Overview of New Markets Tax Credits

New Markets Tax Credit Basics

- Program was created December 2000
- Administered by the CDFI Fund of the US Treasury Dept
  - Certifies Community Development Entities (CDE)
  - Allocates NMTCs to CDEs
  - Monitors CDEs
- NMTCs are claimed over seven years starting on the date the equity investment is made and each subsequent anniversary
  - 5% credit of the investment in years 1 through 3
  - 6% credit in Years 4 through 7
  - 39% credit total
Qualified Projects

NMTC Investments can be made in:

1. A qualified real estate project located in a qualified census tract OR
2. A qualified business that meets the following tests:
   - **Gross Income Test**: More than 50% of gross income must be generated by activities performed in qualified census tracts
   - **Tangible Property Test**: More than 40% of the value of the tangible property must be located in qualified census tracts
   - **Services Test**: More than 40% of the services of the employees must be performed in qualified census tracts

Qualified Projects

- Project(s) must be in a qualified low-income census tract
  - Poverty level greater than 20%
  - Median Income below 80% of the State or Metro Area
- Other qualifications:
  - TIF, Empowerment Zones, Enterprise Communities, rural counties with high migration, FEMA Counties
  - CDEs are now looking to invest in more deeply distressed communities to score higher on CDFI applications
**Qualified Projects**

- Ineligible Businesses
  - The business cannot be a financial institution or finance company
  - The business can’t have more than 5% of assets attributed to collectibles for sale (e.g., art, antiques, baseball cards, etc.)
- There must be a reasonable expectation that the business will continue to meet these tests for the next 7 years
- Businesses can use NMTCs to finance working capital, machinery and equipment, furniture, fixed assets, and research and development

**Transaction Components**

- NMTC Components/Terms
  - CDE/Allocatee
  - Investor
  - QEI (Qualified Equity Investment)
  - Leverage Lender
  - QLICI (Qualified Low Income Community Investment)
  - QALICB (Qualified Active Low Income Community Business)
The CDE is the entity that receives the tax credits from CDFI Fund. The CDE has a 5-year period to find investors. In reality, most CDEs want to get out 85%-95% of their credits in Year 1 to be more competitive in the next CDFI round. Many banks look for projects before they receive their allocation (forward fund).
**Transaction Components: CDE/Allocatee**

- **CDE Expectations**
  - Minimum project size: approximately $8 million
  - Maximum project size per CDE: $10-12 million
    - Usually assemble multiple CDEs for larger development budgets

- **CDE Fees**
  - **Initial load:** Initial fee charged on the Qualified Equity Investment (QEI); typically ranges from 2-5%
  - **Annual asset management fee:** CDE’s annual fee for managing the investments; typically ranges from 25-60 basis points of the QEI paid annually (over 7 years)
  - **Annual audit/legal charges:** Annual fees for required CDFI audits, certification, and partnership legal costs; typically $7,000-$11,000 annually (often capitalized up front)

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**Transaction Components: Equity Investor/QEI**

**Diagram of Sample NMTC Project**

- **Equity Investor**
  - Provides equity up front in return for 7 years of credits
  - Equity Investor

- **Investment Fund, LLC**
  - Owned 100% by Investor; owns 99.99% of sub-CDE (Parent CDE has remaining 0.01%)
  - Investment Fund, LLC

- **CDE (aka Allocatee)**
  - Allocates $2.7M in credits
  - Allocates NMTCs to Sub-CDE, LLC; monitors compliance; reports to IIA3 annually
  - CDE (aka Allocatee)

- **QALICB: Owner/Client Entity**
  - Receives QEI and deed in trust, invests QLICI in QALICB after giving load fees to CDE
  - QALICB: Owner/Client Entity

- **Unleveraged funds**
  - $10,000,000
  - Unleveraged funds

- **QLICI**
  - $10,000,000
  - QLICI

- **Sub-CDE, LLC**
  - $10,110,406
  - Sub-CDE, LLC

- **$7,350,265**
  - Promissory Note

- **$2,760,141**
  - Credits/Equity

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**Leverage-able funds**

- **Bank Loan:** $2,000,000
  - Leverage-able funds
- **Partner Equity:** $5,350,265

**Notes:**

- Pooled funds are lent for 7 yrs; Client can lend equity to project if a minimum of 1% interest rate is used

**Data:**

- A Loan: $7,350,265
- B Loan: $2,649,735
- Both in 1st position
- A Loan is forgiven in 7 yrs for non-profits
Transaction Components: Equity Investor/QEI

- Investor makes a Qualified Equity Investment (QEI)
- The QEI is the purchase of a capital interest in a for-profit corporation or partnership established by the CDE
- The QEI is the amount of the NMTC allocation made from the CDE
- The QEI is the basis for the amount of tax credits received by the investor
- The QEI is equity, not debt
- By IRS definition, the QEI cannot be collateralized
- The QEI must remained invested in the same CDE for the seven year credit period

Transaction Components: Equity Investor/QEI

- Transaction Set-Up
  - Investor creates an Investment Fund, LLC: wholly owned by the Equity Investor
  - QEI is passed to a Sub-CDE, LLC with the CDE as managing member (0.1%) and the Investment Fund, LLC as beneficiary member (99.99%)
Transaction Components: Leverage Lender

- Project can fill gap between Total Development Costs and NMTC equity with a loan, equity, or a combination of both
  - Equity must be loaned to the project at a market rate (typically 1%) for a minimum of 7 years
  - Lender typically wants project owner to have some equity in the deal (cannot finance deal with only NMTC equity and loan)
Exit

At the end of the seven year compliance period, the CDE will exit the deal.

The CDE will have assets: the outstanding balance of the QLICI.

The CDE will also have a capital account: the QEI.

To assist unraveling, there will be both put and call options built into the partnership or operating agreements that essentially force a transfer of interests.

Exit: Put/Call Agreement

Investor & Lender sign Put/Call Option Agreement.

To insure unraveling, there will be both “call” and “put” options built into the partnerships or LLC agreements between the Investor and the Leverage Lender.

These are pre-agreed upon terms in which partners can “put” their interest to another partner (they have to take it) or can “call” an interest from a partner (they have to give it).

Investor can sell interest at end of 7 years, name entity who will be recipient, and name “put” price (usually nominal).

In the event that Leverage Lender needs to call an interest from a partner, the value is significantly reduced through accounting methods.