How Nonprofit Organizations Can Use the New Markets Tax Credit

By Michael I. Sanders

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The New Market Tax Credit (“NMTC”), enacted as part of the Community Renewal Tax Relief Act of 20001 and codified in I.R.C. Section 45D, was designed to stimulate investment in new private capital, which in turn would facilitate economic and community development in distressed communities. It is a program nonprofit organizations may use to their advantage consistent with their exempt function. The NMTC provides investors that make a qualified equity investment (“QEI”) in a community development entity (“CDE”) a 39 percent tax credit over a seven-year period.2 For an investor to claim the credit, the CDE must, inter alia, designate the QEI as such to the Community Development Financial Institutions Fund (“CDFI Fund”)3 and use substantially all of the QEI to make a qualified low-income community investment (“QLICI”).4 The NMTC may serve as a way to provide subsidy or gap financing to charitable organizations that have real estate development, business activities, or charitable operations planned in qualified census tracts.

A tax-exempt organization may participate in the NMTC program in several ways. First, via for-profit affiliates (i.e., a subsidiary of the non-profit organization), it may seek certification from the CDFI Fund as a CDE. A CDE is an entity that serves, or provides investment capital for, low-income communities or people. Entities certified as CDEs may apply for an allocation

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2 See § 45D(a).
3 § 45D(b)(1)(C). The CDFI Fund is a division of Treasury Department. It’s “mission is to expand the capacity of financial institutions to provide credit, capital, and financial services to underserved populations and communities in the United States.” CDFI Fund, About the CDFI Fund, http://www.cdfifund.gov/who_we_are/about_us.asp (last visited August 20, 2009). The CDFI Fund is charged with the duties of certifying entities as CDE and allocating the NMTC to those certified CDEs. Since the inception of the NMTC, the CDFI fund has allocated $21 billion in available NMTCs and will allocate another $5 billion before the end of 2009.
4 § 45D(b)(1).
of the NMTC from the CDFI Fund and will serve a central role in any NMTC transaction for which its allocated NMTCs are designated. Alternatively, a tax-exempt organization may serve in the role of leverage lender in a NMTC transaction. The leverage lender, by providing debt financing to be combined with an investor’s equity financing, will allow an investor to increase the amount of tax credits it receives in exchange for its equity investment. Finally, a tax-exempt entity may act as a qualified active low-income community business (“QALICB”). A QALICB is the entity that actually engages in the development, business, or charitable activity in the distressed community.

For example, a university may use the NMTCs to develop a law school facility in a highly distressed community. The university would receive “gap” financing that has passed through the NMTC structure, resulting in funds received from an investor and leverage lender that are contributed as an equity investment in a CDE, which passes substantially all of the funds it receives to the QALICB university. The university would use the funds it receives to build its law school building and operate the law school over a seven-year compliance period. During that period, the investor will benefit from the tax credits to offset the tax it would otherwise owe on its taxable income. At the end of the seven years, the transaction would typically unwind, allowing the investor and the CDE to exit the NMTC structure with the use of a put/call technique, liquidating the investment fund, and repaying the leverage loan. The university would then be left with its new law school.

**The CDFI Fund – Step One**

The CDFI Fund allocates NMTCs to CDEs through a competitive application process. For each round (year) in which NMTCs are available for allocation, the CDFI Fund issues a Notice of Allocation Availability (“NOAA”), which provides specific guidance on how a CDE may apply to receive an allocation of the NMTC. In order for an NMTC allocation application to be considered, the applicant either (1) must be certified as a CDE at the time of the application or (2) have applied to the CDFI Fund for certification by a particular date, set forth in the NOAA, that is prior to the allocation application deadline. The CDE application deadline typically is in March, while the allocation application deadline usually occurs in early April. The
CDFI Fund reviews the allocation applications and scores each applicant in each of four areas (up to 25 points per area). An applicant CDE will receive a more favorable score on the “Community Impact” portion of the allocation application if it commits to providing at least 75 percent of its QLICIs in “highly distressed” areas. Such areas include census tracts with (1) poverty rates in excess of 30 percent, (2) median family income that does not exceed 60 percent of statewide median family income or the metropolitan area median family income, whichever is applicable, or (3) unemployment rates at least one and a half times the national average.

The allocation application is reviewed primarily in two phases. First, three reviewers independently evaluate each application in the four areas, scoring each area as weak, limited, average, good, or excellent. Additionally, the reviewers rate the applications in the two areas for which the additional five priority points are available. In the second phase of the review, an Allocation Recommendation Panel from the staff of the CDFI Fund reviews the results of from the first phase. For an organization’s application to be considered for an allocation at this point, the application must have received an aggregate score that was at least in the “good” range (i.e.,

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5 The four areas are: business strategy (25 points), community impact (25 points), management capacity (25 points), and capitalization strategy (25 points). An additional ten “priority points” may be awarded for prior experience in providing capital or technical assistance to disadvantaged business communities (5 points), and a commitment to investing in businesses with owners unrelated to the applicant (5 points). See, CDFI Fund, NMTC Program 2009 Allocation Application, http://www.cdfifund.gov/docs/nmtc/2009/2009%20NMTC%20Allocation%20Application.pdf (last visited August 28, 2009)

6 Areas with at least two of the following criteria are also considered to be highly distressed: (1) poverty rates greater than 25 percent, or median family income that does not exceed 70 percent of the applicable statewide or metropolitan area median family income, or unemployment rates of at least 1.25 times the national average; (2) federally designated Empowerment Zones, Enterprise Communities, or Renewal Communities; (3) SBA-designated HUB Zones to the extent QLICIs will support businesses with such certification; (4) brownfields sites; (5) areas encompassed by a HOPE VI redevelopment plan; (6) federally designated native areas; (7) areas designated as distressed by the Appalachian Regional Commission or Delta Regional Authority; (8) colonias areas, (9) federally designated medically underserved areas, to the extent QLICIs will result in the support of health-related services; (10) projects serving “Targeted Populations” as defined in Treasury regulations; (11) high-migration rural counties; (12) state Enterprise zone programs or similar programs targeted toward economically distressed communities; (13) non-metropolitan counties; (14) FEMA disaster areas; and (15) businesses certified by the Department of Commerce as eligible for assistance under the Trade Adjustment Assistance for Firms Program. See NMTC Program 2009 Allocation Application, Question 27.

7 Each category represents a five-point range. For example a weak score is zero to five points, a good score is between sixteen and twenty points. CDFI Fund, 2008 New Markets Tax Credit Program Allocations, http://www.cdfifund.gov/docs/2008/nmtc/2008CompleteAwardBook(All%20Documents).pdf, at 22, (last visited August 28, 2009).

8 Id.

9 Id.
a minimum of 192 total points) and must also achieve a minimum score of good in each of the four application areas (i.e., a minimum of 48 points in each area). In 2008, 40% of non-profit applicants received allocations. Non-profit organizations or subsidiaries of non-profit organizations received $1.92 billion in tax credit allocations, representing 57% of all allocates in 2008.

A CDE that scores high enough in the competitive allocation application process and is awarded an NMTC allocation must ensure that it is, at all times, in compliance with the NMTC program, according to the allocation agreement that the CDE must enter into with the CDFI Fund. First, the CDE has five years from the date on which it executes the allocation agreement with the CDFI Fund to enter into QEIs with investors that total the amount of allocation awarded to the CDE. The CDE also has 12 months from the date it receives a QEI to use that QEI to make one or more QLICIs. Additionally, the CDE must provide information to the CDFI Fund, on an annual basis, in order to demonstrate its compliance with the Code, the regulations, and the requirements of the allocation agreement. Finally, the CDE must ensure that no event occurs during the seven-year period beginning on the date of the original issue of the QEI (the “compliance period”) that would cause the NMTC to be recaptured. Such recapture events include the CDE’s ceasing to be a qualified CDE, the failure of the CDE to use substantially all of the investment proceeds in one or more QLICIs, or the redemption of the investment in the QALICB by the CDE. If a recapture event occurs, the investor will retroactively lose all of the credits previously claimed under the NMTC and will owe interest on that amount.

**NMTC Structuring**

The basic structure of an unleveraged NMTC transaction involves an investor, such as a national bank, that makes a QEI in a certified CDE with an NMTC allocation. The CDE then uses substantially all of the QEI to make a QLICI in a specified manner. A QLICI includes “any
capital or equity investment in, or loan to, any [QALICB].” In general, a QALICB includes any corporation -- including a nonprofit corporation -- partnership, or limited liability company (“LLC”) provided that, with respect to any tax year, (1) 50 percent or more of the total gross income of the entity derives from the active conduct of a qualified business within any low-income community, (2) at least 40 percent of the entity’s tangible property, owned or leased, is used within any low-income community, (3) at least 40 percent of the services performed by the entity’s employees are performed within any low-income community, and (4) “less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to” either nonqualified financial property or collectibles, other than collectibles held primarily for sale to customers in the ordinary course of the business.15

A qualified business is generally any trade or business, not including “the development or holding of intangibles for sale or license,”16 certain “sin businesses”17 and farming.18 Finally, the rental to others of real property is a qualified business only if it is located in a low-income community.19

14 § 45D(d)(1)(A). A CDE may also use substantially all of the QEI to (i) purchase a QLICI loan from another CDE, (2) provide financial counseling and other services to businesses and residents of low-income communities, or (3) make an equity investment in, or loan to, another CDE. § 45D(d)(1).

15 § 45D(d)(2). Collectibles for purposes of the QALICB rules are those defined in § 408(m)(2), and nonqualified financial property has the meaning ascribed to that term in § 1397C(e).

16 See § 45D(d)(3); Reg. § 1.45D-1(d)(5)(iii)(A).

17 “Sin businesses” include operating any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store with the principal business of selling alcoholic beverages for consumption off premises. See § 45D(d)(3); Reg. § 1.45D-1(d)(5)(iii)(B). A QALICB engaged in the rental of real property must also preclude its tenants from operating these sin businesses, so the leases executed by such a QALICB and its tenants must include a provision that prohibits the tenant from engaging in such businesses. See Reg. § 1.45D-1(d)(5)(ii).

18 Farming is an excluded business for purposes of the NMTC if the sum of the aggregate unadjusted bases of assets owned by the taxpayer and used in the business, and the aggregate value of assets leased by the taxpayer and used in the business, exceed $500,000. See § 45D(d)(3); Reg. § 1.45D-1(d)(5)(iii)(C).
community, the property is not residential rental property,\textsuperscript{19} and there are substantial improvements located on the property.\textsuperscript{20}

The NMTC Allocation Agreement that a CDE receiving an allocation of NMTCs will be required to sign places certain restrictions on the CDEs. Those restrictions include prohibiting the CDE from using the proceeds of its QEIs to make loans to or investments in QALICBs with the principal business activity of renting real property unless such proceeds are primarily used for certain purposes. Those purposes include, \textit{inter alia}, “costs in connection with the substantial rehabilitation of such property” or “costs in connection with the acquisition and substantial rehabilitation of such property.”\textsuperscript{21}

In order to meet the substantial rehabilitation threshold, a CDE must show that the cost basis (as defined in 26 USC Section 1012) of any improvements incurred during the 24-month period following the QLICI equals or exceeds 25 percent of the adjusted basis (as defined in 26 USC Section 1011(a)) of the building upon which the improvements are located. This ratio will be assessed as of the first day of the 24-month period. In the case of a QLICI being used to provide “take-out” financing (as permitted under Section 3.3(h) of the allocation agreement), improvements equaling or exceeding 25 percent of the adjusted basis of the

\textsuperscript{19} Residential rental property is “any building or structure if 80 percent or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units.” § 168(e)(2)(A). Thus, as long as twenty percent or more of the gross receipts from the operation of the building derive from income other than rents from living accommodations, the entire operation of the building will constitute a qualified business for purposes of the NMTC if the other conditions are met. The IRS recently issued a private letter ruling in which three buildings were treated as a single building for purposes of determining whether it was residential rental property under § 168(e)(2). The buildings were on the same or contiguous parcels of land and were operated as a single aggregated unit based upon the actual operation, management, financing and accounting for the buildings. PLR 121674-09 (not yet released).

\textsuperscript{20} See § 45D(d)(3); Reg. § 1.45D-1(d)(5)(ii).

building upon which the improvements are located must have occurred within the 24 months prior to the QLICI being made.\textsuperscript{22}

At a minimum, a QALICB must also be located in a low-income community.\textsuperscript{23} Generally, a low-income community is a population census tract with either a poverty rate of 20\% or more, or median family income of 80\% percent or less of either the statewide or metropolitan area median family income, whichever is applicable.\textsuperscript{24} Additionally, certain targeted populations may be treated as low-income communities\textsuperscript{25} under Treasury regulations, and special rules apply for (1) areas not within a census tract,(2) tracts with low-populations, and (3) tracts with high migration rural counties.\textsuperscript{26} Many CDEs prefer to fund projects located in “highly distressed” communities, however, because their allocation applications are scored more favorably for committing to providing at least 75\% percent of their QLICIs in areas that are classified as “highly distressed” and they must agree to do so as a term of their allocation agreement with the CDFI Fund.\textsuperscript{27}

\textbf{Leveraging the NMTC}

To make the NMTC even more attractive to potential investors, a leveraged structure may be used. In such a structure, the NMTC investor typically will form a single-member LLC (the “Fund”), funding it with the investor’s equity in the NMTC transaction. The new Fund then borrows additional funds from an unrelated third-party lender, referred to as the leverage lender, typically on a nonrecourse basis.\textsuperscript{28} The Fund uses the combined equity investment and loan funds to make the QEI in the CDE. This structure permits the investor to receive NMTCs based

\textsuperscript{23} See \textsection 45D(d)(2); Reg. \textsection 1.45D-1(d)(4)(i).
\textsuperscript{24} \textsection 45D(e)(1). For census tracts not located within metropolitan areas, the statewide median family income is the appropriate comparable. For census tracts located within a metropolitan area, the greater of statewide or metropolitan area median family income is used. \textsl{Id}.
\textsuperscript{25} \textsection 45D(e)(2); \textit{See also} Prop. Reg. \textsection 1.45D-1(d)(9), proposing that low-income persons (i.e., individuals with incomes of 80\% percent or less of median family income), and individuals lacking adequate access to loans or equity investments (i.e., those displaced or who lost their principle employment as a result of the Hurricane Katrina) be treated as “targeted populations” for purposes of the NMTC.
\textsuperscript{26} \textit{See} \textsection 45D(e).
\textsuperscript{27} NMTC Program 2009 Allocation Application, Question 27(b).
\textsuperscript{28} The nonrecourse loan may not be secured by the assets of the QLICI investments.
on an amount in excess of its actual equity investment and has been approved by the IRS. For example, if the investor’s equity investment in the LLC is $5 million, and the LLC borrows another $15 million, the QEI will be $20 million, and will generate a $7.8 million credit to the investor over the 7-year compliance period.

The NMTC investor will want to obtain a tax opinion that examines the federal tax treatment of the leverage loan. The tax opinion is typically required by the tax credit investor. The loan terms will need to be examined to ensure that the leverage loan is true debt, expected to be repaid, and not an equity contribution by the tax-exempt entity. Therefore, although the nonprofit leverage lender subsequently may decide to forgive the leverage loan after the seven-year compliance period, it may not make any promises to do so, or give any indication of such an intention, in advance of the conclusion of the compliance period.

Although the leverage lender provides the additional financing to entice many investors to enter a NMTC transaction, and expects that its loan will be repaid, the leverage lender has little control over the CDE or QALICB’s operations during the seven years over which the investor benefits from the NMTCs. The leverage lender may take a security interest in the Fund borrower’s assets, but typically will be required to forbear from exercising any remedies during the seven-year NMTC compliance period. Therefore, the leverage lender must contend with a troubled QLICI loan indirectly and is subject to the “control” requirements of the CDE. In order to alleviate the relatively passive position to which a leverage lender is confined, it may require that the leverage loan documents constrain the ability of the investment funds borrower to approve CDE determinations with respect to QLICI loans without the leverage lender’s consent. Additionally, the leverage lender will also want to include language in the CDE’s operating agreement requiring the CDE to act responsibly in enforcing the QLICI loan documents subject to rules regarding “control” by CDEs originally allocated NMTCs over any sub-allocatees.

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29 See Rev. Rul. 2003-20, 2003-1 C.B. 465 (“[T]he amount of the qualified equity investment made by an LLC classified as a partnership includes cash from a nonrecourse loan to the LLC that the LLC invests as equity in a qualified community development entity.”)
30 CDEs receiving allocations of the NMTC may transfer all or a portion of their allocation authority to sub-allocatees, provided that each sub-allocatee is a qualified CDE, was included as a party to an allocation agreement, and is “controlled” by the allocatee at all times throughout the term of the allocation agreement. Control means
A charitable organization acting as the leverage lender in a NMTC transaction also must be aware of additional special issues that may arise related to such a role. First, the charity must ensure that the funds invested in the CDE are redirected in a manner consistent with the leverage lender’s charitable purpose and community benefit. The charitable leverage lender typically addresses this issue by obtaining an opinion of counsel delivered at the initial closing of the transaction. The opinion will need to be issued with respect to Section 170(c) and conclude that the funds invested in the CDE as part of the NMTC transaction will be used in a manner consistent with the tax-exempt organization’s charitable purpose. However, a project’s location in a qualified census tract, or even a highly distressed census tract, does not necessarily mean that the project will meet the charitable purpose requirements of Section 170. The census tracts are geographically-determined areas based upon the most recent decennial census and a charitable organization must ensure that the activities, not merely the location, related to a particular project are consistent with the purpose for which it received tax-exempt status.

Additionally, a charity often will create a supporting organization under Section 509(a)(3) to engage in the NMTC transaction, which may require the filing of a Form 1023. A new charitable organization that indicates it will participate in NMTC transactions typically causes the 1023 reviewer at the IRS to ask many questions. The charity will likely need to educate the reviewer regarding the NMTC because the Exempt Organizations division of the IRS is separate and unrelated to that part of the IRS charged with administering Section 45D.31

A charitable leverage lender also must engage in advanced negotiation regarding another set of special issues. That lender will want to establish a mechanism allowing it to take “control” if there are problems at the project/QALICB level and funds are redirected to the CDE. To avoid a recapture event that would cause the investor to lose all of its NMTCs, the CDE must maintain a continuous investment of substantially all of the QEI proceeds in a QLICI throughout the

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31 It has been this author’s experience that the Exempt Organizations division of the IRS is not fully educated about the NMTC program.
seven-year compliance period.\textsuperscript{32} In the event the CDE receives repayment of capital, equity, or principal on a QLICI investment, the CDE has one year to recommit the funds to a new QLICI.\textsuperscript{33} The leverage lender should negotiate, in advance, the right to remove the managing member of the CDE (subject to the control rules regarding sub-allocatees mentioned above) if such repayment of the QLICI were to occur under certain circumstances, so that it may redirect the funds to a new QLICI that furthers the leverage lender’s exempt purposes. In this regard, the leverage lender should propose the criteria it will require if QLICI funds need to be reinvested as a result of premature repayment, so that the terms of new QLICI will be consistent with the exempt organization’s charitable purposes. For example, the charity originally may have made the loan because of its interest in a distinct service area (e.g., New York City). In that case, the charity will not want the funds redirected to another geographic area (e.g., Newark).

Finally, the board of directors of a tax-exempt organization often will need to be educated regarding all of these NMTC structural issues. The board will first need to understand how the NMTC transaction operates and the subsidies that are generated as a result. Then it will need to understand how the tax-exempt organization’s role in the transaction furthers it tax-exempt purpose. Before the board approves the execution of the documents by the tax-exempt entity, it will need to ensure that the tax-exempt leverage lender has negotiated rights for itself regarding removal of the CDE’s managing member (subject to the control requirements under a sub-allocation of the NMTCs) in the event of problems with the QLICI loans and criteria for reinvestment of any prepaid QLICI proceeds. Finally, the board of the tax-exempt organization should understand that the CDE and/or the QALICB typically will need to provide a NMTC indemnification or guaranty, in the event the transaction violates the NMTC rules during the compliance period resulting in recapture of the NMTCs.

\textsuperscript{32} See Reg. § 1.45D-1(c)(5)(i).
\textsuperscript{33} Reg. § 1.45D-1(d)(2)(i). In addition, Reg. § 1.45D-1(d)(2)iii) contains a special rule for loans providing that “[p]eriodic amounts received during a calendar year as repayment of principal on a loan that is [QLICI] are treated as continuously invested in a [QLICI] if the amounts are reinvested in another [QLICI] by the end of the following calendar year.”
Exiting the Transaction

At the end of the seven-year compliance period, when the investor has received all of the NMTCs for which it is eligible, the investor, along with the CDE, will likely want to unwind the transaction and exit the structure.

This is typically accomplished through the use of a “put/call” technique that generates a subsidy or grant equivalent to the QALICB.

Under one version of this technique, the investor has the right to require the QALICB, over a specified period, to purchase the investor’s interest in the Fund for a specified price (the “put”).

In the event the put is not exercised, the QALICB (or an affiliate) has the right to purchase the investor’s interest in the Fund over a specified period for fair market value (the “call”).

The put and the call will likely be priced substantially less than the investor’s original investment in the Fund.

If either the put or the call are exercised, the investor would be removed from the structure. An affiliate of the QALICB typically would be substituted in place of the investor, thereby controlling the Fund, and would take steps to redeem the managing member of the CDE. The result here is a net benefit to the project measured by the amount of the investor’s original funds less professional and administrative costs and the price of the put/call.

After the investor is removed, the QALICB may then cause the Fund to liquidate the CDE, often using the QLICI note previously held by the CDE to repay the leverage lender, and subsequently liquidate the Fund, leaving the QALICB on its own and the leverage lender holding the QLICI note. In the event that the leverage lender is controlled by a Section 501(c)(3) entity or is itself a charity, it may decide to forgive the leverage loan at the end of the compliance period. Alternatively, the QALICB may also “refinance” the property and use the funds it receives to repay to the CDE the QLICI note that mirrors the leverage loan, but not the QLICI
note that reflects the investor’s equity. The CDE will then use the funds received from the QALICB to repay the leverage lender.

**Application to Nonprofits and Charitable Projects**

As previously indicated, organizations exempt under Section 501(c)(3), consistent with their charitable purpose, may play various roles in a NMTC transaction. The role may be that of the CDE, the local developer or QALICB, and potentially even the leverage lender.

**As CDE.** A CDE is defined as “any domestic corporation or partnership” provided that (1) its “primary mission … is serving, or providing investment capital for, low-income communities or low-income persons,” (2) it is accountable to residents of low-income communities, and (3) it is certified by the CDFI Fund as a CDE. An organization exempt from tax under Section 501(c)(3), or a for-profit subsidiary of such an organization, could obtain certification as a CDE and apply directly to the CDFI Fund for an allocation of NMTCs. For example, for-profit subsidiaries of Enterprise Community Partners, Inc, a Section 501(c)(3) organization, have already received more than $600 million in NMTC allocations since the inception of the program. In the CDE role, the exempt organization will be able to direct its allocation to projects that meet its charitable goals. For example, an educational organization with NMTC allocations could use those allocations to fund projects to build a charter school or expand the campus of a university. A non-profit hospital with NMTC allocations could structure a NMTC transaction to construct and operate an ambulatory surgical center. Finally, as a CDE, the tax-exempt organization will have responsibility for compliance with the CDFI Fund requirements in connection with any allocation received.

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34 Accountability is maintained through representation of residents of low-income communities on any governing or advisory board of the CDE. § 45D(c)(1)(B). To be deemed representative of a low-income community the CDE’s board members must either reside in a low-income community within the CDE’s designated service area or otherwise represent the interests of residents in such low-income communities. See CDFI Fund, New Market Tax Credit CDE Certification, Question & Answer,” questions 19-27, available at http://www.cdfifund.gov/docs/certification/CDE/CDEcertificationFAQs.pdf (last visited August 25, 2009). When an eligible entity applies for certification as a CDE, it is required to designate a service area for its investments. The potential areas are local (e.g., county), statewide, multi-state, and national.

35 § 45D(c)(1). As of August 1, 2009, the CDFI Fund had certified 3,848 CDEs. See CDFI Fund, Certified Community Development Entities (with Subsidiaries) – Alphabetical by Organization, http://www.cdfifund.gov/docs/certification/cde/CDEsbyOrgName.pdf (last visited August 25, 2009).
As QALICB. A tax-exempt organization may itself be a local developer or QALICB. In this role, the organization may engage in the “business” or development of the project that receives the QLICI. Tax-exempt organizations often engage in this role using the “portions of the business” rules for QALICBs. This rule states that the definition of QALICB includes “any trades or businesses which would qualify as a [QALICB] if such trades or businesses were separately incorporated.”36 In other words, a QALICB may be a portion of an entity’s trade or business, provided that such portion, when viewed as a separate entity, meets the general requirements to be a QALICB, discussed above (e.g., the requirements regarding gross income, use of the tangible property, services performed, collectibles, and nonqualified financial property), and maintains separate books and records.37 An example of a hypothetical exempt organization in the role of QALICB would be Little Sisters and Brothers, an organization mentoring youth in the Bronx, receiving a QLICI from a CDE to build a new facility from which to operate its mentoring programs. Other examples include educational organizations receiving and using QLICIs to build and operate a charter school or a medical organization using such funds to build and operate an urgent care clinic.

Again, the tax-exempt organization will have compliance responsibilities if it is in the role of a QALICB. These responsibilities include ensuring that certain recapture events do not occur -- in particular, that the principal of the QLICI note (or the QLICI equity) is not prematurely repaid. For example, if the QLICI is a loan, interest-only payments may be made during the seven-year compliance period, but not payments of principal. If a recapture event occurs, the primary consequence is to the investor, who will not only forgo any future tax credits not already claimed, but will be required to repay, with interest, any tax credits already used. For this reason, the investor will require the QALICB to provide a guaranty and indemnify the investor against any events of recapture over which the QALICB has control. The indemnification/guaranty often exceeds the net benefit to the QALICB, and this needs to be understood by the board of the tax-exempt organization before it approves the transaction.

36 § 45D(d)(2)(C); see also Reg. § 1.45D-1(d)(4)(iii).
37 See Reg. § 1.45D-1(d)(4)(iii).
As leverage lender. A third potential role for a tax-exempt organization is to act as the leverage lender. The tax-exempt organization may use charitable pledges and/or government funding to make a leveraged loan (typically through an affiliate). The non-recourse loan proceeds are used to provide leverage to the investor’s equity contribution and increase the NMTCs available to the investor. The loan proceeds, combined with the investor’s equity investment in the Fund, are contributed to the CDE in an equity investment, and are ultimately passed to the QALICB as a QLICI and used in a project that is in furtherance of the tax-exempt organization’s charitable purpose, such as the building of a healthcare facility, operation of a school, or the development of a community center. As a leverage lender, the charity’s funds are repaid after seven years, plus interest, which could then be used for another project (assuming the charity does not choose, after the end of the compliance period, to forgive some or all of the loan, if doing so is in furtherance of its exempt purposes).

In all roles. Before entering into a NMTC transaction, a tax-exempt organization must consider whether the parameters of its exemption will permit it to do so. The ability of a tax-exempt entity to engage in a NMTC transaction depends on its exempt function and the role it will play in the transaction. A Section 501(c)(3) organization likely has a significant amount of flexibility under the Code that allows it to be engaged in a number of potential roles in a NMTC transaction. The charitable organization may be able to provide financing to a project that furthers its charitable purposes through the use of the NMTC. At the other end of the spectrum, the charitable organization may develop a project with a charitable purpose that benefits from the financing available from the NMTC.

Other tax-exempt organizations may have less flexibility, however. A title-holding company (Section 501(c)(2) or Section 501(c)(25)), for example, is an unlikely candidate for participation in a NMTC transaction because such organizations are limited to holding title to property, collecting the income from that property, and distributing that income (less expenses) to the organization’s shareholders. The limitations on such organizations would prevent them from acting as the leverage lender because making and servicing loans are not permissible activities. Furthermore, such organizations could not be the CDE, because the CDE must apply for an allocation of credits, receive the QEI, make the QLICI, and monitor compliance with the
allocation agreement. Such activities are not contemplated within the limitations on title holding companies.

A title-holding company may, however, potentially participate in a NMTC transaction as a subsidiary of a Section 501(c)(3) QALICB engaged in a commercial real estate development and rental activities. Subsequent to its development, the property could be transferred to the title-holding company, which would collect the rents from the tenants and distribute those rents to the title holding company’s Section 501(c)(3) parent. The title-holding company may not engage in any of the development activities or receive any fees for such activities. Such activities are outside the scope of the title-holding company’s tax exemption.

Examples

Below are some examples of NMTC transactions involving tax-exempt entities. These entities served in various roles in these transactions including leverage lender, QALICB, end user of the development project, or as affiliated entity of one or more of the other parties to the transaction. To reiterate, the use of the NMTC in these transactions provides gap financing or substantial subsidies to developments in low-income or highly distressed communities. A for-profit investor is attracted to these projects because it can receive tax credits to offset its tax on other income. With the use of leverage, those credits may exceed its equity contribution. The investor therefore may not need to be repaid its equity investment because, by the end of the compliance period, it will have already received an after-tax return on its investment in excess of its original investment in the form of tax credits.

Charter School. A tax-exempt organization, solely owned by a Section 501(c)(3) organization, served as the QALICB in a NMTC transaction, used the funds it received from a CDE to build a charter school in a highly distressed neighborhood of a major metropolitan area. A governmental entity leased the land on which the school was built to the QALICB under a long-term lease. The QALICB leased the completed building to two educational charities, who, in turn, subleased the building to the charter schools themselves. Another tax-exempt organization acted as the leverage lender in this transaction, loaning in excess of $50 million to a fund owned solely by the NMTC for-profit investor, a national bank. The loan, combined with
the equity investment in the fund by the investor, was then used to make a $75 million QEI in a qualified CDE, which generated $29.25 million in tax credits to the investor over the next seven years.

**University.** An affiliate of a state university used the NMTC to finance the development and construction of its new business school building. An affiliate of the university served as leverage lender, as well as the managing member of the QALICB development entity in this $45 million transaction, in which a state government appropriation was used to fund the affiliated leverage lender.

**Community center.** A Section 501(c)(3) charity used funds received as a QLICI loan to finance the redevelopment, renovation and operation of buildings in a major metropolitan area, a portion of which will be operated as a family and community center. A portion of the QLICI funds will also be used to fund the charitable operations of that center. The QEI in this transaction was $24 million, which generated $9.36 million in NMTCs to the investor, for an equity contribution in excess of $7 million. The fixed price for the put that will be available to the QALICB at the end of the compliance period is $1,000, which means that over $7 million of additional financing subsidized this project.

**Conclusion**

Although the NMTC structure itself appears to be useful only to entities that pay tax, tax-exempt organizations have many opportunities to benefit from transactions structured to take advantage of the NMTC as a “grant equivalent.” A tax-exempt organization with substantial funds may use those funds, in the form of a loan, to leverage up a for-profit investor’s equity financing to further the charity’s tax-exempt goals. The investor generates a positive after-tax return on its investment in the form of reduced taxes, while the tax-exempt entity’s mission receives a substantial financial boost, allowing projects to be completed with equity funds, very little of which need to be repaid. Additionally, tax-exempt organizations, strapped for cash in these economically distressed times, may receive critical funds to further advance their charitable missions. There are many opportunities for tax-exempt organizations in the NMTC program as a
community development entity, a leverage lender, or as a developer of the project, and these opportunities are worth exploring.