

New Markets Tax Credits: Issues and Opportunities

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The Pratt Center: Helping Communities Build

The Pratt Institute Center for Community and Environmental Development works for a just, equitable, and sustainable city for all New Yorkers, by empowering communities to plan for and realize their future. As part of Pratt Institute, we leverage professional skills – especially planning, architecture, and public policy – to support community-based organizations in their efforts to improve neighborhood quality-of-life, attack the causes of poverty and inequality, and advance sustainable development.

This report is part of our Helping Communities Build initiative. Through this initiative, we help community-based organizations in low-income neighborhoods create physical development projects that advance community visions and improve neighborhood quality-of-life. We seek especially to help catalyze “breakthrough” projects that push the envelope of community development and can serve as models for replication and systems change.

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NOTE: The recommendations and analysis in this paper do not necessarily reflect official positions of the Taconic Foundation or Pratt Institute.

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Forward: Helping Communities Build Stronger Futures

Over the past few decades, community developers have made remarkable strides bringing investment into low-income neighborhoods – especially by developing affordable housing that has served as a base for the dramatic revitalization of many neighborhoods.

But many communities continue to face steep challenges in recruiting the kinds of capital that create vibrant neighborhoods: for businesses that offer good jobs at living wages, for mixed-use projects that enhance neighborhood quality-of-life, and for community facilities like child care centers and schools.

New Markets Tax Credits were established to address this problem. Created at the end of 2000, the program is the largest federal subsidy for economic development in low-income communities in 30 years. Inspired in part by tours of impoverished urban and rural areas – from Newark and East St. Louis to Appalachia and the Navajo Nation – the goal was to use shallow subsidies to attract private capital.

Jeff Armistead has written an excellent, early-stage progress report on the program. While it is still too early in the program's history for a comprehensive report based on data from a large number of investments (the Treasury Department will begin this process soon), Jeff's paper outlines the history, structure, and key issues facing the program. At the heart of his report are nine cases studies of NMTC investments from across the country, including deals that are:

- Saving a Maine paper mill from bankruptcy while dedicating 240,000 acres of forest for conservation.
- Creating an innovative shopping and community center in inner-city San Diego, with unprecedented levels of resident involvement in development and ownership.
- Building charter schools and child care centers from New Brunswick to Los Angeles.
- Redeveloping historic structures in weaker-market cities like St. Louis, Pittsburgh, and Baltimore.

There are, however, also important areas of concern for those who want to see not only more capital in low-income places, but investment that empowers community residents – generally in the form of not-for-profit, community development organizations or small businesses – to plan for and determine the future of their neighborhoods, and to address the most pressing development needs.

While Jeff's paper makes clear that New Markets Tax Credits can be used in these ways, and that they are in a good number of places, there is some risk that investments may be used for projects that less clearly address neighborhood priorities.

NMTC investors increasingly report that the significant majority of their deals are in real estate (rather than small business, for example). The largest share of these are retail projects, which may offer needed services but generally create the lowest-wage jobs. Relatively few are developed through community-oriented processes that build social capital. And in stronger markets, we have now seen too many places where long-time residents and businesses see too little benefit from rising real estate values.

A challenge for those who want to see development that generates broadly shared prosperity and empowers community residents to create change is to make sure that the promise of New Markets Tax Credits is fulfilled – through more deals and more advocacy, both to keep capital flowing and to direct it to the places where it can make the most difference.

Jeff Armistead's paper helps to point us in that direction. We hope that practitioners and policy-makers alike will find it useful as a road map in helping communities build stronger futures.

Brad Lander
Director, Pratt Center

Executive Summary

I. What is the New Markets Tax Credit? What are the sources of the legislation?

- The New Markets Tax Credit (NMTC), passed by Congress with bipartisan support in December 2000, is the most significant federal subsidy for economic development of depressed areas in thirty years. Designed to stimulate the flow of investment capital into underserved areas, it is intended to bring about the direct investment of at least \$15 billion into these areas over about ten years,¹ and is likely to leverage 2 to 4 times that much in additional investment. The NMTC is an incentive in the form of a tax credit to induce investors to invest in the funds of certain financial intermediaries called “community development entities”, or “CDEs” which, in turn, invest in projects in targeted economically distressed areas. The projects, formally known as “low-income community businesses” can range from manufacturing and service businesses, to commercial and industrial projects such as retail real estate developments, office buildings and warehouses, to mixed use commercial and housing developments to community facilities such as child care centers and charter schools.
- Two key characteristics of the credit are:
 - It is a shallow credit, providing an investor with tax credits over seven years equal to only 39 percent of the amount invested.² In order for an investor to recover the full amount of capital invested as well as a return on capital, the project in which the funds are invested must generate significant economic benefits. By contrast, investors in the Low Income Housing Tax Credit (LIHTC) are able to recover their investment and a satisfactory return from the tax credits alone. To quantify the benefit provided by the NMTC to projects, it is generally thought to lower the interest rate on a loan by about 2 ½ to 5 percent (250 to 500 basis points) relative to a market interest rate, depending on the term of the loan, the CDE and other factors. CDEs in later allocation rounds appear to plan on delivering a greater benefit relative to market than CDEs in earlier rounds. (Allocation rounds are discussed below) and;
 - The NMTC can be used by the CDE for a broad range of eligible projects in specified target areas. The role of the CDE in selecting types of projects in which to invest is critical.
- Four factors contributed to the development of the NMTC legislation:
 - the success of the Low Income Housing Tax Credit in generating large flows of investment into low-income rental housing beginning in 1987;
 - the lessons learned from the CDC Tax Credit, a 1993 pilot program;

¹ Allocations are expected to be made in each year from 2003 through 2007; the investments stimulated by these allocations will generally be made in the ten-year period 2004 through 2013, although some can be made later.

² The face value of the tax credit is 39 percent over seven years. The actual value is less, because the investor’s basis is reduced by the amount of the credit claimed, so that the investor is effectively taxed at the capital gains rate upon exit from the fund.

- the CDFI Fund, established in 1994 to stimulate the creation and expansion of a network of community development financial institutions; and,
- the advocacy and policy work of a group of community development advocates that became the New Markets Tax Credit Coalition.

II. What do practitioners see as its significance?

- The NMTC program is small by comparison to the LIHTC,³ but practitioners in community development, ranging from community development corporations (“CDCs”) to non-profit financial intermediaries to banks, view the program as very important to their overall community development strategies, and believe that the program is allowing them to achieve community economic development objectives that they could not accomplish without it. People interviewed for this paper consistently cited the importance of the NMTC to community development; no-one dismissed it as marginal. As one respondent put it, “it may not be the low-income housing tax credit for economic development, but it is important.”

III. What have the results been so far?

- New Markets Tax Credits are awarded competitively by the CDFI Fund (Community Development Financial Institutions Fund), a unit of the U. S. Department of the Treasury. The statute specified that credits on \$15 billion of investment could be awarded over the seven year period 2001 – 2007.⁴ As of the end of 2004 the CDFI Fund had awarded \$6 billion of credits to CDEs. The competition for awards of credits is intense.
- CDEs have successfully attracted investors, have drawn down about \$700 million of equity investments,⁵ and have invested most of that in projects. Investors are of two types --- those that make investments in CDEs to which they are unrelated (example: Citibank invests in the Community Reinvestment Fund’s CDE, the National New Markets Tax Credit Fund, Inc.) and those that apply for and receive credits themselves and invest in their own related CDE (example: Wachovia Corporation invests in Wachovia Community Development Enterprises LLC, a CDE.) It appears that investors are paying between \$0.70 and \$0.80 per dollar of credit, a price level that it took five years for the Low Income Housing Tax Credit to achieve.⁶ CDEs are investing in a wide range of projects. This paper provides a number of case studies which illustrate the kinds of projects that are receiving the investments stimulated by the NMTC.

³ The tax expenditures table of the FY2005 federal budget shows \$37.55 billion for the LIHTC for the period 2005-2009 and \$3.53 billion for the NMTC for the same period, a ratio of about 10.6 to 1. *Budget of the United States Government, Fiscal Year 2005: Analytical Perspectives*, Table 18-1. Estimates of Total Income Tax Expenditures, pp. 287-288. Office of Management and Budget.

⁴ As it is commonly used by people in the community development field with regard to the NMTC, “\$15 billion of tax credits” actually means “tax credits on \$15 billion of equity invested in CDEs”, which amounts to 39 percent of \$15 billion or \$5.85 billion of tax credits. This is the amount foregone by the Treasury at the current level of authorization of the program. This differs from the usage in the Low Income Housing Tax Credit field, where “\$1 worth of tax credit” means \$1 foregone by the Treasury.

⁵ Amounts recorded in CDFI Fund system as of October 21, 2004.

⁶ Herb Stevens, Esq. Nixon Peabody LLP. Address to Novogradac & Company LLP New Markets Tax Credit Investors Conference, Boston, Massachusetts, October 20-24, 2004. The price quoted is for tax credits only; it does not include any of the economics of the transaction.

V. What key issues have arisen in the early implementation of the program? How are they being addressed?

- In the early implementation phase of the NMTC program, a number of important issues have emerged. The way these are dealt with over the next few years will bear on the long term prospects of the NMTC. These issues include:
 - **Effect of the credit: does it make marginal projects feasible, or does it go to projects that would have been done without it?** By design, New Markets Tax Credits are meant to provide subsidy to marginal projects, to make marginally doable projects into doable projects. But there is also the potential for the credit to be used to finance projects that are feasible without it, and to have the effect of “sweetening an already doable deal” to the (unnecessary) benefit of one or more of the parties. It is a major concern of many practitioners interviewed for this paper, including allocatees, investors, the CDFI Fund, community business owners and others that this outcome be avoided, and they appear to be taking steps to assure that the credit is used properly. Early indications are that the credit is, in fact, generally being used to make financially infeasible projects into feasible ones. The issue deserves, and will undoubtedly receive, a significant amount of examination and discussion over the next few years as more robust data become available.
 - **The NMTC program is both new and complex.** CDEs that have received allocations of credits have spent substantial amounts of money to apply for their allocations, set up the infrastructure to make investments and monitor compliance, and create appropriate structures at the transaction level. Much of this cost is a function of the fact that issues and problems are being addressed for the first time. One early implication of this is that it may not be advisable for smaller organizations to apply for allocations, but rather to try at the project level to use allocations that have been made to larger organizations.
 - **Tilt towards real estate.** There appears to be a significant tilt towards real estate projects as a preferred type of CDE investment. For example, CDEs awarded allocations in the second round (May 2004) intended to use two thirds of their allocations --- about \$2.3 billion --- for real estate projects. This has been a disappointment to many community development practitioners because during the gestation period of the legislation (1998 – 2000) they developed the expectation that the program would be designed to stimulate equity investments and loans to operating businesses. The tilt towards real estate appears to be a result of the recapture provisions of the legislation. This is discussed in detail in the “What are the Issues?” section.
 - **Geographic distribution of credit allocations: urban versus rural.** The NMTC was intended to be a tool for economic development in rural as well as urban areas. Advocates of rural community economic development became concerned when they noted that the percentage of tax credits allocated to CDEs intending to serve rural areas dropped from 20 percent in the first round of allocations (March 2003) to 15 percent in the second round (May 2004). Certain features of the legislation made the credit difficult to use in rural areas. Advocates succeeded in getting an amendment addressing this and some other issues passed in October 2004, and have hopes that this will improve the utilization of the credit in rural areas. The difficulty of doing

rural deals, however, may be a manifestation of the difficulty of doing small deals; better utilization of the credit in rural areas may require finding ways to make it easier to do small deals. This issue will require further monitoring and analysis.

- **Distribution of allocations between for-profit, mission-driven and public CDEs; and distribution of CDE investments at the transaction level between for-profit and non-profit borrowers/investees.** CDEs that apply for and obtain New Markets Tax Credits are of three basic types: those with for-profit parent organizations, such as banks; those with parent organizations that are driven by mission, including not-for-profit community development corporations, community development intermediaries and community development financial institutions; and those with public parent organizations such as city governments or state economic development authorities. Over the first two allocation rounds, CDEs with for-profit parents received 48 percent of the allocations, those with mission-driven parents received 39 percent, and those with public parents received 14 percent. The trend is to some extent toward for-profit parents: for-profit parents' share increased from 44 to 51 percent from Round 1 to Round 2; mission-driven parents' share decreased from 41 to 37 percent; and public parents' share decreased from 15 to 12 percent. It remains to be seen whether this trend will continue in the remaining three rounds of allocations, and if it does, what are its implications for community economic development. CDEs can invest in a broad range of eligible project types and the recipients of the investments can be either for-profit or non-profit entities.

The issue of how CDE investments are distributed between for-profits and non-profits is important because it bears on the extent to which development in targeted communities is directed by residents of those communities. For example, a CDE can provide financing to a small or large private for-profit business; to a community facility such as a child care center or a charter school;⁷ to a real estate development project of a for-profit developer; or a real estate development project done by a community development corporation. This paper provides examples of each of these types of CDE investments. The CDFI Fund is collecting data that will permit analysis of transactions according to these and many other variables. However, that collection process has just begun and the data for such an analysis are not yet available. This is an interesting and important issue that, like many issues with the NMTC, it is too early to address.

- **Reauthorization and extension.** As of November 2004, \$6 billion of credits had been allocated in two rounds, and a third round is underway in which \$2 billion is to be allocated in April 2005. The remaining \$7 billion is scheduled to be allocated in 2006 and 2007. Advocates for the program are turning their attention to extension and reauthorization. Congressman William Jefferson (D-LA) introduced legislation in June 2004 that would have doubled the New Markets Tax Credit (NMTC) allocation levels for Fiscal Years 2005, 2006 and 2007, adding an additional \$9 billion to the program. Although the bill did not pass the House, it is an early indication of forthcoming efforts. Advocates will also be undertaking a number of clarifications and technical corrections in conjunction with these efforts. What are the chances of reauthorization and extension? Although the program appears to be off to a good start, how it will fare in President Bush's second term is

⁷ A child care center or a charter school, of course, could be either for-profit or non-profit. The examples given in this paper are non-profits.

anyone's guess. Although the Low Income Housing Tax Credit program has been popular with both parties over both Republican and Democratic administrations, the new environment in which major tax reform is on the agenda implies highly unpredictable outcomes for tax advantaged community development investments. Supporters of the NMTC face a dual challenge: communicating to members of Congress the achievements of the program and attempting to build bipartisan support for it while simultaneously addressing an unstable environment for community development tax subsidies.

VI. The New Markets Tax Credit has the potential to be a significant tool for the economic development of distressed areas.

As implementation moves into high gear, there are early but promising signs that the program is successfully stimulating the flow of new investment capital into capital-starved areas and that the deployment of this capital is generating increased economic activity in targeted areas. The program, however, is a work in progress. The data that will enable an understanding of program outcomes is just beginning to be available. Critical issues for the program have been identified and major steps to resolve them have been taken. But significant challenges remain; advocates for community economic development must continue their work to shape, improve, extend and expand the program in order for it to achieve its full potential.

Introduction

In March 2003 the National Trust for Historic Preservation (NTHP) was awarded an allocation of \$127 million of New Markets Tax Credits, which it had applied for seven months earlier, as part of the first-ever allocation of credits under this new Federal program to promote economic development. NTHP was one of 66 organizations receiving awards totaling \$2.5 billion. The process was highly competitive: 345 organizations submitted applications requesting a total of \$26 billion, more than ten times the amount available.

By the end of 2003, NTHP had closed twelve transactions utilizing \$76 million of its \$127 million allocation. These projects contained 2.8 million square feet of space, had total development costs of \$372 million, created 12,700 construction jobs and 21,800 permanent jobs and generated \$71.2 million in state and local taxes.⁸ The investor was Bank of America. According to John Leith-Tetrault, Director of the Community Partners Program at the National Trust, in each case it was the NMTC equity that “put the project over the top,” and made the financing feasible.⁹

By the end of October 2004 the Trust had completed 23 transactions utilizing \$125 million in New Markets Tax Credits, nearly its entire first round allocation, with a total development cost of \$550 million¹⁰.

The NMTC is authorized at a \$15 billion level through 2007, or about 120 times the credits allocated to these early projects. According to Bob Rapoza of Rapoza Associates, manager of the New Markets Tax Credit Coalition, it is the largest economic development program in 30 years.¹¹ Even though it is only about 1/10th the size of the Low Income Housing Tax Credit program, it is still a program of major significance for community economic development.¹²

Early results from the NMTC --- the kinds of numbers just cited --- seem impressive. The early responses of community development practitioners, investors, municipal governments, and those to whom New Markets Tax Credits have been allocated¹³ range from cautious optimism to high hopes for the program. Are those hopes well founded?

This paper will look at the public policy sources of the credit, describe how it works, discuss projects that are being done with the credit and the strategies that organizations are developing to utilize it, discuss issues that are arising and how practitioners are being affected by those issues, and, in general, will try to provide some insight into the program early in its implementation. The paper is not intended to be an evaluation. It is far too early for that --- transaction level data only began to be entered into the CDFI Fund’s Community Impact Investment System in the Fourth Quarter of 2004. A rigorous evaluation would be far beyond the scope of the paper in any case. Reports on the NMTC program were done by the General Accounting Office in December

⁸ These figures were provided by Michael Dubansky, National Trust for Historic Preservation.

⁹ John Leith-Tetrault, director of the Community Partners Program, National Trust for Historic Preservation, Interview, July 28, 2004.

¹⁰ John Leith-Tetrault, Presentation to Novogradac & Company LLP New Markets Tax Credit Investors Conference, Boston, Massachusetts, October 20-24, 2004.

¹¹ Robert Rapoza, president and principal of Rapoza Associates and manager of the New Markets Tax Credit Coalition, Interview, October 14, 2004. Rapoza, of course, is excluding the Low Income Housing Tax Credit program from this comparison.

¹² See Footnote No. 2.

¹³ “Allocatees” are entities (Community Development Entities, or “CDEs”) to which NMTCs have been allocated. These are discussed later.

2002 and January 2004¹⁴, and a third is due in 2007. In addition, the CDFI Fund will be contracting for an independent evaluation. Rather than serving as an evaluation, the author and sponsor hope that the paper leads to an increased understanding by practitioners of community economic development of the significance of this tool, and hope to stimulate the thinking and participation that will be necessary to make the credit as effective a tool as possible.

¹⁴ The reports are *New Markets Tax Credit Program: Status of Implementation and Issues Related to GAO's Mandated Reports*, GAO-03-223R, United States General Accounting Office, December 2002; and *New Markets Tax Credit Program: Progress Made in Implementation, but Further Actions Needed to Monitor Compliance*, GAO-04-326, United States General Accounting Office, January 2004

Origins of the New Markets Tax Credit

On December 14, 2000, the White House announced the passage of a “historic new bipartisan New Markets and Community Renewal initiative.”¹⁵ The New Markets initiative included the New Markets Tax Credit, which authorized \$15 billion in tax credits designed to stimulate private-sector investment in a range of privately-managed funds, which in turn would be invested in community businesses in distressed areas of the country; and a smaller New Markets Venture Capital program.¹⁶

Besides the New Markets Initiatives, the legislation included an expansion of Empowerment Zones, the creation of Renewal Communities, an expansion of the Low Income Housing Tax Credit and an increase in the private activity bond cap.

Introduced in September 1999, the New Markets Initiatives were important to President Clinton. The President made three separate trips between July 1999 and April 2000 to impoverished urban and rural areas around the country, publicizing and building support for the program, including stops in the Kentucky Highlands, the Mississippi Delta, East St. Louis, Pine Ridge Reservation, Los Angeles, Newark, Hartford, Hermitage, Arkansas, Chicago, and the Navaho Nation.¹⁷

The New Markets Initiative was focused on the idea that, although by 1999 the country had been experiencing an economic expansion, the inner cities and rural areas were being by-passed, with poverty and unemployment remaining at unacceptably high levels. The President wanted a program that would stimulate the flow of private capital to these economically marginal areas, convinced that the market would do its work, and that increased jobs, wages, economic activity and a better standard of living would ultimately follow. The “New Markets Tour” highlighted several aspects of the President’s thinking. At each site, he focused on economic success stories -- businesses that were working, and on the potential strength of the market. The President was accompanied by or met with business leaders, to demonstrate the importance of focusing the interest of business people on these areas as places of potential opportunity. He asked: if businesses will go thousands of miles to overseas locations to invest in opportunities, if given the right incentives, why wouldn’t they do the same in their own back yard?¹⁸

The legislation that became the centerpiece of the New Markets Initiative --- the New Markets Tax Credit --- also had these roots:

- The success of the Low Income Housing Tax Credit. The Administration had become convinced of the value of this tax incentive program which since 1987 had facilitated the construction of 80,000 to 100,000 low-income rental apartments per year, creating “about 70,000 jobs, \$1.8 billion in wages and \$700 million in tax revenues annually . . .

¹⁵ Press Release. The White House. December 14, 2000.

¹⁶ New Markets Initiatives also included BusinessLINC, a \$7 million program to encourage large businesses to mentor small business owners and entrepreneurs in distressed areas.

¹⁷ Those who have been disappointed by the appearance of a tilt towards real estate as a preferred type of CDE investment and by the difficulty of using the NMTC to make loans and equity investments to non-real estate businesses have pointed out that small business enterprises were prevalent among the sites visited by the President on this tour.

¹⁸ Various White House Press Releases.

leveraging over \$12 billion in corporate investment --- much of it from corporations that had not previously invested in housing.”¹⁹

- Lessons learned from the CDC Tax Credit, a pilot program established in 1993 that provided a tax credit for investors to work with twenty selected community development corporations to enable them to carry out community economic development projects in distressed areas.
- The CDFI Fund, proposed by the Administration, passed and signed into law in 1994, which has stimulated the creation and expansion of a network of community development financial institutions in distressed areas.
- The policy advisory and advocacy work of a group of community development advocates that had worked on developing and shaping the Low Income Housing Tax Credit and the CDC Tax Credit and believed in the importance of developing a tax credit for economic development. This group became the New Markets Tax Credit Coalition.

According to Cliff Kellogg, one of the Treasury Department staff tasked with designing the New Markets Tax Credit program in the winter of 1998, Treasury staff wanted to “nudge the capital markets so that they would fully examine the profit-making potential in these areas.”²⁰ They “aspired to make capital markets work more perfectly, while also giving small businesses in these communities a fair shake,” but they did not want to subsidize uncompetitive businesses. The staff thought that a properly-designed program would have three outcomes: it would “overcome false perceptions of market risk,” encouraging investors to look carefully before they declined to participate in a deal; it would “facilitate more capital going to entities with good investment track records,” effectively rewarding experience and performance; and it would “slightly expand the range of what’s ‘investable’ by providing slightly more return when investors are balancing the risk-return tradeoff.”

These forces largely produced the credit we have today.

¹⁹ Carol Steinbach, *The CDC Tax Credit: An Effective Tool for Attracting Private Resources to Community Economic Development*, Brookings Institution. August 1998, p. 19.

²⁰ Cliff Kellogg, Keynote Speech to Novogradac & Company LLP New Markets Tax Credit Conference, June 7, 2002. See Novogradac & Company website, www.novoco.com/NMTC/Resources/kellogg_keynote.doc. All citations in this paragraph are from Kellogg.

Illustrative Projects

One of the most interesting features of the New Markets Tax Credit that emerged from these origins is the broad range of projects in which it can be used. As one commentator put it: “The best thing about the credit is that you can use it for practically anything; the problem with the credit is that you can use it for practically anything.” This feature has stimulated the development of interesting and creative approaches to community development problems. Illustrated below are ten such examples. This is by no means a scientific sample. Projects were selected because they demonstrated something about the range of types of projects that can be done, and because information was available. Eleven organizations that received allocations are represented here (one example includes two such organizations); eight of them are profiled in greater detail in the case studies in Appendix B, which discuss their strategies for using the NMTC as well as provide more detail on the projects outlined below. (One case study is more focused on the project, Market Creek Plaza, than on the CDE.)

- The National Trust for Historic Preservation, the Enterprise Social Investment Corporation, Bank of America and the Missouri Development Finance Board and others teamed up to finance the renovation of the U.S. Customhouse and Post Office in St. Louis, Missouri, a building of immense historic and architectural significance, using the Historic and New Markets Tax Credits. The 242,000 square foot project generated 1,458 construction jobs, 850 permanent jobs and about \$8 million in state and local tax revenues.²¹ The National Trust’s CDE, NTCIC, made a tax credit equity investment of \$25.5 million (combining Federal, State, Historic and New Markets credits,) and ESIC’s CDE, ESIC New Markets Partners LLP, made a first mortgage loan of \$8.2 million.
- The Community Reinvestment Fund of Minneapolis, Minnesota has used the NMTC to create a secondary market for business loans in the range \$50,000 to \$2.5 million made by community development lenders. The first two loans funded were a loan by New Jersey Community Capital to a non-profit charter school in New Brunswick, N.J. and a loan from the Bay Area Employment Development Company to a company in Hayward, CA that manufactures tortillas. These investments were made through the Business Loan Conduit LLC, one of two CRF sub-allocatees; the other, Commercial Lending LLC, funds the purchase of loans in the \$2 million to \$50 million range.²²
- A Key Bank New Markets Tax Credit investment played a major role in the \$6.2 million development of Arbor Park Place, a 39,000 square foot shopping center in Cleveland which officially opened for business in November 2004. The center is anchored by a 19,000 square foot Dave’s Supermarket, and includes a Footlocker store, a Key Bank branch, Chinese and soul food restaurants, and discount and clothing retailers. Key Bank’s CDE provided a \$1,000,000 loan utilizing New Markets Tax Credits, closing in January 2004. The project was co-developed by two non-profit organizations, New Village Corporation, a subsidiary of Neighborhood Progress, Inc., a citywide community development intermediary, and Burton, Bell, Carr Development, Inc., the Ward 5 community development corporation. It is located in the Central neighborhood, one of

²¹ Presentation by Charles R. Werhane, John Leith-Tetrault and David Kavanaugh at the Novogradac & Company LLP New Markets Tax Credit Investors Conference, Boston, Massachusetts, October 20-24, 2004.

²² Mary Tingerthal, vice president and chief credit officer of Community Reinvestment Fund, Interview, July 16, 2004; also, “NMTC: Charting the Course,” *NMTC Monthly Report*, October 2004, Volume III, Issue X. Novogradac & Company LLP, 2004.

Cleveland's poorest, where about 60 percent of residents are below the poverty level, according to the Poverty Center at Case Western Reserve University.²³

- A \$15 million loan to Market Creek Plaza in San Diego by Clearinghouse CDFI, funded by an investment by Wells Fargo Bank, was a critical piece of financing for a project that is unusual not only for its scale and impact --- a \$23.5 million shopping center anchored by a 57,000 square foot Food 4 Less supermarket --- but also for the unprecedented level of resident and community involvement in its development and ownership. The project will capture for this inner-city community a large portion of an estimated \$60 million in retail spending that was leaking out of the community before development. It has generated 1,700 new permanent neighborhood jobs and 360 neighborhood construction jobs, and will provide for a mix of retail uses ranging from national and regional credit tenants to local entrepreneurs and micro-businesses. It has also involved more than 2,000 residents and community members in planning the economic, social and cultural characteristics of the project. Said Chip Buttner, vice president of the Jacobs Center for Neighborhood Innovation (JCNI), the non-profit development entity developing the project, "getting the loan at the rates and terms the New Markets Tax Credit made possible was absolutely critical to our ability to proceed with this project. These terms were not available to us anywhere else. This deal is what the program was intended for."²⁴
- The Local Initiatives Support Corporation (LISC), in its second NMTC transaction, provided financing for the acquisition and rehabilitation of the Bloom Lake Building in Minneapolis by the Neighborhood Development Center (NDC), a locally-based community development corporation. The property is a 40,000 square foot structure that had been vacant since 1998 and had exerted a blighting influence on the neighborhood. The project will restore the building, bring vitality to the street front, enhance the area's Latino business district, and create opportunities for further arts and cultural programming. Wells Fargo provided both equity and debt to this leveraged structure,²⁵ and additional debt was provided by an affiliate of NDC, which had assembled the funds as loans or grants from nine different sources.
- Coastal Enterprises, Inc. (CEI) made a \$31.5 million loan to Katahdin Forest Management, an owner of timberlands that supply Katahdin Paper and other local paper mills. This was part of a complex transaction involving CEI, The Nature Conservancy (TNC), Great Northern Paper (GNP) and GE Commercial & Industrial Finance in which GNP was restructured into two companies, a paper company and a forest management company; 41,000 acres of wilderness area was transferred to TNC; a conservation easement was placed on 200,000 acres of forest land around Mount Katahdin; and 750 jobs at local paper mills and in forest management were preserved. CEI's Steve Weems said, "The NMTC allowed us to complete an important project focused on our core market: economic development in rural areas in the Northeast with a natural resource based economy."²⁶ GE Commercial & Industrial Finance's Allan Weiman said, "This project got us way up the learning curve."²⁷

²³ "Central Neighborhood Lands Grocery," *The Plain Dealer*, November 16, 2003.

²⁴ Chip Buttner, chief operating officer of the Jacobs Center for Neighborhood Innovation (JCNI), Interview, March 18, 2005.

²⁵ The leveraged structure, one in which a qualified equity investment into a CDE is made with funds whose source is borrowed funds and grants as well as equity, is discussed on page 22.

²⁶ Steven Weems, president of CEI Capital Management, LLC, Interview, October 22, 2004.

²⁷ Allan Weiman, Informal discussion at Novogradac & Company LLP New Markets Tax Credit Investors Conference, Boston, Massachusetts, October 22, 2004.

- GMAC Commercial Holding Capital Corp.'s (Capital Corp.) CDE, Paramount Community Development Fund LLC, received a first round allocation of \$75 million. Its business strategy is to create a mezzanine lending fund which will specialize in short term loans (under 3 years), allowing it to recycle NMTC capital two to three times in the seven-year compliance period. It used this fund to make a \$19.5 million subordinate loan to the Everett Mall, a \$98.8 million redevelopment of a 600,000 square foot regional mall project in Everett, Wash. Capital Corp. estimates that its loan was 500 basis points below market, cites the fact that financing to the project was rejected by two national lenders before their NMTC structure made it work, and cites the following impacts: 2,200 construction/renovation jobs; 5,700 permanent jobs; and 500 jobs in CDFI census tracts.
- Excellent Education Development, Inc. (ExEd) is a non-profit formed in 1998 to improve elementary and secondary public education in lower income communities of Los Angeles by creating and supporting high achieving charter schools. ExEd helps charter school organizers/operators overcome three major obstacles: developing the school, finding appropriate and affordable facilities, and managing the business operations of the school. ExEd provides technical assistance and below-market financing based on the NMTC to selected charter school operators for the construction or rehabilitation of school buildings. ExEd's CDE, LA Charter School New Markets CDE LLC received a first round allocation of \$36 million. ExEd is offering a loan product with an interest rate of approximately 5.75 percent, 90 percent loan to value ratio, 1.2 times debt coverage ratio, 25 year amortization, and a term of seven years. It hopes to close both its qualified equity investments and its first two transactions (about \$7 million to \$8 million each) by the end of the first quarter of 2005.
- Advantage Capital Community Development Fund, LLC, the CDE of Advantage Capital Partners, received a \$110 million allocation in Round 1. Advantage has created a Small Business Investment Fund which "will make equity and debt investments exclusively in businesses located in low-income communities that by their size and nature are likely to have significant job creation and economic development impact in distressed communities."²⁸ Two early investments made by this fund are Stereotaxis, a growing medical device company located in a low-income area of St. Louis, and Hoku Scientific, which has developed a fuel cell membrane technology, and is located in a low-income area of Honolulu, Hawaii.
- Impact Community Capital, an organization that makes and manages investments for its members in the insurance industry, obtained a \$40 million first round allocation, which it will use to invest in child care facilities in low-income communities around the country. Impact's first investment was a \$10.3 million loan to the Fund for Children and communities CDE (FCC CDE), an affiliate of the Low Income Investment Fund (LIIF), and it will be used for child care facilities in low-income neighborhoods in California.²⁹

²⁸ Alex Ruiz, Staff Writer, "Advantage Capital Raises \$55.25 million Under the New Markets Tax Credit Program," *NMTC Monthly Report*, April 2004. Novogradac & Company LLP 2004.

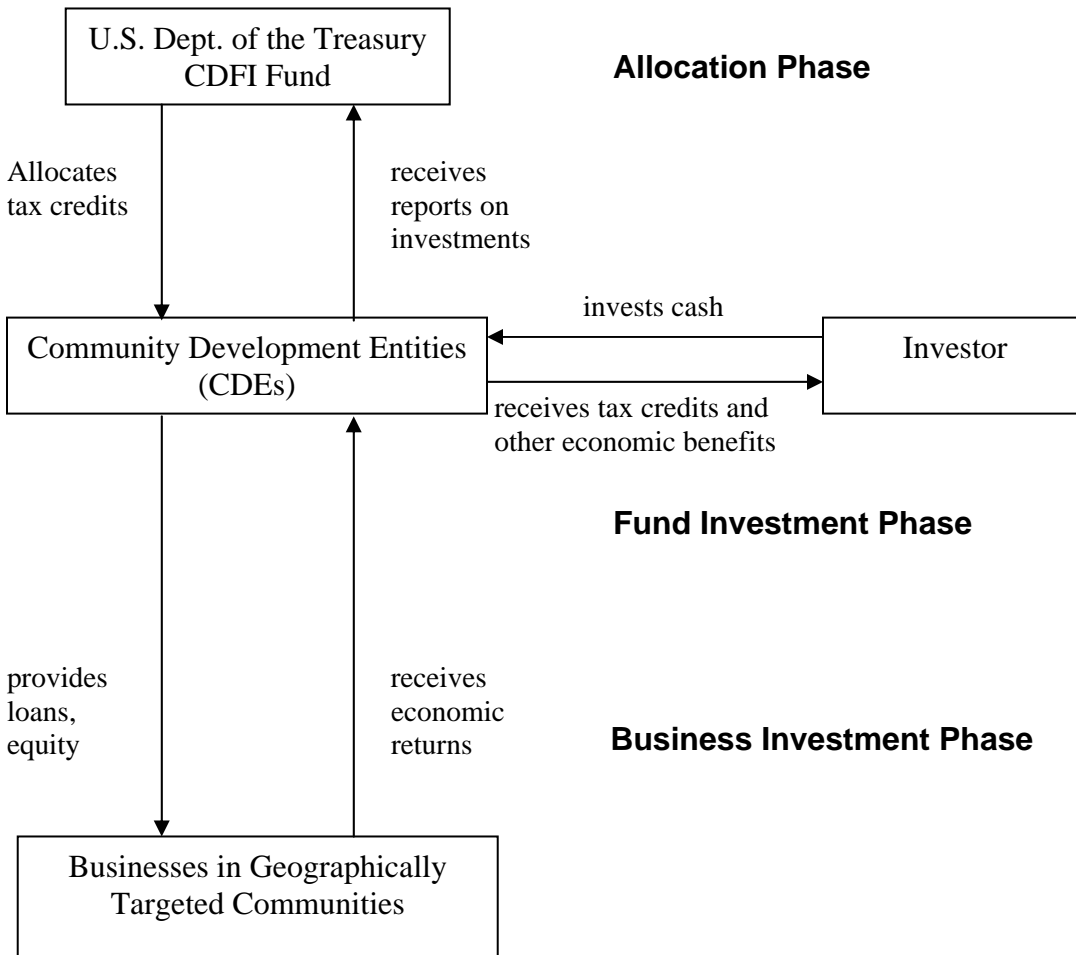
²⁹ Dan Sheehy and Jean Chang, Impact Community Capital, "Insurance Companies Use NMTC to Support Community Facilities," *NMTC Monthly Report*, September 2004, Volume III, Issue IX, Novogradac & Company LLP 2004.

How Does The Credit Work?

A Thumbnail Sketch

The New Markets Tax Credit is an incentive in the form of a credit against federal taxes provided to investors to induce them to invest in economically distressed areas where capital for a broad range of investments has not been available. The NMTC works through a three phase process. In the first, the Allocation Phase, the U. S. Treasury (through the CDFI Fund, its arm which administers the program) allocates credits through a competitive process to financial intermediaries known as “community development entities”, or “CDEs”. In the second, the Fund Investment Phase, the financial intermediaries draw down cash investments from investors in exchange for tax credits and the prospect of other economic benefits. In the third, the Business Investment Phase, the CDEs select, close and monitor investments in businesses located in targeted geographic areas which are projected to generate economic returns for the CDE and the investor. The CDE reports on its activities to the CDFI Fund. The three phases are illustrated in Figure 1. (In practice, the second and third phases often occur simultaneously.)³⁰

Figure 1



³⁰ The terms Allocation Phase, Fund Investment Phase, and Business Investment Phase” are the author’s and are for purposes of explication; they are not CDFI Fund terms or terms formally used in the program.

Allocation phase

The credit ---- a shallow credit --- is competitively awarded by the CDFI Fund to financial intermediaries known as community development entities, or CDEs.

A shallow credit. The NMTC provides investors with a tax credit equal to 39 percent of their investment over seven years: 5 percent each year for the first three years and 6 percent each year for the next four years. The present value of the credit is often cited as about 30 percent of the amount invested.³¹ An investor must therefore be comfortable that the project(s) in which the funds are ultimately invested can provide a return of capital and an appropriate risk-adjusted return on capital in addition to the tax benefits. This is a major difference from the Low Income Housing Credit, where the investor is able to receive its entire return in the form of tax benefits. The bottom line is that the projects in which the NMTC funds are invested must have significant ability to generate economic returns.³²

The CDFI Fund. The responsibility for administering the program rests with the U. S. Department of the Treasury, which has assigned it to the CDFI Fund. The tax issues, of course, are the responsibility of the IRS, and the IRS and CDFI Fund have worked closely on the program.

CDEs. The CDFI Fund awards New Markets Tax Credits to organizations known as Community Development Entities (CDEs), which are meant to function as financial institutions sensitive to the needs of targeted communities; the CDEs raise capital from investors in exchange for the tax credits and other economic benefits, and invest that capital into projects they select. A CDE is a new acronym and a new concept invented for this program. It is built upon the idea of the CDFI (community development financial institution), which is a kind of community development bank, an institution that knows the credit needs of the community and has the skills and knowledge to seek out credit-worthy businesses or projects that mainstream banks might overlook. Legislation in 1993 created the CDFI Fund which has provided equity investments in CDFIs for the purpose of building stronger community-based financial institutions. The CDE is a broader concept. In addition to CDFIs, it potentially includes community development corporations (CDCs), other non-profit financial intermediaries, government and quasi-governmental agencies, banks, investment banks, and other for-profit financial institutions. The CDE is critical to the design and implementation of the NMTC program. One practitioner interviewed for this paper put it this way: “The NMTC program depends for its success on having righteous CDEs.”

There are three statutory criteria for qualification as a CDE. First, “the primary mission of the entity [must be] serving, or providing investment capital for, low-income communities or low-income persons;” second, “the entity [must] maintain accountability to residents of low-income communities through their representation on any governing board of the entity or on any advisory board to the entity;” and, third “the entity [must be] certified by the Secretary . . . as being a qualified community development entity.”³³ Organizations apply to the CDFI Fund to be certified as CDEs. CDFIs and SSBICs (Specialized Small Business Investment Companies) automatically qualify as CDEs.

³¹ This implies a discount rate of about 7 percent, and ignores the implications of the investor’s loss of basis in the amount of the credit.

³² Although the credit is thin, it could have been thinner: the legislation as it first emerged called for a 25 percent credit --- 5 percent per year for five years --- and advocates won a major victory by getting it increased to the current 39 percent level.

³³ IRC Sec. 45D (c) (1) (A) – (C)

The “primary mission test” is satisfied if at least 60 percent of the activities of the entity are dedicated to serving low-income communities or persons. The “accountability test” is satisfied if at least 20 percent of the governing board or advisory board members represent the low-income community. A person may represent the low-income community by residing in the community, or by being a small business owner whose business is located in the community, or by being an employee or board member of a community board or charitable organization serving the community.³⁴ In practice, these are not difficult tests to meet.

Some examples of CDEs, each of which received allocations in the first or second rounds, are as follows:³⁵ Traditional for-profit financial institutions include Wachovia Corporation, Goldman Sachs Group, and Bank of America; Community loan funds include New Jersey Community Loan Fund and Boston Community Capital; Non-profit financial intermediaries are represented by Local Initiatives Support Corporation, the Enterprise Foundation, and the National Trust for Historic Preservation; Community Development Corporations include Coastal Enterprises and Self-Help Ventures; Government-related entities include the City of Phoenix and the Wisconsin Housing and Economic Development Authority.

The fact that CDEs range in size and type from those created by very large banks and investment banks to those created by community loan funds and community development corporations, in conjunction with the central role CDEs play in selecting types of projects and types of entities in which to invest, has left some proponents of community-initiated development unsettled. They fear that if, as discussed below, the trend is toward larger allocations and away from allocations to mission-driven CDEs, there will be insufficient attention paid to the issue of whether or not projects that receive CDE investment funds represent development choices of representatives of the communities in which the projects are located.

The CDFI Fund is authorized to allocate credits on up to \$15 billion of investment through 2007. Credits on six billion dollars of investment have already been allocated. Allocations to date and the schedule for the remaining allocations are as follows:

- \$2.5 billion was allocated in March 2003;
- \$3.5 billion was allocated in May 2004;
- \$2.0 billion is scheduled to be allocated in April 2005; and
- the CDFI Fund plans to allocate \$3.5 billion in 2006 and \$3.5 billion in 2007.

The competitive allocation process. Once an organization has been certified as a CDE, it is eligible to apply directly to the CDFI Fund in response to a notice that funds are available. There are no set allocations by state or region. The allocation process is highly competitive. Over the first two allocation rounds, there were 616 applications from CDEs requesting in total over \$56 billion. Awards were made to 129 CDEs totaling \$6 billion; i.e. about 1 out of 5 applications was successful, and requests were about nine times the amounts allocated. For third round applications submitted as of the October 6, 2004 deadline, the approximate 9 to 1 ratio held: applications for \$23 billion were received from 208 CDEs, and \$2.5 billion will be allocated.

³⁴ Michael J. Novogradac, CPA and Thomas G. Tracy, Esq., *2003 New Markets Tax Credit Handbook*, p. 60 - 62.

³⁵ The named entity is the parent of the CDE; the CDEs, which are for-profit entities controlled by the parent, sometimes have names that would not be easily identifiable.

Applications are scored in four categories: business strategy, capitalization strategy, management capacity and community impact. Each category is worth a base 25 points. The business strategy category seeks to determine whether the applicant organization has both a strategy and a track record in the deployment of capital; the capitalization strategy category, whether it has a strategy and a track record of raising capital; and the management capacity category, whether its management team has the requisite experience to carry out the program. In addition to the base 100 points, up to 10 additional “priority points” are available for the business strategy section, based on priorities stated in the legislation: does the CDE intend to invest in unrelated entities; and, does it have a track record of having successfully provided capital or technical assistance to disadvantaged businesses or communities as opposed to providing capital in general? Overall, an organization’s experience in raising capital and deploying capital, particularly in the targeted communities, is very important.

The fourth section, community impact, requires the applicant to respond to two issues: (1) to what extent is the applicant targeting its investments to areas of greater economic distress within eligible low-income communities; and, (2) what are the expected community development impacts?

Targeting areas of greater economic distress. An eligible low-income community is generally a census tract with a poverty rate of twenty percent or greater, or a census tract in which the median family income is less than eighty percent of either the metropolitan area median or the statewide median, whichever is less.³⁶ About 39 percent of all census tracts are eligible, and about 36 percent of the nation’s population live in eligible census tracts.³⁷ Examples of areas with greater economic distress would be:

- areas with poverty rates greater than 30 percent;
- areas with median incomes of less than 60 percent of area median income;
- areas with unemployment rates at least 1.5 times the national average;
- federally designated Empowerment Zones, Enterprise Communities, or Renewal Communities;
- SBA designated HUB Zones;
- brownfields redevelopment areas; and
- several other categories of distressed communities.³⁸

Question 49 (Part IV, Section A) requires the applicant to “indicate the percentage of total [qualified low-income community investments,] QLICIs (based on dollar amounts) that will be used to finance activities in one or more [such areas].”³⁹ A “tip” on the same page tells the applicant that “the higher the percentage indicated above, the better the applicant will score under the Community Impact Section” and warns the applicant that if it “receives a NMTC allocation, it will be required to meet the percentage figure identified above, and such requirement will be a term of its Allocation Agreement.”⁴⁰

³⁶ There have been some important changes made to the initial definition of low-income community. Please see Issue No. 4, below, in the “What Are the Issues?” section, page 30.

³⁷ *New Markets Tax Credit Program: Progress Made in Implementation, but Further Actions Needed to Monitor Compliance*, GAO-04-326, United States General Accounting Office, January 2004, p. 4.

³⁸ CDFI Fund, *NMTC Program 2005 Application*, p. 30.

³⁹ *Ibid.*

⁴⁰ *Ibid.*

It appears that incentives such as these in the competitive allocation process are having considerable effect in channeling allocations to CDEs that intend to use them in areas of greater economic distress. People knowledgeable about the applications process have said that for the second round there was a rule of thumb that in order to win an allocation an applicant had to state that 80 percent or more of its QLICIs would be in areas of greater economic distress, and, further, that in the third round, that number may be as high as 100 percent.

Expected community development and economic impacts. The applicant is asked if it intends to, and to quantify the extent to which it will do one of the following specifically for low-income persons or residents of low-income communities:

- create or retain jobs;
- increase wages or incomes;
- finance or assist businesses owned by residents of, or otherwise committed to remain in, the low-income communities;
- finance or assist minority- or women-owned businesses;
- finance or assist businesses (including non-profit organizations) or real estate projects that provide childcare, health care, educational or other benefits;
- facilitate wealth creation or asset accumulation (such as home ownership);
- provide goods and services to; and
- other activities.⁴¹

A “tip” in this section of the application (IV.B. Economic Impact) states that “an Applicant that can provide a credible and detailed description of substantial impact will score well.”

The applicant is also required to provide a table projecting: number of projects; dollar amount of NMTC financing; permanent FTE jobs created or retained; pre-development or construction FTE jobs created or retained; square feet of space developed or rehabilitated; number of housing units developed or rehabilitated; number of clients served.

In the first two allocation rounds, awards were based on total score. According to readers of third round applications, in this round the CDFI Fund has increased the importance of the business strategy and community impact sections by first ranking all applications according to the combined scores on these sections and establishing a cutoff, and then taking the remaining applications and ranking them according to the total score on all four sections combined.

Appendix A summarizes the results of the first two rounds of allocations. We have already mentioned that issues to be watched in future rounds are an apparent trend towards a greater share being garnered by CDEs with for-profit parents; the existence of a tilt towards real estate; and an apparent trend towards a smaller share of allocations going to rural areas. In addition, there is a trend in the direction of larger allocations, as a 40 percent larger total allocation went to a slightly smaller number of CDEs. From Round 1 to Round 2, the average went from \$37.9 million to \$55.6 million; the median went from \$21 million to \$47 million; the number of allocations greater than \$100 million went from 7 to 14, and the number of allocations less than \$10 million went from 24 to 6.

⁴¹ Loc cit., p. 31.

The Fund Investment Phase

After receiving an allocation, CDEs negotiate an allocation agreement with the CDFI Fund, which essentially binds them to do what they said they would do in the application. Once the allocation agreements are signed, the CDEs are able to draw down their equity investments from their investors (“qualified equity investments”, or QEIs) and simultaneously pass the tax credits to the investors. Under the NMTC program QEIs must be cash, not commitments; investors only begin to receive credits after they make a cash investment in the CDE.⁴² Investors are entitled to receive a tax credit equal to 5 percent of the QEI on each of the first three anniversary dates of the QEI and 6 percent on each of the next four anniversary dates. CDEs must obtain qualified equity investments within five years of the time the allocation is received from the Treasury.

The Business Investment Phase

The CDE in turn then uses the proceeds of the investment to invest in the types of projects specified in its application and allocation agreement. Four types of uses are allowed: (a) a capital investment in or loan to a qualified business; (b) the purchase of a loan from another CDE; (c) an equity investment in or loan to another CDE; or, (d) financial counseling and other services to businesses or individuals in a low-income community.

“Substantially all” of the funds received as QEIs must be invested in businesses operating within low-income communities; “substantially all” has been defined generally as 85 percent. CDEs have one year to invest substantially all of their investment proceeds, and must reinvest them if they are repaid by the borrower or investee. As noted above, the CDE must invest in businesses located in eligible low-income communities, and if the CDE stated in its application that it would target a certain percentage of its investments to an area of greater economic distress, say, an area with a poverty rate of 30 percent, then that requirement becomes part of its allocation agreement and that is the target that must met. It appears that the percentage of investments targeted to such areas is approaching 100 percent.

What is a “qualified active low-income community business?” As the examples cited earlier show, CDEs have been given wide latitude as to types of projects in which they can invest. What kinds of businesses can a CDE invest in? Technically, the question is: what is the definition of a “qualified active low-income community business?”

The statute excluded certain types of uses. For example, qualified businesses do not include liquor stores, racetracks, gambling facilities, massage parlors, hot tub or suntan facilities, golf courses and country clubs. Also excluded are businesses consisting predominantly of the development or holding of intangibles for license or sale.⁴³

What kinds of businesses qualify? The business must operate “within a low-income community.” To determine if that is the case, “temporary Treasury Regulations contain three requirements or factors: gross income, tangible property, and services. . . . Under the gross income requirement, at least 50 percent of the total gross income of [the business] must be derived from the active conduct of a qualified business within any low-income community. . . . Under the tangible property requirement, at least 40 percent of the use of the tangible property of

⁴² This differs from the LIHTC, under which an investor can begin receiving tax credits when the low-income housing project achieves “qualified occupancy,” regardless of whether the investment was in the form of cash or a commitment.

⁴³ IRC §45D(d)(3)(A).

[the business] (whether owned or leased) must be within any low-income community. . . . Under the services performed requirement, at least 40 percent of the services performed for [the business] by its employees must be performed in a low-income community.”⁴⁴ With respect to the gross income requirement, the Novogradac & Company *2003 New Markets Tax Credit Tax Credit Handbook* says “The administrative and definitional complexities of determining whether this test is satisfied are quite extreme.” This issue was mentioned repeatedly by people interviewed for this paper. These complexities make it attractive for CDEs to invest in real estate projects.

In addition to these tests for whether a business is operated “within” a low-income community, there are several other tests that go to the nature of the business. These are the no collectibles requirement, the nonqualified financial property requirement, and other requirements. Under the no collectibles requirement, less than 5 percent of the property of the business can be attributable to collectibles, other than those held primarily for sale to customers. Under the nonqualified financial property requirement, less than 5 percent of the property of the business is attributable to nonqualified financial property. This definition means that “banks, credit unions and other financial institutions are generally excluded from the definition of qualified active low-income community businesses.”⁴⁵

The leasing of rental residential rental property is specifically excluded. (Furthermore, the NMTC cannot be combined with the LIHTC; see next page.) Residential rental property, however, is defined as a building in which 80 percent or more of the gross income is from dwelling units. Hence mixed-use projects can qualify, as long as the non-residential income exceeds twenty percent. An example of this is the Albers Mill project in Tacoma, Washington. (See Appendix B) The Local Initiatives Support Corporation (LISC) invested \$10.9 million of its tax credit allocation in this mixed-use project which contained 36 market-rate loft-type apartments on four top floors and a ground floor space with retail space, an art gallery, coffee shop, wine bar and deli. The non-residential income exceeds the 20 percent minimum.

Recapture Provisions. The statute specifies conditions under which the tax credits may be recaptured from investors, and these recapture provisions of the statute have played a significant role in the way the NMTC program has been implemented. The statute specifies three recapture events:

- the CDE ceases to be a qualified CDE;
- the requirement that “substantially all” of the qualified equity investments received by the CDE be invested in qualified businesses ceases to be met; or
- the equity investment into the CDE is redeemed by the CDE.

The amount of the recapture is the total amount of tax credits claimed plus penalties and interest. This is generally considered to be a severe if not draconian provision. The recapture provision is generally thought to have played a major role in introducing a tilt towards real estate as a preferred investment, and to have made it extremely difficult for the credit to be used to support equity investments in non-real estate businesses. This is for two reasons. Recapture is triggered if a CDE ceases to have substantially all of investor funds invested in eligible projects. A business that received an investment and then moved out of the target area would no longer be eligible,

⁴⁴ Michael J. Novogradac, CPA and Thomas G. Tracy, Esq., *2003 New Markets Tax Credit Handbook*, Novogradac & Company, LLP, pp. 34-35. See for a full discussion of these tests.

⁴⁵ Novogradac and Tracy, *2003 New Markets Tax Credit Handbook*, p 36.

potentially triggering recapture.⁴⁶ Investing in real estate, which doesn't move, eliminates this risk. Second, recapture is triggered if the investor's equity investment is redeemed before the end of the seven-year period. This means that if capital is returned to the CDE by the business, it must be reinvested for the remaining portion of the term. This is particularly difficult for CDEs whose business is venture capital investing. According to Kerwin Tesdell, president of the Community Development Venture Capital Alliance, venture capital funds typically make investments at the beginning of a ten year period, and then would like to harvest their investment whenever it is possible and appropriate to do so, whether in three years, seven years or ten years. If they are successful in doing so, they don't want to be forced to reinvest. The community development venture capital funds find that the fixed seven year period combined with the reinvestment requirement make the credit largely unworkable.⁴⁷

Combining the NMTC with other federal tax credits. The statute directed that the Secretary of the Treasury develop regulations on a number of issues, including regulations that limit the use of the NMTC for investments subsidized by the LIHTC and other Federal tax benefits. IRS Notice 2002-64 provided guidance that said that the LIHTC limited the availability of the NMTC, but that until further guidance was issued, other Federal tax benefits did not, including the rehabilitation credit under Section 47. This has made a significant difference in the way the credit has been used. For example, the National Trust for Historic Preservation, which pioneered the combining of these two credits, as of late 2004 had completed 23 transactions of this type involving total development costs of \$0.5 billion.

The Leveraged Investment Structure. We have mentioned several times that investors in the NMTC, in order to receive both a return of capital invested and a return on capital, will need both tax benefits (primarily credits) and economic returns generated by the business. As potential CDEs, investors and businesses explored different investment structures, the idea of using a leveraged investment structure was examined. The NMTC requires that in order to qualify for tax credits, the investment into a CDE must be equity, i.e. it must be a qualified equity investment. However, the idea for a leveraged structure was that an entity above the CDE --- a Conduit LLC --- could aggregate equity investments, debt and even grant funds in some cases, and invest the entire amount as equity. The structure is shown in Figure 2. The primary reason for doing this is the assumption that one type of investor wants tax credit returns and another type of investor wants economic returns, and that the total range of investors and quantity of investment in the program would be maximized if investors were offered the chance to bifurcate returns in this manner. A secondary reason for doing this is bringing grant funds into a project in a way that increases the tax credit available to the project.

The IRS responded to a request to rule on this issue with Revenue Ruling 2003-20, which essentially said that under a certain set of facts, the structure would be acceptable. CDFI Fund official Linda Davenport announced at a conference in October 2004 that 16 out of the 40 first round allocatees used a leveraged structure, and that about 1/3rd of the \$672 million in QEIs that had been registered in the CDFI Fund's reporting system as of that date were generated using a leveraged structure. However, it remains to be seen whether the apparent acceptance of this structure will hold up. Some investors interviewed for this article said that they questioned whether the complexity and attendant cost (including significant accounting and legal costs) generated by the leveraged structure were worth the purported benefit. We will see whether

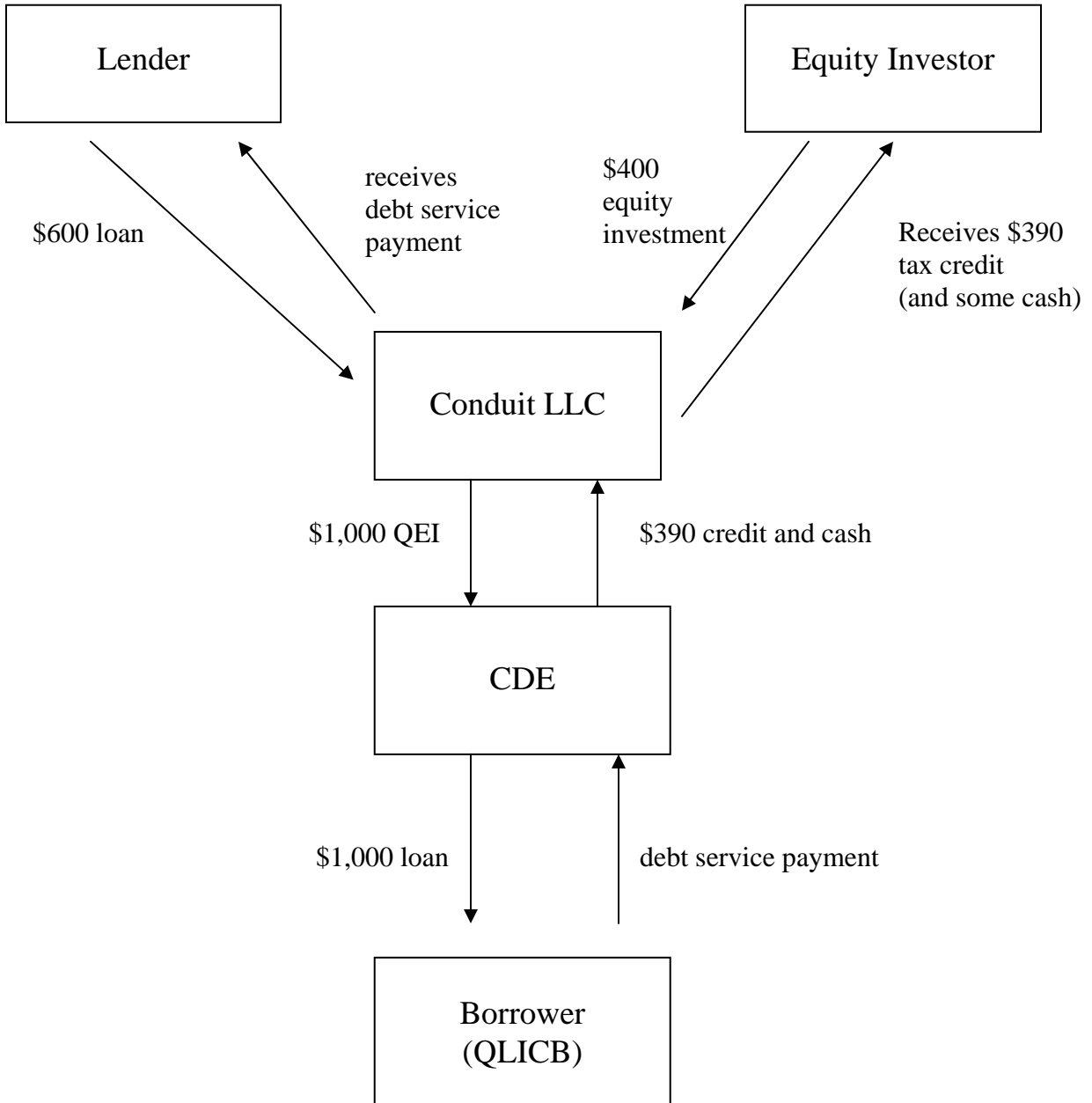
⁴⁶ Recapture is not triggered in this case, however, if there was a "reasonable expectation" that the business would remain in the low-income community at the time the investment was made.

⁴⁷ Kerwin Tesdell, president of the Community Development Venture Capital Alliance, Interview, October 25, 2004.

investors develop preferences for simpler structures and the leveraged model continues to be accepted.

Figure 2

Leveraged Structure



Note: This is a simplified diagram, which leaves out features such as fees and percent ownership of the different entities. Note that because the leverage is 60 percent to 40 percent, the Investor (upper right) puts in \$400 and receives \$390 in tax credits, and therefore needs some cash return as well. A higher leverage ratio, say 70 percent to 30 percent, makes it possible for the investor's entire return to be from tax credits, but the IRS has ruled specifically only on the 60/40 case. (The IRS has not said that higher ratios are not acceptable, however.)

What Are the Issues?

The NMTC is a work in progress. As the program has been and is being implemented by investors, CDEs, the CDFI Fund, the IRS, and owners of businesses, numerous issues have arisen and have been or are being worked on. The most important issues are these:

Issue 1

The central issue of the NMTC is whether the overall effect of the credit is to make economically marginal deals feasible, as it was intended to do, or whether instead the effect is to sweeten deals that would have been done anyway.

Status. The anecdotal evidence is that the credit is going to deals that are sound but marginally infeasible and “putting them over the top.” The industry regards this as an important question and is taking it seriously. The CDFI Fund is collecting data that will allow analysis of this issue, although we should recognize that the “but for” question is notoriously difficult to answer definitively. A sufficient data set does not yet exist to allow this question to be addressed other than anecdotally, because it is too early in the program.

Discussion. By design, New Markets Tax Credits are meant to provide subsidy to marginal projects -- those that in the absence of the subsidy provided by the credits generate some economic returns but not a sufficient level of returns to make the project economically feasible, and further, those projects which will be rendered economically feasible by the addition of the tax credits. The credit is supposed to make marginally doable projects into doable projects. Because the subsidy is designed to be functional at the margin, there exists an inherent potential for the credit to be used to finance projects that are feasible without it, and to have the effect of “sweetening an already doable deal” to the (unnecessary) benefit of one or more of the parties.

It is too early to be able to draw any firm conclusions on these issues on the basis of completed deals --- there is simply too little data. As of October 21, 2004 only 40 qualified equity investments into CDEs, totaling \$673 million, had been entered into the CDFI Fund tracking system; transaction level data, i.e. data on CDE investments into businesses, were just beginning to be entered. It will be the 4th Quarter 2005 or 1st Quarter 2006 before there will be enough data to begin analyzing this issue other than anecdotally. In the meantime, what can be concluded about the deals that are being done?

There are two good indicators of what is happening with respect to the “but-for” question. The first is the anecdotal evidence of the deals that are being done. The second is the fact that a system is being created in which there are pressures that are likely to influence CDEs in the direction of investing in “but-for” deals.

First, the anecdotal evidence is that the credit is, in fact, generally operating to make financially infeasible projects into feasible ones. For this paper, people playing influential roles in the NMTC sector of the community development industry were interviewed. They include: representatives of eight CDEs appearing in the case studies, which include four large non-profit community development financial intermediaries (LISC, the Enterprise Foundation, the National Trust for Historic Preservation, and the Community Reinvestment Fund); one small special purpose CDE (ExEd); one large community development corporation (Coastal Enterprises, Inc.); two large financial institutions (Key Bank and GMAC Commercial Holding Capital Corp.); and representatives of the non-profit recipient of a large NMTC loan (Market Creek Plaza). Together the CDEs represented have closed more than 50 transactions. In addition, those interviewed include representatives of another large CDC/CDFI (Self-Help); bankers in the community development division of a major investor in NMTC funds (Citibank); representatives of the New Markets Tax

Credit Coalition and the Community Development Venture Capital Alliance; and lawyers and accountants from the handful of firms that are developing a significant practice in the NMTC area. In addition, the paper draws upon the experience of attending several NMTC conferences in which typically 200 to 250 of the most active players in the industry attend, and on the experience of reviewing news articles and industry publications. The overall impression gained from these sources is that the deals that are being done are generally those in which the NMTCs are making undoable deals doable. Overall, people consistently described deals that they had done, those they were working on, and those that they had heard about in these terms. When asked to identify a deal which was clearly a case of one which used the NMTC but didn't really need it, people in general were unable (or perhaps unwilling) to do so. This overall impression is, hopefully, communicated by the case studies.

Of course, since the people interviewed are essentially key players in a NMTC sector of community development finance, for which this is an important question, and whose interests might not be served by a finding that the credit was in general going to deals that didn't need it, some readers might reject these anecdotal findings as motivated by self-interest. However, as can be seen by reading the case studies, the people interviewed have substantial careers and reputations in the world of community development finance. Their impressions and observations carry some weight.

Of course, even if it is correct that in general the NMTC is being used to make undoable deals doable, there will undoubtedly be cases in which the benefit to a particular deal is minimal. The important question is how the credit is being used overall.

Second, pressures are being created within the system of allocation of credits and reporting on their use that are likely to influence CDEs in the direction of doing "but for" deals. What are they?

- (a) The competition for allocations is intense, so there is a powerful incentive to applicants to make choices that will increase their score.
- (b) Applicants are being asked a series of questions about how they are going to use the credits. The uses that earn more points are associated with delivering more benefit to the deal, i.e. making deals more doable.
- (c) Applicants are being required to sign allocation agreements that hold them to the use of the credits that was specified in the application. Allocatees have to adhere to them and report on them.
- (d) A reporting system has been created that will allow a determination of the extent to which the terms of the allocation agreement have been met. Ultimately this can be fed back in to the allocation process.

Here is some detail about the feedback mechanism that is being created:

- (i) The CDFI Fund focuses attention on the extent to which a CDEs proposed financial products are below market. In the application for allocation, the CDE must "indicate the percentage of total QLICI activities that will have particularly flexible or non-traditional features . . . that are specifically enabled by the receipt of a NMTC allocation."⁴⁸ They are put on notice that if they receive an allocation, they "will be required to meet the percentage identified . . . and such requirement will be a term of its allocation agreement."⁴⁹ They must also specify what

⁴⁸ NMTC Program 2005 Application, p.10.

⁴⁹ Ibid.

financial products they intend to offer and characterize the extent to which these products are below market. They must specify in which of the following categories they intend to offer flexible and non-traditional rates or terms: “equity products, equity equivalent terms and conditions, debt with equity features . . . , subordinated debt, below market interest rates, lower than standard origination fees, longer than standard period of interest-only loan payments, higher than standard loan to value ratio, longer than standard amortization period, more flexible borrower credit standards, nontraditional forms of collateral, lower than standard debt service coverage ratio, loan loss reserve requirements that are less than standard,”⁵⁰ or other. For each category in which they plan to offer flexible and non-traditional rates and terms, they must describe “a) the rates and terms that will be offered; b) how these rates and terms compare with what is typically offered . . . in the marketplace; c) how the benefits of the NMTC enable [them] to offer these more favorable rates and terms; and d) how these better rates and terms will ultimately benefit end-users.”⁵¹

- (ii) The CDFI Fund is requiring applicants to indicate where the subsidy provided by the tax credit is going. The CDFI Fund introduced a new question --- No. 36 --- into the third round application to focus even more attention on this issue. Question 36 reads:

The NMTC creates an economic benefit that can be shared among the investor, the CDE, the QLICI, and end-users . . . in the low-income communities. Quantify as best you can, for each of your planned investment types, how the economic benefits of the NMTC Allocation will be apportioned amongst: a) the investors, through economic returns; b) the QLICI investees/borrowers, through lower costs of capital; and c) the Applicant, through fees or economic returns. . . Be sure to reference related market benchmarks or practices where applicable.⁵²

- (iii) In July 2004 the CDFI Fund announced the launch of the Community Investment Impact System (CIIS), which requires CDEs to report on each transaction they finance. The data points being collected seem capable of capturing the extent to which the financial products actually offered by the CDE conform to those stated in the application and allocation agreement. (Please see Appendix D, Selected Data Points of the Community Investment Impact System.) They also seem capable of capturing the extent of the economic impact of the investments. For example, annual gross revenues of the business and number of jobs at the time the investment is made are captured, and then these indicators are reported on annually, so that growth can be tracked. On the other hand, the data points currently collected do not allow for measurement of job quality, such as wages and benefits.

⁵⁰ Ibid.

⁵¹ NMTC Program 2005 Application, p. 11.

⁵² NMTC Program 2005 Application, p. 20.

The issue of whether the overall effect of the credit is to make economically marginal deals feasible, or whether it is to sweeten deals that would have been done anyway, is an important one. It will undoubtedly receive a significant amount of examination and discussion over the next few years as more robust data become available.

Issue 2

Targeting and Economic Impact. One critique of the NMTC’s design is that it is not highly targeted to economically distressed areas, and the economic impact of the credit is not easily identifiable.

Status. The requirements of the competitive application process, the negotiation of the allocation agreement and the reporting requirements appear to have significantly increased the degree of targeting and to have caused applicants to specify expected and actual economic impacts.

Discussion. As discussed in “How Does the Credit Work?,” the NMTC is not highly targeted by legislation. Approximately 39 percent of the census tracts in the country are eligible and 36 percent of the population lives in eligible tracts. The competitive application process, however, provides additional points for applicants that plan to make investments in areas of higher economic distress, such as areas with poverty rates greater than 30 percent; areas with median incomes of less than 60 percent of area median income; areas with unemployment rates at least 1.5 times the national average; Empowerment Zones, Enterprise Communities, or Renewal Communities; and other such areas. It appears that incentives such as these in the competitive allocation process are having considerable effect in channeling allocations to CDEs that intend to use them in areas of greater economic distress. People knowledgeable about the applications process have said that for the second round there was a rule of thumb that in order to win an allocation an applicant had to state that 80 percent or more of its QLICs would be in areas of greater economic distress, and, further, that in the third round, that number may be as high as 100 percent.

The extent to which the credit brings about desired economic impacts is also an issue about which much concern has been expressed. The benefit of the Low Income Housing Tax Credit is easily identifiable through the income characteristics of the tenants of the buildings whose owners receive the credit. The NMTC by contrast is invested in eligible geographic areas. Similar to the way the competitive process functions to influence applicants to offer products that are significantly below market, to transfer the benefit of the credit to the deal, and to focus investments on areas of higher economic distress, the competitive process influences applicants to specify the economic impacts that are expected to occur from their investments. Actual impacts are then reported on, and can be compared to those projected. Ultimately this information can be fed back into the application process, although the mechanism is lengthy and attenuated.

Issue 3**The complexity of the program, and the attendant cost of utilizing the credit, is often cited. How big a problem is this, and for whom?**

Status. The NMTC program is very complicated, and working out solutions to problems that have arisen has been expensive. But this has much to do with the fact that issues are being raised and solved for the first time.

Discussion. Almost everyone asked to discuss the New Markets Tax Credit comments on its complexity. Practitioners have spent substantial amounts of money to apply for and obtain allocations, set up the infrastructure to make investments and monitor compliance, and create appropriate structures at the transaction level. Structures involving leverage and the combination of the historic and New Markets credits are particularly complicated. An oft-repeated joke is that the program is a full-employment program for accountants and lawyers. The complexity and expense is in large part a function of the fact that the implementation of the program is in its early stages. Problems are being identified and resolved for the first time, and the CDEs and investors are appropriately noting the burden of these first-time costs. In the long run, the CDEs that will be able to bear the costs of solving start-up problems and the substantial costs of making and monitoring investments will be those that receive large and repeated allocations. It is also worth noting that these widespread comments about efficiency and expense are reminiscent of the early days of the Low Income Housing Tax Credit as well, which has evolved into a highly efficient market. It might be appropriate to note that smaller organizations that wish to use the credit to make their projects feasible do not have to set up a CDE and obtain an allocation of credits in order to receive the benefits at the project level: they can seek and obtain project level financing from a CDE that has the scale and financial strength to obtain an allocation and undertake the implementation and compliance costs.

Issue 4**The tilt towards real estate.**

Status. There appears to be a significant tilt towards real estate as a preferred type of CDE investment. For example, CDEs intended to use about two thirds of the second round allocation --- about \$2.3 million --- for real estate projects. This has been a disappointment to many community development practitioners because during the gestation period of the legislation (1998 – 2000) they developed the expectation that the program would be designed to stimulate equity investments and loans to operating businesses. The tilt towards real estate appears to be largely a result of the recapture provisions of the legislation. Recapture provisions in addition are a major factor in the difficulty of using the NMTC for venture capital investing.

Discussion. As discussed in the section on recapture provisions, there are three events that trigger recapture: (a) the CDE ceases to be a certified CDE; (b) the CDE ceases to have “substantially all” of its QEIs invested in qualified low-income community investments over the seven-year credit period; and (c) the investment is redeemed by the CDE before the end of the seven-year credit period. The amount recaptured is the entire amount of the tax credit plus interest and penalties.

The difficulties of monitoring compliance with the tests for whether a business is operating within a low-income community have also already been discussed. If a CDE manages to overcome these obstacles, it is still faced with the issue that if it invests in a business and the business moves out of the low-income community, the CDE is in danger of failing the “substantially all” test. Investing in real estate, which doesn’t move, eliminates this risk.

The provision that calls for recapture if the investment is redeemed before the end of the seven-year period makes it additionally difficult for CDEs to make patient equity investments in businesses. Community development venture capital advocates say that they need the ability to “harvest” venture capital investments at any time from, say, three to ten years. If they did so at five years, they could not reasonably expect to make and recover another equity investment in two years. The solution proposed by the Community Development Venture Capital Alliance is to have the option for the CDE to repay the investor in less than seven years, as necessary to solve this problem, and for the investor to receive a correspondingly truncated tax credit.⁵³

Another difficulty with the redemption issue for all users is that “redemption” is not clearly defined.

Advocates are likely to focus attention in the near future on possible changes in the recapture provisions, and clarifications or changes in the definition of events that trigger recapture, in order to address the difficulty of using the credit for business loans and equity investments.

Issue 5

Is the credit proving to be appropriately useful in both urban and rural areas? Does the definition of “low-income community” need modification?

Status. There is reason for concern about the prospects for using the NMTC in rural communities. The NMTC Coalition successfully advocated for modifications in the definition of “low-income community” that improved these prospects, and also made the credit more usable in certain urban sites (particularly “brownfields”) and for certain groups of individuals.

Discussion. The NMTC was intended to be a tool for economic development in rural as well as urban areas. Advocates of rural community economic development became concerned when they noted that the percentage of tax credits allocated to CDEs intending to serve rural areas dropped from 20 percent in the first round of allocations to 15 percent in the second round. The New Markets Tax Credit Coalition advocated for a change designed to make it easier to use the credit in rural areas. The change was, in the case of a “high out-migration rural county,” to allow the median income of the census tract to be as high as 85 percent of the statewide median income and still be eligible as a low-income community. Their efforts were rewarded with the passage of HR4520 in October 2004 which incorporated this change, and two others for which they had advocated as well.

One of these was to include in the definition of a low-income community census tracts with a population of less than 2,000 which are in a federal Empowerment Zone and contiguous with a qualified low-income community. This makes it possible to invest in certain “brownfields,” which might be located in areas with minimal or no population.⁵⁴ The other was under certain circumstances to allow groups of low-income individuals lacking access to capital (such as a Native American tribe, for example) to be designated as a low-income community.

This was an example of the ongoing legislative and policy role played by the Coalition.

⁵³ Kerwin Tesdell, president of the Community Development Venture Capital Alliance, Interview, October 25, 2004.

⁵⁴ See www.newmarketstaxcreditcoalition.org for a complete description of the changes and their implication.

It remains to be seen whether this will make a significant difference in allocations to CDEs that intend to serve rural communities, or in the volume of transactions in rural communities. The difficulty of using the NMTC in rural deals may be a manifestation of the difficulty of using the credit in small deals. Further scrutiny of the allocation trends and of the transaction level data as it begins to be recorded will be important.

Issue 6

Is there an appropriate balance between allocations to profit-motivated CDEs versus mission-driven CDEs? Is there an appropriate balance between CDE investments in for-profit businesses (QALICBs) and non-profit businesses? What is the significance for community economic development of these questions?

Status. Early in the program some non-profit organizations feared that they would be competing for allocations with for-profit financial institutions at a disadvantage. From the first round to the second round of allocations, there appeared to be a shift of allocations to CDEs with for-profit parents. It remains to be seen (1) whether this shift will continue; (2) if it does continue, what implications it has for the characteristics of CDE investments in businesses, such as the distribution between for-profit and non-profit businesses.

Discussion. CDEs that apply for and obtain New Markets Tax Credits are of three basic types: those with for-profit parent organizations, such as banks; those with parent organizations that are driven by mission, including not-for-profit community development corporations, community development intermediaries and community development financial institutions; and those with public parent organizations such as city governments or state economic development authorities. As noted in the Executive Summary, over the first two allocation rounds, CDEs with for-profit parents received 48 percent of the allocations, those with mission-driven parents received 39 percent, and those with public parents received 14 percent. The trend is to some extent toward for-profit parents: for-profit parents' share increased from 44 percent to 51 percent from Round 1 to Round 2; mission-driven parents' share decreased from 41 percent to 37 percent; and public parents' share decreased from 15 percent to 12 percent.

CDFIs (a subset of mission-driven) are particularly concerned because their share of allocated dollars dropped from 40 percent to 19 percent.

Several people interviewed for this paper raised the question of whether or not there would be a need at some point for a set-aside for non-profits. That question presumes --- not unreasonably --- that there are or will be important differences between the types of investments in businesses made by CDEs with for-profit parents and mission-driven CDEs. For example, the mission-driven CDEs might be presumed to be more open to invest in non-profit businesses such as child care centers or charter schools; more open to invest in the most distressed neighborhoods; more open to invest in very small or very difficult deals; more open to invest in deals with a high degree of input from neighborhood residents, or deals with other characteristics. However, as discussed in Issue No. 1, the data that can show whether these patterns actually exist are not yet available.

On an anecdotal level, it appears that CDEs with for-profit parents are investing in both for-profit and non-profit QALICBs; and CDEs with mission-driven parents are investing as well in both for-profit and non-profit QALICBs. See Table 2, which takes the examples cited in this paper and arrays them by CDE's type of parent versus type of QALICB (non-profit, for-profit, real estate, non-real estate, community facility, etc.) Although a bias may show up after the

transaction data are analyzed, it is not yet clear from these examples that there is such a bias. One of the interesting things about the examples is the range of combinations they show.

Table 2
For All Examples Cited:
Type of CDE Parent vs. Type of Project in Which it Invested

Type of Project in Which CDE Invested	CDE w/ for-profit parent	CDE w/ mission-driven parent
For-profit business	Advantage Capital Partners' CDE invested in Stereotaxis and Hoku Scientific.	Coastal Enterprises invested in Katahdin Forest Management.
Non-profit business	No example cited.	No example cited.
For-profit real estate development	GMAC Commercial Holding Corp's CDE made subordinate loan to Everett Mall, Everett, WA, a for-profit developer's project.	National Trust for Historic Preservation's CDE made equity investment in Post Office Associates, for-profit developer of the U.S. Customhouse/Post Office, St. Louis.
Non-profit real estate development	Key Community Development Corp's CDE made a \$1,000,000 loan to the non-profit developers of Arbor Park Place, Cleveland. Clearinghouse CDFI invested in Market Creek Plaza.	The Local Initiatives Support Corporation (LISC) CDE invested in the Bloom Lake Building in Minneapolis, a project of the non-profit Neighborhood Development Center.
For-profit community facility	No example cited.	No example cited.
Non-profit community facility	Impact Community Capital (insurance industry group) CDE invested in Fund for Children and Communities, which invests in child care centers.	Excellent Education Development, Inc's CDE invested in non-profit charter schools.

Before the question of the need for set asides can be addressed, and before we know whether it needs to be addressed, we will need the results of at least the third allocation round and we will need data that indicate on more than an anecdotal level what differences there are between the transaction patterns of the two different types of CDEs and their economic impacts.

Issue 7

Over half of the initial authorization of \$15 billion will have been allocated by early 2005. What are the prospects for reauthorization and extension? What can be done to support it?

Status. Although the program appears to be off to a good start, how the program will fare in President Bush's second term, where budget deficits are expected to mount and major changes in the tax code are on the agenda, is anyone's guess.

Discussion. A total of \$8 billion --- 53 percent of the \$15 billion specified in the 2000 legislation --- will have been allocated by early 2005, and the remaining \$7 billion is scheduled to be allocated in 2006 and 2007. Advocates for the program are turning their attention to extension and reauthorization. Congressman William Jefferson (D-LA) introduced legislation in June 2004 that would have doubled the New Markets Tax Credit (NMTC) allocation levels for Fiscal Years 2005, 2006 and 2007, adding an additional \$9 billion to the program. Although the bill did not pass the House, it is an early indication of forthcoming efforts. Advocates will also be undertaking a number of clarifications and technical corrections in conjunction with these efforts.

Players in the community development industry have been focusing over the last four years on implementing the program, solving start-up problems, and making it work. While that work continues, the New Markets Tax Credit Coalition is mounting a significant effort and preparing a report to Congress to be delivered in the spring of 2005, documenting the achievements of the program and its success in stimulating community economic development. Early in 2006 there will probably be enough data for an initial picture of closed transactions. The CDFI Fund will contract with a third party for an evaluation. The General Accounting Office will publish a third audit in January 2007. This all takes place against a background in which both the Democratic and Republican parties have supported the Low Income Housing Tax Credit throughout administrations of each party. However, the new environment in which budget deficits mount and major tax reform is on the agenda implies a highly unpredictable outcome for tax advantaged community development investments. The large industry that has developed around the Low Income Housing Tax Credit and the nascent one working with the New Markets Tax Credit will be working hard to make the case for the value of these two credits in the environment in which major tax reform is one the agenda.

Supporters of the NMTC face a dual challenge: communicating to members of Congress the success of the program and building bipartisan support for it while simultaneously addressing an unstable environment for community development tax subsidies.

Appendix A

The Allocation Phase in Practice: Results of the First Two Round of Allocations

Who applied for and received the \$6 billion allocated in these first two rounds?

The types of CDEs that apply for tax credits can be classified in three groups: those with mission-driven parents, public parents, and for-profit parents.⁵⁵ Mission driven parents include community development corporations, community development financial institutions, non-profit financial intermediaries, and others. Public parents include city governments, housing finance agencies, economic development authorities, port authorities and similar bodies. For-profit parents include banks and investment banks.

To whom did the allocations go?

In the first round, 29 CDEs with for-profit parents received allocations, representing 50 percent of all awardees; 33 mission driven CDEs received awards, representing another 6 percent, while 4 public-parent entities, or 6 percent of the total, received awards. The dollar amounts awarded closely track these percentages: for-profit parent CDEs received \$1.1 billion, 44 percent of the funds, mission-driven CDEs received \$1.0 billion (41 percent) while public-parent CDEs \$0.39 billion, or 15 percent.

CDE Parent Type	Round 1 Allocatees			
	Number	Percent	\$ Billion	Percent
For-profit	29	44%	1.11	44%
Mission-driven	33	50%	1.04	41%
Public	4	6%	0.39	15%
	66	100%	2.54	100%

Source: CDFI Fund

In the second round, 63 CDEs received allocations⁵⁶ totaling \$3.5 billion. This time the number of mission-driven entities receiving allocations dropped by 10 to 23, and the number of public entities increased to 8. Mission-driven organizations represented 37 percent of the awardees and 37 percent of the dollars; for-profit parent CDEs were 50 percent of awardees and received 51 percent of the funds, and public parent CDEs represented 13 percent of allocates and 12 percent of the funds.

CDE Parent Type	Round 2 Allocatees			
	Number	Percent	\$ Billion	Percent
For-profit	31	50%	1.77	51%
Mission-driven	23	37%	1.3	37%
Public	8	13%	0.43	12%
	62	100%	3.50	100%

⁵⁵ Since all CDEs that receive allocations must be for-profit entities, the classification looks to the parent of the organization.

⁵⁶ Initially the CDFI Fund announced that 62 CDEs had received allocations in the Second Round. Then they announced a 63rd award. However, the tables have not been recalculated. Since the award was small (\$17,000,000), the tables will not be significantly affected.

The picture of the combined total allocations is as follows: mission-driven organizations received 39 percent of the funds, public entities 14 percent, and for-profits 48 percent.

CDE Parent Type	Round 1 and 2 Allocatees - All Awards			
	No. of Awards	Percent	\$ Billion	Percent
For-profit	60	47%	2.88	48%
Mission-driven	56	44%	2.34	39%
Public	12	9%	0.82	14%
	128	100%	6.04	100%

The CDFI Coalition, a coalition of all certified Community Development Financial Institutions, has pointed out another trend that is troubling to their members. They have looked at the subset of CDEs that are CDFIs to track how they are faring in the competition for allocations of New Markets Tax Credits. As shown in the table below, they note that whether you look at number of CDFIs receiving allocations or the total dollars received by CDFIs, the Round 2 percentages are about half of the Round 1 percentages.

Allocations Received by CDFIs

	Round 1	Round 2
No. of Allocatees	66	63
No. of CDFIs receiving Allocations	29	14
Percent	44%	22%
Total Dollars Allocated (Billions)	\$2.50	\$3.50
Dollars Allocated to CDFIs (Billions)	\$1.01	\$0.66
Percent	40%	19%

This trend may well cause the CDFI Coalition and other organizations to advocate for set-asides, whether for mission-driven organizations or for CDFIs.

The next set of tables present additional comparisons of Round 1 and Round 2, and in some cases examine the allocation statistics for Round 2 only. Several things are noteworthy. One is the trend is toward larger allocations. Fewer entities applied in the second round, and they applied for more funds, so the average amount requested increased. An additional \$1 billion was awarded in Round 2 to nearly the same number of CDEs, so the average allocation went up significantly. The median allocation more than doubled, as the number of awards of \$100 million or more doubled and the number of awards of \$10 million or less went from 24 to 6. (In Round III, 208 organizations applied, requesting a total of \$23 billion; the planned allocation is \$2.5 billion.)

**Allocation Statistics for Round 1 and Round 2
(and preliminary Round 3 numbers)**

	Round 1	Round 2	Round 3
Amount Allocated (\$ Billion)	\$2.5	\$3.5	\$2.0
Number of CDEs Receiving Awards	66	63	
Percentage of Successful Applications	19%	23%	
Amount Requested in Total by All Applicants (\$ Billion)	\$25.80	\$30.40	\$22.90
Number of Applications	345	271	208
Average Amount Requested	\$74,800,000	\$112,100,000	
Average Allocation	\$37,900,000	\$55,600,000	
Median Allocation	\$21,000,000	\$47,000,000	
Smallest Allocation	\$500,000	\$2,000,000	
Largest Allocation	\$170,000,000	\$150,000,000	\$150,000,000
Number of Organizations Receiving > \$100 million	7	14	
Number of Organizations Receiving < \$10 million	24	6	
States Covered	40 + D.C.	44 + D.C.	
# allocatees focusing on local markets	27	21	
# allocatees focusing on statewide service area	17	15	
# allocatees focusing on national or multi-state area	22	27	

Note: The \$2.0 billion allocation for Round III is the CDFI Fund's target.

The Fund has imposed a \$150 million cap on any single allocation.

Source: CDFI Fund and Rapoza Associates

There also appears to be a shift away from allocatees focusing primarily on local markets towards allocatees focusing on national or multi-state areas. This, of course, would be consistent with the shift towards larger allocations.

The next table, below, shows the clear predominance in Round 2 of CDEs that intend for their major activity to be financing real estate projects --- 57 percent . (We do not have these figures for Round 1.) Even more striking are the dollars allocated to CDEs that intend to focus on real estate financing --- two-thirds of the \$3.5 billion allocated. These figures may not be as significant as they seem because, as we will see in the case studies, some CDEs are using real estate financing or loan purchases in part as a way to assist businesses. Also, the figures show the predominant financing activity of the CDE, and they don't take into account that the secondary financing activity might be quite large.

Round 2 Predominant Financing Activity - Numbers of CDEs

	N	%
Loans to or equity investments in business	24	38%
Loans to or equity investments in real estate projects	36	57%
Loan Purchases	1	2%
Capitalization of other CDEs	2	3%
Financial counseling and other services		
Total	63	100%

Round 2 Predominant Financing Activity - Dollars Allocated

	\$ Billions	%
Loans to or equity investments in business	0.97	28%
Loans to or equity investments in real estate projects	2.33	67%
Loan Purchases	0.15	4%
Capitalization of other CDEs	0.04	1%
Financial counseling and other services		
Total	3.50	100%

Source (both table): Rapoza Associates

It is also striking the extent to which CDEs that are focusing on real estate are planning to focus on retail projects --- 14 CDEs (38 percent) and \$1 billion (43 percent) are earmarked for this activity. Office space is next at \$500 million and mixed-use next at \$300 million; these three together account for 77 percent of the dollars allocated to CDEs planning to do real estate. In fact, the amount allocated to CDEs that plan to finance predominantly retail, mixed-use and office real estate projects is half of the entire Round 2 allocation!

Round 2 Allocations by Type of Real Estate, Number of CDEs and Allocation Amount

Real Estate Type	N CDEs	\$ Allocated (Billions)
Retail	14	1.006
Office	5	0.502
Mixed	5	0.300
Industrial	4	0.169
Housing	2	0.029
Facilities	5	0.219
Business	2	0.108
Total	37	2.333

Source: Rapoza Associates

Finally, the dollars CDEs targeted to rural areas are nearly the same for the two rounds, but the \$514 million targeted to rural in Round 2 represents a significant drop in share.

Allocations to Rural Areas

	Round 1	Round 2
Dollars allocated to rural areas	\$509,000,000	\$514,000,000
Percent allocation for rural areas	20%	15%

Source: Rapoza Associates

Appendix B

Case Studies

1. National Trust for Historic Preservation – Off to a Fast Start
2. Community Reinvestment Fund - Overcoming an Obstacle to Expansion
3. Local Initiatives Support Corporation: Supporting the Economic Development Agenda of Community Development Corporations (CDCs)
4. Enterprise Social Investment Corporation: Taking on New Lines of Community Development Activity
5. ExEd - Meeting a Critical Need for School Facilities Financing,
6. Key Bank – Striving for Impact in a Twelve State Region
7. GMAC Commercial Holding Capital Corp.: A Subordinated Debt Strategy
8. Coastal Enterprises, Inc.: Using NMTCs to Implement a Triple Bottom Line Strategy
9. Market Creek Plaza: NMTC Financing Supports Community-Led Urban Redevelopment

1. National Trust for Historic Preservation – Off to a Fast Start

The National Trust for Historic Preservation (NTHP), founded in 1949, is a privately funded non-profit organization whose mission is “to provide leadership, education, advocacy and resources to preserve America’s historic places and to revitalize communities.”⁵⁷ From its origins as an organization whose primary purpose was to acquire and administer historic sites, NTHP has vastly expanded its activities. In 1980 it created the National Main Street Center which focuses on preservation as a tool for the economic and physical revitalization of traditional business districts in cities and towns across the country. In 1990 the Community Partners Program was created to employ a similar approach to revitalize historic properties, central business districts and urban neighborhoods. Among the resources provided are various loan products to facilitate acquisition and revitalization of properties. Working with Bank of America, NTHP set up a Historic Tax Credit Fund to invest in projects eligible for federal and state historic tax credits. Staff of the Community Partners Program saw the potential to use New Markets Tax Credits to stimulate investment in historic properties, particularly by using it in tandem with the Historic Tax Credit, and through its CDE, National Trust Community Investment Corporation (NTCIC), NTHP applied for and in March 2003 received a first round allocation of \$127 million. By the end of 2003, NTCIC had closed twelve transactions utilizing \$76 million of its \$127 million allocation. In total the projects had \$372 million in development costs, 2.9 million square feet of space, created 12,692 construction jobs and 21,729 permanent jobs, and generated \$71.2 million in state and local taxes. The investor was Bank of America. Ten months later, NTCIC had completed another 11 transactions for a total of 23, and had utilized \$125 million in New Markets Tax Credits, nearly its entire first round allocation, in projects with a total development cost of \$550 million.⁵⁸ According to John Leith-Tetrault, director of the Community Partners Program at the National Trust, in each case it was the NMTC equity that “put the project over the top,” and made the financing feasible.⁵⁹

NTCICs main line of business is investments that combine Historic Tax Credits with New Markets Tax Credits. “We are flooded with requests for this product. Preservation is seen today as an important component of community development, far more so than it was ten years ago.”⁶⁰

Why is NTCIC off to such a fast start? The National Trust had a partnership with Bank of America focused on investment in Historic Tax Credits prior to the advent of the New Markets Tax Credit program. John Leith-Tetrault, Director of the Community Partners Program at the National Trust, said: “The Historic Tax Credit is easy to combine with the New Markets Tax Credit; it takes only minor modifications of existing documents. We’ve had a lot of experience with the historic credit, and we’re adapting pretty easily.” There is also a substantial market for the product. According to the National Trust, “38 percent of National Register-listed historic districts and 58 percent of buildings within these districts are located in New Markets-eligible census tracts. This represents a pool of 947,000 contributing buildings that could benefit from the New Markets Tax Credit.”⁶¹

⁵⁷ http://www.nationaltrust.org/about_the_trust/

⁵⁸ John Leith-Tetrault, director of the Community Partners Program, presentation at the Novogradac & Company LLP New Markets Tax Credit Investors Conference, Boston, Massachusetts, October 20-24, 2004.

⁵⁹ John Leith-Tetrault, Interview, July 28, 2004.

⁶⁰ Ibid.

⁶¹ Main Street Notes: Information from the National Trust for Historic Preservation’s National Main Street Center, April 2003, p.9.

The Trust was able to take historic tax credit projects already in the pipeline and add a New Markets component. This additional equity investment in many cases put the deal over the top --- it made a formerly infeasible deal feasible. This makes some projects do-able that simply couldn't be done before.”

NTHP does this investment through two similar structures. The Banc of America Historic Tax Credit Fund provides new markets equity to investors in historic rehabilitation projects where the Fund is the rehab tax credit investor. New Markets Tax Credits are suballocated from NTCIC. The second structure is the Historic New Markets Conduit Fund, which acts as a conduit by offering other tax credit investors and syndicators access to NMTC enhancement. Bank of America is a participant in that fund as well. To date, NTCIC has done so for investments by Bank of America and Chevron, TCI.

The partnership with Bank of America has been useful in other ways as well. The Trust was not able to apply for a second round allocation because it had not secured QEIs equal to 50 percent of its first round allocation. However, Bank of America applied in the second round and received an allocation of \$150 million, much of which will be available for the pipeline of National Trust projects that the Trust and Bank of America did through their partnership in the first round.

NTHP also has a Main Street Conduit Lending Fund to serve the needs of its network of Main Street programs. Under this structure, a local Main Street program would identify both a qualified investment opportunity and a local bank that was interested in making an investment in it. The bank would make an equity investment in NTCIC, which would immediately make an investment in the local project. Leith-Tetrault says NTHP is finding there is less demand for this program than they expected. Initially, they projected that these Main Street loans would consume \$35 million of their \$127 million allocation; in fact they used only about \$10 million. They had been expecting a demand for small business loans which didn't materialize.

NTHP also assumed that local Main Street revitalization organizations or local governments might want to establish their own CDEs, and that NTCIC might suballocate credits to them. Leith-Tetrault reports that he has been receiving inquiries from local governments about this possibility. NTCIC has not yet suballocated credits to one of these Main Street affiliated organizations, but is open to pursuing it further.

The power of the financing vehicle created by combining the New Markets tax Credit and the Historic Tax Credit is illustrated by a project presented by the principals at the Novogradac & Company LLC October 22, 2004 New Markets Tax Credit Conference. NTHP, Bank of America, the Enterprise Social Investment Corporation, and the Missouri Development Finance Board teamed up to finance the renovation of the U.S. Customhouse and Post Office in St. Louis, Missouri, a building of immense historic and architectural significance. The presenters noted that the building, designed by Alfred B. Mullet and built between 1868 and 1884, is one of only five “Second Empire Style” Federal Buildings of the period remaining outside of Washington, DC. Its historic significance, they said, includes the fact that it projected the authority and permanence of the union in a southern state.

The total development cost of the 242,000 square foot project is \$51.4 million. Historic Tax Credits (both federal and state) and New Markets Tax Credits generated an equity investment of \$25.5 million (50 percent) --- \$18 million Historic and \$7.5 million New Markets. Other sources of financing were an ESIC New Markets Partners first mortgage loan of \$8.2 million, a Missouri Development Finance Board loan of \$12.4 million. Private contributions and federal/city grant funds made up the remaining \$5.3 million. The project generated 1,458 construction jobs, 850

permanent jobs and about \$8 million in state and local tax revenues.⁶² Major tenants are Webster University, the Eastern District of Missouri Court of Appeals, restaurants, retailers and offices. Additional impact measures cited by the presenters are that the project stimulated rehabilitation of five adjacent historic properties, with total development costs of \$250 million, a five to one ratio. The additional projects include 400 market rate and affordable housing units, 1,130 parking spaces, 65,000 square feet of retail space and 220,000 square feet of office space.

This project illustrates the power of the NMTC to fill a financing gap, in this case about 15 percent of the project (the Historic Credit provided about 35 percent). In addition, the NMTC was utilized in the ESIC first mortgage loan. The presenters described the project as one that could not have been done without the tax credit --- other sources of subsidy simply were not available. The question was raised at the presentation of whether the project “should have been done,” given the size of the subsidy required to place the building back into use. The response was that this was a judgment call that all parties had to make, and had to take into account the combined economic impact and the historic and cultural value of rehabilitating the building. The presenters cited a long list of entities that endorsed or approved the project, including the Advisory Council on Historic Preservation, the National Park Service, the Missouri State Historic Preservation Office, the Missouri Development Finance Board, NTHP, the City of St. Louis, and the investors. This case raises one of the central issues of the NMTC: the credit can be used for a broad range of activities, and about 39 percent of the country’s census tracts are eligible. In addition, there is no minimum standard for the distribution of the benefit among the investor, the CDE and the project. The response of the presenters to this question, however, is the right one: the tool is a powerful one and the subsidy is significant; but it requires CDEs to be rigorous about allocating the credit to worthy projects and allocating the benefit properly. The latter is in turn dependent upon the development of a market and the availability of information about the terms of deals being done.

2. Community Reinvestment Fund - Overcoming an Obstacle to Expansion

The Community Reinvestment Fund of Minneapolis, Minnesota (CRF) has worked for nearly fifteen years to create and expand a national secondary market for community development loans, and has achieved significant success.⁶³ Through straight loan purchases, advance commitments to purchase, loans to lenders and structured finance transactions CRF to date has provided \$410 million to 110 lenders in 24 states and the District of Columbia; it has purchased more than 1,500 loans in 39 states. Over \$300 million of its debt securities have been purchased by banks, insurance companies and pension funds. CRF hopes to use the New Markets Tax Credit to bring about a major increase in the scale of its operations. The \$312.5 million in allocations it has received (\$162.5 million in Round 1 and \$150 million in Round 2) is sizeable enough to make a difference --- it is nearly equal to CRF’s total activity to date.

Founder Frank Altman became convinced in the late 1980s that purchasing community development loans from small originators in Minnesota would provide an important boost to local economic development efforts, and contacted originators throughout the state to sell them on the idea. CRF reports that the initial reaction was one of skepticism, but Altman persisted and closed CRF’s first transaction in 1989. In the intervening fifteen years CRF has dramatically expanded its operations.

⁶² Presentation by Charles Werhane, John Leith-Tetrault and David Kavanaugh at Novogradac & Company LLP New Markets Tax Credit Investors Conference, Boston, Massachusetts, October 20-24, 2004.

⁶³ CRF purchased its first loan in 1989.

CRF has until recently had two main lines of business, purchasing small business loans and loans for affordable housing. Small business loans purchased by CRF are made to owner-occupied businesses and are secured by a second lien on real estate, the first lien generally being held by a local bank. The total loan-to-value ratio is up to 90 percent, debt coverage ratio is 1.2 minimum, and the average loan size is about \$300,000. The first position loan averages about \$700,000. The program is modeled after the SBA 504 program, but provides loans that generally are either too small for the SBA 504 programs or are outside of program guidelines for technical reasons. These loans are mostly for acquisition and expansion of facilities. Says Mary Tingerthal, vice president and chief credit officer, "We might provide financing for a business that wants to own rather than rent its facilities. We like to finance businesses that are doing modestly well and have an opportunity to grow. Long term real estate financing helps to stabilize them. These businesses are really important for the jobs they provide in the community --- strengthening these businesses is an important community development function."⁶⁴

Also included in the portfolio of CRF loan purchases is a small percentage of loans to non-profits, often for development of non-profit headquarters office facilities. CRF is considering expanding this segment to include charter schools and day care centers.

In 2003 CRF bought \$45 million in loans from 25 different sellers. Sellers included government or quasi-government agencies, such as port authorities; certified SBA 504 originators; and CDFI's and CDFI-like entities. Says Tingerthal, "these originators are an important source of financing for borrowers who are unable to obtain financing from more traditional providers. But the demand generated by borrowers in their local markets exceeds the capital they are able to access. They tell us they could do so much more if they had more money to lend. CRF's mission is to provide access to that capital."

CRF also has a business niche in the purchase of affordable housing loans, particularly the purchase of first mortgages on low-income housing tax credit (LIHTC) projects. Sellers are generally non-profit housing consortia and housing finance agencies, and the average loan is a seasoned loan of about \$2 million.

CRF's portfolio overall is split about 50 percent affordable housing and 50 percent to business/non-profit loans, but in 2003 they did about 75 percent business/non-profit loans.

Explains Tingerthal, "we use a warehouse line of credit to buy the loans, and we package them and sell them to CRA-motivated investors. CRF normally keeps a 20 percent subordinated interest in the economic development loans, 3 percent on the housing side. Our source of funds is CRA and socially motivated below-market investors who provide PRIs and near-equity investments. But as our operation grows, these funds are increasingly difficult to obtain. We saw that if CRF were going to be of significant scale, the amount of below-market financing we would need would be out of reach. The New Markets Tax Credit and the structure we have created solve that problem for us. In our leveraged structure, the equity investor plays the role of the social investor. The tax credit --- which flows to the equity investor --- places a floor on the equity investor's return. After a seven year period, we package and sell the loans in the portfolio. The debt investor has been receiving payment of interest over the seven year period. The equity investor has been receiving tax credits. Upon sale and exit, the equity investor gets the difference between the sale price and the outstanding principal balance. The borrower has received a loan

⁶⁴ Mary Tingerthal, vice president and chief credit officer of Community Reinvestment Fund, Interview, July 16, 2004.

with an interest rate about 150 to 200 basis points less than current rates for equivalent loans. Our real business is the same as it has always been. The tax credit simply allows us to take it to a new level.”

The tax credit has also allowed CRF to add a large scale commercial lending function. Tingerthal notes that CRF had never been able to get access to capital for large commercial properties. But, she says, with access to the tax credit they have been able to attract a major investor --- Bear Stearns --- in an unleveraged fund that will finance major properties such as shopping centers and hotels. “This is a new venture for us,” says Tingerthal. “One of the exciting aspects of this is that financing these large projects is an opportunity for us to develop linkage programs with local service organizations specializing in job placement, so that we can demonstrate a direct link between the development of these projects and the creation of temporary and permanent jobs for residents of the neighborhoods where they are being built.”

CRF has split its Round 1 allocation nearly equally between the Commercial Lending and the Business Lending program. The commercial lending facility closed in November 2003 and the entire QEI was made by Bear Stearns as an unleveraged investment in March 2004. Several deals have been closed. The business lending facility closed in August 2004 with Citibank as agent bank. Investments of both debt and equity were provided by Citibank, J.P. Morgan, Wells Fargo, Washington Mutual, Merrill Lynch CDC and Met Life. U.S. Bancorp and Prudential are providing equity only. The QEI will come in over about twelve months.

CRF has similarly split its Round 2 Allocation, and is using the same structures. Its commercial program commenced in November 2004 and its business loan program is slated to begin in the first Quarter of 2005.

Tingerthal says that the most challenging issue they have faced to date is closing the leveraged fund.⁶⁵ On the debt side of a leveraged deal, a bank is making a seven-year loan to a conduit LLC, which in turn makes an investment into a CDE/investment LLC. Because of the requirement that the investment cannot be redeemed during the seven year compliance period, the bank lender cannot receive amortization payments during the term --- the bank at most can get slightly more than interest only. The bank lender also cannot take a collateral interest in the business which ultimately receives the loan. Finally, the bank lender does not have the right to step in and take control of the CDE in the event of default. As one banker said at a NMTC conference: “No amortization, no collateral, can’t step in --- it sounds a lot like equity.” In these circumstances, Tingerthal said, getting the bank lender to price their loan at “secured” debt levels is a challenge. This has been a steep learning curve for people on both sides of the transaction. Tingerthal listed several possible techniques for alleviating the concerns of lenders: First, they can be given control over cash flowing into the CDE. Second, they can be provided with a debt service reserve account at the level of the conduit LLC. Third, they can be given a pledge of the equity investor’s interest in the CDE (assuming that the same institution is on both the equity and debt side of the leveraged transaction.) Finally, they can be given a “springing” collateral pledge at the end of the compliance period.

Tingerthal also commented on the problem of alleviating investor concerns about the problem of exit at the end of the compliance period. Investors have expressed concern about the potential for a higher interest rate environment at the end of the compliance period. Tingerthal noted that it must be demonstrated to investors that recipients of CDE loans and investments: (1) will be able to refinance

⁶⁵ Mary Tingerthal, presentation at the Novogradac & Company LLP New Markets Tax Credit Investors Conference, Boston, Massachusetts, October 20-24, 2004.

balloon loans at higher interest rates; (2) can bear higher interest rate resets; and (3) can operate commercial properties at higher cap rates and still meet debt coverage ratio and loan to value standards

3. Local Initiatives Support Corporation (LISC): Supporting the Economic Development Agenda of Community Development Corporations (CDCs)

The Local Initiatives Support Corporation (LISC) is the nation's largest community development financial intermediary, providing equity, loans, grants and technical assistance to community development corporations around the country. LISC operates nationally through 33 local programs and a rural program. LISC supports the development of local leadership in these areas, and supports the creation of affordable housing, commercial, industrial and community facilities, businesses and jobs. Its primary focus is on the neighborhood revitalization work of CDCs and other community-based organizations. Since 1979, LISC has raised more than \$5.7 billion from 3,100 investors, lenders, and donors and channeled it to more than 2,400 CDCs in over 300 urban and rural communities nationwide. LISC affiliates include the National Equity Fund (NEF), which invests in community-based LIHTC developments; The Retail Initiative (TRI), which manages a commercial equity fund; and the Community Development Trust (CDT), a Real Estate Investment Trust (REIT) specializing in equity and debt for affordable housing and community development properties. In 2003 LISC and its affiliates committed \$600 million to low-income neighborhoods.

Historically the bulk of LISC's funds have been for housing, but in recent years the organization has expanded its investments in commercial real estate and community facilities. The New Markets Tax Credit provides an important resource for LISC to expand its work in this area. LISC's New Markets strategy is consistent with its focus on supporting the redevelopment efforts of CDCs and neighborhood based organizations.

LISC received a first round allocation of \$65 million in New Markets Tax Credits and established a new affiliate, the New Markets Support Company, LLC, to manage its NMTC-related activities. It signed an allocation agreement in November, 2003 and closed on its first project investment in February 2004. LISC uses a "transaction approach to debt and equity financing. We provide equity and debt capital investments that support the community development strategies of local LISC programs."⁶⁶ Local LISC Program Directors in general are responsible for identifying and responding to the needs of CDCs in their areas, providing them with packages of financing and technical assistance. Traditionally this has been predevelopment loans, working capital loans, and equity investments for housing-related projects, but LISC is increasingly looking for ways to respond to the need for financing of commercial real estate, community facilities, and to some extent businesses. The projects vary over a broad spectrum of project types and needs, consistent with the unique characteristics of LISC program areas. The decision to craft a number of unique solutions to individual problems rather than to market a single uniform product reflects LISC's philosophy of community development.

CEO Michael Rubinger said: "We use the New markets Tax Credit to further our community development mission. We try to focus on the areas where we are already doing business, and to support the strategies of local CDCs. New Markets is not taking us in a new direction --- it is

⁶⁶ All citations in this paragraph are from LISC internal documents.

providing us with a new weapon in the arsenal. For any project in which we invest, if a CDC isn't the developer, they are in the mix somewhere."⁶⁷

Robert Poznanski, president of LISC's New Markets Support Corporation, said: "NMSC is concerned that a one-size-fits-all approach will not necessarily address some of the financing challenges facing some high-impact projects in LISC-supported communities. . . . Instead of underwriting transactions to pre-established criteria, NMSC and a project's developer will identify an appropriate investor for the project and underwrite the transaction per that investor's standards through a single-project CDE, with NMSC working to maximize the financial benefit to and community impact of the project."⁶⁸

By the end of 2004, LISC had closed on five projects totaling \$38 million of NMTC allocation authority. The projects illustrate the LISC commitment to supporting the development efforts of CDCs and local LISC programs. They also illustrate the broad range of projects that can be done with the NMTC. The five projects include: two CDC-developer projects and three for-profit-developer projects; four real estate projects and one business project; three arts-related projects; three projects that combine New Markets with Historic Tax Credits; and five leveraged structures.

Albers Mill, Tacoma, Washington

Albers Mill, LISC's first NMTC transaction which closed in February 2004, is a mixed-use residential and retail project located adjacent to the Hilltop neighborhood, an area in which the Washington State LISC program has invested heavily. Although the developer, Heritage Properties LLC, is not a CDC, the project was strongly favored by the local LISC program as supportive of its prior investments and of the city and state government development priorities. The property is a former mill on a Brownfield site, adjacent to Tacoma's newly opened Museum of Glass International Center for Contemporary Art. It is a five-story building with 36 market-rate loft apartments on the top four floors, and about 10,000 square feet of ground floor commercial space including an art gallery, coffee shop, wine bar and deli. LISC provided a \$10.9 million allocation of NMTC; US Bancorp was the investor.

Bloom Lake Building, Minneapolis, Minnesota

LISC's second NMTC transaction closed in July 2004, providing financing for the acquisition and rehabilitation of the Bloom Lake Building in Minneapolis by the Neighborhood Development Center (NDC), a locally-based CDC. The property is a 43,000 square foot structure that had been vacant since 1998 and had exerted a blighting influence on the neighborhood, according to Minneapolis LISC Program Director Paul Williams. Says Williams, "NDC worked with a variety of community partners to formulate a viable plan for the facility that will restore the building, bring vitality to the street front, enhance the area's burgeoning Latino business district, and create opportunities for further arts and cultural programming in the neighborhood."⁶⁹ Wells Fargo provided both equity and debt to this leveraged structure, and additional debt was provided by an affiliate of NDC which it assembled from nine different sources.

⁶⁷ Michael Rubinger, chief executive officer of LISC, Interview, October 25, 2004.

⁶⁸ Robert Poznanski, president of New Markets Support Corporation, LISC internal documents.

⁶⁹ LISC press release, July 2004.

S&S Cycle, Inc.

LISC's third transaction, a \$5.5 million allocation of NMTC, closed in October 2004, funding an industrial and business loan to S&S Cycle, Inc. of LaCrosse and Viola, Wisconsin. The transaction was brought to LISC by Impact Seven, a large rural CDC that has worked extensively with LISC's rural program. S&S is a fifty-year old private company in rural Wisconsin that manufactures high-performance V-twin motorcycle engines and parts, particularly for Harley Davidson. The loan will allow S&S Cycle to remain in its current location, expand an existing research and production facility in Viola, Wisconsin and acquire and upgrade a storage and distribution facility in LaCrosse, Wisconsin. This will create 111 construction jobs, retain 20 manufacturing jobs, and create 85 new manufacturing jobs. In a leveraged transaction, US Bank LaCrosse and US Bancorp CDC respectively provided loan and equity capital.

Martineau-Division Oakes Initiative

LISC's fourth transaction, closed in December 2004, provided a \$7.8 million loan to Dwelling Place of Grand Rapids, Michigan, a CDC developer of a mixed-use residential and artist live/work space. The project involves the rehabilitation of four dilapidated, vacant buildings on contiguous lots in the Heartside neighborhood of Grand Rapids. The ground floors will have an art gallery and art-friendly tenants, a commercial bakery, a café and a retail bakery. The second and third stories will contain live and work space.

In a leveraged transaction, National City Bank provided debt and equity to a conduit LLC, which received subordinate loans from Dwelling Place and Heartside as well.

Summit Place

LISC's fifth transaction, closed in December 2004, used a \$7.5 million NMTC allocation to provide financing for the rehabilitation of three former industrial buildings into offices and the construction of a new office building. The West Allis, Wisconsin development by private developer Whitehall Summit LLC will produce about 500,000 square feet of office space and parking, create more than 2,600 permanent jobs and 300 construction jobs, and produce an estimated annual tax increase of \$1.4 million.

Is the NMTC program making it possible for deals to get done that couldn't get done in its absence? Rubinger addressed that question in the interview for this paper. "I believe that this program will, in fact, direct flows of capital to underserved areas," he said. "The deals that we have done have pushed projects into the workable range. Given the areas we target --- those that have higher indices of need than the minimum --- these projects would not have happened without the tax credit. Although the eligibility criteria might be a little too broad, I nevertheless believe the resources will end up in the right place."

4. Enterprise Social Investment Corporation: Taking on New Lines of Community Development Activity

The Enterprise Social Investment Corporation (ESIC) is an affiliate of the Enterprise Foundation, the country's second largest community development intermediary, which has invested \$5 billion in low-income communities over the last 20 years. Enterprise provides resources to community development organizations, including both community development corporations (CDCs) and other community-based organizations (CBOs) attempting to improve

the quality of life in their communities by focusing on issues such as the need for affordable housing, better schools, safer streets or more jobs.

The Enterprise Foundation works through a number of affiliates, including Enterprise Housing Financial Services, a nonprofit that provides loans for affordable housing, child care facilities, job training centers, commercial development and other community activities; Enterprise Social Investment Corporation (ESIC), the socially motivated for-profit subsidiary that invests equity in LIHTC projects; Enterprise Mortgage Investments, Inc. (EMI), which finances affordable and market-rate multifamily housing; and Enterprise Homes, Inc. (EHI), which develops homes affordable and market-rate homes for sale and rent. Enterprise's newest affiliate is ESIC Realty Partners (ERP), created to utilize ESIC's New Markets Tax Credit allocations which total \$230 million --- \$90 million in the first round and \$140 million in the second.

Enterprise has articulated a broad and ambitious four part NMTC strategy, described by Enterprise CEO Bart Harvey and by Charles Werhane, President of ESIC Realty Partners, the affiliate created to implement a large portion of the strategy.⁷⁰

First Component: Project-Based Senior and Mezzanine Debt.

As the first component of the strategy, ESIC Realty Partners has structured the Enterprise Communities Fund, which provides a senior debt and a mezzanine debt product to developers of commercial real estate projects "that have a catalytic impact on community revitalization in underserved and emerging markets."⁷¹ According to Werhane, Enterprise is targeting commercial properties because "we want to play a role in community development that is larger than housing. We want to stimulate the development of commercial properties in neighborhoods where we have significant housing investment. We're looking at retail, office, mixed use, incubator space, warehouse space and other uses."

Werhane believes access to the products ERP has created will make projects feasible that can't be done with traditional financing. Terms on ERP's senior debt are: interest rate equal to the 10 year Treasury bill with a 5 percent floor; 30 year amortization; minimum debt service coverage of 1.25; and a maximum loan to value of 75 percent. Senior debt is secured by a first lien. Mezzanine debt terms are a 9 percent preferred return plus cash flow participation to 12 percent; interest only; minimum debt service coverage of 1.1; maximum loan to value of 90 percent. Mezzanine debt is secured by partnership interests. ERP committed its entire Round 1 allocation of \$90 million to these products.

ERP's first investment, closed July 30, 2004, was a \$12 million loan to the retail component of the South Campus Gateway project in Columbus, Ohio. The investor was Fifth Third Bank. The project, being developed by Campus Partners for Community Urban Redevelopment, a non-profit entity created by Ohio State University, is one of the largest mixed-use urban redevelopment projects ever undertaken in Central Ohio. The retail component of the project, to which the investment was directed, includes 229,000 square feet of space with entertainment, restaurants, shopping, and service businesses. Besides the retail component, the project will include 88,000 square feet of office space, 190 housing units and a parking garage. According to

⁷⁰ F. Barton Harvey, chief executive officer of the Enterprise Foundation, Interview, October 26, 2004; and Charles Werhane, president of ESIC Realty Partners, Interview, July 22, 2004.

⁷¹ ESIC Realty Partners, Inc. brochure.

Werhane, the NMTC allowed ERP to make a loan to the project at 250 basis points below market.

Like LISC and others, ERP is creating single investor funds. Unlike LISC, they are not using a leveraged structure. Werhane comments that a lot of effort has been put into trying to resolve the difficulties of doing leveraged structures, but he believes that ultimately investors will find them unsatisfactory

Revitalization of the University District, where the South Campus Gateway project is located, has been a priority for both the City and the University. It includes both a densely populated student neighborhood and a low-income, minority neighborhood. The project falls within the boundaries of the Columbus Empowerment Zone.

Werhane views the NMTC as a critically important source of subsidy for difficult projects. He says there are many examples of deals in which a key piece of financing is withdrawn and the project is left with a capital gap. The NMTC makes it possible for important projects of this type to be rescued and brought to completion. Werhane is confident that the number of deals that require this type of subsidy far exceeds the amount available. He reported that his fund of \$140 million was already two times oversubscribed as of the date of the interview. He believes that ERP can probably do \$100 million of investments annually in good projects. He views development of commercial real estate as a significant catalyst for economic development.

As of the end of 2004, ERP had committed \$72 million and funded \$32 million in project-based investments.

Second Component: Entity-Based Investments

Harvey and Werhane outlined a second component to the strategy ---- making loans to large CDCs and other large non-profits to enhance their ability to do projects of significant scale. These would include working capital loans and project loans and investments. "There is a higher level of risk associated with these loans," said Harvey, "but we are willing to take that risk. We will also provide these non-profits with grants and technical assistance. The total package to a non-profit could be as large as \$3 million." As of the end of 2004 ERP had committed \$27 million in entity-based investments and funded \$15 million.

Third Component: Large Scale Urban Redevelopment

The third component of Enterprise's NMTC strategy is providing a significant piece of financing for a massive urban redevelopment project in East Baltimore. The project is an 80-acre \$800 million urban redevelopment effort led by a new non-profit organization, East Baltimore Development, Inc. Partners involved in the redevelopment effort include Johns Hopkins Medical Center, the Annie E. Casey Foundation, city and state government, and others. According to Harvey, Enterprise (through ERP) has already closed a \$15 million loan to the entity utilizing New Markets Tax Credits and is committed to funding a total of \$60 million. The project is a mixed-use development that will ultimately include 1,200 units of mixed-income housing; 4,000 - 6,000 new jobs in the life sciences and biotechnology sectors; retail, parks and open space.

Fourth Component: Ground Floor Retail in Housing Developments

Harvey emphasized that Enterprise wanted to use New Markets Tax Credit financing to solve the problem of financing ground-floor retail in rental housing developments. "This is a very

important activity to finance in order to create livable neighborhoods, but one that has been particularly difficult to underwrite,” he said. “In New York we’re going to be developing a pilot program and a risk mitigation strategy to see if we can get investors comfortable.”

Harvey echoed one of the concerns held by many others interviewed for this paper. “These funds in general have the potential to finance projects that are already financeable,” he said. “The control mechanism that you have to ensure that there is real social impact is the CDE. That’s where we start: we ask ourselves what is the social impact of anything that we do. The NMTC program depends on other CDEs approaching it that way as well. This is something that Treasury should look at very carefully when extension of the program is on the table.” Werhane also addressed this point. “We look at any project to see who is getting the benefit. We need to be convinced that we are filling a financing gap, or, for example, in a commercial real estate project we are making it possible for a non-credit tenant base to get access to space. If the project has a strong tenant base and no financing gap, then we would pass.”

Despite these concerns, Harvey felt that overall the program was likely to meet its objective of increasing the flows of capital for economic development to areas in which it was in short supply. He noted that Enterprise was diligent about utilizing its allocation in the most economically distressed areas. He expressed some concern that it is very difficult to get NMTC financing to smaller projects, and he also noted the difficulty of using the financing for small business development.

5. ExEd - Meeting a Critical Need for School Facilities Financing

Excellent Education Development, Inc. (ExEd) is a non-profit organization formed in 1998 whose mission is to improve elementary and secondary public education in lower income communities of Los Angeles by creating and supporting high achieving charter schools. ExEd helps charter school organizers/operators overcome three major obstacles: developing the school, finding appropriate and affordable facilities, and managing the business operations of the school. The space issue is a particularly thorny one, and it is particularly difficult in Los Angeles because of the high cost of land and construction.

ExEd expects to contribute to the solution of this problem by providing technical assistance and financing to selected charter school operators for the construction or rehabilitation of school buildings. ExEd will make financing available to these operators at rates and terms not available in the market, based upon the New Markets Tax Credit.

ExEd applied for and received a first round allocation of \$36 million which it intends to use exclusively to create facilities for charter schools in low income Los Angeles County communities.

ExEd is offering a loan product with an interest rate of approximately 5.75 percent, 90 percent loan to value, 1.2 debt service coverage, 25 year amortization, and a term of seven years.

The fund is leveraged. Investors will provide an \$11 million equity investment and the fund will borrow \$25 million at 200 basis points over the seven year treasury rate. Investors in the ExEd fund are likely to be Citibank (as lead lender and investor), City National Bank (debt and equity), Prudential (debt), LISC (debt) and Wells Fargo (equity). When initially interviewed for his paper in July 2004, Ex Ed Vice President Anita Landecker had hoped to close the fund in mid-October

2004 and close its first loan about a month later.⁷² When contacted in January 2005, the timetable had been pushed back about four months, and Landecker was hoping to close with investors soon and close on the first two deals in March 2005. The delays ExEd has experienced are perhaps testimony to both the difficulty of a relatively small non-profit closing a leveraged fund for a specialized product, and the difficulty of bringing the specialized transactions to a state of readiness to close.

The first two deals are the Camino Nuevo High School, a non-profit charter school with about 1,200 students in its fifth year of operations in one of the lowest income neighborhoods in Los Angeles, and View Park Preparatory School, a six-year old charter. Each loan will be \$7 million to \$8 million. Both are new construction, although Camino Nuevo is 100 percent traditional construction while View Park will combine traditional construction with modular units. In the Camino Nuevo transaction, the CDE will make its loan to a CDC closely linked to the charter school, which will lend to Camino Nuevo. In the View Park transaction, the CDE will lend to Pacific Charter Development Corporation, a non-profit which is developing the school property (and at least two others); the facility will be leased to View Park. According to Landecker, there are three or four more projects in their pipeline that will consume the remainder of the fund, and she hopes to close them in the next year. Landecker points out the fact that this is an underdeveloped market. There is a shortage of good development sites, relatively little predevelopment money available to developers, and very little history and experience of this type of development. Because of these factors, she notes, it is not yet clear how large the market is for this product beyond the five or six initial transactions. Landecker says that in future rounds ExEd may consider providing operating loans to school operators as well as facilities loans.

Landecker believes that the New Markets Tax Credit is making it possible for deals to be done that would not be possible in the absence of the tax credit. In addition, she says, the banks are becoming familiar with the charter school facilities lending opportunity by reviewing the opportunity to invest in ExEd's fund, and as a result are also now considering direct lending for school facilities. Up until now, she says, no Los Angeles bank had originated a loan for a charter school facility. One local bank --- City National Bank--- provided a \$1.3 million loan to Camino Nuevo which refinanced loans originated by non-profit intermediaries LISC and LIHF. However, Washington Mutual has recently closed a charter school facilities loan that it underwrote based in part on its due diligence on ExEd's fund, and other investors are considering loans as well.

6. Key Bank: Striving for Impact in a Twelve State Region

Key Bank, a unit of KeyCorp, the nation's 5th largest commercial real estate lender and small business lender, is rolling out a major NMTC program.⁷³ Their CDE, Key Community Development New Markets LLC, a subsidiary of Key Community Development Corporation, received a \$150 million allocation in Round 1, the third largest in that round.

⁷²Anita Landecker, vice president of Excellent Educational Development, Inc., Interviews, July 2004 and January 2005.

⁷³The information presented here was obtained from *New Markets Tax Credit: Overview*, Key Bank Community Development Lending, a Powerpoint presentation by Rosalyn Ciulla, manager of Key Community Development Corporation, at the New Markets Tax Credit Coalition Annual Meeting, Washington, D.C., December 7, 2004 and from an interview with Ms. Ciulla, July 27, 2004.

It has been allocated internally as follows:⁷⁴

\$137.5 million	real estate loans and equity; business loans
\$5 million	Brownfield Redevelopment
\$5 million	Mezzanine Loans for Business
\$2.5 million	Financial Literacy and Counseling

Key's NMTC strategy is to utilize the credit throughout their 12 state footprint, allocated among markets based on the market's proportionate share of deposits. They intend to leverage the NMTC with community development loans and loans from other bank lines of business.⁷⁵ Key CDC expects the NMTC to enable them to reduce rates on loans by 350 to 450 basis points relative to market.⁷⁶

A Key Bank New Markets Tax Credit investment played a major role in the \$6.2 million development of Arbor Park Place, a 39,000 square foot shopping center which officially opened for business on November 17, 2004.⁷⁷ Arbor Park Place is a redevelopment of the deteriorated Longwood Plaza, which was poorly maintained and tenanted and a persistent hangout for drug dealers. The center is anchored by a 19,000 square foot Dave's Supermarket, and includes a Footlocker store, a Key Bank branch, Chinese and soul food restaurants, and discount and clothing retailers. Key Bank provided a \$1,000,000 loan utilizing New Markets Tax Credits, closing in January 2004. The project is co-developed by two non-profit organizations: New Village Corporation, a subsidiary of Neighborhood Progress, Inc., a citywide community development intermediary, and Burton, Bell, Carr Development, Inc., the Ward 5 community development corporation. It is located in the Central neighborhood, one of Cleveland's poorest, where about 60 percent of residents are below the poverty level, according to the Poverty Center at Case Western Reserve University.⁷⁸ According to Neighborhood Progress Inc., Arbor Park Place "is part of a major initiative being undertaken by the City of Cleveland --- improving the quantity and quality of retail outlets available to city residents."⁷⁹ An NPI study found that 1/3rd of every retail dollar spent by Clevelanders was spent outside the city, and the city is attempting to change that. In addition to providing better quality and better priced retail goods and services, these shopping centers bring jobs to the neighborhoods. Arbor Park Place will create about 80 jobs, and the developers are working with the Cuyahoga Workforce Training Agency and the Cleveland Career Center to fill about two-thirds of the jobs from low-income households.⁸⁰

Russell Berusch, Senior Vice President of New Village Corp., confirmed that this project met the "but for" criterion. "Without the lower interest rate that Key provided by virtue of having the NMTC allocation, the project would not have gotten done. This project is fragile economically, because it is an extremely poor neighborhood. The blended cost of funds had to be low, so the tenants could have rents that they could live with. Without the NMTC program, this project could not have been financed."⁸¹

⁷⁴ NMTC: Overview, Slide 9.

⁷⁵ Slide 25.

⁷⁶ Slide 26.

⁷⁷ See "Central Neighborhood lands grocery," *The Plain Dealer*, November 16, 2003; "New Markets Credits Turn 'Un-doable' Deals into 'Can Do' Deals," *Community Developments*, Summer 2004, online magazine, http://www.occ.treas.gov/cdd/nmtcs_turn.html, Office of the Comptroller of the Currency; "Thanksgiving Comes Early to Central: Arbor Park Place Retail Center Officially Opens," press release by Neighborhood Progress, Inc. and Burten, Bell, Carr Development, Inc. November 5, 2004.

⁷⁸ "Central Neighborhood lands grocery."

⁷⁹ "Thanksgiving Comes Early to Central."

⁸⁰ Ibid.

⁸¹ Quoted in "New Markets Credits Turn "Un-doable" Deals into "Can Do" Deals."

In an interview, Rosalyn Ciulla, Manager, Key Community Development Corporation discussed her views on the important issues that have arisen in KCDCs work with the NMTC. “We are using the NMTC to provide a substantial reduction in interest rate. We are passing the entire subsidy to the borrower.” But, she said, we need mechanisms to ensure that all CDEs are delivering maximum community benefit. A critical issue for the program is how to insure that community benefit takes place and how to document it. “I would like to see the CDFI Fund screen future awards based on community impact.”

Ciulla also discussed KCDCs interest in using the NMTC for business loans, but cited the difficulty of doing so under the program’s regulations. One flaw that she noted was the difficulty of meeting the documentation requirements of lending to businesses that had multiple locations when not all of them were in LICs. She also said that the original intent of the program was economic development --- making it possible for more businesses to open up in economically depressed areas. According to Ciulla, KCDC hopes to encourage this by doing more business lending, using the NMTC as a loan loss reserve for business borrowers with higher credit risk.

7. GMAC Commercial Holding Capital Corp.: A Subordinated Debt Strategy

At the 2004 Novogradac & Company LLP New Markets Tax Credit Investors Conference in Boston, Massachusetts, October 20-24, Kermit S. Billups, managing director, presented a case study on GMAC Commercial Holding Capital Corp.’s (Capital Corp.) \$19.5 million NMTC investment in the Everett Mall Redevelopment in Everett, Wash. Paramount Community Development Fund LLC, a CDE controlled by Capital Corp., received a \$75 million allocation in the first round. As of the date of the conference, the CDE had taken in \$37.5 million in QEIs and closed on \$25 million in QLICIs. According to Billups, Capital Corp. has created an NMTC Services Platform that enables the company to provide development services and balance sheet support to smaller NMTC developers who might require it in addition to the investment capital provided by the CDE. Capital Corp.’s mission for this program is to “improve the availability and reduce the cost of capital in low-income areas nationwide” and their strategy is to provide subordinate or “mezzanine” loans with terms of approximately three years, allowing NMTC capital to be recycled two to three times in a seven-year period.

Capital Corp.’s first NMTC investment under this strategy was the Everett Mall, a 600,000 square-foot regional mall which was under severe stress. Before redevelopment, the mall had a 30 percent vacancy rate and a poor tenant mix. The developer had limited equity and had been turned down by two national lenders for a critical piece of financing that would enable redevelopment to begin. Capital Corp. was able to use its NMTC funds to make a \$19.5 million subordinate loan to fill the gap between the \$98.8 million redevelopment cost, developer equity of approximately \$15 million and approximately \$65 million in available senior debt. The terms of Capital Corp.’s loan were three years, interest-only at a floating rate estimated to be approximately 500 basis points below market.

Billups made the case that mezzanine loans were an efficient use of NMTC capital with the following analysis: First he assumes a \$100,000,000 allocation is invested in projects over the seven-year compliance period. He also assumes the benefit is delivered to projects in the form of a 25 percent annual interest rate reduction relative to a market rate. Given these assumptions, if the allocation were used for first mortgages with a term of seven years and a market rate of 5 percent, the annual interest rate reduction would be 1.25 percent to 3.75 percent. The total benefit of \$100,000,000 times seven years times 1.25 percent equals \$8,750,000. If the same \$100,000,000 of allocation were used for seven-year higher rate (assume 14 percent) mezzanine loans, the annual

interest rate reduction would be 3.50 percent (14 percent market rate of interest reduced by 25 percent to 10.5 percent.) The total benefit of this scenario would be \$100,000,000 times seven years times 3.75 percent, or \$24,500,000. This analysis forms a significant portion of the basis for Capital Corp.'s NMTC strategy of targeting mezzanine loans.

In selecting among projects eligible for NMTC investment, Capital Corp. intends to maximize the number of jobs created per NMTC dollar, or to maximize other desirable outcomes per NMTC dollar. Billups illustrated the point by citing the results of an independent analysis (provided by American Economics Group) of the benefits generated by the Everett Mall project. These include:

- 2,200 construction/renovation jobs
- 5,700 permanent jobs in the county
- 500 jobs in CDFI census tracts
- \$20 million net county tax impact
- \$81 million net national tax impact
- one permanent job per \$2,360 of NMTC allocation used.

In an interview in March 2005, Billups and his colleague, Randall Kahn, vice president and managing director of Capital Corp.'s NMTC platform, elaborated further on Capital Corp.'s NMTC strategy. As of that date all \$75 million in QEIs had been taken down, and three project investments totaling \$34.5 million had been closed. These are the Everett Mall project and two other similar subordinate loans. Kahn and Billups indicated that subordinate debt would continue to be their primary strategy, although they didn't rule out other types of investments altogether, including loan purchases from other CDEs. They emphasized that there were a significant number of eligible deals to choose from, and that they used the criterion of maximizing community benefit to choose among them. They cited three measures of community benefit which they favored: number of jobs created per NMTC dollar; amount of market rate financing per NMTC dollar; and efficiency of the credit --- how much of the benefit of the credit is being passed through to the project. They also reiterated their intention to support and, if necessary, partner with undercapitalized developers to make it possible to get deals done. Capital Corp. has applied for an allocation in the third round, and in addition to pursuing their subordinated debt strategy, they hope to increase the development support function.

Throughout the interview Billups and Kahn stressed the importance to Capital Corp. of maximizing community benefit. In response to a question about the extent to which this is important to other players in the industry as well, Kahn said, "The program is very flexible. Community benefit can be measured in a number of different ways. The industry has to police itself---there needs to be a forum and dialog in the industry on this issue. It is critical to the long-term success of the program." Kahn felt the industry was paying attention to the issue and overall doing well in obtaining community benefit. He noted the important role of organizations such as the New Markets Tax Credit Coalition and the National Housing and Rehabilitation Association in focusing attention on this and other critical issues of the NMTC, pointing out that NH&RA devoted a day of its 2005 Annual Meeting to NMTC issues, including a panel on "The Challenge of Achieving---and Measuring--- Community Benefit in NMTC Transactions."

8. Coastal Enterprises, Inc.: Using NMTCs to Implement a Triple Bottom Line Strategy

Coastal Enterprises, Inc. of Wiscasset, Maine (CEI) is a 27 year old CDC which has loaned or invested \$187 million in its target communities and has \$247 million under management. The mission statement of CEI --- "to help create economically and environmentally healthy

communities in which all people, especially those with low incomes, can reach their full potential.” --- puts the three Es of triple bottom line investing (Economics, Equity and Environment) at the center of their approach to community development.⁸² CEI received an allocation of \$65 million in Round 1 and another \$64 million in Round 2. The NMTC program is the responsibility of their CEI Capital Management LLC subsidiary, managed by Steven Weems. CEI Capital Management first asks the “but for” question: would the “project or business under consideration be viable and would it most likely succeed if it did not have the benefits of the NMTCs?”⁸³ If the proposed project passes this screen, CEI will evaluate its fit with the three E orientation of the organization. These include “an evaluation of a project’s Economic viability, its positive community social Equity, and its integration with sustainable Environmental principles.”⁸⁴ CEI, however, is “practical in applying this mission underwriting perspective; not every project is expected to meet all of the criteria. Some projects are compelling enough in just one or two of these areas.”

CEI’s first two investments certainly exemplify a use of NMTCs closely aligned with the organization’s mission. One of CEI’s goals is to foster sustainable development in the northern forests of Maine, Northern New England and western New York State, in recognition of the importance of the natural resource base in the region’s economy. This involves preserving jobs in both forest management and forest products industries, as well as advocating for development policies that will protect the environment of the region. A critical need for intervention surfaced when Great Northern Paper (GNP), which operated paper and pulp mills employing 1,130 people in Millinocket and East Millinocket, Maine appeared in 2002 to be moving toward declaring bankruptcy.

In a complex transaction, The Nature Conservancy (TNC) and Great Northern Paper entered into an unprecedented agreement under which TNC purchased a \$50 million mortgage on GNP’s land held by John Hancock Financial Services, retired \$14 million, and refinanced the balance at less than half the rate of the retired note, providing substantial breathing room to GNP. In return, GNP transferred 41,000 acres in the Debsconeag Lakes wilderness area to TNC and placed “a conservation easement on 200,000 acres of forestland around Mount Katahdin, which will guarantee public access, recreational uses, sustainable forestry, and no future development.”⁸⁵ In April 2003 GNP was purchased by the Brascan Corporation of Canada, an asset management company with a focus on real estate, papermaking and power generation. The pulp and paper mills were transferred to Brascan affiliate Katahdin Paper Company, LLC, and the forest land to Katahdin Timberlands, LLC, which in turn owns Katahdin Forest Management, LLC. The mills have been able to reopen with 530 workers, about half of the former workforce. (With new technologies under which the mill is operated, only 530 employees are required.) Katahdin Paper now says, “We’re here to stay.”⁸⁶

A critical piece of the financing was a NMTC-financed \$31.5 million loan by a CEI affiliate to Katahdin Paper, the successor to GNP, that replaced the interim financing provided by TNC. The QEI was made by GE Commercial and Industrial Finance. The loan appears to have satisfied all four of CEI’s criteria: “but for”, economics, equity and environment.

⁸² *Annual Report 2004*, Coastal Enterprises Inc.

⁸³ CEI’s website, www.ceimaine.org, “CEI Capital Management’s Mission-Oriented Approach to Underwriting”

⁸⁴ *Ibid.*

⁸⁵ TNC Press Release. <http://nature.org/success/katahdin.html>.

⁸⁶ John O’Hanlon, “The Maine Chance” The Manufacturer.Com
http://www.themanufacturer.com/us/detail.html?contents_id=2752

CEI's second NMTC loan was a \$4 million long term loan to the Gulf of Maine Research Institute (GMRI) on Portland's waterfront (formerly the Gulf of Maine Aquarium.) The 56,000 square foot new structure is to house "a variety of nonprofit, governmental and for-profit tenants, all focused on the Gulf of Maine and its watershed. With laboratories, research centers, and exhibit spaces, this state of the art facility is positioned to become a world-class marine research and education center. One critical role for the GMRI is to be a 'neutral convener', bridging a long-standing gap between scientists and fishermen."⁸⁷ The QEI was made by People's Heritage Bank. "CEI was attracted to GMRI for its high quality jobs, as well as the commitment to sustain the Gulf of Maine's fishery ecosystem and the 25,000 fishing jobs, fishing communities and fishing families that depend on it."⁸⁸

CEI's President Ron Phillips says that CEI's \$17 million NMTC-backed loan to the Appalachian Mountain Club (AMC), financed by a QEI from Citizen's bank, is another triple bottom line win. The loan is in support of the Maine Woods Initiative, which is designed to both support the sustainable forest economy and to build a new "green" tourism industry. According to AMC, it "acquired the 37,000-acre Katahdin Iron Works tract from International Paper in December 2003, and operates Little Lyford Pond Camps, a traditional Maine sporting camp open to members and the general public, on its Maine Woods property."⁸⁹ AMC will set aside approximately 10,000 acres as an ecological preserve, and the balance will be used for sustainable forestry, recreation and other uses. Illustrating the two types of uses planned for the Maine Woods project, AMC has hired a logging company to do an initial harvest on the land, supplying mills in the state, and it is also building hiking and skiing trails and planning backcountry lodging and recreation uses.

Said Phillips, "It is an exceptional opportunity to use the New Markets Tax Credit program to support traditional manufacturing industries, . . . recreational tourism in interior Maine, and community use of the forest, at the same time altering the economics of owning working timberlands to facilitate sustainable forestry practices."⁹⁰

In an interview on October 22, 2004, Steven Weems reflected on both the complexity of the process and of the importance of the NMTC to doing their achieving their mission.⁹¹ With respect to the first, he said he wouldn't advise smaller CDCs to apply for allocations of tax credits, but instead to seek QLICIs for their projects from larger CDEs. "Writing the application, negotiating the allocation agreement, the reporting and compliance procedures --- it's just too expensive for a small organization. We put a lot of money into the process before we saw any results." On the other hand, he said, the NMTC allowed them to accomplish things they would have been unable to do without it. "The NMTC allowed us to complete an important project focused on our core market," he said, "economic development in rural areas in the Northeast with a natural resource based economy."

⁸⁷ CEI 2004 Annual Report,

⁸⁸ Ibid.

⁸⁹ AMC website, <http://www.outdoors.org/conservation/maine/mainewoods-whitepaper.cfm>.

⁹⁰ Appalachian Mountain Club Press Release, January 24, 2005.

⁹¹ Steven Weems, president of CEI Capital Management, LLC, Interview, October 22, 2004.

9. Market Creek Plaza: NMTC Financing Supports Large-Scale Community-Led Urban Redevelopment Project⁹²

A \$15 million NMTC-supported loan has played a pivotal role in a unique and highly significant urban redevelopment project --- Market Creek Plaza in San Diego. The loan was made by the Clearinghouse CDFI (a first round allocatee) based on a QEI by Wells Fargo Bank, and was announced in June 2004. The project is impressive enough on its face --- a \$23.5 million shopping center in the culturally diverse Diamond Neighborhood of San Diego, featuring a 57,000 square foot Food 4 Less supermarket as anchor tenant and a mix of national/regional tenants ranging from Starbucks, Wells Fargo Bank, San Diego Gas & Electric and Curves for Women to local ethnic restaurants and space for micro-entrepreneurs. Equally impressive are the highly neighborhood-targeted economic impacts cited by project sponsors:

- The project recaptures much of the \$60 million in annual sales estimated by a San Diego State University study to be formerly leaking out of the community;
- more than 1,700 new neighborhood jobs, and 360 construction jobs with training for emerging contractors, supported by contractor lines of credit; (69 percent of the construction contracts were awarded to local minority-owned enterprises.)
- 91 percent of the initial employees at Food 4 Less were hired from the community. All jobs are unionized and include living wages, health care and pension plans.⁹³

However, the unique aspect of the project is the extraordinary commitment to community planning, participation and ownership in all phases of the development.

The project reflects the Jacobs Family Foundation's (JFF) vision of how community redevelopment should be implemented. Established in 1988 by Joseph and Violet Jacobs, with a \$25 million endowment, JFF initially "focused on grantmaking and technical assistance to community-based nonprofits, but in 1997 decided to shift toward intensely place-based community development focused on southeastern San Diego, where the Foundation's founder had a personal connection."⁹⁴ JFF moved its headquarters into the Diamond neighborhood of southeastern San Diego in 1998, and through its operating foundation, the Jacobs Center for Neighborhood Innovation, purchased the site of an abandoned aerospace factory, and hired neighborhood residents to conduct a survey of neighborhood residents and businesses to learn what was the community's vision for the site. The survey was conducted in four languages, reached out to 600 individuals and 200 businesses, and was supplemented by hundreds of community meetings. What resulted from this process was not only a vision of such important issues as the mix of retail tenants (including national and regional credit tenants as well as local entrepreneurs and micro-entrepreneurs), but also the overall cultural and architectural components of the project. These include a 500-seat outdoor amphitheater, community art works, the vision of the center as a "safe place for intergenerational and multi-ethnic interactions"⁹⁵ and such details as natural vegetation and walking paths.

Community participation was not limited to initial planning; the entire project has been implemented with intense community involvement and ownership. Ownership is literal, not

⁹² This case study focuses not on a CDE, like all of the others, but on a single project with unique characteristics. The NMTC financing which was critical to this project was made by Clearinghouse CDFI, which received a \$56 million allocation in Round 1.

⁹³ Market Creek Plaza website, www.marketcreek.com/mcp_project.html

⁹⁴ "Ensuring Livable Communities: Family Foundation Case Studies," prepared by the Funders' Network for the 2003 Family Foundations Conference, February 2003.

⁹⁵ www.marketcreek.com/mcp_project.html

figurative. The project developer, JCNI, created a for-profit special purpose entity --- Market Creek Partners, LLC --- as a vehicle for residents, JCNI and a community foundation to own shares in the development.⁹⁶

The Clearinghouse CDFI/Wells Fargo Bank loan was a critical event in the development of this landmark project. The first phase of the project, the Food 4 Less anchored shopping center, now open and fully leased, was initially seen as high-risk and “unbankable.”⁹⁷ According to JCNI president Jennifer Vanica, the closing of the \$15 million loan was “huge” in two ways. “One is the fact that the plaza is being seen as bankable and commercially viable --- and that’s a huge milestone. But equally important is the value of the loan itself. This really escalates our ability to head into the next phase of work.”⁹⁸

Said Chip Buttner, vice president of the Jacobs Center for Neighborhood Innovation (JCNI), the non-profit development entity developing the project, “getting the loan at the rates and terms the New Markets Tax Credit made possible was absolutely critical to our ability to proceed with this project. These terms --- 3% interest, 7 year term, 25 year amortization, one year interest only --- were not available to us anywhere else.”⁹⁹ According to Buttner, JCNI had loaned \$23 million to the project, and being able to refinance \$15 million was critical to their being able to proceed to the next phase.

The second phase of the project includes 380 units of housing and a 75,000 square foot community center. According to the San Diego Business Journal, Market Creek Plaza is to “become a pilot village, a project selected by the City of San Diego to serve as an example of development envisioned by the City of Villages plan, which calls for a mix of housing, jobs, shopping and public transportation on sites around the city.”¹⁰⁰ Buttner says he is negotiating a NMTC loan of about the same size for the second phase as well.

Initially, it was not easy getting the attention of CDE lenders, he said. “Ours was a difficult deal,” he said. “Initially, nobody really wanted to talk to us. They were looking at making NMTC loans to better projects --- projects on which they could get better returns. Our deal pushed them. Our deal is what the program is intended for.”

⁹⁶ *“Ensuring Livable Communities: Family Foundation Case Studies,”*

⁹⁷ Jordan Robertson, “Group lands loan for mall expansion,” *Union Tribune*, June 30, 2004.

⁹⁸ *Ibid.*

⁹⁹ Chip Buttner, chief operating officer of the Jacobs Center for Neighborhood Innovation (JCNI), Interview, March 18, 2005.

¹⁰⁰ Mandy Jackson, *San Diego Business Journal*, August 2, 2004.

<http://www.knowledgeplex.org/news/42593.html>

Appendix D

Selected Data Points of the Community Investment Impact System¹⁰¹

Transaction Profile

- Original Loan/Investment Amount
- Primary Purpose of Loan/Investment (e.g. business fixed asset, business working capital, real estate construction commercial, etc.)
- Transaction Type (e.g. term loan, equity investment, etc.)
- Interest Rate
- Points at Origination
- Origination Fees
- Amortization Type (e.g. full, partial, balloon)
- Equity-Like Features
- Term in Months
- Guarantee Source
- Lien Position
- Collateral Type

Borrower/Investee Profile

- Type (Real Estate or non-Real Estate)
- Structure (e.g. for-profit, non-profit)
- Minority Owned or Controlled
- Women Owned or Controlled
- Low-Income Owned or Controlled
- Jobs at Time of Loan/Investment
- Jobs at Reporting Period End
- Annual Gross Revenue from Business Operations during the Reporting Period

Impact Profile

- Gender
- Race
- Hispanic Origin
- Annual Gross Revenue from Business Operations at Time of Loan/Investment
- Total Project Cost

Projected Impacts

- Projected Jobs to Be Created
- Capacity of Community Facility
- Square Feet of Real Estate by Type (sq. ft. manufacturing, office, retail, etc.)
- Asking Rent per Square Foot

¹⁰¹ Community Investment Impact System, FY 2004 CDE Transaction Level Report Instructions, November 15, 2004). For full document see www.cdfifund.gov/ciis/

Housing Units (Sale, Rental)

Affordable Housing Units (Sale, Rental)

NMTC Compliance Data

Better Rates and Terms (Which types were offered)

Areas of Higher Distress (Which definitions apply)

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