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Industry Presses for NMTC Extension, While Dealing With Leveraged Loan Problem, Other Issues

After a solid eight-year history, the federal new markets tax credit (NMTC) program faces a variety of critical issues – on the legislative, regulatory, and market fronts.

These issues were discussed by industry officials on 6/11/09 at a Washington, DC conference held by Novogradac & Company, LLP.

Established in 2000, the NMTC is a federal tax incentive that helps finance real estate projects, businesses, and other qualified activities in low-income communities. Special organizations called community development entities (CDEs) compete for allocations of NMTC authority in periodic funding rounds held by the Community Development Financial Institutions (CDFI) Fund. CDEs that win awards issue the tax credits to investors in exchange for cash that is deployed into eligible projects and businesses called Qualified Active Low Income Community Businesses (QALICBs). Investors claim the tax credits over seven years.

Legislative Campaign

The industry is pressing for Congress to enact legislation this year to extend the new markets program beyond its scheduled sunset date of 12/31/09, and to provide for parity of the NMTC with other federal tax credits, such as those for low-income housing and historic rehabilitation projects. New housing and historic credits, for instance, can be used to reduce federal income tax liability under the alternative minimum tax (AMT) – treatment not available for the NMTC.

“We are optimistic that we will see an extension. Probably not the long-term extension that we would all like, but an extension of the tax credit beyond 2009,” said speaker Alison Feighan of Washington-based Rapoza Associates, which manages the New Markets Tax Credit Coalition. She noted two key players in the creation of the NMTC during the Clinton Administration, Gene Sperling and Michael Barr, hold key posts in the Obama Administration.

Several speakers said the industry’s first priority should be to seek a permanent extension of the new markets program, which occurred in 1993 for the low-income housing tax credit.

Legislation pending in the U.S. House of Representatives (H.R. 2628), and expected to be introduced soon in the Senate, would extend the NMTC program through 2013, provide \$5 billion in annual allocation authority, and permit the NMTC to offset AMT. House bill lead sponsors are Ways and Means Committee members Richard Neal (D-MA) and Pat Tiberi (R-OH); expected Senate lead sponsors are Finance Committee members Jay Rockefeller IV (D-WV) and Olympia Snowe (R-ME).

Feighan indicated a possible legislative vehicle for an NMTC extension provision is a tax “extenders” bill, which she didn’t think Congress will take up until “very late this year.” She said there’s “no reason to think” an NMTC extension provision won’t be part of that package.

Rockefeller tax counsel Jorge Castro expects the Finance Committee to put together an extenders package this fall. But he pointed out

that this year's version won't include the traditional "big anchor" in an extenders package, the highly popular research and development tax credit.

Market Issues

Other critical market issues discussed included the continuing shortage of leveraged loan financing for NMTC projects, and the rising number of NMTC-financed projects and businesses in financial difficulty, including some on the brink of foreclosure. Speakers also reported that prices being paid by investors for new markets tax credits have fallen.

"The leveraged lender issue is kind of the biggest issue that we're facing now," said Washington, DC attorney Kristin DeKuiper, a partner in Holland & Knight LLP.

After the tax credit itself, leveraged loans have been the lifeblood of the financing packages for many NMTC projects and businesses. Loans funneled through an upper-tier investment fund in a leveraged loan structure produce more tax credits for the investor than a non-leveraged structure, and provide a healthy return to the lender.

The past year's financial market and economic difficulties have prompted a pullback by a number of major sources of leveraged loans, such as major banks and specialized lenders. In addition, some leveraged lenders are moving to tighten deal terms to enhance their security and reduce their risk further.

"We're seeing tougher deals, frankly," said Columbus, OH attorney Steven Mount, a partner in Squire & Dempsey, LLP, in a comment echoed by other speakers.

As a result of the cutback in leveraged loan funds, financing packages for new NMTC transactions increasingly are turning to other types of debt (e.g., government-guaranteed loans) to supplant or back leveraged loans, to gap funds, and to other resources to make deals happen.

San Francisco CPA Michael Novogradac, of Novogradac & Company LLP, for instance, said some clients have utilized U.S. Small Business Association guaranteed loans. Washington, DC attorney Greg Doran, a partner in Nixon Peabody, LLP, said the U.S. Department of Agriculture's Business and Industry Guaranteed Loan Program has been "helpful in a few transactions." He noted federal guaranteed loan programs are getting

some leveraged lenders "comfortable."

Doran also said, "We are seeing a lot of QALICBs and QALICB affiliates that are stepping in and playing the role of the leveraged lender."

Portland, OR attorney Karen Williams, a shareholder in Lane Powell PC, said a "creative solution" is to find other parties interested in the project for whatever reason that might be a source of capital, such as a municipality with a subsidy, or an equipment vendor interesting in making a sound investment to boost its industry. These sources can provide capital that can be leveraged, she noted.

Williams also cited the growing frequency and burgeoning opportunities in pairing new markets credits and federal renewable energy tax credits to finance energy facilities. These renewable energy credits include the 30% investment tax credit (ITC), and the production tax credit (PTC). She suggested that the "landscape" of competition for tax credits may well be changed by new stimulus act provisions that give taxpayers an option to take the renewable energy ITC in lieu of the PTC, and an option to exchange the ITC for a federal cash grant.

On the investor side, both negative and positive trends were noted. Chicago attorney Scott Lindquist, a partner in Sonnenschein Nath & Rosenthal LLP, said with many companies and large financial institutions hit by large losses, investor demand for NMTCs "has fallen off." Marc Hirshman of US Bancorp Community Development Corporation, St. Louis, a major investor in new markets credits, said there's "not a whole lot" of active NMTC investors today. He predicted a continuation of falling credit prices and rising yields to investors.

At the same time, Stephen Murphy of TransCapital said, "Recently we've been seeing a little bit of an uptick in interest in investing, from new institutions and new corporate investors." Similarly, Doran noted, "We're beginning to see some non-traditional investors – smaller banks, regional banks."

CDFI Fund Update

Acting NMTC Program Manager Rosa Martinez, of the CDFI Fund, reported that the Fund:

- Recently announced supplemental 2008 allocation awards of \$1.5 billion in NMTC authority provided by the American Recovery and Reinvestment Act (ARRA). She said these awardees will be subject to special reporting requirements mandated by ARRA, but noted that exactly what must be reported is still being worked out.
- Should be finished soon with the first of two stages of review of NMTC applications received in the 2009 competitive funding round. Awards will be announced in October.
- Will be publishing, perhaps in a month, a notice that requests comments from NMTC program stakeholders on various issues, both those raised by the industry and “things we’ve been grappling with.” Among these will be the related entity test, and fees charged by CDEs. She noted the Fund doesn’t want to dictate or proscribe what are considered reasonable fees. But she added that some program participants are finding the fees charged by some CDEs a “barrier.” Currently, each CDE in its allocation application must provide information on the fees it expects to charge.

On the regulatory side, questions remain about when the IRS will issue the final version of several pending proposed rules related to the NMTC program, and whether the final regulations will reflect changes or clarifications sought by industry participants.

One will be the final version of a multi-faceted IRS proposed regulation published in August 2008, covering recapture events, redemptions, reasonable expectation requirements, and other issues. IRS senior analyst Grace Robertson said these final regulations are in the “final stages” of internal review, and expressed hope for issuance by calendar year-end.

She said the issue of “targeted populations” will be addressed in this rule. Last year the IRS issued a separate proposed rule on targeted population transactions – a set of alternative standards that allow projects and businesses not in geographic low-income communities to qualify for new markets credits.

IRS Projects

Robertson reported on other current and future NMTC projects.

She noted the Service has completed an audit program where 90 CDEs were examined by IRS agents. Of the 90 cases, only 13 are still open, she said. Robertson said the audits were conducted for a Government Accountability Office (GAO) report on the NMTC program that may be issued in early 2010. She noted the audit program findings indicate that “you’re a compliant market segment.”

The 90 CDEs represented a sample that the IRS tried to make as representative as possible of the entire universe of CDEs, as to size, location, etc.

Robertson said the Service is also working on a review of NMTC investors to determine whether they have filed a tax return, and sending letters to those that haven’t. “We’re not expecting to conduct audits at this level, unless there’s a non-compliance issues that surfaces,” she said.

Robertson said the Service will be issuing and making public $\text{\textcircled{D}}$ probably by the end of September at latest – an “audit techniques guide” for the NMTC program. This will provide guidance to IRS revenue agents on how to conduct examinations and audits of federal tax returns involving new markets credits. A revised draft of the guide is undergoing final internal review at the IRS. Robertson said the guide’s five chapters will cover: an overview of the program; techniques for auditing a CDE; techniques for auditing investors; nonprofit issues; and how the report is to be written by the agent. IRS audit technique guides for many different industries are posted on the Service’s Web site (<http://www.irs.gov>). \square