GINSBERG JACOBS LLC

NEW MARKETS, HISTORIC and REHABILITATION TAX CREDITS

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In the recently passed Wall Street Bailout, Congress and the President extended the New Markets Tax Credit ("NMTC") for 2009. Introduced originally in the Community Renewal Tax Relief Act of 2000, the NMTC originally was envisioned as an incentive to encourage investments in operating businesses located in economically disadvantaged areas, but most NMTC investments typically are made in connection with developments of non-residential real property (use of credits for residential projects is extremely limited).

Under the NMTC provisions, the government makes credit allocations to Community Development Entities (CDE), which must be invest in projects located in qualified low income census tracts that have suitable community impact. The allocations for 2008 were announced on October 17, 2008 and the 2009 allocations will be announced in late October or early November next year.

CDEs are often owned or controlled by banks. Because the credits are passive within the meaning of the federal passive loss tax rules, real estate developers with significant passive income and C corporations (such as banks) can benefit significantly from the use of the credits. In most cases, large C corporations end up being the credit investors. In fact, most major banks have groups dedicated to investing in NMTC transactions. Because of the tremendous credit subsidy that the banks receive, they are generally willing to provide more generous financing at more reasonable rates than they would in the absence of the credits.

Mechanics of the NMTC

The NMTC is a 39 percent credit on an equity investment in a CDE. The credit is claimed over a 7-year compliance period (5 percent over the first 3 years and 6 percent over the last 4 years). The CDE must make a Qualified Equity Investment or loan to a Qualified Business in a Qualified Low-Income Community (QALICs). Most Commercial and mixed-use real estate development projects located in QALICs are Qualified Businesses. (Residential projects without a commercial component do not qualify.) The New Markets program is designed to encourage investments in QALICs that traditionally have had poor access to debt and equity capital. To avoid recapture of the credits, at least 85% of the original investment must remain invested during the first six years of the credit period and at least 75% must remain invested during the seventh year.

NMTC Investments (inside the CDE structure)

NMTC deals are structured in two ways: unleveraged and leveraged. In an unleveraged transaction, the investor makes a direct investment in a CDE, which, in turn, invests in a project. The investor is then entitled to credits based upon the direct investment.

In a leveraged transaction, a credit investor or a developer will form a limited liability company or limited partnership (an "Investment Fund"). The credit investor will make an equity contribution to the Investment Fund and the Investment Fund will borrow on a non-recourse basis certain of the funds necessary to complete the project. These funds may be borrowed in lieu of mezzanine debt or construction financing for the project. The

Investment Fund in turn will make an equity investment in the CDE. The CDE in turn will loan funds to the project in the form of an "A Loan" which represents the non-recourse loan and a "B Loan" or equity contribution that represents the equity investment. By leveraging the transaction in this manner, the equity contribution of the Investment Fund in the CDE for which NMTCs are available is the sum of the direct investment plus the non-recourse debt.

The benefit of a leveraged transaction can be illustrated as follows. Assume that a project needs $20 million of financing and that a lender is willing to make a non-recourse loan of $14 million to an Investment Fund. A credit investor might invest additional funds of $6 million in the transaction. By structuring a leveraged transaction, the entire $20 million will be eligible for the NMTC. Consequently, the credit investor will receive aggregate credits of $7.8 million over the seven year period which exceed its total investment.

While it may seem unlikely that lenders will lend to a real estate project without security, it is not unusual in a NMTC deal. Typically, the lender will also be the credit investor. Investing in NMTC deals garners a bank credit under the Community Reinvestment Act ("CRA"). Banks are very concerned about their CRA ratings. Consequently, they work hard to get NMTC deals funded.

Developer Economics in NMTC Deals

A developer's economics in an NMTC deal differ depending upon the type of CDE that provides allocation for the project, but CDEs affiliated with financial institutions typically are not seeking a "piece of the action" in a deal. Rather, the CDE will look to receive fixed fees in the nature of asset management fees and will typically sell the credits to entities that are looking for internal rates of return ranging from 7% to 10%. Since these credit investors often receive credits that exceed their investment, the distributions from the development entity up the ownership chain will often be substantially less than the equity invested. In these types of transactions the B Loan (the amount representing the credit investor's equity contribution) will typically have a very long term and will bear interest at a nominal rate, such as one percent (1%). At the conclusion of the seven year recapture period, the B Loan will typically be settled at a fraction of its face amount.

On the other hand, CDEs affiliated with for-profit businesses will typically take a significant percentage of the deal and will look to receive the credit investment returned, as well as a significant internal rate of return on the investment amount ranging from 15% to 25%. In addition, the CDE will typically remain an investor receiving a percentage of the cash flow and capital event proceeds. During the seven-year recapture period, the CDE will receive interest payments on the A and B Loans and will share in remaining cash flow at a significant percentage. The B Loan will typically be paid after seven years and once the CDE receives its minimum internal rate of return, the sharing ratios will flip further in favor of the developer.

Combining the NMTC with Historic or Rehabilitation Tax Credits

The Historic Tax Credit (HTC) is a credit equal to 20 percent on all qualified development costs incurred in restoring a certified historic structure. The Rehabilitation Tax Credit (RTC) is a credit equal to 10 percent on all

qualified development costs incurred in restoring a non-certified historic structures built prior to 1936. To avoid recapture, the user of the credits must possess the real property interest for a period of five (5) years.

The New Markets Tax Credit and the HTC/RTC are natural allies. QALICs are defined as U.S. census tracts with a 20 percent poverty rate or household incomes at or below 80 percent of the area or statewide median, whichever is greater. Because most old buildings are found in disinvested parts of any city or town, and most rehabilitation tax credit projects are located in central business districts, many rehabilitation projects also qualify for NMTCs. In fact, in 2005, 68 percent of the HTC approvals were granted for properties in qualified NMTC census tracts. The IRS has provided specific guidance that allows for the "twinning" of the HTC/RTC and NMTC.

Using the above example, if the project's full $20 million cost are considered qualified development costs, then the credit investor will receive an additional $4 million in HTC or $2 million in RTC. This additional tax credit will serve to increase the overall equity investment by the credit investor and reduce the amount of loan required for the project. The preferred mechanism to accomplish either the HTC or RTC is by entering into a long term master lease for the property with an entity that is 99.9% owned by the credit investor, but managed and controlled by an affiliate of the developer. By using this structure, the credits are passed through to the credit investor and the virtually all the cash flow is passed through to the fee owner of the property. The Master Lessee will enter into or be assigned the actual space lease for the property.

The HTC or RTC credit investment documents typically include a put option for the credit investor at a fraction of credit investment and a call option for the developer at the fair market value of the credit investment. These options are exercisable after the 5 year recapture period. After the put or call is exercised and the developer owns both the fee interest in the property and the Master Lessee, the Master Lease transaction is typically collapsed.

Conclusion

The New Markets Tax Credit, Historic Tax Credit and Rehabilitation Tax Credit can be powerful tools and significant sources of financing for real estate projects. However, the amount of available NMTC credit allocation is limited. Consequently, developers that might have qualifying projects should explore CDE investments as early as possible during the project planning. In other words, it is important for the client to engage its bank early (even before development financing is required) before the lender's credit allocation is used up; whether the bank has a credit allocation may influence the selection of the lender doing the acquisition and development loan.

Darryl Jacobs is a partner at Ginsberg Jacobs LLC and concentrates his practice on international, federal and state tax matters, with a principal focus on and pass through entities — including partnerships, LLCs and S corporations. Darryl has represented many real estate developers in tax credit transactions.