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From the State to the Shareholder: Rent and the Production of Shareholder Value in Real Estate

Renee Tapp

Graduate School of Design, Harvard University, Cambridge, MA, USA; ctapp@gsd.harvard.edu

Abstract: Following the 2008 global financial crisis, the use of real estate tax credits to generate shareholder value for investors increased significantly. While tax credits are lauded as crucial to the delivery of social goods like affordable housing, the multiplier effects they supposedly generate fail to account for the hollowing out of the state that occurs as public funds are transferred to shareholders. Through a detailed case study of the historic tax credit industry in the United States, this research shows how many of the banks and financial institutions investing in tax credits have come to rely on overly engineered forms of landownership, deeply discounted credit pricing, and a wave of stock buybacks to boost their corporate profitability. This paper therefore develops a theoretical framework to understand taxation as a financialised accumulation strategy where the state serves as an important—if not problematic—source of real estate profit.

Keywords: rent, tax, banks, LLCs, Dodd-Frank, buybacks

Introduction

A short decade after real estate markets' near fatal collapse, property is once again a booming site for investor profits (Evans 2019). Real estate tax credits are among the most significant investment strategies that have emerged in the United States: investment in the federal historic tax credit, one of three federal credits used in real estate deals,[1] has doubled in volume after the crisis, growing to a $70 billion market in the last 10 years (Tapp 2019). Banks and financial institutions, who are behind the surge of investment, actively began to "pad their profits" (Peters 2014) under "the most comprehensive financial reform legislation since the 1930s" (Webel 2017:ii). While tax credits tie into the production of social goods like historic preservation and affordable housing (TPS 2019), they also promise to deliver high rates of return to investors and their shareholders (Ernst and Young 2012).

The majority of research on profit-making in real estate is encompassed under the term "financialization"—at times an unwieldy concept (Christophers 2015)—that when more specifically applied to property, signals the treatment of real estate as a financial asset capable of not only generating profits for landowners but also for shareholders (Coakley 1994; Rutland 2010; Wissoker 2016). Recent attempts to unpack the "black box" of financialisation return to foundational debates in urban political economy around theories of rent (Ward and Aalbers

2016; cf. Purcell et al. 2019), that largely originated within this journal nearly a half century ago (cf. Harvey and Chatterjee 1974; Walker 1974). Broadly considered to be income generated by an asset, rent is a "transfer payment" over the right to use property (Harvey and Chatterjee 1974:32). Scholarly attention to rent in the built environment reveals fundamental changes in how property is owned and used—that is, how property becomes a financial asset for investors (Christophers 2019; Haila 2016)—but rarely considers the state as the source of rents. By overlooking this fact, scholars miss a fundamental feature of financialisation: it grinds down the redistributive capacity of the state (cf. Piketty 2017; Saez and Zucman 2019).

This paper argues that the extraction of rents from the state has become an important source of shareholder value in the aftermath of 2008 global financial crisis. Using historic tax credits as an illustrative example, it provides detailed quantitative and qualitative analysis of the financial context in which these rents emerge and transform into profit. The paper begins by combining an approach to financialisation that emphasises the role of shareholder value in corporate governance with Marxist urban rent theory. It develops a theoretical framework that addresses not only the state as the source of shareholder value but also the intricate legal vehicles and structures used to accumulate real estate profits. Next, the paper discusses the rationale for the historic tax credit, and the research data and methods used in this study. The focus then shifts to the case study; detailed empirics show how [i] banks engineer ownership of historic properties with cleverly crafted deals, [ii] gaps between the market and nominal value of credits encourages profit maximisation, and [iii] the subsequent corporate cash piles that result from falling tax rates are raided by executives with stock buybacks. In the conclusion, the paper considers the wider implications of tax profiteering on the state at large.

Rent Beyond the Rent Gap in the Era of Shareholder Value

Financialisation as shareholder value is rooted in corporate governance practices that emerged during the late 1970s. Previously, American corporations practiced a "retain and reinvest" approach to profit redistribution that saw companies reallocate earnings to workers and increase their firm's productive capacities (Lazonick and O'Sullivan 2000). This changed after a wave of corporate raiders bought controlling shares in underperforming businesses, removed CEOs, and implemented cost-cutting and revenue-generating operational changes in the name of shareholder value (Froud et al. 2000). Using the company's stock price as a barometer of success (Dobbin and Zorn 2005), the shift in management—termed "downsize and distribute"—that accompanied hostile takeovers ranged in strategies from layoffs to investment cuts, mergers, acquisitions, buybacks, selloffs, and the pursuit of tax savings (Bhagat et al. 1990). A central tenant in the shareholder value thesis became that to insulate against future raids, corporate managers' interests should align with shareholders' interests (Jensen and Meckling 1976). As more firms have embraced the shareholder ethos, it has become standard practice to issue executive remuneration in the form of stock-based pay (Lazonick 2014).

The emergence of shareholder value as the dominant corporate ideology has had important impacts on urban real estate markets. While hostile takeovers temporarily weakened the demand for urban office buildings in the early 1980s as corporations abandoned plans to lease, buy, and build space in expensive downtowns (Feagin and Parker 1990), many actors in real estate—lenders, builders, and investors—have adopted the shareholder value mindset in their own business practices. In residential markets, Wissoker (2016:553) finds that the "affirmation of these ideas pushed homebuilders to expand, to look for additional ways to cut costs … and to do what was necessary to increase the value of their shares". Likewise, mergers and acquisitions within the lenders of real estate finance—the banking sector—have helped sustain "abnormal sectoral profitability" for these firms and their shareholders in the era of financialisation (Christophers 2018:864). Intense scrutiny by capital markets means real estate is expected to "perform according to a common standard of shareholder value-creation" (Rutland 2010:1175), resulting in what Aalbers (2019:379) notes are projects which "increasingly developed with an investor rather than a user in mind". As property markets in general and income-generating buildings in particular are sites to realise shareholder value for a variety of firms, investors demonstrate a willingness "for whatever reason hold a claim on rent rather than on some other form of future revenue" (Harvey 2007:348).

Real estate offers four broad financial benefits to investors: rates of return, diversification, price appreciation, and tax benefits (Brueggman and Fisher 2016:344). Geographers and critical social scientists provide valuable insights into the spatial manifestations of these investment approaches, noting how in the decade since the crisis, private equity funds snapped up rental properties across the global North (Fields 2017; Immergluck and Law 2014; Mills et al. 2019). Financed by institutional investors like corporations, pension funds, and insurance companies, real estate funds have diversified investors' existing holdings with a global portfolio of properties, generating returns from monthly cash flows and capital gains from property sales (Van Loon and Aalbers 2017). Elsewhere, there is evidence that price appreciation practices once confined to the single-family home market (Smith 1979), specifically landowners "flipping" distressed properties in order to capture a rent gap, are scaling upwards to institutional investors and outwards towards multifamily homes (Slater 2017; Teresa 2019).

Tax reducing benefits like depreciation deductions[2] and tax credits, established by the prevailing tax law, create opportunities for investors in specific real estate markets (Ball 1994; Beauregard 1994; Tapp and Kay 2019). Hanchett (1996:1097) shows that accelerated depreciation established by the Internal Revenue Code of 1954 transformed real estate into a "lucrative tax shelter" that pushed insurance companies to develop shopping centres on the suburban fringe. Similar sheltering activity driven by depreciation schedules in the 1980s fuelled a boom in office and apartment buildings (Fainstein 2001; Feagin 1987; Knuth 2014; Weber 2015). However the US Tax Reform Act of 1986 (TRA86) closed these tax loopholes (Feagin 1987); and as an object of scholarly concern, the rise of debt and mortgage markets during the 1990s and 2000s eclipsed tax research (Wissoker et al. 2014) as "banks were willing to finance projects with little or no equity from borrowers, thereby encouraging the speculative use of debt" (Beitel 2000:2123).

The return of tax sheltering as an accumulation strategy reignites long-held debates around the role of the state and rent. Some scholars consider the fact that tax credits pass from the state to landowners "as a factor that influences the levels of existing types of rent" (Park 2014:95).[3] Yet, such orthodoxy means that "the theory of rent seems to have been an article of faith rather than a dynamic tool for empirical research" (Haila 1990:275). Instead, this paper posits, tax credits—and tax benefits more broadly—should be understood as "redistributional rents" (Walker 1974:55). Using the Federal Housing Authority's mortgage-subsidy program as an example, Walker argues that because the government's reallocation of surplus value—in the form of insurance—is attached to a place, not a person, it constitutes a distinct type of rent that impacts the urban form by driving building and land values in particular areas over others. Indirect expenditures like subsidies are no different than direct forms of redistribution like social security: both are redistributional rents used by the government to create effective demand for a particular asset, as well as for the rent itself (Walker 1974:56). However, redistributional rents are like all rents in that they depend on specific forms of landownership (Massey and Catalano 1978), making it important to note who owns property, what precisely they own, and how they own it.

Financialisation complicates rents because property ownership is highly fragmented. Where ownership of income-generating properties was once characterised by a single-entity wholly owning a building, property ownership today is fractured, and rents are derived from a number of ownership arrangements (Sagalyn 2016; cf. Erturk et al. 2010). There are two clear examples of this. First, in common law countries like the United States, many different investors can possess ownership rights in a single building. Similar to processes of rural land development (Kay 2016), urban developers and investors increasingly view buildings as "bundled financial assets" which unravel into discrete interests (Tapp 2019:14), such as air rights (Chen 2020) and subterranean ground rights (McNeill 2019). While the selling and stacking of these rights make particular real estate developments financially possible, the purchasing and trading of detachable property rights increases the profitability of a building as multiple rent streams are pulled from a single project and circulated on capital markets.

Second, changes in tax law have increased the variety of ownership vehicles available for real estate investors making it possible for shareholders to invest in both properties and in landlords. The most well known example of shareholders investing in property are real estate investment trusts (REITs) (Gotham 2006). Created by the Internal Revenue Code of 1960 and popularised in the 1990s (Downs 1999), publicly traded REITs and other real estate funds are structured as corporations, business trusts, or associations (Sagalyn 2016). After amassing a portfolio of properties, they sell shares in their firm and distribute profits to their shareholders in the form of dividends. Effectively, REITs integrate shareholders into real estate markets by greatly reducing the degree of ownership and amount of capital required from an investor to profit from property (Downs 1999).

Fractional forms of landownership took off in the 1970s and 1980s with "pass-through" entities like limited partnerships, limited liability companies (LLCs), and S corporations. These entities corral multiple investors into one partnership structure that holds title to the property; investors in pass-through entities act like stockholders in that they buy interests in the partnership. Pass-through entities work on behalf of individual and corporate investors to extract rent with what on the surface appears to be a single owner, facilitating a "progressive transfer of ownership" from developers to investors (Leitner 1994:795). Profits and losses are distributed to the entity's members based on their ownership percentage in the partnership (Hamill 2005). Whereas other ownership shares, including those associated with REITs, must be fully transferable, equity interests in pass-through entities are deliberately slower to sell and often require the approval of the partnership's other members before an investor exits (Sagalyn 2016). Fractional ownership arrangements benefit investors who want the financial benefits of owning property without the risk and responsibilities of being a landlord.

Producing shareholder value as a financialised accumulation strategy is thus dependent on the source of rents and the form of asset ownership. Following the 2008 global financial crisis, the state closed the door on subprime mortgages (Ashton and Christophers 2018) and opened the window for tax credit investing, shifting banks and financial institutions from debt lenders to property owners. The remainder of this paper analyses how banks and financial institutions leverage credits to create value with highly structured ownership schemes and a limitless source of state-backed rents. By considering accumulation by taxation as a critical component of rentiership, this work points to the ways financialisation invisibly remakes the welfare state.

Historic Tax Credits

The US tax code offers property owners two tax-related benefits associated with real estate: deductions and investment tax credits. Deductions reduce taxable income while credits erase tax liability. To illustrate this in practice, consider a taxpayer with an adjusted gross income (AGI) of $500,000. They are taxed in the 35% bracket, and have either a $10,000 deduction or a $10,000 credit. The deduction reduces the AGI to $490,000, that taxed at 35% means the taxpayer has a tax bill of $171,500. In the second scenario, the taxpayer owes $175,000[4] in taxes that they are able to reduce to $165,000 with the $10,000 credit. Where the value of a deduction depends on the taxpayer's marginal tax bracket, the credit lowers the tax bill, dollar for dollar, regardless of which tax bracket the individual is in.

Historic tax credits are a characteristic neoliberal policy whereby the state mobilises capital markets to achieve some social welfare objective, in this case, historic preservation. Enacted by law in 1978 as an incentive and amended to its current form as a credit in 1986, historic tax credits stimulate private investment in historic preservation by providing property owners with an income tax credit that covers 20% of the qualified rehabilitation expenses accrued in the redevelopment of a historically designated income-generating property (see, for more details, Tapp 2019). From the state's perspective, tax credits foster social goods as "they promote the rehabilitation of historic structures of every period, size, style, and type … [and are] instrumental in preserving the historic places that give cities, towns and rural areas their special character" (TPS 2012:2). Advocates claim that subsidising preservation of the nation's older resources generates positive externalities that more than pay for the program (Mason 2005; Rypkema 1994). Recent estimates from the federal government suggest that throughout the lifetime of the program, more federal tax receipts have been collected than credits allotted (TPS 2019:6). Indeed, economic impact analysis of the program show that "the federal government ultimately received more than $1.20 in tax revenues for every $1.00 it provides in historic tax credits" (PlaceEconomics 2017:3). Through job creation, economic activity, and increased property values, the state generates multiplier effects while leveraging private investment at "a net benefit to the US Treasury" (TPS 2019:6).

Scholarship on historic tax credits have focused on their use in downtown revitalisation, low-income housing, job creation, adaptive reuse, improved property values, and the preservation of important cultural structures (Ryberg-Webster 2013). Yet, evidence demonstrates that these "social goods" are also a catalyst for gentrification (Smith 1998). Recent findings show that across very low-income and low-income neighbourhoods in six post-industrial cities, the historic tax credit produced market-rate units five-to-one over low-income apartments (Ryberg-Webster and Kinahan 2017). In a similar study, Kinahan (2019) found historic tax credit projects correlated to a significant increase in the median household income in neighbourhoods where the redevelopment is located. Sceptics of historic tax credits acknowledge that while they reduce the risk in tricky projects, they ultimately encourage rent-seeking behaviour as government funds are transferred to "powerful but undeserving constituencies" (Swaim 2003:38). Moreover, the exclusive focus on the social goods that the credit produces acts as a diversion from the economic and political consequences of rentiership engendered between the state, developers, and the banking industry.

Complex provisions in existing tax law—enacted in 1986 to curb the abuse of tax credits as tax shelters—limit the credit to passive income,[5] benefiting investors who amass sizable passive tax liabilities from elsewhere in real estate markets (Committee on the Budget–US Senate 2016:395). The current regulations around the type of income the historic tax credit offsets means most developers and households cannot use the credit themselves. Instead, property developers can monetise the credit by transferring it to banks, financial institutions, and corporations in exchange for project equity. A developer described this process in their first tax credit deal:

> I didn't realise this until much later, you don't just get the credits … You literally go out to the market and procure bids. You get a broker working on your behalf and you go out and get bids individually. That's the way it's done. Some lenders will pay 70 cents on the dollar [for $1.00 of credits], others will pay 90 cents on the dollar. It's pretty complicated on how it works. (Personal communication, 16 February 2017)

On the surface, this appears to be little more than a sale. However, historic tax credit regulators like the Internal Revenue Service prevent developers from selling the credit outright to investors. To comply with regulation, property developers and investors concoct elaborate business partnerships to manoeuvre credits between both parties (OCC 2017). Despite the fact that "buying" tax benefits like tax credits necessitate complex ownership arrangements that decrease their liquidity (Hanchett 1996), historic tax credits "earn attractive rates of economic returns" for investors (OCC 2017:17). Measured in the real estate industry as internal rates of return (IRR), historic tax credits have "consistently been above after-tax, five-year Treasury yields" (OCC 2017:3).

Conducting research into tax credit markets is far from straightforward. As noted by other historic tax credit researchers (Ryberg-Webster and Kinanhan 2017), the federal historic tax credit database is not publicly accessible and must be obtained through a Freedom of Information Act request to the National Park Service. Further, the agency within the National Park Service who administers the credit, Technical Preservation Services, does not keep record of who is awarded the credit. Capturing a picture of the investor market is further clouded by the fact that much of the financing for historic tax credit deals occurs under partnerships that shield the names of the investors and developers in the project. Only the Internal Revenue Service keeps record of who files the credit, and they do not disclose taxpayer information to the public.

This paper sheds light on a mysterious market and forges an empirical path that moves scholars closer to understanding how tax investments benefit shareholders at the expense of the state. The empirical findings presented in this paper draw on semi-structured interviews, participant observation at an industry conference, and a dataset of all historic tax credit projects between 2001 and 2018 (n=13,598). Semi-structured interviews occurred between September 2016 and November 2017 with property developers (10), accountants (3), preservation consultants (8), regulators (12), and financial institutions and bankers (4), all of whom were actively working in the tax credit industry; many of whom worked exclusively in the industry for at least the last 10 years. Conversations focused on tax credit deal structuring and the impact of the financial crisis on the industry. Interview data were supplemented by 40 hours of participant observation at a tax credit industry conference held in September 2016. The conference delivered content on emergent industry-wide best practices, including how to interpret Internal Revenue Service regulations without being audited, innovations in legally structuring deals, profit-maximising strategies in the face of changing federal and state tax law, and networking opportunities to match investors with developers, accountants, and lawyers. A voluntary public poll conducted by the conference organisers revealed that participants worked in the industry for less than five years (20%), five–ten years (40%), and more than ten years (40%). Participants' professions included syndicators (27%), developers (7%), and business services (66%) such as preservation consultants, architects, and bankers. Interview and participant observation data are supplemented by secondary literature, including industry and governmental reports, news stories, and annual financial reports from banks. It is to the analysis of this data that this paper now turns.

Fragmented Ownership, Divided Landlord: The Rise of LLCs

Over the last two decades, one of the easiest ways to minimise risk and maximise returns in historic tax credit deals is through the use of business entities called limited liability companies (LLCs). As a relatively non-existent entity as late as the 1980s, LLCs emerged from statewide legislation first adopted in Wyoming that spread rapidly throughout the United States. Conceived as a way to eliminate the so-called double taxation[6] that corporations face, LLCs are hybrid business entities that "promise the best of both worlds—the limited liability of corporations and the favorable tax treatment of partnerships" (Hamill 2005:295–296). The distinguishing feature of a LLC is that it is a pass-through entity. Unlike a corporation where the business and their shareholders both pay taxes, a LLC is structured in such a way that it does not pay tax itself. Instead LLCs pass profit and loss on to its members who report it on their own tax filings. As Goldberg (1994:996) notes, many real estate endeavours opt to organise as a LLC because "to the extent that business can be conducted through an LLC instead of through a corporation, an entire level of tax can be avoided". By 2015, over 60% of all historic tax credit projects were owned by LLCs (TPS 2016), making them the "preferred investment structure of institutional investors" (Novogradac & Company LLP 2010:13).

In addition to their use in tax planning, LLCs carve out distinct benefit streams from an asset while limiting the risk investors are exposed to in the whole property. This is especially important in historic tax credit deals which are almost always financed by multiple equity investors. For example, industry reports and scholarly research shows that nearly all federal historic tax credits projects also use equity from federal low-income housing or new markets tax credits. And in the last two decades, an estimated 80% of all federal historic tax credit projects also sourced equity from state historic tax credits (Tapp 2019). Projects that are too big and that bring together too many different investors are perceived as risky for banks and financial institutions. One financier warns:

> We like large deals because of the tax credit volume we get, but very very large deals tend to have a hard time making sure they happen. If a project is too large there is concern that it will fall under its own weight. (Personal communication, 2 November 2016)

Given that developers layer multiple tax credits in a project's capital stack, the only way to navigate through these complex financing schemes are with LLCs that keep the investors and developers at arm's length distance from the deal itself. LLCs limit personal liability, letting "investors safely accumulate more assets and block creditors and others from going after their holdings" (Parker 2018). It is now common for both developers and investors in the historic tax credit industry to create a LLC as a project-specific subsidiary in order to [i] establish ownership interests in a deal, [ii] direct the distribution of profit within a single project, and [iii] protect the investor and developer's other assets from risk of project failure. To fully capture the importance of LLCs in property ownership, it is important to first understand how they are deployed in structuring a tax credit deal.

The Art of Structuring a Deal

Structuring historic tax credit deals take two forms—single-tier or pass-through[7]—that depend on the size of the tax credit and the complexity of the project. Tax credit experts estimate that 95% of all historic tax credit projects use the pass-through arrangement to structure deals since the 2008 global financial crisis (Personal communication, 21 September 2016).

Pass-through deals move tax credits from the state to investors, and cash from tenants to developers. As Figure 1 illustrates, pass-through deals include two partnerships: a landlord LLC that holds title to the building and is responsible for any debt (loans) associated with the project and a tenant LLC. The historic tax credit equity investor—bank or financial institution—buys a majority of ownership interests in the tenant LLC, which in turn buys a minority share in the landlord LLC. The tenant LLC receives both equity from the tax credit investor and lease payments—the income-generating activities produced by preservation—collected directly from the building's tenants that it proportionally splits between the landlord LLC and the tax credit investor. Credits eventually filter from the state to the landlord LLC to the tenant LLC, then to the parent equity investor where they trickle-down to the company's shareholders. Augmented forms of property ownership enabled by LLCs not only "redefine aspects of income and wealth as non-taxable" (Cameron 2008:1152), but also separate tax credits from the social goods historic preservation supposedly generates.

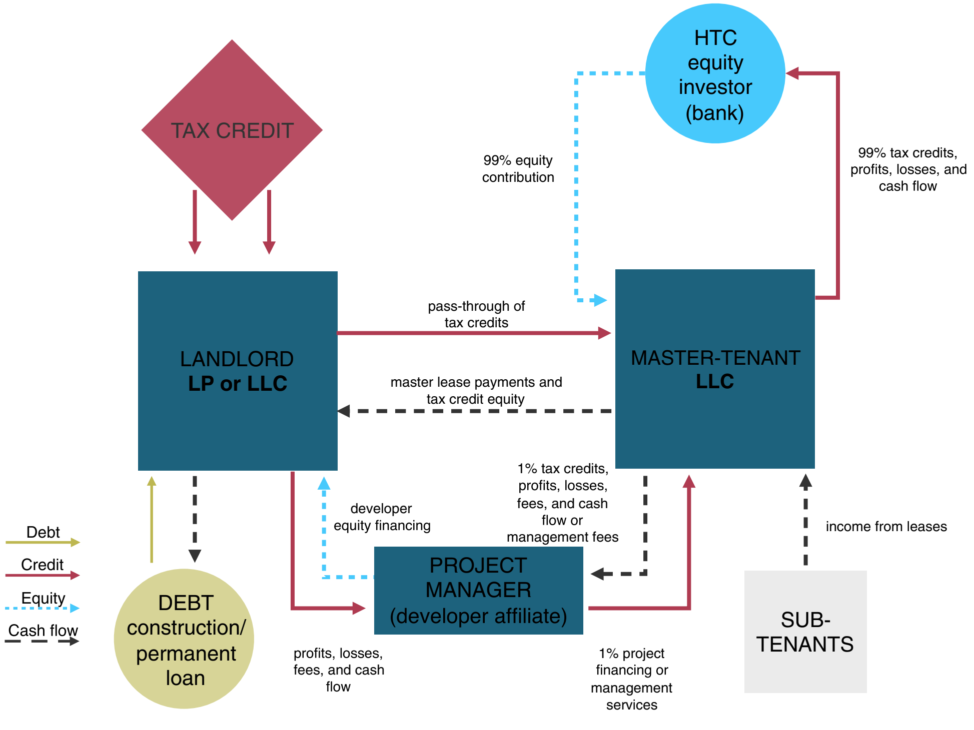

Figure 1: Pass-through structure for historic tax credit deals (adapted from the Office of the Comptroller of the Currency 2017; chart by author 2019) [Colour figure can be viewed at wileyonlinelibrary.com]

Over the last decade, the tax credit industry has quickly institutionalised pass-through structures as industry norms. National accounting firms like Novogradac and law firms like Nixon Peabody and Squire Patton Boggs sponsor industry conferences and symposiums throughout the country. There, certified public accountants and lawyers instruct other tax credit industry professionals on how to navigate tax law, establish LLCs, and construct deals that meet the "different risk tolerance" of their clients (Personal communication, 1 March 2017). While many of the precise details on structuring a deal are sold as proprietary knowledge to a client base at the conferences, a second implicit goal of these gatherings is to synchronise deal-making in the industry. Coordinated tax credit deals distribute the risk of audit over a large geographic area as identically structured deals attract less attention from the tax authorities.

Deals structured such as these have long been legal. Until 2007, there was virtually no Internal Revenue Service litigation involving federal historic tax credits (Novogradac 2017). That changed when Historic Boardwalk LLC, a partnership between the New Jersey Sports and Exposition Authority (the non-profit tasked with rehabilitating Boardwalk Hall in Atlantic City, New Jersey) and the investor (a subsidiary of the Pitney Bowes Corporation) raised flags from state and federal regulators. After their audit, the Internal Revenue Service argued to the Third Circuit in the 2012 case, *Historic Boardwalk Hall LLC vs. The Commissioner of the Internal Revenue Service*, that the investors were partners in the historic tax credit project in name, but not substance; the deal amounted to little more than a direct sale. The court agreed with the Internal Revenue Service and found evidence of widespread legal arrangements within the tax credit industry that sheltered tax credit investors from absorbing any true risk associated with a project's success (Jacobs 2013). Investors wanted the benefits of the tax credits without the risk, or as one investor reflected, "we'd just buy the credit if we could" (Personal communication, 2 November 2016). This ruling introduced ambiguity in what had been a stable market and diminished competition among investors as players like Chevron left the game entirely.

Swiftly relinquishing ownership interests in pass-through deals has become a critical aspect of restoring certainty to the tax credit market. Safe Harbor guidelines issued by the Internal Revenue Service in 2013—Revenue Procedure 2014-12—clarified permissible ownership structures of historic tax credit deals and authorised a partnership or "asset flip" as an exit strategy for investors to claim their tax credits. Asset flips begin at the start of a historic tax credit deal as the developer and investor buy interests in the partnership that holds title to the property, initially 1% and 99% respectively (see Figure 1). After 60 months, their interests automatically flip to 95% and 5% (Boccia 2014). The partnership dissolves when the developer buys out the investor, paying for their interests with tax credits. Disposing of ownership interests in this way helps investors reduce or even avoid any capital gains that conventional landlords face when they sell a property (ibid.).

Despite reregulation meant to move historic tax credits away from a disguised sale, the industry has quickly adopted safe ways to structure deals at the edges of the law. Back-end arrangements like asset flips increase liquidity in tax credit deals, while LLCs splinter off discrete revenue streams in a building. The combination of these ownership forms and techniques push historic properties away from a social good and closer to a pure financial asset (Coakley 1994), as the tax planning industry invents new ways to "disarticulate building development from ownership" (Leitner 1994:795). Fractured ownership structures that divorce tax benefits from the physical structure and social context in which preservation occurs thus provide a channel to more directly siphon rents from where they originate: the state.

Rent-Maximising with Big Deals

As the demand for tax credits has grown, many investors seek particular rates of return that can only be met by investing in large-scale projects. Projects that net upwards of $5–8 million in federal tax credits, the so-called "big deals", are the first to be financed (Tax Credit Conference, 22 September 2016). One consultant to tax credit projects described the frenzy around large projects as "the wild west" where "investors are trying to make a quick deal, but they only want things that are over $5 million in tax credits" (Personal communication, 21 September 2016). Figure 2 shows an increase in the number of historic tax credit projects before and after the global financial crisis. Big, extra big, and mega deals that incur upwards of $15 million in qualified rehabilitation expenses and thus generate more than $3 million in historic tax credits, significantly outpaced growth in all other sized deals.

Big deals edge out "small deals" which are often bankrolled by the "unused personal income" of a group of wealthy clients (Personal communication, 20 September 2016). Yet, regulations around passive income and the complexities in structuring historic tax credits make a sole investor financing a single (small) deal the exception, rather than the rule. Instead, syndicators bundle various, scattered projects into one package that they broker to an investor. Like the big deals, syndicators reported assembling $5 million of credits even if "it just happens to be in 25 projects" (Personal communication, 2 November 2016). The focus on deal size produces uneven value across historic properties, and gives rise to divergent geographies of portfolio acquisition.

Even though syndicated small deals mimic the economic logics of large deals, many banks and financial institutions prefer to build a portfolio of tax credit investment based on a small number of large projects. A financier explained the preference for big deals:

> It's about efficiency, plain and simple. Pointy head bankers and investors want to get the most bang for our buck. In our budget forecast, we want $100 million of this type of tax advantage investment and we want to get there as painlessly as possible in terms of transaction costs. [This is] because it costs the same amount to do a smaller building that isn't going to deliver as much qualified rehabilitation expenses as it does for a larger building, in terms of setting up the partnership arrangements and documenting and papering the deal. It really is a cost-benefit-analysis that does squeeze smaller projects. (Personal communication, 2 November 2016)

	2001-2008	2009-2018	% Change
Extra small <$1 million	3173	4390	38.35%
Small $1-5 million	1097	2345	113.76%
Medium $5-15 million	453	1167	157.62%
Big $15-50 million	176	608	245.45%
Extra big $50-100 million	29	105	262.07%
Mega >$100 million	9	46	411.11%
Total	4937	8661	75.43%

Figure 2: Count of tax credit deals, size determined by qualified rehabilitation expenses, 2001–2008 and 2009–2018 (data from Technical Preservation Services; chart by author 2019)

Given that historic tax credit projects generate similar transaction costs regardless of the project's size (Coase 1992), big deals benefit large scale investors with access to in-house lawyers and accountants required to minimise legal, accounting, and preservation consulting fees.

Large deals provide investors with two ways to maximise rents on tax credit investment. First, big buildings net more tax credits because the amount of credits awarded to the investor is derived as a fraction of qualified rehabilitation expenses. For example, $50 million in qualified rehabilitation expenses net investors up to $10 million in historic tax credits. This is a high-cost but high-reward investment strategy that capitalises on a building's square footage to increase the size of the tax credit. It also creates perverse incentives for developers to seek out more extensive projects. Developers have found that in undertaking a tax credit project they no longer need to search for equity—the "hardest money to raise"—because investors actively pursue them (Personal communication, 22 February 2017). Figure 3 illustrates the amount invested into tax credit projects by deal size between 2001 and 2018. Adjusted for inflation, 215% more capital went into historic tax credit deals after the crisis, with the largest growth of investment occurring in big (250%), extra big (294%), and mega (460%) deals.

Second, big deals maximise rent extraction when a project's cash flows co-mingle with tax credits and can be diverted to investors. Reregulation in the industry stemming from the Boardwalk case now requires investors to start holding upside potential or downside risk. As a result, investors treat tax credits as commercial real estate transactions, meaning they except to receive cash flow commensurate with their ownership interest as a preferred return (OCC 2017). Accountants structure deals for investors that yield annual priority returns on cash flows that ranged from 2% to 3% of the equity contribution (Personal communication, 4 March 2017). Using the tax law gymnastics described in the previous section,

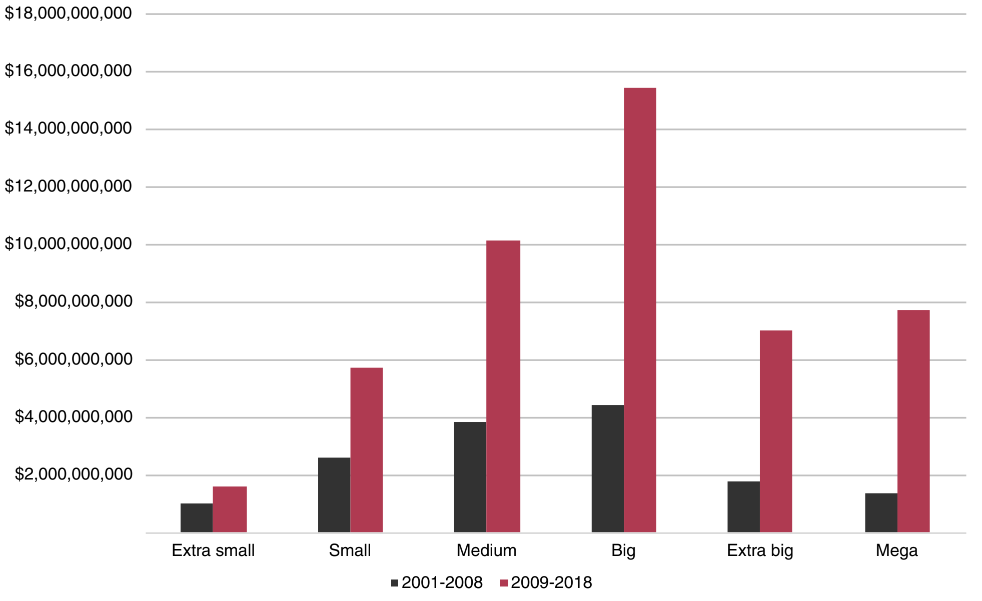

Figure 3: Total qualified rehabilitation expenses in tax credit deals adjusted to 2018 dollars, 2001-2008 and 2009-2018 (data from Technical Preservation Services; chart by author 2019) [Colour figure can be viewed at wileyonlinelibrary.com]

large buildings create opportunities for investors to access cash flows associated with the leasable space, at the same time these legal arrangements demonstrate a profit motive necessary for a partnership to not be classified as an outright sale.

Using these rent-maximising strategies, investors have exploited low levels of competition in the market and the uncapped feature of the credit program (OCC 2017). Without limits on the redevelopment costs of a single project or the amount of national tax credits to be awarded annually, investors have a bottomless well to cheaply source profit. Even with upside potential (cash flows), tax credits for big deals are routinely priced below their nominal value (Personal communication, 20 September 2016). For example, investors can pull $1.00 of historic tax credits from the state's coffers for $0.70–$0.90,[8] depending on the project's "size, structure, location and market" (OCC 2017:8). Gaps between the market price and nominal value of the credit matter because they allow investors to capture a larger slice of the infinite public purse with bigger deals.

Postcrisis Financial Regulations and Investing for Shareholder Returns

Financial institutions and banks have targeted tax credits as a response to the tightening of the markets and the reregulation of lending practices that followed the 2008 global financial crisis (Badler 2017). Yet, in spite of postcrisis financial regulation, there has been what Chronoplouos et al. (2015) identify as "profit persistence" in the banking industry. While monopolistic conditions derived from industry concentration, barriers to entry, and collusion have certainly helped banks generate new sources of income (Christophers 2018), American banking giants like Bank of America, US Bank, PNC Bank, and JP Morgan Chase and a number of smaller community banks have engaged in tax credit investments that offset federal and state taxes while fulfilling federal lending obligations.

Tax credits have been steadily recast as an asset class that fulfils two major pieces of federal financial regulation: the Community Reinvestment Act and Dodd-Frank. Requirements of the Community Reinvestment Act of 1977 mandate that banks lend equity in low-income communities where they take deposits. To comply with this regulation, major banks and financial institutions established subsidiary organisations called community development corporations to target new markets and customers, especially low-to-moderate income populations and the underbanked (Wyly and Hammel 2001). With bank-owned community development corporations acting as intermediaries, national banks and financial institutions have quickly penetrated local real estate markets, funnelling capital into tax credit projects in low-income neighbourhoods that previously—pre-crisis—fell short of the bank's lending policies (Badler 2017).

The second major factor causing the increased volume of investment in the credit market is the 2010 Dodd-Frank Wall Street and Consumer Protection Act. The Volcker rule,[9] named after former Federal Reserve Chairman Paul Volcker, bans banks from trading securities and derivatives with their own money and restricts their ownership interests in hedge funds and private equity funds. Designed to discourage banks from risky investments, historic tax credits constitute a notable exemption to the Volcker rule. The contradictions and tensions in Dodd-Frank (Ashton and Christophers 2018), specifically the fact that tax credits satisfy anti-speculation regulation, has encouraged banks to account for the majority of investors in the historic tax credit market (OCC 2017).

As banks and financial institutions have pivoted towards tax credits, many have shied away from debt lending altogether. One financier states:

> Our group has two arrows in its quiver when it comes to historic revitalisation projects. One is in investing and monetising the tax credits. Here is where we become an equity partner in the transaction with the developer. Then we structure it [the deal] legally allowing us to utilise and have the credits flow to us. Two is the debt or lending piece. Sometimes we lend on the projects we invest in. The majority of the time we are just the [credit] investor and the developer has a relationship with another debt lender or has the cash or money from some other source. (Personal communication, 2 November 2016)

The shift from debt lender to equity investor has accelerated after 2008 when the "onset of the financial crisis caused an increased focus on expense management, including reducing taxes" as a way to increase shareholder value (Ernst and Young 2012:2). As such, "many large banks have learned to embrace tax credits as a method to reduce tax liability and earn a competitive return on capital" (Badler 2017).

Generating Shareholder Value

Tax credits save banks millions of dollars in taxes in a single year and as a corporate strategy, investing in tax credits is highly lucrative for shareholders. A number of financial institutions and banks "chopped" their effective tax rate in half with credits (Peters 2014). For example, one Buffalo-based community bank—Evans Bancorp—reportedly lowered their tax rate from 31.5% in 2012; to 18% in 2013; and 7.9% in 2014. The decline was a result of "investing in community projects which generated historic tax credits" (Evans Bancorp 2014:41). One financier who works for a different financial institution explained:

> Tax credits have a tax advantage return to us. And the bank likes that, right? Shareholders like that we are offsetting our federal tax bill to the government, as a result of monetizing these credits. (Personal communication, 2 November 2016)

Like other firms, banks and financial institutions pass these "savings" on to shareholders through dividends and stock buybacks (Lazonick and O'Sullivan 2000). Evans Bancorp opted for the later. In March 2013 as the bank's effective tax rate was falling, Evans Bancorp's board of directors approved a stock buyback program for 100,000 shares of its stock on the "belief in the strength of Evans' balance sheet and the company's commitment to delivering value to shareholders" (Buffalo News 2013). Reducing the number of overall shares lifted the earnings per share from a low of $12.80 on 1 January 2012 to $24.31 on 31 December 2014.[10]

Shareholders realise short-term increases in stock prices in what is "effectively stock-price manipulation" (Lazonick 2014:50). However, the real beneficiaries of buybacks are corporate executives whose compensation comes from stock-based instruments (ibid.). This is especially significant given that in 2018, the Federal Reserve rolled back regulatory burdens for big banks and financial institutions, and approved the distribution of a "flood of payouts" to shareholders (Eavis 2018). Bank of America, Citibank, JP Morgan Chase, and PNC Bank, among other tax credit investors, immediately initiated new buyback plans (Peters 2018). At the end of the year, compensation for CEOs at the above listed banks and financial institutions increased on order of 5-36% (Russell and Williams 2019). To compound the problem, the practice of remunerating executives with these corporate "profits" coincides with a drop in the marginal income tax rate for the highest earners.[11] Thus, not only do high net worth individuals, the banking industry's "shareholders", pay less than ever in taxes (Piketty 2017; Saez and Zucman 2019), but their income—which in the case of tax credits comes from the state—is permanently insulated from future taxation.

Conclusion

This paper asked how tax credits generate shareholder profits after the 2008 global financial crisis. It answered that question by combining rent theory rooted in political economy (Haila 2016; Harvey and Chatterjee 1974; Ward and Aalbers 2016) with an approach to financialisation that emphasises the primacy of shareholder value in corporate governance (Lazonick and O'Sullivan 2000; Rutland 2010; Wissoker 2016). An emphasis on rent reveals how sophisticated legal vehicles and structures mutate landownership, a factor that is particularly useful in understanding tax credits as redistributional rents (Walker 1974). Banks and financial institutions pivoted towards tax credits to boost profitability in a regulated sector. Yet, many of the pathways that redistributional rents take—from the state to the shareholder—follow the route of stock buybacks, enriching executives with taxpayer-subsidised funds.

As the rest of these concluding remarks will discuss, the findings of this paper broadly call attention to an increasingly regressive form of state redistribution. Here, the paper considers three key points for future research. First, the reliance on clever deal structures blur the lines between delivering historic preservation and redevelopment as a social good and producing it as a financial asset. Many of the twists and turns in deal structuring exist to legally sell real estate tax benefits to investors who aren't interested in being landlords. What appears is a 21st century version of Massey and Catalano's (1978) "financial landlord". Investors make a majority ownership stake in a landlord entity to capture the tax credit stream from the building, while LLCs and pass-through structures sever investors from the risk and social context in which historic preservation occurs.

Second, historic tax credits are lauded as a ubiquitous way to preserve all of the nation's resources, yet the demands for big buildings suggest unevenness in the market that is playing out in the urban form. Industry practices and regulatory compliance encourage the redevelopment of large-scale buildings at the expense of small projects. Disparity in the market price and nominal value that exists in the industry enables a process of financialised accumulation by which banks and financial institutions amass large amounts of tax credits at deep discounts. Moreover, because pricing for credits often includes access to cash flows—something older buildings supposedly have difficulty generating—big historic properties can be highly profitable in their own right. If that is the case, then why is the market underpricing the redevelopment of these buildings and at what cost to the public?

Finally, the short-term gains for investors have long-term impacts on the state. Tax credits are largely an invisible national revenue loss that increasingly claim an outsized portion of the welfare state's budget (Howard 1999). The multiplier effects of the tax credit—which are instrumental to its public justification—fail to account for the ways the credit amplifies the hollowing out of the state, like how tax credits lower corporate tax rates, which trigger stock buybacks that enrich executives who pay lower personal taxes on these "earnings". In fact, these multiplier effects would be better understood as an "inequality spiral" (Saez and Zucman 2019:22). And yet, rather than enacting a tax code to redistribute wealth downwards, recent tax legislation has intensified the ways the system pulls wealth upwards. This case is an important reminder that tolerating the extraction of rents from the state is a collective choice. Future struggles to (re)build a more progressive welfare state thus depend on confronting the tax profiteering strategies of rentiers in real estate and reclaiming the tax system as a political terrain.

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Endnotes

[1] Others include the low-income housing tax credit (LIHTC) and the new markets tax credit (NMTC).

[2] Recognised by the United States tax code, depreciation allows property owners to write-off the physical wear and tear each year from their taxes.

[3] Monopoly, absolute, and differential rent 1 and 2.

[4] $500,000 × 0.35 = $175,000.

[5] All income falls into three categories: active, passive, and portfolio. These categories matter not only for the rates in which real estate profits are taxed, but also for the ways that tax benefits become shareholder profits. Examples of active income include income from wages and salaries; portfolio income includes interest, dividends, and sales of stock; and income from real estate is considered passive income. Notably, REITs, which are considered a type of tax-advantaged pass-through company, are required to pay out 90% of their taxable income—cash flows from their portfolio of properties—in the form of dividends to their investors. Dividends from REITs are treated as active income by the IRS and for that reason companies structured as REITs cannot invest in tax credit markets.

[6] Corporations are taxed on earnings and their shareholders are taxed on their dividends.

[7] Also called a master-tenant structure.

[8] This continues to be the case even after the 2017 Tax Cut and Jobs Act lowered corporate tax rates. In the year following the tax law change, industry analysts report "prices from the high 80s to the low 90s" for historic tax credits (Leith-Tetrault 2018).

[9] Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

[10] https://finance.yahoo.com/quote/evbn/

[11] The 2017 Tax Cuts and Jobs Act lowered the top marginal income tax rate from 39.6% to 37.0%.

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