BRINGING CAPITAL TO UNDERSERVED COMMUNITIES:
AN INTRODUCTION TO NEW MARKETS TAX CREDITS

by Delphine G. Carnes[*]

Over the past three years or so, financing any type of real estate development has been very challenging, particularly in low-income areas, also referred to as "underserved communities." Developers, investors, lenders, and their respective counsel have had to adapt to a changing economic environment, showing an ever-increasing amount of creativity and innovation in their use of the financing tools available for their projects. The New Markets Tax Credits ("NMTC") program constitutes yet another financing tool in our collective toolbox. Since its creation over ten years ago, it has been used not only by itself but increasingly in tandem with other federal and state programs.

What follows is a brief introduction to the NMTC program: how it works, how it has evolved, and how it benefits low-income communities across the country. This is not an attempt to describe in detail every rule or regulation applicable to the NMTC program or to the other programs mentioned herein. It is simply an overview, or perhaps a refresher, designed to illustrate the ways the NMTC program can help finance projects and spur economic development.

The NMTC program is very rich in acronyms and other defined terms; in a nutshell, it involves Community Development Entities ("CDEs") which must use "substantially all" of the proceeds from Qualified Equity Investments ("QEIs") to make Qualified Low-Income Community Investments ("QLICIs") in Qualified Active Low-Income Community Businesses ("QALICBs") located in Low-Income Communities ("LICs").

I. THE BASICS OF THE NMTC PROGRAM

In 2000, Congress enacted the NMTC program as part of the Community Renewal Tax Relief Act[1] to encourage investments in low-income areas by providing tax incentives to community development lenders and investors. It enables taxpayers (i.e. investors) to claim a credit against federal income taxes for QEIs made to acquire a capital interest in designated CDEs. Designated CDEs must in turn use "substantially all" of the proceeds from the QEIs to make QLICIs. The tax credit provided to the investor is equal to 39% of the QEI amount and is claimed over a seven-year credit period, starting on the date when the QEI is made into the CDE and on each subsequent anniversary. In each of the first three years, the investor receives a tax credit equal to five percent of the total amount paid for the capital interest at the time of purchase. For the next four years, the value of the tax credit is six percent annually.[2]

[*] Delphine G. Carnes is a partner with Crenshaw, Ware & Martin, P.L.C. in Norfolk, VA. She has been involved in all facets of the NMTC program since its inception and created Virginia's first CDE in 2003. She has structured multiple NMTC transactions, including real estate transactions that combined NMTC with state and federal HTC, tax-exempt bonds, HUD public housing funds, TIF proceeds, traditional debt, charitable contributions, various grants, and debt with equity features. She also has experience preparing NMTC Allocation Applications, representing QALICBs, and counseling developers in connection with NMTC and HTC financing structures as well as compliance issues. She regularly provides NMTC training to debt providers and developers. She served as counsel to the CDEs in the transactions mentioned in this article.

[1] Codified in I.R.C. § 45D.

[2] I.R.C. § 45D(a).

A. Community Development Entities ("CDEs")

The NMTC program is administered through the Community Development Financial Institutions Fund (the "CDFI Fund"), a department of the U.S. Treasury. The CDFI Fund certifies CDEs on an ongoing basis[3] and distributes NMTC Allocations annually to select CDEs through a competitive application process. A CDE is any duly organized entity treated as a domestic corporation or partnership for federal tax purposes that: (a) has a primary mission of serving or providing investment capital for low-income communities or low-income persons; (b) maintains accountability to residents of low-income communities through their representation on any governing board of the entity or any advisory board to the entity; and (c) has been certified as a CDE by the CDFI Fund.[4] A CDE cannot be a single member limited liability company disregarded for federal income tax purposes.[5] CDEs can be nonprofit or for-profit entities, but only for-profit entities can issue QEIs to investors.[6] Entities already in existence that have been certified as Community Development Financial Institutions ("CDFIs") do not need to file an application to be certified as CDEs; they need only to register.

Eligible CDEs apply to the CDFI Fund for an award of New Markets Tax Credits. The application and selection is based on objective criteria, including the expertise of the management team, the experience of the CDE in working with disadvantaged businesses and communities and the CDE's ability to use an NMTC Allocation in a way that will generate positive community impact, including job creation. Once a CDE is awarded tax credit allocations, the CDE is authorized to allocate its given amount of tax credits to private equity investors in the CDE.

B. Qualified Equity Investments ("QEIs")

1. Requirements

A QEI is an investor's equity contribution to a CDE in the form of a capital contribution to a partnership or limited liability company, or a purchase of stock at its original issue solely in exchange for cash.[7] The QEI cannot be redeemed for seven years (the "Compliance Period"). In addition, "substantially all" of such cash must be used by the CDE to make QLICIs (as further described below), and the CDE must designate the investment as a QEI and report it to the CDFI Fund. The amount of QEIs a CDE can issue cannot exceed the amount of NMTC Allocation received by the CDE from the CDFI Fund.[8] The timing of the investment is critical: the QEI must be made in the CDE within five years of the allocation of NMTCs to the CDE. Once the CDE receives the QEI, the CDE has twelve months to use the QEI proceeds to make one or more QLICIs.

2. The "Substantially All" Test

The CDE must invest at least 85% of the QEI proceeds in a QLICI, which includes up to 5% for a loan loss reserve. This requirement is reduced to 75% in year 7 of the compliance period. The test must be met for each year of the seven-year compliance period, and one dollar can make the difference

[3] The application for CDE status is available on the CDFI Fund website: www.cdfifund.gov/what_we_do/programs_id.asp?programID=5.

[4] I.R.C. § 45D(c)(1).

[5] A limited liability company wishing to be certified as a CDE must have at least two members or elect to be treated as a C corporation for federal income tax purposes.

[6] Therefore, a nonprofit CDE that is the recipient of a NMTC allocation from the CDFI Fund would transfer its allocation to for-profit subsidiaries in order to close transactions.

[7] I.R.C. § 45D(b)(1).

[8] I.R.C. § 45D(b)(2).

between passing and failing.[9] It is important to remember that issuance costs, fees, and CDE overhead costs do not count toward meeting the "substantially all" test.

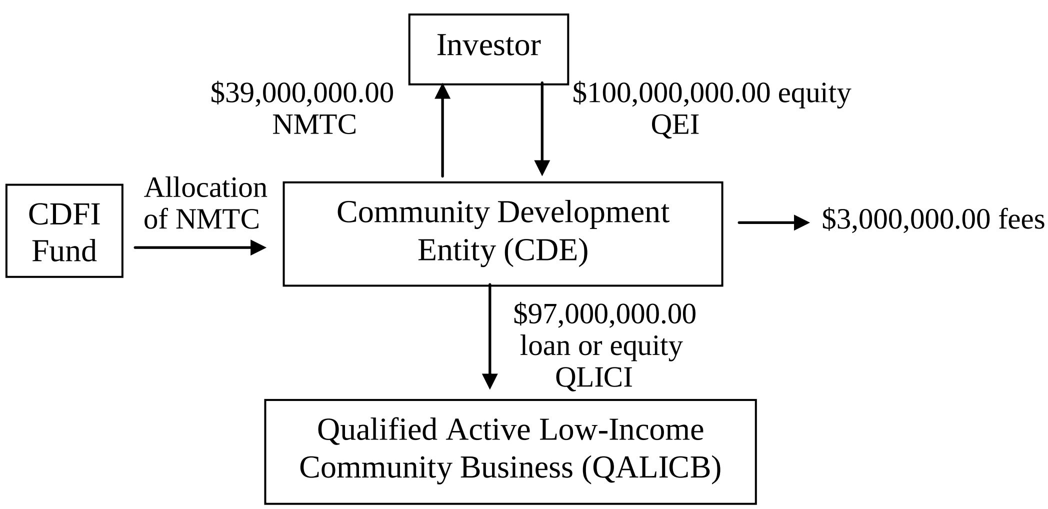
The "substantially all" test is performed once in the first year of the compliance period and twice at six-month intervals every year thereafter. The CDE may choose the same two testing dates for all QEIs. Failure to meet the "substantially all" test triggers a tax credit recapture (see below).

Two different methods can be used by the CDE to show that it complies with the "substantially all" (85%) requirement: the "direct tracing test" and the "safe-harbor test". Under the direct-tracing test, the CDE has to show that, for each QEI made by each investor, 85% of the cash was invested in a QLICI. Under the safe-harbor test, the CDE has to show that at least 85% of the aggregate amount of QEIs it received (from various investors, for various different transactions) has been invested in QLICIs.

C. NMTC Structures

Contrary to programs such as the Low-Income Housing Tax Credit or the Historic Rehabilitation Tax Credit where the amount of the potential credit depends on the amount of the project level "eligible basis" or "qualified rehabilitation expenditures," the NMTC is calculated based on the amount of the QEI, which is the amount of NMTC allocation used for a project, irrespective of total project costs. For example, the total costs of developing a project may be $100,000,000.00 but if only $50,000,000.00 of QEIs are made, the investor will claim tax credits equal to 39% of the $50,000,000.00 QEI. Figure 1 illustrates the basic NMTC structure, using a QEI amount of $100,000,000.00. In this example, in exchange for his $100,000,000.00 equity investment, the tax credit investor will receive $39,000,000.00 in tax credits over seven years, starting with the date on which the QEI is made. For purposes of this example, we assume a 3% fee charged by the CDE at closing, which results in a QLICI in the amount of $97,000,000.00. A more detailed discussion of fees is included later in this article.

Figure 1: The basic "non-leveraged" structure



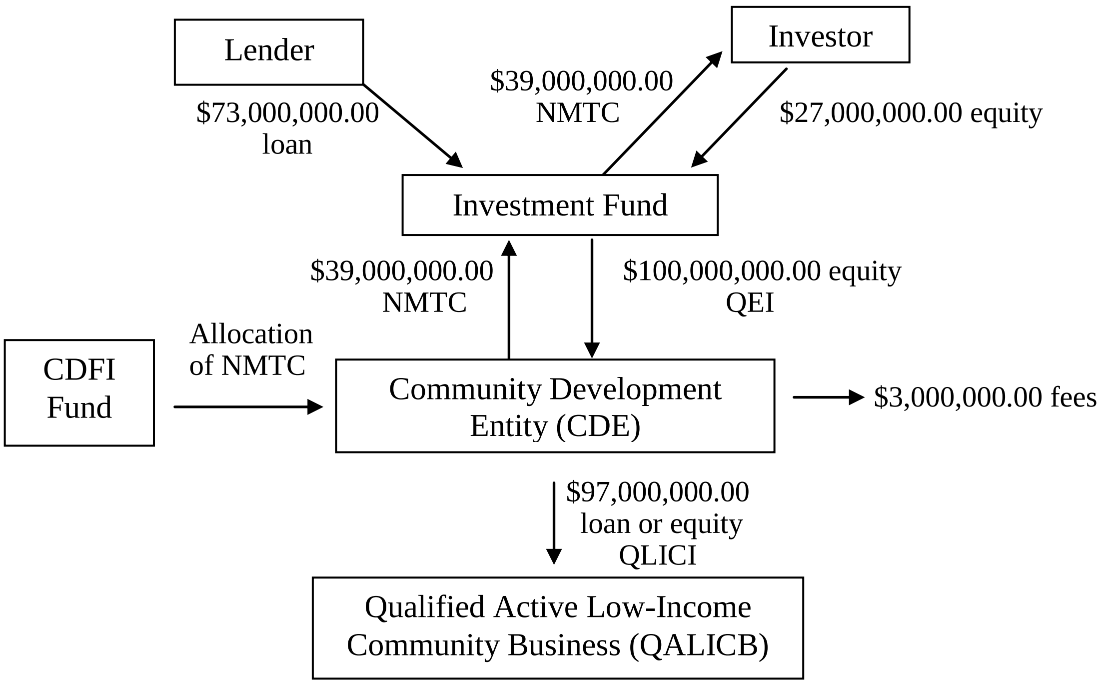
Because the size of the QEI determines the amount of tax credits, an investor who expects to receive a market rate return will either need to obtain a cash return on its investment (for example in year 7 when he exits the NMTC structure) or leverage his investment with borrowed funds.[10] Most NMTC

[9] The final regulations allow for one opportunity to correct a "substantially all" failure.

[10] Revenue Ruling 2003-20 allows for the use of the leveraged financing structure by providing that a QEI can include cash obtained through a nonrecourse loan.

transactions closed in the past three years involve a leveraged structure: the tax credit investor combines his equity with funds borrowed by a special purpose entity, which in turn makes a QEI into the CDE. The advantage of the leveraged structure is that the tax credit investor obtains tax credits based on the full QEI amount (including the leveraged loan) rather than solely on the amount of his equity. Figure 2 illustrates the benefits of a leveraged NMTC structure.

Figure 2: The "leveraged" structure



D. Qualified Low-Income Community Investments ("QLICIs")

Any of the following activities engaged in by the CDE is a QLICI:

1. An equity or capital investment in, or a loan to, a QALICB;
2. Financial counseling and other services (for example, advice on organization and operation of a business) to businesses located in and residents of Low-Income Communities;
3. The purchase from another CDE of any QLICI loan made by that other entity to a QALICB;
4. Equity investments in or loans to another CDE, subject to certain requirements regarding the uses of the funds by the second CDE.[11]

During the first six years of the compliance period, principal loan repayments or equity distributions back to the CDE from a QLICI must be reinvested in another QLICI within twelve months, otherwise the CDE fails the "substantially all" test. This is referred to as the CDE's reinvestment obligation, and it is a way to ensure that the proceeds of the QEI remain invested in underserved communities for the majority of the compliance period. Note that this rule prevents returns *of* capital to the CDE, not returns *on* capital.

[11] I.R.C. § 45D(d)(1). Please note that a grant to a project is not a valid QLICI.

E. Qualified Active Low-Income Community Businesses ("QALICBs")

A QALICB is any corporation (including a nonprofit corporation), partnership, or sole proprietorship engaged in the "active" conduct of a "qualified" business that meets all of the following requirements:[12]

First, the QALICB must be located in an LIC, and it must have a substantial connection to that LIC. Generally, LICs are census tracts where the poverty rate is at least 20% or census tracts where the median family income is below 80% of the area median family income.[13]

The business will have a substantial connection to the LIC if, for the taxable year, (i) at least 50% of its total gross income is derived from the active conduct of a qualified business within the LIC;[14] (ii) at least 40% of the use of its tangible property (whether owned or leased and on a cost basis) is within the LIC; *and* (iii) at least 40% of the services performed by its employees is performed in the LIC.[15]

Second, less than 5% of the average aggregate unadjusted bases of the entity's property can be attributed to collectibles (as defined in I.R.C. § 408(m)(2)) or certain nonqualified financial property ("NQFP").[16] Collectibles include art and antiques, other than those for sale in the ordinary course of business. NQFP includes debt instruments, stock, partnership interests, options, futures contracts, forward contracts, annuities and other similar instruments with a term in excess of eighteen months. NQFP also includes unreasonable levels of working capital in cash or a cash equivalent.

The business must be recognized as an "active business," meaning the CDE must reasonably expect the business to generate revenues within three years after the QLICI is made.[17]

The business must be a "qualified business," which is defined by what it is not. The business cannot be engaged in the following: (i) developing or holding intangibles for sale or licensing as its primary business; (ii) rental of residential property;[18] (iii) operating a country club, golf course, massage parlor, hot tub facility, sun tan facility, racetrack or other gambling facility or liquor store (known

---

[12] I.R.C. § 45D(d)(2).

[13] I.R.C. § 45D(e). Specific rules exist for high migration rural counties, census tracts with less than 2,000 people that are contiguous to a LIC and within an empowerment zone, and "targeted populations." *See* 76 F.R. 75774 for the final regulations governing targeted populations.

[14] The gross income test is met if either the tangible property or the services test is met at a minimum of 50%.

[15] If the business does not have any employees, it meets the services and gross income tests if it meets the tangible property test at a minimum of 85%.

[16] I.R.C. § 45D(d)(2).

[17] If the business is a nonprofit entity, it must be expected to be engaged in an activity that furthers its purpose as a nonprofit within three years after the QLICI is made.

[18] I.R.C. § 168(e)(2)(A) defines residential rental property as any building or structure if 80% or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units. This rule allows for the use of NMTC to finance mixed-use projects where more than 20% of the gross income from the building is derived from non-residential sources, such as a retail business, office space and other commercial components included in the building. In addition, based on guidance included in PLR 200947005 and PLR 200949019, two or more buildings located on a single parcel (or contiguous parcels) of land and operated as an integrated unit may be treated as a single building for purposes of determining whether the building is "residential rental property."

collectively as the "sin businesses"); (iv) government owned property; (v) real estate without "substantial improvements;" (vi) real estate with tenants who are engaged in sin businesses or other disqualified businesses; or (vii) certain farming[19] businesses.

Retail centers, manufacturing facilities, commercial facilities and health care facilities are examples of qualified businesses. Rental of property that is 100% residential or holding of unimproved land, however, are not qualified businesses for the purpose of NMTC. Rental of property that is mixed residential and commercial can qualify as a QALICB as long as the gross income from the residential units does not exceed 80% of the total gross income.

If the CDE has "control"[20] of the business to which it is making a loan, then the business must meet the tests outlined above continuously over the seven-year period. Such a controlling interest thus requires the CDE to monitor the business and make sure that it continues to qualify as a QALICB in order to satisfy its 85% minimum investment requirement.

If the CDE does not have "control" of the business, then the tests are deemed to be satisfied for the whole seven-year period if the business was a QALICB at the time the QLICI was made and the CDE could "reasonably expect" that the business would continue to qualify as QALICB for the seven-year compliance period. Therefore, if the CDE does not have control of the QALICB and, for example, the entity engages in an excluded business after the QLICI closing or the business moves outside of the original LIC, the credits will not be recaptured. If it does not have "control," the CDE does not have to monitor the business to make sure it remains a QALICB for the duration of the compliance period.

F. Recapture

Recapture is a risk under the NMTC program, but that risk can be avoided through careful structuring. If a recapture does occur, the NMTC rules are very punitive and include recapture for the entire amount of tax credits claimed plus interest[21] from the QEI date. There are three events of recapture:[22]

1. If the CDE ceases to qualify as a CDE, i.e., if it ceases to fulfill the "primary mission" and the "accountability" requirements.

2. If the CDE redeems the QEI. This should not happen if the documents governing the investment specify that, during the seven-year period, the investor only receives income and cannot get his investment back.[23]

3. If the CDE ceases to invest "substantially all" of the QEI in QLICIs. This is the most dangerous of the three recapture events. It includes failure to meet the 85% threshold,[24]

---

[19] Within the meaning of I.R.C. § 2032A(e)(5)(A) or (B).

[20] "Control" is defined as (i) direct or indirect ownership (based on value) of 33% or more of the business the CDE invests in; or (ii) voting or management control of 33% or more of the entity it invests in. The CDE does not control the business if an unrelated person possesses greater control over the business than the CDE.

[21] At the IRS underpayment rate.

[22] I.R.C. § 45D(g)(3); Treas. Reg. § 1.45D-1(a)(2).

[23] The rules include a Net Operating Income Safe Harbor: if the CDE makes pro rata distributions that do not exceed the CDE's operating income, such distributions are not treated as a redemption. Non pro rata *de minimis* cash distributions are also not treated as a redemption.

failure to invest in a valid QALICB and failure to meet the twelve month investment requirement.[25]

The rules allow a one-time cure period for failure of the "substantially all" test. If a CDE fails to invest 85% of a QEI in a QLICI and the CDE corrects the failure within six months after the date the CDE becomes aware or reasonably should have become aware of the failure, it is not a recapture event.[26] In addition, if a QLICI is redeemed by the CDE, for example, through a repayment of principal or foreclosure, the CDE can avoid failure of the "substantially all" test and recapture by reinvesting the QLICI funds into another qualifying project as long as such reinvestment occurs within twelve months.

It is important to note that the bankruptcy of the CDE does not constitute a recapture event. In addition, the fact that a QALICB goes out of business is not in itself a recapture event. Last, but not least, a CDE may request a waiver of the requirements or an extension of deadlines from the IRS in order to avoid recapture.[27]

II. ADDING COMPLEXITY: MULTIPLE CDES AND COMBINING THE NMTC WITH OTHER PROGRAMS

A. Multiple CDEs in One Single Transaction

Since 2006, the number of transactions involving multiple CDEs making QLICIs to one single QALICB has increased, which is largely due to two factors:

(1) The amount of NMTC allocation requested by the QALICBs largely exceeds the amount of allocation that CDEs have available. Many projects in need of $20,000,000.00 or more in NMTC financing must request the assistance of more than one CDE to make up the full financing package because many CDEs do not have enough allocation to finance the whole transaction themselves. The higher the costs of the project are, the more likely it is that multiple CDEs will be needed for the QALICB to maximize the portion of project costs financed with NMTC.

(2) Even in situations where one CDE has enough NMTC allocation to finance a whole project, the CDE may choose to only use a portion of its allocation for a given QALICB. That enables the CDE to diversify its investments by making QLICIs in multiple QALICBs, potentially in different geographical markets and/or for different types of facilities. Many CDEs take that approach to demonstrate their ability to close multiple types of projects, which may be an advantage when the CDEs apply for additional NMTC allocation in future rounds.

For the reasons outlined above, it is now quite unusual to see one single CDE provide a QEI of $20,000,000.00 or more. Transactions involving three or four CDEs, each bringing allocation to make the

---

[24] In years 1 through 6, the threshold is 85%, which can include a 5% loan loss reserve. In year 7, the threshold drops to 75%, which can include a 5% loan loss reserve.

[25] One risk is for the CDE to invest in a QALICB that later ceases to qualify as a QALICB. Depending on how much the CDE invested in that particular business, it could trigger recapture. The CDE's investment must remain at least equal to 85% of the QEIs during the 7-year period in order to avoid recapture. The issue of "control" is crucial here: if the CDE does not have control of the business, then as long as the CDE had a reasonable expectation at the time it made its investment that the business would remain a QALICB for the whole seven-year period, there is no recapture.

[26] And the CDE does not have to notify the Internal Revenue Service.

[27] The CDE must show good cause and the situation must not frustrate the purposes of I.R.C. § 45D.

project work, are very common. Transactions involving more than four CDEs are rare because of the additional complexity that each additional party brings to a project. As a result, in cases where a very large amount of allocation is requested, the project is either broken into separate phases (with two or three CDEs involved in each phase, for example) or financed with a lesser amount of NMTC allocation than originally anticipated.[28]

B. Combining the NMTC with Other Programs

The NMTC has often been described as a shallow credit since it equals 39% of the QEI, which seems low compared to a deeper credit such as the Low Income Housing Tax Credit ("LIHTC"), equal to 90% of basis. As a result, industry practitioners started thinking very early on about ways to maximize the subsidy, and that trend has increased in recent years, with innovative structures constantly emerging. Most of the strategies used to increase the subsidy in a NMTC structure involve the combination of a number of different sources of funds and types of tax credits.[29]

The NMTC program is very flexible and can be combined, at least in theory, with most other tax credits and federal sources of funds, other than the LIHTC which is specifically excluded by the NMTC rules.

The requirement that a NMTC project be mixed-use, as discussed above, seems to exclude the possibility of combining LIHTC and NMTC on one single project. Strictly speaking, that remains true. In practice, the two types of tax credits can be combined for one single project if they have separate ownership structures[30] and a clear segregation of the entity legally created for the affordable housing component (which will be financed with LIHTC proceeds) from the entity legally created to own and operate the commercial component (which will be financed with NMTC proceeds). The two components would exist side by side, and, although complex, this type of structure allows for the successful financing of two critically needed and complementary products: affordable housing units and retail/community services for the residents.

One of the first ways the industry "improved" on the NMTC was to combine it with federal historic rehabilitation tax credits ("HTCs"). Of course, this assumes the NMTC project undertaken by the QALICB involves the rehabilitation of a historic structure. Structures combining NMTC with HTC are widely used, particularly the "master lease" structure, which enables the QALICB to pass the HTCs to the HTC investor (often but not necessarily the same entity as the NMTC investor) through a master tenant entity owned by the CDE.

Another wave of innovations came in 2006 when, for the first time, the proceeds of tax-exempt bonds were used as leveraged debt in a NMTC transaction. The transaction involved the financing of a new hotel in Norfolk, Virginia, and our client provided the needed NMTC allocation. In addition to the traditional financial benefits of NMTC structures, using tax-exempt bonds as leveraged debt can have other advantages. First, using tax-exempt bonds in any project can be a way to access capital at a lower

---

[28] It is not uncommon to see transactions where only a portion of the project cost is financed through a NMTC structure. In those cases, the balance of the financing needed by the QALICB is obtained "outside" the NMTC structure through conventional financing, developer equity or other sources.

[29] The NMTC program has been combined with multiple other sources of funds not examined in detail here, such as Renewable Energy Tax Credits and 1603 grants, Small Business Administration 7a loans, Community Development Block Grant funds and Tax Increment Financing proceeds.

[30] For example, through the creation of a condominium regime with a condominium unit for the commercial component and a separate condominium unit for the residential component of the overall "project."

cost.[31] Second, tax-exempt bonds can be a way to access leveraged debt when conventional loans are not available. Identifying financial institutions willing to serve as leveraged lenders in NMTC transactions has always been a challenge, particularly in the past three years or so when financing any type of project with almost any type of debt, with or without NMTC, has become more difficult. Although the NMTC program has now been in existence for over ten years, many financial institutions, particularly small to medium size local banks, are not familiar and/or comfortable with NMTC structures. Tax-exempt bonds can be a way to find leveraged debt when conventional debt is simply not available. Of course, this assumes that the underlying project and/or entity meets the requirements of the particular tax-exempt bond program used.

Interestingly, the challenge in twinning tax-exempt debt with NMTC has always been a bond problem, not an issue under the NMTC rules. Indeed, the NMTC program is remarkably flexible and allows for the use of a variety of funds as the source of leveraged debt. The main difficulty in a NMTC transaction using tax-exempt bonds as leveraged debt is to come up with a structure that satisfies the bond requirements, particularly the rules regarding tax exemption. The conclusion reached in the transaction mentioned above and in other transactions closed since then is that, as long as the bond proceeds reach the QALICB (which must qualify for tax-exempt purposes and for NMTC purposes), then the ability to exempt interest payments from tax is preserved, even though the funds go through several entities as part of the NMTC structure before they reach the ultimate borrower.

While a number of federal sources of funds have been used as leveraged debt in NMTC transactions since the inception of the program, twinning NMTC with U.S. Department of Housing and Urban Development ("HUD") public housing funds has been a much more challenging endeavor. This is largely due to the nature and complexity of the HUD rules applicable to public housing and the need to obtain HUD approval of this new type of mixed-finance transaction. The first transaction to use HUD public housing funds as leveraged debt in an NMTC structure is the Jazz @ Walter Circle project, a mixed-use facility located in East St. Louis, one of the most severely distressed communities in the state of Illinois. The transaction was sponsored by the East St. Louis Housing Authority ("ESLHA"), and the QEI was made in December 2010. It set a precedent for housing authorities across the country, enabling them to raise equity to finance mixed-use developments. The facility is currently under construction and will include seventy-four units of affordable rental housing for senior citizens, a community health and wellness center, office space for affiliates of the ESLHA and retail space on the ground floor.

In the past two years or so, transactions using grant funds from the Health Resources and Services Administration ("HRSA") as the indirect source of leveraged debt in NMTC structures have also become more common. We were recently involved as CDE counsel in a transaction where our client used NMTC allocation, twinned with a HRSA grant, to help finance the construction of a new medical center and dental clinic in Arrington, Virginia. Such transactions require HRSA approval, and, on January 20, 2011, HRSA actually issued guidance for the use of its grant funds in combination with NMTC.[32]

The HRSA guidance was welcomed by the NMTC industry as a sign that increased flexibility is now available to finance community health centers. It confirms that HRSA grant funds "may not be directly invested in NMTC and/or HTC financing," but it specifically states that, subject to HRSA approval, grant proceeds may be used to repay bridge financing used for construction. This created the possibility of using HRSA grant proceeds to repay a bridge loan used as leveraged debt in an NMTC

[31] The cost of capital is a relative consideration that depends on the type of project being financed and the risk profile of the underlying asset.

[32] The guidance was sent to Health Center Program Grantees, Primary Care Associations and National Cooperative Agreements regarding the implementation of Capital Development, Facility Investment Program and Capital Improvement Program Projects using NMTC and/or HTC financing structures. The guidance includes an outline of the HRSA approval process for such financing structures, including a list of documents to be submitted in support of requests for approval.

structure. Several different financing structures are possible as long as both the HRSA and the NMTC requirements are met.

Notwithstanding the complexity, and often the additional cost, associated with the twinning of various programs, the enormous need for creative financing for so many projects around the country makes these transactions worthwhile.

C. Costs and Fees

Like bond transactions and structures using other types of tax credits, NMTC transactions involve a number of costs and fees. Typical fees paid in NMTC transactions include fees payable to the CDEs for the use of their NMTC allocation, finance or loan fees payable to leverage lenders, syndication costs, asset management fees, loan servicing fees, compliance fees and sometimes exit or success fees. Most of those fees are typically paid by the QALICB, either directly or indirectly, out of the equity generated by the syndication of the tax credits.

The fees charged by CDEs vary tremendously from one CDE to the other, both in terms of the amount paid and the way the fees are structured. Many CDEs collect a fee payable at closing out of the QEI amount (i.e. the 3% fee in Figure 1 and Figure 2), as well as an ongoing asset management fee payable each year for the duration of the compliance period. Some CDEs also receive a loan origination fee or sourcing fee at the closing of the QLICI and sometimes an exit fee or success fee in year 7 when the parties "collapse" the structure. Certain fees may also be paid to the tax credit investor, including ongoing asset management fees and/or operating costs and sometimes an exit fee in year 7. Those fees and costs vary depending on which investor is involved.

In addition to those fees, the QALICB is also responsible for all closing costs, including the legal fees of all parties involved in the closing, accounting costs, recording costs and title insurance premiums.

Over the past five years or so, some CDEs have reduced their fees to be more competitive. Indeed, fee structures must be disclosed in the applications for NMTC submitted to the CDFI Fund, which has increased the pressure on CDEs to deliver a larger portion of the subsidy to QALICBs.

Overall, it is true that NMTC transactions are expensive for the QALICB, ranging on average from 6 to 9% of the QEI over seven years. Although the fees and costs are mostly paid out of the equity generated by the NMTCs, those costs ultimately reduce the net subsidy available to the project. In transactions that involve multiple CDEs and/or multiple sources of funds, the fees and costs are often larger. Again, those costs are "absorbed" by the additional subsidies brought to the financing structure, but they still reduce the net benefit to the project. As the industry has evolved, some of the fees and costs have decreased, and industry participants have made efforts to make the program more efficient, reduce costs and streamline the closing process. As the program continues to grow, transactions may become more standardized and therefore less expensive to close. Increased competition for NMTC allocation may also continue to force CDEs to reduce their fees. We have certainly started to see some improvement in that area in recent transactions.

Ultimately, even though some of the fees and costs depend on the QEI amount, other costs remain the same regardless of the size of the project, meaning that smaller projects (i.e. $2,000,000.00 and below) may not be particularly suitable candidates for a NMTC transaction. The costs may simply be too high compared to the subsidy generated by the program. That is certainly not always the case, and there are ways to maximize the benefits of the transaction and achieve efficiencies. Overall, however, given the costs involved and the complexity of these financing structures, it is fair to say that NMTC transactions are not for the faint of heart. They require patience, endurance and professional expertise.

II. Impact of the Program and Legislative Uncertainties

The NMTC program has been successful in stimulating economic activity around the country. According to a CDFI Fund report, through FY 2010, approximately $21,000,000,000.00 has been invested in QLICIs to finance 3,000 QALICBs that have created 300,000 jobs. The NMTC program has basically fulfilled the goals for which it was originally created. It has attracted private capital to underserved markets in a way that spurs economic activity, job creation and community revitalization. In addition, the businesses financed with NMTC proceeds have served as catalysts for further economic investment. However, the lack of a long term authorization of the program has created uncertainties that continue to limit the industry's potential to further improve LICs.

Indeed, the NMTC program is not currently a permanent program. The statute originally included allocations for years 2001 through 2007. Since then, the program has been periodically renewed for one or two years at a time. It is currently scheduled to expire with the 2011 round of allocations recently announced.

Bipartisan legislation to extend the NMTC program has been introduced in the House and Senate and continues to gather bipartisan support. But progress has been slow, partially due to the fact that the NMTC program is part of the much larger discussion regarding tax extension legislation. House Select Revenue Measures Subcommittee Chairman Pat Tiberi (R – OH) held a hearing on April 26, 2012 to review individual tax extenders, including the NMTC. During the hearing, several members of Congress expressed their support for an extension of the NMTC program, including Reps. Richard Neal (D – MA), Erik Paulsen (R – MN), Jim Gerlach (R – PA), Jim Costa (D – CA) and John Larson (D – CT).

On February 23, 2012, CDFI Fund Director Donna J. Gambrell announced the recipients of the 2011 $3,600,000,000.00 NMTC awards under the most recent program round, which is also currently the last round authorized by Congress until an extension is approved.

During the announcement, U.S. Department of the Treasury's Deputy Secretary Neal Wolin declared, "For so many vital economic development projects across the country, the New Markets Tax Credit has been a critically important piece of the puzzle. This targeted tax credit has a strong record of spurring economic growth in low-income and distressed communities across our country." In the 2011 round, the CDFI Fund selected seventy organizations across the country to receive awards from a pool of 314 applicants that collectively requested over $26,700,000,000.00 in NMTC allocations.[33]

Industry practitioners are still learning how best to implement the program and how to maximize the subsidy to QALICBs in a time when there is such a need for lower cost financing. The need is as great now, if not greater, than when the NMTC program was created. For as long as there is uncertainty about the future of the NMTC program, potential investors and CDEs will be reluctant to participate, and that will limit the potential increase in the pricing of the credit, which also limits the ultimate subsidy and benefit to the projects. The best way to improve the efficiency and impact of the NMTC would be to make the program permanent.

Notice pursuant to IRS regulations: Any tax advice contained in this article is not intended to be used and cannot be used by any taxpayer to avoid penalties under the Internal Revenue Code. Such advice is not intended to be used and cannot be used to support the promotion or marketing of a transaction. Additional issues may exist outside the limited scope of any advice provided in this article, and any such advice does not consider or provide a conclusion with respect to any additional issues.

[33] "This is the largest number of NMTC Program applications the CDFI Fund has received from Community Development Entities (CDEs) since 2002, the first year the program was available, and reflects an increase of 26 percent over the number of applications received for the 2010 round." *See* CDFI Fund website news release dated August 4, 2011: www.cdfifund.gov/news_events/.

Taxpayers contemplating using NMTC or any other financing tool in a transaction should seek advice from their tax advisors based on their particular circumstances.