Real Estate Development In 2012

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Tax credits and government grants can make your project happen.

INVESTORS ARE skittish. Capital is scarce. How, then, are development projects being undertaken? In many cases, the answer lies in the availability of tax credits and government grants. These sources of "real money" can help bridge the gap between available equity capital on the one hand and borrowed money on the other. Myriad tax credits and grants are available from all levels of government, based upon a variety of rationales. This article focuses on the more popular federal programs, but notes the existence of programs available in many states.

NEW MARKETS TAX CREDITS • An increasingly popular, and certainly the most complicated, source of benefits is the federal New Markets Tax Credit Program (hereinafter the "NMTC Program"). Its requirements are set forth in section 45D of the Internal Revenue Code ("Code") (all section references are to the Code unless otherwise specified). This article summarizes in general terms the process of obtaining benefits under the NMTC Program for a project.

The proposed project must be a qualifying project located in a qualifying low-income community. Among the projects that are not eligible for New Markets Tax Credits are those that derive more than 80 percent of their gross income from rental dwelling units, golf courses, racetracks or other gambling facilities, country clubs, massage parlors, hot tub facilities, suntan facilities, and liquor stores. Treas. Reg. §§1.45D-1(d)(5)(ii) and (iii)(B).

A qualifying low-income community is referred to as a "QLIC." A QLIC is any population census tract if its poverty rate is at least 20 percent. Alternatively, in the case of a census tract not located within a metropolitan area, the tract qualifies as a low-income community when median family income does not exceed 80 percent of the statewide median family income. A census tract located within a metropolitan area will qualify as a low-income community if the median family income does not exceed 80 percent of the greater of the statewide median family income or the metropolitan area family median income. Finally, if the census tract has a population tract of less than 2,000 and lies within a federal empowerment zone (discussed in more detail below) and is contiguous to one or more low-income communities, it, too, will qualify as a QLIC. Code §45D(e). Qualifying low-income communities are listed on the Community Development Financial Institution Funds website (hereinafter the "New Markets Tax Credit website"). http://www.cdfifund.gov/what_we_do/programs_id.asp?programid=5 (last updated Jan. 13, 2012).

The proposed project must involve a "qualified active low-income community business," commonly known as a "QALICB." These include proprietorships, corporations or partnerships engaged in the active conduct of a qualified business within a low-income community, so long as at least 50 percent of the entity's total gross income is derived from the active conduct of a qualified business within a low-income community; at least 40 percent of the property it owns or leases is located in that community; at least 50 percent of its services are performed in that community; and less than five percent of the average of the aggregate adjusted basis of the property of such entity is attributed to collectibles or nonqualified financial property. Code §45D(d)(2)(A); Treas. Reg. §1.45D-1(d)(4). In many cases, the QALICB is the entity that will own the project. Special care must be taken to assure that the QALICB will meet the "reasonable expectation of success" test and various operating requirements. See Treas. Reg. §1.45D-1(d)(6).One of the legal opinions that will be required at the closing of a New Markets Tax Credit transaction is that there is a "reasonable expectation" of the project's success.

A qualified community development entity ("CDE") is a domestic corporation or partnership whose primary mission is serving low-income communities or low-income persons, is accountable to residents of low-income communities, and is certified as such by the Secretary of the Treasury. Code §45D(c). CDEs are defined in Code section 45D(c)(1). A qualified CDE is an entity that has or will receive a New Markets Tax Credit allocation from the Community Development Financial Institution Fund ("CDFI"), which is administered by the United States Department of Treasury, and may be willing to make an allocation to the project. Eligible CDEs are identified on the New Markets Tax Credit website.

When seeking the benefits of the NMTC Program, sponsors of a development project should first identify the cost of the proposed project and the amount of New Markets Tax Credit allocation that will be requested. Then, a solicitation package is prepared for delivery to the CDE. In evaluating the request for allocation, a CDE typically considers the project's eligibility, the level of distress in the low-income community, the potential impact on the low-income community, whether the project would go forth without the New Markets Tax Credit allocation, the financial viability of the project, the background of the developers, and other matters that may be of interest to a particular CDE. A request for allocation may be circulated to more than one CDE, since CDEs do not always have a sufficient allocation of credits for any particular project. Once a CDE has tentatively accepted a project, it is common for the CDE and the project's sponsors to enter into a memorandum of understanding. At this time, the QALICB is organized if it does not already exist.

Next, the project sponsors must make, or cause someone to make, a qualified equity investment in the CDE. Code §45D(b). A qualified equity investment must be in cash. Code §45D(b)(1)(A). Qualified equity investments in a CDE are typically made by an investment entity, although they may be made by an individual. The qualified equity investment in the CDE may be made wholly with the investor's own funds, but it often includes funds provided to the investor through a leverage loan. The proceeds of this loan either fund or refund a portion of the equity investment and increase the leverage to be gained from the tax credits. The leverage loan may be secured, but it may not be secured with a mortgage on the project. Using the qualified equity investment, the CDE makes a qualifying low-income community investment ("QLICI") in the form of a loan to or equity investment in the QALICB. Code §45D(b)(1)(B).

The New Markets Tax Credits themselves are then assigned to the persons making qualified equity investments by the CDE. *See* Code §45D(a). Interestingly, the tax credits begin to accrue in the year that the investor or investor entity makes its equity contribution to the CDE, regardless of whether the CDE makes the QLICI in or to the QALICB in that year. *Id.* The total credit for each project is 39 percent of the original qualified equity investment, taken over a seven-year period. For the first three years, the credit is five percent of the original qualified equity investment, and in the final four years, the credit is six percent of the original qualified equity investment. The investment is claimed on IRS Form 8874, "New Markets Credit," and may not be repaid prior to seven years following the investment.

A simple New Markets Tax Credit transaction might be described as follows: An investor makes a $5 million qualified equity investment in a CDE. The CDE then makes a $5 million loan to a QALICB. The investor receives a New Markets Tax Credit allocation of $1,950,000 over seven years.

A more complicated NMTC structure, involving leverage, might be described as follows: A New Markets Tax Credit investor makes a $5,400,000 equity investment in a leverage fund. That fund also takes a $14,600,000 loan from a lender, resulting in a total infusion of $20 million into the investment fund. The $20 million is then submitted as equity to a CDE, which in turn makes two loans (an "A" loan and "B" loan) to the QALICB (one mirroring the loan made to the leverage fund and the other under different, possibly more favorable, terms and conditions). The leverage fund investor receives $7,800,000 in New Markets Tax Credits. In both cases, the benefit to the QALICB is significant interest rate savings as a result of the New Markets Tax Credit investor's willingness to accept a lower return on his or her investment in return for the tax credit.

At the end of seven years, the New Markets Tax Credit transaction is unwound. In the case of a leveraged New Markets Tax Credit transaction, the loan the lender made to the leverage fund, which in turn resulted in an identical loan from the CDE to the QALICB, must be repaid in accordance with its stated terms. The unwinding of the "B" loan (or in the case of a non-leveraged transaction, the sole loan) can occur in a variety of ways, some of which do not involve direct payment. One of these employs a redemption of sorts. Under this method, the CDE transfers the QALICB note to the investor or leverage fund in exchange for that person's equity interest in the CDE.

When marketed, from an investor who or which is not able to take full advantage of them, New Markets Tax Credits typically "sell" for approximately 70 cents on the dollar, in recent years ranging from 68 cents on the dollar to 72 cents on the dollar.

It is difficult to overstate the complexity and expense involved in obtaining benefits under the NMTC Program, and the foregoing summary is a simplification. In addition, such transactions are not without risk. For example, if the CDE ceases to be a "qualified CDE," or if substantially all of the proceeds of the investment are no longer used for qualified low-income community investments, or if the investment is redeemed by the CDE, then the New Markets Tax Credits can be recaptured. Code §45D(g).

HISTORIC TAX CREDIT PROGRAMS • There are currently two federal tax incentive programs designed to preserve historical structures — the federal Historic Preservation Tax Credit ("Federal Credit") and the 10 Percent Rehabilitation Credit ("10 Percent Credit"). In addition, some states provide historic preservation tax credits. These federal programs are targeted at income-producing property having a substantial amount of development costs.

Federal Historic Preservation Tax Credit

The National Park Service ("NPS") and the IRS jointly administer the Federal Credit. The program offers a tax credit equal to 20 percent of the cost of rehabilitating a certified historic structure. It is available to those who substantially rehabilitate a depreciable structure used for commercial, industrial, agricultural, or rental residential purposes. The credit permits a dollar-for-dollar reduction in the amount of federal income tax liability. The Federal Credit may not be used for rehabilitating structures that are used exclusively as places of residence.

A rehabilitation project must meet two main requirements to qualify for the Federal Credit. First, the building must be a "certified historic structure." Code §47(a)(2). The Code defines a certified historic structure as a depreciable building that is listed in the National Register of Historic Places or a building that is located within a registered historic district and certified by the NPS as contributing to the historic significance of that district. Code §47(c)(2)(B)(iv). A registered historic district is any district that is listed in the National Register of Historic Places or locally designated as such, if permitted by a local or state ordinance that is certified by the secretary of the interior. Code §47(c)(3)(B)(ii)(I).

Second, the project must constitute a "certified rehabilitation." A certified rehabilitation is any project that the NPS, while acting on behalf of the secretary of the interior, certifies and approves as maintaining the historic character of the property or the district in which the property is located. Code §47(c)(2)(C). The NPS highly recommends that the owner/lessee apply for the tax credit before beginning rehabilitation work. *See* Historic Preservation Tax Incentives, at http://www.nps.gov/tps/tax-incentives/taxdocs/about-tax-incentives.pdf (2009). Long-term lessees are eligible to apply for the Federal Credit if the lease is over 27.5 years for residential property or 39 years for nonresidential property. The application consists of three parts. Parts one and two, as applicable, should be filed in advance of any work.

Once the owner completes the rehabilitation project, he or she must submit Part 3 of the Historic Preservation Certification Application, which is a Request for Certification of Completed Work. Application available at http://www.nps.gov/tps/tax-incentives/application.htm (last revised 2011). The NPS will evaluate the completed work and determine whether it comprises a certified rehabilitation, thus warranting the Federal Credit.