



New Markets Tax Credit Connection

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Spring 2007

NMTC Challenges for GO Zone QALICBs

By: Phil Cornblatt

The Gulf Opportunity Zone (GO Zone) Act of 2005 added new opportunities for NMTC investments in areas devastated by Hurricane Katrina. On July 17, 2006, the Internal Revenue Service issued Notice 2006-60 providing guidance on how to incorporate the new rules related to the GO Zone prior to issuing updated Regulations.

These new opportunities are only available with regard to Qualified Low Income Community Investments (QLICI) made under the increase in the NMTC limitations pursuant to Internal Revenue Code Section 1400N. Only CDEs that received a special allocation described in Section 1400N may take advantage of these provisions. These CDEs are required to have a significant mission

of recovery and redevelopment of the GO Zone.

For purposes of GO Zone allocations made under Section 1400N, these rules have expanded the area in which a Qualified Active Low Income Community Business (QALICB) may be located and who the beneficiaries may be. Where prior to this legislation a QALICB could only be located in a qualifying low-income census tract, now the QALICB may be located in targeted areas the Federal Emergency Management Agency (FEMA) has declared as flooded, having sustained extensive damage, or having sustained catastrophic damage as a result of Hurricane Katrina.

The new rules now define, for GO Zone purposes only, the GO Zone targeted population as an individual "considered to otherwise lack adequate access to loans or equity investments only if the individual was displaced from his or her principal place of business as a result of Hurricane Katrina and/or the individual lost his or her principal source of employment as a result of Hurricane Katrina." In addition, the Notice states that to meet this definition, "the individual's principal residence or principal source of employment, as applicable, must have been located in a population census tract within the GO Zone that contains one or more areas designated by FEMA..."

For a project to qualify as a QALICB for GO Zone purposes, it must satisfy

one of three criteria. The criteria are gross income, employment, or ownership of the QALICB entity.

The easiest to satisfy is the ownership criterion. This criterion requires that 50% of the QALICB must be owned by GO Zone targeted populations, low-income persons, or some combination thereof. A CDE can easily verify this at the time a QLICI is made.

The next criterion more difficult to pass than the ownership criterion is the employment criterion. The rules require that at least 40% of the QALICB's employees must be from the GO Zone targeted population, low-income persons, or some combination thereof. This criterion must be satisfied at the time the employee is hired. The difficulty of meeting this criterion is this may run afoul of federal, state, and/or local fair employment laws. A QALICB would be required to ask for information and base hiring practices on potentially discriminatory practices. Before engaging in this, a QALICB should discuss this with an attorney who specializes in labor law.

The last criterion is the gross income criterion. The rules require that at least 50% of the entity's total gross income for any taxable year must be derived from sales, rentals, services, or other transactions with GO Zone targeted populations, low-income persons, or some combination thereof. In addition,

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Making the NMTC Program Work with Affordable For-sale Housing

By: Charles Loveman, Heritage Housing Partners

Suppose a lender offered you these terms: \$6.3 million will be lent to you, interest only, for a seven-year period, at a fixed interest rate of under 5%. At the end of seven years, you will repay only 15% of the principal; you get to keep the other 85%. There are some expensive transaction costs to this loan, specifically a hefty origination fee of about 10%, and legal costs could be another 3% of the original \$6.3 million loan. Still, even after factoring in these costs, you get to keep about 72% of the original loan proceeds on a net basis.

There are several other catches, not the least of which is that the loan proceeds must be spent in a qualified low-income community. Since this loan will be made in conformance with NMTC rules, there are a host of compliance and reporting issues. Nonetheless, if you are like me, you would say yes to this loan.

My firm, Heritage Housing Partners (HHP), is a nonprofit, affordable housing developer, based in Pasadena, California. Often our development projects are located within NMTC-qualifying census tracts. Since we primarily build and sell housing units at affordable prices to income-eligible first-time homebuyers, our funding sources typically include municipal, county, and state monies. A couple of years ago, we were trying to develop a 40-unit project located in Pasadena called Fair Oaks Court. We had been very successful in getting funding commitments from all the available city, county, and state programs, but we were still several million dollars short of being able to afford the project. To close the gap, we started pursuing New Markets financing. It was an unexpectedly challenging journey.

The first thing we learned is that no one believed that the New Markets program would work with for-sale housing. Since NMTC investments cannot be repaid to the tax credit investor for at least seven years, for-sale housing by its nature does not fit that investment term. Typically, a for-sale project takes two to three years from conception to completion. At completion, sales proceeds are earned; however, under NMTC rules, the proceeds cannot be repaid to the tax credit investor. Instead, they must be reinvested into another qualifying NMTC project within a maximum of 12 months.

At HHP, we explored several ways to resolve this reinvestment dilemma. But before we got there, we needed to find someone who believed that NMTCs could work with affordable for-sale housing. That someone had to have an allocation of tax credits in order for their support to be meaningful.

Enter Clearinghouse CDFI, an Orange County, California-based Community Development Financial Institution that has successfully received New Markets allocations in three of the past four allocation rounds. Clearinghouse committed to nearly \$14 million of allocation to the Fair Oaks project, and together we worked on various approaches to solving the reinvestment dilemma. Ultimately, the most straightforward reinvestment strategy was to create a pipeline of future projects and move the surplus sales proceeds from one for-sale housing project into another similar project. Based on the typical timeline for our projects, we expected to fund three different projects over the seven-year investment term. Clearinghouse especially liked this reinvestment approach, because one

allocation can be used on a revolving basis to create three eligible projects.

Armed with an allocation and reinvestment strategy, HHP and Clearinghouse approached a number of prospective tax credit investors. Most would not take the risk that we would find additional qualifying projects within the required time frames. However, all it takes is one, and that was Commercial Capital Bank (now Washington Mutual), who assessed HHP's potential deal flow and decided to take the risk. CCB was particularly comforted by Clearinghouse's excellent track record of placing allocation. As CCB's president said at the time of their commitment, if HHP and/or Clearinghouse couldn't find additional NMTC-qualifying projects within the Southern California marketplace, then something was wrong.

Shortly after CCB/WaMu committed to be the investor, HHP entered into an agreement with the City of Glendale, California to re-deploy the net proceeds of our NMTC loan from the Fair Oaks project in Pasadena to a new project in Glendale. The timing was almost perfect, given that just about the time we completed construction in Pasadena, we would be receiving all our entitlements and would be ready to start construction in Glendale.

Most important of all, both Pasadena and Glendale agreed to put their subsidy dollars through the New Markets structure. The result was that the cash repayment of the CCB/WaMu NMTC loan at the end of the seven-year term was greatly reduced because of the additional credits earned from the cities' funds. This aspect of the deal was key. By their nature, the cities' subsidies do not need to be repaid (or

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...GO Zone QALICBs

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if the trade or business of the QALICB is the rental of real property to GO Zone targeted populations, low-income persons, or some combination thereof, at least 50% of the entity's total gross income must come from the rentals to the GO Zone targeted population, low-income persons, or some combination thereof.

Meeting the requirement as a landlord is much easier than as a trade or business providing goods or services to GO Zone targeted populations, low-income persons, or some combination thereof. This is true because at the time a lease is signed, the landlord may ask questions as to whether the tenant is from the GO Zone targeted population, low-income persons, or some combi-

nation thereof. Just as with employees, there may be laws — the fair housing laws, for example — that may not allow the landlord to discriminate between potential tenants based on this requirement. Again it is recommended that the QALICB discuss this with a qualified attorney.

The biggest challenge would be if the QALICB were to provide goods or services, other than rentals, to GO Zone targeted populations. How would a QALICB that sells widgets within a qualified GO Zone census tract go about asking questions of its customers? For example, "Are you part of the GO Zone targeted population?" Would it turn potential customers away? In addition, how does a QALICB document that it met the gross income requirement? Would the QALICB require the customer to sign an affidavit? Would the

QALICB be required to add a special key to its registers so that all gross sales could be segregated based on sales to GO Zone targeted populations and sales to others? Assuming the CDE will not control the QALICB, how does the QALICB provide comfort to the CDE at the time the QALICB is made that there will be a reasonable expectation that the QALICB will be able to comply with these requirements?

Until the Internal Revenue Service issues updated Regulations, there is no way to know the answers to meeting these requirements. Hopefully the new Regulations will include examples showing how a QALICB in GO Zone census tracts can meet these challenges. For now a QALICB within the GO Zone needs to understand the requirements and the challenges of meeting those requirements, especially if the CDE will rely on the information provided by the QALICB in order for it to reasonably expect at the time of making the QALICB that the QALICB can meet these requirements for the entire compliance period. ■

...For-sale Housing

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more correctly, they will be repaid with an equal amount of silent second mortgages in favor of the affordable home buyers). Credits earned from the cities' funds, plus credits from CCB/WaMu's investment, equaled about 85% of the cash investment by CCB/WaMu. The total of credits created is almost dollar-for-dollar the amount not to be repaid at the end of seven years.

Under a conventional affordable for-sale transaction, the cities of Glendale and Pasadena would have provided subsidies for affordable for-sale housing. The difference with the NMTC structure is that, as a result of all the credits earned, including the credits from the cities' funds, some \$70,000 per affordable unit of additional subsidy will be created over three separate projects over seven years.

Not a bad loan. ■

...Coalition Corner

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which will be released at the NMTC Coalition Policy conference in Washington, DC on May 15th.

Details on the NTSC's Coalitions Policy Conferences can be found on the Coalition's website along with registration materials (www.newmarketstaxcreditcoalition.org). ■

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