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New Markets Tax Credits — The New Brownfields Development Tool

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07/17/07

Introduction

The federal government has created many tools for economic stimulus, but none that foster public-private partnerships as New Markets Tax Credits do. New Markets Tax Credits ("NMTC") are distributed through a federal program that generates funds for community and economic development projects. The subsidy may be used to support commercial, industrial and retail real estate projects, as well as business loans or equity investments, among others. It may also be used to subsidize the cost of providing technical assistance and financial counseling to qualifying commercial or industrial activities. The tax credits are available through a program established by Congress in 2000, and continued during the Bush administration. The program has strong bipartisan support and is expected to be reauthorized.

In the Northwest, this program has been used to finance the revitalization of the Portland Armory into a performing arts center, to remodel the old Meier & Frank building in downtown Portland (now Macy's), and to create commercial and office space in Tacoma. Other projects now reviewing the program include a health care clinic, a retail center and an industrial plant.

The program's purpose is to encourage private investment in qualified low-income communities through federal income tax credits. A Low-Income Community is a census tract in which the median income is 80 percent of the area median, or in which 20 percent of the households have incomes below the poverty line. Since many brownfields sites are located in qualifying census tracts, NMTCs are emerging as a powerful new tool for brownfields redevelopment.

The legislation authorized tax credits equal to approximately 39 percent of a total of $15 billion over a period of seven years. The program is administered by the Community Development Financial Institution Fund, within the U.S. Treasury Department (the "CDFI Fund").

In order to use the credits, an applicant must create a Community Development Entity ("CDE"). The CDE must invest substantially all of its assets into eligible projects and activities. There is a safe harbor of 85 percent of gross assets, to meet the "substantially all" test. The CDFI Fund is raising the bar on this measurement through the competitive application process.

There are several alternative approaches to utilizing NMTCs. Some sponsors may elect to form and qualify a CDE, and propose a single project or undertaking for a credit allocation. Others develop a broad community development strategy that utilizes combined sources of funding in order to accomplish a blend of small business lending, marquee projects, venture capital participation and related community development activities. Some sponsors use the program to provide funds for loan pools or other activities.

The list of eligible undertakings is unusually broad and the funds are surprisingly flexible, particularly for a federal program. The use of these funds generates true public/private partnerships in order to create wealth and new jobs in low-income areas. Approximately 40 percent of Portland's geography qualifies for this program.

The Community Development Entity

NMTCs are awarded to qualified CDEs. An entity must meet certain criteria to be recognized as a CDE:

- *Legal Structure:* Non-profit and for-profit domestic corporations or partnerships that are duly organized and validly existing under the laws of the jurisdiction in which they are incorporated or established may apply for an allocation of tax credits. Non-profits cannot utilize tax credits, so their application must include their plan for reallocating any award they receive to for-profit subsidiaries.

- *Primary Mission:* An applicant entity must demonstrate that it has a primary mission of serving, or providing investment capital for, low-income communities or low-income persons, and that at least 60 percent of its activities are targeted to low-income persons or low-income communities.

- *Accountability:* The applicant must identify a qualifying geographic service area and demonstrate that it maintains accountability to the residents of the low-income communities in that area. To demonstrate accountability, the CDE must establish a board (governing or advisory, depending on CDE structure) in which at least 20 percent of its members represent the low-income communities within the service area. Board members can represent the community either by being a resident of a low-income community in the service area, or being a representative. Representation includes owning a business in the community, or serving as an employee or board member of an organization that serves the community.

Application Process and Timelines

After an entity receives status as a CDE, it must make a competitive application for an allocation of NMTCs. Entities that are not certified as CDEs have to apply for that status before the NMTC application deadline in order to be recognized and still have time to make an allocation application, though CDE certification is rolling. There are good reasons for entities that do not intend to apply for an allocation to nonetheless pursue CDE status, which is relatively simple to do. Generally, applications are due in mid-September, and awards are made in late March or early April of the following year.

The application form includes applicant instructions, requirements for assurances and certifications, general information and a glossary. The substantive material is divided into four parts:

1. Business Strategy, which includes: Products, Services and Investment Criteria; Prior Performance; Prior Performance in Disadvantaged Communities or with Disadvantaged Businesses; Projected Business Activities; and Investments in Unrelated Entities.

2. Capitalization Strategy, which includes: Investor Commitments; Investor Strategy; Sources of Capital; and Flow of Allocations.

3. Management Capacity, which includes: Management Team; Experience Deploying Capital or Services; Experience Raising Capital; Asset Management and Risk Management Experience; and Program Compliance.

4. Community Impact, which includes: Targeting the Use of Proceeds within Low-Income Communities; Community Accountability; and Economic Impacts.

A successful applicant will earn a high score in each of the four areas, though for some areas it may rely on the track record of its management team or certain related entities. Applicants may partner with government or community development entities, service providers, or engage managers and consultants who will strengthen a proposal.

Successful applicants include large financial institutions and small, single-project community enterprises, and many in between. While the program does require sophisticated advisors because of the financial and tax structuring aspects, it is not inaccessible for smaller organizations. Transaction costs mean it is probably not generally suitable for projects smaller than about $5 million in total financing.

In the last round, the CDFI Fund received approximately 400 applications and made awards to 41 applicants. Generally, awards are limited to not exceed $150 million, though exceptions may be made. Many awards are much smaller, particularly if an applicant presents an application comprised of a single project. In order to be successful, the applicant must show that the project or undertaking is essentially ready to proceed, except for the financing gap to be filled with the NMTC subsidy. Projects that are speculative, or have a great deal of predevelopment work remaining to be completed, are unlikely to receive an award.

However, those projects may apply for financing to entities that have received awards and are making loans or investments in the project geographic area. For instance, an awardee focuses on helping nonprofits construct primary care health clinics by combining the NMTC subsidy with tax-exempt bonds and technical development and architectural assistance. Health care providers may use this service instead of making their own applications.

Other allocatees are providing below-market loans for commercial and retail real estate development, mixed-use projects and other job-related construction. A summary of allocatees and their business plans is available at the CDFI Fund website (http://www.cdfifund.gov).

Utilization

After receipt of the allocation, the CDE will have five years to issue equity investments or the unused portion of the allocation will terminate. The CDE must ensure that substantially all of its assets are invested in qualifying investments, a requirement which may be met by meeting the safe harbor of assuring that 85 percent of its aggregate gross assets are invested in qualified activities. The CDFI Fund may recapture the tax credit if the CDE fails to meet the program requirements for investment and reinvestment of returned capital. Returned capital must be reinvested within twelve months of receipt, as long as the twelve months will terminate within the seven-year compliance period (capital returned to the CDE in the 73rd month or later, probably need not be reinvested).

Investments of funds raised through NMTCs must be made in qualified Low-Income Communities. Those investments may consist of:

- any loan or equity investment in any qualified Low-Income Business;
- the purchase from another CDE of any loan made by such entity that is a qualified Low-Income Community investment;
- technical assistance to help in the organization or operation of a business in Low-Income Communities; or
- investments in other CDEs that are making investments or providing technical assistance in Low-Income Communities to Low-Income Businesses and Low-Income Persons.

A qualified business may not engage in certain prohibited activities that include massage parlor, golf course, sale of alcoholic beverages or development of property to be licensed, such as software. In addition, a qualified low-income business:

- derives at least 50 percent of its income from doing business in the Low-Income Community, or
- 40 percent of the low-income business is located in the Low-Income Community, or
- 40 percent of the services provided by the company’s employees are provided in the Low-Income Community.

NMTCs can either provide a seven-year interest subsidy, or, in the leveraged method, provide up to about a 20 percent subsidy of the total amount financed. The leveraged method is most appropriate for financing packages in excess of $10 million. The subsidy comes from investors who buy equity in the CDE, in exchange for the right to use the tax credits to offset the investors’ federal income tax liability. The tax credits are best utilized by institutional investors, whose capital is then loaned or reinvested by the CDE into the project. It is generally not appropriate for wealthy individuals to invest in NMTCs because they are likely to trigger alternative minimum tax liability.

The transaction involves generating funds from an investor, potentially leveraging that equity with bank or other borrowing, and placing the combined fund as equity into the CDE. The CDE then uses the proceeds to make its own loans or equity investments in a qualifying project. The funds from the investor constitute a subsidy for the project because the investor receives the benefit of the tax credits and does not need to have all of its money paid back.

This is a sophisticated and somewhat complex financial transaction. It is not an appropriate tool for small projects because of the transaction costs. However, for the right project, the transaction can result in a subsidy of up to approximately 20 percent of the overall financing package.

The complexity and transaction costs are somewhat made up for by the unusual flexibility of this program. It has broad eligible uses for the funds.

Because the program requires that the subsidy funds remain invested during the seven-year compliance period, most CDEs structure their participation in a project such that the CDE receives only interest payments for the first seven years. Some CDEs allow longer terms at below-market interest rates. Other CDEs make equity investments in businesses. These transactions are frequently on a venture capital model.

There are certain types of businesses that are ineligible for financing by CDEs. These include businesses that hold certain financial assets such as promissory notes, those that sell alcohol or tobacco, golf courses, and those that produce intellectual property (software development). A manufacturing or retail facility within a qualified census tract is an ideal target for this program.

NMTC proceeds may also be used for real estate acquisition, construction, and permanent phase financing. So-called “soft costs” are eligible, including architectural and engineering, development, financing and other fees, as well as traditional “hard costs” related to actual construction. Equipment and working capital are also eligible, with certain limitations. Transactions may be structured as financing leases, equity investments or loans.

As with all federal programs, and particularly federal income tax programs, it is very important for participants to get appropriate advice early in their efforts so they do not waste time or money trying to put together a transaction that might not qualify.

For more information, please contact the Environmental Practice Group at Lane Powell:

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