New Markets Tax Credit Overview

How NMTCs Work and How Minority and Community Banks Can Participate

WEBINAR PRESENTATION

Federal Reserve Bank of Philadelphia (Partnership For Progress)

Dionne T. Savage
Lowe & Savage LLC
1650 Market Street, 36th Floor
Philadelphia, PA 19103
(267) 675-7063 (office)
(215) 514-1901 (cell)
dsavage@lowesavage.com

History of New Markets Tax Credit

- *New Markets Tax Credits ("NMTC")* **was established by Congress on December 21, 2000 pursuant to the Community Renewal Tax Relief Act of 2000.**

Facts

- **NMTC Program is one of the largest economic development incentive programs ever created to stimulate investments in low income communities.**
- **NMTC Program is administered by the** ***Community Development Financial Institutions Fund*****, a division of U.S. Treasury Department ("CDFI Fund").**
- **To date, the CDFI Fund has made 396 awards totaling $21 billion in NMTC allocation authority.**

LOWE & SAVAGE
COUNSELLORS AT LAW

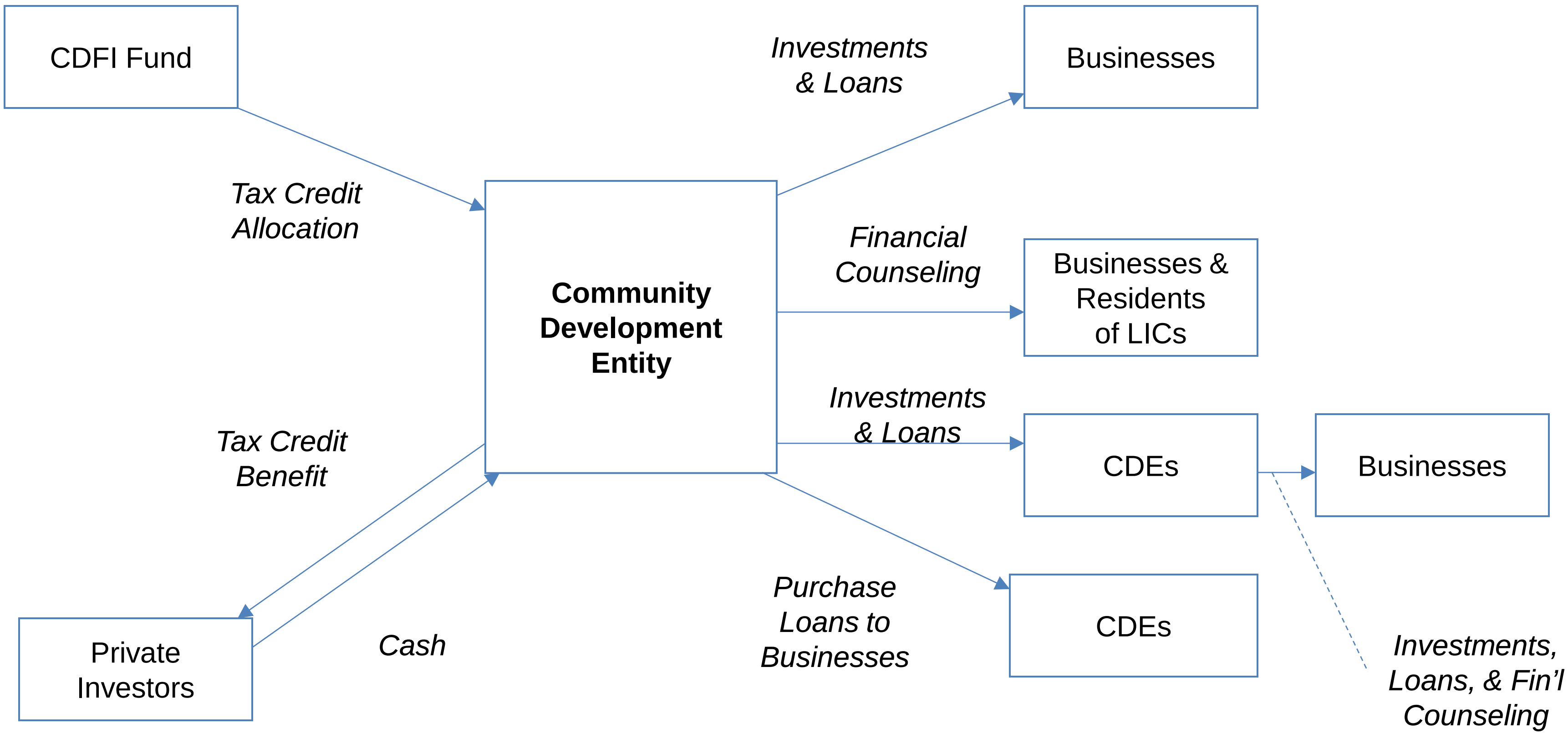
History of NMTCs (continued)

Facts (continued)

- **Taxpayers receive a 39% credit (over 7 years) against federal income taxes for making qualified equity investments in** *Community Development Entities (CDEs)*
- **Purpose of the NMTC Program is to attract funds from private investors to provide capital to certain qualified businesses located in "Low Income Communities" (LIC) that traditionally lack access to capital**
- **A community is a LIC if:**
  - **the poverty rate for the census tracts is at least 20%; or**
  - **median family income does not exceed 80% of the greater of statewide median family income or the metropolitan area median family income;**
  - **The NMTC Program is a placed based commercial development program – the project or business must be located in a qualified census tract.**

LOWE & SAVAGE
COUNSELLORS AT LAW

How NMTC Work



Current NMTC Lending Environment

- As a result of the economic conditions larger banking institutions are not lending or are re-evaluating their NMTC Programs
- Current economic conditions create opportunity!
- The time to ACT is now
  - Development project opportunities still exist
  - Federal (HUD) and state/grant financing options have become a source of capital
  - GAO Report outlined the lack of minority participation in NMTCs

LOWE & SAVAGE
COUNSELLORS AT LAW

Benefits from the Current NMTC Lending Environment

- As a minority bank or community bank:
  - Your size allows you to be more flexible
  - Can develop and adjust a NMTC Program faster then larger banks – many minority banks have been successful -
  - Successful Allocatees:
    - - Liberty Bank, Legacy Bank, Harbor Bank and Carver Bank
  - Already focused on the NMTC targeted geographic areas and populations based on the banks lending activities
  - Ability to leverage community relationships
  - Knowledge of the local real estate or financing market

LOWE & SAVAGE
COUNSELLORS AT LAW

BENEFITS TO YOUR BANK

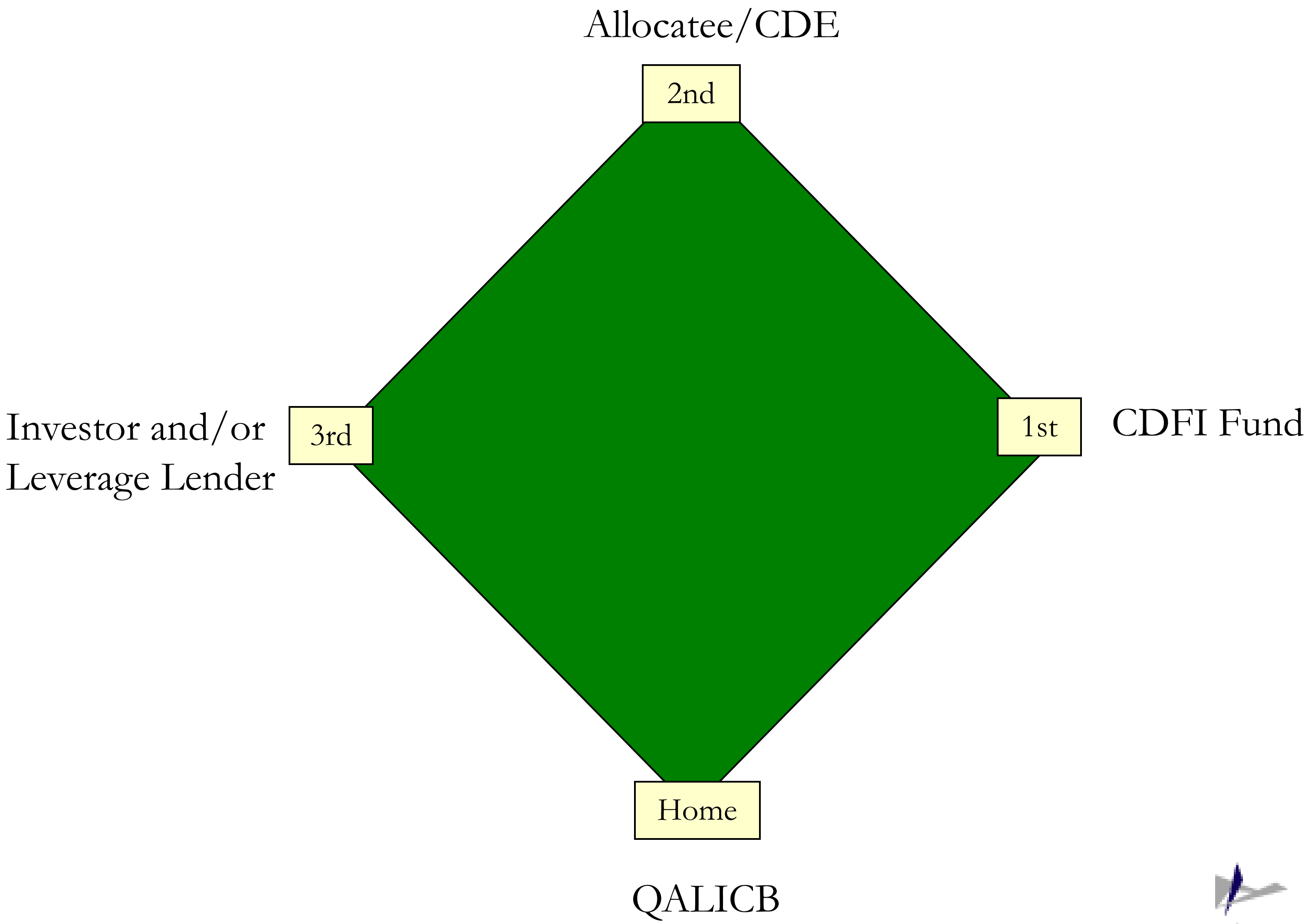
Overall benefits depend on the role that you play in NMTC Projects, but a few of the top benefits are the following:

A FEW SIMPLE NMTC BENEFITS:

- Reasonable risk/return proposition – overall reasonable return of 6-7% after tax IRR
- Generate overall transaction fees and increase bank revenue
- Promotes job creation in your target area
- Perfect tool to drive development to your target area
- Enhances existing loan portfolio – through bringing more equity to the transaction
- Structure allows better/reduced interest rates to bank customers
- Provides access to larger development projects in target area

LOWE & SAVAGE
COUNSELLORS AT LAW

The Players In New Markets Tax Credits



Transaction – Example 1
Single –Entity

Tax Credit Investor
Investment Fund LLC

Equity
($100)

Tax Credits over 7 years
($39) and Cash Return

Managing
Member

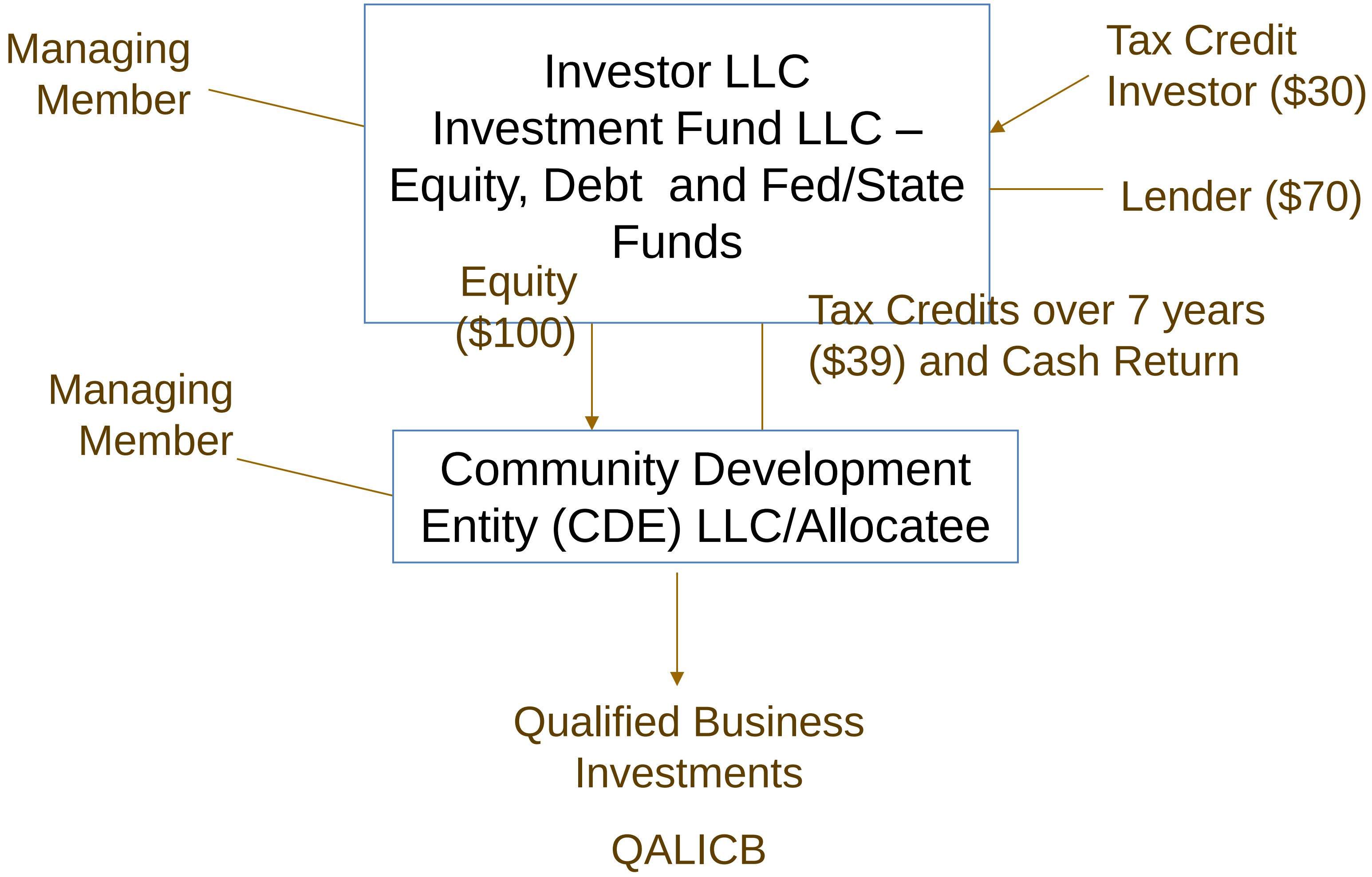
Community Development
Entity (CDE) or Allocatee

Qualified Business
Investments

QALICB

LOWE & SAVAGE
COUNSELLORS AT LAW

Transaction - Example 2
Multiple Entities – Leverage Structure



LOWE & SAVAGE
COUNSELLORS AT LAW

CDFI Fund

- NMTC Program is administered by the CDFI Fund.
- CFDI Fund allocates NMTCs to "Community Development Entities" (CDE) through a competitive application process - CDEs are creatures of the CDFI Fund.

The CDFI Fund:

- Performs CDE certifications
- Maintains the mapping system used for determining whether a qualified business is located in a LIC
- Monitors CDE compliance with the various Allocatees and allocation agreement requirements
- Tracks NMTC investments made by CDEs
- An extension of the NMTC Program is in process

LOWE & SAVAGE
COUNSELLORS AT LAW

Allocatee

- An entity that submits a NMTC Applications to the CDFI Fund and receives an allocation of NMTCs.
- The Allocatee can be a non-profit organization, but must allocate the NMTC Authority to an affiliated for-profit CDE.
- The NMTC Application process is competitive and NMTC Allocation request can range up to $150 million.
- Many organizations that apply have a community and economic development mission and already make loans in low-income communities:
- Two special types of organizations are automatically treated as CDEs:
  - Specialized small business entities (as defined in IRC Section 1044(c)(3)), and
  - Community development financial institutions (as defined 12 U.S.C. 4702).

LOWE & SAVAGE
COUNSELLORS AT LAW

CDE

- The CDE is the investment vehicle for NMTCs.
- CDFI Fund certification of CDE status is accomplished through the CDFI Fund's CDE application process.
- A CDE is a domestic corporation or partnership (including a limited liability company taxed as a partnership) which:

(1) Has a primary mission of serving or providing investment capital for LICs,

(2) Maintains accountability to residents of LICs through their representation on any governing board of the entity or on any advisory board to the entity, and

(3) Is certified by the CDFI Fund as being a CDE.

Investor

- A taxpayer ("Investor") is entitled to a NMTC to offset its federal income tax liability when the Investor makes a "Qualified Equity Investment" (QEI) in a CDE.
- The NMTC is a federal income tax credit equal to 39% of the Investor's QEI in a CDE.
- The NMTC is claimed by the Investor over 7 years:

  5% of the QEI in years 1 though 3
  6% of the QEI in years 4 though 7

LOWE & SAVAGE
COUNSELLORS AT LAW

Investor (continued)

- Investors subject to Community Reinvestment Act (CRA) requirements, such as banks and savings institutions, can also satisfy CRA requirements through NMTC investments.

  Example: An Investor makes a $10 Million QEI in a CDE. The Investor may claim a total of $3,900,000 of NMTCs (39% x $10 million) over a 7 year period:

Year	Amount	%
1	$500,000	5
2	$500,000	5
3	$500,000	5
4	$600,000	6
5	$600,000	6
6	$600,000	6
7	$600,000	6

LOWE & SAVAGE
COUNSELLORS AT LAW

QEI – Qualified Equity Investment

- A QEI is a "qualified equity investment" in a CDE (i.e. acquisition of stock of a corporation or a capital interest in a partnership or limited liability company) if:
  (1) The investment is acquired by the Investor at its original issue solely for cash,
  (2) The CDE designates the investment as a QEI, and
  (3) Substantially All of the cash is used by the CDE to make QLICIs.
- A QEI does not include any equity investment issued by a CDE more than <u>5 years</u> after the date the CDE enters into its allocation agreement with the CDFI Fund.
- The Investor's QEI in a CDE must be an equity investment
  - it cannot be a loan from the Investor to the CDE.

LOWE & SAVAGE
COUNSELLORS AT LAW

QLICI/Investment in a Qualified Business

- QLICIs include any <u>equity investment</u> in, or <u>loan</u> to, a qualified business located in a LIC.
- Loans from the CDE to a qualified business are the most prevalent form of QLICI.
  - 7 year interest only loan
  - Below market interest rates
  - Flexible underwriting criteria
  - Longer amortization periods
  - Access to subordinated debt or equity like structures
  - Payment during the seven year term is generally not acceptable (i.e. prepayment penalty)

QLICI

- QLICIs can also include:
  (1) the purchase from another CDE of any QLICI loan made by that CDE to a QALICB,

  (2) The provision of financial counseling and other services to businesses located in, and residents of, LICs, and

  (3) an equity investment in, or loan to, another CDE.

QLICI (continued)

- A CDE must use Substantially All of the Investor's QEI to make QLICIs.
- The term Substantially All means 85%.
- The Substantially All test must be satisfied each year in the 7-year credit period using either a direct tracing calculation or a safe-harbor calculation provided in the Treasury Regulations.
- Amounts received by a CDE in payment of principal with respect to a QLICI loan must generally be re-invested by the CDE in new QLICIs within 12 months from the date of receipt to be treated as continually invested in QLICIs.

LOWE & SAVAGE
COUNSELLORS AT LAW

QALICB

- A QALICB is any corporation (including a nonprofit corporation) or a partnership if, for any taxable year the business meets the following statutory tests:
  (1) At least 50% of the total gross income of such entity is derived from the active conduct of a "qualified business" (discussed below) within a LIC,

  (2) At least 40% of the services performed for such entity by its employees are performed in a LIC,

  (3) At least 40% of the use of the tangible property of such entity, whether owed or leased, is within a LIC,

  (4) Less than 5% of the entity's assets are certain collectibles (e.g. works of art, rugs or antiques, metals or gems, etc.), <u>and</u>

  (5) Less than 5% of the entity's assets are nonqualified financial property."

LOWE & SAVAGE
COUNSELLORS AT LAW

QALICB (continued)

- Qualified businesses <u>do not</u> include:
  (1) Leasing of unimproved real property or residential rental property
  (2) Residential rental property - any building or structure in which 80% or more of the gross rental income is from dwelling units.
  (3) Any trade or business predominately consisting of the development or holding of intangibles for sale or license,
  (4) Any trade or business the principal activity of which is farming, and
  (5) Any trade or business consisting of the operation of a
    - golf course, country club, massage parlor,
    - hot tub or suntan facility, racetracks or other gambling facilities, or
    - any store the principal business of which is the sale of alcoholic beverages for consumption off premises (i.e. liquor stores).

LOWE & SAVAGE
COUNSELLORS AT LAW

QALICB (continued)

- Reasonable Expectations Rule:

  An entity is treated as a QALICB for the duration of the CDE's investment in the entity if the CDE reasonably expects, at the time it makes its equity investment in, or loan to, the entity, that the entity will satisfy the requirements to be a QALICB throughout the entire period of the investment or loan.

- Exception:

  If a CDE controls or obtains control of the entity during the 7-year credit period, the entity will be treated as a QALICB only if the entity actually satisfies the QALICB requirements throughout the period the CDE controls the entity. In general, control means more than 50% of ownership or management control of the entity.

LOWE & SAVAGE
COUNSELLORS AT LAW

Downside - Recapture

- A tax credit recapture event occurs during the 7-year credit period if:
  1. (1) The CDE ceases to be a CDFI Fund certified CDE,
  2. (2) The Substantially All (85%) test is not met, or
  3. (3) The CDE redeems the equity investment.
- In order to comply with the Substantially All test requirements and avoid NMTC recapture issues during the 7-year NMTC period, QLICI loans made to QALICBs are generally structured with:
  1. (1) A maturity date of 7 years,
  2. (2) Interest-only payments for 7 years with a lump-sum principal payment on maturity, and
  3. (3) Risk that the qualified borrower have difficulty refinancing the balance of the loan after maturity.
- If a recapture event occurs during the 7-year credit period, then 100% of the NMTC claimed by the Investor must be recaptured (i.e., total recapture of all prior credits), plus interest on the amount of underpayment of tax.

Next Steps

- Become comfortable with the NMTC Program and the limitations of the NMTC Program
  - Collateral interest is vested in the CDE, and not the leverage lender(s)
- Be committed to the NMTC Program
  - Participate in upcoming events to learn more about NMTC and how to prepare a CDE, CDFI or NMTC Application
  - Commit Bank Resources
  - Identify an NMTC point person within your organization
- Develop overall strategy for use of NMTC financing
- Become a certified CDE or become a CDFI
- Secure (conditional) commitments of capital
- Identify potential pipeline projects
- Apply to the CDFI Fund for an NMTC allocation

LOWE & SAVAGE
COUNSELLORS AT LAW

Contact Information

Dionne Savage, Esq.

Lowe & Savage LLC

One Liberty Place

1650 Market Street - 36th Floor

Philadelphia, PA 19103

Office - 267-675-7063

Cell - 215-514-1901

dsavage@lowesavage.com

LOWE & SAVAGE
COUNSELLORS AT LAW