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HISTORY AND THE HILL



CDFI Fund Provides HTC Relief on NMTC Related Party Test

By John Leith-Tetrault, National Trust Community Investment Corporation

After years of waiting, the historic tax credit (HTC) industry has finally obtained a reprieve from the Community Development Financial Institutions (CDFI) Fund's related party test (RPT), which has greatly complicated twinned federal historic and new markets tax credit transactions since the early days of the NMTC program. Because surveys show that about 10 percent of all NMTC transactions and 20 percent of qualified equity investments (QEIs) by dollar volume involve use of the HTC, this rule change could have a considerable impact on both credits. But first some background.

Background

The CDFI Fund has always been concerned about related parties obtaining an NMTC allocation and essentially funding their own transactions in which they materially participate as owner, contractor, tenant or developer. There has also been the worry that NMTC investors would funnel their own allocations to qualified active low-income businesses (QALICBs) from which they derive some additional monetary benefit beyond the value of the credit.

To address this potential program abuse, the CDFI Fund awards applicants five additional points on their NMTC allocation applications if they agree to make "substantially all" of their investments in QALICBs that are unrelated. On an application scoring system of 100 points, given how competitive the applications have become over the last seven Rounds, a loss of five points is usually deadly. So after

Round 1, the word was out that you had better "check the box." But the problem was in the nature of the test.

The community development entity (CDE or allocatee) was deemed to be related to the QALICB if it, directly or indirectly, owns more than 50 percent of the capital or profits interest in the QALICB (assuming the QALICB is a partnership for federal tax purposes). The "50 percent test" became most problematic for HTC/NMTC equity transactions in which the CDE almost always had more cash in the deal than the developer, as one would expect. This is because the CDFI Fund required until the recent change that the RPT be applied after the CDE made its qualified low-income community investment (QLICI) to the QALICB. As a result, CDEs interested in rehabilitating historic structures that qualified for both credits have been forced to convert into debt what would have been equity contributions to the LLC, creating unnecessary debt service that most of these economically challenging deals can't afford.

Even non-historic NMTC transactions suffered. Take the case of a not-for-profit sponsored QALICB that receives a large number of government grants and private donations and wants to leverage the value of that hard earned equity by including it in basis for the 39 percent NMTC. Under the old rules, if a CDE received those sources as a QEI as part of a leveraged transaction it would most likely have had to contribute most of those sources to the QALICB as debt so as not to exceed the cash the notfor-profit sponsor contributed

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directly as developer equity. How frustrating is that—having to pay interest on dollars you have raised as donations or grants!

To make matters even worse, all of that debt eventually ran up against the “true debt test,” which, in layman’s terms, means that you can’t include in tax credit basis debt that can’t reasonably be repaid. With a community theater deal or not-for-profit service facility that cannot be expected to generate significant revenue, it doesn’t take long before you fail that test. Finally, in its most annoying consequence, the old RPT complicated developer exit from these leveraged transactions. More than any other factor, the old RPT rendered the NMTC a much less efficient credit than it otherwise could be when compared to other social investment credits in the IRC, such as the low-income housing and historic tax credits.

The New Related Party Test

So how does the new RPT work? In a splendid example of coordinated lobbying, the Novogradac NMTC Working Group, the NH&RA NMTC Steering Committee and the NMTC Coalition, all, with some variations, endorsed the idea that the RPT should be conducted after the QEI in the CDE, but before the QLICI into the QALICB. So if the investor or the sub-CDE is not related to the qualified business before the real estate deal, under the new RPT, neither can be related to it after the transaction closes. Additional support for the change came from the recent Government Accountability Office (GAO) study of the NMTC program that urged the CDFI Fund and the industry to find ways to leave more equity at the QALICB to give it the best chance to survive after the seven-year compliance period without further government subsidy.

In its Q&A for the Round 8 application, the CDFI Fund asks applicants to refer to Internal Revenue Code (IRC) section 267(b) and 707(b)(1) for guidance on what would constitute relatedness after the QEI. Under IRC Section 707(b)(1), if after the QEI an investor or subCDE owns more than 50 percent of the capital interest, or the profits interest, in the QALICB, they are related. History on the Hill has also learned that the CDFI Fund may issue guidance soon that this new RPT must be applied to all transactions after April 15, 2010.

Impact of the New RPT

What will change with HTC/NMTC transactions as the new RPT is applied? Hopefully a lot. A CDE should be free to make equity QLICIs without regard to the comparative amount of equity it has in the deal. It should reduce the need to wrestle with true debt tests and minimize forgiveness of debt taxable events upon exit. All these changes will reduce closing costs that are now burdened by efforts to eliminate or mitigate these negative side effects of the old RPT. Tax credit investors and syndicators who use the federal

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HTC regularly may be able to get back into the business of equity investments in real estate. All CDEs will have the ability to leave more of the value of the HTC and NMTC in the QALICB, which was the original intent of the NMTC program.

Potential Legal Challenges Ahead

But there is a dark cloud on this horizon. (It's tax-driven real estate after all!) What the advocates of this RPT change have recognized is that another NMTC regulation that governs the application of certain safe harbor or "reasonable expectation" rules may come into play in equity based investments. A CDE is able to avoid the recapture events that might otherwise be triggered if a QALICB fails to maintain its QALICB status (e.g. fails to maintain an 80-20 ratio of residential to commercial revenue in a mixed-use project during the entire seven-year compliance period *if it had a reasonable expectation that the QALICB will remain in compliance*). But the ability to use the reasonable expectations test cannot be used by a CDE that "controls" the QALICB, either through direct or indirect ownership based on "value" or control based on voting or management rights of more than 50 percent of the QALICB.

Jerry Breed of Bryan Cave says the problem is that there is no IRS guidance on how to value equity as it relates to control of a QALICB that has received NMTC equity. "That's the \$64,000 dollar question," Breed said. "Without any regulations on this issue, we don't know if a subCDE that contributes substantially more than 50 percent of the equity in an NMTC transaction might not be deemed by the IRS to be a controlling entity of the QALICB, thereby voiding any reliance on reasonable expectations. If value in this context is measured by the distribution of proceeds from an immediate sale of the project, the CDE would likely receive the lion's share of the proceeds. If value is determined by the sharing ratios of the equity owners of the project based upon cash flow and anticipated residual value over the life of the project, the CDE likely would not control the project owner. It is not clear whether anticipated federal, state or local tax benefits would be taken into account in this analysis. Investors may consequently be nervous about a transaction in which the reasonable expectations test is replaced by the need for constant vigilance over seven years by the participating subCDE and its parent CDE."

Owen Gray of Novogradac and Company has suggested that there may be additional work ahead for the Novogradac NMTC Working Group to try to obtain more clarity from the IRS on what would constitute control of a QALICB where more than 50 percent of the equity is contributed by the sub-CDE. ❖

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John Leith-Tetrault has 32 years of experience in community development financing, banking, community organizing, historic preservation, training and organizational development. He has held senior management positions with Neighborworks, Enterprise Community Partners, Bank of America and the

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