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New Markets Tax Credits Offer Innovative Financing

By Elka T. Sachs and Rebecca L. Regan

Boston Collegiate Charter School is a neighborhood school that dreams big. Located in a distressed part of Dorchester, BCCS provides highly acclaimed programming to prepare Boston public school students for college and beyond. When BCCS needed the resources to expand, it turned to an innovative financing structure – the New Markets Tax Credit. The school serves an at-risk population – more than 40 percent of its students are minority, and more than 40 percent qualify for free or reduced-price lunch (the trigger for low-income eligibility). More than 80 percent of students' parents have not graduated from college. The school's goal is to instill in its students the expectation of college from the moment they walk through BCCS' doors; for five years in a row, 100 percent of the senior class has been accepted into college. A $15.8 million NMTC allocation will allow the school to expand by 50 percent to 660 students and provide very low-cost permanent financing for the school. The expansion of the organization would not have been possible without the infusion of equity and permanent debt from the New Markets Tax Credit structure.

The NMTC program is administered through the Community Development Financial Institutions Fund of the U.S. Department of the Treasury, which awards tax-credit allocation authority to community development entities (CDEs). The program is an outgrowth of the bipartisan Community Renewal Tax Relief Act, intended to encourage public and private sector investment in the "places left behind": urban, older suburban and rural areas of distress. To date, the program has brought more than $5.4 billion in new investments to 1,131 qualified businesses and real estate developments located in low-income communities.

The CDFI Fund reports that it awarded $16 billion in tax-credit allocation authority during the first five rounds of the program. It anticipates announcing $3.5 billion in new awards of allocation authority in October 2008.

The Boston Collegiate project, like many NMTC transactions, included many players, each of whom obtains a different benefit from the NMTC financing: the tax credit investor, the leverage lender, the qualified low-income community business (which may be nonprofit or for-profit) and the CDE.

• *Tax credit investors.* Tax credit investors can obtain a tax credit equal to 39 percent of the cost of the investment. The credit can be claimed over the 7-year NMTC period. In a typical NMTC financing, the qualified equity investment includes loan proceeds in addition to the tax credit investors' funds. These loans are often referred to as leverage loans because they increase, or leverage, the tax credit obtained by the tax credit investor.

• *Leverage lenders.* For third-party leverage lenders, NMTC financings can contribute to loan portfolio diversity, both because of their alternative structure, and because they target distressed areas. In addition, commercial lenders may obtain Community Reinvestment Act credits through NMTC financings.

• *Qualified low-income community businesses.* For qualified nonprofits and for-profits, the NMTC program provides an additional source of financing for projects that might be less attractive to conventional lenders, however worthy, because they are located in low-income communities or for other underwriting reasons.

• *Community development entities.* CDEs are usually mission-oriented entities, which facilitate the financing of projects aligned with their missions. They typically charge a fee, which may be substantial, for their participation in a NMTC financing. The fees can significantly contribute to the CDE becoming a self-sustainable organization, reducing its reliance on grant dollars and making those grant dollars and NMTC fees available for reinvestment into the community.

Basic Requirements

Key NMTC program requirements that apply during the 7-year NMTC period, and influence the financing structure, are as follows:

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• *Leverage loan v. direct loan.* For third-party leverage lenders new to NMTC financing, understanding the nature of the collateral and how it differs from other types of financing is critical. A leverage loan is not a direct loan to the project, but a loan to an investment fund typically created for the transaction. In order to leverage the tax credits, the leverage loan and the tax credit investment are pooled in the investment fund before the qualified equity investment is made. Because the leverage loan is not a direct loan, the leverage lender will not have a direct collateral interest in the project during the 7-year NMTC period.

• *Recapture due to repayment.* The tax credit will be subject to recapture if the proceeds of the qualified equity investment cease to be invested in a manner that satisfies NMTC requirements, or if the qualified equity investment is redeemed or otherwise cashed out by the CDE. For this reason, repayment of principal is generally prohibited during the 7-year NMTC period. For the same reason, the leverage lender's ability to trigger foreclosure will be limited or prohibited during this period.

• *CDE control.* The CDE, typically through a subsidiary, uses the qualified equity investment to make a loan to, and/or equity investment in, the qualified low income community business. The CDE risks its CDE status if it cedes all control over the loan or investment to the leverage lender. Loss of CDE status will trigger recapture of the tax credits, so CDE compliance matters to both the CDE and the tax credit investor.

After the 7-year NMTC period, a third-party leverage loan can be converted to a direct loan with a direct collateral interest in the financed project, and repayment of principal can begin. The CDE and tax credit investor may exit from the transaction, unless they can obtain additional benefits which extend beyond the 7-year period. The leverage loan conversion and exit strategies should be built into the transaction at the outset.

The players must protect their own interests, but recognize the interests of the other necessary parties. The tax credit investor expects a certain return and the CDE wants to protect its CDE status and its fee. At the same time, a third-party leverage lender needs adequate security against interest payment defaults during the 7-year NMTC period, and protection against devaluation (through mismanagement or otherwise) of the collateral which will serve as its security when the leverage loan converts to a direct loan.

Last, but not least, the qualified low-income community business must consider the often substantial up-front soft costs (ideally financed as part of the transaction), and whether it can handle the loan repayment obligations which remain at the end of the 7-year NMTC period, as well as any payments or liabilities which are triggered when the CDE and tax credit investor exit the transaction. The result is that all parties engaged in a NMTC financing must consider innovative strategies which are not typical of standard commercial loans, or other forms of tax credit financing.

Originally conceived as a vehicle for leveraging private investment capital into our poorest neighborhoods, the NMTC program has indeed proven to be a powerful tool for community organizations with a vision for change. It has allowed them to realize their visions – seizing opportunities, shoring up their facilities and ensuring their futures.

Interested parties can contact CDEs to learn more about their requirements. On its Web site, the CDFI Fund publishes the complete list of CDEs that have been awarded NMTC allocations (including Massachusetts Housing Investment Corp. and Boston Community Capital), as well their target investments. Another approach is to retain a financial consultant specializing in NMTC transactions, who can bring the necessary parties together and structure and implement a transaction tailored to the parties and particular circumstances at hand. ■