

PRACTICAL ISSUES FACING NONPROFITS STRUCTURING NEW MARKET TAX CREDIT DEALS

The growth of the NMTC program is a prime example of an important joint venture structure that blends social need and tax-based incentives.

Author: MICHAEL I. SANDERS

*MICHAEL I. SANDERS is a partner in the Tax, Benefits and Private Client group of the Washington, DC tax department of Blank Rome LLP. The author would like to express his appreciation to Dustin Lauermann for his research contribution towards this article. Portions of this article have been excerpted from Sanders, *Joint Ventures Involving Tax-Exempt Organizations* (John Wiley & Sons, Inc., © 2107).*

Since the Great Recession, nonprofits have been receiving less support from budget-constrained governmental agencies and fewer contributions from the private sector.¹ Similarly, many state and other nonprofit universities have seen their budgets drastically reduced.² Funding is not likely to increase under the Trump administration.³ As a result, charities need to develop new avenues, structures, and partners to conduct their programs. In some cases, charities have joined forces to accomplish fundraising or program related goals by forging partnerships and other co-investment relationships with for-profit entities to access otherwise unavailable capabilities, capital, and resources.

Over the years, the position taken by the IRS has evolved. Opposition to joint ventures between nonprofits and for-profit entities has given way to acknowledgement of the various bona fide purposes of such arrangements and the establishment of guidelines for nonprofits to protect their exempt status while engaged in such partnerships.⁴ Pursuant to these guidelines, nonprofits will not jeopardize their exemption by participating in a joint venture so long as they have sufficient control to ensure that the venture will further the nonprofit's exempt purposes and there will be no impermissible private benefit or inurement.⁵ Although there is no bright-line test, the nonprofit partner having at least 50% voting control of a venture in regard to matters that relate to its charitable goals is a positive factor.⁶ The IRS will examine all of the facts and circumstances to make a determination as to whether the joint venture is permissible, and will not issue advance rulings in this area.⁷ Thus, a nonprofit intending to participate in joint ventures must

disclose such planned or potential activity on its exemption application.⁸ It is therefore important to have a joint venture policy in place and to carefully structure ventures pursuant to these guidelines.⁹

One of the leading examples of the application of the joint venture structure is the success of the New Markets Tax Credit (NMTC) program, in which for-profit investors subsidize development in qualified census tracts (QCT)-i.e., distressed communities with high poverty and unemployment-in order to generate economic growth and opportunity. Such projects can include:

- Food, grade, recycled containers and processing facilities.
- Charter schools/parochial schools.
- Food banks.
- Biomedical office parks.
- Medical school campus.
- Mixed-use housing and office spaces.
- Manufacturing facilities.
- Lumber mill and logging company.

To date, the Community Development Financial Institutions Fund ("CDFI Fund") has made 1,032 awards totaling \$50.5 billion in allocation authority.¹⁰ In calendar year rounds 2002-2016, the CDFI Fund received 3,481 applications for allocations of NMTCs.¹¹ These entities collectively requested nearly \$313.8 billion in allocation authority.¹² As of January 2017, over \$43.5 billion in qualified equity investments (QEIs) have been made into Community Development Entities (CDEs) since the NMTC Program's inception.¹³ Through January 2017, CDEs disbursed a total of \$42.8 billion in QEI proceeds to over 4,224 Qualified Active Low-Income Community Businesses (QALICBs).¹⁴

The growth of the NMTC program is a prime example of an important joint venture structure that blends social need and tax-based incentives. It may consist of community-based nonprofits and for-profit organizations that establish ventures, businesses, and commercial development in low-income census tracts. Creating the vehicle in today's environment, however, is a challenge.

The NMTC program gives a nonprofit the opportunity to subsidize or provide "gap" financing for developments in a qualified census tract. In return, there are financial benefits to developers, businesses, and charities-a 39% tax credit on the capital invested in a CDE. Major investors, such as commercial and investment banks, invest in a leveraged structure by making a cash infusion to the development, which may not be paid back at the end of the seven-year compliance period. In the event of an exercise of a

"put/call" under the leveraged structure, the investor may receive a 5%-10% after-tax return on its investment.

In November 2016, the CDFI Fund announced its \$7 billion allocation for the combined calendar year (CY) 2015 and 2016 rounds of the NMTC program.¹⁵ There were 120 CDE allocatees headquartered in 34 states, Washington, D.C., and Puerto Rico that will invest \$1.271 billion in rural areas and another \$5.729 billion in major and minor urban areas.¹⁶ The 2017 application was opened this Spring, published on the CDFI Fund website, and was due on or before June 21, 2017 in electronic form.

Although a nonprofit may participate in a NMTC transaction in numerous ways, including as a CDE or leverage lender, the balance of this article assumes that its role will be solely that of a QALICB, the ultimate beneficiary of the loan or equity proceeds that will be invested in the low-income community.

The CDFI Fund issued a series of New Markets Tax Credit Compliance and Monitoring Frequently Asked Questions ("FAQs") by adding, revising, or updating select questions, including a revised condition of eligibility beginning in the 2015 Allocation Round.¹⁷ It is important to note that the applicant will not be permitted the use of the proceeds of QEIs to make Qualified Low-Income Community Investments (QLICs) in QALICBs where QLICI proceeds are used to repay or refinance any debt or equity provider (or a party related to any debt or equity provider) whose capital was used to fund the QEI, except in limited circumstances.¹⁸ Those circumstances require that (1) the QLICI proceeds are used to repay documented reasonable expenditures that are directly attributable to the qualified business of the QALICB, and that such past expenditures were incurred no more than 24 months prior to the QLICI closing date; or (2) no more than 5% of the QLICI proceeds are used to repay or refinance prior investment in the QALICB. Refinancing for this purpose includes transferring cash or property directly to any debt or equity provider or indirectly to a party related to any debt or equity provider.

Reasonable expenditures are those made for legitimate business expenses that occur in the normal course of the business' operation and that are similar in amount and scope to the expenditures that would occur by a similarly situated entity on a similar project.¹⁹ Refinance includes transferring cash or property directly or indirectly to the debt or equity provider (or affiliate thereof.) The QALICB may use QLICI proceeds to repay or refinance expenditures to such parties for the acquisition of any asset contributed, sold or otherwise transferred to the QALICB to the extent such asset represents a reasonable expenditure directly attributable to the qualified business of the QALICB. However, the amount that can be repaid or refinanced for such an asset is limited to the asset's original cost and not to any accreted value obtained by appraisal or other valuation methods. Such transactions remain subject to the 24 month rule or 5 percent

rule.^{19.1}

NMTCs have a long and rich history of being utilized in conjunction with the historic tax credit (HTC). As a result of this "twinning," the subsidy to the project would be increased. Based on experience in the marketplace, the net NMTC subsidy typically is 20%-25%; the HTC subsidy could add an additional 15%. Thus, twinning the two credits may provide up to a 40% subsidy. Although the structure can be complicated, a "side-by-side" NMTC/HTC structure is often used. To comply with the federal tax rules, however, it is important to examine the HTC guidance in [Rev. Proc. 2014-12](#)²⁰ and meet the safe harbor within a single tier or through a master lease pass-through structure. This guidance was issued in response to the Third Circuit's decision in the *Historic Boardwalk* case.²¹ In addition, the nonprofit needs to understand the potential impact of the temporary regulations on [Section 50\(d\)](#) income. There is also an opportunity to use EB-5 funds with NMTCs,²² although there has been limited success in doing so and the EB-5 program has its own foibles.²³

With regard to [Rev. Proc. 2014-12](#), it is important to note that the developer, master tenant, or principal of either may not lend any investor the funds to acquire any part of the investor's interest. Furthermore, no call options are allowed. Put options are acceptable but they may not exceed the fair market value of the investor's interest. It is important to examine the permissible guarantees under the revenue procedure as well as those that have been rejected. The investor must participate in the up-side and down-side of the partnership operations in the manner that is not limited to a preferred return. Moreover, the value of the investor's interest may not be reduced through fees, lease terms, or disproportionate rights to distributions or other arrangements. In effect, the terms must be reasonable in comparison to real estate development projects that do not qualify under [Section 47](#).

New Markets and nonprofits-Working with nonprofit boards

It is recommended that nonprofit counsel meet with the nonprofit's board in advance to discuss the following QALICB risks, *inter alia*:

Guaranty obligations if any, recapture risks, indemnification, etc.

In most transactions, the nonprofit needs to execute an indemnification agreement in the event there is a "recapture event."²⁴ In practice, the "recapture amount" will exceed the equity investment. It is standard that the nonprofit unconditionally agrees to pay, reimburse, exonerate, indemnify, and hold the investor

harmless against any loss, damage, liability, cost, or claim incurred by the investor as a result of the loss, recapture, disallowance, or inability to claim the tax credits. In addition to reimbursing the investor for the lost credits, the nonprofit must also make the investor whole by paying an additional sum that is generally equal to their rate of return that the investor would have received had the tax credits not been disallowed, lost, or recaptured. This is so even if the investor is a national bank with assets far in excess of that of the nonprofit.

Risk of nonexercise of put or call.

There is no assurance that the investor will exercise its put option at the end of the seven-year compliance period, although the practice has been to do so.²⁵ If the investor does not exercise its put option, the nonprofit QALICB must consider whether to purchase the investor's interest for fair market value-i.e., the call price.

After the investor is removed from the structure, through the exercise of either the put or the call, the nonprofit QALICB may then take steps to have the investment fund, which it now controls, liquidate the CDE. The QALICB will often use the QLICI note previously held by the CDE to repay the leverage lender or otherwise, refinance the debt to the extent of the A Note (which would be equal to the leverage loan). Following the exit after seven years, the structure would leave the QALICB as the unencumbered owner of the property or business with the leverage lender holding the QLICI note unless being paid in full upon the refinancing.

Net benefit of transaction.

The board should evaluate the "net benefit" of the structure before undertaking a NMTC financing. The net benefit to the project is measured by looking at the amount of the investor's original funds (contributed as equity) less fees, professional and administrative costs, and the price of the put/call.

In the event that the leverage lender is a charity or is controlled by another [Section 501\(c\)\(3\)](#) organization, it may decide to forgive all or a portion of the loan at the end of the compliance period. However, it must not be legally obligated to do so at inception or even intimate that it might do so during the compliance period. Such an obligation or intimation may trigger a recapture event because the loan would not be considered "true debt" which is a legal requirement to validate the NMTC structure.

Formation of new entities, such as SMLLCs as QALICBs.

A nonprofit may organize a QALICB as a single-member LLC to control the operations of the newly created "business" entity and insulate itself from liability that might arise in connection with the assets transferred or the activities conducted. It may also utilize a supporting organization under [Section 509\(a\)\(3\)](#), a subsidiary organization, or an LLC with a for-profit member as the QALICB. In such a case, it is important that the activities of the QALICB not be attributed to the nonprofit under the *Moline Properties* analysis; and be respected as a separate entity. Moreover, a charitable organization that indicates it will participate in a new market tax credit transaction through the use of a newly organized supporting organization will be required to file a Form 1023 with the IRS. It should be noted that the IRS exempt organization reviewer is likely to ask numerous questions about the NMTC program, since it is the experience of this author that the exempt organization division of the IRS is not fully educated about the NMTC program.

New partnership audit issues and the potential of private benefit.

In the context of joint ventures, it is important to review the new partnership audit rules enacted in the new Bipartisan Budget Act of 2015 ("BBA"),²⁶ which fundamentally changed the way in which partnership audits are conducted by replacing the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) rules with a centralized partnership audit regime. The purpose of the centralized partnership audit regime is to make it easier for the IRS to make adjustments to all items of income, gain, loss, deduction, or credit-i.e., to allow the IRS to collect revenue without Congress raising taxes. The new partnership audit rules are effective for partnership years beginning after 12/31/17, but partnerships may elect to have the new rules apply earlier. Additionally, certain partnerships may elect out of the new rules.

Under the new centralized partnership audit regime, each partnership is required to designate a partnership representative each year on the partnership's return. The partnership representative serves in a role similar to that of the tax matters partner under TEFRA in that the partnership representative has the sole authority to act on behalf of the partnership. There are two important differences between the tax matters partner and the partnership representative, however. First, whereas the tax matters partner must be a general partner and may be an individual or an entity, the partnership representative can be any person or entity, including a non-partner, so long as the partnership representative has a substantial presence in the United States. A substantial U.S. presence is required so that the partnership

representative is available to communicate with the IRS during an audit.

Second, whereas the tax matters partner has the authority to bind the partnership, it cannot bind other partners in the partnership. Unlike the tax matters partner, the partnership representative has the sole authority to bind both the partnership and the individual partners.

It is vital that a nonprofit member of a partnership select the appropriate partnership representative because the partnership representative is the only one entitled to participate in IRS proceedings involving the partnership; partners do not have a statutory right to notice of, or participate in, the partnership-level proceeding. For a nonprofit organization involved in a joint venture, LLC, or partnership, the partnership representative must be appointed to carry out the interests of the nonprofit. If the partnership representative is not appointed directly by the nonprofit organization, the nonprofit should have consent rights over partnership representative decisions and actions, so that it can ensure that its rights are protected. An ideal outcome would be for a nonprofit to designate one of its officers (e.g., its CEO or CFO) as the partnership representative in order to protect its rights on audit.

It should be noted that a partnership may elect out of the new rules if it meets the following criteria:

- All partners are individuals, estates of a deceased partner, S corporations, C corporations (or foreign entities taxed in the United States as a C corporation), including nonprofits organized as corporations.
- It is not required to issue more than 100 Schedule K-1s. (Note that if a partnership furnishes more K-1s than actually required by [Section 6031\(b\)](#), the additional K-1s are not taken into account when determining whether or not this criterion is met.)
- The election is made on a timely filed partnership return (including extensions) for that tax year.

If a partnership elects out of the new rules, it must notify each of its partners that it made the election within 30 days of doing so-i.e., within 30 days of submitting the tax return.

There are two important terms that are essential to understanding the new partnership audit rules-"reviewed year" and "adjustment year." The reviewed year is the year that is under audit. The adjustment year is the year in which the adjustments are taken into account by the partnership-i.e. when the audit or any judicial review of the audit is completed.

The default rule under the centralized partnership audit regime is that partnership adjustments (the

imputed underpayments) are made at the partnership level and the underpayment must be paid by the partnership. The partnership representative, however, may make a "push out" election-i.e., the partnership representative may elect to have the partners in the partnership for the reviewed year pay any tax and penalties due as a result of the imputed underpayment.

If the partnership representative does not so elect, a nonprofit organization may be required to pay its proportionate share of the tax and penalties on the imputed underpayment, even if it was not a partner in the reviewed year. It remains to be seen whether the nonprofit paying the tax and penalties relating to a current or departed partner constitutes an impermissible private benefit or private inurement. A nonprofit organization partner should ensure there are appropriate protections in the partnership agreement to prevent such private benefit or inurement from occurring.

Example. ABC LLC has ten partners in the 2016 tax year (the reviewed year). In 2017, an exempt organization joins ABC LLC while three partners withdraw. On 3/1/18, the IRS proposes a \$10,000 adjustment to ABC LLC's 2016 tax return. On 3/1/19, the partnership representative negotiates a settlement with the IRS. Unless the partnership representative makes the "push out" election, ABC LLC will be responsible for paying the net adjustment agreed to by the partnership representative in 2019, the effect of which is that the exempt organization will be responsible for paying a proportionate share of the adjustment relative to 2016 tax year, which will benefit for-profit members who have withdrawn.

Additionally, there are special rules for partnerships with nonprofit partners. A partnership may request modification of the imputed underpayment based on the tax-exempt status of one of its partners in the reviewed year. If the IRS approves the modification request, the imputed underpayment is calculated without regard to the portion that would be allocated to the tax-exempt partner. The IRS is unlikely to grant such a request if the imputed underpayment relates to unrelated business income tax (UBIT), which the tax-exempt partner would have been responsible for in the reviewed year.

Potential snares

Finally, the board of the charity needs to be educated by counsel with regard to possible "traps for the unwary" involving UBIT, advance agreement to forgive the leverage loan, the CDE fee structure, the allocation of COD income, and the use of a "straw party" as a party to the unwind.

- (1) There is a potential UBIT concern regarding the exit by the nonprofit charity, after the

seven-year compliance period expires, if the project is not "substantially related" to the exempt function of the organization (such as relief of the poor or underprivileged or relieving the burdens of the government).²⁷ The location in a QCT is not enough.

(2) It is critical that there be *no* agreement in advance that the leverage loan will be forgiven at end of the compliance period; otherwise, the basic structure of the NMTC may be defective.

(3) In most cases, there may be a need for multiple CDEs in order to direct their allocations to the project. It is important that the board of the nonprofit examine the proposed CDE fees, since the fees fluctuate and, in some certain cases, may be above-market.

(4) If the QALICB is structured as a LLC, with multiple parties or members-including a nonprofit-and taxed as a partnership, the operating agreement should contain specific language covering the allocation among the partners of the COD income, if any. It is important to define narrowly the section on "Refinancing Proceeds" relative to exercise of a put.

(5) A "straw party" should not be used by a QALICB to acquire the equity interest pursuant to the exercise of the put or call. The approach may backfire on the QALICB under the related party rules-i.e., direct or indirect acquisition of debt which could generate COD income for the taxpayer.

The future of the NMTC program

During 2017, given the likely attempt to enact tax reform legislation, there is obvious concern that the NMTC provisions may be repealed or significantly modified. Unlike the low-income housing tax credit and the historic tax credit, the NMTC is not permanently codified in the Code. Thus, some legislators may be tempted to propose eliminating the NMTC program to pay for other items, e.g., lowering corporate tax rates. However, since the PATH Act provided \$3.5 billion in annual allocation authority to the CDFI Fund through 2019,²⁸ it is unlikely that the program will be terminated prior to 2020 as part of tax reform.²⁹

Conclusion

There is no longer one paradigm for joint ventures. Creativity, flexibility, and unique approaches are flourishing as individuals and businesses forge new paths in an effort to address world problems through outside-the-box solutions. For the nonprofit seeking to expand its activities and income stream to support those activities, properly structured joint ventures provide unlimited potential.

The New Markets Tax Credit structure is a prime example of a new, successful, unique and innovative program that provides critical gap financing for businesses and developments in qualified census tracts. It

is often twinned with the historic tax credit to provide up to a 40% subsidy to the project. But it is not without challenges that require counsel to educate nonprofit boards in advance of making a decision to proceed. Issues arise with regard to the charity's guarantee obligations, risks involving the non-exercise of the put option at the end of the compliance period, and the new partnership audit rules along with structural decision-making. Finally, there is concern that this highly successful program may be detrimentally impacted by Congress in the attempt at tax reform during 2017-2018.

¹ "Government Giving Nonprofits Angst," N.Y. Times, 11/7/13, page F4.

² Ostashevsky, "As economy rebounds, state funding for higher education isn't bouncing back," The Hechinger Report, 9/15/16, available at <http://hechingerreport.org/as-economy-rebounds-state-funding-for-higher-education-isnt-bouncing-back>.

³ O'Neil and Sandoval, "Trump's White House Victory Could Spell Money Woes for Charities," The Chronicle of Philanthropy, 11/9/16, available at www.philanthropy.com/article/Nonprofits-Worry-About/238355.

⁴ See [Rev. Rul. 98-15, 1998-1 CB 718](#) ; [Rev. Rul. 2004-51, 2004-22 IRB 974](#) .

⁵ Sanders, "The IRS View of Joint Ventures Involving Tax-Exempts in Today's Climate," 26 Exempts 3 (Nov/Dec 2014), page 3.

⁶ *Id.*

⁷ *Id.*

⁸ See IRS Form 1023, Part VIII, Line 8.

⁹ Sanders, *supra* note 5 at 3.

¹⁰ NMTC Program Award Book CY 2015-2016. Available at www.cdfifund.gov/Documents/FINAL%202015%202016%20NMTC%20Award%20Book%20Nov2016.pdf.

¹¹ Office of Inspector General: Dep't of Treasury. "Audit Report," OIG-17-009 (2016), available at www.treasury.gov/about/organizational-structure/ig/Audit%20Reports%20and%20Testimonies/OIG-17-009.pdf.

¹² *Id.* (citing that the 3,481 applicants have requested tax credit authority supporting a total of more than \$314.5 billion in equity investments).

¹³ *Id.*

¹⁴ *Id.*

¹⁵ Press Release, U.S. Dep't of Treasury, "Treasury Announces \$7 Billion Allocation of New Markets Tax Credits" (11/1716), available at www.treasury.gov/press-center/press-releases/Pages/jl0615.aspx.

¹⁶ Note 10, *supra*.

¹⁷ See CDFI Fund, "Certification, Compliance Monitoring and Evaluation: 2017 FAQs (Updated January 2017), available at [www.cdfifund.gov/Documents/NMTC%20Compliance%20Monitoring%20FAQs%20-%20January%202017%20\(Approved\).pdf](http://www.cdfifund.gov/Documents/NMTC%20Compliance%20Monitoring%20FAQs%20-%20January%202017%20(Approved).pdf).

¹⁸ See *id.* at FAQs 44, 45, and 46.

¹⁹ See *id.* at FAQ 44.

^{19.1} See *id.* at FAQ 46.

²⁰ 2014-3 IRB 415.

²¹ *Historic Boardwalk Hall, LLC*, 694 F.3d 425 [110 AFTR 2d 2012-5710](#) (CA-3, 2012), *cert. den.*, 133 S. Ct. 2734 (2013).

²² See Persaud, "New Markets Tax Credits and EB-5: Combining Two Programs for One Goal," 21 *J. of Affordable Housing* 249 (2012).

²³ Singer and Galdes, "Improving the EB-5 Investor Visa Program: International Financing for U.S. Regional Economic Development," Brookings-Rockefeller Project (Feb. 2014), available at www.brookings.edu/wp-content/uploads/2016/06/EB5_Report.pdf.

²⁴ Reg. 1.45D-1(g)(3) . "Recapture event" is a statutorily defined term that includes a CDE ceasing to be a CDE, substantially all of the QEI ceasing to be used for investments in QLICs, or the investment being redeemed by the CDE.

²⁵ It is important to note that at the QALICB level, that there could be a change of administration and attitude by the investor at the end of the compliance period as compared to its present intent-especially by an institutional investor, which may decide not to exercise the put.

²⁶ The Bipartisan Budget Act of 2015, P.L. 114-74, 11/2/15.

²⁷ See Rev. Rul. 85-1, 1985-1 CB 177 ; Rev. Rul. 85-2, 1985-1 CB 178 .

²⁸ The Protecting Americans from Tax Hikes Act of 2015, P.L. 114-113, 12/18/15.

²⁹ On 2/15/17, Reps. Pat Tiberi (R-Ohio) and Richard Neal (D-Mass.) introduced bipartisan legislation in the House to make the NMTC a permanent part of the Code. See The New Markets Tax Credit Extension Act of 2017, H.R. 1098, 115th Cong., 1st Sess. (2017), available at www.congress.gov/115/bills/hr1098/BILLS-115hr1098ih.pdf.