Reznick Group

New Markets Tax Credit Connection

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Spring 2010

What Next? Issues to Consider In NMTC Workouts

By: David Norton, Reznick Group

The Great Recession has been a challenge for many businesses. As a result, more Community Development Entities (CDEs) are confronted with the prospect of having to work out their Qualified Low-Income Community Investment (QLICI) with their Qualified Active Low-Income Community Business (QALICB). The tax issues that may arise are varied and are dependent upon a number of variables, which include but are not limited to: whether the QLICI is a loan or an equity investment, whether the CDE is a corporation or a partnership, whether the investment entity is leveraged or not and whether the leveraged lender is a third party or related to the QALICB. Given the flexibility in the New Markets Tax Credit (NMTC) program that allows for many different deal structures and the variables mentioned above, it is impossible to address all the issues that may arise in a short article. My goal is to highlight some of the tax issues that might be encountered.

QLICI Loan

A CDE has several options if the QALICB is struggling to meet its debt service requirements on the QLICI loan from the CDE. First, the CDE should review its loan documents to determine what rights and remedies it has under the loan. Some typical options are: work out the debt with the QALICB, which may include changing the term, interest rate or payment terms of the note; forebear collection on the note for some period of time; convert the loan into an equity interest; or foreclose on the property. Each of these options has its own tax consequences to the QALICB and the CDE, not to mention the economic issues it creates for the NMTC investor and the leveraged lender if there is one.

Debt Workout

A change in the rate, term or scheduled payments under the note could be considered a material modification of the debt which, for tax purposes, is deemed to be a sale of the old debt for the new debt. This, in turn, could create a taxable event and give rise to capital gains or losses to the CDE and the QALICB, cancellation of debt (COD) income to the QALICB and a bad debt deduction to the CDE, or original issue discount (OID) affecting both the CDE and the QALICB. A partial forgiveness or, in some cases, a forgiveness of all of the outstanding indebtedness will give rise to COD income to the QALICB and a loss to the CDE that may give rise to a bad debt deduction or a capital loss depending upon the CDE's treatment of the QLICI loan.

The debt workout also has implications to the investor. If the CDE is a pass-through entity, the tax consequences to the CDE will pass through to the investment entity which, in turn, if it is a pass-through entity, will pass up to its investors.

Additionally, if a leveraged investment structure is used, a change to the QLICI notes may raise the issue of how the leverage loan is serviced. This may be easier to address if the leveraged lender is related, in some way, to the QALICB. However, if the leveraged lender is a third party, the question is likely more problematic. Some questions to consider: Are there guarantees to the leveraged lender that the leverage lender could call upon? What collateral does the leveraged lender have? Are there guarantees to the NMTC investor that guarantee the credit stream, and might those guarantees be called upon if the leverage lender takes the investment in the CDE? If the leverage lender is related to the QALICB borrower,

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In This Issue

Indian Country: An NMTC Investment Oasis in an Uncertain Market

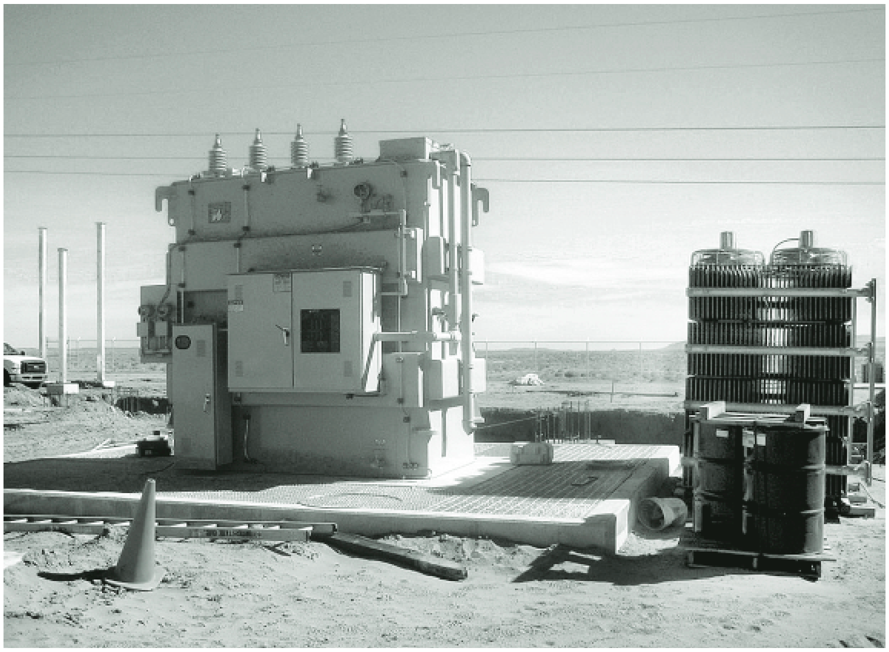
By: Phil Glynn, Director, Travois New Markets, LLC

The New Markets Tax Credit (NMTC) industry — Community Development Entities, lenders, investors and their professional partners — are adjusting to the new norm. More than two years after the credit crisis began, crucial leverage loans are still difficult to obtain. NMTC investors are confronted with greater market risks than in the past as a range of asset classes — mixed use, retail and hospitality — remain troubled. Over the same two-year period, however, a number of successful NMTC transactions have taken root in unlikely places: American Indian Reservations and Alaska Native Villages.

Native communities might seem unlikely oases of investment during tough economic times. Stories of the poverty and unemployment that mark reservation life are common knowledge. But the types of projects on which Native communities have embarked and the sources of capital they have employed have helped greatly to increase the adoption of the NMTC in rural Native communities.

The Navajo Tribal Utility Authority (NTUA) NMTC transaction of 2009 brought one of Indian country's biggest needs into focus: infrastructure. The Navajo Nation has one of Indian country's largest populations, largest reservations and most diverse economic interests ranging from oil and gas to cultural and eco-tourism. Despite these facts, it remains an extremely economically distressed place. One-third of Navajo Nation residents do not have adequate utility service. As a nonprofit, NTUA must serve this very low-income population — extending utility service across a 17 million acre reservation on extremely thin margins. In 2009, NTUA used internal funds as a leverage loan in a $6.4 million Qualified Equity Investment with Travois New Markets' NMTC allocation. The project funded new substations in the towns of Cudeii and Shiprock. This $6.4 million investment will lay the groundwork for $41 million of real estate development that could not have proceeded without this critical infrastructure.

The Bois Forte Band of Chippewa has spent decades building a diverse portfolio of business interests. Strong in natural resources, gaming and broadcasting, the Band is one of Minnesota's most progressive Native communities. Its central government — providing a range of social service, educational and financial services — had been operating for years out of an inadequate, unsafe, inefficient building. The Band used $12 million in NMTC allocation to fund a new, energy-efficient landmark building that is an appropriate symbol of its growing economic power. The project had been needed for years but became even more urgent when, during the closing process, the old government



NTUA Electrical Substation

NTUA Electrical Substation being off-loaded in Shiprock, New Mexico

Substation equipment being installed at Shiprock, New Mexico

Transmission equipment being installed to tie into grid

services center was destroyed by arson. Travois New Markets acted as the Band's consultant, helping the Band use its own funds as a leverage loan with both equity and NMTC allocation provided by Wells Fargo.

The Coastal Villages Region Fund (CVRF) is a nonprofit organization that serves Alaskan Natives living on the western coast of the Calista region. CVRF operates a range of seafood businesses around the Bering Sea — one of the world's richest fisheries. CVRF's mission is twofold: to run its businesses successfully and to ensure that success helps improve the quality of life in coastal Native communities through scholarships, internships and other tools for economic empowerment. CVRF used internal funds from its seafood operations to act as the leverage lender in a large NMTC transaction using allocation from Travois New Markets, Waveland Ventures and NCB Capital Impact. The $41 million investment resulted in a new salmon processing plant that will employ more than 150 people in the village of Platinum — population 41. This plant will allow local fishermen to sell their catch in Platinum — greatly increasing economic opportunities in this remote, distressed village. By alleviating the processing bottleneck, CVRF is also able to increase the number of fishing permits to 600 — significantly increasing the primary driver of the local economy.

These Indian country projects represent a wide range of project types — infrastructure, real estate and manufacturing. They share, however, common themes. First, Native organizations are often structured in such a way as to be able to pool funds to create sizable leverage loans. Second, the needs in Indian communities are not necessarily for speculative or income-

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Grand opening of CVRF Processing Plant

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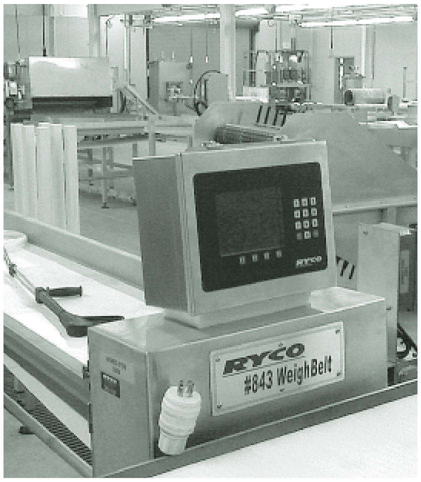
producing properties. Demand exists for quasi-public or quasi-governmental projects. When the project sponsor is providing its own leverage loan for such a project, the risk profile for the NMTC investor is significantly lower than deals taking place in what has traditionally been thought of as the economic mainstream.

The greatest incentive, however, for Indian country investments is to make an investment that will change lives in some of America's poorest communities. The nature of the deals — high demand for services and availability of self-leverage — combines a safety of investment with community impact that investors cannot find anywhere else. ■

CVRF fish processing plant



CVRF equipment

Aerial view of Coastal Villages Region

CVRF shipping dock

New Markets Tax Credit Asset Management Roundtable

By: Tom Dolan, CCML Asset and Relationship Manager

Transaction Level Reports, Investor Level Reports, substantially-all test, non-qualified financial property and the unwinding of deals coming to the end of their seven-year compliance period are just a few issues faced by all New Markets Tax Credit (NMTC) asset managers. Many NMTC asset managers expressed an interest in discussing these issues, and others, with their peers. In order to address this interest, CEI Capital Management LLC ("CCML"), based in Portland, Maine, formed the NMTC Asset Management Roundtable.

Each month, CCML hosts the Roundtable conference call that is moderated by various asset managers from throughout the industry. The moderator selects a topic of interest to discuss on the call and is typically joined by an expert guest speaker. Generally, the Roundtable call consists of a brief presentation by the guest speaker on a pre-selected topic followed by an interactive Q&A session. The Roundtable provides an opportunity for the industry asset managers to get to know each other and discuss issues of common interest in a "no stress environment." The Q&A sessions have proven to be both informative and immeasurably beneficial for all in attendance. In a very short time, interest in and attendance at the Roundtable calls has grown substantially.

This past February 2nd, Scott Szeliga, a principal with Reznick Group's Audit and Accounting Group, served as the Roundtable's guest speaker. Under the moderation of CCML's Asset and Relationship Manager, Tom Dolan, Mr. Szeliga brought his more than twelve years of experience in the areas of audit, accounting and tax credit syndication to bear on the topic of "CDE Financial and Compliance Reporting." Mr. Szeliga's presentation focused on a host of issues that he has encountered in his work with Community Development Entity (CDE) clients. He discussed a multitude of real life situations and answered some very difficult questions posed by the asset managers. His presentation was extraordinarily well received.

The prior month's Roundtable call was moderated by Marie Mann Bibbs, Executive Vice President of City First Bank of D.C. and featured Kristin A. DeKuiper, Esq. of Holland & Knight LLP as the Roundtable guest speaker on the subject of "Monitoring and Managing Troubled Assets and Workouts."

Future Roundtable topics include: Material Events and Reporting; Data Management & Technology Solutions; Qualified Active Low-Income Community Business Privacy and CDE Lender Liability; Credit and Financial Monitoring; Indemnification Issues; Reporting Requirements for Recovery Act Allocatees; Allocatee Responsibilities Post-Compliance Period; Twinned Historic Tax Credit/NMTC Projects and Downward Adjusters; Managing Cancellation of Debt (phantom income) and Adjustments in Tax Basis.

Upcoming moderators include Ms. Tonja L. Adams, Senior Vice President, Tax Credit Asset Management at Bank of America Merrill Lynch (March) and Ms. Margaret C. Whitesides, Director, Asset Management at Enterprise Community Investment, Inc. (April), with topics and guest speakers to be announced.

All NMTC asset managers and other interested parties are welcome to join the Roundtable. The Roundtable conference call occurs every month on the first Tuesday at 10 am EST. If you wish to be included on the distribution list for the Roundtable, please send an email to Ms. Leah B. Thibault with CCML at *lbt@ceimaine.org*. ■

NMTC Coalition Corner

On February 18th, Treasury Secretary Timothy Geithner announced the Administration's support for $5 billion in New Markets Tax Credit (NMTC) authority for 2010 and $5 billion in NMTC authority for 2011. In addition, Secretary Geithner discussed support for targeted improvements to the program in keeping with several recommendations the New Markets Tax Credit Coalition has proposed. These changes include allowing NMTC to off-set Alternative Minimum Tax (AMT) liability for all outstanding credits. CDFI Fund Director Donna Gambrell noted, "Allowing the credit to off-set the AMT will help this tool to speed recovery in the hardest hit communities by greatly increasing its ability to attract private investors."

Secretary Geithner made the announcement while touring an NMTC-financed business in Durham, North Carolina, with CDFI Fund Director Donna Gambrell. Several NMTC Coalition board members were in attendance and participated in a roundtable discussion with the Secretary on the importance of the Credit.

In addition to maintaining funding authority and ensuring parity with other tax credits through AMT relief, Treasury and the Internal Revenue Service are working on the following:

- a revenue ruling to clarify how the passive activity loss rules apply to investors,
- guidance to clarify treatment of recourse loans in the leverage structure,
- new rules to support greater investment in institutions such as CDFIs that invest in small businesses and
- ways to ensure flexibility for Community Development Entities (CDEs) to provide working capital and other short-term loans by weighing the effect of the requirement that "substantially all" of a CDE's investments be deployed at all times.

Geithner pointed to the positive impact the NMTC has had in economically distressed communities, saying, "The New Markets Tax Credit helps these communities attract new investors and ensure they stay invested long enough for businesses to overcome obstacles and grow." Geithner and Gambrell highlighted the benefits of the program to small businesses, the ability to spur job creation and its ability to leverage private dollars 12:1. Director Gambrell noted, "These latest enhancements are a part of a broader commitment on the part of the Obama Administration to increasing opportunities for small businesses and community development where it is needed most."

The NMTC Coalition was pleased to see the Administration step out with such a strong endorsement of the NMTC, that the Coalition's efforts to secure AMT relief for NMTC investors is included in the Administration's proposed modifications to the program

NMTC Summit Sets Sail for Miami — Reznick Group's Renowned NMTC Summit to be held May 5-7, 2010

Reznick Group will be hosting its **9th Annual New Markets Tax Credit (NMTC) Summit** at the Loews Miami Beach Hotel in South Beach, Miami, May 5-7, 2010. The NMTC Summit has been branded in the marketplace as the most informative and current conference to update industry participants on trends, issues and the latest developments facing the industry.

In 2009 the Summit broke all previous attendance records with over 300 attendees from across the nation, including institutional investors, lenders, CDEs, developers and business owners looking for opportunities. This year's program will feature speakers from all segments of the industry and will cover topics which are on the cutting edge of what is happening in today's market and how to assess opportunities capitalizing on the NMTC. The Summit is the ideal forum to make connections, gain knowledge and learn from true industry experts and leaders.

For more information or if you would like to register for the Summit, please visit the Conference and Events section of Reznick Group's website at

www.reznickgroup.com/conferences

and the Administration's desire to promote more NMTC investing in operating businesses. The Coalition has been in conversation with the Treasury Department, with both the Assistant Secretary for Financial Institutions, Michael Barr, and the Assistant Secretary for Tax Policy, Michael Mundaca, about these proposals and will continue working with the Department to work out the details on encouraging business lending and investing.

While Congress has yet to pass an NMTC extension and any tax extender bill, the Coalition is continuing to pursue the NMTC extension and an AMT fix: the Administration's endorsement will be of great help. ■

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does the leverage lender's taking of the investment in the CDE create deemed COD to the QALICB? If the CDE and the QALICB become related, does that violate the CDFI Fund agreement? Might the CDE be deemed to control the QALICB?

Another possibility is that the third party leveraged loan could be modified, partially or fully forgiven. Many of the same issues previously discussed with respect to a modification of the QLICI loan are applicable in this situation. In addition, a forgiveness of all or a portion of the loan will cause a reduction in the investment entity's basis in its investment in the CDE to the extent of the forgiveness. Because the basis of the investment must be reduced by the amount of the NMTC received, there is a question as to what happens to the credit if the investor does not have sufficient basis to absorb the basis reduction? Can the credit still be utilized by the investor despite the lack of basis to absorb the basis adjustment? Does the credit get suspended until sufficient basis is created, or does the investor recognize income to the extent the basis adjustment exceeds the investor's basis in the investment? Surprisingly, there is no definitive guidance although informally the Internal Revenue Service has indicated that the credit would be suspended until basis is created.

Foreclosure

A foreclosure by the CDE on the collateral securing the QLICI loan raises additional issues. A foreclosure on collateral securing a nonrecourse obligation is treated as a purchase by the lender and a sale by the borrower of the collateral for the amount of the nonrecourse debt. If the note were recourse, the collateral is deemed to be sold at its fair value and the debt in excess of the collateral's fair value is deemed to be COD income.

Some questions that arise include: Does a foreclosure by the CDE constitute a repayment of the QLICI loan, which would start the 12-month, redeployment clock ticking? Perhaps, if the collateral were property other than equity interests in the QALICB, but if the collateral were equity interests in the debtor, then the QLICI loan may have been converted into a QLICI equity investment. If the CDE's QLICI loan was converted into a QLICI equity investment, does the CDE now have control of the QALICB and has the QALICB always complied with the substantially-all test? If the collateral is considered a repayment of the QLICI loan, does the collateral have to be converted to cash if redeployment is necessary?

QLICI Equity

If a CDE's QLICI investment is an equity investment in the QALICB and the QALICB fails, there is an investment loss to the CDE. However, the worthless QLICI investment is still considered a QLICI for purposes of the substantially-all test. Assuming that the CDE still qualifies as a CDE and there is no redemption of the Qualified Equity Investment, then the investor will still receive the NMTC. As discussed previously with respect to QLICI loans, the investor's issue, especially in a leveraged structure, is whether it will have sufficient basis to absorb the downward basis adjustment arising each year when the NMTC arises. Other similar issues relate to the leveraged lender and how the leveraged debt is serviced, whether guarantees can be called, etc.

As the above discussion illustrates, there are many decisions that can impact the tax consequences of the QALICB, CDE, leveraged lender and the investor when working out troubled QLICIs. In addition, there are many program-related questions — oftentimes with no clear answers. Be sure to attend the workout panel discussion at Reznick Group's 9th Annual New Markets Tax Credit Summit to hear what the experts think about some of these questions. ■

About Reznick Group

Focusing on the community development and real estate industries for more than 32 years, Reznick Group is recognized as one of the nation's leading advisors to developers, managers, lenders, owners, investors, public finance agencies and other participants in the field. As a national leader in providing public accounting and business advisory services, Reznick Group is committed to providing clients with outstanding service.

With professional and staff members serving clients nationwide, Reznick Group provides value by exercising the highest levels of integrity, quality and responsiveness in providing solutions to help our clients meet their business objectives in the community development and real estate industries. To learn more about the services we provide and our perspective on issues that impact your business, please visit *www.reznickgroup.com*. ■

We Want Your Feedback!

Please send us your feedback so we can include articles and information on NMTC topics you choose. This approach will ensure you spend your time reading about issues and opportunities that are most important to you! Send your feedback to *nicole.mazmanian@reznickgroup.com*.

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