

New Markets Tax Credits: Unlocking Investment Potential

Abstract

This *Insights* report describes the New Markets Tax Credit (NMTC) Program and the major considerations banks may need to address when using the tax credits to support community and economic development activities. The report examines the primary opportunities and risks associated with the use of NMTCs and discusses the methods used by national banks and federal savings associations (collectively, banks) to structure transactions and use the credits effectively. The report addresses banks' participation in the NMTC Program as investors, as recipients of the tax credits (allocates), and as leverage lenders.

The information in this report was obtained from a variety of sources, including banks, nonsupervised financial intermediaries, investment fund advisers, and others that actively use NMTCs to finance a diverse range of activities. This information represents our understanding of federal income tax laws and regulations but does not constitute tax advice. Banks should consult their tax advisers about the tax treatments described in this report and the consequences that may apply to their own transactions.

Project summaries of several NMTC transactions are included in a case study in appendix A. Appendix B presents a glossary of terms about the NMTC Program. The resource directory in appendix C contains sources of additional information on the program.

I. What Is the New Markets Tax Credit Program?

The NMTC Program was created in December 2000 by the Community Renewal Tax Relief Act of 2000.¹ The program is jointly administered by the Community Development Financial Institutions Fund (CDFI Fund) and the Internal Revenue Service (IRS).² The NMTC Program uses federal tax incentives to attract private capital into operating businesses and real estate in urban and rural low-income communities (LIC). Through May 2013, the CDFI Fund had awarded approximately \$36.5 billion in NMTC

¹ U.S. Department of Housing and Urban Development, Public Law 106–554, appendix G, www.hud.gov/offices/cpd/economicdevelopment/lawsandregs/laws/actof2000.pdf.

² The IRS has published regulations at 26 CFR 1.45D-1 and interpretative guidance to assist taxpayers claiming the tax credit(s) under Internal Revenue Code (IRC) section 45D.

authority to specially designated financial institutions called community development entities (CDE).³ The CDEs use those credits to raise private capital, which is then invested in qualifying projects.

From 2003 through 2009, \$6 billion in NMTC credits generated nearly \$50 billion in financing to businesses and commercial real estate projects in low-income communities.⁴ The tax credit helped fund a variety of qualified businesses, including commercial and industrial facilities, retail and mixed-use projects, community facilities, “green” energy-producing facilities, and equipment and working capital for operating businesses. According to a 2008 study, more than 75 percent of NMTC-financed projects were in communities with significant levels of distress.⁵

By investing in a CDE with an NMTC allocation, an investor is able to claim a federal tax credit equal to 39 percent of the investment, which is referred to as a qualified equity investment (QEI).⁶ The tax credit is claimed over a seven-year period, with 5 percent of the investment amount claimed in each of the first three years and 6 percent in each of the following four years, as shown below. The NMTC Program provides a relatively “shallow” subsidy into the projects: NMTCs amount to approximately 20 percent to 30 percent⁷ of the total project costs.⁸ In the standard NMTC structure, the investor receiving the tax credit typically recovers all or a portion of the original investment after the end of the seven-year compliance period.

Table 1: Schedule of Tax Credit Benefits for a \$10 Million QEI

Year	Amount	Percentage
Year 1	\$500,000	5%
2	\$500,000	5
3	\$500,000	5
4	\$600,000	6
5	\$600,000	6
6	\$600,000	6
7	\$600,000	6
Total	\$3,900,000	39%

Source: OCC

The investor may also receive additional economic benefits, such as interest payments, from the investment.

Banks can participate in the NMTC Program in several ways. Banks can be allocatees, receiving NMTC allocation authority from the CDFI Fund through bank-owned CDEs. Through the 2011 funding round, bank-controlled CDEs have received approximately

³ CDFI Fund, “New Markets Tax Credit Program,” www.cdfifund.gov/what_we_do/programs_id.asp?programID=5.

⁴ New Markets Tax Credit Coalition, *The New Markets Tax Credit 10th Anniversary Report*, December 2010 (www.nmtccoalition.org).

⁵ CDFI Fund, *Promoting Investment in Distressed Communities The New Markets Tax Credit Program*, October 2008. Areas with significant levels of distress are defined in appendix B.

⁶ An equity investment in a CDE. See appendix B for more information.

⁷ U.S. Government Accountability Office, *New Markets Tax Credit The Credit Helps Fund a Variety of Projects in Low-Income Communities, But Could be Simplified*, GAO-10-334, January 2010.

⁸ Individual projects can vary significantly. In addition, fees and the method of financing affect how, and how much of, the subsidy reaches the borrower. According to our interviews of industry professionals, fees and expenses can reduce the amount of the subsidy to 15 percent to 20 percent.

23 percent of the NMTC allocations from the CDFI Fund. Banks can also be investors, either in their own CDEs or in third-party CDEs. In 2011, 86 percent of the money invested in CDEs came from regulated depository institutions.⁹ Banks can be lenders, providing loans into the leverage structure investments described later in this report. In practice, banks play significant roles in the NMTC Program and can participate in multiple ways on a single project.

II. Why Is the NMTC Program of Interest to Banks?

NMTCs are of interest to banks for the following reasons.

NMTCs are a critical tool in helping meet the credit needs of low-income communities. According to program guidelines, an NMTC investment must be made in a low-income community¹⁰ or serve a targeted population.¹¹ In practice, most of the investments go to areas of higher distress than required by the regulations.¹² The tax credits bring new private investment into poor communities. According to the U.S. Government Accountability Office (GAO), 88 percent of the NMTC investors surveyed said they would not have invested in a low-income community without the tax credit.¹³ NMTCs have helped banks support needed community facilities, such as charter schools¹⁴ and grocery stores.¹⁵

Community impact and accountability are essential to the NMTC Program. CDE applicants to the program must demonstrate the ability to

- identify investments in low-income communities or that serve target populations.
- achieve selected community development outcomes.
- track projected outcomes.
- meaningfully engage community stakeholders around planned NMTC investments.
- finance activities that encourage other non-NMTC investments in their low-income communities.

NMTCs are important in helping meet customer needs. NMTCs provide resources that can help create a satisfactory loan structure for a customer who might otherwise be turned down or offered a loan at a much higher rate. The tax credit provides a subsidy that is used to substantially reduce the interest rate on loans to businesses¹⁶ or to enhance the business owner's equity in a transaction by leaving a portion of the investment in the project after the NMTC compliance period, as described later in this report. In addition, NMTC loans to qualifying businesses often have flexible terms, including lower origination fees, extended interest-only payment periods, higher loan-to-value (LTV) ratios, lower debt coverage ratios (DCR), and longer amortization periods.

⁹ New Markets Tax Credit Coalition, *New Markets Tax Credit Progress Report 2012*, June 2012.

¹⁰ See definition of a low-income community in appendix B.

¹¹ See definition of a target population in appendix B.

¹² See definition of areas with significant distress in appendix B.

¹³ GAO, *New Markets Tax Credit Appears to Increase Investment in Low-Income Communities, But Opportunities Exist to Better Monitor Compliance*, GAO-07-296, January 2007.

¹⁴ OCC, *Charter School Financing Opportunities*, Spring 2011.

¹⁵ OCC, *Community Developments Investments*, "Bank Financing of Healthy-Foods Initiatives," August 2012.

¹⁶ According to *The New Markets Tax Credit 10th Anniversary Report*, nearly 90 percent of CDEs reported providing debt at below-market interest rates.

NMTCs can be used in connection with many other credit enhancements that support development in low-income communities. These enhancements include historic rehabilitation tax credits, renewable-energy investment tax credits,¹⁷ state NMTCs, and several U.S. Department of Agriculture (USDA) loan programs.¹⁸

NMTCs can help banks meet their financial goals. Investors in NMTCs can receive competitive returns on their equity investments. Leverage lenders may earn rates at or near market rates and are able to participate in transactions that would not be feasible without NMTCs.

NMTCs can help banks meet their Community Reinvestment Act (CRA) requirements.¹⁹ A bank can receive consideration for its investments in CDEs, or for the pro rata portion of a loan originated by a CDE, based on the bank's percentage of equity ownership in the CDE. A bank can also receive a partial credit for the investment and a partial credit for the loan. The investment in the CDE must benefit a bank's assessment area or a broader state or regional area that includes its assessment area.²⁰ In the case of leverage structure transactions,²¹ the equity investor and the leverage lender each may receive CRA consideration based on the pro rata share of their investment.

III. How Does the NMTC Program Work?

CDEs are specially designated financial institutions that receive allocations of NMTCs from the CDFI Fund, use those credits to raise QEIs from investors, and then invest the QEI proceeds into qualified low-income community investments (QLICI).²² Figure 1 shows how the program works.

¹⁷ OCC, *Investing in Solar Energy Using the Public Welfare Authority*, July 2011.

¹⁸ In February 2012, the USDA published an administrative notice on using the NMTC Program with the Business and Industry Guaranteed Loan Program, the Rural Energy for America Program, and the Biorefinery Assistance Program. See www.rurdev.usda.gov/SupportDocuments/an4625.pdf.

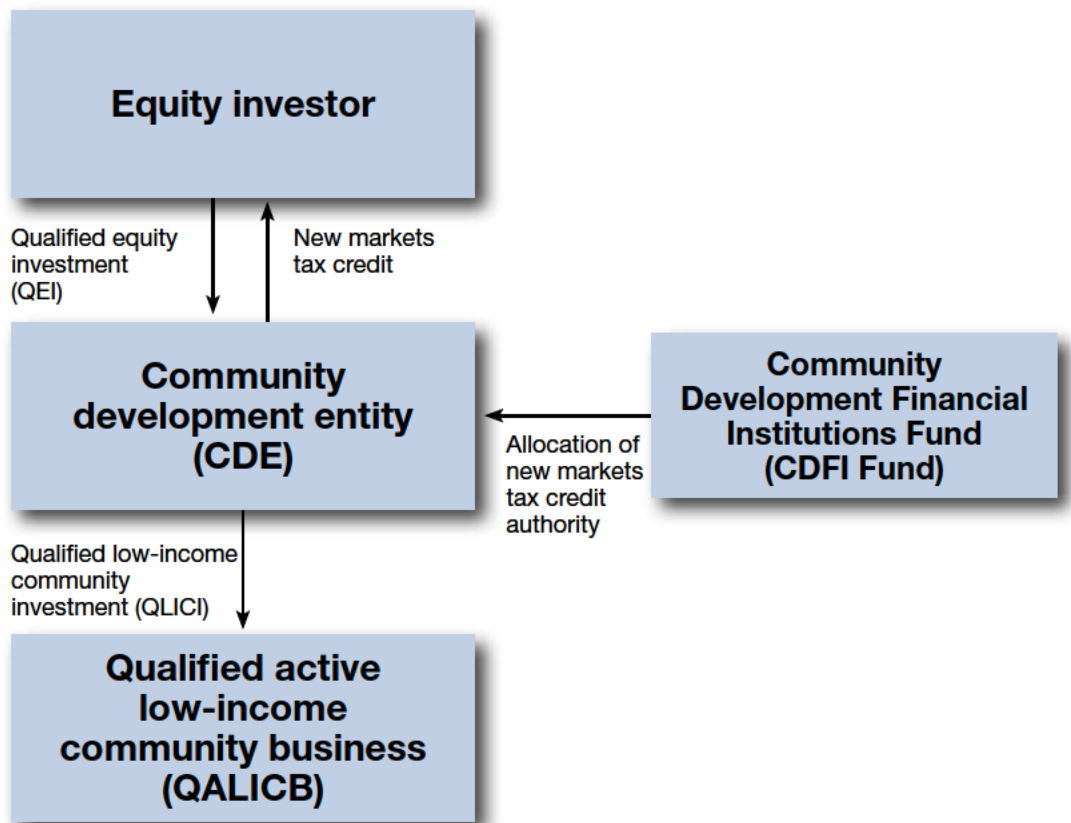
¹⁹ *Federal Register*, Vol. 75, No 47, pp. 11646, 11648, and 11652, "Interagency Questions and Answers Regarding Community Reinvestment."

²⁰ On March 18, 2013, the OCC, Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (FDIC) released a notice and request for comment regarding proposed updates to Interagency Questions and Answers Regarding Community Reinvestment, *Federal Register*, Vol. 78, No. 52, pp. 16765–16775. The proposed updates address several issues, including the treatment of community development activities outside an institution's assessment area and investment in nationwide funds that invest in community development.

²¹ The leverage structure is described in the next section.

²² This term has the same meaning as set forth in IRC section 45D(d) and 26 CFR 1.45D-1(d). See appendix B for QLICI definition.

Figure 1: New Markets Tax Credit Program: Key Terms and Relationships



Source: OCC

A CDE is formally defined²³ as a domestic corporation or partnership that

- has a primary mission of serving or providing investment capital for low-income communities or individuals,
- maintains accountability to residents of low-income communities through the residents' representation on a governing board or advisory board of the CDE, and
- has been certified as a CDE by the CDFI Fund.

Specialized Small Business Investment Companies (SBIC)²⁴ certified by the Small Business Administration CDFIs²⁵ certified by the CDFI Fund automatically qualify for CDE certification.²⁶ Affiliates of CDFIs and SBICs do not automatically qualify as CDEs and must complete the certification process.

Nonprofit and for-profit entities may apply for CDE certification. All CDEs are eligible to receive loans and investments from, or sell loans to, other CDEs that have been issued tax credit allocations by the CDFI Fund. Only for-profit CDEs, however, may raise capital by offering tax credits to investors. A nonprofit CDE applying for an NMTC allocation must present a strategy to form and transfer its entire allocation to a for-profit subsidiary or subsidiaries.

²³ See IRC 45D(c)(1).

²⁴ As defined in IRC 1044 (c)(3).

²⁵ As defined in section 103 of the Community Development Banking and Financial Institutions Act of 1994.

²⁶ See IRS LMSB-04-0510-016, *New Markets Tax Credit*, May 2010.

Awards of NMTC allocation authority from the CDFI Fund have been very competitive. Since the program's inception, the CDFI Fund has made 749 allocation awards totaling \$36.5 billion.²⁷ Demand for the credits has far exceeded the supply. In 2011, 314 CDEs requested \$26.7 billion from a pool of \$3.6 billion in allocation authority.²⁸ Successful CDE applicants must show, among other criteria, that they can

- identify investment opportunities in distressed areas.
- offer flexible or non-traditional financial products that meet community needs.
- raise capital from investors.
- deploy that capital within three years of the allocation.
- manage those investments and comply with NMTC regulations.

With an allocation of NMTCs from the CDFI Fund, a CDE allocatee can then raise equity from investors. The investments, or QEIs, are usually in the form of stock purchases if the CDE is a corporation or an equity investment in a limited partnership interest if the CDE is a partnership. A CDE must place the credits with investors within five years of receiving the allocation. As of February 2013, there was approximately \$1.9 billion in uncommitted NMTCs.²⁹ QEIs totaled \$3.8 billion in 2009, \$4.2 billion in 2010, and \$5.7 billion in 2011.³⁰

“Substantially all,”³¹ or at least 85 percent, of the investment in a CDE must be used within one year for QLICIs.³² Eligible investments include

- loans or investments into qualified active low-income community businesses (QALICB).
- loans or investments into other CDEs that, in turn, make QLICIs.
- loans purchased from other CDEs, if the loan is a QLICI.
- financial counseling or other services to businesses in or residents of low-income communities.

A QALICB can be

- an operating business in a low-income community.
- a business that develops or rehabilitates commercial, industrial, retail, and mixed-use real estate projects in a low-income community.

²⁷ CDFI Fund, “New Markets Tax Credit Program,” www.cdfifund.gov/what_we_do/programs_id.asp?programID=5.

²⁸ Tax Credit Advisor, *The Winner's Circle Treasury Announces 2011 New Markets Tax Credit Allocation Awards*, April 2012.

²⁹ CDFI Fund, *New Markets Tax Credit Qualified Equity Investments Report*, February 4, 2013.

³⁰ New Markets Tax Credit Coalition, *The New Markets Tax Credit Progress Report 2012*, June 2012. The report uses data from the CDFI Fund for this statistic.

³¹ See definition in appendix B.

³² Given the competitive nature of the application process, CDEs may voluntarily commit to investing a minimum of 95 percent or more of the QEIs in QLICIs.

- a business that develops or rehabilitates community facilities such as charter schools or health centers in a low-income community.³³
- a business that develops or rehabilitates for-sale housing in a low-income community.

Examples include for-profit retail businesses, mixed-use shopping centers, manufacturers, service providers, community facilities, and nonprofit businesses. Qualifying businesses must meet several eligibility requirements. Rental housing and certain types of businesses (including golf courses, racetracks, gambling facilities, and massage parlors) are specifically excluded.³⁴

In 2006, Congress required the NMTC Program to ensure that nonmetropolitan counties receive proportional allocation of QEIs.³⁵ To implement this, the CDFI Fund established a process so that a proportionate number of applicants that are “rural CDEs” receive tax credits, and that at least 20 percent of the proposed aggregate investments made with each round of NMTC allocations are made in eligible nonmetropolitan counties.³⁶

Most NMTC investments are structured in one of two ways: the standard structure or the leverage structure.

Standard Transactions

In a standard transaction, the NMTC is typically used to reduce the interest rate on the loan to the borrower (QALICB) below what the market would otherwise dictate. The transaction is structured as follows: An investor makes a QEI into a CDE (often through a sub-CDE created as a single-transaction entity), and the CDE then makes a QLICI (almost always a loan) to an eligible project (QALICB). The investor receives two cash streams over the seven-year compliance period: the interest payments on the loan to the QALICB, passed through the CDE, and the tax credits the investor claims on federal tax returns. The tax credit allows the CDE to offer the QALICB a considerable reduction in interest rates, while allowing the investor to receive market rate returns on the investment. Figure 2 shows how the standard transaction works.

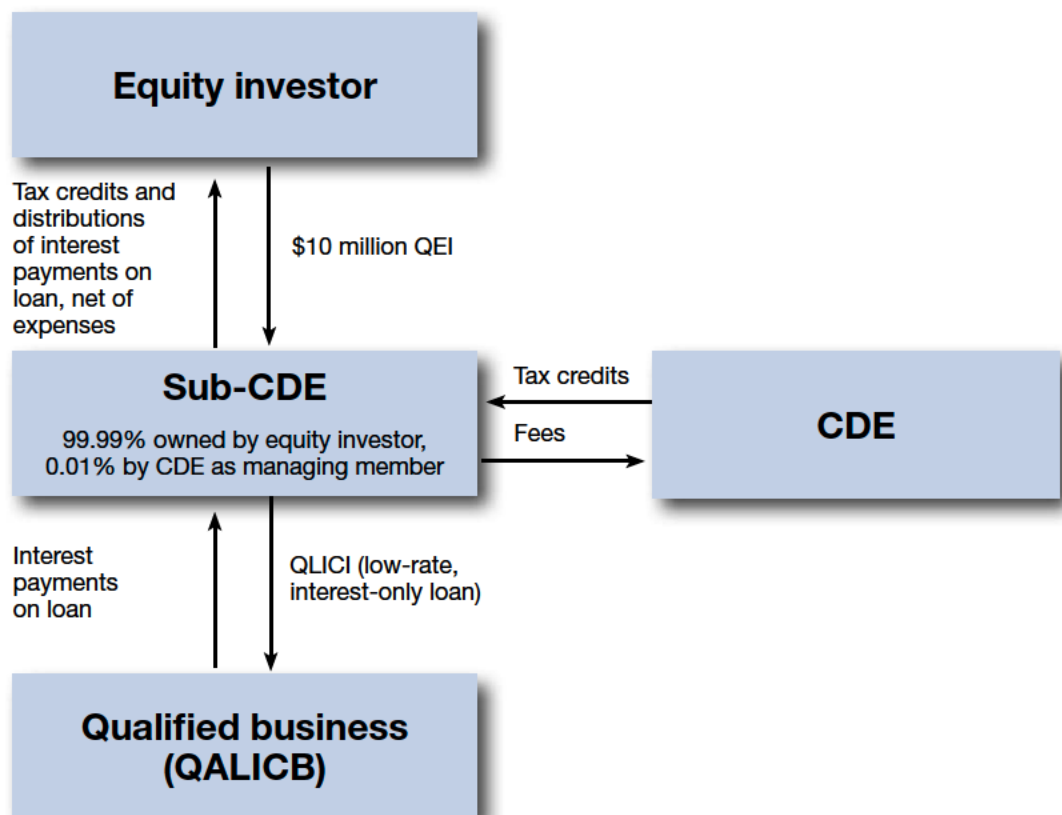
³³ To date, the majority of NMTC investments have related to real estate projects. To encourage working capital and equipment loans to non-real estate businesses, new regulations were adopted that allow a CDE that makes a QLICI in a non-real estate business to invest certain returns of capital from these investments in unrelated CDFIs that are CDEs. See *New Markets Tax Credit Non-Real Estate Investments*, *Federal Register* Vol. 77, No. 189, pp. 59544–59547, September 28, 2012.

³⁴ Treasury Regulations section 1.45D-1(d)(5).

³⁵ Tax Relief and Health Care Act of 2006, Public Law 109-432, div. A, title I, part 102(b), 120 stat. 2922 (2006).

³⁶ GAO, *Community Development Financial Institutions and New Markets Tax Credit Programs in Metropolitan and Nonmetropolitan Areas*, GAO-12-547R, April 2012.

Figure 2: NMTC Standard Transaction



Source: OCC

For example, consider the benefit stream going back to an investor from a \$10 million QLICI made by a CDE (figure 2 and scenario B of table 2). Using the standard transaction structure, the investor receives a tax credit of 39 percent on the \$10 million, or \$3.9 million. This works out to an annual rate of return to the investor of approximately 5.6 percent as a result of the credits alone.

If the investor wants to receive a rate of return equivalent to the market rate (in this example, 8 percent), the CDE could drop the interest rate to the borrower (QALICB) to as low as 2.4 percent.³⁷ And while the investor receives a market return, the borrower, with a 2.4 percent loan, saves \$3.9 million in interest expense over the course of the seven-year compliance period.³⁸ With this structure, the investor expects either to recover all of its initial investment at the end of the compliance period or to convert its investment in the CDE into a conventional loan to the QALICB.

³⁷ Rounded from 2.4286 percent.

³⁸ No fees are reflected in this example.

Table 2: Comparative Distribution of NMTC Benefits

	Scenario A: Market rate loan (no NMTCs)	Scenario B: NMTC standard transaction	Scenario C: NMTC leverage structure transaction
CDE loan to QALICB	\$10 million loan	\$10 million loan	\$10 million loan in A-note and B-note
Interest rate	8%	2.4%	8% (A-note) 1% (B-note)
Interest revenue	\$5,600,000	\$1,700,020	\$4,502,400
Tax credits	\$0	\$3,900,000	\$3,900,000
Total financial benefit	\$5,600,000	\$5,600,020	\$8,402,400
Net benefit after put/call \$2,800,000	Not applicable	Not applicable	\$5,602,400
Borrower cost: interest payments	\$5,600,000	\$1,700,000	\$4,502,400
Borrower savings			
Interest expense	\$0	\$3,899,980	\$1,097,600
Equity	\$0	\$0	\$2,800,000
Effective subsidy	\$0	\$3,899,980	\$3,897,600

Source: OCC

Banks have used this structure to offer low-interest loans to qualifying customers. In some cases, banks have developed standardized paperwork and processes to minimize NMTC transaction costs. This allows the banks to use the NMTC with smaller transactions than allowed by the leverage structure described below. With a steady stream of customers demanding smaller transactions, CDEs can more easily redeploy any funds repaid during the seven-year compliance period to other borrowers and avoid any violations of the “substantially all” requirement.³⁹ The CDE can receive principal repayments during the compliance period and the money can be re-lent to additional borrowers relatively quickly and efficiently. This ability to make loans for shorter terms and lower amounts makes the standard transaction model particularly attractive for lending to operating businesses.

Leverage Structure Transactions

Under the leverage structure, the NMTCs are used to leverage additional investment into a project. The leverage structure can offer more attractive returns to investors than the standard structure, attracting more capital to the program. The leverage structure also benefits the QALICB differently than the standard transaction structure. Typically, a portion of the investor’s equity is sold to the QALICB for a nominal price at the end of the seven-year compliance period rather than being returned to the investor. This boost in the owner’s equity allows for greater access to conventional financing at standard LTV ratios.

³⁹ See definition in appendix B for more information on the “substantially all” requirement.

NMTC investments using the leverage structure differ from those using the standard structure.⁴⁰ (See figure 3.) In the leverage structure, the equity investor borrows from a leverage lender, blends those borrowed funds with its own cash, and then uses the blended funds to make a QEI into a CDE (again, typically through a sub-CDE created as a single-transaction entity). Typically, the equity investor receives tax credits on the full amount of the QEI, and the leverage lender receives interest on the amount borrowed by the equity investor.⁴¹

To execute a leverage structure transaction, the equity investor forms a wholly owned limited liability entity called an Investment Fund. The equity investor capitalizes the Investment Fund with an amount of cash equivalent to the present value of the stream of tax credits that will be generated by the investment. Industry practitioners reported that the investor's contribution is typically 25 percent to 28 percent of the total amount of the QEI that will go into the CDE.⁴² The leverage lender makes a nonrecourse loan to the Investment Fund.

The borrowed funds and the equity investor's cash are pooled in the Investment Fund and used to make a QEI into a CDE. The CDE then makes a QLICI into a QALICB. The CDE may make two loans into the QALICB: an A-note in the amount of the leverage lender's debt contribution to the Investment Fund, and a B-note at below-market rates equal to the amount of the equity investor's contribution less any fees retained by the CDE.

The CDE passes the tax credits and interest earned on the investment (less any fees) back to the Investment Fund, where they are distributed to the equity investor and leverage lender. The equity investor receives the full amount of tax credits generated by the pooled investment. This substantially increases the return the equity investor receives on its equity contribution. The leverage lender receives interest-only payments on the leverage loan throughout the seven-year compliance period. The interest rate earned by the leverage lender can be at or near market rates.

The equity investor normally receives a sufficient return on its investment from tax credits alone. NMTC leverage structure agreements typically allow the QALICB or an affiliate of the QALICB to purchase the investor's interest in the Investment Fund through a "put/call" technique⁴³ that generates a subsidy or grant equivalent in the amount of the B-note less the negotiated purchase price. The QALICB or affiliate then repays or

⁴⁰ IRS Revenue Ruling 2003-20. See www.cdfifund.gov/docs/2003_nmhc_irs_borrowed_funds_Qual_equity_invstmnt.pdf.

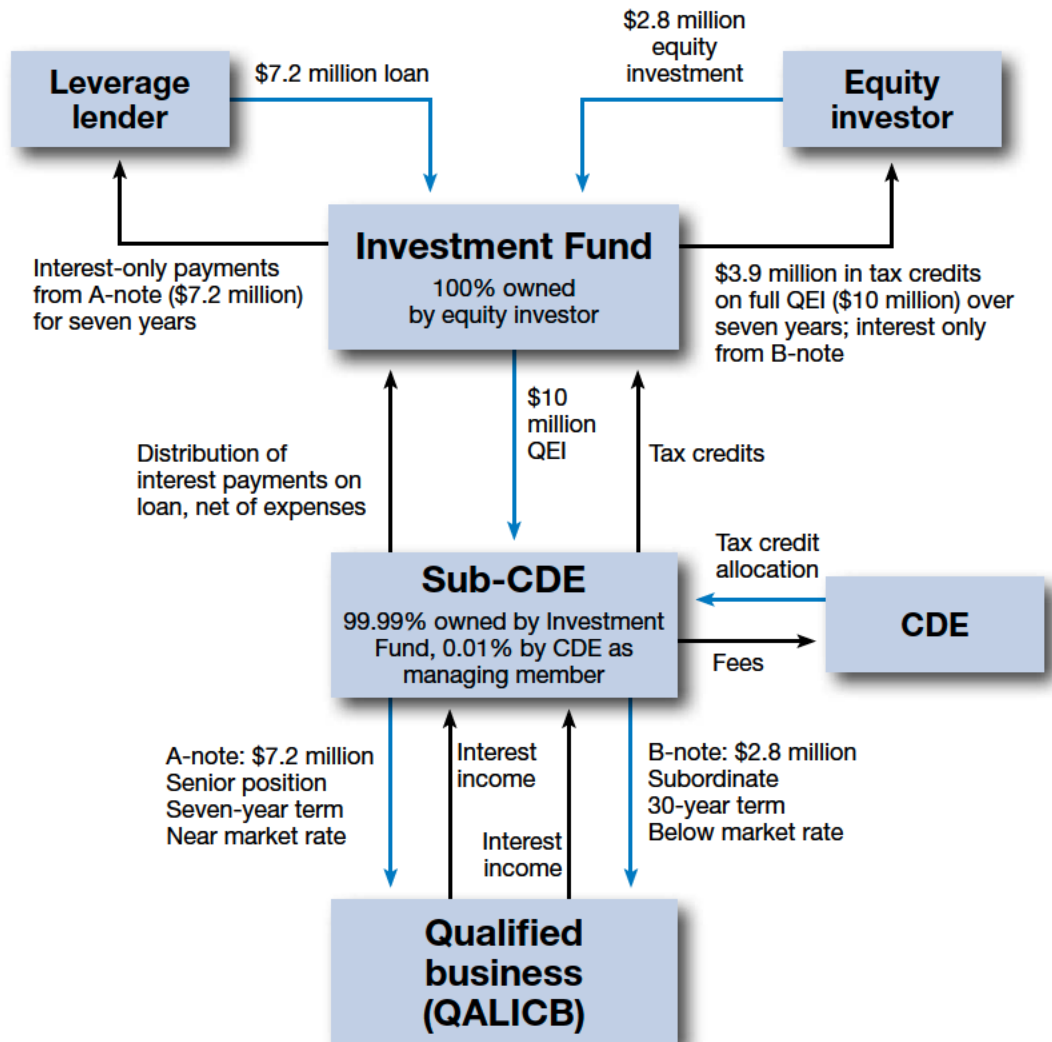
⁴¹ Banks may be both investor and leverage lender on a leverage structure transaction.

⁴² The leverage structure allows equity investors flexibility in pricing their purchase of tax credits. The amount of tax credits that can be claimed is fixed, given the amount of the QEI. In the leverage structure, the equity investor typically receives the entire amount of credits available from the QEI (including the equity and the borrowed funds). Because the relative contribution by the equity investor into the QEI can vary in a leverage transaction, so too can the return that the equity investor receives from the credits. For example, an equity investor receives \$3.9 million in tax credits with a \$10 million QEI, regardless of whether the investor contributed \$2 million or \$2.8 million of equity. Pricing is subject to market forces.

⁴³ A put option is a contract that gives the holder of the contract the right to sell all or a portion of its interest in a security to a specified entity at a predetermined price. Conversely, a call option gives the holder the right to purchase all or a portion of an interest in a security from a specified entity at a predetermined price. In the case of the NMTC leveraged structure, CDEs generally structure transactions so that the tax credit investor may "put" its tax credit equity to the QALICB or the QALICB may "call" the tax credit equity from the investor for a predetermined price at the end of the seven-year period. See GAO, *The New Markets Tax Credit: The Credit Helps to Fund a Variety of Projects In Low-Income Neighborhoods, But Could be Simplified*, GAO-10-334, January 2010.

renegotiates the A-note with the leverage lender. A key assumption behind this structure is that after seven years of operation the QALICB will be a stronger credit, particularly with the improved LTV ratio as a result of the NMTC equity being absorbed into the project.

Figure 3: NMTC Leverage Structure Transaction



Source: OCC

Returning to table 1, in scenario C we can see how the returns to investors and benefits to the QALICB differ in the leverage structure. The \$10 million QEI is made up of \$2.8 million in investor equity and a \$7.2 million leverage loan. Because the investor receives tax credits on the entire QEI (39 percent of \$10 million, or \$3,900,000), the return to the investor is increased to 9 percent, a substantial increase when compared with the 6 percent return earned under the standard transaction model.

In this example, the investor also receives 1 percent interest from the B-note,⁴⁴ and the leverage lender receives an 8 percent interest-only rate on its loan of \$7.2 million. Together, the equity investor and the leverage lender receive \$8.4 million in interest

⁴⁴ In some cases, the interest earned on the B-note pays for asset management and servicing fees.

expense and tax benefits, considerably more than the \$5.6 million received through either the market transaction or standard transaction scenarios. Because it is expected, however, that the QALICB will purchase the equity investor's interest in the Investment Fund for a nominal fee, in the leverage structure scenario the return is discounted by \$2.8 million, the amount of the equity investor's interest in the Investment Fund.

The borrower in the leverage structure still benefits from a lower interest rate on its loan from the CDE (a 6.43 percent blended rate⁴⁵ on the entire \$10 million loan), although the discount is not as steep as in the standard transaction model. In the leverage structure, the QALICB realizes a benefit from the equity left in the project at the end of the compliance period, as well as savings in interest. As can be seen in the "borrower savings" section of table 1, the amount of subsidy in the leverage structure remains the same as in the standard or subsidized interest rate model, but the subsidy is deployed differently.

Lenders are attracted to the NMTC leverage structure because it helps them make loans at or near market rates with a more favorable LTV ratio. The leverage structure is attractive to equity investors because the returns they achieve when using the leverage structure are much higher than they would achieve using the standard transaction model. The return for investors increases from approximately 5 percent to 6 percent in the standard model to 9 percent to 10 percent in the leverage structure, depending in part on how much the equity investor pays for the credits. In addition, the risks for the equity investor are more limited in the leverage structure than they are in the standard model because the equity investor in a leverage transaction does not need to recover its initial investment in order to achieve a financial return.

Several examples of leverage structure transactions are illustrated in appendix A. Banks can use the leverage structure to strengthen loans to customers. Project sponsors can use the attractive rates of return offered with the leverage structure to attract equity investors that might not normally participate in a community development project. Traditionally, banks have been the principal source of leverage loans to NMTC transactions. Increasingly, new sources of hard and soft debt, such as debt from public and philanthropic sources, have been used in leverage transactions. Moreover, multiple banks and other entities can participate on both the debt and equity sides to bring transactions to scale.

The leverage structure is not appropriate for all circumstances. This structure raises the complexity and therefore the costs of the transaction. Some industry experts have suggested a minimum size for a leverage transaction of about \$5 million to \$10 million to justify the higher transaction costs. The leverage structure is generally less appropriate when the interest rate on the loan needs to be well below market, for example, when the DCR is more important than the LTV ratio. With smaller transactions, or deals in which fees and transaction costs need to be minimized, alternative NMTC structures should be considered.

Multiple-CDE Transactions

Larger NMTC projects can involve multiple CDEs. Each of the contributing CDEs provides a portion of the equity in a transaction, limiting each CDE's exposure and allowing it to participate in larger transactions than it could individually. Multiple-CDE transactions can be more expensive, because each CDE must expend transaction fees

⁴⁵ The A-note of \$7.2 million has an interest rate of 8 percent, and the B-note of \$2.8 million has an interest rate of 1 percent, generating \$643,200 in interest payments annually.

for due diligence, document preparation, closing costs, ongoing asset management and audit fees, and closing costs at the end of the compliance period. CDEs participating in these types of transactions have begun to explore cost-sharing arrangements to reduce duplicative efforts and make the transactions more efficient.

Twinning

Commercial real estate projects that combine federal NMTCs with state NMTCs,⁴⁶ historic rehabilitation tax credits⁴⁷ (HTC), or renewable-energy investment tax credits⁴⁸ (ITC)—often referred to as “twinned” transactions—have been popular with some bank investors, because the blend of NMTC and HTC or ITC equity increases the return for investors in these projects and enables transactions that previously were considered unattractive to be financed.⁴⁹

IV. What Are the Key Risks and Regulatory Issues Associated With the NMTC Program?

The risks a bank may face in an NMTC transaction depend in part on its role in the transaction. Bank investors in NMTCs are concerned with acquiring and using the credits over the seven-year compliance period. Both investors and allocatees want to avoid recapture of the credits by ensuring compliance with program requirements. Leverage lenders want their loans repaid and face challenges that often differ from those presented by conventional financing. And, regardless of role, banks have accounting and regulatory issues to consider.

Key Risks

Recapture Risk

Under the NMTC Program, tax credits can be recaptured if

- the CDE ceases to be a CDFI Fund-certified CDE,
- “substantially all”⁵⁰ of the QEI proceeds are no longer continuously invested in QLICs, or
- the CDE redeems⁵¹ the equity investment.

Generally, if the transaction is structured properly and compliance is up to date, the risk of recapture is low.

The penalties for recapture are severe, however, when compared with other types of community development tax credits. When the recapture provisions are triggered at any point during the seven-year compliance period, 100 percent of the credits are recaptured,

⁴⁶ More than a dozen states have developed programs that work similarly to the federal NMTC program but offer a reduction of state tax liability. Most are designed to work in tandem with the federal program.

⁴⁷ Historic rehabilitation tax credits provide a reduction in federal taxes in exchange for investments in the rehabilitation of historic buildings.

⁴⁸ The renewable-energy investment tax credit program reduces federal income taxes by offering a 30 percent tax credit to owners or long-term lessees for qualified property that meets established performance and quality standards.

⁴⁹ The OCC report “U.S. Bank Invests in Solar Installations In Affordable Housing Communities” (July 2011) includes an illustration of a transaction that twinned NMTC and ITC. The report can be found in *Investing in Solar Energy Using the Public Welfare Investment Authority* at www.occ.gov/static/community-affairs/community-developments-investments/solar11/cdesolar11_index.htm.

⁵⁰ See appendix B for more information.

⁵¹ Treasury Regulations section 1.45D-1(e)(2)(iii). See IRS LMSB-04-0510-016, *New Markets Tax Credits* (May 2010) for more information, including how redemption is defined for different types of CDEs.

along with interest and penalties, for the entire period. Because the tax credit investor's financial return comes primarily from the tax credits, recapture has significant negative consequences.

A CDE's designation as a CDE lasts for the life of the organization, provided the CDE continues to comply with NMTC Program requirements. To maintain its status as a CDE, the CDE must demonstrate that at least 60 percent of its products and services are directed toward serving low-income communities or individuals and that at least 20 percent of its governing or advisory board members are representatives of a low-income community within the CDE's service area. A CDE may be required, on an annual basis, to certify to the CDFI Fund that it continues to meet its primary mission and accountability requirements. A CDE with NMTC allocations (from the CDFI Fund or another CDE) may be required to provide additional reports.⁵² NMTC investors are generally advised to check annually that a CDE is fulfilling its accountability requirements.

CDEs are required to have "substantially all" of the QEI proceeds invested in QLICIs. CDEs must invest the proceeds of a QEI within one year, and fees cannot exceed 15 percent of the QEI. Violations of the "substantially all" test may occur after the initial QLICI investments have been made if a CDE is making QLICIs of less than seven-year maturities, if a QALICB is in a foreclosure situation, or if the CDE steps in as owner of a QALICB. CDEs have 12 months to reinvest any QLICIs that are repaid or recovered. CDEs that are at risk of not meeting the "substantially all" test should develop a pipeline of additional QLICI opportunities.⁵³ CDEs with QALICBs facing foreclosure should thoroughly understand the responsibilities and options of a CDE in this situation.

A QEI cannot be redeemed during the seven-year compliance period. Generally, QLICIs are not amortized because the payments cannot be passed upstream to the investor and "substantially all" of the QEI must be invested in QLICIs throughout the compliance period. When there is a recovery of nonaccruing funds, however, and in certain circumstances in which credits are twinned, additional scrutiny may be necessary to avoid redemption.

Industry practitioners advise that the strength of the CDE is a key factor in the decision to invest in an NMTC project. The investor is entering into a seven-year relationship with the CDE, and it is important that the CDE have the capacity and expertise to manage the investment throughout the compliance period. The investor often wants to see that the CDE has a track record of successfully developing and managing NMTC investments. The CDE also needs to have the systems in place to assure that it meets the requirements of a CDE and that "substantially all" of the proceeds of the QEI are invested in QLICIs.

Default Risk

Allocatees, investors, and lenders all have strong incentives to see NMTC projects thrive. Standard-structure investors and leverage lenders both expect to receive interest income over the seven-year compliance program, as well as the repayment or refinancing of their initial investment. Because leverage structure investors derive most or all of their

⁵² CDFI Fund, *New Markets Tax Credit Program CDE Certification Question and Answer*, July 2005.

⁵³ To encourage working capital and equipment loans to non-real estate businesses, new regulations were adopted that allow a CDE that makes a QLICI in a non-real estate business to invest certain returns of capital from these investments in unrelated CDFIs that are CDEs. See *New Markets Tax Credit Non-Real Estate Investments*, *Federal Register*, Vol. 77, No. 89, pages 59544–59547 (September 28, 2012).

financial return on the NMTC investment from the tax credits, and the tax credits will continue even if the project goes into bankruptcy, they may be seen as having less risk. However, recovery of all or a portion of the original QLICI puts the investment at risk with the “substantially all” test, which may lead to recapture if not properly reinvested within 12 months of recovery.

Nonpayment risk can be mitigated with sound underwriting of both the CDE and the QALICB. Investors and lenders should look for a CDE with a strong track record in NMTC or similar types of investments. The CDE should have proven capabilities in identifying and underwriting NMTC-like investments, asset and risk management, NMTC compliance, and raising equity and market rate lending capital. The CDE should be financially sustainable throughout the seven-year compliance period and subsequent unwinding of the transactions. The CDE should also have a pipeline of qualifying projects and suitable underwriting and advisory procedures to reasonably ensure that the projects are consistent with community needs and priorities.

Leverage loans are underwritten and risk-rated according to traditional underwriting standards. Bank leverage loans are often underwritten by specialized lending departments (i.e., retail, institutional, or commercial real estate) rather than the community development departments where NMTC programs are commonly located.

Leverage lenders have challenges that differ from those raised by conventional financing. Because the collateral on the loan is held by the CDE, the leverage lender has only an indirect security on the loan. To avoid triggering the recapture provision if “substantially all” of the QEI does not stay invested during the entire seven-year compliance period, leverage lenders are typically bound by standstill agreements that permit the lender to collect only interest during the seven-year compliance period. Additionally, forbearance agreements restrict the ability of the leverage lender to foreclose during the compliance period. If the CDE does foreclose on a QALICB, the proceeds are usually reinvested in another project.

Most bank leverage lenders interviewed reported few material concerns with these requirements, although some also referred to the use of “work-around” procedures to mitigate the effects of these requirements. For example, the lack of amortization during the seven-year compliance period could be a concern. Some banks described using sinking funds, with the borrower depositing any excess cash after expenses into a reserve, as a way to mitigate the lack of amortization. After the compliance period ends, the proceeds of the sinking fund are then used to retire the principal in a lump sum.

In the case of foreclosure and redeployment, funds must be redeployed within 12 months of the cash being returned to the CDE. Because the process of foreclosure starts well before the return of funds, this gives the partners adequate time to find another transaction. The leverage lender may negotiate a time period (usually six months) to find and suggest a new project that meets their needs and credit standards. The leverage lender may also require specific underwriting standards (i.e., LTV or DCR) for a period. Eventually, however, all of the restrictions imposed by the lender expire, and the CDE can make a decision unilaterally to invest in another project before the deadline triggering recapture.

Reputational Risk

Banks also need to consider reputational risk. The NMTC Program was created to meet the public goals of revitalizing low-income communities and assisting low-income

individuals. Banks participating in NMTC transactions need to consider how these public goals are being met, how the community supports the project being financed, and how the benefits to low-income communities and individuals are documented. CDEs may ask a QALICB to sign a Community Benefits Agreement that outlines the goals of the project and details responsibilities for tracking community impact, including jobs and the provision of community services. Failure to adequately identify and document community support and community impact may violate allocation agreements⁵⁴ with the CDFI Fund, and could result in negative publicity on the use of public funds.

Liquidity Risk

Because no mature secondary market exists for these investments, NMTCs are highly illiquid. Bank investors should enter the NMTC Program with the understanding that the investment will most likely be held for the full seven-year compliance period; consequently, they should project taxable income for the duration of the investment term when determining their tax credit appetite. Bank investors should also consider that the NMTCs can be carried back one year and carried forward for 20 years.

Regulatory Issues

Accounting Issues

A bank can invest in NMTCs through direct investments into a bank-owned or third-party CDE (LP or LLC), or through a bank-owned Investment Fund (leverage structure transactions) or through a syndicated NMTC equity fund (LP or LLC). The accounting treatment for these investments is dictated by accounting rules governing partnerships and limited liability entities. Banks making investments in NMTC projects through direct investments or through leverage structure transactions should refer to the call report instructions (glossary sections Equity Method of Accounting and Subsidiaries) and generally accepted accounting principles for guidance on accounting for these investments.⁵⁵

Investment Authority

National banks: Under the OCC's public welfare investment (PWI) authority, national banks may invest in NMTC and other community and economic development entities (CEDE) and projects that are designed primarily to promote the public welfare, as specified in 12 USC 24(Eleventh) and federal regulation 12 CFR 24. Regulation 12 CFR 24 states that a national bank or national bank subsidiary may invest directly or indirectly if the investment primarily benefits low- and moderate-income individuals, low- and moderate-income areas, or other areas targeted by a governmental entity for redevelopment, or the investment would receive consideration as a "qualified investment" under 12 CFR 25.23 of the CRA. Because NMTC investments generally meet these criteria, they are eligible under this authority.

Regulation 12 CFR 24 requires that a bank's aggregate PWIs and outstanding commitments, including the proposed investment, cannot exceed 15 percent of its capital and surplus. A bank needs written OCC permission, however, if its aggregate investments

⁵⁴ See appendix B for the definition of an allocation agreement.

⁵⁵ See Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 323-30, Investments—Equity Method and Joint Ventures—Partnerships, Joint Ventures, and Limited Liability Entities (formerly, EITF Issue No. 03-16, "Accounting for Investments in Limited Liability Corporations").

exceed 5 percent of capital and surplus. Furthermore, under 12 CFR 24, a bank's NMTCs and other PWIs may not expose it to unlimited liability.⁵⁶

Regulation 12 CFR 24 requires banks to notify the OCC either through an after-the-fact notification or through a prior approval request process. Generally, a bank completes the CD-1-National Bank Community Development form to provide information about its PWI. The bank then sends the form to the Community Affairs Department of the OCC.⁵⁷

If the CEDE⁵⁸ in which a national bank invests limits its activities to making loans to small businesses under the NMTC Program, the bank may invest in the CEDE either as an operating subsidiary or as a noncontrolling equity investment if the requirements in 12 CFR 5.34 or 5.36, respectively, are satisfied. Such investments are not subject to the limitations of 12 CFR 24.⁵⁹

Federal savings associations: In addition to their general lending and investment authorities, federal savings associations (FSA) may use the following authorities to make PWIs, including investments in projects involving NMTCs:

- De minimis investments, under 12 CFR 160.36⁶⁰
- Community development-related equity investments in real estate under
 - the Home Owners Loan Act (HOLA) 5(c)(3)(A)
 - 12 CFR 160.30
 - May 10, 1995 letter⁶¹

⁵⁶ 12 CFR 24.4(b).

⁵⁷ Each national bank making a PWI under 12 CFR 24 shall maintain in its files information adequate to demonstrate that its investments meet the public welfare beneficiary standards and investment limit requirements.

⁵⁸ A CEDE is an entity that makes investments or conducts activities that primarily benefit low- and moderate-income individuals, low- and moderate-income areas, or other areas targeted by a governmental entity for redevelopment, or would receive consideration as "qualified investments" under 12 CFR 25.23. The following is a nonexclusive list of examples of the types of entities that may be CEDEs: (1) national bank community development corporation subsidiaries; (2) private or nonbank community development corporations; (3) CDFI Fund-certified Community Development Financial Institutions or Community Development Entities; (4) limited liability companies or limited partnerships; (5) community development loan funds or lending consortia; (6) community development real estate investment trusts; (7) business development companies; (8) community development closed-end mutual funds; (9) nondiversified closed-end investment companies; and (10) community development venture or equity capital funds.

⁵⁹ See "Legal Authority for Bank Investments in Subsidiary Community Development Entities and New Markets Tax Credits" at www.occ.gov/topics/community-affairs/resource-directories/public-welfare-investments/common-part-24-questions.html.

⁶⁰ Under the de minimis authority, the FSA may invest, in the aggregate, less than or equal to the greater of 1 percent of capital or \$250,000 in community development investments of the type permitted for a national bank under 12 CFR 24, including investments in NMTCs.

⁶¹ Under HOLA 5(c)(3)(A), the FSA may make investments in real property and obligations secured by liens on real property located in areas "receiving concentrated development assistance by a local government under Title I of the Housing and Community Development Act of 1974." To be permissible for investment, the real estate (including NMTC projects) must be located within a geographic area or neighborhood that receives assistance or is covered by, for example, the U.S. Department of Housing and Urban Development's Community Development Block Grant program. Under 12 CFR 160.30, which covers the general lending and investment powers of FSAs, an FSA's aggregate community development loans and equity investments may not exceed 5 percent of its total assets, provided that its equity investments do not exceed 2 percent of total assets. The qualitative standards for such loans and investments are explained in an opinion of the Office of Thrift Supervision (OTS) Chief Counsel, dated May 10, 1995. If the FSA meets all the standards, then it would not need to provide notice to the OCC.

- Investments in Service Corporations and Lower-Tier Entities for community development investments, under 12 CFR 159⁶²

Generally, an FSA is not required to seek approval for or provide notice to the OCC for public welfare investments using the de minimis authority (12 CFR 160.36) or the equity investments in real estate (HOLA 5(c)(3)(A)) that comply with the May 10, 1995 letter.⁶³ If the FSA meets the standards in the May 10, 1995 letter but is not eligible for expedited treatment pursuant to 12 CFR 116.5, then the FSA would be required to provide notice to the OCC Community Affairs Department at least 14 calendar days before making the investment. If the FSA does not meet the standards in the May 10, 1995 letter, then the FSA must seek a no-action letter from the OCC. Investments in service corporations and lower-tier entities for community development activities, under 12 CFR 159, are subject to prior notice to or approval by the OCC. The FSA should follow the filing requirements outlined under 12 CFR 159.11.

V. Who Is in the New Markets Tax Credit Program Today?

As of July 2012, 5,780 entities have been certified by the CDFI Fund as CDEs.⁶⁴ Through FY 2012, the most recent year of allocations, 749 award allocations have been made for a total of \$36.5 billion. In the 2012 awards, more than half (58 percent) of the awardees (or sponsors) identified themselves as nonprofit organizations, followed by certified CDFIs (31 percent). Approximately 14 percent of awardees identified themselves as non-CDFI banks or bank holding companies. Nine percent identified themselves as real estate companies, and 15 percent as governmentally controlled entities.⁶⁵ Of the allocatees, 48 percent offer services nationally, 16 percent offer services across multiple states, 18 percent are limited to a single state, and 18 percent serve a local area. Based on the initial estimates of the allocatees, most (54 percent) of the investments are projected to be made in major urban areas,⁶⁶ with 24 percent projected in minor urban areas⁶⁷ and 22 percent in rural⁶⁸ areas.⁶⁹

According to the NMTC Coalition, regulated financial institutions have been the principal source of investment capital for the program since its inception. In 2012, CDEs reported that 86 percent of QEI investment dollars secured in 2011 came from regulated depository institutions.⁷⁰

⁶² Under the authority of 12 CFR 159, the FSA may make investments in service corporations and lower-tier entities that engage in community development activities. A service corporation may engage in certain preapproved activities, including those that serve primarily community, inner-city, or community development purposes, including investments in NMTC projects. The FSA may invest up to 3 percent of its assets in service corporations, but any amount exceeding 2 percent must serve “primarily community, inner-city, or community development purposes.”

⁶³ The FSA should maintain appropriate documentation to ensure that its community development investments conform to the statutory and regulatory requirements governing those investment authorities.

⁶⁴ According to the CDFI Fund, 5,780 organizations were certified as CDEs as of July 31, 2012.

⁶⁵ Applicants could identify themselves in more than one category.

⁶⁶ Counties in metropolitan areas with a population greater than or equal to 1 million.

⁶⁷ Counties in metropolitan areas with a population of less than 1 million.

⁶⁸ Nonmetropolitan counties.

⁶⁹ CDFI Fund, *2012 New Markets Tax Credit Program Allocations*, 2013.

⁷⁰ NMTC Coalition, *The New Markets Tax Credit Progress Report 2012*, June 2012.

In 2012, 82 percent of NMTC CDEs that responded reported using the leverage structure to raise capital. Leverage debt came from a variety of sources, including from an NMTC equity investor, a financial institution other than the equity investor, a charitable donor, the project sponsor, or another business entity. For most of these CDEs (89 percent), 100 percent of their investment capital used the leverage structure.⁷¹

VI. How Does the Cost and Pricing Structure Work?

An organization considering becoming an NMTC allocatee needs to consider how it will fulfill the requirements of a CDE, including

- outreach.
- fundraising.
- identifying and underwriting investment opportunities.
- loan processing.
- asset management.
- project outcome tracking and reporting.
- compliance with NMTC rules and regulations.

In addition, NMTC transactions such as QEIs or QLICs require specialized legal and accounting skills. A single NMTC allocation is a seven-year commitment, and the competitive nature of the application process makes annual allocations uncertain. Allocatees need to consider sustainability strategies that will enable them to meet the asset management requirements over the compliance period, and the closing requirements as the transactions unwind after year seven.

Large-bank CDEs have developed specialized NMTC programs that are augmented by the bank's traditional commercial and institutional underwriters and credit committees. Typically, the large banks combine staff with investment and CDE responsibility. Smaller community banks, generally with assets greater than \$1 billion, have also developed CDEs using a limited number of dedicated staff and drawing upon existing bank resources as needed. In at least one case, a consortium of community banks has used a CDE that is housed in a trade association.⁷² Most CDEs draw on specialized consultants to help them set up compliance and project-tracking systems and to audit those systems on an ongoing basis.

The revenue to support CDEs comes from fees. A CDE can retain up to 15 percent of the QEIs it receives, although in practice the amount retained is usually less than 5 percent.⁷³ CDEs may also charge origination fees, management fees, and closing fees at the end of the compliance period. Fees are one consideration in NMTC applications, but competitive pressures tend to keep these fees well below market rates and allowable program maximums.

The revenue stream for investors comes from the tax credits and interest payments on their investments, and investors are generally experiencing market returns. In the standard transaction model, the return to the investor is based on how much of the tax credit subsidy is passed on to the borrower in the form of interest rate savings. In the leverage model, the return is based upon the relative contributions of the investor and the

⁷¹ Ibid.

⁷² See Community Bankers Association of Indiana. The National Community Investment Fund also has an NMTC fund for CDFI banks.

⁷³ NMTC Coalition, *New Markets Tax Credit 10th Anniversary Report*. The report found that 96 percent of reporting CDEs had committed to investing at least 95 percent of their QEIs.

leverage lender. The price paid for the credits depends upon the time value of money and the market for credits. Based on the interviews that we conducted in 2011, investors were paying 65 to 73 cents on the dollar for credits, with most realizing returns in the range of 7.5 percent to 8.5 percent.

Leverage lenders receive interest-only payments on their loan over the course of the seven-year compliance period. Some leverage lenders, such as charitable or governmental entities, make leverage loans at significantly reduced interest rates. Bank leverage lenders typically realize returns at or near market rates.

VII. What Barriers Have Constrained the Growth of the NMTC Program?

Several factors have limited the growth of the NMTC Program:

Continuing congressional allocations: The NMTC Program requires continued allocations of credits from Congress. The Community Renewal Tax Relief Act of 2000 first authorized the NMTC Program through 2007. Subsequent legislation extended the program in one- or two-year increments, with the most recent authorization expiring in 2013.⁷⁴ The uncertainty of the program's future can be a disincentive for potential investors.

Limited credits: The amount of credits available to potential applicants is limited, making the award process very competitive. Over the first 10 years of the program, demand has outstripped the supply of tax credits by a margin of more than seven to one. The number of applicants for the 2011 round of allocation authority increased 26 percent over the number of applicants in 2010.

Costs and complexity: While continued innovation and development of the program has brought in new CDEs and leverage lenders, program complexity and high transaction costs can be significant barriers to new investors. NMTC regulations are complex, and penalties for noncompliance can be severe. Triggering recapture, even in the later years of the investment, can affect all of the credits previously claimed. The high, mostly fixed transaction costs have encouraged larger transactions, and limited the ability of smaller transactions to be economically feasible.

The CDFI Fund has been effective in promoting greater diversity among allocatees and investment types. The types of CDEs are quite diverse, and their numbers have increased every year. In addition, the IRS adopted rule changes that are designed to make it easier to invest in operating businesses.⁷⁵ These new rules are expected to help diversify the types of investments made through the program beyond real estate-related investments.

⁷⁴ The Gulf Opportunity (GO) Zone Act of 2005 allocated an additional \$1 billion of NMTCs for qualified areas affected by Hurricane Katrina for three years; the Tax Relief and Health Care Act of 2006 provided a one-year allocation in 2006; and the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 provided \$3.5 billion in tax credits in 2008. The American Recovery and Reinvestment Act of 2009 allocated \$3 billion in tax credits to be split equally between 2008 and 2009. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 provided an allocation limit of \$3.5 billion in NMTCs both in 2010 and in 2011, and the act extended for two years, through 2016, the carryover period for unused NMTCs. The American Taxpayer Relief Act of 2012 allocated \$3.5 billion each to 2012 and 2013.

⁷⁵ *New Markets Tax Credit Non-Real Estate Investments*, Federal Register, Vol. 77, No. 189, pp. 59544–59547, September 28, 2012.

The introduction of the leverage structure has brought in new lenders, including public and philanthropic lenders who offer debt at below-market rates. These new leverage lenders have, in turn, encouraged investors into new geographic areas and different types of projects. Practitioners have remarked that there has been a significant surge in the number of new leverage lenders over the past few years.

The number and type of investors still tends to be very concentrated, however, with a large percentage of QEIs coming from banks, and a significant portion of that investment coming from a limited number of large financial institutions. These investors have traditionally had a strong appetite for NMTCs and a high degree of familiarity with the program's complex structures, making these investors an easy first choice for many CDEs.

The NMTC Program does not have many of the incentives for new investors that are in place for other types of credits, however. There also is little transparency around the performance of NMTC investments, so potential investors seldom have up-to-date information on market conditions, pricing, credit recapture, delinquencies, and yields on investments. There is no formal secondary market for NMTCs. And NMTCs do not have the flexibility of other credits in providing Alternative Minimum Tax relief or the option of using the effective-yield method of accounting.

VIII. Conclusion

The NMTC Program has been very successful in bringing new investment into low-income communities and channeling that investment into projects that provide quality jobs and services for residents of low-income communities, and that stimulate additional economic growth. Banks have been important partners in that process by establishing CDEs and receiving NMTC allocations, by investing in NMTC initiatives through their own CDEs and in other third-party CDEs, and by lending funds through leveraged transactions.

Participating in the NMTC Program helps banks meet customer needs by providing an additional tool for making commercial transactions in low-income communities that they might not otherwise be able to make. The subsidy provided through the NMTC Program can be flexibly applied to meet the needs of the borrower. The NMTC Program can help banks serve their communities, and NMTC investments may be eligible for positive CRA consideration. Finally, participation in the NMTC program can provide attractive financial returns to banks, including but not limited to the tax credits.

Appendix A: Case Studies

Case Study One: Standard Model Charter School Facility

QLICI: \$3 million

Project overview: A nonprofit acquires a vacant parochial school building in a low-income neighborhood, and is seeking financing to refurbish and update the classrooms and recreational facilities that will be leased to a charter school.

Tax credit project financing: A national bank-owned CDE uses its NMTC allocation to provide \$3 million in financing to the QALICB, the nonprofit sponsoring the development of a charter school facility. The financing consists of a \$3 million senior loan, developer cash equity of \$50,000, and a municipal grant of \$150,000 to purchase the existing building. The CDE, using the NMTC-enhanced standard financing structure, is the only private lender involved. The loan has a rate of 2.5 percent. Origination fees are half of what the bank normally charges its market rate customers. The loan is interest-only for seven years, a period that is substantially greater than the bank's normal practice. The LTV ratio is substantially higher than the bank's normal 70 percent ceiling. The loan will be refinanced after seven years without incurring any additional fees.

Case Study Two: Standard Model Business Loan Pool

QLICI: Ranges from \$25,000 to \$300,000

Project overview: A community bank with assets of \$3 billion has a strong history of outreach that has provided a robust pipeline of loans to businesses throughout its service area. In some of the low-income areas, however, it has been difficult to make loans where property values and sales are weaker than normal. The areas are showing signs of some growth, largely from an active immigrant community, and before a recent recession the areas were seeing signs of an economic resurgence. The bank uses NMTCs to set up a loan pool that could provide low-interest loans with flexible terms to businesses located in these communities.

Tax credit project financing: A \$20 million loan fund is created using NMTCs. The community bank provides two \$10 million QEIs to capitalize the loan fund. The rates and terms of the loans available through the fund are standardized. Rates and fees are approximately half of market rates, and the term can range from one to five years. The loans fully amortize. The bank is able to remain in compliance with the "substantially all" test by relending the funds to additional borrowers as the principal is repaid on the initial loans made by the CDE. Loan officers originating commercial loans are required to check all business loans being rejected under conventional financing criteria for eligibility under this program.

Case Study Three: Leverage Structure Single-Bank Upgrade to an Existing Industrial Use

QLICI: \$17 million

Project overview: A commercial lending department in a bank with a NMTC allocation has a loan request from an established customer looking to upgrade an existing facility where electric motors used in industrial applications are manufactured. The facility is located in a low-income neighborhood and has been a major employer in the area. The project is expected to create 100 well-paying jobs and retain 200 additional jobs by modernizing an aging industrial facility. The local industrial development authority has committed to provide \$3 million in soft⁷⁶ debt. The completed facility has an appraised value of \$25 million. The financials on the project are good, but the LTV is below bank credit standards.

Project financing: The commercial lending department contacts the community development department, and they determine that the project is eligible for NMTCs. An Investment Fund is created, with the community development department providing the equity portion of the investment (\$4,773,600) and the commercial lending department providing the leverage loan (\$12,226,400). Using the pooled funds, the Investment Fund makes a \$17 million QEI into a bank-owned CDE. The CDE then makes two loans into the industrial business, a senior A-note at near market rates (6 percent) and a B-note at 1 percent interest, both with interest-only payments for seven years. (For the borrower, the blended interest rate is 4.6 percent.) The combined rate for the loans is approximately 300 basis points below market. The B-note has a put/call option that allows the business to purchase the note at a nominal rate at the end of the seven-year compliance period. Over the compliance period, the A- and B-notes earn \$6,250,560 in interest, and the equity investment provides \$6,630,000 in tax credits, providing a return to the bank of approximately 10.5 percent before taxes.

⁷⁶ Soft debt is debt, usually from a public or philanthropic source, that is subordinate to other debt in the project and repayment is required only when there is sufficient cash flow.

**Case Study Four: Leverage Structure
Pooled Third-Party Leverage Lender
Primary Health Care Facility**

QLICI: \$13 million

Project overview: A nonprofit agency is sponsoring the development of a new community health facility in an underserved low-income community. The new health facility will provide primary care to a community with very low rates of private health insurance coverage. Primary care in communities with low rates of private insurance has proven to lower public costs for emergency room care. The nonprofit agency has raised debt and grant contributions from a variety of sources, but a \$3.5 million gap in the financing remains. The nonprofit agency pools all of this debt and grant funding, and offers this pooled funding as a leverage loan to a NMTC equity investor.

Project financing: The institutional lending department of the bank investor reviews the transaction and determines that the project will work with a NMTC investment. An Investment Fund is formed by the bank, a \$3,650,400 bank equity investment is pooled with \$9,360,000 from the nonprofit agency, and a \$13 million QEI is made into the CDE. The CDE then lends the money into the project using an A-note and a B-note. The A-note earns near market rate interest, and the B-note, equivalent to the bank equity investment, earns 1 percent interest, with interest-only payments for the first seven years. A put/call option is put in place that allows the B-note to be purchased by the borrower at a nominal rate at the end of the compliance period. The bank equity investment earns \$5,325,528 in interest and tax credits over seven years, providing a 6.5 percent return to the bank.

**Case Study Five: Leverage Structure
Multi-Bank Participation
Biomass Facility**

QLICI: \$80 million

Project overview: A company proposes a biomass facility that will create 150 new jobs in an area with high unemployment as a result of the collapse of the timber industry. The proposal is shown to a group of local bank representatives who then contact a CDE experienced in this type of development.

Project financing: Because the deal is bigger than any single bank can handle alone, the participation of multiple banks is necessary. The banks put together an \$80 million QEI using the leverage structure. Two banks agree to provide \$22,464,000 of equity into the transaction, and three banks provide \$57,536,000 in debt financing as the leverage lender.

Appendix B

Glossary of Terms

Allocatee: An applicant that receives an NMTC allocation.

Allocation agreement: Executed by the CDFI Fund and the allocatee, and the subsidiary allocatee, as applicable. The agreement contains terms and conditions governing the uses of the NMTC allocation, including, but not limited to, delineating service area(s) and targeted population(s) that the allocatee will serve and the favorable underwriting terms and conditions that will be used in providing financial assistance. The agreement also specifies events of default and recapture and the remedies available to the CDFI Fund, including reporting to the IRS, which would make the determination as to whether an event of recapture has occurred.

Areas of significant distress: Areas where the unemployment rate exceeds 1.5 times the national average, poverty rates exceed 30 percent, and median incomes are at or below 60 percent of area medians.

Community development entity (CDE): Any domestic corporation or partnership, for federal tax purposes, certified as a CDE by the CDFI Fund pursuant to IRC section 45D(c). Requirements for a CDE include that

- the primary mission of the entity is serving, or providing investment capital for, low-income communities or persons.
- the entity maintains accountability to residents of low-income communities through their representation on any governing board of the entity or on any advisory board to the entity.
- the entity is certified by the CDFI Fund as a CDE.

Gulf Opportunity (GO) Zone: That portion of the Hurricane Katrina disaster area determined to warrant assistance from the federal government to mitigate damage resulting from the hurricane. The Hurricane Katrina disaster area is an area that has been declared a major disaster area before September 14, 2005, under section 401 of the Gulf Opportunity Zone Act of 2005 (Public L. 109-135), by reason of Hurricane Katrina. The GO Zone is in effect until December 31, 2014.

Low-income community (LIC):

Any population census tract where the poverty rate for such tract is at least 20 percent; or (1) in the case of a tract not located in a metropolitan area, the median family income for such tract does not exceed 80 percent of statewide median family income; or (2) in the case of a tract located within a metropolitan area, the median income for such a tract does not exceed 80 percent of the greater of statewide median family income or the metropolitan area median family income.

- Targeted areas that include the following:
 - High Out-Migration Rural County Census Tract: a population census tract within a county which, during the 20-year period ending with the year in which the most recent census was conducted, has a net out-migration of inhabitants from the county of at least 10 percent of the population of the county at the beginning of such period, if the median family income for the census tract does not exceed 85 percent of statewide median family income;

- Low-Population/Empowerment Zone (EZ) Census Tract: a population census tract with a population of less than 2,000 if the tract is within an empowerment zone, and is contiguous to one or more low-income communities (not including other low-income communities in this category); and
- Targeted population: certain individuals, or an identifiable group of individuals, including an Indian tribe, who (1) are low-income persons; or (2) otherwise lack adequate access to loans or equity investments.

NMTC allocation: An allocation of tax credit authority pursuant to the NMTC Program. A CDE that receives an NMTC allocation is an allocatee. If applicable, an allocatee may transfer all or part of its NMTC allocation to a subsidiary allocatee(s).

Qualified active low-income community business (QALICB): Any corporation (including a nonprofit corporation), partnership, or other business that meets the requirements set forth in IRC 45D(d)(2) and 26 CFR 1.45D-1(d)(4). Requirements for a QALICB include, but are not limited to, the following:

- At least 50 percent of the total gross income of such entity is derived from the active conduct of a qualified business within any low-income community.
- A substantial portion of the use of the tangible property of such entity (whether owned or leased) is within any low-income community.
- A substantial portion of the services performed for such entity by its employees are performed in any low-income community.

Qualified equity investment (QEI): An equity investment in a CDE that meets the requirements of IRC section 45D(b) and 26 CFR 1.45D-1(c). “Substantially all” of the investment must be made into a QLICI.

Qualified low-income community investment (QLICI): This term has the same meaning as set forth in IRC section 45D(d) and 26 CFR 1.45D-1(d). QLICIs include

- loans to, or capital or equity investments in, any QALICB.
- the purchase from a CDE of any loan made by such entity that is a QLICI.
- financial counseling and other services to businesses located in, and residents of, low-income communities.
- any equity investment in, or loan to, a CDE.

Standard transaction: The basic financing structure, in which the NMTC investor provides a QEI to a CDE, which, in turn, makes QLICIs to QALICBs.

Leverage structure transaction: A more complex financing structure, resulting from IRS Revenue Ruling 2003-20, that permits the QEI from an NMTC partnership entity, or Investment Fund, to include cash from a nonrecourse or recourse (pursuant to Revenue Ruling 2010-17) loan (debt) in addition to equity capital, thereby “leveraging” the NMTC investment.

Service area: The geographic area that encompasses the low-income communities in which the allocatee is authorized to make QLICIs using the proceeds of QEIs.

Standstill agreement: An agreement between a lender and a borrower in which the lender stops demanding the repayment of a loan. In the case of an NMTC leverage structure transaction, the borrower is the Investment Fund. Generally, the Investment Fund negotiates a standstill agreement to stop a leverage lender from foreclosing on a QALICB during the NMTC compliance period and threatening recapture of the tax credits.

“Substantially all” requirement: “Substantially all” of the equity investment in a CDE must be in QLICs. Treasury Regulations section 1.45D-1(c)(5)(i) defines “substantially all” to mean at least 85 percent. The “substantially all” requirement must be satisfied for each annual period in the seven-year credit period. For the first annual period, the requirement is considered met if the calculation is performed on a single testing date and the result is at least 85 percent. For all subsequent annual periods, the “substantially all” requirement is considered met if the calculation is performed every six months and the average of the two computations for the annual period is at least 85 percent. In the seventh year of the seven-year credit period, 85 percent is reduced to 75 percent. See IRS LMSB-04-0510-016, *New Markets Tax Credit*, May 2010.

Targeted population:

As defined in 12 USC 4702(20) and related CDFI Fund and IRS guidance documents, “targeted population” refers to individuals, or an identifiable group of individuals, including an Indian tribe, who (1) are low-income persons; or (2) otherwise lack adequate access to loans or equity investments.

There are two categories of eligible targeted populations under the NMTC Program:

Low-income targeted population (LITP): The LITP is composed of low-income persons. An individual is considered to be “low-income” if the individual’s family income, adjusted for family size, is not more than (1) for metropolitan areas, 80 percent of the area median family income; and (2) for nonmetropolitan areas, the greater of 80 percent of the area median family income, or 80 percent of the statewide nonmetropolitan area median family income.

GO Zone targeted population (GZTP): The GZTP is composed of individuals who were displaced from their principal residences and/or lost their principal source of employment as a result of Hurricane Katrina. In order to meet this definition, an individual’s principal residence or principal source of employment, as applicable, must have been located in a population census tract within the GO Zone that contains one or more areas designated by the Federal Emergency Management Agency as flooded, having sustained extensive damage, or having sustained catastrophic damage as a result of Hurricane Katrina.

Appendix C

Resource Directory

Community Development Financial Institutions Fund

www.cdfifund.gov

CDFI Coalition

www.cdfi.org/cdfiinst.asp

New Markets Tax Credit Coalition

www.newmarketstaxcreditcoalition.org

Novogradac New Markets Tax Credit Resource Center

www.novoco.com/NMTC/index.shtml

OCC Fact Sheet on New Markets Tax Credits

www.occ.gov/cdd/Fact_Sheet_NMTC.pdf

OCC Public Welfare Investments (12 CFR 24) Resource Directory

www.occ.gov/topics/community-affairs/resource-directories/public-welfare-investments/index-public-welfare-investments.html

David Black was the primary author of the most recent update to this report. Stephanie Caputo was the primary author of the original report published in 2007. *Community Developments Insights* reports differ from OCC advisory letters, bulletins, and regulations in that they do not reflect agency policy and should not be considered as definitive regulatory or supervisory guidance. Some of the information used in the preparation of this paper was obtained from publicly available sources that are considered reliable. The use of this information, however, does not constitute an endorsement of its accuracy by the Office of the Comptroller of the Currency.

The Tax Cuts and Jobs Act (Pub. L. No. 115-97), signed into law on December 22, 2017, made numerous changes to the Internal Revenue Code. This document has NOT been updated to reflect these changes. Banks or other entities considering a tax credit equity transaction should consult with a tax professional with knowledge of how the changes in the tax code may affect specific tax credit equity transactions.