

# New Markets Tax Credit

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# Background

- New Markets Tax Credits (NMTC) were created pursuant to the Community Renewal Tax Relief Act of 2000. The NMTC is codified at Section 45D of the Internal Revenue Code and tax regulations governing NMTCs are in Section 1.45D-1 of the Treasury Regulations.
- Purpose is to attract funds from private investors that are used to provide capital to certain businesses located in “Low Income Communities” (LIC).
- A community is a LIC if:

The poverty rate for the census tract is at least 20%, or

Median family income does not exceed 80% of the greater of statewide median family income or the metropolitan area median family income.

# CDFI Fund

- NMTC program is administered by the Community Development Financial Institutions Fund (CDFI Fund) of the United States Department of the Treasury.
- CDFI Fund allocates NMTCs to “Community Development Entities” (CDE) through a competitive application process.
- CDEs awarded credits enter into an allocation agreement with the CDFI Fund.
- As modified by the recent American Recovery and Reinvestment Act of 2009, the cap amount of NMTCs that can be allocated by the CDFI Fund to CDEs is \$5 Billion for 2008 and \$5 Billion for 2009.

# CDFI Fund

The CDFI Funds also:

- Performs CDE certifications,
- Maintains the mapping system used for determining whether a qualifying business is located in a LIC,
- Monitors CDE compliance with the various NMTC and allocation agreement requirements, and
- Tracks NMTC investments made by CDEs.

# Tax Credit Overview

- A taxpayer (Investor) is entitled to a NMTC to offset its federal income tax liability when:
  - (1) The Investor makes a “Qualified Equity Investment” (QEI) in a CDE,
  - (2) The CDE uses “Substantially All” of the proceeds from the QEI to make a “Qualified Low Income Community Investment” (QLICI), and
  - (3) The QLICI made by the CDE is to a “Qualified Active Low-Income Community Business” (QALICB) located in LIC.

# Tax Credit Overview

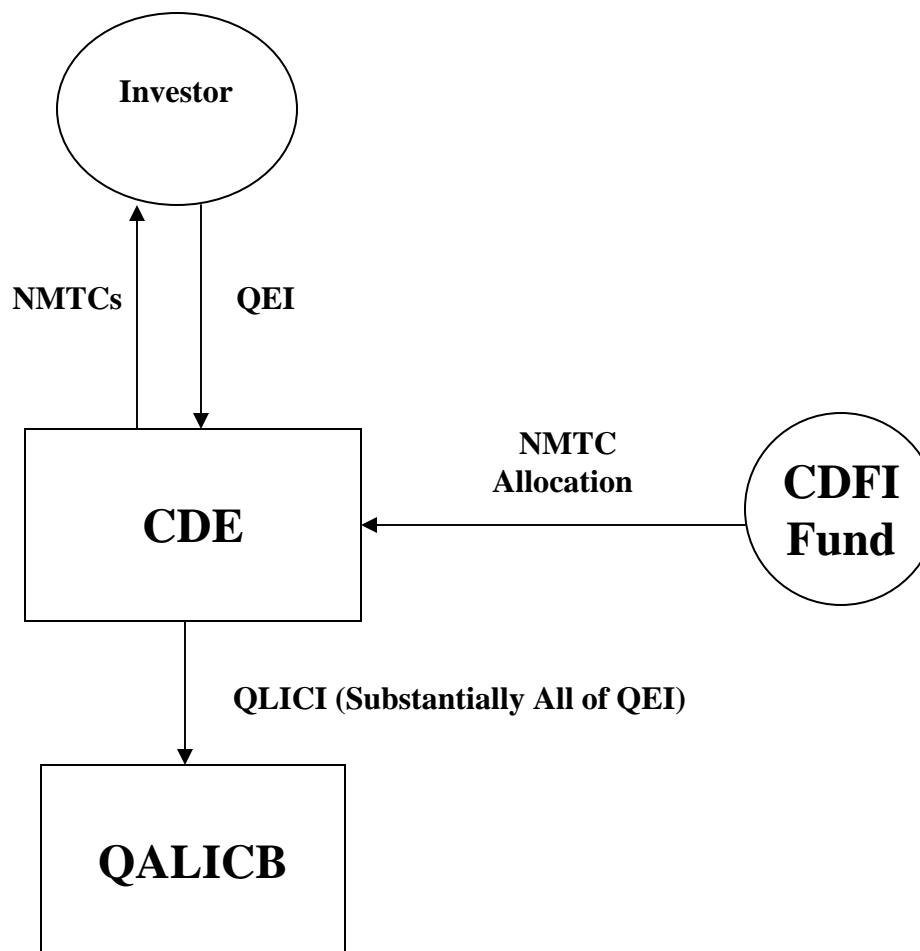
## Basic Parties and Process:

CDFI Fund allocates  
NMTCs to CDE

Investor makes QEI  
in CDE

CDE makes QLICI of  
Substantially All of QEI  
to QALICB

Investor allocated NMTCs  
from CDE



# Tax Credit Overview

- The NMTC is federal income tax credit equal to 39% of the Investor's QEI in a CDE.
- The NMTC is claimed by the Investor over 7 years:
  - 5% of the QEI in years 1 through 3
  - 6% of the QEI in years 4 through 7
- Investors subject to Community Reinvestment Act (CRA) requirements, such as banks and savings institutions, can also satisfy CRA requirements through NMTC investments.
- NMTCs cannot be used to offset Alternative Minimum Tax.
- Unused NMTCs can be carried back 1 year and forward 20 years.

# Tax Credit Overview

**Example:** An Investor makes a \$10 Million QEI in a CDE. The Investor may claim a total of \$3,900,000 of NMTCs (39% x \$10 million) over a 7 year period:

<u>Year</u>	<u>Amount</u>	<u>%</u>
1	\$500,000	5
2	\$500,000	5
3	\$500,000	5
4	\$600,000	6
5	\$600,000	6
6	\$600,000	6
7	\$600,000	6



# CDE

- The CDE is the investment vehicle for NMTCs.
- A CDE is a domestic corporation or partnership (including a limited liability company taxed as a partnership) which:
  - (1) Has a primary mission of serving or providing investment capital for LICs,
  - (2) Maintains accountability to residents of LICs through their representation on any governing board of the entity or on any advisory board to the entity, and
  - (3) Is certified by the CDFI Fund as being a CDE.

# CDE

- Two special types of organizations are automatically treated as CDEs:

Specialized small business entities (as defined in IRC Section 1044(c)(3)), and

Community development financial institutions (as defined 12 U.S.C. 4702).

- CDFI Fund certification of CDE status is accomplished through the CDE application process for NMTCs.
- Most CDEs are structured as partnerships or limited liability companies (i.e., tax pass-through entities).

# QEI

- A QEI is an “equity investment” in a CDE (i.e. acquisition of stock of a corporation or a capital interest in a partnership or limited liability company) if:
  - (1) The investment is acquired by the Investor at its original issue solely for cash,
  - (2) The CDE designates the investment as a QEI, and
  - (3) Substantially All of the cash is used by the CDE to make QLICIs.
- A QEI does not include any equity investment issued by a CDE more than 5 years after the date the CDE enters into its allocation agreement with the CDFI Fund.

# QEI

- The Investor's QEI in a CDE must be an equity investment – it cannot be a loan from the Investor to the CDE.
- Rev. Rul. 2003-20 concluded that cash from a nonrecourse loan to a limited liability company Investor which the Investor used, together with cash contributions from the Investor's members, to acquire an equity interest in a CDE met the requirement that the investment be acquired solely for cash. The loan was secured by the Investor's interest in the CDE (not by the assets of the CDE) and was otherwise treated as a "loan" to the Investor for tax purposes. Rev. Rul. 2003-20 allows an Investor to "leverage" the amount of its QEI in the CDE.

# QEI

- A CDE “designates” an investment as a QEI by providing a notice to the Investor within 60 days after the Investor makes its equity investment in the CDE. Notice is made using IRS Form 8874-A, a copy of which is also filed with the IRS.
- Within 60 days of the Investor’s equity investment, the CDE must also notify the CDFI Fund of the QEI using the CDFI Fund’s electronic allocation tracking system.

# QEI

- A QEI may be sold by the Investor and the investment will continue to carry the NMTC in the hands of the purchaser if the investment was a QEI in the hands of the Investor.
- The Investor must reduce the basis of its stock or partnership interest in the CDE by the amount of any NMTC generated by the investment. The basis reduction occurs on each credit allowance date. As a result of the basis reduction, an Investor may have a larger gain on any sale of its interest in the CDE.

# QLICI

- QLICIs include any equity investment in, or loan to, a QALICB located in a LIC.
- Loans from the CDE to a QALICB are the most prevalent form of QLICI.
- Because allocation agreements between the CDFI Fund and many CDE's prohibit the CDE's "control" of a QALICB in which the CDE makes a QLICI, there are fewer CDE equity QLICI investments in QALICBs.

# QLICI

- QLICIs can also include:
  - (1) the purchase from another CDE of any QLICI loan made by that CDE to a QALICB,
  - (2) The provision of financial counseling and other services to businesses located in, and residents of, LICs, and
  - (3) an equity investment in, or loan to, another CDE.



# QLICI

- A CDE must use Substantially All of the Investor's QEI for QLICIs.
- The term Substantially All means 85%.
- The Substantially All test must be satisfied each year in the 7-year credit period using either a direct tracing calculation or a safe-harbor calculation provided in the Treasury Regulations.
- Amounts received by a CDE in payment of principal with respect to a QLICI loan must generally be re-invested by the CDE in new QLICIs within 12 months from the date of receipt to be treated as continually invested in QLICIs.

# QLICI

- A failure to meet the Substantially All test can result in NMTC recapture.
- In order to comply with the Substantially All test requirements and avoid NMTC recapture issues during the 7-year NMTC period, QLICI loans made to QALICBs are generally structured with:
  - (1) A maturity date of 7 years, and
  - (2) Interest-only payments for 7 years with a lump-sum principal payment on maturity.

# QALICB

- A QALICB is any corporation (including a nonprofit corporation) or a partnership if, for any taxable year:
  - (1) At least 50% of the total gross income of such entity is derived from the active conduct of a “qualified business” (discussed below) within a LIC,
  - (2) At least 40% of the services performed for such entity by its employees are performed in a LIC,
  - (3) At least 40% of the use of the tangible property of such entity, whether owed or leased, is within a LIC,
  - (4) Less than 5% of the entity’s assets are certain collectibles (e.g. works of art, rugs or antiques, metals or gems, etc.), and
  - (5) Less than 5% of the entity’s assets are “nonqualified financial property.”

# QALICB

- The gross income test is deemed to be satisfied if either the tangible property or the services test is satisfied by substituting 50% for 40%.
- If an entity has no employees, the entity is deemed to satisfy the gross income and services tests if the tangible property test is met by substituting 85% for 40%.
- For purposes of the “nonqualified financial property” test, such property includes stock, partnership interests, debt, options, futures contracts, forward contracts, notional principal contracts, annuities and similar property. It does not include reasonable amounts of working capital held in cash (or cash equivalents), debt instruments with a term of 18 months or less, or accounts receivable. Because the term “nonqualified financial property” includes debt instruments with terms in excess of 18 months, banks and similar financial institutions are generally excluded from the definition of a QALICB.

# QALICB

- Portions of the Business Rule:

A CDE may treat a portion of a trade or business as a QALICB when:

- (1) It would meet the requirements for a QALICB if the portion of the business were separately incorporated, and
- (2) A complete and separate set of books and records is maintained for the portion of the business.

- The portions of the business rule allows an entity with business operations both inside and outside an LIC to be treated as a QALICB with respect to the portion of its business located in an LIC.

# QALICB

- Example of Portions of the Business Rule:

CDE receives a NMTC allocation from the CFDI Fund. Investor pays \$1 million for a capital interest in CDE. Z is a corporation that operates a supermarket that is not in an LIC. CDE uses the proceeds of Investor's investment to make a loan to Z that Z will use to construct a new supermarket in a LIC. Z will maintain a complete and separate set of books and records for the new supermarket. The proceeds of the loan will be used exclusively for the new supermarket. Assume that Z's new supermarket in the LIC would meet the various QALICB requirements if it were separately incorporated. Pursuant to this rule, CDE can treat Z's new supermarket as a QALICB and its loan to Z for the new supermarket as a QLICI.

# QALICB

- In general, “qualified businesses” are most businesses that constitute a trade or business for federal income tax purposes, including the rental of improved nonresidential real estate.
- For purposes of this requirement, a nonprofit corporation is treated as engaged in the conduct of an active trade or business if it is engaged in any activity that furthers its nonprofit purpose.

# QALICB

- Qualified businesses do not include:
  - (1) Leasing of unimproved real property or residential rental property,
  - (2) Any trade or business predominately consisting of the development or holding of intangibles for sale or license,
  - (3) Any trade or business the principal activity of which is farming, and
  - (4) Any trade or business consisting of the operation of a golf course, country club, massage parlor, hot tub or suntan facility, racetracks or other gambling facilities, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises (i.e. liquor stores).



# QALICB

- Residential rental property is any building or structure in which 80% or more of the gross rental income is from dwelling units.
- If more than 20% of building's gross income is from the rental of commercial space, the building is not residential rental property. Accordingly, it is possible that mixed-use rental property of a QALICB can constitute a qualified business even though a portion of it contains residential rental units.
- The business may use a condominium structure to separate the commercial and residential components of a project to mitigate risks associated with mixed-use property. The CDE would make the loan or investment to the owner of the commercial unit.

# QALICB

- Reasonable Expectations Rule:

An entity is treated as a QALICB for the duration of the CDE's investment in the entity if the CDE reasonably expects, at the time it makes its equity investment in, or loan to, the entity, that the entity will satisfy the requirements to be a QALICB throughout the entire period of the investment or loan.

- Exception:

If a CDE controls or obtains control of the entity during the 7-year credit period, the entity will be treated as a QALICB only if entity actually satisfies the QALICB requirements throughout the period the CDE controls the entity. In general, control means more than 50% of ownership or management control of the entity.

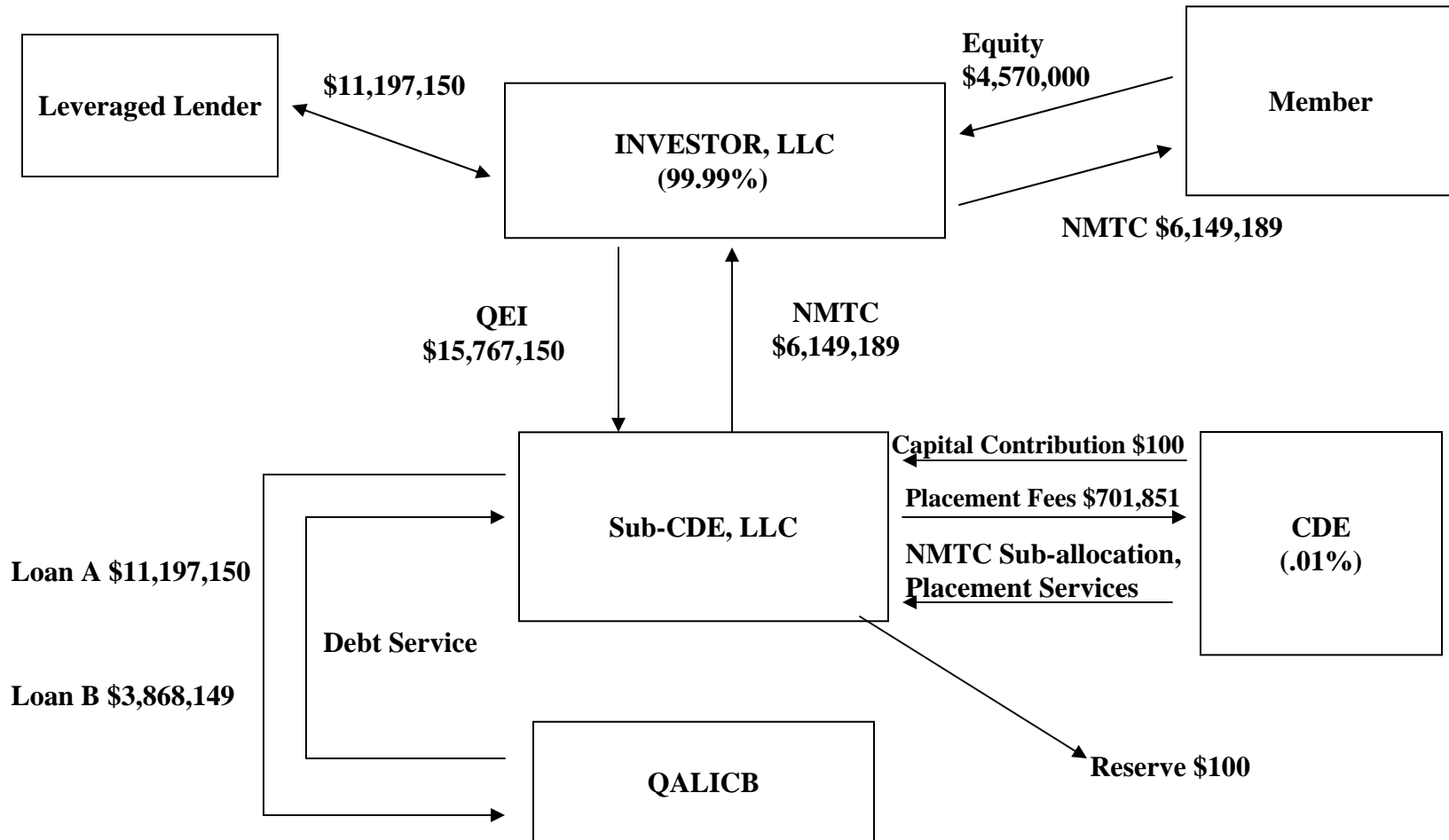
# Recapture

- A tax credit recapture event occurs during the 7-year credit period if:
  - (1) The CDE ceases to qualify as a CDE,
  - (2) The Substantially All test is not met, or
  - (3) The Investor's QEI is redeemed by the CDE.
- If a recapture event occurs during the 7-year credit period, then 100% of the NMTC claimed by the Investor must be recaptured (i.e., total recapture of all prior credits), plus interest on the amount of underpayment of tax.

# Use With Other Tax Credits

- NMTCs can be used in combination with projects that also generate Historic Tax Credits (IRC Section 47) and Energy Credits (IRC Section 48).
- NMTCs cannot be used in combination with projects that generate Low-Income Housing Tax Credits (IRC Section 42).

# Typical NMTC Transaction



# **Combining the New Market Tax Credit with Rehabilitation Tax Credit and the Energy Tax Credits**

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# The federal historic tax credit program

- Established in 1976, the federal historic tax credit program is the nation's key program for encouraging investment in the renovation of historic buildings
- Diverse uses of the subsidy, including retail uses, theaters, apartments, hotels and office
- Program is based on a partnership among the federal government, state governments and the private sector
- Over 1,000 projects approved in 2008
- Over one million buildings are listed in or contribute to historic districts in the National Register of Historic Places

# What is the federal historic tax credit?

- A federal income tax credit for renovation of historic buildings equal to 20 percent of qualified rehabilitation expenditures incurred with respect to a certified historic structure. See § 47 of the Internal Revenue Code (IRC)
- The credit is a dollar-for-dollar offset against the building owner's federal tax credit liability.
- Generally, the historic tax credit is allowed in the year in which the renovated building is first placed back in service.
- Buildings first placed in service before 1936, which are not certified historic structures, may still receive a 10% historic tax credit.



# Basic requirements for the historic tax credit

- A qualified project that the Secretary of the Interior designates as a “certified rehabilitation” of a “certified historic structure.”
- “Certified historic structure” is a building that either:
  - is individually listed in the National Register of Historic Places or;
  - is located in a registered historic district and certified by the Secretary as being of historic significance to the district.
- The state historic preservation office plays a key role in the certification process.
- There is a three part certification process:
  - Part 1 – with respect to buildings that are not listed in the National Register of Historic Places, evaluate the historic significance of the building to the historic district in which it is located
  - Part 2 – approval of the scope of the renovation work
  - Part 3 – certification of completion of the renovation work

# Basic requirements for the historic tax credit

- A “certified rehabilitation” is a rehabilitation that has been certified by the Secretary as being consistent with the historic character of the building or the district in which it is located.
- The building must be “substantially rehabilitated.” In general, this requires that the qualified rehabilitation expenditures during the 24-month period selected by the taxpayer exceed the adjusted basis of the building, including its structural components.
- The requirements for the historic tax credit can be satisfied in a manner that allows for a “rolling rehabilitation” of a building (i.e. one in phases).

# What are “qualified rehabilitation expenditures?”

- Qualified rehabilitation expenditures generally are costs incurred for the renovation of a building that would be depreciable under IRC Section 168 (e.g. construction costs, architect’s fees, engineering fees and related costs of carry). See IRC § 47(c)(1)(A)
- Reasonable developer fees do generate historic tax credits.
- Qualified rehabilitation expenditures do not include:
  - Land costs
  - Costs of acquiring the building
  - Costs of enlarging the building
  - Costs of related facilities, such as sidewalks, parking lots and landscaping
- Personal property, such as appliances, cabinets and furniture do not generate historic tax credits.

# Recapture of historic tax credits

- Historic tax credits are subject to “recapture,” which results in a federal income tax liability to the person who had claimed the credit.
- The recapture period is the five-year period commencing on the date the renovated building was placed in service.
- Recapture occurs if:
  - the building is sold or ceases to be used for business purposes during the recapture period;
  - with respect to any partner, if the partner sells 2/3rds or more of its interest in the owner of the renovated building; in this case, recapture is pro rata based on the amount sold in excess of 2/3rds; or
  - a project ceases to be a certified historic structure, whether because of casualty, owner renovations that change the historic character of the building or otherwise. See IRC § 50(a).
- The recapture amount is 100 percent during the first one year period following the placed in service date, 80 percent the next year, etc. until the recapture period terminates on the fifth anniversary of the placed in service date.
- Because of recapture tax liability, the owner must plan on having a minimum five year holding period for the project.

# Use of historic tax credits by lessee

- Subject to certain requirements, an owner can make an election to “pass-through” the historic tax credits to its tenant, See IRC § Section 50(d)(5).
- The pass-through election structure is common in historic tax credit transactions.
- To receive the maximum allowable amount of historic tax credits in connection with a pass-through lease transaction, either (A) the lease term must be at least 80 percent of class life of the renovated building (e.g. for a non-residential building, the minimum lease term would be 31.2 years [80 percent of 39 years]), or (B) the lease must be a “net lease.”
- One of the primary benefits to the pass-through structure is that it does not require the owner to reduce its depreciable basis by the amount of qualified rehabilitation expenditures. Instead, the master tenant must recognize income ratably over the shortest cost recovery period for the rehabilitation expenditures.

# Additional tax considerations

- Except in connection with the pass-through lease structure (described above), the owner's basis is reduced by the amount of the historic tax credits allowed.
- As a result of the Housing and Economic Recovery Act of 2008, the historic tax credit can be used to offset a taxpayer's liability for alternative minimum tax.
- The allocation of historic tax credits must follow general profits. This requirement constrains how the tax credit may be allocated among the parties to a transaction.
- Historic tax credits are subject to the "at-risk" rules, including a rule that not more than 80 percent of a project's credit basis can be financed with non-recourse debt.

# Additional tax considerations

- Special tax exempt use rules restrict the leasing of more than 50% of a historic tax credit building to governmental entities or other tax exempt entities.
- Additional tax rules restrict ownership of historic tax credit buildings by governmental entities or other tax exempt entities.
- There are structuring techniques to manage the problems raised by ownership or use of a project by a tax-exempt entity.
- Historic tax credits are subject to passive loss rules, which generally make the historic tax credits unavailable to individual taxpayers.

# Market Conditions for Historic Tax Credits

- A small, but active effective, market exists for investments in historic tax credits. Because of the passive loss limitations, historic tax credits are primarily purchased by profitable, widely held C-corporations.
- An historic tax credit investment involves a mix of tax investment and economic return – the tax credits cannot be sold without an economic return to the investor.
- Tax credit prices generally range from \$0.90 to over \$1.00 per credit depending on many factors, including timing of equity investments, the required economic return to the historic tax credit investor, structure of tax credit investment and perceived tax risk.
- This market has held up relatively well because (a) the historic tax credit is an investment credit that is 100% allowed the year the improvements are placed in service, and (b) the recapture/investment holding period is only 5 years.



# Other Business Considerations

- Usually, the historic tax credit investor demands a cash-on-cash return of 2% to 3% on its investment.
- Typically, the historic tax credit investor has the option to put its investment to the deal sponsor at a pre-determined price after the recapture period.
- In addition, the sponsor often has a call option to purchase the interest of the historic tax credit investor for the fair market value of the interest of the historic tax credit investor.
- The client must evaluate the economic implications of these provisions as well as tax consequences to the sponsor from entering into the HTC transaction.

# Market Conditions for NMTCs

- Pricing for the NMTCs in the \$.60 to \$.70 range (net) and likely falling
- Leveraged loans are tough to find
- Banks are the predominant leveraged lender and investors
- Real estate underwriting standards are becoming tougher
- Deals in highly distressed areas are favored by many CDEs
- CDE fees and transaction costs can cut deeply into the proceeds to the owner
- Deals with lots of subsidy in addition to the NMTC are favored

# Combining with NMTCs

- The historic tax credit can be “twinned” with the new market tax credit.
- The twinned structure can increase the net proceeds from the historic tax credit investment by 20 to 25%
- While there are numerous ways to structure the new market tax credit investment with the historic tax credit equity, a single equity investment by a CDE is often the most efficient.

# Energy Tax Credits under IRC Section 48

- An investment tax credit under IRC Section 48 for investment in “energy property”
- A 30% credit is available for:
  - Solar technology used to generate electricity (if placed in service by end of 2016)
  - Solar equipment to heat or cool a structure building or to provide hot water (but no swimming pools allowed) (if placed in service by end of 2016)
  - Equipment for fiber-optic distributed sunlight (if placed in service by end of 2016)
  - Qualified fuel cell property
  - Qualified small wind energy property

# 10% Energy Property

- A 10% credit is available for:
  - Equipment used to produce, distribute or use energy from a geothermal deposit
  - Qualified microturbine property (if in service by end of 2016)
  - Combined heat and power system equipment
  - Equipment that uses the ground or ground water as a thermal energy source (heating) or a thermal energy sink (cooling)

# Rules for Energy Credits

- Rules generally match the rules for the historic tax credit and other investment credits, including recapture, pass-through election of leased property, governmental use and tax-exempt use property
- Can combine with NMTCs
- Can not claim historic tax credit and Section 48 tax credit on same property – no double dipping
- Except in connection with pass-through election, Section 48 tax credit reduces basis by 50% of the credit amount

# Rules for Section 48 Energy Credits

- Property must meet performance and quality standards, if any, prescribed by the IRS based on consultation with the U.S. Department of Energy

# Grants in Lieu of Credit

- Housing and Economic Recovery Act of 2009 allows for grants in lieu of tax credits for 100% of the amount of the credit that would have been allowed
- This program is available only for property placed in service during 2009 or 2010, or property under construction during 2009 or 2010
- The taxpayer must apply to the Secretary of the Treasury for the grant in lieu of credit and comply with program requirements
- Grants are also subject to recapture rules