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ABA SECTION OF TAXATION'S COMMITTEE ON EXEMPT ORGANIZATIONS

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COMMUNITY IMPACT OPPORTUNITIES

FOR EXEMPT ORGANIZATIONS

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- **The Community Renewal Tax Relief Act of 2000, enacted in December 2000, amended the Internal Revenue Code (IRC) by adding IRC Section 45D, New Markets Tax Credit. This new section required the Secretary of Treasury to establish a program that would provide an incentive to investors in the form of a tax credit over seven years, which credit will stimulate investment in new private capital that, in turn, will facilitate economic and community development in distressed urban and rural communities.**

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- The New Markets Tax Credit (NMTC) is to generate $15 billion in new investments over the next six years. The limitation for 2001 was $1 billion, $1.5 billion for 2002 and 2003, $2 billion for 2004 and 2005, and $3.5 billion for 2006 and 2007. In its 2003 allocation, the CDFI Fund modified the limitations by combining the 2001 and 2002 limitations for a total allocation amount of $2.5 billion. The 2004 allocation, combining 2003 and 2004 limitations, was greater than the first round, allocating a total of $3.5 billion to 63 organizations. Unlike the first two allocations, the third round of allocations encompasses only one year’s (2005) limitation, amounting to $2 billion. The fourth round (2006) allocated $4.1 billion (which includes $600 million in the GO Zone).

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- **To date, the Fund has made 233 awards totaling $12.1 billion. The fourth round application will be available December 1, 2006 and must be filed on or before February 28, 2007.**

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- **The term of the NMTC is seven years. Investors will be eligible to claim a tax credit equal to 5% for each of the first three years of an investment and 6% for each of the next four years, a total tax credit of 39% (or an approximate net present value of 30%).**

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- **The Opportunities. The NMTC is designed to help underserved low-income communities by offering investors an attractive tax benefit which will boost the yield, i.e., increase return on investment while fulfilling Community Reinvestment Act responsibilities.**

A. The NMTC is flexible and can be used for traditional investments such as <u>loans</u> (both first mortgage and mezzanine debt) and equity investments in businesses, investments in real estate, and the purchase of loans, as well as non-traditional investments such as charter schools, community health centers, day care centers, and other community facilities.

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B. While residential rental housing is not eligible, the NMTC can be used for mixed-use developments or to finance businesses that purchase, rehab and sell single family housing.

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- The NMTC functions more like an interest subsidy than a capital grant. The ultimate investment in the qualified low-income community must generate significant cash flow and/or return of capital and appreciation to supplement the relatively shallow credit. In contrast to the LIHTC which provides a significant return to the investors based solely upon the value of the tax credit, the NMTC cannot stand on its own without significant economic benefits in addition to the credit.

- **The NMTC is based on the amount of cash invested in the CDE; since it will return only 39 percent of the investment, an investor needs to be assured of a market rate return and will require additional cash flow or otherwise will need to leverage its investment through personal borrowing. The economic issues become critical especially since the equity investment in the CDE must remain outstanding for a 7-year period.**

- **Treasury Department requires the CDE Allocatee to execute an Allocation Agreement, a copy of which is available on the CDFI website. When the Allocatee makes a loan it must consider using a number of subsidies which may involve one or more of the following:**

  1. **A loan to value ratio that is higher than the standard ratio;**
  2. **A longer than standard amortization period;**
  3. **More flexible borrower credit standards;**
  4. **Nontraditional forms of collateral;**

5. Below market interest rates;
6. A longer than standard period of interest only loan payments;
7. Lower than standard origination fees;
8. Debt service coverage ratios that are less than standard;
9. Loan loss reserve requirements that are less than standard; or
10. Equity-equivalent terms and conditions.

There is also a monitoring/compliance fee of an amount not to exceed $10,000 a year.

- **Moreover, in circumstances where the underlying investment in the community is structured as a first mortgage and/or mezzanine debt, that totals more than 85 percent of the initial value of the property (with limited amortization) an issue may arise as to whether the CDE will be able to refinance the debt under market conditions after the 7-year period in order to pay back the investor its capital account.**

- The Details. To qualify for the NMTC, an investor must make a *Qualified Equity Investment* in a *Qualified Community Development Entity* that in turn makes a *Qualified Low-Income Community Investment* in a *Qualified Active Low-Income Community Business* located in a *Qualified Low-Income Community*. These key terms are defined below:

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- *Qualified Equity Investment* (QEI) is the actual cash investment made by investors. QEI means any equity investment in a *Qualified Community Development Entity* (CDE) if (a) such investment is acquired by the investor at its original issue solely in exchange for cash, (b) substantially all of such cash is used by the CDE to make *Qualified Low-Income Community Investments*, and (c) the investment is designated by the CDE as a QEI.

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CAVEAT: There is a safe harbor for the "substantially all" requirement if (a) at least eighty-five percent (85%) of the taxpayer's investment is directly traceable to qualified low-income community investments or (b) at least eighty-five percent (85%) of the aggregate gross assets of the qualified CDE are invested in qualified low-income community investments.

- **Since the CDE has one year after receiving the cash to reach the 85 percent threshold, it may consider drawing down the funds in installments, especially if there aren't available investment opportunities in the low-income community during the initial period. Each draw will be treated as a separate investment within its own 7-year credit period, and will extend the date upon which an investor can be fully redeemed.**

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- The “substantially all” test must be met for each annual period during the 7-year period. The test must be performed semi-annually with the average of the calculations meeting the 85 percent rule. Presumably, the remaining 15 percent may be applied to fund cash reserves, pay brokers and underwriter fees and administrative expenses.

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- ***Qualified Community Development Entity*** **(CDE) is the entity that receives the allocation of NMTC and makes the investments. A CDE is any domestic corporation, partnership, or limited liability company if (a) the primary mission of the entity is serving or providing investment capital for low-income communities or persons, (b) the entity maintains accountability to such communities or persons, and (c) the entity is certified by the Community Development Financial Institutions Fund of the U.S. Treasury Department.**

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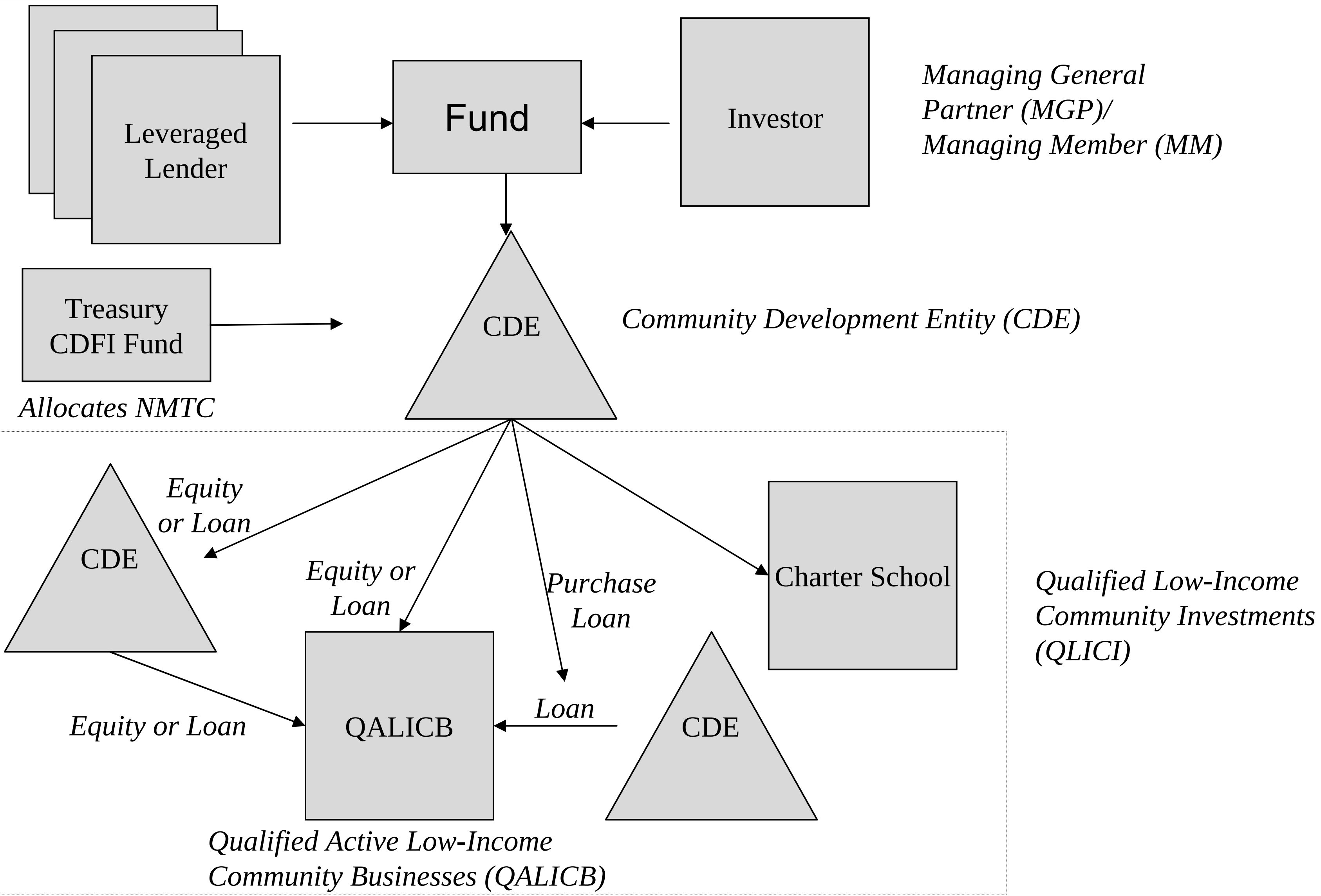
NMTC STRUCTURE



- **The CDE certification requirements include primary mission and accountability. A certification of authorized representative must demonstrate that at least 60 percent of the products and services will be directed to low income persons, communities or organizations serving such persons or communities.**

- As to the accountability test, the CDE must be accountable to the residents of the community it serves. It must demonstrate than 20 percent of the members of its governing board or advisory board represent the low-income community in the service area. Only certified CDEs can receive an allocation of the NMTC.

- ***Qualified Low-Income Community Investment*** **(QLICI) is the actual investment that a CDE is required to make. A QLICI is (a) any capital or equity investment in, or loan to, any Qualified Active Low-Income Community Businesses, (b) the purchase from a CDE of a loan made by a CDE that is a QLICI, (c) financial counseling or other services to businesses located in, or residents of,** ***Qualified Low-Income Communities*****, and (d) any equity investment in, or loan, to, any CDE.**

- The NMTC could be implemented with construction loans as well as predevelopment loans and could enable the lender to provide an indirect subsidy to the developer or homebuyer through a below market interest rate. Moreover, CDE’s may be able to buy loan pools. Thus, community banks may be able to sell their current target area loans to a pool created by another CDE.

- **Amounts received by a CDE in payment of, or for, capital, equity, or principal with respect to a QLICI must be reinvested by the CDE in a QLICI no later than twelve (12) months from the date of receipt to be treated as continuously invested in a QLICI.**

- **Since CDE investments must be made in active businesses, in the case of a construction loan, the construction of the real estate should be treated as an active business, even before the real estate project is complete. This is especially important where the construction period exceeds the 12 month window for the CDE to invest in an active business.**

CAVEAT: Portion of a Business. The Final Regulations provide that a CDE may treat any trade or business (or portion thereof) as a qualified active low-income community business if the trade or business (or portion thereof) would meet the requirements of a QALICB provided that if the trade or business (or portion thereof) were separately incorporated and a complete and separate set of books and records is maintained for that trade or business (or portion thereof).

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- Interest or dividend payments to a CDE do not have to be reinvested and may be distributed to the investors. Periodic payments received during a calendar year as repayment of principal on a loan that is a QLICI are treated as continuously invested in a QLICI if the amounts are reinvested in another QLICI by the end of the following calendar year.

- **Thus, principal amortization on mini-perm loans would require the CDE to reinvest the funds on continuous basis unless Treasury provides a "de minimis" exception to the rule. The funds need to be reinvested or "churned" within the targeted low-income community, which requires the availability of new projects to come "on-line" where construction, development or mini-perm loans are repaid during the 7-year credit period.**

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- *Qualified Active Low-Income Community Business* (QALICB) is the recipient of the NMTC investment. A QALICB is any corporation, partnership or limited liability company if (a) at least 50% of the total gross income of the entity is derived from the active conduct of business within a *Qualified Low-Income Community* (QLIC), (b) a substantial portion (at least 40%) of the use of the tangible property of such entity is within a QLIC, and (c) a substantial portion (at least 40%) of the services performed for such entity by its employees are performed within a QLIC.

- **Potential QALCIBs include:**

  ● Real Estate Investments, including Retail Shopping Centers, Offices, Supermarkets, Charter Schools, Industrial/Manufacturing Facilities Warehouse.

  ● Providing Services, including Day Care Centers, Community Centers, and Financial Services/Technical Assistance.

  ● Business Investments, including Small Business Loans or Venture Capital.

- **NOT ELIGIBLE, Residential Rental Housing, Certain Enumerated Businesses (gambling facility, liquor store, country club, etc.)**

- Residential rental property means a building if 80 percent or more of the gross income is rental income from dwelling units. Thus, if more than 20 percent of the income is derived from commercial or retail use, the building would qualify for the NMTC. A residential development or management company qualifies as a business distinguished from residential rental property for these purposes.

- **Assisted living facilities which resemble an operating business should also be eligible for the NMTC. In any event, the NMTC is available for commercial rental properties and sale of residential housing in low-income communities.**

- **Substantial Improvements Rule: Permanent Loan Refinancing.**

- *Qualified Low-Income Community* (QLIC) is the geographic area in which NMTC investments may be made. A QLIC is any population census tract (a) in which the poverty rate is at least 20% or (b) with median family income of up to 80% of the area or statewide median family income. Because the determination of median family income is made separately for each state, NMTC investments will be dispersed throughout the country. An online program for locating QLICs by census tract or postal zip code is available at www.cdfifundhelp.gov.

▪ Target population eligibility.

- ***Recapture*. If, at any time during the 7-year period beginning on the date of the original issue of the QEI in a qualified CDE, there is a recapture event with respect to such investment, the taxpayer's income tax liability is increased by the credit recapture amount.**

- The credit recapture amount equals the sum of the aggregate decrease in the general business credits allowed to the taxpayer for all prior taxable years which would have resulted if no NMTC had been allowed with respect to the investment, plus interest at the Section 6621 of the Code underpayment rate on that amount.

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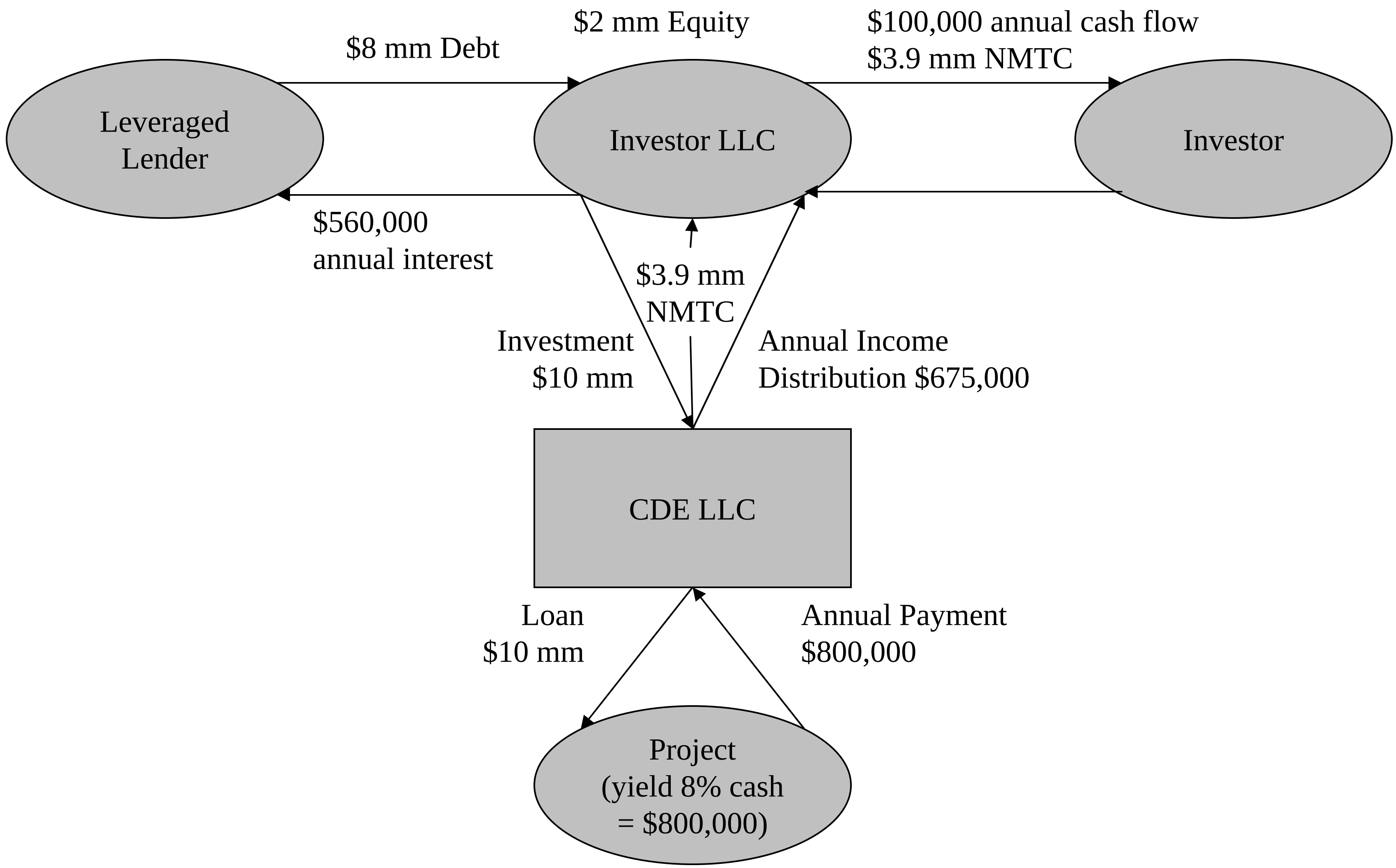
- There is a recapture event with respect to a QEI in a qualified CDE if (a) the CDE ceases to be a qualified CDE; (b) the proceeds of the investment cease to be used as required, e.g., no longer satisfy the “substantially all” test; or (c) the investment is redeemed by the CDE.

- **The Timeline.**
- **The Treasury's CDFI Fund currently is accepting certification applications for Community Development Entities. The Applications are available online at <u>www.cdfifund.gov/applications/index.asp</u>.**

The NMTC **Leveraged** Structure



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