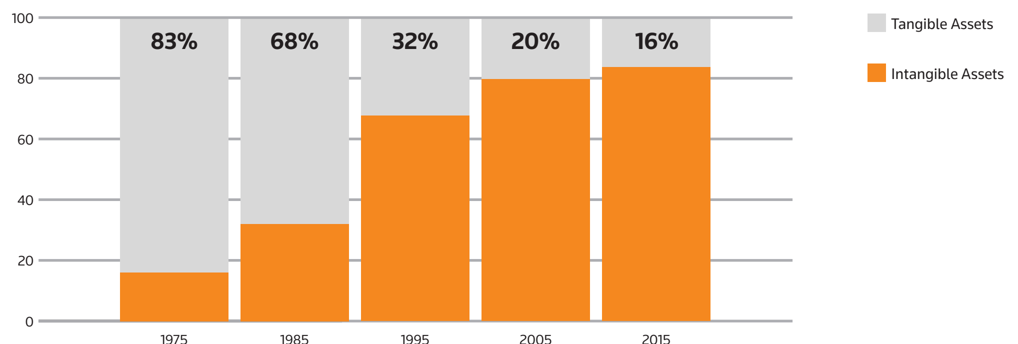
The inherently subjective nature can make ESG factors hard to quantify. There are several main reporting frameworks, including but not limited to GRI, SASB, CDP, and TCFD that aim to guide companies on how to measure, assess and report on their ESG initiatives, risks, and opportunities. An acceptable degree of standardization around transparency, governance, and environmental impact is essential for providing investors a framework with which to evaluate investments. In turn, as gathering and processing data becomes even easier and cheaper, investments in areas like renewable energy and sustainable development will increase.

> *"There could be natural synergies between Tax Credits and ESG because there is any number of large institutional investors in the US that have mandates from management to invest heavily in renewable energy and clean energy-related projects," says David Lowman, a partner at Hunton Andrews Kurth.*
>
> *That is because "Investment Tax Credits provide companies with an economic incentive to invest. They lower the risk of projects by cutting capital expenditure costs and raising long-term returns," Norcini explains.*

Figure 2: The potential power of this new market dynamic is clear

Components of S&P 500 Market Value

The role intangibile factors - reputation, esg, and others play in the percieved value of companies has dramatically increased.



Source: S&P Global

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Environmental

Accelerating Clean Energy and Decarbonization

Solar Energy
The solar Investment Tax Credit (ITC), IRC Section 48, is one of the most important federal policy mechanisms to support the growth of solar energy in the United States. Since the ITC was enacted in 2006, the U.S. solar industry has grown by more than 8,600 percent, creating hundreds of thousands of jobs and investing billions of dollars in the U.S. economy in the process.

The ITC is currently a 26 percent federal tax credit on the upfront cost of a solar system. The tax credit is a dollar-for-dollar reduction in the federal income taxes that a company would otherwise pay the federal government. The ITC is earned at the placed in-service date of the project and is a one-year credit. The credit is available to all federal taxpayers, regardless of industry. The ITC allows a taxpayer to control the utilization of their tax dollars, directing them to worthy projects that benefit their communities or align with their corporate social responsibility goals and commitments.

In addition, by funding solar projects upfront, companies are often developing renewable assets that may not have been built. Instead of passively procuring renewable energy, they are actively participating in the fight for decarbonisation. A good example is Facebook's groundbreaking 379MW Prospero Solar project. As their Energy Strategy manager Peter Freed explained:

> *"We were involved very early in this project, much earlier than investors are typically involved in projects, because we wanted to make sure that we can really say that our involvement helped it move forward and got it across the finish line."*

Benefits of clean energy tax credit investing:

- Create economic development investment and jobs in manufacturing, installation, and operations
- Improve public health by reduced air and water pollution
- Enhance electricity reliability and resilience
- Improve energy security

Carbon Capture and Sequestration
Section 45Q provides a tax credit on a per-ton basis for CO2 that is captured and permanently sequestered. In February 2018, the Bipartisan Budget Act included a new expanded IRC Section 45Q to include enhanced Production Tax Credits (PTC) for companies that capture and sequester carbon dioxide. Now, technology that can capture CO2 emissions and is necessary for slowing global warming is economically and financially viable for investors. Enhancements to the new section 45Q tax credit is intended to spur the deployment of and unlock investment in clean energy in the U.S.

Carbon sequestration is considered to be essential to global efforts to reduce CO2 emissions and is beneficial to U.S. domestic energy security. Captured CO2 can be used to produce more energy through enhanced oil recovery, resulting in 'low carbon fossil fuels' that will bridge the gap through the ongoing energy transition.

> *"45Q is regarded as the most progressive CCS-specific incentive by many," says the Global CCS Institute. "It provides a stable and predictable value on carbon reflecting the externalities created by pollution."*

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Benefits of Carbon Sequestration tax credit investing:

- Prevent atmospheric carbon dioxide release
- Reduce the conventional energy sector's environmental impact
- Provides additionality by increasing investment in carbon capture which lowers costs, attracts more investors

Social

Providing Substantial Benefits to Underserved Communities

Affordable Housing
The United States has a severe affordable housing shortage. Housing insecurity undermines employment, health, education, and sustainable and stable living. The consequence of the affordability gap is costly for individuals, families, communities, and the economy. According to a 2019 study by the National Low Income Housing Coalition, "in no state can a person working full-time at the federal minimum wage afford a two-bedroom apartment at the Fair Market Rent." The Low-Income Housing Tax Credit (LIHTC) is the federal government's main program for encouraging investment in the development of affordable rental housing for low-income families. The LIHTC program was established as part of the Tax Reform Act of 1986 and provides tax incentives to encourage corporate investors to invest in the development, acquisition, and rehabilitation of affordable rental housing. The tax credit is calculated as a percentage of costs incurred in developing the affordable housing property and is claimed annually over a 10-year period.

> *David Wood, Director of the Initiative for Responsible Investment at Harvard University points out that "the Low-Income Housing Tax Credit has opened the door to investment in affordable housing, helping to build a market for public benefit in real estate".*

Benefits of LIHTC investing:

- Provide lowest default rate of all real-estate asset classes
- Provide the most predictable 10-15 year benefit stream
- Offer dollar-for-dollar tax liability offset
- Create high impact investments
- Credit Community Reinvestment Act (CRA) compliance (for bank investors)

Sustainable Communities
The Federal Historic Preservation Tax Incentives program (HTC) encourages private sector investment in the rehabilitation and re-use of historic buildings. The HTC creates jobs and is one of the nation's most successful and cost-effective community revitalization programs and has leveraged more than $102.64 billion in private investment in efforts to preserve 45,383 historic properties since 1976. A HTC project takes qualified buildings and converts them into residential, retail, office, cultural, community and educational centers, increasing property values on surrounding parcels and encouraging continued redevelopment. These properties can also be used for affordable housing. HTC projects have revitalized distressed areas by creating jobs and bringing renewed commerce to the historic cores of cities and towns.

The HTC tax credit equals 20 percent of the qualifying expense spent rehabilitating historic buildings. The tax credit is amortized over a five-year period after the property reaches its certificate of occupancy. Past-periods data shows historic credits are one of the safest real estate-related asset classes.

In addition to the federal HTC program, many states have historic building preservation tax credit programs that mirror the federal program and can be used in conjunction with the federal credit.

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Governance

Thinking about Governance and the Stakeholders

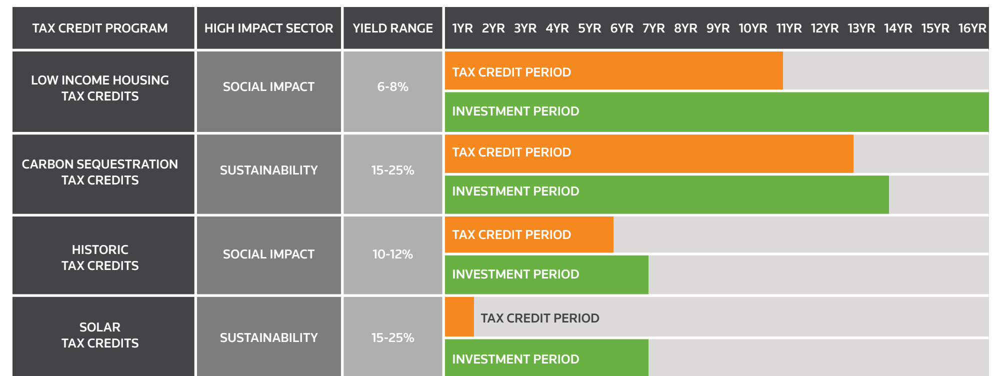
While governance issues, such as business ethics, are less quantifiable, it is not necessarily any more difficult to integrate governance factors into qualitative due diligence of a project or development company. When selecting and directing capital into environmental and social impact tax equity investments, investors can apply a governance filter to their investment thesis, underwriting and diligence process, and formal ongoing reporting framework. For example, solar project development companies seeking tax equity investments can be interviewed about their board diversity, executive pay, ownership and control, accounting, anticompetitive practices, and contribution to financial system instability. This governance information can be considered in the context of ESG investing and used to screen potential investments.

Engagement and active ownership can positively influence a company to achieve targeted ESG objectives along with financial returns. In addition, continuous monitoring over the project's life cycle aids strategy and materiality reporting. Enhancing investors' ESG understanding and giving investors a broad set of standardized ESG data and metrics is integral to the dialogue around increasing ESG transparency and voluntary disclosure.

Benefits of good corporate governance:

- Encourage positive behavior
- Reduce the cost of capital
- Improve top-level decision-making
- Assure internal controls
- Enable better strategic planning

Figure 3: US Federal Allocated Tax Credit Programs with ESG Impact



TAX CREDIT PROGRAM	HIGH IMPACT SECTOR	YIELD RANGE	1YR 2YR 3YR 4YR 5YR 6YR 7YR 8YR 9YR 10YR 11YR 12YR 13YR 14YR 15YR 16YR
LOW INCOME HOUSING TAX CREDITS	SOCIAL IMPACT	6-8%	TAX CREDIT PERIOD INVESTMENT PERIOD
CARBON SEQUESTRATION TAX CREDITS	SUSTAINABILITY	15-25%	TAX CREDIT PERIOD INVESTMENT PERIOD
HISTORIC TAX CREDITS	SOCIAL IMPACT	10-12%	TAX CREDIT PERIOD INVESTMENT PERIOD
SOLAR TAX CREDITS	SUSTAINABILITY	15-25%	TAX CREDIT PERIOD INVESTMENT PERIOD

Source: Foss & Company

Benefits of HTC investing:

- Revitalize communities by reusing historic structures to the benefit of the community
- Provide the most predictable five-year benefit stream
- Offer dollar-for-dollar tax liability offset
- Create local jobs and capacity for community investment

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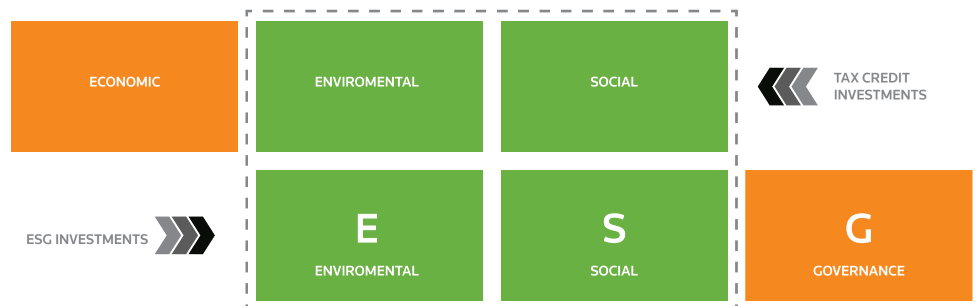
Conclusion

Gradually shifting weather patterns, rising sea levels, and more extreme weather events disproportionately affect people living at the base of the economic pyramid and perpetuate inequity as an effect of Climate Change. Climate risk is business risk, and major investors will increasingly scrutinize the ESG goals and performance of companies they invest in.

> *"Any investment, including tax credits, should integrate material and relevant ESG factors and deploy effective stewardship. Anything else, and an investment manager will not be fulfilling their financial fiduciary duty," points out Leon Kamhi, Head of Responsibility, International at Federated Hermes.*

Now, more than ever, tax credit investments can be used as a tool to combat the negative effects of climate change and expand economic opportunity for underserved people and communities. By incorporating climate-positive and social-impact into a company's investment and underwriting policy framework, an organization can spur investments in initiatives that align with their mission and values. Foss & Company and our investors are committed to moving the needle toward a more sustainable future. Undertaking the implementation of ESG tax credit programs can seem challenging, but Foss & Company can help corporations and institutional investors through the process with direct investment transactions or through our tax credit investment fund vehicles.



About Foss & Company

Since 1983, Foss & Company has helped our institutional clients access the right investment solutions to meet their strategic tax planning needs. Our tax credit solutions deliver attractive risk-adjusted returns into tax enhanced asset categories that frequently also meet investor ESG goals. With close to $7 billion in tax equity invested, Foss & Co. is a full-service advisor with proven expertise in navigating the world of tax credit investment.

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The GIIN 2019 Annual Impact Investor Survey, 2019
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