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Credits & Incentives talk with Deloitte

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CREDITS & INCENTIVES TALK WITH DELOITTE

Navigating a Rewarding Financing Tool: New Markets Tax Credit

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Before the end of the year, the U.S. Treasury Department will announce a total of $7 billion in New Markets Tax Credit (NMTC) awards to Community Development Entities (CDEs),[1] each with a tailored mission of stimulating investment in low-income urban neighborhoods and rural communities. This announcement will mark the largest award in the NMTC program's 15-year history. In a 2015 announcement, U.S. Treasury Secretary Jacob J. Lew said, "Every community deserves a chance to succeed, and the . . . tax credit allocation authorities announced today will go to community development organizations that will make much needed private sector investments in businesses and real estate projects located in the nation's distressed urban and rural communities. Along with these investments come jobs, vital services, and opportunities where they are needed the most."[2]

Over its history, the NMTC program has contributed to meaningful and transformative impacts on qualifying, low-income community businesses and the communities in which they operate. The program has been named multiple times as one of the top contenders for the prestigious Innovations in American Government Award. In the program's first ten years, NMTC investments generated nearly $118 billion in economic activity and created 744,267 jobs in low-income rural and urban communities.[3]

Although $7 billion of investments in one year is a sizable amount, many companies may not have heard about the NMTC program. This introduction is intended to offer an overview and practical insights into seeking the benefits of NMTC financing.

How NMTC can impact a business

One unique aspect of the NMTC program is that the intended beneficiaries, the qualifying businesses making the investments, do not receive tax credits. Instead, the qualifying businesses receive discounted cash financing.[4] This makes the NMTC program a viable financing tool not just for profitable endeavors, but also for businesses in loss positions and for nonprofit organizations.

The federal tax credit[5] is granted to private investors (generally large financial institutions) to incentivize the revitalization of low-income communities. The investment contributed by the private investor is typically made through an investment fund to a subsidiary partnership, which makes a loan to the qualifying business. NMTC loans typically carry an interest rate that is 50 percent below market rates and contain a seven-year interest only period.[6] Most NMTC loans are made with an expectation that a portion of the total loan amount will not be repaid or cancelled.

The average unpaid principal amount represents approximately one-fourth of the total loan amount, or two-thirds of the total tax credits generated from the investment. For example, a $10 million NMTC investment generates $3.9 million of tax credits (39% tax credit) over a seven-year statutory period. At the end of the seven years, the borrower would generally only repay $7.4 million of the $10 million loan principal. This transaction leaves $2.6 million with the borrowing business to further its activity in low-income communities without the obligation to repay.

How is such a favorable loan term made possible? Why would any lender be willing to walk away from one-fourth of the loan principal? The economics behind the NMTC program are rather straightforward: investors capture their required rate of return from the tax credits generated by the transaction and the borrowing business receives capital with terms far superior to market rates or that fill a financing gap to enhance a project's viability.

Real life examples

With such a meaningful financial impact, NMTC investments have made possible development projects and business expansions that may not have otherwise been possible. NMTCs played a critical role in financing the construction of a revitalized St. Bernard Parish Hospital in Chalmette, Louisiana, devastated by Hurricane Katrina;[7] the development of a cleantech innovation campus in Los Angeles to build a green economy and create a potential 600 new jobs;[8] and the expansion of the San Antonio Food Bank, doubling its capacity to meet an increasing demand for healthy food distribution.[9]

These handful of projects are indicative of the many hundreds of businesses that have benefitted from NMTC capital targeting the development and sustainability of low-income communities.

Policy shaping the NMTC program

Since the first awards were granted in 2002, the NMTC program has evolved substantially, led in large part by policy decisions and by competition for the right to use NMTCs for investments. The Community Development Financial Institutions (CDFI) Fund is the division of the U.S. Treasury responsible for implementing the NMTC program.[10] With a limited amount of tax credits available each year, the CDFI Fund created a competitive application process for the right to grant tax credits to investors and to make qualified NMTC investments.

This right is referred to as "NMTC Allocation" and is awarded to certified CDEs that must have a mission of investing in low-income communities and maintain representation of low-income communities through governing or advisory board membership.[11] The CDEs become the gatekeepers of the tax credits, offering tax credits to cash investors and using that capital to make investments (typically loans) that further the mission and objectives of the NMTC program.

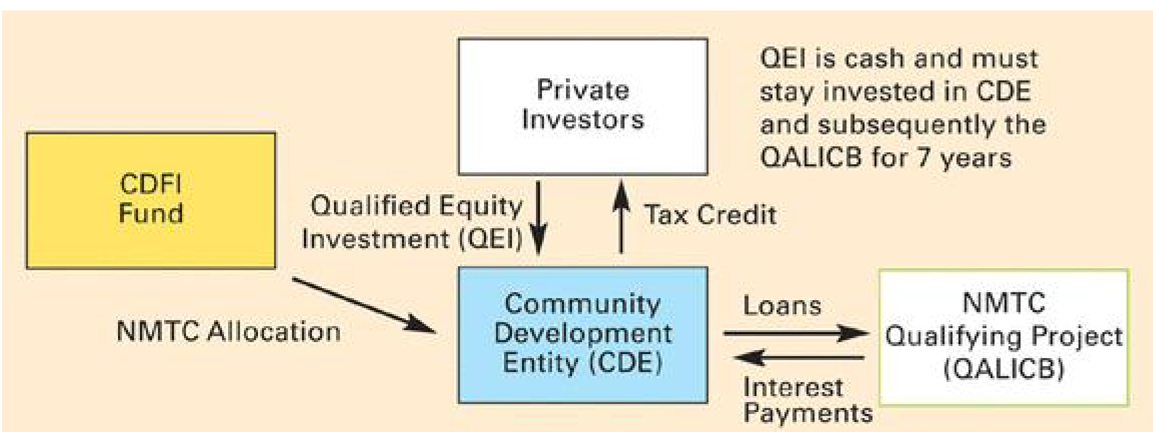
Built into the application process are CDFI Fund policy provisions that encourage NMTC Allocation recipients to align their investment objectives with preferred outcomes dictated by the CDFI Fund. These policies include passing the economic benefits derived from the tax credits down to the low-income community; selecting compelling projects that will have a lasting and transformative effect on low-income communities and disadvantaged individuals; and targeting areas of high distress based primarily on poverty rate, median family income, and unemployment rate where the investment is made.[12] The growing competition for the credits and continually evolving application process have led to a more acutely focused and refined NMTC program that reaches into the low-income areas and populations that the program was intended to positively impact.

Entering into a successful NMTC transaction

Though the NMTC concept is fairly simple—loans to qualified businesses and tax credits to investors—structuring an investment to comply with the tax rules and to meet economic objectives is typically complex. Multiple parties are involved, which means multiple sets of legal counsel. Further, introducing additional incentives such as tax-free bonds, tax-increment financing, grants and other sources of subsidized capital into the transaction can escalate legal fees significantly.

Legal and other closing fees in an average NMTC transaction may range between $200,000 and $300,000, and can be much higher with project-specific complexities. On top of that are fees to the CDE for the right to use the NMTC allocation and in many cases fees to consultants and investment bankers that bring NMTC parties together. The accompanying exhibit illustrates the structure of a standard NMTC transaction.

Structure of a standard NMTC transaction



For a business seeking NMTC financing, there are a number of considerations, leading practices, and pitfalls to avoid, including the following:

1. Project size—The amount of capital needed from NMTC financing can be a gatekeeping issue. When considering the complexity and fee structure of NMTC investments, a $5 million minimum

investment amount is typically required to make the benefits worthwhile. While CDE and investor partnerships have created loan programs designed to reach smaller businesses, those are less common.

2. Financing sources—In a NMTC transaction, there are typically multiple financing sources. The tax credit investor can provide 100 percent of the total project cost; however, they most commonly provide only the portion that will provide them an expected return of a certain amount of tax credits. Other financing sources typically include bank financing, government grants and incentives, private equity, owner's equity, or in the case of a nonprofit business, bridge financing for future capital pledges. With multiple parties at the table, negotiations around collateral, intercreditor agreements, and other negotiated documents require significant due diligence and collaboration.
3. Timing—NMTC investments must remain in a qualified business for a seven-year period. Any principal amount repaid during that period must be reinvested by the CDE until the seven-year period expires. Most CDEs and investors seek to avoid the reinvestment requirement and structure interest-only loans that prohibit principal prepayment until the seven-year anniversary is met.
4. Wind-up—If the NMTC investment included an opportunity for a portion of the investment to go unpaid, the wind-up is a critical aspect to securing the intended benefit. The mechanism used is typically an option held by the investor, giving it the right to sell its investment in the transaction to the borrower for a nominal price (e.g. $1,000).
5. NMTC program intent—A business entering into an NMTC investment should be aware of the purpose of the NMTC program and consider whether its business meets the intended outcomes established by the IRS and U.S. Treasury. The large majority of past NMTC investments have aligned with the program's objectives, but examples can be found where CDEs, investors, and/or businesses entered into transactions that did not directly align with the NMTC program's intent.[13]
6. Experienced advisors—With the many complexities, costs, and nuances around NMTC investments, a business is strongly advised to consult with experienced legal counsel and tax advisors. An NMTC advisor can also be helpful to play the quarterback role by leading the transaction and its multiple parties and issues through the closing process.

State NMTC programs

The success of the federal NMTC program has led to more than a dozen states adopting their own NMTC legislation. The majority of the state NMTC programs follow the federal rules with some modifications that vary from state to state. Some of the more common ways that states have modified the federal rules include specifically targeting smaller businesses, simplifying the application process, prohibiting the use of real estate rental businesses, and capping the amount of tax credits that can be allocated to any one project.

The economic impact of the state NMTC programs alone is typically less than the federal impact because the economic return to investors for state tax credits is generally lower than what they receive for federal credits. A benefit gained by many businesses is combining federal and state NMTC credits. Some states even require that state credits may only be used in conjunction with federal credits. Pairing federal and state NMTC credits provides greater benefit to the qualifying business from a higher loan principal amount expected to go unpaid at the conclusion of the tax credit period.

Status of federal and state NMTC programs

Currently, the federal NMTC program is not permanent and must be renewed regularly; however, Congress has renewed the federal NMTC each time it has been scheduled to expire. The most recent renewal legislation was included in the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act),[14] extending the program for five years, through 2019. The CDFI Fund maintains a highly optimistic position for future renewal of the federal NMTC, and the program's supporters continue to seek permanency. We should expect to see further development of the NMTC program on both the federal and state levels, as the demand for NMTC benefits continues to grow and participants continue to refine the economic reach of one of the more innovative private/public financing tools available today.

Conclusion

The NMTC program offers valuable financial incentives for organizations with the right facts and circumstances, and the NMTC is one of the few tax credits that creates economic benefits for multiple parties. Tax credit investors receive an acceptable rate of return while qualifying businesses profit from gap financing with favorable terms that they may not otherwise secure in the marketplace. Even nonprofit organizations or companies in a loss position may benefit from the NMTC program. With the recent legislative renewal and allocation of $7 billion in NMTC for this year, 2016 is a great time to learn more and consider participation.

[1] https://www.cdfifund.gov/Documents/2015%20NMTC%20NOAA%20Amendment.pdf, page 1; https://www.cdfifund.gov/news-events/Pages/news-detail.aspx?NewsID=209&Category=Updates, page 1; https://www.cdfifund.gov/Documents/NMTC%20NOAA%20QA%20FINAL%20041216.pdf, page 1.

[2] http://www.mycdfi.cdfifund.gov/news_events/CDFI-2015-22-Treasury_Announces_3-5_Billion_in_New_Markets_Tax_Credit_Awards.asp, page 1.

[3] http://nmtccoalition.org/wp-content/uploads/A-Decade-of-the-NMTC.pdf, page 4.

[4] *See* Internal Revenue Code (IRC) Section 45D(d)(1)(a) and page 2 of the CDFI Fund's January 2016 NMTC Fact Sheet: https://www.cdfifund.gov/Documents/NMTC%20Fact%20Sheet_Jan2016v2.pdf

[5] *See* IRC Section 45D and Treasury Regulation Section 1.45D-1

[6] CDFI Fund 2014 Allocation Agreement Template Section 3.2(f)

[7] http://nmtccoalition.org/wp-content/uploads/Louisiana-St-Bernard-Parish-Hospital.pdf

[8] http://nmtccoalition.org/wp-content/uploads/2014-1-9-La-Kretz-Announcement.pdf

[9] http://nmtccoalition.org/wp-content/uploads/Texas-SAFB.pdf

[10] https://www.cdfifund.gov/Documents/CDFI_Brochure%20Updated%20Jan2016.pdf, p. 2.

[11] See IRC Section 45D(c)(1) and https://www.irs.gov/Businesses/New-Markets-Tax-Credit-1#8, p. 6.

[12] See most recent (2015) NMTC Allocation Application, pp. 25-29, at https://www.cdfifund.gov/Documents/2015%20NMTC%20Application%20FINAL.pdf

[13] An anti-abuse provision was included in Treasury Regulation Section 1.45D-1(g), which if triggered causes a recapture of the tax credits.

[14] Public Law No: 114-113; https://www.congress.gov/bill/114th-congress/house-bill/2029/text, p. 815. On the state level, legislative renewal is anticipated in certain states along with additional rounds of applications opening this year. It should be noted that some states have put a pause on the NMTC renewal process given mixed reviews of the program.