The New Markets Tax Credit Program

A CEOs for Cities Briefing Paper:

How This New Incentive Can Strengthen America's Cities

by

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Prepared for

CEOs for Cities

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A national, nonpartisan alliance of mayors, business executives, university presidents and civic leaders that strengthens the economic competitiveness of cities through an exchange and application of best practices, ideas, and advocacy.

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Preface: *This paper is divided into three sections: an overview, a detailed description of the New Markets Tax Credit program, and profiles of closed and pending deals.*

Section I is intended to bring the reader up to date (mid-April 2004) on the program by providing a general description of its objectives, some perspective on how the NMTC program compares with other subsidies, some potential problems, and finally some comments by practitioners.

Section II provides program details: how the program is administered, which census tracts are eligible, qualifying investments and investors and how NMTCs are allocated.

Section III describes the financial structure of two deals that closed using NMTCs, and then provides examples of four pending deals in Columbus, Ohio, that can move forward with the help of NMTCs.

Table of Contents

I. Overview

Powerful Tool

The New Markets Tax Credit program (NMTC) was passed by Congress in December 2000, as part of the Community Renewal Tax Relief Act. The program is designed to stimulate investments in commercial real estate and business ventures located in low-income urban and rural areas. Over a seven-year period (2001-2007), $15 billion of investment capital will be eligible for tax credits. The NMTC program provides investors with tax credits that total 39 percent of their investment, distributed over a seven-year period.

Although the program is in the early stages and its full potential has yet to be explored, economic development practitioners insist that the NMTC program is a much-needed catalyst for private-sector investments. Used correctly, they say, the NMTC program can close financing gaps and bring difficult, previously stalled projects to fruition.

"In terms of programs that have existed, this is one of the most powerful tools to come along in the last decade," said Joseph Pettiford, administrator with the National Trust for Historic Preservation's Community Partners Program. "There is some wariness about it, just as there was about the Low-income Housing Tax Credit (LIHTC) program when it was introduced in the 1980s. But those who see how it can work are running with it."

The NMTC program is frequently described as a "shallow subsidy," in contrast to the deeper LIHTC incentive. But the NMTC program is more flexible than the LIHTC, which means it can be applied to a wide range of commercial investments that further community-development goals. "The best way to think about the program," explains Buzz Roberts, vice president for policy at Local Initiatives Support Corporation (LISC), "is [community economic development practitioners] have access to $15 billion at 2 or 3 percentage points below the rate that we would otherwise. When you have a marginal deal, if you can lower the cost of capital by 2 or 3 percentage points, it could work."

According to Bob Milbourne, president of the Columbus Partnership, an important NMTC program asset is its ability to reassure private-sector investors. "In every community we search for private investment: Where is it going to come from for major projects? It's been very hard to identify private sources," Milbourne explains. "The NMTC is the device that will elicit private investment. It will bring private investors into urban projects. That's been our experience here in Columbus." The Columbus Partnership received commitments from 15 corporations for $275 million, which was used to support the organization's application for $190 million in NMTCs.

Getting Up To Speed

The NMTC program offers individual and corporate taxpayers a credit against federal income taxes for qualified equity investments (QEIs) made through investment vehicles called community development entities (CDEs). In turn, CDEs make loans and equity investments in commercial enterprises located in qualifying low-income rural and urban census tracts.

The NMTC program is administered by the Community Development Financial Institutions Fund (CDFI Fund), an office within the U.S. Treasury Department. The CDFI Fund began accepting applications for $2.5 billion first-round tax credit allocations in spring 2002 and by August had received 345 applications. The first-round applicants requested an aggregate of $26 billion, an indication, CDFI Fund officials say, of the extraordinary demand for the product. Sixty-six CDEs received NMTC authority in March 2003; however, the first allocation agreement was not signed until fall 2003 and some were not completed until as late as January 2004. According to a Treasury Department report, as of March 2004, "29 allocatees reported that they have issued Qualified Equity Investments (QEIs) for a total of $473 million from investors."

The average first-round allocation was $38 million and ranged from $.5 million to $170 million. Six CDEs received allocation awards of more than $100 million. Eighty percent of the NMTCs were awarded to CDEs that serve urban and suburban areas, as opposed to rural areas.

Phoenix Community Development and Investment Corporation, a subsidiary of the city of Phoenix, received the largest allocation, $170 million, in November 2003. Phoenix was the only city to receive an NMTC allocation in the first round. Phoenix officials say the major portion of its NMTC allocation will support commercial real estate investments in distressed neighborhoods. Another focus will be loans to minority women-owned businesses. As of April 2004, Phoenix had yet to close a deal.

The names of awardees of the $3.5 billion second round of NMTC allocations are scheduled to be announced in late-April 2004. CDFI Fund officials report that the second round received fewer applications than the first round (271 vs. 345), but more money was requested ($30.1 billion vs. $26 billion). Non-profit organizations or subsidiaries of non-profit organizations accounted for that 38 percent of second-round applicants, according to CDFI Fund officials. Nineteen percent of the applicants were banks, thrifts or bank holding companies, and 6 percent of applicants were government-controlled entities or their subsidiaries.

First-round Caution

Economic development organizations proceeded cautiously during the first round of applications, either limiting their request or sitting out, waiting until the program is tested and its parameters become more apparent. This hesitancy was particularly evident among banks and city governments. "Banks and cities, for the most part, sat out the first round," explains John Leith-Tetrault, director of the Community Partners Program for the National Trust for Historic Preservation. "But now that they understand the usefulness of NMTCs we see more of them participating."

To date, relatively few deals using NMTCs have been completed. As noted, only $473 million of the $2.5 billion credits available were applied as of March 2004. Practitioners attribute the slow pace to the steep learning curve. Thomas Lattimore, CEO of Seattle-based Impact Capital and LISC's Washington State program director, used NMTCs allocated to LISC in a $12 million adaptive re-use project in downtown Tacoma, one of the first deals to close. The closing, said Lattimore, "was somewhat akin to building an airplane while you're flying it. Investors had to do their analysis to see what their return would be. After the 400th deal, everyone will feel more comfortable."

The learning process is likely to continue slowly, officials say, because many of the organizations that won allocations in the first round did not apply for round two. Several first-round awardees reported difficulty meeting the application criteria for second-round credits, particularly the aggressive CDFI Fund time requirements. In order to be considered for a second-round allocation, at least 50 percent of the first-round allocation must have been committed by the March application deadline.

Many first-round awardees, including LISC and NTHP, will not compete in the second round because of the 50-percent rule. (LISC received a $65 million first-round allocation and NTHP received $127 million.)

"Tough economic development deals in tough communities take time to cook," explains LISC's Roberts. "In our case, most of the deals we wanted to do were slow-cook, and we were not able to get them done in time. I respectfully disagree with the way Treasury structured its time requirement for second-round bidding."

Adds NTHP's Leith-Tetrault: "You shouldn't be forced to get deals out to meet a deadline. The 50-percent rule could cause people to throw credits around to deals that don't need them."

Even CDEs with small allocations had difficulty meeting the 50-percent rule. Nuestra Comunidad, a Boston-based Community Development Corporation, had none of its $1 million first-round allocation committed by the application deadline. "We signed our allocation agreement in January, and there was no way we could have commitments in place by March," explains Kevin Wynn, Nuestra's director of lending and technical assistance.

CDFI Fund spokesman, Bill Luecht, acknowledged the stringent time requirements, but insisted that awardees had sufficient time to meet the deadlines. "Some took longer than others to close [sign the allocation agreement], which made things more difficult. But part of the evaluation for the allocation was how many commitments they had in hand. Treasury wants to make sure the credits are being used."

Practitioner Comments: The Importance of NMTC

The majority of community economic development practitioners surveyed said the NMTC program is extremely important, although most acknowledge, as one said, "It will not make a bad deal a good deal." Its strength is filling investment gaps in projects that have some economic fundamentals in place. "It's a shallow subsidy if you just take it in the simplest form," explains Joseph Flatley, CEO of Massachusetts Housing Investment Corp., which has closed several deals in which NMTCs were applied. "But it can be used within a leverage structure that can cover a significant portion of the project. For example, if you have a project with a million-dollar gap between what it costs and what it's worth, NMTCs can fill that gap by 25 percent. So it's a valuable tool."

Practitioners offer conflicting recommendations regarding whether city governments should themselves apply for an NMTC allocation or work through existing community development organizations. "Find somebody else to do it," Flatley advises. "The city of Boston works through us. We have been doing this for a long time, and we know how these deals can be structured." He argues that using NMTCs to full advantage requires specialized expertise that takes time, and money, to acquire. Scale, i.e., the volume of deals, is also important.

Lynda Dodd, NMTC coordinator for the city of Phoenix, said the city applied for an allocation for control purposes. "We did consider partnering with a local CDE, but that CDE's service area expands beyond Phoenix." A potential drawback of a city administering the NMTCs, she said, is that investors worry that political pressure could be exerted to fund projects that are not financially viable. In Phoenix, she said, the CDE's board, which by law has strong community representation, insulates decisions from untoward political influences.

II. The Program

Community Development Entities

New Market Tax Credits can be applied only to equity investments in certified Community Development Entities. With these funds, CDEs are expected to use their local knowledge to make loans and investments in businesses located in low-income communities. A CDE must have a primary mission of community development through capital investment. Only a for-profit CDE can pas tax credits to investors, but nonprofit organizations can apply for an NMTC allocation and bring in investors by forming a for-profit CDE as a subsidiary, partnership or limited liability company.

Qualified CDEs must ensure accountability to residents of low-income communities by including community representation on a governing or advisory board. A CDE can meet the community accountability requirement through its controlling parent organization. The Treasury Department certifies CDEs. Certified Community Development Financial Institutions (CDFIs) and Specialized Small Business Investment Companies are automatically qualified.

CDE eligibility is offered to such entities as community development banks or venture funds, community development corporations, small business investment companies focused on low- and moderate-income communities, New Markets Venture Capital companies and other investment funds.

CDFIs are specialized financial institutions that serve low- and moderate-income areas. New Market Venture Capital companies are newly created entities licensed by the Small Business Administration. They direct investments and loans towards smaller firms in low-income areas "that will benefit from capital managerial, and entrepreneurial assistance." Small Business Investment Companies are private venture firms licensed by the SBA to invest in small growing businesses.

An entity may receive CDE certification even if it does not plan to seek an NMTC allocation, but instead intends to sell loans to a CDE that has received an NMTC allocation or wants an investment or loan from a CDE that has an NMTC allocation.

CDEs that received NMTC allocations must use at least 80 percent of committed funds (Qualified Equity Investments) by May 2006 and 100 percent of their QEIs within five years after entering into an allocation agreement. The QEI must stay in the CDE for seven years. Investors can claim the NMTC in the taxable year in which they make the investment in the CDE.

As of February 2003, the CDFI Fund, the Treasury division that administers the NMTC program, had certified 821 organizations as CDEs. One year later, that total has risen to 1362, an increase of 64 percent.

Qualifying Low-Income Communities

The NMTC program defines low-income communities that are eligible for investment under three categories: 1. A census tract with a poverty rate of 20 percent; 2. A metropolitan area census tract with a median income below 80 percent of the median for the entire metropolitan area or below 80 percent of the statewide median income or whichever is greater; and 3. A non-metropolitan area census tract (or county) with a median income below 80 percent of the statewide median.

Analysts say most urban census tracts qualify for NMTC investments under these definitions. Eighty percent of median income ($50,200 nationally) encompasses moderate-income households as well as low-income.

"Substantially all" (85 percent) of the investor's NMTC equity investments must be used for eligible purposes. A CDE can use NMTC investment proceeds to provide loans and equity investments to eligible businesses or other CDEs, to purchase loans made to eligible businesses by other CDEs, to provide financial counseling and other services to eligible businesses and to finance its own eligible businesses. For example, a shopping center developed and operated by a CDE could be eligible.

Qualifying Investors

Any taxable investor, including an individual, company or investment fund, that invests in a CDE is eligible. Examples of qualified investors are banks, venture capital funds, finance companies, individuals, and corporations. Investors will receive tax credits based on the amount of their equity investment in a CDE. Tax credits are claimed over seven years, starting on the date of the investment and one each anniversary: 5 percent for each of the first three years and 6 percent for each of the next four years for a total of 39 percent. The investor's basis is reduced by the tax credits, and they can be applied retroactively to projects dating back to December 2000.

Equity investments can take the form of stock or any capital interest in a partnership and must be paid in cash. Equity investments must be made within five years of the tax credit allocation to the CDE.

The NMTC program includes a "recapture" provision. Within the first seven years after the investment is made, an investor could lose the tax credits it has claimed, plus interest, if: 1. Substantially all of the cash proceeds are not used for eligible purposes; 2. The investor cashes out its equity investment in the CDE; or 3. The CDE loses its Treasury certification as a CDE. Treasury is expected to write rules for curing violations within a reasonable period to prevent unwarranted recaptures.

Qualifying Investments

Almost all businesses located in low- or moderate-income areas could qualify for loans or equity investments. These could include small technology firms, inner-city shopping centers, manufacturers, retail stores or micro-entrepreneurs. A business must meet several eligibility requirements: 1. Be located in a qualifying census tract; 2. Have a substantial connection to that area by having at least 50 percent of the business's income derived from activity in a low-income community; 3. Have a substantial portion of the business's property located in low-income community; 4. The employees of the business must perform a substantial proportion of their work in the low-income community; and 5. Less than 5 percent of the business's assets can be held in unrelated investments.

Applying for NMTCs

The $15 billion in tax credit eligibility is being made available through a competitive process over the seven years of the program (2001-2007). Administrative delays moved the first round, $2.5 billion, to 2002, and the second round, $3.5 billion, to 2003. Second-round awardees will be announced in late April, according to Treasury officials.

CDE applicants undergo a "review process to identify those best suited to have the greatest community development impact," according to government documents. The review includes the CDE's business strategy to make investments in low-income communities, capitalization strategy to raise equity from investors, management capacity, targeting to areas of highest distress, and impact on jobs and economic growth in low-income communities where investments are made.

III. Anatomy Of A Deal

Tacoma, Washington

One of the first deals to close using NMTCs took place in February 2004 in Tacoma, Washington. The project, Albers Mill Lofts, was a $12 million renovation of an historic property consisting of commercial space on the first floor and 36 market-rate loft apartments on the top four floors. Albers Mill Lofts is located on a former Superfund site and in a Federal Renewal Community. Renovation of Albers Mill Lofts is part of Tacoma's revitalization plan for the Thea Foss Waterway, which includes adapting vacant buildings for new uses and transforming contaminated properties into a public space, including 1.5 miles of waterfront walkway, public event plazas, marinas, shops and cultural centers. Tacoma officials expect Albers Mill Lofts to be a catalyst for community economic development.

NMTC authority of approximately $11 million was provided to the project by LISC, which operates in Washington State in conjunction with Impact Capital. "Albers Mill Lofts had been working through the pipeline for a number of years, getting historic designation and design plans in order," relates Tom Lattimore, Impact Capital's CEO and LISC's Washington State program director. "When the deal was originally conceived, the market was better, and a private loan could have been had. But the downturn in the economy changed that." The project was languishing, Lattimore says, until NMTCs became available. "NMTCs significantly decreased the debt service while significantly increasing the amount of equity financing to the project."   As Lattimore explained, NMTCs filled a critical need for capital to close a gap in construction costs, "and the access to equity meant a lower a cost of financing to make the deal feasible."

According to a report of the deal written by Ruth Sparrow, an attorney with Seattle law firm Garvey Schubert Barer, who represented Heritage Properties, LLC, the developer in the transaction, the financing structure was multifaceted, both in terms of participants and financing tools. Sparrow writes: "US Bancorp Community Development Corporation (USB CDC) provided the NMTC equity investment in consideration for NMTCs, historic rehabilitation tax credits and other economic benefits. Other financing included bridge financing provided by a Community Development Block Grant loan and local tax incentives. US Bank NA provided a construction loan to the project, which was taken out by the NMTC financing. USB CDC's NMTC equity investment in New Markets Investment I [LISC's subsidiary CDE], financed a loan and equity investment by the CDE in the project. The additional NMTC equity is an important component of the overall financing of the project….

"The parties also negotiated their respective rights and obligations, including consent rights and compliance obligations taking into account the economic and compliance risks of each of the parties. The developer [Heritage Properties, LLC of Anchorage, Alaska] controls the day-to-day management of the project. USB CDC retains consent rights necessary to protect its significant economic investment in the project, and the CDE maintains an important role in oversight of NMTC compliance of the project and achievement of its mission of serving the low-income community. The CDE that transfers its NMTC authority to the transaction has its own interests in the success of the project and will negotiate rights and obligations accordingly."

New Bedford, Massachusetts

Another of the early deals closed with the help of NMTCs is Coffin Lofts, New Bedford, MA. The Coffin Lofts projects is a $5.8 million renovation into mixed-use properties of three vacant historic buildings in the Central New Bedford Historic District in downtown New Bedford. When completed, the buildings will be interconnected by a common elevator and lobby and consist of 18 mixed-income residential units on upper floors, and four artist live/work spaces and more that 5,000 square feet of commercial space on the ground floor.

Financing for the project was structured by the Massachusetts Housing Investment Corp.(MHIC), a non-profit private financier of affordable housing and community development in Massachusetts. MHIC, which received a $25 million NMTC allocation in the first round, describes its mission as "providing financing that would not otherwise be available and extending the impact of that financing to ensure the broadest possible benefit."

MHIC's CEO, Joseph Flatley, says the NMTC program fits perfectly with his organization's mission. "It supports our core competencies," Flatley explains, "and takes advantage of existing infra-structure. Our goal is to maximize the value-added by our capital structure, and use this added value to support projects that would not otherwise be feasible."

In the Coffin Lofts project, the New Markets Fund (MHIC's subsidiary CDE) will provide approximately $4.2 million, including $1.1 million in subordinate debt and $1.9 million in combined historic and new markets tax credit equity. Subordinate debt financing that will flow through MHIC's structure are HOME loans of $550,000 each from the City of New Bedford and the Massachusetts Department of Housing and Community Development. Added subsidies include a $300,000 Federal Home Loan Bank (FHLB) Direct Subsidy and a $1.4 million FHLB Subsidized Advance through Compass Bank. Of the 18 residential units, five will be set aside for low-income households, six for households at or below 65 percent of area median income and seven will be market rate.

Compass Bank is providing 20-year, fixed-rate financing to MHIC's CDE. The CDE's loan to the project will not be refinanced. At the end of the NMTC compliance period, Compass Bank is expected to exercise its option to acquire the CDE's note to the project.

Deals in the Pipeline

More than 270 CDEs applied for NMTC allocations in the second round, requesting a total of $30.1 billion in tax credits with only $3.5 billion available. Among the second-round applicants was Columbus Inner City Partnership (CICP), subsidiary CDE of the Columbus Partnership. CICP requested $190 million in NMTCs and had $275 million in commitments from private investors to support its applications. CICP is awaiting the announcement of second-round awardees, scheduled for late April.

If CICP's application is successful, seven projects in downtown Columbus will get the financing they need to get underway, according to Bob Milbourne, president of Columbus Partnership. "There are many projects that almost make sense but never get done," explains Milbourne, referring not only to Columbus projects but also to those in cities across the country. "It's one thing to say these projects are close, but it doesn't matter if they're close if they don't get done. The NMTC is a catalyst for the private investment we need to get them done."

The projects in CICP's pipeline include:

- Renovation of a failed downtown shopping center. A $40 million adaptive reuse project is proposed.
- Renovation of a 100-year-old former department store for office use by state employees. The building was donated to CICP. The cost of renovation is $30 million.
- Expansion of the city's art museum. CICP will lend $15 million at zero interest to the museum for the expansion. The museum is eligible for NMTC credits because it is located in a qualifying census tract. At the end of seven years, the museum will pay back the loan without interest.
- Creation of a working capital fund for small businesses. Qualified businesses will be eligible for low-interest loans.