Using Tax Credits in Your Main Street

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1. Recap & Overview
2. Tax Credit Financing Q&A
3. Irvin Henderson Main Street Revitalization Fund
4. General Q&A
1. Recap & Overview
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4. General Q&A
Who is NTCIC?

• National Trust Subsidiary formed in 2000 to take advantage of the newly created New Markets Tax Credit Program
  – Community Development Financial Institutions Fund (CDFI Fund)
  – Internal Revenue Service (IRS)
• Qualified Community Development Entity (CDE)
  – CDFI Fund only AWARDS New Markets Tax Credits (NMTCs) to CDEs
• Tax Credit Syndicator
  – Connect private investor capital with developers rehabilitating historic buildings
Tax Credit Basics

• Generally designed to encourage or reward certain types of investment and development that are considered beneficial to the economy, the environment or to further any other purpose the government deems important.

• Tax credits reduce the amount of income tax dollar-for-dollar that individuals or companies owe to federal and state governments.

• Investors with a large tax liability want to buy tax credits to lower taxes – e.g. large banks.

• Historic restoration projects need inexpensive capital.

• Tax credit syndicators connect investors with projects that qualify for tax credits.
How HTCs Work

• To generate HTCs, property owners or developers must undertake the **substantial rehabilitation** of a **certified historic structure** with an **eligible end use**

• To qualify for certification, developers must complete a **3-part application** that is approved by the state **SHPO** and the **NPS**

• Tax credits are equal to **20%** of the qualified rehabilitation expenditures (**QREs**)

If project is eligible, the building owner is able to attract capital from investors in exchange for these credits
How NMTCs Work

• CDFI Fund announces **NMTC allocation availability** for a Calendar Year Allocation Round

• CDEs must apply through a **competitive application** process to be considered for NMTCs

• Projects must meet certain criteria to qualify as a **QALICB**

• CDEs identify projects that align with their individual missions – **community benefits**
New Markets Award Process

Basically, a CDE uses a QEI to make a QLICI in a QALICB located in a LIC.
Tax Credit Uses

Eligible Uses
- Community facilities – recreation centers, rehabilitation centers,
- Healthy Foods – grocery stores, food halls,
- Healthcare – FQHCs, hospitals, urgent care clinics
- Commercial/Industrial uses
- Residential – can only be up to 80% of total gross revenue

Ineligible Uses
- Golf courses
- Race tracks
- Gambling facilities
- Certain farming businesses
- Country clubs
- Trades or businesses involving intangibles
- Massage Parlors
- Hot tub facilities
- Suntan facilities
- Stores where the principal business is the sale of alcoholic beverages for consumption off premises
1. Recap & Overview

2. Tax Credit Financing Q&A

3. Irvin Henderson Main Street Revitalization Fund

4. General Q&A
Tax Credit Investments

• How can a nonprofit capitalize on tax credits?

• What have been some recent challenges HTC has faced that can affect projects?

• How can you pair multiple tax credits?

• How can smaller projects monetize tax credits?
Tax Credit Investments

• How can a nonprofit capitalize on tax credits?

Tax Exempt Use Property

❑ Be aware of tax exempt use issues with Historic Tax Credits

❑ Section 47 of the Code provides that QREs eligible for Historic Credits do not include expenditures allocable to the portion of the property which is (or may reasonably be expected to be) “tax exempt use property”.

❑ A tax exempt entity as an owner of or tenant in a historic building can cause a loss of Historic Tax Credits so careful structuring of any tax exempt entity participation is required.

❑ Grants/donations to the owner of a historic building can also cause tax issues and potential reduction of Historic Tax Credits if not handled appropriately.
Tax Credit Investments

• How can a nonprofit capitalize on tax credits?

Tax Exempt Ownership:

- Who is a Tax Exempt entity?*
  - Governmental/State entities
  - Any organization exempt from income taxes (such as a 501(c)(3))
  - Any foreign person or entity
  - Any Indian tribal government

- Can the Tax Exempt (or its sub-entity) make a 168(h) election to be taxed as a for-profit entity?

- Will the same Tax Exempt be the end-user of the Building?

*IRC Section 168(h)(2)(A)
Tax Credit Investments

• How can a nonprofit capitalize on tax credits?

Tax Exempt Use:

- Specific limitations on Tax Exempt Use by end-user tenants
- 50% limitation (up from 35%)
  - What counts towards the limitation?
- Qualified vs. Disqualified Leases to Tax Exempt Entities
- Did the tax exempt participate in the financing?
- Is there a fixed purchase price/option to buy under the Lease?
- Is the Lease term in excess of 20 years?
- Has there been a “sale/leaseback” with the Tax Exempt

Courtesy of Klein Hornig
Tax Credit Investments

Managing Member (Developer Affiliate)
- 1% Credits, Profits & Losses, Fees and Cash Flow
- Developer Equity

Tax Credit Investor LLC
- Historic Tax Credit Equity
- 99% Credits, Profits & Losses & Cash Flow

Tax Credit, LLC (Property Owner)
- Loan Proceeds
- Debt Service Payments
- Rental Payments

Developer
- Dev. Fee

Construction/Perm Lender
- Tenants

Courtesy of Klein Hornig
Tax Credit Investments

Managing Member (Developer Affiliate)

90% Profits & Losses, Fees and Cash Flow
1% Credits, Profits & Losses, Fees and Cash Flow

Developer Equity

Landlord, LLC (Property Owner/Lessor)

Loan Proceeds
Debt Service Payments
Construction/Perm Lender

Pass-through of Historic Tax Credits & Share of Residual
Lease Payment & Equity Investment in exchange for 10% of profits, Losses, and Cash Flow

Master Tenant, LLC (Master Tenant)

Rental Payments
Sub-Tenants/End Users

Tax Credit Investor LLC

Historic Tax Credit Equity
99% of Credits, Profits & Losses & Cash Flow

Courtesy of Klein Hornig
Tax Credit Investments

• How can a nonprofit capitalize on tax credits?

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• How can you pair multiple tax credits?

• How can smaller projects monetize tax credits?
Tax Credit Investments

• Revenue Procedure 2014-12

- Establishes a “safe harbor” for structuring transactions
- Does not address other tax credits
- By following the terms of the Guidance, developers can be certain that the HTC generated by an investment will be allocated to the Investor and that Investor will be respected as a Partner
- No minimum amount of cash needs to be distributed to the Investor (and recent discussions with Treasury confirm this approach), therefore economic substance issues are now less important*
- Investor must receive reasonably anticipated value, exclusive of tax benefits, commensurate with the Investor’s percentage interest in the Partnership

*Many investors require some amount of cash flow and may require a specific cash on cash return
Tax Credit Investments

• Revenue Procedure 2014-12

- “Commensurate” being interpreted to mean that cash flow and residual distributions in accordance with the % interest of the Investor (99% interest then 99% distributions)
- But a “Flip” of interests is allowed after year 5
  - At least a 5% interest must be maintained, but possible to “flip” the investor from a 99% interest to a 5% interest
- BUT economic value of the Investor’s Interest must not be reduced through fees, lease terms or other arrangements that are “unreasonable” compared to non-HTC projects
- This will require additional underwriting and review
  - Subleases are directly challenged
  - Developer Fees and Incentive Management Fees are also at issue if they are cash flow based fees
  - Investor preferred returns are permitted, but they can’t be guaranteed
Tax Credit Investments

• Revenue Procedure 2014-12

Downside Risk

- At least 20% of investor equity must be contributed prior to placement in service
- At least 75% of the Investor’s total expected capital contributions must be fixed before placement in service
  - But this 75% portion may be subject to conditions such as placement in service, stabilization or receipt of Part 3 approval

Guaranties:

- Funded guaranties not allowed (including minimum net worth)
- Impermissible guaranties include:
  - Guaranty of partnership distributions or economic returns
  - Tax structure risk or other disallowance or recapture events not due to an act or omission of the Developer
  - Cannot pay costs of audit
  - 100% structure risk now on the Investor (almost all investors require transactions to be Safe Harbor compliant)
Tax Credit Investments

- Revenue Procedure 2014-12

- The Investor may hold an option to put its interest to the developer at an amount not to exceed FMV

- Developer may not have a call right at FMV, but because of the ability to structure a “flip” in interests after the compliance period, there is some ability to structure around this issue

- The Investor is now going to receive additional cash flow during the compliance period, and the exit will be less certain.

- Guidance effective as of December 30, 2013.
Tax Credit Investments

• Section 50(d) Income

- On July 21, 2016, the IRS amended the Income Tax Regulations (26 CFR part 1) under section 50(d)(5), providing guidance for the application of section 50(d) with respect to the income allocation provided under former code section 48(d), applying to lease pass-through allocations of historic tax credits.

- In a “direct” investment, the corresponding provision requires the historic building to undergo a basis reduction equal to the tax credit claimed. An equal reduction is also applied to the investor’s capital account and to its basis in its partnership interest. Therefore these new regulations only apply to lease pass-through transactions.

- Single tier “direct” structure takes away the §50(d) question but adds some new ones (such as Foreclosure Rights Agreement, cash flow and ownership considerations)
Tax Credit Investments

• Section 50(d) Income

New 50(d) Regulations:

- Section 50(d) income is a partner item, not a partnership item.
- Section 50(d) income goes to the partner in the lessee that used the tax credits.
- Section 50(d) income will not increase capital accounts.
- Partners are not entitled to increase their bases in their partnership interests as a result of the Section 50(d) income inclusion.
- In addition, the regulations allow for a new optional election to accelerate the income inclusion by a partner or S corporation shareholder outside the tax credit recapture period.
Tax Credit Investments

• Section 50(d) Income

WHAT IS THE TREATMENT UPON EXIT OF THE INVESTOR?

☐ If Income IS Accelerated
☐ Pricing Considerations
☐ If Income is Not Accelerated?
☐ What happens under GAAP?
☐ Do Investors want phantom income over time?
☐ Most investors are absorbing the 50(d) income on exit and have reduced pricing accordingly.
Tax Credit Investments

• How can a nonprofit capitalize on tax credits?

• What have been some recent challenges HTC has faced that can affect projects?

• **How can you pair multiple tax credits?**

• How can smaller projects monetize tax credits?
Typical Leverage Structure

LENDER
$70 loan

Investment Fund
$30 equity

Tax Credit Investor
$39 NMTCs

CDE (Allocatee)
$100 QEI
Suballocation of Tax Credit Authority

CDE (Subsidiary)
QLICI (>85% of QEI)

QALICB
"Twinned" Leverage Structure

LENDER

$70 loan

$30 equity

Tax Credit Investor

$39 NMTCs

Credits, profits, losses & cash flow

CDE (Allocatee)

$100 QEI

Suballocation of Tax Credit Authority

CDE (Subsidiary)

Investment Fund

HTC equity

QALICB

Pass through of HTCs

Master Tenant

Managing Member (Developer)

HTC Equity

1% owner and operator
Tax Credit Investments

• What other types of financing can a project use in addition to tax credits?

Additional Financing tools
• Construction loans
• Capital campaigns
• State grants
• Brownfield revitalization funds
• PACE
• EB5
• State Historic Tax Credits
Tax Credit Investments

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# The Irvin Henderson Main Street Revitalization Fund

NTCIC offers low-cost tax credit financing to historic properties in Main Street communities. NTCIC’s Main Street Revitalization Fund provides up to **$2 million** in tax credit financing per project with a combination of federal HTC and NMTCs.

## Key Features

<table>
<thead>
<tr>
<th>Location</th>
<th>Size</th>
<th>Readiness</th>
<th>Impact</th>
<th>Tax Credits</th>
<th>Structure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Located in a Low-Income Community that has:</td>
<td>• Qualified rehabilitation expenditures should be between $4MM - $8MM</td>
<td>• National Park Service (NPS) Part I is complete</td>
<td>Community impacts must include:</td>
<td>• HTCs are enhanced with NMTCs</td>
<td>The NTCIC MSRF will invest in both the NMTCs and HTCs. A project cannot elect to take only HTC or NMTC equity.</td>
</tr>
<tr>
<td>• Poverty rates greater than 30%; or</td>
<td>• All other sources of financing have been confirmed</td>
<td>• Part II should already be submitted to NPS, if not already complete</td>
<td>• Housing locally-owned and small community businesses</td>
<td>• Employ a simpler structure to help minimize legal fees and transaction costs</td>
<td>• A leverage NMTC structure with an HTC master tenant structure will be utilized</td>
</tr>
<tr>
<td>• Median incomes less than 60%; or</td>
<td></td>
<td>• All local approvals have been received and building permits have been issued</td>
<td>• Creating quality jobs accessible to low-skilled workers</td>
<td></td>
<td>• No other NMTCs can be utilized outside NTCIC’s investment</td>
</tr>
<tr>
<td>• Unemployment greater than or equal to 12.45%</td>
<td></td>
<td>• Architectural drawings have been prepared and general contractor has been identified</td>
<td>• Support from the local community</td>
<td></td>
<td>• A third party will be required to bridge the majority of financing needed during construction</td>
</tr>
<tr>
<td>• Poverty rate, median incomes and unemployment rate are based on 2011-2015 ACS data</td>
<td></td>
<td></td>
<td>• If there are residential units, at least 20% must be set aside at below market and leased to households earning 80% AMI or less</td>
<td></td>
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</tr>
</tbody>
</table>
Main Street Revitalization Fund

• How do I know if my project is big enough to use tax credits?

• What are costs associated with smaller projects?

• How do community benefits factor in to tax credit utilization?

• What are the biggest items I need to have in place in order to close a project?
Project Size

• Total Development Cost

• QRE Size

• NMTC allocation

• Financing Gap

• Functionally related investments

• Think Big!
Main Street Revitalization Fund

- How do I know if my project is big enough to use tax credits?

- **What are costs associated with smaller projects?**

- How do community benefits factor in to tax credit utilization?

- What are the biggest items I need to have in place in order to close a project?
Project Costs

- Legal fees
- Accounting Fees
- Architectural, Engineering, and Environmental
- Development Fees
- Project readiness is key

### Project Sources

<table>
<thead>
<tr>
<th>Source</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>NMTC Equity</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>HTC Equity</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Capital Campaign</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Leverage Loan</td>
<td>$2,000,000</td>
</tr>
<tr>
<td><strong>Total Sources</strong></td>
<td><strong>$6,000,000</strong></td>
</tr>
</tbody>
</table>

### Project Uses

<table>
<thead>
<tr>
<th>Use</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hard Costs</td>
<td>$4,500,000</td>
</tr>
<tr>
<td>Legal Fees</td>
<td>$150,000</td>
</tr>
<tr>
<td>Accounting Fees</td>
<td>$150,000</td>
</tr>
<tr>
<td>Architect/Engineering/Environmental</td>
<td>$225,000</td>
</tr>
<tr>
<td>Additional Soft Costs</td>
<td>$975,000</td>
</tr>
<tr>
<td><strong>Total Sources</strong></td>
<td><strong>$6,000,000</strong></td>
</tr>
</tbody>
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Main Street Revitalization Fund

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• What are the biggest items I need to have in place in order to close a project?
Community Benefits

• How do community benefits factor in to tax credit utilization?

  – Overall impacts are very important
    • Jobs
      – Quantity
      – Quality
    • Patients served
    • Community input
    • Annual Participants

  – Required reporting over full 7-year compliance period
Main Street Revitalization Fund

• How do I know if my project is big enough to use tax credits?

• What are costs associated with smaller projects?

• How do community benefits factor in to tax credit utilization?

• What are the biggest items I need to have in place in order to close a project?
Project Readiness

• What are the biggest items I need to have in place in order to close a project?

  – Find your dream team!

  – Site Control

  – Construction Budget

  – NPS Approval

  – Sources & Uses
Questions?

For any questions we are not able to answer during the presentation, be sure to reach out to us and we will be happy to help!

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