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Calculating the Value of the New Markets Tax Credit

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One of the most common uses of new markets tax credits (NMTCs) is to provide loans for construction or renovation of real estate projects. In keeping with the objectives of the NMTC program, the structure of these loans is often designed to transfer a substantial portion of the subsidy created by the tax credits to qualified active low-income community businesses (QALICBs).

There are a number of ways this can be accomplished, but this article will focus on the common structure in which a community development entity (CDE) makes two loans — a senior loan that provides most of the economic return on the investment in the CDE (Loan A), and a subordinate loan that corresponds to the portion of the CDE investment whose return on investment is primarily via the receipt of the NMTCs (Loan B).

Typically, Loan A will mimic a market rate loan as to interest rate, loan-to-value and funding parameters. Loan B typically will be subordinate debt that bears a very low rate of interest (*e.g.*, 1 percent), has a long maturity (*e.g.*, 40 years) and represents the “mezzanine” or higher-risk capital in the project. In this kind of structure, at least Loan B (and often both loans) will be interest-only throughout its term.

This approach is used widely because it fits well within the NMTC program, and within a leveraged investment structure in particular (with Loan A effectively providing the source of payment of the leverage loan and Loan B providing only the supplemental cash flow needed for the expenses of the CDE and the fund). But as CDEs and QALICBs structure these transactions, they should fully understand the value they create for the QALICB. In the face of the complexity of the documentation and often high transaction costs, it is important that both the benefits and the costs be assessed accurately.

Assume a transaction in which:

- ♦ a CDE receives a single \$10 million qualified equity investment (QEI) from an investment fund that becomes the 99.99 percent member of the CDE;
- ♦ the fund borrows \$7 million under a leverage loan (the fund loan) at 8 percent *per annum* and obtains the remaining \$3 million from a tax credit investor that the fund uses to make a \$10 million QEI in the CDE and acquire a 99.99 percent membership interest in the CDE;
- ♦ the CDE uses the QEI to pay \$600,000 in transaction costs and fees and to make a Loan A to the QALICB of \$7 million (mirroring the fund loan) as a first mortgage loan, with an interest rate of 8 percent *per annum*, and a Loan B to the QALICB of \$2.4 million as a subordinate mortgage loan with an interest rate of 1 percent *per annum* (with both loans being interest-only until maturity);
- ♦ the tax credit investor is given a right to “put” its membership interest in the fund to the QALICB (or to a designee of the QALICB) at the end of the compliance period for \$50,000.

Under this structure, the tax credit investor will receive its desired yield mainly from the tax benefits (approximately \$3.9 million in tax credits, along with some losses resulting from the amortization of the fees paid by the CDE and interest expense of the fund loan). Typically, the investor will not receive any significant cash distributions.

(continued on page 2)

Calculating the Value

(continued from page 1)

Once the compliance period ends, given the small amount of residual payments available to the tax credit investor (after the required payments on the fund loan), the parties to these transactions typically assume that the investor will be willing to exercise its “put” at that time. In the transaction outlined above, when the QALICB (or its designee) acquires the tax credit investor’s interest, it ends up owning essentially all of the CDE’s right to receive \$2.4 million in exchange for a payment of only \$50,000 (the put price), creating a benefit to the QALICB of about \$2.35 million in gross dollar terms.

One effect of this transfer, however, can be to produce an income tax liability for the QALICB (or its members or partners). This is because the regulations under Section 108 of the Internal Revenue Code (IRC) require that when a borrower or a “related” party acquires, directly or indirectly, indebtedness of that borrower at a discounted amount, a portion of that indebtedness — generally equal to the amount of the discount — is deemed canceled. Treas. Reg §1.108-2. This deemed cancellation of debt constitutes income to the QALICB (COD income).

Whether a party is related for this purpose is based on the tests in IRC sections 267(b) and 707(b)(1), under which parties are deemed related if there is more than a 50 percent commonality of ownership (based on either capital or profits). Where the QALICB or a related party purchases the tax credit investor’s interest, this may be treated as an “indirect” acquisition of the debt of the QALICB under the regulations, and if it is, COD income would be created. In the above example, there would be a deemed cancellation of \$2.35 million of debt, generating an income tax liability of approximately \$822,500, which offsets part of the benefit described above.

Under some circumstances, it may be possible to defer the timing of this income. Under IRC Section 108, an election can be made to take a basis reduction in assets of the taxpayer, in lieu of recognizing COD income. However, this relief is available only to the extent that there is “qualified acquisition indebtedness” secured by property that exceeds its fair market value, or where the taxpayer is otherwise insolvent or the discharge occurs in bankruptcy. Moreover, under IRC Section 108(d)(6), where the QALICB is a partnership for tax purposes, these conditions would be applied at the partner level. In a case where this election is available, the reduction in basis may still cause gain to be realized on a disposition of the property, but it would defer the tax liability to a point in time at which there may be cash to pay that liability.

Absent the availability of the election under IRC Section 108, the QALICB might arrange for a party not related to the QALICB to purchase the tax credit investor’s interest, with a view to having Loan B remain out-

(continued on page 3)

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Calculating the Value

(continued from page 2)

standing, at least until the QALICB sells the property. Still, to the extent Loan B is ultimately repaid, the party that purchases the debt would then have a gain to the extent that the amount it receives exceeds what it paid to acquire Loan B. And to the extent the indebtedness under Loan B is eventually cancelled (such as when the property is sold), this would result in COD income to the QALICB. Thus, when valuing the benefits of the transaction to the QALICB, there will be an eventual tax liability that needs to be taken into account.

But there is a further element of value to Loan B that should not be overlooked. The additional capital of Loan B generally represents "mezzanine" debt, *i.e.*, the investment layer in excess of what a first mortgage lender would be prepared to lend on market terms. Loan B represents the riskiest piece in the capital structure and, as high loan-to-value debt, bears a cost of capital that typically is quite high. Absent the availability of NMTCs, the QALICB might expect to pay anywhere from 14 percent to 20 percent *per annum* from market rate sources (and even higher for traditional equity, given the equity investor's preferred return and percentage share of refinancing and sale proceeds).

The tax credits enable the QALICB to borrow this same money for around 1 percent *per annum*. In the above example, an interest savings of 13 percent *per annum* on \$2.4 million over seven years would result in a total reduction in interest costs of \$2,184,000 over seven years on a nominal basis. At a 19 percent *per annum* interest savings that total increases to \$3,192,000 on a nominal basis. And, since this is interest that was never charged and that never had to be paid, this benefit doesn't create an off-setting tax liability.

Of course, the above benefits may be smaller on an after-tax basis because the QALICB's partners will not be deducting the higher interest costs associated with a market rate mezzanine loan. However, the amount of the reduction in benefit will depend on the partners' ability to use the additional deductions. Moreover, this will be academic where the QALICB simply couldn't qualify for or pay the debt service on a market rate mezzanine loan.

This serves to demonstrate the real power of the new markets tax credit. Not only does it provide a source of higher-risk capital that can eventually be turned into equity in the project, but it does so while enabling CDEs to charge only a tiny fraction of the rates that would otherwise be charged for that capital.

On a \$10 million transaction, based on the assumptions described above, the total financial benefit that the QALICB can expect to realize would be somewhere between \$3,711,500 and \$4,719,500 (depending on

(continued on page 4)

Calculating the Value

(continued from page 3)

what the market mezzanine loan rate would be), even *after* deducting the tax liability from the cancellation of debt under Loan B as described above (but ignoring other tax effects). When all of these benefits are taken into account, it seems that the NMTC may not be such a shallow subsidy after all. ❖

Scott Lindquist is a partner in the Chicago office of Sonnenchein Nath & Rosenthal LLP. A substantial portion of his practice is devoted to representation of a wide variety of clients in the new markets tax credit area. Robert J. Wasserman is the vice president of historic and new markets tax credit investments for US Bancorp Community Development Corporation.

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