

Memorandum

FROM: Dan McRae
DATE: October 17, 2007
RE: Better Financing Through New Markets Tax Credits and Tax-Exempt Bonds

Capital Cost and Financing Structures

This Memorandum addresses the financing of real estate developments that promote in some way economic development or another public purpose. There are a number of often over-looked programs that can facilitate such projects through reducing the cost of capital or providing better financing structures.

Two of these programs are new markets tax credits (“**NMTC’s**”), which are a federal income tax credit, and tax-exempt bonds (“**TEB’s**”). These programs may not be suitable for every development. However, when there is a match between the development financing needs and the program requirements, the result can be beneficial.

This Memorandum will present a high level overview of NMTC’s and TEB’s. This is only a summary of some of the main features of these programs. This summary is qualified in its entirety by reference to the applicable statutes and regulations. More information regarding these programs is available on the “White Papers” page and the *Quick Takes* page of [danmcræ.info](#).

An NMTC-based loan often provides interest-only financing. Also, as stated in the Comptroller of the Currency’s publication “Community Development Insights” for February 2007 (the “**Comptroller Document**”): “The additional cash-equivalent value of the tax credits helps NMTC transactions meet investors expected risk-adjusted returns.” In some transactions involving NMTC’s, the only yield to the equity investor is the credits themselves.

In addition to lower interest than conventional loans, industrial development revenue bonds structured as “lower floaters” (variable rate demand bonds) can also offer an interest-only period, with the interest in some cases being capitalized. Another advantage of financing through lower floaters is the increased term, up to 30 years in some cases.

NMTC'S

NMTC's are a federal program intended to encourage private sector investment in lower income areas, both urban and rural¹. The program has both corporate applications, and commercial real estate applications. Examples of corporate investments include funding senior debt, subordinated debt and equity investments in businesses. Examples of closed commercial real estate investments involving NMTC's include the conversion of industrial buildings into an office complex with attendant parking, the new construction of a large medical office building, and the construction of the retail portion of a civic redevelopment project.

Pursuant to this program, the U.S. Department of the Treasury, through its Community Development Financial Institutions Fund ("**CDFI Fund**"), allocates NMTC's under IRC Sec. 45D to community development entities (each, a "**CDE**"), certified as such by the CDFI Fund. Providers of equity to the CDE then receive NMTC's as a result of their investments ("**Qualified Equity Investments**", or "**QEI's**"). Credits are available to the investors in accordance with the following 7-year schedule- years 1-3: 5% of the amount of the QEI's; years 4-7: 6% of the amount of the QEI's. Thus, the credits amount to 39% of the investment at the end of the 7-year period. The CDE uses the investment to provide financial assistance in one of the ways² authorized by the NMTC program ("**Qualified Low-Income Community Investments**", or "**QLICIS**") to "**Qualified Active Low-Income Community Businesses**", or "**QALICB's**". If the QLICI is repaid prior to the end of the 7-year period, the CDE must use the proceeds to make another QLICI.

Thus, loans by CDE's are normally structured as 7-years interest-only with a bullet maturity at the end of the 7-year period. Typical financing structures are the "Non-leveraged Structure" and the "Leveraged Structure," which are depicted on diagrams taken from the Comptroller Document, and attached hereto as Figure 2 and Figure 3, respectively.

¹ According to the Comptroller Document, "approximately 39 percent of the Census Tracts in the United States, based on year 2000 census data, satisfy at least one of the Fund's threshold criteria: a project must generally be located in a census tract with: 1) a poverty rate of 20 percent or greater; or 2) a median family income at or below 80 percent of the area median family income. Areas with higher distress criteria include, but are not limited to, those having unemployment rates at least 1.5 times the national average; and/or areas that have been designated for economic development through other governmental programs, such as Brownfields, empowerment zones, and renewal communities." Comptroller Document, note 7.

² CDE's often provide: "... a host of financial and technical assistance to eligible businesses: investing in or lending to these business enterprises; investing in or lending to CDEs; purchasing loans from CDEs; and providing financial counseling and other services (FCOS) by the CDE to organizations, including nonprofit organizations, to assist with business plan development, financial analysis, financing, and similar activities." Comptroller Document, page 2.

The NMTC program has many terms and conditions, including recapture provisions, which are not described in this Memorandum. Specific professional advice should be obtained in connection with any of the matters covered by this Memorandum.

TEB's

Industrial development revenue bond financing is a type of structured finance. As such, it can offer advantages to a project's capital structure, through such features as reduced interest, interest-only periods, and longer terms. The interest rate is lowest when the bonds are federally tax-exempt. Developers most often see tax-exempt financing in connection with manufacturing projects financed with "small issue" tax-exempt bonds, or projects for non-profits that are federally recognized tax-exempt organizations and that can use "qualified 501(c)(3)" tax-exempt bonds for financing. Sometimes tax-exempt "exempt facilities" bonds are used.

Although interest rates are not as low as with tax-exempt bonds, industrial development revenue bonds on which the interest is not federally tax-exempt ("taxable" bonds) can still offer interest rate advantages when structured as lower floaters; *i.e.*, "taxable floaters." In addition, the other advantages of bond financing are still available. Note that lower floaters are secured by a bank letter of credit.

In addition to, or in some cases aside from, providing financing for a project, a bond-financed sale-leaseback structure is used in some states, including Georgia, as the basis for providing state and community incentives such as property tax abatement and grants. If other sources provide the actual funding, the bonds are cashless "bonds for title."

Combining NMTC's and TEB's

It has been reported that, in a recent transaction, an equity investor obtained NMTC's on the total debt and equity capital received by a CDE, when the debt was tax-exempt bonds. The proceeds of the capital investment were used by the CDE for the financing of a charter school. For more information, please see the July 2007 article, "NMTC's Paired with TEB's to Finance Charter School Facilities," at

http://www.novoco.com/new_markets/resource_files/article_month/nmtc_article_of_month_0707.pdf (or contact the author of this Memorandum for more information).

Conclusion

NMTC's and TEB's can be used in appropriate cases to reduce the cost of capital or provide better financing structures for projects.

Regarding these programs, this Memorandum is a quick-reference guide for company executives and managers, financial and real estate industry participants, economic developers, and their advisors. The information in this Memorandum is general in nature. Various points, which could be important in a particular case, have been condensed or omitted in the interest of

readability. Specific professional advice should be obtained before this information is applied to any particular case. Any tax information or written tax advice contained herein (including any attachments) is not intended to be and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. (The foregoing legend has been affixed pursuant to U.S. Treasury Regulations governing tax practice.)

If you have any questions or comments, we would be pleased to provide more information. Please contact:

Daniel M. McRae

Partner
Seyfarth Shaw LLP
404.888.1883

dmcrae@seyfarth.com
dan@danmcrae.info

Suite 700
1545 Peachtree Street
Atlanta, GA 30309
fax 404.892.7056

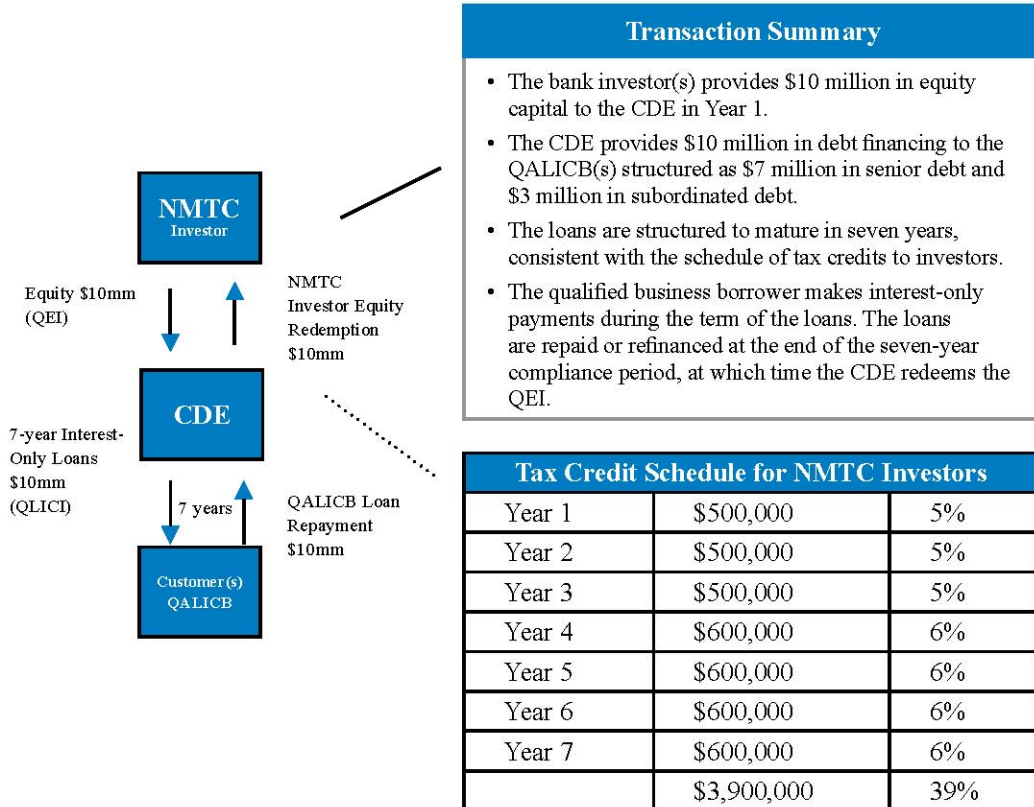
DMM:cm

Figure 1

[from Comptroller Document- omitted]

Source for Figure 2: Comptroller of the Currency’s publication “Community Development Insights” for February 2007

Figure 2
Example of NMTC Non-Leveraged Transaction

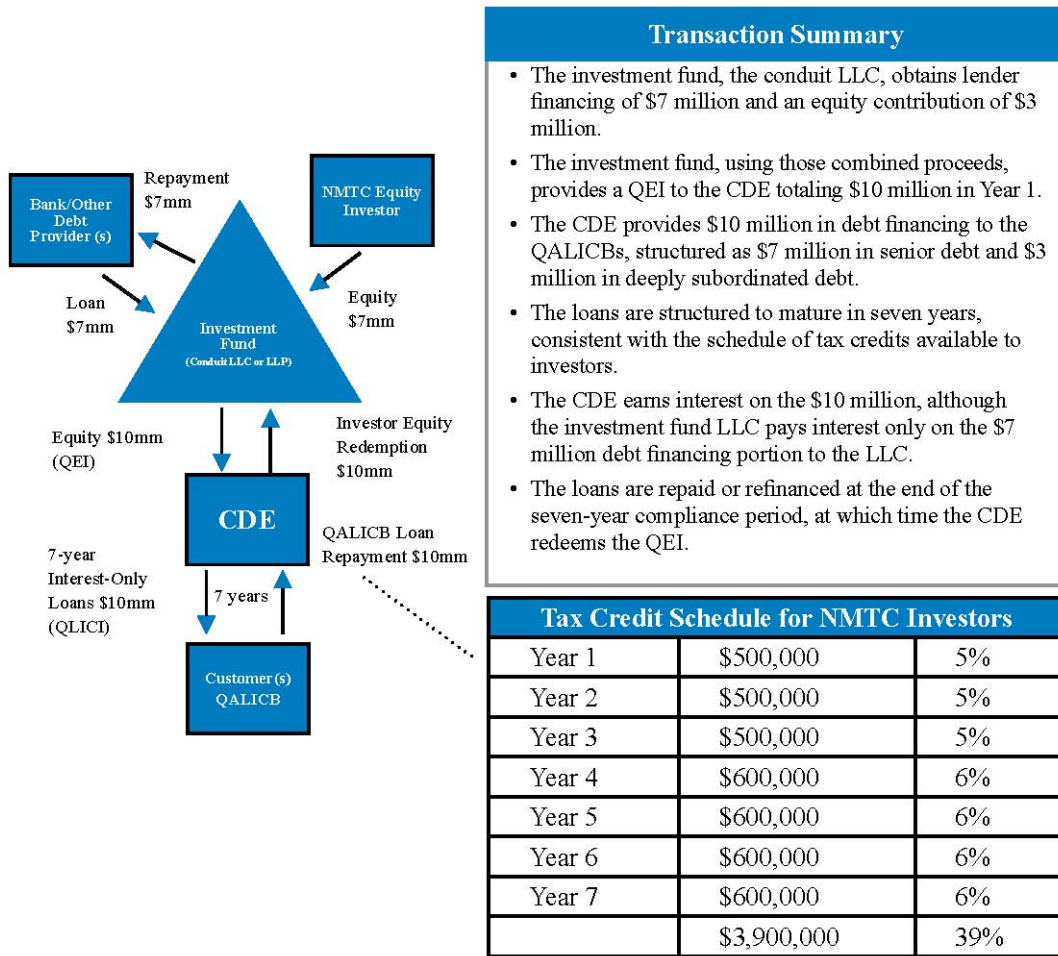


Transaction Summary	
•	The bank investor(s) provides \$10 million in equity capital to the CDE in Year 1.
•	The CDE provides \$10 million in debt financing to the QALICB(s) structured as \$7 million in senior debt and \$3 million in subordinated debt.
•	The loans are structured to mature in seven years, consistent with the schedule of tax credits to investors.
•	The qualified business borrower makes interest-only payments during the term of the loans. The loans are repaid or refinanced at the end of the seven-year compliance period, at which time the CDE redeems the QEI.

Tax Credit Schedule for NMTC Investors		
Year 1	\$500,000	5%
Year 2	\$500,000	5%
Year 3	\$500,000	5%
Year 4	\$600,000	6%
Year 5	\$600,000	6%
Year 6	\$600,000	6%
Year 7	\$600,000	6%
	\$3,900,000	39%

Source for Figure 3: Comptroller of the Currency’s publication “Community Development Insights” for February 2007

Figure 3
Example of NMTC Leveraged Transaction



ERRATUM (from the author of this Memorandum)- As noted, Figure 3, was taken from a publication of the Comptroller of the Currency. However, it appears that in the Figure, the amount of the equity depicted top right in the Figure, should be \$3mm, not \$7mm.