Tools and Trends in Contemporary Economic Development:

New Markets Tax Credits as Creative Finance Mechanisms and Cutting-Edge Incentives

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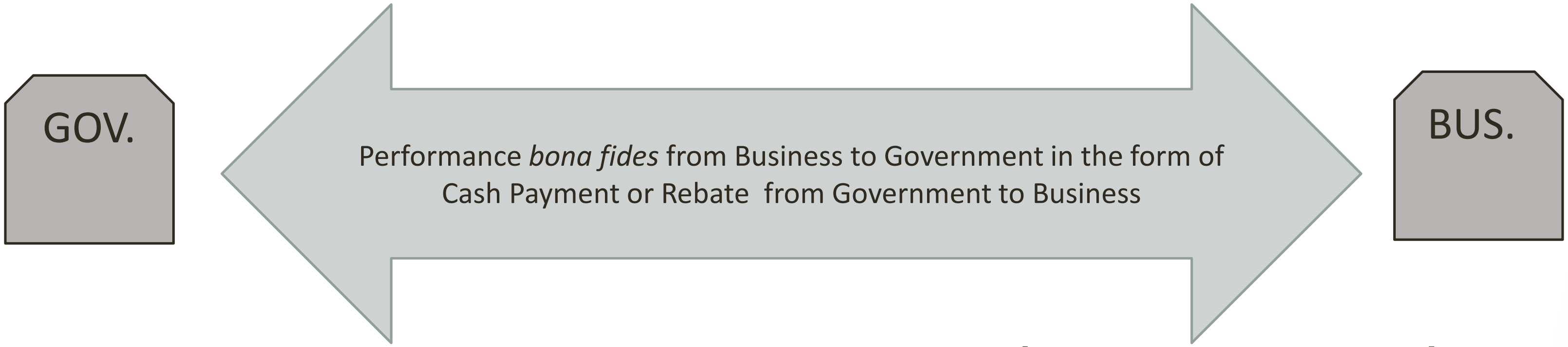
NMTC Essentials – *The What*

- New Market Tax Credits ("**NMTCs**") are a Clinton-era federal program designed to create funding in **low-income communities** ("**LICs**") by providing incentives for private **investors** to fund **qualifying businesses**.
  - For the **investor**, the incentive provided by NMTCs is a significant tax credit against otherwise applicable federal tax liability (39% of investment, taken over 7 years, 5-5-5-6-6-6-6). Note, NMTCs are not a *refundable* tax credit.
  - For the "**qualifying business**," NMTC financing provides the availability of free equity and low-or-no cost debt financing that improves profitability and overall project bottom line.
- Established by the **Community Renewal Tax Relief Act of 2000** (Section 45 D of the Revenue Code) -- amended and continued thereafter on an **annual basis**.
- To date, Congress has authorized approximately $40 Billion in NMTC authority the the Treasury (including **$3.5B** to be allocated in both 2013 and 2014).

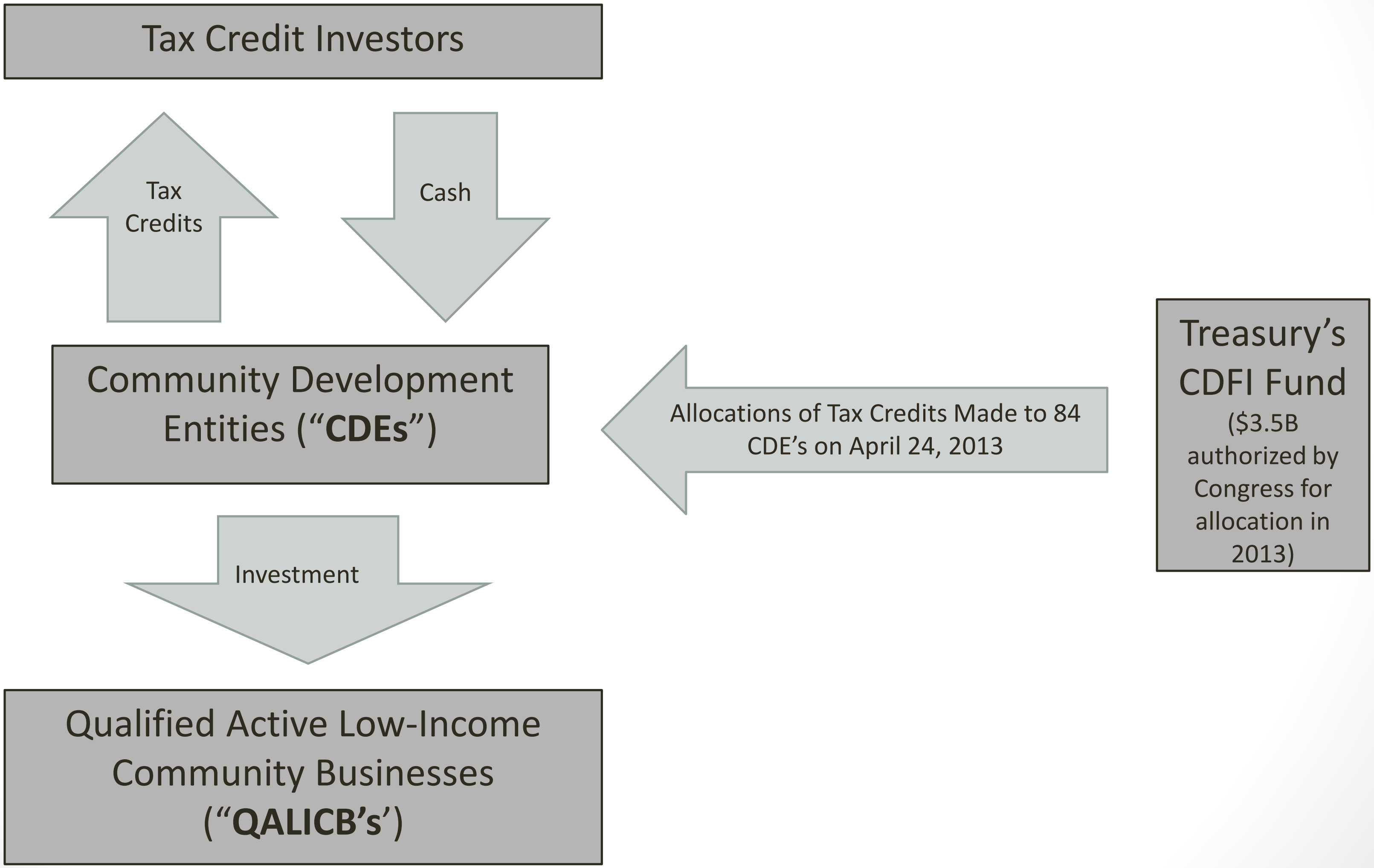
The What (cont.) –*Distinguish NMTCs from Traditional Public Incentives*

- <u>Traditional Public Incentives</u> – tend to be linear, **direct** payments by government to qualifying businesses that meet pre-agreed targets.



- <u>NMTCs</u>– In contrast, NMTC transactions are a complex legal web that creates a real (but **indirect**) benefit to the qualified business. Thus, in a NMTC transaction, no direct money is provided by the government (whether federal, state, or local); rather, the NMTC catalyzes private finance.

The What (cont.) – *The Basic NMTC Structure*



The Who – *Making Sense of the Alphabet Soup*

- **<u>CDFI Fund</u>**. The NMTC program is managed by a specialized division of the Department of Treasury – the Community Development Financial Institutions Fund ("**CDFI**") – which allocates tax credit authority to transaction intermediaries known as Community Development Entities ("**CDE**").
- **<u>CDEs</u>**. CDEs are specialized financial institutions certified by the CDFI Fund, and have the primary mission to benefit LICs. Certified CDEs are eligible to apply for NMTC allocation from CDFI Fund and are accountable to the LIC through an advisory group or governing board. In New Mexico:
  - Ten (10) CDEs that have been certified, but only Finance New Mexico has ever received allocations; and
  - Even FNM has not consistently been awarded allocations (though, as of May, FNM still retained approximately $23,654,000.00 in pre-2013 allocation.
- **<u>QALICB</u>**. A Qualified Active Low Income Community Business is a business (or project) that has a substantial connection to a LIC, measured by percentage of gross income, tangible property and/or services (typical of operating businesses). Note, that real estate deals in LICs qualify; but certain "sin" business are specifically prohibited by statute.

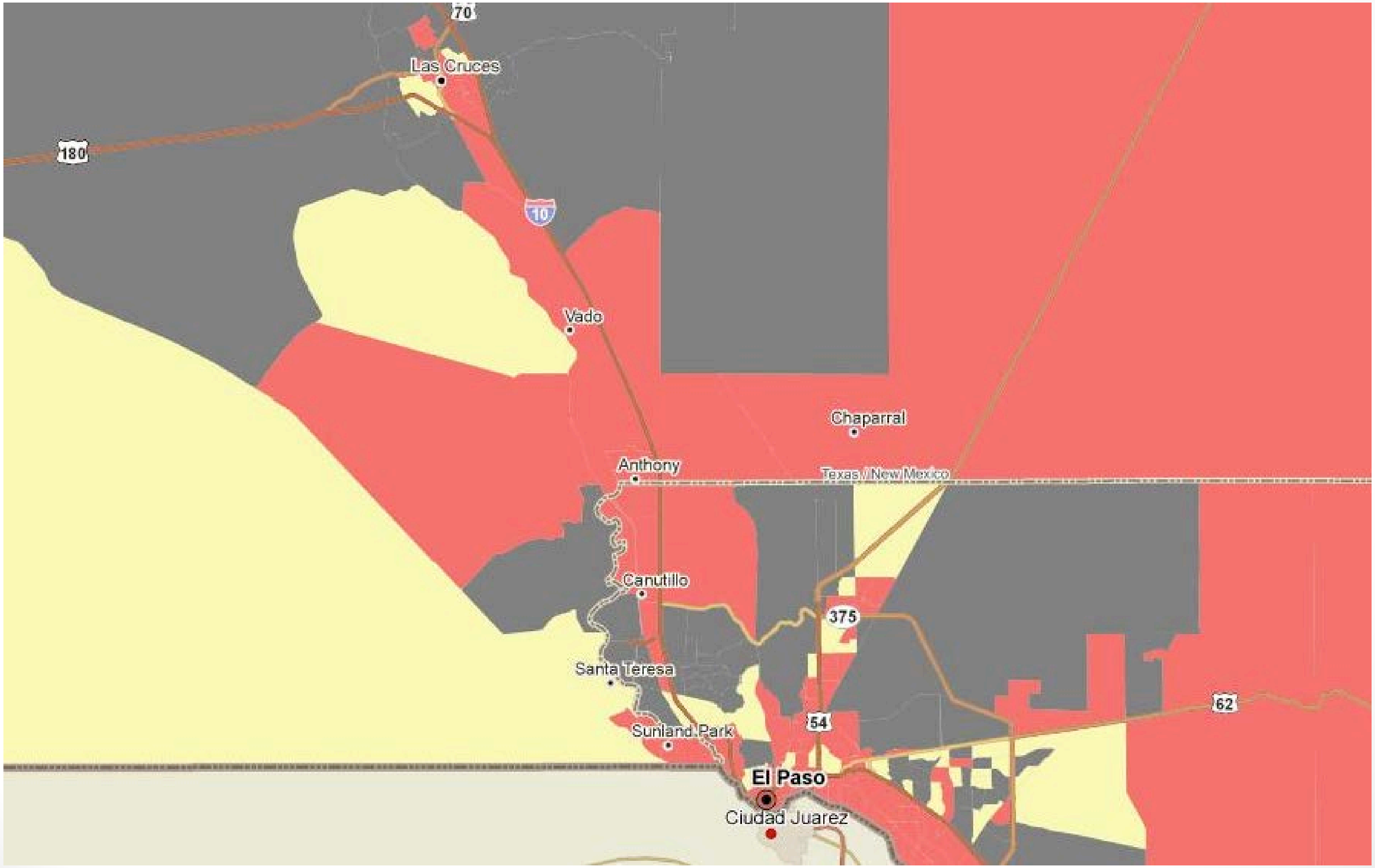
The Where – *Location is a Key Component*

- Typically, NMTC projects must be located within qualified low-income communities ("**LICs**").
  - LICs are either eligible census tracts (based on poverty level criteria), special empowerment zones or enterprise communities, rural counties losing population, or other special targeted populations.

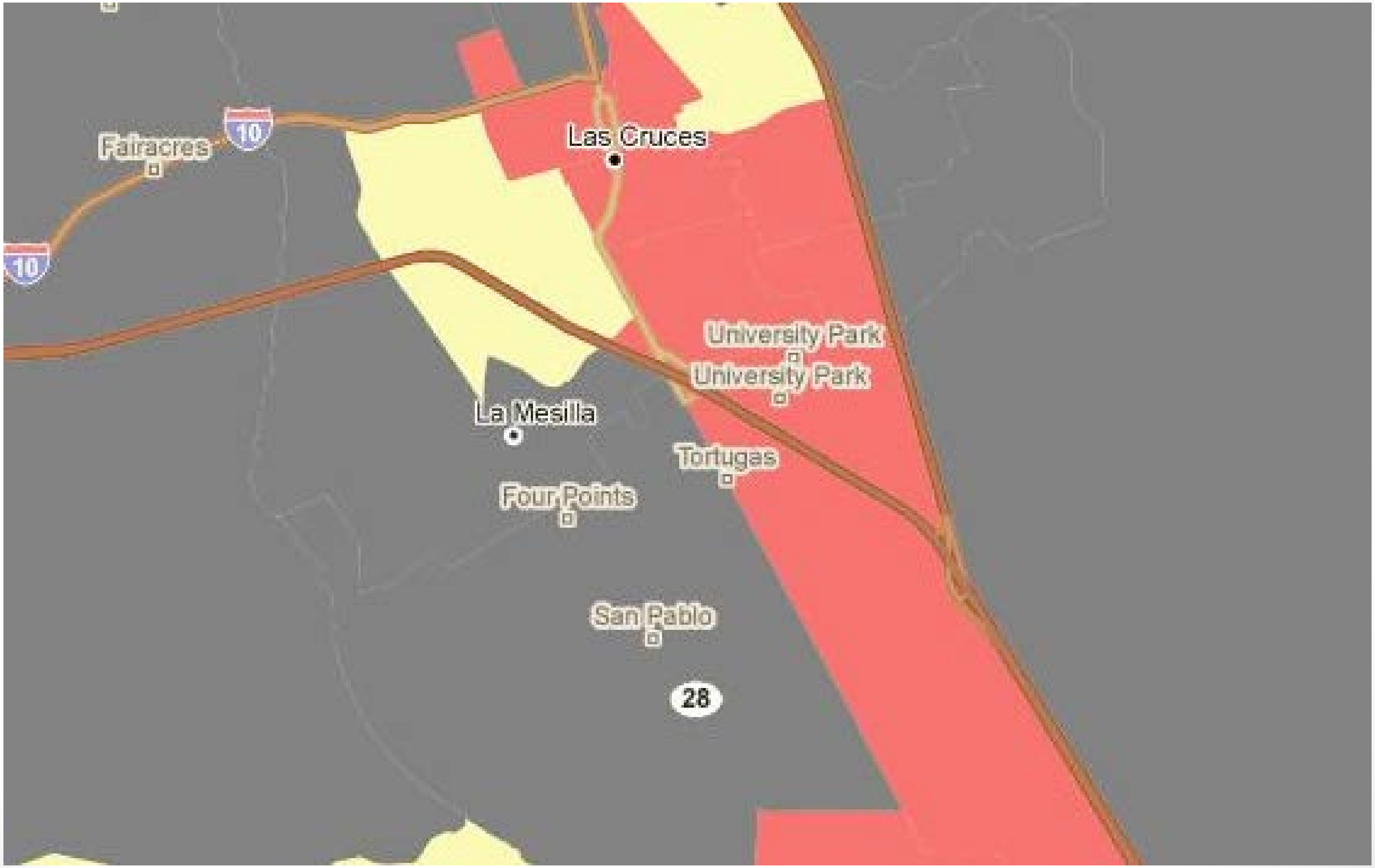
  - Absent location in a LIC, only projects that have a significant and demonstrable benefit to "targeted low-income populations" will qualify (measured by quantifiable ownership, client base, or employment of low-income persons).

  - Note, however, that at present the definition of LIC is loose enough that it embraces approximately:
    - **39% of all census tracks in the US; and**
    - **36% of the US population.**
  - CDFI (and then by extension CDEs) have recently been emphasizing (i) non-urban projects; (ii) projects addressing HFFI (food deserts phenomenon); and (iii) specific states and territories that are thought to be under-represented in the program.

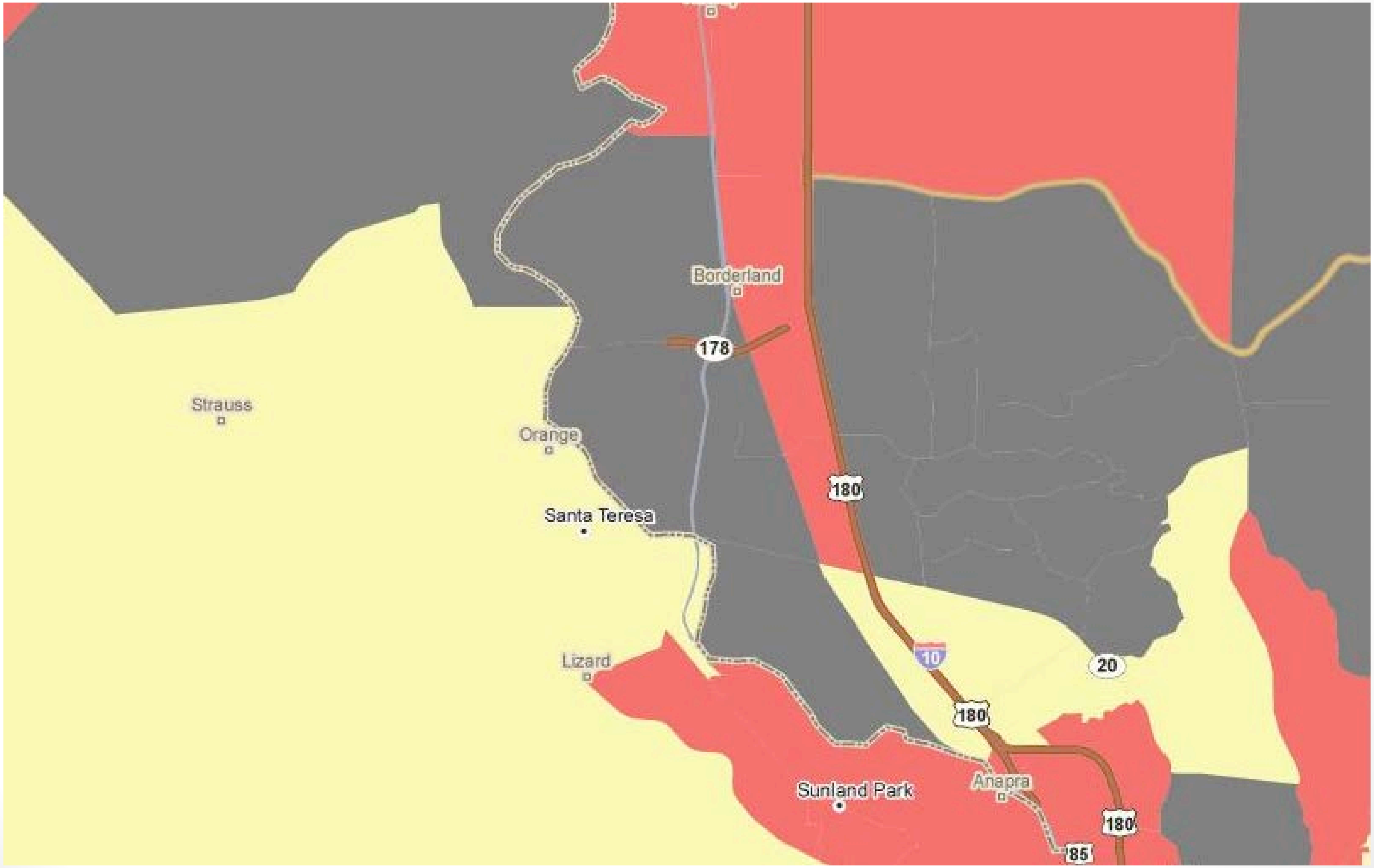
The Where (Example) – Mesilla Valley



The Where – Las Cruces



The Where – Santa Teresa



The When – *NMTC Funding Thought of as Gap Financing*

- From the perspective of the **QALICBs**, NMTC transactions should be considered anytime a project suitable for placement in a LIC is under consideration which either requires supplemental funding or for which typical commercial financing is unavailable.
- Although NMTCs can support a variety of business-related enterprises (including operating capital for existing businesses in LICs – and this is a current area of CDFI Fund emphasis), historically about **65%** of NMTC transactions are for purposes of **real estate** acquisition, development, and rehabilitation.
  - This might include office, retail, warehouse, and manufacturing space, et al. – the substantive property use is very flexible
- NMTCs can be (and in fact often are) combined with other local, state, and/or federal credits and incentives, including:
  - TIF and IRBs;
  - Historic tax credits;
  - Environmental programs (including brownfields remediation); and
  - Grants of various types (e.g., HRSA community health facilities).

The Why – *NMTC Can Improve the Bottom Line*

- Historically, according to the GAO, NMTCs typically provide 20-30% of overall financing for transactions in which they are a component.

- For the **Investor**, the financial benefit is obvious – reduced federal tax liability. In addition, NMTCs are usually purchased from the CDE for a significant discount below the face value of the credits).
  - i.e., an Investor might buy $1,000,000 in NMTC for $720,000.
  - According to GAO, the average discount is about 28%, but the current market may be closer to 24%.

- For the **QALICB**, the nature of the financial benefit varies from deal to deal depending on it’s structure, but typically results in a combination of:
  - ‘Free’ Equity;
  - Reduced debt service (low-to-no interest); and
  - Improved loan-to-value ratios that assist other borrowing.

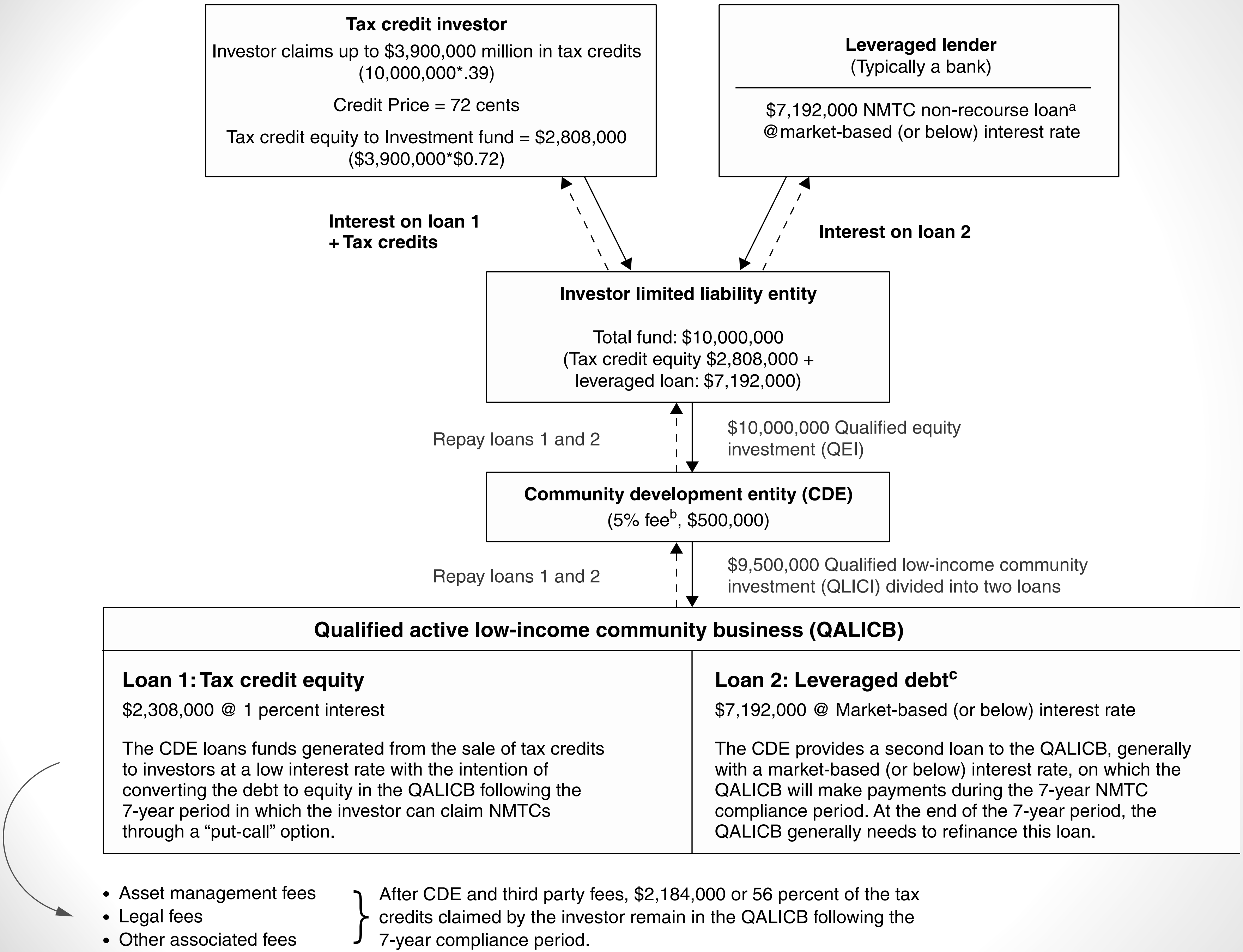
Specific NMTC Thoughts for New Mexico & Mesilla Valley

- Creation of focused local-level CDE(s) – *i.e., a "CDE of the Mesilla Valley" that is dedicated to specific local needs and opportunities.*

- Congress of existing New Mexico based CDEs – *Coordinate understanding of program cycle and assess ways to maximize opportunities to receive allocation in a competitive market*.

- Refocus FNM's efforts and approach to deployment of NMTCs – Create internal understanding of how deployment effects future allocation, etc., and raise market awareness of existing opportunities.

- Assess viability and impact of State-level NMTC analogue.


Tax credit investor
Investor claims up to $3,900,000 million in tax credits (10,000,000*.39)
Credit Price = 72 cents
Tax credit equity to Investment fund = $2,808,000 ($3,900,000*$0.72)
Leveraged lender
(Typically a bank)
$7,192,000 NMTC non-recourse loan[a] @market-based (or below) interest rate
Interest on loan 1 + Tax credits
Interest on loan 2
Investor limited liability entity
Total fund: $10,000,000
(Tax credit equity $2,808,000 + leveraged loan: $7,192,000)
Repay loans 1 and 2
$10,000,000 Qualified equity investment (QEI)
Community development entity (CDE)
(5% fee[b], $500,000)
Repay loans 1 and 2
$9,500,000 Qualified low-income community investment (QLICI) divided into two loans
Qualified active low-income community business (QALICB)
Loan 1: Tax credit equity
$2,308,000 @ 1 percent interest
The CDE loans funds generated from the sale of tax credits to investors at a low interest rate with the intention of converting the debt to equity in the QALICB following the 7-year period in which the investor can claim NMTCs through a "put-call" option.
Loan 2: Leveraged debt[c]
$7,192,000 @ Market-based (or below) interest rate
The CDE provides a second loan to the QALICB, generally with a market-based (or below) interest rate, on which the QALICB will make payments during the 7-year NMTC compliance period. At the end of the 7-year period, the QALICB generally needs to refinance this loan.
• Asset management fees
• Legal fees
• Other associated fees
After CDE and third party fees, $2,184,000 or 56 percent of the tax credits claimed by the investor remain in the QALICB following the 7-year compliance period.