TAX CREDIT TRAINING
New Markets Tax Credits
Spring 2017
Enterprise®
NMTC: Background

- Created by Congress as part of the Community Renewal Tax Relief Act of 2000

- Codified in Section 45D of the Internal Revenue Code

Administered by the Community Development Financial Institutions (CDFI) Fund of the US Treasury Department
## NMTC: Overview

<table>
<thead>
<tr>
<th>Purpose:</th>
<th>Encourage the investment of private &amp; patient capital in low-income communities.</th>
</tr>
</thead>
<tbody>
<tr>
<td>What is it:</td>
<td>39% tax credit (.39 for every $1) on the capital invested in a Community Development Entity (CDE), over 7 years (5% in yrs 1-3; 6% in yrs 4-7)</td>
</tr>
<tr>
<td>Who is eligible for the credit?</td>
<td>Only a CDE can apply for an allocation of federal tax credits. Only investors who make a qualified investment can claim the credit.</td>
</tr>
</tbody>
</table>
| Who benefits from the credit? | Investors get credits  
CDEs further mission  
Businesses / projects get financing in form of loans or equity |
| Eligible Property Types: | Low-income community businesses  
Commercial properties or mixed-use projects |
NMTC: How it Works

- Enterprise applies for and receives NMTC "allocation authority" from CDFI Fund
- Investors form partnerships with Enterprise
- Investor’s capital contributions and loans are used to make investments in qualified projects
- Qualified projects result in new or rehabbed facilities
### NMTC vs. LIHTC

<table>
<thead>
<tr>
<th>NMTC</th>
<th>LIHTC</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Commercial / Flexible</td>
<td>• Residential</td>
</tr>
<tr>
<td>• Place based*</td>
<td>• People based</td>
</tr>
<tr>
<td>• CDEs like Enterprise controls credit</td>
<td>• Developer controls credit</td>
</tr>
<tr>
<td>• Full year of credit taken on day of Qualified Investment</td>
<td>• Credits begin when units are placed in service</td>
</tr>
</tbody>
</table>

*Some exceptions allow “people-based” NMTC investments*
NMTC vs. LIHTC

- **Calculation of credits**
  - Tax credits generated based on sources of cash flowing from CDE into the project (including equity contribution from NMTC investor)
  - Not generated by the project development cost (no “eligible basis”)

- NMTC investments are not typically set up to create tax losses

- **Recapture risk**
  - “All or nothing” for NMTC (i.e., 100% recapture)
NMTC: Volume

How Much are We Talking About?

• $50 billion total allocation awarded to date
  - $15 billion originally authorized through 2007;
  - $35.5 billion through extensions and special allocations

• Applications requests over $330 billion

• “Allocation” is not the same as tax credits

• Numbers sound big, but demand is even greater (NMTC allocation is a rationed commodity)
NMTC: Program Overview

Eligible Projects – Real Estate Program
Types of Properties Which Can Receive NMTC investments (QLICIs)
- Commercial, non-residential, or mixed-use
- Mixed-use developments must have at least 20% of gross income generated by commercial component
- For-sale product can be challenging due to investor concerns re: early return of capital/tax credit recapture
  - Program favors 7-year investments
  - Some investors have structured for-sale deals

Type of Construction
- New Construction or Substantial Rehab
- Avoid refinancing of existing buildings (can do take-out)
- Can be combined with Historic Tax Credits
- Cannot be combined with LIHTC (unless a separate condo regime)
What do NMTCs do for projects?

- Gap financing for commercial and mixed-use projects

- Shallow subsidy compared to LIHTC –

   NMTC “equity” is 20 to 30% of the NMTC financing.

   Could represent 20-30% of TDC if NMTC finances 100% of the project cost.
How the NMTC Works

Credits are earned on a “Qualified Equity Investment” (QEI) in a “Community Development Entity” (CDE) which uses substantially all of the QEI proceeds to make “Qualified Low-Income Community Investments” (QLICIs) in “Qualified Active Low-Income Community Businesses” (QALICBs) located in Low-Income Communities (LICs)
What is a *Low-Income Community*?

- **Census tracts where:**
  - Poverty rate exceeds 20%; or
  - Median income is below 80% of the greater of:
    - Statewide median income or
    - Metropolitan area median income

- **Also:**
  - “Targeted populations”
  - Census tracts with less than 2,000 people that is contiguous to a Low-Income Community and within an empowerment zone
  - High migration rural counties (use 85% median income instead of 80%)
What is a *Qualified Equity Investment (QEI)*?

- A cash (equity) investment in exchange for an ownership interest in a “Community Development Entity”

- By virtue of making a QEI the investor (a taxpayer) may claim tax credits

- CDE must further invest substantially all (85%) of the QEI proceeds in qualified projects or businesses
What is a *Community Development Entity (CDE)*?

- A special purpose intermediary entity (LP, LLC or corporation) which must:
  - Have a mission of serving low-income communities (LICs) or low-income persons (LIPs)
  - Be accountable to residents of LICs (>20% of governing or advisory board)
  - Be certified by the CDFI Fund
What is a *Qualified Low-Income Community Investment (QLICI)*?

- A loan to or investment in a qualifying business
- A loan to or investment in another CDE
- Purchase of a QLICI originated by another CDE

- Can also be financial counseling and other services to benefit low-income persons or communities
What is a **Qualified Active Low-Income Community Business (QALICB)**?

- Any corporation or partnership (including a nonprofit corporation) engaged in the “active” conduct of a qualified business that meets 5 separate requirements and is not engaged in an excluded business or activity.

- “Active” means the business can reasonably be expected to generate revenues within 3 years after the QLICI is made (or for nonprofit to generate funds to further support its mission).
5 requirements for a QALICB

• At least 40% of the **Tangible Property** is in a LIC
• At least 40% of **Services** (by payroll paid) is performed in a LIC
• At least 50% of **Gross Income** must be derived in a LIC
• < 5% of property can be **Non-qualified Financial Property**
• < 5% of property can be **Collectibles**

(Modified percentages for entities with no employees)
What are Excluded Businesses?

- Liquor store
- Racetrack or other gambling facility
- Massage parlor
- Hot tub facility
- Suntan facility
- Country club
- Golf course

Restrictions apply to QALICB and Tenants of QALICB
What are Other QALICB Restrictions?

• Can’t be a business which develops or holds intangibles for sale or lease
• Can’t be certain farming businesses

• Can’t be residential rental property (at least 20% gross rental income must be from commercial uses)
Acquisition and tenant improvements for a new 39,000sf headquarters and program space for LightHouse for the Blind and Visually Impaired, a 113 year old San Francisco-based non-profit organization providing a range of services to people who are blind and low vision of all ages. 100% of LightHouse clients are legally blind. More than 70% of are low income or below the poverty line. 50% are multi-disabled and 60% represent minority groups. The new facility will showcase innovative lighting, soundscape and architectural design features that will set a new standard of universal design for people with all levels of eyesight. The new space is floors 9, 10 and 11 of an 11 story existing building.

**Community Impact:** This new headquarter location will allow Lighthouse: increase the number of blind job seekers trained from 28 per year to 100 per year, provide support services to 500 individuals from 141 individuals, increase the number of rehab students from 309 per year to 1,000 year. Other project offerings include accessible workstations open to the public, a 12 person teaching kitchen and a demonstration room. The expansion will create approximately 50 new permanent jobs and 100 construction jobs.
GMDC – Atlantic Ave (Brooklyn, NY)

NMTC Allocation: $12MM total

Sponsor: Greenpoint Manufacturing and Design Center Local Development Corporation (GMDC). Non-profit, industrial property developer.

Other Sources: Enterprise debt, NYC grant, Brooklyn Borough grant, Sponsor equity

Adaptive reuse of a 50,511 sf, two-building industrial complex into a multi-tenanted center for small-scale manufacturing.

Community Impact: The location houses 14 small business is spaces that range from 1,200 sq ft to over 7,000 sq ft. Tenants include woodworkers, a metal finisher, a model maker, a special effects studio, display makers, a home goods manufacturer, and a furniture upholsterer. Tenants pay $14-$18 psf.
NMTC Allocation: $32.5MM total

Lender: THEARC Affiliate

Lender Source: Bank debt, CDFI debt

110k sq ft center that will be home to four partners: Children’s National Health System/Children’s Health Fund, the Bishop Walker School for Boys, The Phillips Collection and AppleTree Institute for Education Innovation. The project goal is provide much needed services to children and families east of the Anacostia River.

Location: Ward 7 and Ward 8 are home to 40% of all DC youth. Forty-nine percent of the community’s children live at or below the poverty line.
NMTC: Pros & Cons

Pros:
- “But for” projects are completed
- Focus on creating substantial community benefits
- Efficient use of taxpayer dollars

Cons:
- Limited access to credits; strong competition
- Strict compliance issues
- Transaction structures can be costly & complex
- Program renewal risk

**Significant Recapture Risk:**
The compliance period is 7 years from date of QEI
Amount of recapture = NMTC (39% of QEI) + interest + penalty
NMTC: Participant Roles

**NMTC Allocatee** (Enterprise)
- Bring NMTC sub allocation to the CDE for the direct benefit of the NMTC Investor and the indirect benefit of the borrower
- Compliance, accounting, asset management, and investor reporting

**NMTC Investor / Lender**
- **Economic investors** typically focus on cashflow and depend on project performance to receive a return on capital
  - Construction/permanent lender ("leverage lender")
  - Equity investors (sponsor, preferred equity)
- **Tax credit investors** typically focus on the receipt of tax credits and depend on regulatory compliance to ensure a return on capital.
NMTC: Participant Roles

**Sponsor / Developer**

- Articulate community impact
- Specify level of commitment of all funding sources
- Develop a pro-forma that articulates NMTC allocation required and appropriate fees
- Begin conversations with NMTC allocatees / CDEs and Investors
  - Allocatees control their own credits
  - Investors control the $$$
NMTC: Participant Risks

Key risk categories

Real estate risk (leverage lender, sponsor)
  ▪ Project performance
  ▪ Effect of market-based conditions

Compliance risk (tax credit investor, CDE)
  ▪ Following IRS guidelines
  ▪ Complying with Allocation Agreement with CDFI Fund

Management of risk allocation (sponsor, tax credit investor, CDE)
  ▪ Transaction structuring to ensure appropriate party bears risk

Reputation risk (CDE)
  ▪ Ability to receive future NMTC allocations
    (maintain track record)
CDE Concerns

- Carry out Enterprise mission & strategy
- Meet goals of NMTC program
- REMAIN HIGHLY COMPETITIVE IN APPLICATION FOR ALLOCATION AUTHORITY
- Maintain compliance / prevent recapture
- Balance investor demands
- Transaction selection:
  - Community benefits
  - Deal Execution: timing and complexity
  - Reputation risk
Investor/Leverage Lender Concerns

Investor Risks

- Tax credit recapture
- Exit/refinancing strategy – unexpected tax consequences
- Extensive NMTC compliance issues + tax and accounting

Leverage Lender Risks

- Forbearance
- Lack of mortgage
- Refinance / repayment risk
Transaction Selection

- Is it a Qualified Active Low Income Community Business?
- Does it meet Enterprise strategy & commitments?
  - Located in Enterprise market
  - Green
  - Investor relations
  - Project type, community impact, but-for
  - Located in highly distressed census tract?
- Does it meet the requirements of applicable Allocation Agreements?
- Does it meet the investment guidelines for investors?
Transaction Selection

Filters: Community Impact

CDE must consider benefits to community/end-users

- Job creation/retention
- Quality jobs: wages / benefits
- Brings goods and services to underserved areas
- Flexible financing for business operations
Transaction Selection

Filters:
Project or other benefits would not be achieved “but for” NMTC

- Demonstrate that all other sources of subsidy have been exhausted
- Targeted towards investments that have a funding gap
- Commercial projects in “low-rent” areas
- Cannot access market rate capital
- Goal: Efficient use of taxpayer money
CDE Compliance

IRS Regulation vs. Allocation Agreement

- Violation of IRS Regs $\rightarrow$ recapture
- Violation of Allocation Agreement $\rightarrow$ CDFI remedies
Recapture

Events of recapture:

- CDE ceases to be qualified
  - Change of primary mission or non-accountable board

- “Substantially All” requirement is not met
  - 85% of QEI must be invested in a QLICI “at all times”

- QEI is redeemed or cashed out by CDE
  - Cash in excess of “net operating income” is distributed to investment fund / investor

Recapture = loss of all tax credits + interest & penalties
Recapture is not triggered if:

- CDE goes bankrupt
- QALICB goes out of business
- Mortgage is foreclosed upon
  - Any QLICI proceeds repaid are still subject to reinvestment requirements
Sub-all – Ensure 85% of QEI is invested

- Six month cure period
  - One cure period per QEI
  - 6 months begins when CDE knew or should have reasonably known that they would fail the sub-all test

- “Just in time” QEI funding, or QLICI to project level escrow account

- Structure loans with no amortization, prohibit prepayments

- Have reinvestment procedures / pipeline in place

- Reasonable expectation protection for QALICB status
Reasonable Expectation Protection

- Document at time of investment
- Support that the QALICB is a QALICB and why it is expected to remain a QALICB
- Significant protection against recapture
Allocation Agreement – Authorized Uses

At least 85% of QLICIs must be invested in:

- Eligible activities
- Allocatee’s Service area
- Unrelated businesses (if applicable)
- May be limited to specific project(s)

Use of the Allocation must be “generally consistent with the strategies (including, but not limited to, the proposed product offerings and markets served) set forth in the Allocation Application”. (3.3(i))
NMTC Deal Structure - leveraged

NMTC Investor

Leverage Lender

Equity

Loan(s)

Investment Fund

Qualified Equity Investment

Community Development Entity

GP in CDE

(“B” Loan)

(“A” Loan)

Qualified Project (Borrower)

Multiple Sources
Example Project

NMTC Investor

Leverage Lenders

Investment Fund

Bank

City grant
State soft loan
Bridge loan

NMTC Equity $3M

Loans

$5M

$2M

$10M

Qualified Equity Investment

Enterprise CDE

GP in CDE

$10M NMTC Allocation

Fee: $300k

$10M

A Loan

B Loan

NMTC Equity

Project

(Borrower/Building Owner/Landlord)

$2M ("B" Loan)

$2.7M ("C" Loan)

$5M ("A" Loan)

$3M

$10M QEI x 39% = $3.9M NMTC
### Example of the numbers...Gross Equity

<table>
<thead>
<tr>
<th></th>
<th>Example 1</th>
<th>Example 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>QEI</td>
<td>$10,000,000</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>NMTC Rate (over 7 years)</td>
<td>39%</td>
<td>39%</td>
</tr>
<tr>
<td>Total NMTCs Generated</td>
<td>$3,900,000</td>
<td>$3,900,000</td>
</tr>
<tr>
<td>Equity Price per NMTC</td>
<td>$0.77</td>
<td>$0.85</td>
</tr>
<tr>
<td>Gross NMTC Equity Generated</td>
<td>$3,003,000</td>
<td>$3,315,000</td>
</tr>
</tbody>
</table>
### Example of the numbers…Net Equity

<table>
<thead>
<tr>
<th>Gross NMTC Equity Generated</th>
<th>Example 1</th>
<th>Example 2</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ 3,003,000</td>
<td>$ 3,315,000</td>
</tr>
<tr>
<td>Less: Placement Fee (% of QEI)</td>
<td>$ (300,000)</td>
<td>$ (300,000)</td>
</tr>
<tr>
<td>Less: NMTC Transaction costs</td>
<td>$ (300,000)</td>
<td>$ (300,000)</td>
</tr>
<tr>
<td>CDE Asset Management Fee (% of QEI)</td>
<td>$ (350,000)</td>
<td>$ (350,000)</td>
</tr>
<tr>
<td>CDE Audit / Tax Return Expense</td>
<td>$ (70,000)</td>
<td>$ (70,000)</td>
</tr>
<tr>
<td>Total Ongoing Annual Expenses</td>
<td>$ (420,000)</td>
<td>$ (420,000)</td>
</tr>
<tr>
<td>Net NMTC Equity for Project</td>
<td>$ 1,983,000</td>
<td>$ 2,295,000</td>
</tr>
</tbody>
</table>
### Example Project: Budget

**Sources:**
- $5 Bank leverage loan
- $3 NMTC equity
- $1 Bridge loan
- $0.5 City loan / grant
- $0.5 State loan
- $10M NMTC Allocation (NMTC Financing)
- $2 other sources (incl def dev fee)
- $12M total sources

**Uses:**
- $1.5 Acquisition
- $7 Construction hard costs
- $1 Soft costs
- $0.5 Developer fee
- $0.5 Reserves
- $1.5 Fees and expenses
- $12M total uses
NMTC Deal Structure - leveraged

NMTC Investor

Leverage Lender

Equity

Investment Fund

Loan(s)

Debt service

Cash Flow Distributions

Multiple Sources

$3.9M NMTC

GP in CDE

Community Development Entity

Qualified Equity Investment

("B" Loan) ("A" Loan)

Debt service

Qualified Project (Borrower)
**NMTC Deal Structure - Unwind**

**NMTC Investor**
- $3M Equity
- $10 QEI

**Leverage Lender**
- $7M Loan(s)

**Investment Fund**
- $3M Equity
- $7M Loan(s)

**Community Development Entity**
- GP in CDE

**Qualified Project (Borrower)**
- $3 (“B” Loan)
- $7 (“A” Loan)

**Multiple Sources**
- Hard leverage loans repaid
- Sponsor may purchase Fund & related loans

**Investor leaves; GP owns CDE**

**InVESTOR gets $0 cash back**

“**A**” Loan = Repaid

“**B**” Loan = May not be repaid; Put/Call Options
Example Project: simplified unwind

Bank
NMTC Investor

Receives $ “put price” & sells Fund

$10M NMTC Allocation

GP in CDE

Investment Fund

Leverage Lenders

$5M

Enterprise CDE

$3+2=5M loans “assigned” & Fund redeemed out of CDE

(B” & “C” Loans)

Project
(Borrower/Building Owner/Landlord)

$5M

$5M

Bank

City State

“B” & “C” Loans

$5M repaid

$10M QEI x 39% = $3.9M NMTC

Developer / Affiliate

Purchases Fund from Investor

$5M

$5M
What’s Happening Right Now in NMTCs

- **Within 30 days…**
  - A new NOAA (Notice of Allocation Availability) will be released by the CDFI Fund

- ** Throughout 2017…**
  - CDEs with allocation will be focused on closing 2017 transactions
  - Policy efforts to protect / strengthen NMTC program

- **End of 2017…**
  - 2017 Allocation Awards announced by CDFI Fund
Tax Reform

- Tax reform is a top priority for Congress and the Administration
- House is currently working to translate tax reform blueprint into legislation, expected this spring
  - Blueprint would eliminate most tax expenditures in order to lower top corporate tax rates from 35 to as low as 20%
- Administration proposed lowering top corporate rates even further to 15%, but no details yet
- Senate will not release tax reform proposal until summer (or later)
The Impact of Tax Reform

- Potential Threats to key programs
  - Elimination or substantial reduction
  - Efficacy undermined by reforms
    - E.g. lower corporate tax rate
- Potential Opportunities
  - Expansion and extension / permanence
    - Legislation introduced in February to make NMTCs permanent
  - Efficacy enhanced by reforms
Historic Rehabilitation Tax Credits

- Legislation originally enacted in 1978
- Now part of IRC section 47
- Incentive for developers and investors to restore older/historic buildings to productive use
- More than 31,000 historic properties and more than $31 billion of rehabilitation completed as of 2007
- HTC adds an additional layer of equity financing to a project’s budget.
Calculating HTC

- Credit is calculated based on qualified rehabilitation expenditures
  - 10% of QREs on buildings placed in service before 1936
  - 20% of QREs on buildings that are certified historic structures

- Credit is claimed in the year the property is “placed in service”

- 5 year recapture period. Building must remain in use and cannot change ownership.

- Credit vests 20% per year; no interest/penalties on recaptured amount.
### HTC Example

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>HTC Qualified Rehab Expenditures</td>
<td>$4,500,000</td>
</tr>
<tr>
<td></td>
<td>x 20%</td>
</tr>
<tr>
<td>Amount of HTC generated</td>
<td>$900,000</td>
</tr>
<tr>
<td>x price paid by investor per $1 of HTC</td>
<td>$0.85</td>
</tr>
<tr>
<td>Equity generated</td>
<td>$765,000</td>
</tr>
</tbody>
</table>

HTC Equity is usually contributed by the tax credit investor as the 99% limited partner in the building ownership.

Credits can be passed through to the tenant in master lease structures.
1. Building must be a Qualified Rehabilitated Building

2. National Park Service (NPS) must certify the plans and final outcome to obtain 20% credit.

3. Rehabilitation must be ‘substantial’.

4. Credit is calculated only on Qualified Rehabilitation Expenditures (QRE).

5. The credit must be reported to the IRS by the taxpayer and the NPS.
Important Terms

- **Certified Historic Structure** = a building on the Department of the Interior’s National Park Service Division’s National Register of Historic Places that is:
  - Designated as being of historic significance to a historic district or
  - Located in a historic district

- **Qualified Rehabilitated Building**
  - Substantially rehabilitated (rehab cost more than basis of the building before rehab; costs incurred in same 24-month period)
  - Placed in service prior to rehab
Important Terms

- **Qualified Rehabilitation Expenditures (QRE)**
  - Any amount related to depreciable property that is chargeable to a capital account and
  - Incurred in connection with the rehab of a qualified rehabilitated building.

- QREs include:
  - Demolition, hard costs, soft costs (architect, etc)
  - Developer fee; must be properly documented
  - Capitalized interest and taxes during construction

- Not a QRE:
  - Land; Building acquisition
  - Site improvements
  - Equipment, furniture, fixtures that have depreciable life of less than 12.5 years
NPS and SHPO

Part 1 – Evaluation of Significance
- Building adds to the historic district’s sense of time and place and historical development
- Generally must be more than 50 years old

Part 2 – Description of Rehab
- Rehab is consistent with the historical significance of the district or building
- Most Investors will require a Part 2 for closing

Part 3 – Request for Certification of Completed Work
- Final certification; gets submitted to IRS to allow tax credits
HTC Structures: Direct

Developer
1%

Tax Credit Entity

Historic Building

Lease to Third Parties

Tax Credit Member
99%
HTC Structures: Lease Pass Through Structure

- Developer: 100%
- Fee Owner Entity
  - Master Lease to Tax Credit Entity
    - Developer: 1%
    - Lease to Third Parties or Developer Affiliate
    - Tax Credit Member: 99%
HTC Revenue Procedure

Created a “Safe Harbor” for HTC Investments

- Released by IRS in Jan. 2014
- Investor Interest & Return
  - Investor’s economic return should vary based on success / failure of the project
  - Return cannot be limited to preferred return
- Gaurantees
  - Cannot be unlimited
- Fees
  - Must be “reasonable”
- Exit
  - Allows “flips”
  - Puts allowed, but not calls
Layering HTCs with NMTCs

**NMTC Investor**
- $3M Equity
- $10M

**Leverage Lender**
- $7M Loan(s)

**Investment Fund**
- $10M
- Qualified Equity Investment

**HTC Investor**
- $3M Equity

**Master Tenant**
- $3M ("B" Loan)

**Developer**
- $1M Loan

**Community Development Entity**
- $7M ("A" Loan)

**Qualified Project (Borrower)**
- HTCs
- $1M Loan

**Multiple Sources**