



Articles

Using New Markets Tax Credits to Finance Commercial Real Estate Development

Eric Usinger

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Eric Usinger (eusinger@emmetmarvin.com) is an attorney in the New York office of Emmet, Marvin & Martin, LLP. Usinger’s practice focuses on the financing and development of commercial real estate projects, including those incorporating federal and state Low Income Housing Tax Credits, New Markets Tax Credits, and other affordable housing and community development funding sources.

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I. Introduction

Ten years have passed since the bipartisan efforts of Congress and President Clinton led to the establishment of the New Markets Tax Credit (NMTC);¹ in that time, the program has had a remarkable impact on the development of commercial real estate in low-income communities. In raw numbers, NMTC financings have generated nearly \$10 billion in new real estate loans and investments. These projects have been diverse and many. Of the 4,430 NMTC transactions closed through 2010,² almost half have been real estate related projects consisting of, among others, new and expanded “fresh foods” grocery stores, charter schools and other educational facilities, job-creating industrial centers, day care services, medical facilities, office space, restaurants and other retail services, residential housing, and social and other support services. These projects have added nearly seventy-five million square feet of new and rehabilitated commercial space³ together with nearly 161,000 construction sector jobs,⁴ the majority in communities afflicted with unemployment rates exceeding the national average by at least 150 percent.⁵

The NMTC has changed the economic landscape for commercial investment in low-income communities and, in many ways, complements the Low Income Housing Tax Credit (LIHTC) and other available federal and state affordable housing programs. Indeed, creative affordable housing developers have used the NMTC to add complementary retail and other

1. The NMTC was enacted as part of the Community Renewal Tax Relief Act of 2000 and is codified in I.R.C. § 45D.

2. CMTY. DEV. FIN. INSTS. FUND, U.S. DEP’T OF THE TREASURY, PERFORMANCE AND ACCOUNTABILITY REPORT, FY 2010 (2011).

3. *Id.*

4. *Id.*

5. A recent study found that 61 percent of NMTC investments are made in communities with unemployment rates exceeding 1.5 times the national average. NEW MARKETS TAX CREDIT COAL., THE NEW MARKETS TAX CREDIT: 10TH ANNIVERSARY REPORT (Dec. 2010).

necessary services to or near affordable housing projects in ways that have enhanced their marketability and attractiveness.

Unlike the LIHTC, however, which can often generate sufficient capital to finance an overwhelming portion of a project's total development cost, the economic benefits afforded by participation in the NMTC program are more limited. Accordingly, NMTC developments rely heavily on private sector resources. Moreover, it is a fundamental program requirement that any financial institution utilizing NMTCs consider whether a project would be possible "but for" the availability of NMTCs.⁶ To that end, the highest and best use of the NMTC is to assist those projects that are competitively disadvantaged in terms of market support but are necessary for community revitalization and require supplemental financial assistance.⁷

The NMTC is a flexible program that allows for creative utilization and innovative structuring across a wide range of projects.⁸ In fact, the implementing regulations specifically allow the use of the credit with other federal tax credits;⁹ and experienced developers have used the NMTC in

6. NMTC allocations are competitively awarded based upon a set of criteria that the U.S. Treasury Department's Community Development Financial Institutions Fund has determined will increase the effectiveness of the credit and ensure the distribution of capital in accordance with the program's goals. As the General Accountability Office pointed out in its most recent report, "a key question is whether the investment is likely not to have taken place in the absence of the NMTC. That is, would investors have invested in the specific project in the same location 'but for' the NMTC subsidy included in the project?" Industry parlance refers to this concept of determining the utility of the investment as the "but for" test. See *NEW MARKETS TAX CREDIT: THE CREDIT HELPS FUND A VARIETY OF PROJECTS IN LOW-INCOME COMMUNITIES, BUT COULD BE SIMPLIFIED*, GAO-10-334 (Jan. 2010).

7. This is not to say that the NMTC cannot be both socially important and profitable. The entities that utilize or invest in NMTCs and their objectives are diverse. For example, the NMTC is an excellent tool for social investment institutions. When used by certain banks and other financial institutions, it can also provide a financial return to investors while simultaneously helping to satisfy their obligations under the Community Reinvestment Act. Under the Community Reinvestment Act of 1977, a bank is obligated to invest in community development activities in the areas in which it accepts deposits. A bank is evaluated based on three tests: a lending test, an investment test, and a service test. A properly structured NMTC transaction can satisfy the lending or investment tests under the Community Reinvestment Act. For developers, the NMTC helps even the playing field between low-income and more affluent communities, increasing the profit motive for investment where it is needed most.

8. Although the majority of NMTC financings are for projects under \$10 million, larger transactions are also common. See *NEW MARKETS TAX CREDIT COAL.*, *supra* note 5. In this study, it was found that businesses with project costs of \$10 million or less accounted for 1,743 of the 2,704 projects examined, 749 projects had project costs in the \$10 million to \$50 million range, and 212 projects had project costs exceeding \$50 million.

9. See Treas. Reg. § 1.45D-1(g)(3).

connection with, among others, the federal Historic Tax Credit; the Energy Investment Tax Credit; and, with careful structuring, the LIHTC. Accordingly, a broad understanding of how the credit works, how it may be utilized, and the typical issues involved in structuring NMTC transactions can prove useful for practitioners, investors, and developers interested in developing and improving the resources, services, and economic opportunities available in low-income neighborhoods.

II. New Markets Tax Credit

The NMTC is a federal tax credit equal to 39 percent of an investor's qualified equity investment (QEI) in any community development entity (CDE) that has received an allocation of NMTCs from the U.S. Treasury Department's Community Development Financial Institutions Fund (CDFI Fund). The NMTC is a seven-year credit, taken in increments of 5 percent for the first three years and 6 percent for the last four years.¹⁰ The NMTC is nonrefundable, meaning that it cannot offset more than an investor's total tax liability.¹¹

A. Basic Structure

In the most basic NMTC transaction, a tax credit investor (investor) contributes funds to a CDE. In turn, the CDE uses the investor's funds to make a loan to, or equity investment in, a qualified active low-income community business (QALICB). The investor's contribution to the CDE constitutes the QEI. In return for making this QEI, the investor is entitled to a credit equal to thirty-nine cents on each dollar invested. Figure 1 on the next page illustrates this basic structure.

As illustrated in Figure 1, three participants are essential to any NMTC transaction:

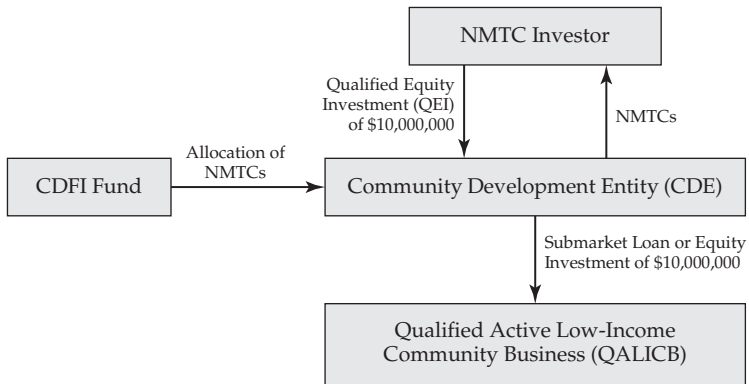
CDE (community development entity), which is an organization certified by the CDFI Fund that (1) has a primary mission of serving or investing in low-income communities or people and (2) includes residents of low-income communities on its governing or advisory board.¹² CDEs are di-

10. I.R.C. § 45D(a). It should be noted that the NMTC credit is claimed as soon as an investor makes its initial cash investment in the CDE and on each one-year anniversary thereafter. As such, the initial 5 percent credit is taken in the tax year in which the investment is made.

11. In addition, the NMTC cannot offset a taxpayer's liability under the alternative minimum tax. However, at the time of the writing of this article, Congress is considering H.R. 992, the Building American Jobs Act of 2011, which includes among its provisions a modification that would allow the NMTC to be claimed against the alternative minimum tax through January 1, 2012. As of March 23, 2011, the bill had been referred to the House Ways and Means Committee for recommendation and had not been enacted into law.

12. A CDE must be a domestic corporation or partnership for federal income tax purposes. A complete list of CDEs can be found on the CDFI Fund's website. See www.cdfifund.gov.

Figure 1
The Basic NMTC Structure



verse and range from small community development organizations to affiliates of large financial institutions. The CDE is the party that applies for and obtains the tax credit allocation.

Investor, which is the taxpayer that makes the QEI in the CDE and claims the tax credit on its income tax return.

QALICB (*qualified active low-income community business*), which is the entity that uses “substantially all” of a NMTC investment or loan to further its business purpose. A QALICB can be any active business, trade, or non-profit organization that has its principal operations in a low-income community and is not otherwise prohibited from participating in the program. In a real estate transaction, the QALICB is typically a single-purpose entity owned by the developer of the project.

B. Qualified Equity Investments (QEIs)

In order for an investor’s equity investment in a CDE to be deemed a QEI, the CDE must loan or invest “substantially all” of the investor’s equity into a qualified low-income community investment (QLICI). There are several ways in which an investor’s QEI may constitute a QLICI,¹³ but the only one that practically applies for financing real estate developments are those consisting of loans to or equity investments in QALICBs. Under the

13. The other forms of investments that qualify as QLICIs are financial counseling services to businesses and residents of low-income communities, certain investments and loans to other CDEs, and certain purchases of loans from CDEs that qualify as QLICIs. See I.R.C. § 45D(d)(1); Treas. Reg. § 1.45D-1(d)(1).

regulations, at least 85 percent of the CDE's loan or investment must remain invested in a QLICB for seven years in order to satisfy the "substantially all" requirement.¹⁴ This may be reduced to 75 percent in the final year of the tax credit allowance period.¹⁵ Nevertheless, the CDE's allocation agreement may require a higher threshold for the entire seven-year compliance period.

C. *Qualified Businesses (QALICBs)*

A QALICB is broadly defined¹⁶ as any trade, business, or nonprofit activity that satisfies the following criteria:

1. Active Business

A QALICB must be an "active" business, which simply means that the CDE must "reasonably expect" that the QALICB's business will generate revenues within three years or, in the case of a nonprofit entity, will engage in an activity that furthers its purpose within such time.

2. Definition of Low-Income Community

A QALICB must be located within a "low-income community," which, for NMTC purposes, means any census tract with a poverty rate of at least 20 percent or with a median income of up to 80 percent of the area or state-wide median, whichever is greater. However, a CDE's allocation agreement may impose more conservative limitations or additional requirements.

3. Excluded Businesses

A QALICB's primary trade or business may not consist of the following: private or commercial golf course; country club; massage parlor; hot tub facility; suntan facility; racetrack; gambling facility; store principally selling alcohol for off-premises consumption; farming; bank, credit union, or other financial institution; or the development or holding of intangibles (i.e., stocks, bonds, bank notes, trade secrets, patents, copyrights, and trademarks) for sale or license.

D. *General QALICB Tests*

The Tax Code establishes certain additional tests that all QALICBs must satisfy. Generally, if the QALICB is formed as a single-purpose entity and is

14. One practical limitation of the "substantially all" requirement is that no more than 15 percent of the investor's QEI may be used to pay the investor's or the CDE's fees, overhead, and closing costs; to fund reserves; or to pay for any other non-qualified expenses. In addition, a special rule applies to reserves. Under the existing guidelines, not more than 5 percent of a taxpayer's cash investment may be held by the CDE as reserves for loan losses, as fees paid to third parties to protect against loss, or as payments of interest or principal on a loan. See INTERNAL REVENUE SERV., NEW MARKETS TAX CREDIT, LMSB-04-0510-016 (May 2010).

15. See Treas. Reg. § 1.45D-1.

16. The regulatory requirements for QALICB status and the related NMTC tests can be found in Treas. Reg. § 1.45D-1.

also a single-asset entity, as is common and advisable for real estate financings, the NMTC tests described below should not be problematic. Nevertheless, these tests are important and must be observed and considered.

- *Tangible Property Test*: At least 40 percent of the “use” of the tangible property of a QALICB (including the QALICB’s owned and leased property) must be located within a low-income community.¹⁷
- *Gross Income Test*: At least 50 percent of a QALICB’s trade or business must be derived from the active conduct of a qualified business located within a low-income community. This gross income test can be reduced to 40 percent if the tangible property test is satisfied at a 50 percent threshold.
- *Services Test*: At least 40 percent of the services performed for the QALICB by its employees must be performed in low-income communities. If the entity has no employees, the services test is satisfied if the tangible property requirement is satisfied at an 85 percent threshold.
- *Limited Collectibles Test*: No more than 5 percent of a QALICB’s personal property may consist of collectibles (i.e., works of art, rugs or antiques, any metal or gem, any stamp or coin, or any alcoholic beverage).
- *Nonqualified Financial Property Test*: No more than 5 percent of a QALICB’s assets may consist of “nonqualified financial property,” broadly defined to include any debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notational principal contracts, annuities, and other similar property. However, federal regulations allow a QALICB to hold “reasonable” amounts of working capital if such working capital is held in cash, cash equivalents, or debt instruments with a term of eighteen months or less.
- *Deadline for Investment*: Generally, a CDE must invest the proceeds of an investor’s QLICB into a QALICB within twelve months of its receipt of such funds from the investor.¹⁸

17. The calculation for determining what percentage of a QALICB’s tangible property is “used” within a low-income community is figured by counting the amount of time in which the tangible property is used during the QALICB’s business hours. If the amount of the time that the property located within a low-income community is used by the QALICB during its normal business hours is at least 40 percent or more than the amount of time in which property located outside a low-income community is used by the QALICB during its normal business hours, the tangible property test will be satisfied. In situations where the QALICB owns or leases property that is both within and outside of a low-income community, the CDE may treat the portion of the QALICB’s trade or business located within the low-income community as separate (provided that the QALICB maintains separate books and records), but the portion of the QALICB’s trade or business located outside of a low-income community will not qualify for NMTCs.

18. Treas. Reg. § 1.45D-1(c)(5)(iv).

E. Real Estate QALICB Specific Requirements

Although NMTC investments are often used to finance real estate projects generally, it is important to distinguish those projects developed by real estate businesses and those projects developed by non-real estate businesses. Generally, a real estate business is one in which the QALICB's primary business is the ownership, operation, rental, or development of real property.¹⁹ Examples of non-real estate QALICBs are, without limitation, day care centers, community service groups, industrial or manufacturing businesses, and educational institutions. Each may own real property but only as is necessary to further its primary, non-real estate business purpose. If the QALICB's business is to principally own, operate, rent, or develop real property, it will be subject to the following additional requirements.

1. Substantial Improvements Test

A QALICB's business cannot consist of the rental of unimproved real estate. Therefore, a QALICB engaged in leasing real property must make "substantial improvements" to any commercial or mixed-use rental project that utilizes NMTC financing. In technical terms, this means that the cost basis of the improvements incurred for the twenty-four-month period following a QLICB closing must equal or exceed 25 percent of the adjusted basis of the building where the improvements are made.²⁰ The proceeds of an NMTC financing need not be used to pay construction costs; however, the QALICB must demonstrate that it has incurred the necessary costs in connection with the improvements. Many allocation agreements expand upon these regulations to allow take-out financings for loans or investments used to pay for construction and rehabilitation costs, provided that substantial improvements have been made.²¹ Generally, if a QALICB's business is renting real property, NMTCs cannot be used to refinance or repay a nonconstruction loan.

2. "Exclusively" Residential Test

If the QALICB's business is the rental of real property, the use of the property cannot be "exclusively" residential. Under the Tax Code, the term *residential* refers to a property in which 80 percent or more of the gross rental income for a taxable year is rental income from dwelling units. As such, mixed-use projects in which more than 20 percent of the gross income of the building is derived from nonresidential sources (i.e., the commercial component of the building) may still qualify for the NMTC program. Since this test is based upon the gross income of the building rather than the building's square footage, any NMTC project should build in additional

19. See CDFI FUND, NEW MARKETS TAX CREDIT COMPLIANCE AND MONITORING FREQUENTLY ASKED QUESTIONS (Sept. 2011).

20. See *id.*

21. See *id.*

buffer protection to ensure that any decline in rental revenue from any one commercial source will not materially increase the ratio of residential rental income in the building.

III. Practical Considerations for Financing Commercial Real Estate

Once the technical aspects of the program have been considered, the practical minded will understandably ask how the NMTC may be used with specific outcomes in mind. Can NMTC funds be used for acquisition financing? What type of properties may utilize NMTC financing? What restrictions apply?

Generally, projects involving the acquisition, construction, or rehabilitation of real property located in low-income communities will qualify for NMTC financing if those projects fall into any one or more of the following categories: (1) the acquisition of an owner-occupied project, with or without construction or improvements to the project; (2) the construction or improvement of an owner-occupied project; (3) the construction or substantial improvement, which may include limited acquisition costs, of a commercial rental project; and (4) the construction or substantial improvement, which may include limited acquisition costs, of a mixed-use rental project in which at least 20 percent or more of the gross rental revenue comes from commercial sources.

The following projects are generally excluded from utilizing NMTC financing: (1) acquisitions of rental projects in which no improvements have been made, (2) land acquisitions in which the property will not be utilized to further any business purpose or nonprofit activity, and (3) projects that are exclusively residential rental units or mixed-used rental projects in which less than 20 percent of the gross rental revenue comes from commercial sources. With this in mind, let us now consider the various ways in which real estate projects may use NMTC financing.

A. Acquisition Financing

The determination of whether NMTCs can be used to finance the acquisition of real property may hinge on the terms of the CDE's allocation agreement. Generally, different rules apply with respect to loans or investments to QALICBs primarily engaged in operating rental properties and to those that are not.²²

The typical allocation agreement will not impose any restriction on a QALICB's use of NMTC financing to acquire real estate provided that the QALICB's business is not primarily the rental to others of real property. As such, a qualified supermarket, charter school, supportive services group, or community organization in need of a building to house its primary

22. Owen P. Gray, *Using NMTCs to Purchase Existing Buildings*, 1:8 NOVGRADAC J. TAX CREDITS (Aug. 2010).

business or activity (e.g., selling food, operating a school, providing supportive services or a community center for residents of a low-income community) should qualify for NMTC financing.

If the QALICB is primarily engaged in the leasing of space, however, the cost of acquiring the property cannot exceed the amount that would cause the QALICB to violate the substantial improvements test described earlier. In practical terms, this means that an analysis of the acquisition costs and construction/rehabilitation costs will be needed to determine whether the costs to be incurred in constructing or rehabilitating the building (and the timing of when those costs will be incurred) can support the planned acquisition costs.

B. Construction and Rehabilitation Financing

There are two practical considerations to observe when structuring an NMTC financing for the construction or rehabilitation of real property: when the QLICI will be invested or loaned to the QALICB and when the QALICB will expend those funds.

Generally, a CDE has twelve months to invest the proceeds of an investor's QLICI into a QALICB.²³ In the construction loan context, this means that the proceeds of the construction loan need to be fully advanced to the QALICB project borrower within twelve months from the CDE's loan closing—assuming that the investor's equity was contributed to the CDE at the same closing.

Similarly, once a CDE makes an advance of a construction loan to a QALICB, the QALICB must expend those funds within twelve months after the date that the advance is made. The reason for this is that under the nonqualified financial property test, a QALICB is prohibited from holding large cash reserves.²⁴ An exception to this rule provides that the proceeds of a construction loan may be deemed "reasonable" working capital if those proceeds are expended by the QALICB within twelve months of the advance. This is particularly relevant in NMTC transactions intended to finance new construction or substantial rehabilitation projects because it has become common practice to fully advance the proceeds of a CDE's construction loan to the QALICB at closing and hold those funds in a blocked disbursement account to be released monthly upon the satisfaction of customary construction loan advance conditions.

A construction project need not be completed within twelve months. However, all NMTC money must be expended within twelve months, and sufficient work must be completed within twenty-four months to satisfy the substantial improvements test.²⁵ This often poses a problem for lenders

23. Treas. Reg. § 1.45D-1(c)(5)(iv).

24. See Treas. Reg. § 1.45D-1(d)(5)(ii) (as amended as of Jan. 28, 2005); CDFI FUND, NEW MARKETS TAX CREDIT COMPLIANCE AND MONITORING FREQUENTLY ASKED QUESTIONS (May 2009).

25. See Treas. Reg. § 1.45D-1(d)(5)(ii); CDFI FUND, *supra* note 24.

that want substantial developer equity invested in a project before loan proceeds are utilized. As such, it is always useful for a CDE financial institution to carefully examine the project's construction budget and completion timeline prior to committing to the terms of an NMTC financing. In cases where a CDE's loan funds are needed beyond the initial twelve months, it may be necessary to close the CDE's loan to the QALICB in multiple tranches that fund only work that can be completed within the allotted time.

C. Loan Terms

In a typical construction loan, the construction lender will expect repayment not long after the project is completed. In take-out financings, the permanent lender's terms will often include the payment of scheduled principal amortization. In an NMTC project, however, both a construction lender and a permanent lender may need to revisit their typical lending practices to conform to the program's requirements. As stated earlier, the NMTC program requires that substantially all of an investor's equity remain invested in a QALICB for a period of seven years. Although a shorter loan term is possible (in which case the QALICB would be subject to reinvestment by the CDE), the typical NMTC loan is a seven-year, interest-only product.

D. Commercial Tenants

Compliance with the NMTC program does not stop with the QALICB. If the QALICB's business is the operation of a commercial or mixed-use rental project, each tenant must also satisfy the program's requirements. In particular, no tenant may engage in any of the so-called sin businesses in which a QALICB is prohibited from engaging, i.e., those listed under Part II.C.3.²⁶ An NMTC practitioner should always review the prohibited use section of any existing or proposed lease to determine if a tenant could engage in any of the foregoing businesses without the QALICB landlord's approval, as well as to ensure that each lease contains strong enforcement and termination provisions in the event of a violation.

E. Mixed-Use Housing

NMTC financing cannot be used to finance projects that are deemed residential under Tax Code § 45D. This is one of the more misunderstood aspects of the program. A plain text reading would seem to exclude the use of NMTCs for any type of residential development. However, the Tax Code's definition of a residential property refers to buildings in which 80 percent or more of the gross rental income for a taxable year is rental income from dwelling units.²⁷ As such, mixed-use projects in which more

26. See Treas. Reg. § 1.45D-1(d)(5)(ii).

27. See *id.*; I.R.C. § 168e2(A)(1).

than 20 percent of the gross income of the building is derived from nonresidential sources, i.e., the commercial component of the building, may still qualify for the NMTC program. Since this test is based upon the gross income of the building rather than the building's square footage, any NMTC project should build in additional buffer protection to ensure that any decline in rental revenue from any one commercial source will not materially increase the ratio of residential rental income. Percentage rent leases, therefore, should be avoided in any NMTC project that includes a substantial residential component.

F. For-Sale Housing

NMTC rules do not prohibit the use of NMTCs for the construction of for-sale housing. To the contrary, the development of for-sale housing in low-income communities may be a qualified community business investment. The challenge, however, is in finding ways to resolve the NMTC's seven-year principal investment requirement, which leads most NMTC loans to be seven-year, interest-only products, with the earlier rolling pay-down schedules that are associated with the sale of housing units. One solution is to use NMTC financing only for multiphase construction projects having a completion schedule of at least seven years where the proceeds from the sale of early phases are reinvested to finance the construction of later phases.²⁸ However, in today's market, it may be difficult to find an investor willing to gamble on the success of a second or third phase of a project prior to the completion of the first. Alternatively, if the NMTC investor or the CDE has a portfolio of additional projects in which it can reinvest, NMTC financing may be a good way to deliver favorable-rate financing.

G. Affordable Housing

If the NMTC project consists of either mixed-use rental housing (assuming at least 20 percent of the gross rental income is derived from commercial sources) or for-sale housing, the CDE's allocation agreement may impose the additional requirement that such housing units be affordable. With respect to rental units, the CDFI Fund requires that for the full seven-year compliance period, at least 20 percent of the units financed with NMTC funds must be both rent restricted and occupied by individuals whose income is 80 percent or less of the area medium income. With respect to for-sale housing, each unit purchaser must be an owner-occupier having a debt-to-income ratio no greater than 38 percent and a median family income not greater than 80 percent.²⁹

28. See NOVGRADAC & CO. LLP, 5:6 NMTC MONTHLY REPORT (June 2006).

29. See CDFI FUND, *supra* note 24.

IV. Structuring an NMTC Transaction

In the simple NMTC structure (see Figure 1 on page 273), an investor makes a QEI in a CDE, which in turn invests substantially all of those funds to make a QLICB usually through a loan to a QALICB. In this model, a financial institution through an affiliated CDE can invest its own capital to make a loan or investment to a QALICB project borrower upon terms that are more favorable than the QALICB could otherwise obtain through traditional financing.

Unfortunately, not all CDEs are affiliated with financial institutions willing or able to invest. In addition, for those that do, the simple structure is not necessarily the best way to maximize the potential equity that can be generated for an eligible project. Soon after Congress enacted the NMTC, owing to these shortcomings, practitioners began combing through the Tax Code to find suitable ways of generating tax credit equity from market-rate debt. In response to requests for clarification on this point, the IRS issued Revenue Ruling 2003-20, which interpreted the NMTC regulations to provide that a QEI made by an investor to a CDE could include cash derived from a nonrecourse loan.³⁰ This gave rise to what is commonly referred to as the leveraged loan structure.

A. Leverage Loans

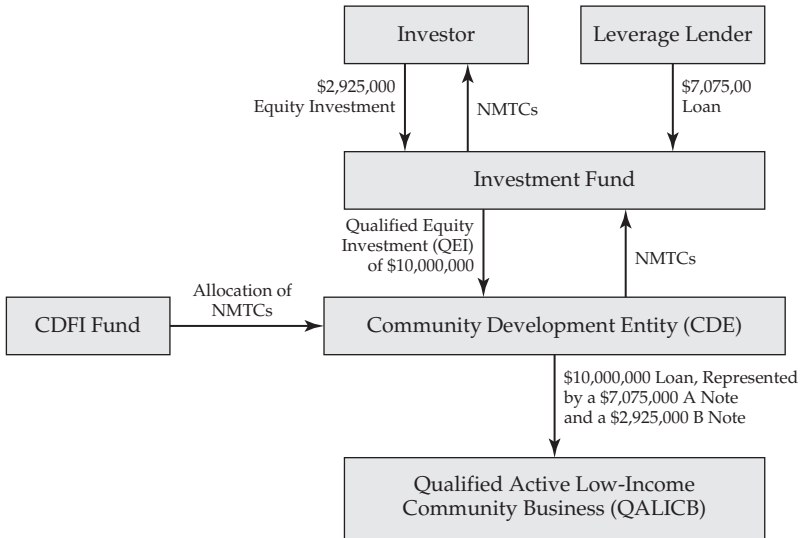
Under the simple NMTC structure, a CDE's ability to lend or invest in a QALICB is limited by the amount of funding it obtains from its investor; and in most cases, the CDE will typically expect repayment from the QALICB for the full amount of its loan or investment. However, in the leveraged loan structure, a new investment fund entity is created to obtain a nonrecourse loan, referred to as a leverage loan, from a third-party lender at market terms. This enables an investor, which is allocated nearly all of the tax credits, to contribute equity to the investment fund without the expectation or requirement of repayment but with the expectation of a favorable internal rate of return on its investment. The investment fund then utilizes the investor's equity together with the leverage lender's loan proceeds to make a single QEI to a CDE. The CDE, in turn, makes a loan to the QALICB project borrower; this loan is evidenced by a promissory note in the amount of the leverage loan (the so-called A Note) and a promissory note in the amount of the investor's equity investment less fees taken out at the investment fund level (the so-called B Note). Figure 2 on the next page illustrates the typical leveraged loan structure.

B. Calculating Tax Credit Equity

Once a CDE is located with an available allocation of NMTCs, and after taking into consideration the size of the project, the basic formula for calculating the amount of investor equity to be generated though the

30. Rev. Rul. 2003-20.

Figure 2
The Leveraged Loan Structure



leveraged loan structure (utilizing a project of at least \$10 million and assuming that an equal-sized allocation is available) can be expressed as follows:

$$\frac{\$10,000,000 \text{ (QEI amount)}}{39\% \text{ of QEI (NMTC credit)}} = \$3,900,000 \text{ (credit amount)} \times \$0.75/\text{credit} = \$2,925,000 \text{ (NMTC equity)}$$

Required leverage loan amount = \$7,075,000³¹

In the formula above, at \$0.75 per credit, the investor pays \$2.925 million to purchase the \$3.9 million of tax credits that are generated by the total \$10 million investment. In order to achieve this investment amount, the \$7.075 million leverage loan is combined with the \$2.925 million of investor equity. After deducting fees and expenses, this money is now available to the project as either a very low interest loan or more often as a subsidy. Clearly, this can have a great advantage for an eligible project.

31. The price that investors will pay for the NMTC will vary from time to time and from market to market. The \$.75 price per credit used above is given simply for example purposes only.

C. Leveraged Loan Structure Considerations

Structuring, negotiating, and closing a leverage loan will involve issues unique to NMTC financings. The following describes some of the key recurring themes that come up in real estate financings utilizing the leveraged loan structure model.

1. Collateral

A QALICB is prohibited from providing direct collateral to the leverage lender. As such, a key structural consideration for a leverage lender (often a financial institution accustomed to traditional mortgage debt financing) is its comfort with the typical leverage loan collateral. Generally, the leverage lender's collateral will be a pledge by the investment fund of its limited membership interests in the CDE. If the CDE obtains mortgage collateral from the QALICB for its loan, that mortgage will be held for the benefit of the CDE, not the leverage lender. Nevertheless, for practical purposes and if structured correctly, if the QALICB defaults under the CDE's loan, the CDE is entitled to foreclose on its mortgage, take possession, and sell the property. Subject to the applicable forbearance and reinvestment requirements during the compliance period, the resulting sale proceeds would eventually be available for distribution by the CDE to the investment fund, which would then be required to use those funds to satisfy its debt to the leverage lender.

2. Flow of Funds

A leveraged NMTC transaction is a multitiered structure dependent entirely on cash flow from the lower tier. As such, properly documenting the flow of funds from the lower tier to the upper tier of the structure is essential. In particular, after taking into consideration the CDE's fees and expenses, each dollar that the QALICB pays to the CDE under its loan must in turn be distributed by the CDE to the investment fund as a capital distribution, thereby enabling the investment fund to pay the debt service owed to the leverage lender. The documentation must correctly reflect this reality to avoid cash flow shortfalls during the term of the loan.

3. Management, Servicing, and Control

Control of the flow of funds, management of the investment fund, and oversight of the CDE's servicing of the QALICB loan all must be considered when structuring an NMTC financing. Essentially, an investor will be concerned with ensuring that its QEI remains invested in a qualified project for the full seven-year compliance period. The leverage lender's priority will be ensuring that its collateral, i.e., the QALICB's real property, is securely pledged to the CDE and that it continues to receive its debt service payments. As previously explained, the typical structure will grant the leverage lender a pledge of the investment fund's ownership interests in the CDE.

The issue that often arises, however, involves the management of the CDE. Under the NMTC program's requirements, only an entity certified

by the CDFI Fund may act as a manager of a CDE. Therefore, in situations where the leverage lender does not possess CDFI Fund certification, a common solution is for the CDE to grant revocable servicing rights to the leverage lender. This enables the leverage lender to obtain a degree of day-to-day administration and oversight of the QALICB.

4. Default, Reinvestment, and Cure

Default at the QALICB or CDE level can have harsh consequences for an investor if the default results in a recapture of NMTCs. Unlike other tax credit programs used for real property development, NMTCs can result in full credit recapture, meaning that all past and future credits plus interest will be lost. Recapture can be triggered by the following situations: (1) the CDE fails to qualify as a CDE, (2) the CDE's investment in the QALICB is redeemed, or (3) the CDE ceases to invest substantially all of an investor's QEI in a QLICB.³²

Generally, recapture should not occur in a properly structured leverage loan transaction, if the CDE retains its CDFI Fund qualifications, does not call its QALICB loan due, and prohibits prepayments and, at the time of the QLICB closing, substantially all of the investor's QEI is invested in a QALICB. Under the regulations, there is a presumption that an entity will satisfy the requirements to be a QALICB if the CDE has a "reasonable expectation" that the QALICB will be a QALICB for the entire duration of the NMTC investment, and the CDE does not "control" the QALICB.³³ Accordingly, the best way for an investor to avoid recapture is to conduct due diligence on the QALICB and require that the CDE's loan documents with the QALICB retain strong program compliance provisions.

That said, defaults do occur, and one way of mitigating the investor's ultimate risk of recapture is through the negotiation of appropriate investor cure and reinvestment rights. Under the rules, a recapture resulting from a failure of the "substantially all" requirement may be avoided, but not more than once, if the underlying default condition is cured within six months from the date that the CDE becomes aware or should have become aware of the recapture event.³⁴ Also, if a QLICB is redeemed through repayment, foreclosure, or otherwise, the QLICB may be reinvested in another NMTC-eligible investment. If this occurs, the CDE will generally have one year to reinvest in another QLICB.³⁵ If the default is with respect to the CDE's

32. See I.R.C. § 45D(d)(3); Treas. Reg. § 1.45D-1(e)(2).

33. See MICHAEL J. NOVOGRADAC & THOMAS G. TRACY, *NEW MARKETS TAX CREDIT HANDBOOK* 111-12 (2011).

34. If reinvestment is not an option and the CDE is willing to foreclose and take possession of the QALICB, the rules generally allow the QALICB to continue to constitute a QLICB if, throughout the remainder of the compliance period, the QALICB continues to otherwise satisfy the requirements for NMTC compliance.

35. Also, a CDE may apply for a waiver or extension on recapture, and such a waiver or extension may be granted in specific circumstances.

failure to manage the investor's QEI or failure to maintain its CDE status, it is common for investors to negotiate the right to remove the managing member for cause. The replacement managing member would be subject to the approval of the CDFI Fund.³⁶

5. Investor Guarantees

For those who have negotiated favorable mortgage loan or tax credit equity guarantees, NMTC guarantees may seem particularly strong. Investors will often require that a QALICB's principals guarantee the investor's full expectation loss in the event that the project no longer qualifies for tax credits. In addition, a CDE may also be expected to indemnify the investor against expectation loss resulting from the failure of the CDE to continue to qualify as a certified CDE.

6. Forbearance and Loan Purchase Structure

A QEI must remain invested for seven years. During that time, the investor will need the leverage lender's loan to remain outstanding, notwithstanding problems at the QALICB loan level. This forbearance from calling the leverage loan due poses no problems if the QALICB is making its regularly scheduled loan payments. If the project goes into default, forbearance can cause repayment and underwriting issues for the leverage lender.

These risks can be mitigated in two ways. First, the leverage lender can negotiate clear conditions by which a CDE must foreclose its interests in the QALICB and provide criteria for reinvestment. Second, it can obtain an agreement from the principals of the QALICB to purchase the leverage lender's interest in the leverage loan. Under a loan purchase arrangement, the principals of the QALICB essentially give a guarantee to the leverage lender that they will take out the leverage lender if the QALICB defaults under its agreements with the CDE. This has the added benefit, from the investor's perspective, of allowing the leveraged loan structure to remain in place after the leverage lender has exited the transaction.

7. End-of-Compliance Period Strategies

There are several different ways in which a leverage loan may be unwound at the end of the seven-year compliance period. If the CDE's expectation is the repayment of the B Note, then the sole alternatives may simply be to repay the loan or obtain a refinancing of the debt. More likely, the parties will want to find a way to extinguish the debt evidenced by the B Note. The most common way of doing this is through negotiation of a put/call option.

Using this approach, the investor is granted the right, i.e., the put option, to require an affiliate of the QALICB to purchase its interest in the investment fund for a designated sum, usually a nominal amount. If the investor fails to do this, the QALICB's affiliate is granted a similar right,

36. See CDFI Fund, *supra* note 19.

i.e., the call option, to purchase the investor's interest at fair market value. In either case, the investor exits the transaction, and the QALICB obtains the investor's interest in the investment fund, at which point it can take steps to unwind the transaction. It is important to consider, however, that the put/call option may have economic consequences. In particular, if the investor fails to exercise its put option, the result could be the QALICB paying a considerable amount (the market value of the B Note at such time) to extinguish the debt.

Careful consideration will also be needed to minimize the QALICB's exposure to so-called cancellation of indebtedness taxation as a result of the unwinding structure. Assuming the investor exercises its put option, common strategies to reduce the value of the B Note at the end of the seven-year period and thus mitigate these economic events include (1) making the term of the B Note considerably longer than the compliance period of the NMTCs (commonly thirty years), (2) adjusting the interest rate due under the B Note, and (3) negotiating an option to convert the B Note into an equity interest in the QALICB prior to the expiration of the compliance period.³⁷ The use of any of these or other tax strategies will be determined on a case-by-case basis and should be thoughtfully discussed with counsel prior to closing.

V. Combining NMTCs with Other Tax Credit and Subsidy Sources

The use of NMTCs to finance the acquisition, rehabilitation, and/or construction of real property projects has naturally led participants in the NMTC industry to look for ways to combine NMTCs with other federal, state, and local tax credit and financing programs.³⁸ In particular, there are three federal tax credit programs that are obvious targets for partnering with an NMTC project: the LIHTC, the Historic Rehabilitation Tax Credit, and the Solar Energy Investment Tax Credit.

A. Low Income Housing Tax Credit

For the past quarter century, the federal LIHTC has helped increase the availability of quality affordable housing for low-income households by encouraging private sector investment in select development and rehabilitation projects. Likewise, the NMTC can help encourage the development of the types of commercial services that are necessary for these newly reinvigorated communities to thrive.

37. See Lane Powell, *Managing the Exit Tax Burden of the QALICB (Part 1)*, 2:4 NOVOGRADAC J. TAX CREDITS (Apr. 2011) (part 1 of 2); Lane Powell, *Managing the Exit Tax Burden of the QALICB (Part 2)*, 2:5 NOVOGRADAC J. TAX CREDITS (Apr. 2011) (part 2 of 2).

38. In an early study, roughly 75 percent of all program funds used through 2005 financed new construction and/or rehabilitation of commercial real property. CDFI FUND REPORT: NMTC QUALIFIED EQUITY INVESTMENT REPORT (Mar. 1, 2007).

In direct technical terms however, NMTCs and LIHTCs are incompatible. The requirement that an NMTC project be mixed-use, i.e., at least 20 percent commercial, runs contrary to the IRS's more favorable depreciation rules for residential structures as are typically used for projects financed with LIHTCs. Also, the IRS has determined that if a CDE makes an NMTC loan or investment to finance the construction of a residential building, the investment or loan will not be a QLICI to the extent that the building's eligible basis under the LIHTC is financed with proceeds of an NMTC loan or investment.³⁹ These two rules can be substantial hurdles for incorporating NMTC finance into a project financed with LIHTCs.

Nevertheless, if structured correctly—by segregating the commercial portion of a project from its affordable housing component legally, structurally, and financially—NMTCs and LIHTCs can finance complementary structures. One way of accomplishing the structural segregation of an LIHTC project from an NMTC project is by utilizing the so-called dual-ownership condominium structure. In this way, the commercial portion of the project is owned by a single purpose entity dedicated to the ownership and operation of the commercial space, and the residential portion is owned by a separate single purpose entity. If properly structured, the NMTC project exists side by side with the LIHTC project so that NMTC financing can be used to finance the non-LIHTC-eligible basis costs of the project that are attributable only to the commercial portion of the project. Figure 3 on the next page illustrates one form of the dual-ownership condominium structure.

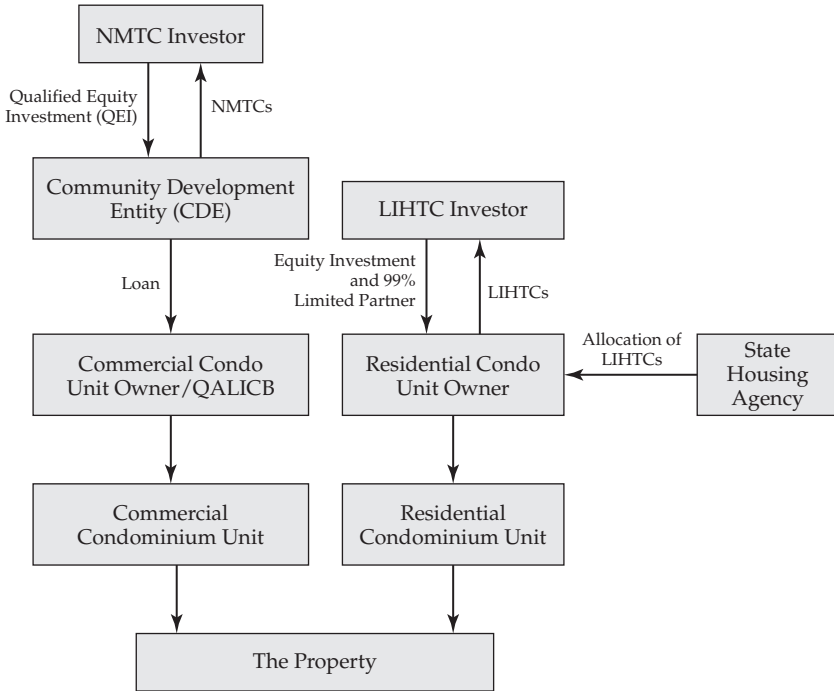
Utilizing the dual-ownership condominium structure will add complexity and cost to a transaction. Depending on the location and scope of the transaction, some state housing finance agencies may have reservations about incorporating commercial space into a residential structure. Also, a financial analysis of the construction costs associated with a project will be necessary to determine if there are sufficient non-LIHTC basis costs to be financed with NMTCs. Determining which costs are attributable solely to the commercial portion of a project may be difficult if constructing a vertical mixed-use project. In this case, it may be necessary to add the NMTC financing to the overall project at the point during construction where the commercial build-out is ready to begin. However, successful projects led by experienced developers can overcome these complexities and derive real value from participation in both programs, both in reducing the local subsidy and LIHTC allocation burden on local housing agencies and in bringing needed retail and support services closer to the residents of the LIHTC-financed housing project.

B. Historic Rehabilitation Tax Credit

The federal Historic Rehabilitation Tax Credit (HTC) encourages the rehabilitation of historic buildings by allowing the owner of a project to

39. See Treas. Reg. § 1.45D-1(g)(3)(C)(ii).

Figure 3
Combining NMTCs and LIHTCs in the
Dual-Ownership Condominium Structure



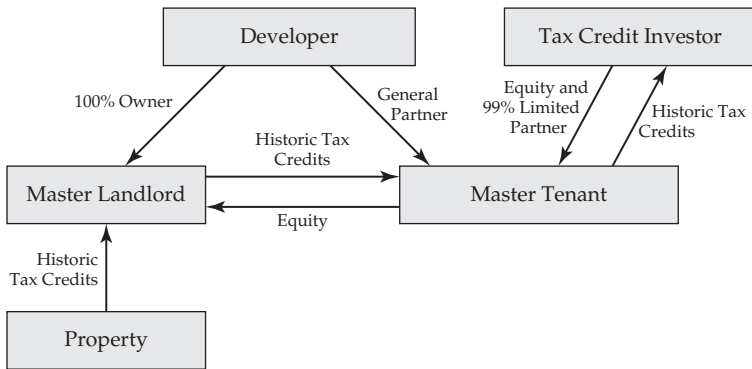
claim a tax credit equal to either (1) 20 percent of its qualified rehabilitation expenditures incurred in connection with the rehabilitation of a certified historic structure or (2) 10 percent of its qualified rehabilitation expenditures incurred in connection with the rehabilitation of certain noncertified structures built before 1936. The owner must maintain compliance with the HTC program for at least five years, including the maintenance of certain aesthetic aspects of the building, which can often add cost to a project as well. Also, only a party with an ownership interest, which may include leasehold interests, in the rehabilitated structure may claim the credit.⁴⁰

Provided the project involves the rehabilitation of a historic structure located in a low-income community, HTCs and NMTCs can be directly utilized to rehabilitate historic school buildings, community centers, and retail shopping centers, among others. How these two programs are

40. See generally I.R.C. § 47.

incorporated, however, is often a question of the comfort level of the participants in the project. If the developer has sufficient equity in the project and tax liabilities to offset, the developer may simply use the HTC to reduce its overall tax liability. Alternatively, if the developer seeks investor equity, the developer could submit to the “master lease structure,” pursuant to which the developer (as the master landlord) enters into a master lease with an entity known as a master tenant, whose equity interests are held by the HTC investor and whose general partnership interests are controlled by the developer.⁴¹ In this manner, an HTC investor obtains an ownership interest in the property and thus is allowed to claim HTCs. Figure 4 below illustrates a typical HTC master lease structure.

Figure 4
The Historic Tax Credit “Master Lease” Structure



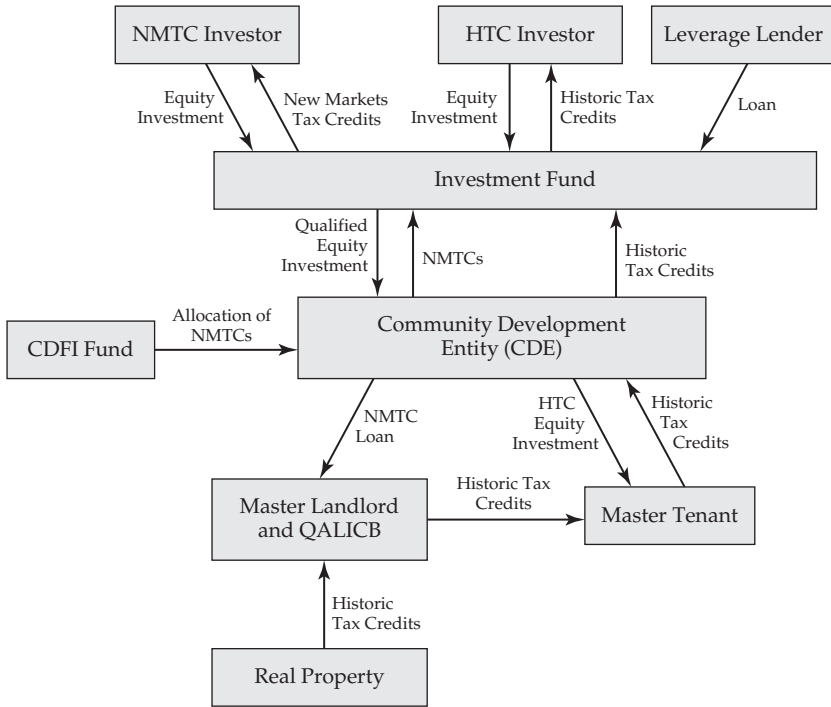
More challenging, but often desired, is the option of leveraging additional NMTC equity by twinning the HTC master lease structure described above into the NMTC leveraged loan structure, maximizing the potential benefits of participation in each program. In a combined HTC-NMTC structure, the CDE obtains a limited equity interest in the master tenant entity, enabling the property owner to pass HTCs through the NMTC leveraged loan structure. Figure 5 on the next page illustrates one way of leveraging NMTC equity by utilizing HTC equity.

In the illustration above, the total QEI to the CDE is increased by the amount of HTC equity invested by the HTC investor.⁴² In order to pass the HTCs to the HTC investor, the QALICB enters into a master lease with an entity, referred to as the master tenant, that is owned in limited part by the

41. The Tax Code allows credits to be transferred to a master tenant.

42. Note, however, that HTCs are generated based upon the amount of qualified rehabilitation expenditures and NMTCs cannot increase the available amount of HTCs.

Figure 5
Leveraging HTC to generate NMTCs



CDE. This enables the CDE to obtain a pass-through interest in the property, allowing HTCs to flow through the structure to the HTC investor.⁴³ Nevertheless, choosing the structure appropriate for a particular project must be made on a case-by-case basis after careful discussion with counsel.

43. Until recently, a key structural consideration for twinning HTCs with NMTCs was the so-called related parties rule. Under this rule, no more than 50 percent of the equity interests in a QALICB could be held, directly or indirectly, by the CDE. Given that the NMTC was intended to foster loans and investments to QALICBs, this rule seemed to frustrate the program's intent. Recently, however, the CDFI Fund revised the related parties rule, clarifying that the test be applied after the QEI is made in the CDE but before the investment is made in the QALICB. This should allow CDEs to make direct equity investments in QALICBs (making the twinning of HTCs with NMTCs easier), but time will tell how long it takes the industry to adapt to the new guidance. See John Leith-Tetrault, *CDFI Fund Provides HTC Relief on NMTC Related Party Test*, NOVGRADAC J. TAX CREDITS (June 2010).

C. Energy Investment Tax Credit

The Energy Investment Tax Credit (EITC) is a federal tax credit equal to 30 percent⁴⁴ of all qualified costs incurred in connection with the acquisition and installation of any qualified solar electricity or heating unit, fuel cell property, distributed sunlight system, or wind energy project.⁴⁵ A properly structured project can therefore take advantage of the EITC to help an NMTC-financed project sustain the cost of incorporating green energy systems, which can help make a project both environmentally friendly and energy efficient.⁴⁶

As with the HTC, the EITC is an investment credit claimable only by those with an ownership interest in the invested property. In the case of the EITC, however, the use of the credit follows the ownership of the energy property installed, e.g., a solar panel unit, rather than the real property upon which it may be situated. As such, there are several ways to incorporate NMTCs and the EITC into a single project. The developer of the NMTC project or a separate energy property owner may claim the EITC credit on its own tax returns or obtain an equity investment from a third-party investor, which would be allocated the use of the EITCs. Alternatively, a greater return on investment may be realized through the use of a master lease structure similar to those used for HTC investments. In this case, the CDE acquires an interest in the energy property, allowing EITC equity to be counted in the NMTC QEI and thereby leveraging additional NMTC equity. As stated earlier, choosing the structure appropriate for a particular project must be made on a case-by-case basis after careful discussion with counsel.

VI. Outlook for the Future

The prevalence of NMTC investments in real estate projects is widespread, as is the use of the credit with other governmental financing sources.⁴⁷ In fact, a recent study by the Government Accountability Office

44. Under current law, the 30 percent credit will be reduced to 10 percent for credits claimed on or after January 1, 2017.

45. See generally I.R.C. § 48.

46. The EITC is determined by an owner's cost basis in a project without reference to any outside allocation authorities and therefore may be taken as of right by the owner of any qualified energy project. Nevertheless, in order to qualify for the credit, an energy property must obtain and maintain all applicable licenses and permits to operate and must produce electricity or provide heat or light at the applicable performance and quality standards, if any, that have been prescribed by federal, state, and local regulations; this requires additional regulatory considerations on a case-by-case basis.

47. For a general discussion on this matter, see *Addressing the Prevalence of Real Estate Investments in the New Markets Tax Credit Program: A Study Conducted for the Federal Reserve Bank of San Francisco and the United States Department of the Treasury's Community Development Financial Institutions Fund* (Fed. Reserve Bank of S.F. & U.S.

highlighted the frequency with which NMTCs are paired with other federal, state, and local tax benefits aimed at historic preservation, environmental cleanup, energy efficiency, or community development. Furthermore, according to the report, industry trends show that it is common for NMTCs to bridge the financing gap not just for market financing but also for the limited availability of other government subsidy programs.⁴⁸ The list of other federal, state, and local community development programs that have utilized NMTCs includes, among other agencies, the Department of Housing and Urban Development's Section 108 Program⁴⁹ and Neighborhood Stabilization Program,⁵⁰ the Federal Housing Administration's Section 220 Program,⁵¹ the Small Business Administration's Section 7(a) Loan Program,⁵² and the various tax-exempt bond programs.

The NMTC can also be a flexible tool for the federal government to mobilize private sector support for its community development objectives. Through the credit allocation process, the CDFI Fund competitively selects allocatees capable of maximizing the impact of tax credit investments with a certain degree of coordination. As an example, the federal government—under the 2010 Healthy Food Financing Initiative spearheaded by First Lady Michelle Obama—made a substantial commitment to expanding access to healthy food alternatives in low-income communities by issuing \$250 million of NMTC allocation authority specifically earmarked for the development and construction of new or expanded healthy food supermarkets and grocery stores. In this way, the federal government can target areas of need in low-income communities while simultaneously allowing

Dep't of Treasury Cmty. Dev. Fin. Insts. Fund, Working Paper No. 2008-04, Fall 2008), available at <http://frbfs.org/cdinvestments/>.

48. See *NEW MARKETS TAX CREDIT*, *supra* note 5.

49. HUD's Section 108 Program provides loan guarantees to local governmental agencies that fund economic development activities, which may include certain commercial and mixed-use construction and rehabilitation projects.

50. HUD's Neighborhood Stabilization Program is a locally administered program in which state housing agencies utilize federal funds to establish financing mechanisms for the purchase and redevelopment of foreclosed residential properties and the redevelopment of demolished or vacant properties.

51. The FHA's Section 220 Program insures lenders against default on eligible multifamily housing projects located in certain targeted urban areas. Under the Section 220 Program, eligible mixed-use projects include those in which the aggregate commercial floor area does not exceed 20 percent of the gross floor area of the project and commercial income does not exceed 30 percent of the estimated total gross income of the project.

52. CDEs qualified as SBA-approved lenders are able to combine NMTC financing with SBA § 7(a) small business loans, which can be used to make long-term SBA guaranteed loans for real estate projects at preferential rates. See Eric Usinger, *Twinning NMTCs with SBA 7a Loans: Legal and Practical Considerations*, NOVGRADAC J. TAX CREDIT (Aug. 2011).

the private sector to pick up the more complicated task of finding projects in which to invest.

Community revitalization requires quality and affordable housing together with good jobs and appropriate commercial services. Over the decades, the affordable housing industry has developed effective and potent tools for addressing the need for quality affordable housing. Provided that it retains bipartisan support and weathers the inevitable shifts in policy in the years to come, the New Markets Tax Credit very likely will mature into the linchpin of commercial development that is needed to effectively and systematically generate the jobs and commercial services that many low-income communities are sorely lacking.