

## NEW MARKETS TAX CREDIT PROGRAM SUMMARY

### *Introduction*

The New Markets Tax Credits (NMTC) program was enacted in December 2000 to facilitate investments that generate employment and other community benefits for low-income persons and residents of low-income communities. It was created as part of the Community Renewal Tax Relief Act of 2000, and is administered by the Community Development Financial Institutions (CDFI) Fund, a division of the U.S. Department of Treasury. Originally authorized to provide annual allocations of tax credits through 2007, the NMTC program has recently been extended for at least one year, providing an additional allocation of credits in 2008.

The program provides federal income tax credits to private investors based on their investments made in entities that have received an allocation of NMTCs. These entities, such as the Chicago Development Fund, are known as Community Development Entities, or CDEs. CDEs that have received an allocation of NMTCs must use the proceeds of these investments to provide equity or debt capital to businesses or real estate projects located in Census Tracts that meet the CDFI Fund's definition of Low-Income Communities (LICs).

In practice, the program is primarily applicable to commercial, industrial, and mixed-use real estate projects, as well as community-serving facilities.

The following sections outline the process for obtaining and deploying NMTCs. A glossary of key program terms and additional program background information are provided at the end of this document for reference.

### *Obtaining NMTCs*

Through a competitive application process, the CDFI Fund grants allocations of NMTCs to CDEs. A CDE may be for-profit or not-for-profit. In order to make investments into eligible projects, however, a not-for-profit CDE must create one or more for-profit subsidiaries through which to make its investments.

### *Value of the Tax Credit*

NMTCs provide a federal income tax credit to investors in CDEs over 7 years totaling 39% of the amount invested. The credits are claimed on the following schedule:

<b>Year</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>Total</b>
Tax Credit as % of Investment Amount	5%	5%	5%	6%	6%	6%	6%	<b>39%</b>

The funds provided by investors to CDEs are known as “Qualified Equity Investments,” or “QEIs.” Based on this formula, an investor providing \$1 to a CDE in the form of a QEI would receive tax relief benefits of \$0.05 in each of Years 1 through 3, and \$0.06 in each of Years 4 through 7, for a total of \$0.39 of benefits. In this example, \$1 of the CDE’s NMTC Allocation would be expended. The Chicago Development Fund’s 2006 NMTC allocation of \$100 million will thus allow investors to realize \$39 million of tax relief. Because the tax relief is phased in over a 7-year period, investors typically apply a discount factor when determining how much up-front cash they are willing to provide to the CDE in exchange for the \$0.39 of benefits. Currently, this up-front value tends to range from \$0.25 to \$0.30 in the market.

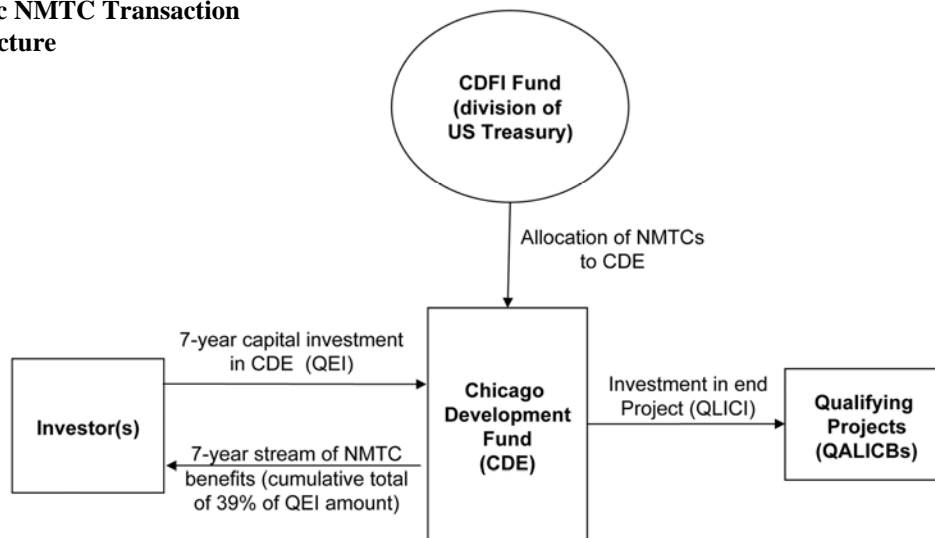
Chicago Development Fund’s \$100 million NMTC allocation can thus be expected to generate \$25 to \$30 million in capital that does not need to be repaid to the investors. After paying for Chicago Development Fund’s general operations and the specific costs of underwriting and closing transactions, the remainder of this capital can be used to assist qualifying development projects that fit within CDF’s mission and program parameters.

### ***Basic Transaction Structure***

In a typical New Markets Tax Credit transaction, the CDE acts as an intermediary between the investors and the end recipients of capital. In most cases, the provision of a QEI from investors to a CDE is directly linked to a specific project that the CDE intends to support with a loan or equity investment. The end recipient of capital must qualify as a “Qualified Active Low-Income Community Business” (QALICB) based on the federal regulations governing the program. These qualifying factors are based on demonstrating that the QALICB’s activities are principally located in Low-Income Communities and/or serving Low-Income Community residents. The Chicago Development Fund’s 2006 NMTC allocation will exclusively be used to support real estate projects in qualifying Census tracts. Therefore, the QALICBs will be real estate development companies.

The CDE’s investment in the QALICB is known as a Qualified Low-Income Community Investment (QLICI). The CDE must invest all QEI proceeds (net of certain fees) in corresponding QLICIs and keep the funds invested over the full 7-year tax credit period in order to maintain compliance with program regulations and maintain the flow of tax benefits to investors. The figure below illustrates the basic structure of a typical NMTC transaction.

### Basic NMTC Transaction Structure



### *Benefits to Recipients of NMTC Financing*

QLICIs can take a number of different forms, but are generally structured as loans from the CDE to the QALICB. Because the investors receive a portion of their returns through the 7-year stream of tax credit benefits and therefore do not need full repayment of the QEI, the CDE has flexibility to structure QLICIs to include below-market terms such as reduced interest rates, partial loan forgiveness, and/or enhanced loan-to-value ratios. These advantageous terms can help community-benefiting projects overcome financing gaps and other feasibility issues.

### *Raising Capital*

A CDE typically obtains capital from private sector investors/lenders, which are usually commercial banks or their community development subsidiaries. The most common types of capital raised by CDEs are as follows:

- (1) **Tax Credit Investments** – As discussed above, investors provide up-front capital in the form of an equity investment or a low-interest forgivable loan to the CDE in return for a 7-year stream of federal income tax credits. These investors are essentially “buying” the future tax credits, and do not tend to need any other return of or on their initial investment.
- (2) **Economic Investments** – Since each dollar of QEI provided to a CDE can produce about \$0.30 in discounted tax credit value for an investor, this portion of the \$1 of investment does not generally need to be repaid by the CDE. However, some or all of the remaining \$0.70-\$0.75 of investment must generally be made on terms that include an economic (i.e. non-tax credit) return to the investor. This typically takes the form of debt, repayable by the QALICB receiving the capital investment from the CDE.
- (3) **Grants or Other Non-Economic Investments** – Funding from sources that do not need economic returns or tax credit benefits (such as grants) can be substituted for all or part of the economic investment component described above. This funding is provided to the CDE in

the form of a QEI, and in turn packaged as part of the CDE's investment in the QALICB. This approach is most commonly used in NMTC transactions that are supporting QALICBs that have little ability to support true debt (i.e. economic investments) such as cultural institutions and not-for-profit community facilities.

## ***Glossary***

**Community Development Entity (CDE):** Entity certified by the CDFI fund as eligible to receive an allocation of New Markets Tax Credits. A CDE acts as an intermediary for providing loans, investments, and/or financial counseling in Low-Income Communities (LICs). CDEs must have a primary mission of serving, or providing investment capital for, LICs or Low-Income Persons. They must also maintain accountability to residents of the LICs that they serve.

**Low-Income Community (LIC):** Generally, Census tracts with a poverty rate of at least 20%, or median family income at or below 80% of the area median.

**Qualified Active Low-Income Community Business (QALICB):** Businesses that are eligible to receive assistance through the NMTC program. A QALICB must meet several tests confirming that the majority of its activities take place in or that it serves primarily residents of a Low-Income Community.

**Qualified Equity Investment (QEI):** Any cash investment in a for-profit CDE that triggers the flow of New Markets Tax Credits benefits to the investor. The QEI must remain invested in the CDE for 7 years to maintain program compliance.

**Qualified Low-Income Community Investment (QLICI):** Loan and/or investment provided by a CDE to a QALICB or to another CDE. Typically takes the form of debt or equity that carries below-market interest rates and/or return expectations.

## ***Other Background***

### **How does the NMTC compare to the Low-Income Housing Tax Credit?**

The NMTC program is similar to the Low-Income Housing Tax Credit ("LIHTC") program in that it provides an income tax reduction for investors in exchange for up-front capital to support projects meeting the mission and guidelines of the program. The two programs differ in several key ways, including the following:

- Types of projects supported. The LIHTC is specifically tailored to support low-income housing projects, while NMTC is generally more flexible. NMTC can support operating businesses as well as real estate projects, provided that not more than 80% of the income from the projects comes from rental housing.
- Amount and duration of the credit. The LIHTC is realized over a 10-year period at an annual rate of either 4% or 9% of the project's eligible costs (totaling up to 90% of the

project's eligible costs over the ten-year credit period). Compliance with affordability and other requirements must be maintained for at least 15 years, but sometimes longer based on local policy. The NMTC is taken over 7 years at a rate of 5-6% of the eligible *investor capital* per year, with a concurrent 7-year compliance period.

- Allocation processes. The LIHTC is allocated by the federal government to state housing agencies and the City of Chicago based on population. These entities in turn provide credits to individual projects. The NMTC is allocated to CDEs based on a competitive application process managed by the U.S. Department of Treasury. In addition to non-profits and government-controlled entities, CDEs can be controlled by private for-profit corporations such as banks.
- Investor's Interest. In order to claim the LIHTC, the tax credit investor typically takes a limited partnership-based interest in the end project, receiving a share of project income, losses, and depreciation in addition to tax credit benefits. NMTC investors frequently provide their capital in the form of one or more loans to the CDE, which in turn invests in and/or lends to the end projects. Therefore, the NMTC investor's returns are generally based on tax credit benefits and debt service payments, rather than a direct ownership stake in the end project or business.

### **Have NMTCs Been Used in Chicago?**

In the four NMTC application rounds that have occurred to date, ten entities in Chicago have received a total of about \$370 million in NMTC allocation. Also, a number of allocatees (NMTC recipients) located elsewhere include Chicago in their potential investment areas. These include banks such as U.S. Bank, JP Morgan Chase, and National City, as well as non-profits such as the Local Initiatives Support Corporation (LISC). To date, however, relatively few NMTC transactions appear to have closed in Chicago. No up-to-date comprehensive summary is available of this activity, but known transactions include:

- Bethel New Life Community Development Corporation's use of \$1.5 million of NMTC allocation to support a mixed-use community center
- The rehabilitation of the historic Blackstone Hotel
- Illinois Facilities Fund's (IFF) use of NMTC to support its community facility lending programs