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Law Practice Concentrating in Affordable Housing and Community Development Law

New Markets Tax Credits for Developers
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I. **Background**

a. Codified in Section 45D of the Internal Revenue Code, the New Markets Tax Credit (NMTC) program was enacted in the 2000 with the goal of stimulating economic and community development and job creation in low-income communities.
b. NMTC encourages private capital investment in low-income communities.
c. NMTC Program is administered by the Community Development Financial Institutions Fund (CDFI Fund), an arm of the U.S. Treasury Department.
d. NMTC allocation authority is awarded on an annual basis to applicants that qualify as Community Development Entities (CDE).
e. Applications for the eighth (2010) application round are currently being scored and $5 Billion in NMTC allocation authority was awarded to CDEs in 2009.
f. Through the 2009 Fiscal Year reporting period, CDEs have disbursed a total of $15.8 Billion in NMTC investment proceeds. With approximately 63% (or roughly $10 Billion) going to real estate businesses.

II. **Essential NMTC Acronyms**

a. Developers using NMTC for the first time will notice that the funding partners, lawyers and consultants that work with NMTC constantly use abbreviations for key NMTC terms and it is important to learn them all quickly.
b. <u>CDE</u> – "Community Development Entity" is a corporation, partnership or LLC that is certified by the CDFI Fund as an entity with a primary mission to serve or provide capital to low-income communities or low-income person. CDEs apply to the CDFI Fund for NMTC allocation authority and CDEs sub-allocate NMTC authority to specific transactions.

c. LIC – “Low Income Community” is a census tract with (a) a poverty rate more than 20% or (b) median family income less than 80% of the applicable area median income.
d. QEI – “Qualified Equity Investment” is the equity investment in a CDE that triggers the availability of the NMTC to the equity investor. CDEs must use substantially all the proceeds of a QEI to make QLICIs within 12 months of receipt.
e. QLICI – “Qualified Low-Income Community Investment” is an equity investment in or a loan to a QALICB from a CDE.
f. QALICB – “Qualified Active Low-Income Community Business” is a corporation, partnership or LLC that is qualified to receive QLICIs.

III. **QALICB Requirements**

a. Single purpose entities that are formed for the purpose of holding title to real estate typically have no difficulty meeting and continue meeting the QALICB test. QALICBs that are a single member limited liability company should be careful because single member LLCs are disregarded for federal tax purposes and therefore the QALICB test is with respect to the sole member.

b. A QALICB is any corporation (including not-for-profits) or partnership engaged in the active* conduct of a qualified business* that meets all five of the following requirements:
*These definitions to be discussed below

1. Gross Income – 50% of gross income of the business must be derived from active conduct of a qualified business in a LIC, however, this requirement is met if the tangible property test below is met at a 50% threshold.
2. Use of Tangible Property - At least 40% of the use of tangible property of the business is within a LIC;
3. Services - At least 40% of the services performed by the employees of the business must be within any LIC, however, if the business has no employees, this test is satisfied if the tangible property test above is met at an 85% level;
4. Collectibles – Less than 5% of the average of the aggregate unadjusted basis of the property of the business can be attributable to collectibles like antiques, stamps, baseball cards, etc., not including collectibles held primarily for sale to customers.
5. Nonqualified Financial Property – Less than 5% of the average of the aggregate unadjusted basis of the property of the business can be attributable to stock, debt, partnership interests, options, futures etc, not including reasonable amounts of working capital. Cash reserves and other accounts are included in this definition and therefore it is important to

make sure that during the compliance period, these cash accounts are remain less than 5% of the unadjusted basis of the businesses property.

c. Active Conduct – a QALICB is engaged in the active conduct of business when it reasonably expects to generate revenues within three years after the QLICIs are made or, in the case of a not-for-profit if it is engaging in activity that further its charitable purpose.

d. Qualified Business - Generally, any trade or business except:

(1) QALICBs and tenants in QALICB owned buildings cannot operate a country club, private or commercial golf course, massage parlor, hot tub facility, suntan facility, racetrack or other gambling facility, store the principal business of which is the sale of alcoholic beverages for consumption off premises (bars and grocery stores are usually qualified); and

(2) Rental of real property that is residential rental property as such term is defined in Section 168(e)(2)(a) of the Code to mean any building or structure if 80% or more of the gross rental income from such building or structure within such taxable year is rental income from dwelling units.

(3) Although the combination of both LIHTC and NMTC credits is difficult because most LIHTC buildings are residential rental property, condominium structuring may be used to allow for LIHTC to be utilized in the same structure as NMTC.

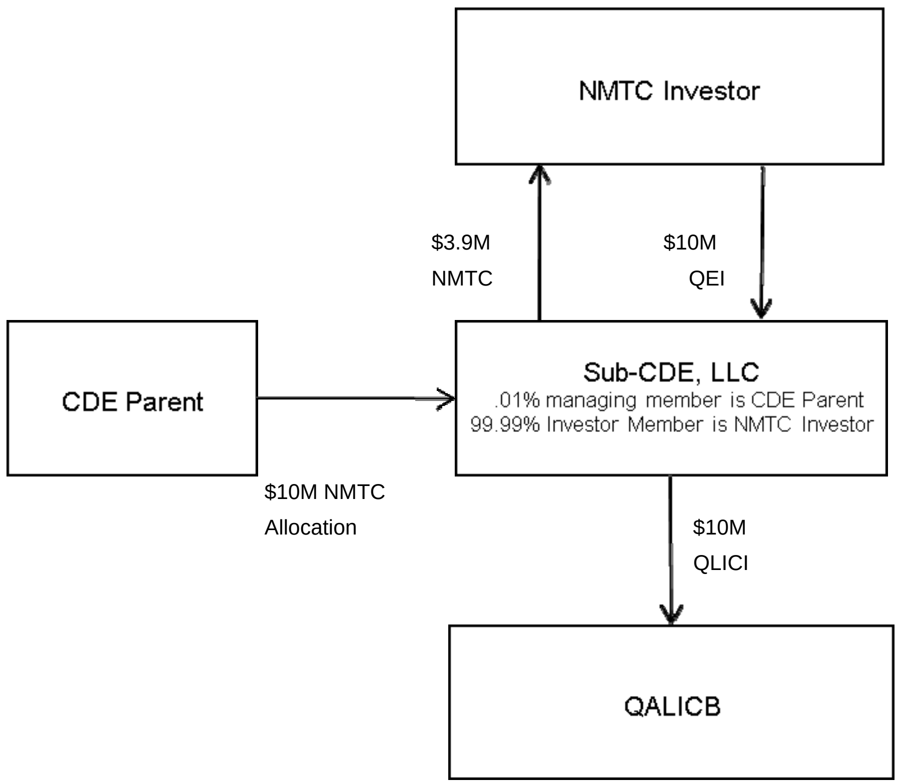
IV. **NMTC Structure**

a. The NMTC is equal to 39% of the QEI and a portion is claimed by the investor each year over a seven year NMTC compliance period, i.e. 5% in years 1-3 and 6% in years 4-7.

b. CDE's must use substantially all (at least 85%) of the QEIs to make QLICIs which must remain invested in QALICBs for the full seven years compliance period that commences on the day the QEI is made. This means that no principal repayment or return of capital is permitted during the compliance period unless the CDE redeploys such capital within a 12 month period, otherwise recapture of NMTC can result.

c. Unlike Rehabilitation Tax Credits and Low-Income Housing Tax Credits, the amount of NMTC available to an investor is not dependent on the capitalized expenditures on the underlying real property but rather is solely a function of the amount of the QEI and a NMTC Investor need not own an interest in the owner of the underlying real property being developed. Some other different attributes of these credits include the duration of the compliance period and state involvement (i.e. no state involvement in NMTC transactions is necessary).

d. Sample simple structure flow chart:



e. Note in the example above, the investor would expect a real cash return of its equity in seven years because the benefits generated by the NMTC are much less than the QEI contributed.

Contrast this with a LIHTC or HTC transaction where the investor yield is largely a function of the tax credits generated with little or no expectation by the investor of a cash return of its equity.

The return provided by the NMTC provides flexibility on the terms that can be offered by the CDE to the QALICB on a loan or investment.

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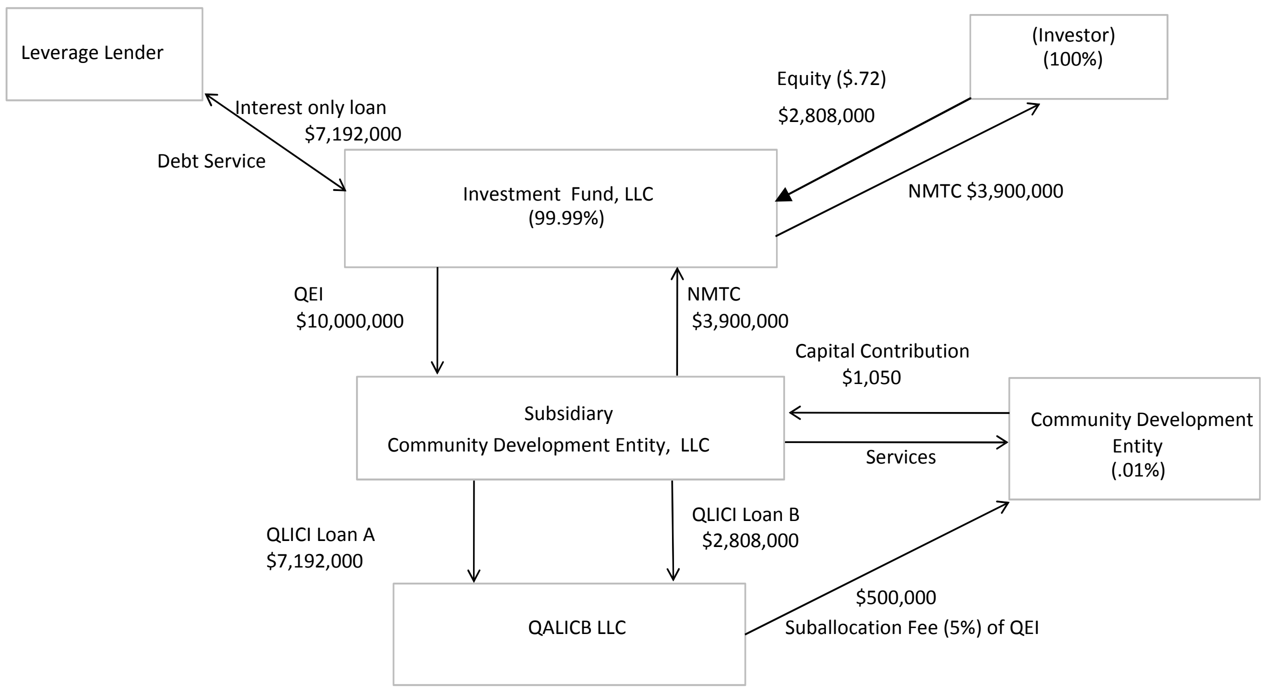
f. In order to enable the yield on investments in NMTC transaction to be solely a function of the value of the NMTC delivered, the industry has developed the so-called “leveraged” transaction structure which is typically utilized in real estate transactions.

   This structure allows the debt, grants or owner equity that is already needed to finance the transaction to be utilized as part of the QEI.

   When these sources are pooled together with the NMTC equity, this provides enough capital to make the total QEI with the NMTC investor allocated all the NMTC available while only contributing a portion of the equity needed to make the QEI.

g. In the leveraged model, an investment fund (usually an LLC) is formed for purposed of pooling funds that will be used to make the QEI to the CDE. The NMTC investor is usually the 100% member or 99.99% member of the investment fund and makes a capital contribution to the fund in an amount such that the after tax internal rate of return on such equity investment is anywhere from 7.8% to 12%, which generally equates to $.69 - $.75 in equity paid per NMTC delivered.

h. Sample leveraged structure flow chart on the following page:



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i. The QLICI loans made by the CDE to the QALICB usually bear the same characteristics as the source of funds to the Investment Fund they relate to.

   In the example above, the QLICI Loan A is related to the leveraged loan to the Fund (which in this example is conventional debt), as such, it will have very similar terms which are usually market rate interest only payments with a seven year maturity and collateralized by a mortgage.

   The QLICI Loan B is related to the equity contribution the investor made to the Fund and as such it is debt with equity like features, i.e. nominal interest rate, long term maturity, deferred principal and interest payments and collateralized by a mortgage.

   It often occurs that, in order to show the CDFI fund that more than one below market loan was made, a CDE will want to blend the interest rates of the QLICI Loan A and B such that the total interest paid by the QALICB stays the same but the interest rate on the QLICI A Loan will be lower and the interest rate on the QLICI B Loan will be higher (but still below market).

j. Note that often times grant proceeds and owner equity can be used to fund the Investment Fund as a soft leverage loan. Typically, grants would be funded to a tax exempt entity (to avoid grant income to the Investment Fund) which in turn will make a loan of the grant proceeds to the Investment Fund. Similarly, an affiliate of the QALICB owner may be capitalized with equity and make a leverage loan to the Investment Fund in the same amount.

Owner equity that has already been spent on predevelopment costs or otherwise can be unlocked and used to fund the Investment Fund utilizing a one-day loan mechanism. This works by having a conventional lender make a loan expected to be outstanding only on a short term basis, usually one day, to the Investment Fund. The Investment Fund combines these proceeds with other leveraged sources and equity to make the required QEIs. The proceeds from the QLICIs are then used to reimburse the developer for the costs it has incurred to date. The developer, or an affiliate, then uses those proceeds to purchase the one day loan so that it is a long term lender to the Investment Fund.

k. Respecting the NMTC structure: This is a mantra that developers will see frequently when trying to structure a NMTC transaction. Often times grant proceeds or soft loan sources come with strings attached such that an owner must comply with certain use restrictions for a period of time. It is sometimes challenging structuring a soft loan with strings attached as a leveraged loan because the lender does not have contractual privity with the ultimate owner QALICB as a result of the NMTC transaction structure. It can be a difficult and time consuming process to convince grantors and soft source financing to participate as a leverage lender for these reasons. Timing of soft grant sources is also often problematic as cash is needed up-front to fund the QEI but many grant programs are on a reimbursement funding basis. As such a bridge loan is often required to fill the timing gap.

l. Mortgages: Another hurdle in convincing lenders to participate as leverage lenders in NMTC transactions is that a leverage lender may not have a direct mortgage on the property securing its loan to the Investment Fund as the borrower, i.e. the investment fund, does not own the real estate.

If the leverage lender has a direct mortgage, this would not respect the structure and it would look to the IRS as if the leverage lender were making a direct loan to the QALICB that could jeopardize the NMTC.

In lieu of a Mortgage, the leverage loan will be secured by a pledge of the Investment Fund's membership interest in the CDE. If the QLICI loans are in default and the CDE forecloses, the leverage lender has leverage to cause the proceeds from such foreclosure to be distributed to the Investment Fund to use to repay the leverage loan.

However, investors will typically require the leverage lender to forebear on enforcement of the pledge of the Investment Fund's interest in the CDE or enforcement actions against the

Investment Fund during the compliance period. This is necessary to ensure that the QEI is not redeemed during the compliance period, which could jeopardize the NMTC.

m. Exit Strategy: Typically, following the end of the seven year compliance period, the investor will exit the transaction by exercising a put option for a nominal payment whereby it will put its membership interest in the investment fund to an affiliate of the QALICB. Care should be taken when structuring this component of the transaction so as to not create cancellation of indebtedness income resulting from the new member of the investment fund (which is a 99.99% member of the CDE and therefore essentially the lender to the QALICB) being deemed related to the QALICB borrower.

n. CDE allocations. Typically there are limits to the amount of NMTC authority any one CDE will allocate to a single transaction. This range is usually within the $10-$15 million. As such, for particularly large transactions, we typically see more than one CDE to allocate NMTC authority to your transaction. This adds to the complexity of the structure of the transactions through paperwork and costs.

V. Is the Juice Worth the Squeeze

a. What are the net benefits of using NMTC for your real estate project? As you can see from the example above, the equity contributed to the transaction in exchange for NMTC is equal to $2,808,000.

After (1) fees paid to the CDEs (usually 7-10% of the QEI a portion of which is typically payable at closing with the balance paid each year from a capitalized reserve),

(2) fees paid to lawyers, accountants and consultants, if applicable (usually the CDE, Investor and QALICB are represented), and

(3) expenses related to CDE audit and investor asset management (typically about $35,000 annually for seven years),the net benefit to the transaction generally ranges from $.40 to $.50 per NMTC depending on various factors like transaction size and CDE fee structures. Given that attorneys fees and audit and management fees are generally fixed costs, the smaller the transaction, the less benefit available from the NMTC. As a general rule, the greater the QEI, the greater per credit net benefit received from the NMTC.

b. The extra time, expense and complexity involved with NMTC are typically justified by the rational that the $.40-$.50 per credit net benefit is found money.

It takes time to find a CDE with allocation, find a NMTC investor, find a leverage lender and get all project participants and funding sources on board with the proposed structure.

Once a team is assembled with all the necessary partners, a transaction can move relatively quickly toward closing.

Plan on at least 4-6 months for this process to be completed, which timing may vary widely depending on the number of CDEs involved, transaction complexity and a myriad of other factors.

c. Guarantees: In addition to guarantees typically associated with borrowing, such as a guaranty of completion and payment, Environmental indemnification, etc., the developer will be expected to guaranty the yield generated by the NMTC to the investor.

Most of the potential triggers of recapture are within the power of the QALICB to control. For example, the QALICB must continue to be a QALICB for the term of the compliance period. Investors typically do not carve out recapture risk associated with change in law but typically will carve out recapture that result from actions of the CDE for which the investor will receive a separate indemnification from the CDE.

One of the greatest risks is that a tenant of QALICB will ignore the terms of its lease and engage in one of the NMTC prohibited activities discussed earlier which jeopardizes the status of the QALICB economic nonperformance of the transaction during the compliance period can lead to recapture.

If the QLICI loans are in default, the CDE could potentially foreclose on the property. Any proceeds attributable to the principal amount of the QLICI from such foreclosure need to be redeployed by the CDE in another QLICI within 12 months in order to avoid a recapture. Landlords and property managers must be particularly vigilant in overseeing activities of tenants for this reason.

d. Reporting: As part of the NMTC participation, CDEs are required to report various community and economic impacts of their investments to the CDFI Fund. As such, QALICB will be required to provide annual reports with respect to such community and economic impact as, for example:

(a) The amount of development attracted or catalyzed by the project;
(b) The amount of permanent full time jobs created and maintained by the project;
(c) The amount of construction jobs created by the project;
(d) The amount of targeted jobs to low-income persons or residents of low-income communities;
(e) How the project increased the provision of goods and services to low-income persons or residents of low-income communities;
(f) How the project financed or assisted minority-owned businesses, or businesses owned by low-income persons;

(g) How the project facilitated the development of rental housing units in the community, especially units that were offered to low-income persons or residents of low-income communities;
(h) How the project created environmentally sustainable outcomes; and
(i) How the project facilitated or provided economic stabilization for the area.

e. Summary: the introduction of NMTC adds a significant layer of complexity to a real estate transaction and some additional potential risk associated with the NMTC guaranty. Developers must weigh the potential net benefit (including time considerations) to the transaction with these factors. Generally, for those developers willing to deal with complexities, the NMTC offers developers a way to plug budget gaps with low-cost capital, with manageable incremental risk.

VI. How Do I Start?

a. Confirm with resources available online or through professionals that your property does in fact reside in a low-income community census tract.

Have a Story: In order for CDEs to obtain allocations of NMTC from the CDFI Fund, they must make certain promises and are held accountable for keeping those promises which are evidenced in an allocation agreement each CDE enters into with the CDFI Fund.

The more community and economic impact a project has or will catalyze in the future, the more attractive it will look to CDEs who, in many cases, must participate in transactions in highly distressed areas. Ideal projects will also have a need for the NMTC subsidy such that the transaction would not be feasible but for the NMTC assistance.

Projects that will provide community services (for example a medical clinic or charter school) or provision of essential goods (such as a grocery store) to a low-income community are also attractive to CDEs.

Also, Establish a Pro Forma: Although you may have a great story to tell, the transaction must still pass the underwriting scrutiny of investors and lenders. As such, it is important to have development and operating budgets that meet investment and/or lending criteria. These budgets, along with proposed transaction structure and project description are passed on to investors to review.

CDEs, accountants, consultants and lawyers can often assist with finding investor and lender partners and assembling budgets and structuring proposals.

b. Sign a term Sheet: Once the CDE, investor and lenders are in place, a term sheet memorializing the proposed investment and/or loan terms are typically executed.

c. Closing: Weekly conference calls commence, due diligence checklists are generated, documents are generated and negotiated, transaction structure is finalized, comprehensive financial forecast is approved, legal opinions are rendered and flow of funds are prepared.