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Structuring NMTC Loan Funds is Key

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In the competitive market for new markets tax credit (NMTC) allocation authority, loan funds may provide an edge.

By reducing transaction costs (as discussed in *NMTC Practitioners Finding Ways to Complete Small Deals,* April 2018 Novogradac Journal of Tax Credits), loan funds facilitate qualified low-income community investments (QLICIs) of $2 million or less (small-dollar QLICIs), investments in small businesses and flexible terms. Loan funds are also used with larger QLICIs to reduce transaction costs and increase the benefits provided to borrowers.

In my experience as tax counsel closing loan funds on behalf of allocatees, intermediary community development entities (CDEs), lenders and investors, there are as many potential loan fund structures as there are allocatees. The structure selected will depend on the allocatee's business model and the intended investments.

A few examples of the range of types of loan funds include:

- **Mezzanine financing**: Good Jobs Investment Fund, managed by New Markets Support Company LLC (NMSC), an affiliate of Local Initiatives Support Corporation (LISC),) closed in April 2018. LISC provided the NMTC allocation. The Good Jobs Investment Fund is a $5 million revolving loan fund that will provide NMTC-enhanced mezzanine financing from $250,000 to $2 million to small businesses to create quality jobs accessible to low-income community residents nationwide. The financing includes favorable terms, including below-market interest rates and subordinate debt or equity QLICIs.
- **QLICI loan purchases, working capital financing**: Capital Access Fund of Greater Cleveland is a $2 million revolving loan fund, closed with a loan purchase structure in accordance with Treasury regulations. The CDE is treated as making the QLICIs purchased from an affiliate of National Development Council, as the third-party originator. NMSC manages the Capital Access Fund. Morgan Stanley provided the NMTC allocation and leverage loan. The Capital Access Fund provides working capital loans from $50,000 to $150,000 focused on serving women and minority-owned businesses.
- **Rural loan fund**: Midwest Minnesota Community Development Corporation (MMCDC) manages the WF MMCDC Small Project Investment Fund of approximately $9 million, including leverage loans from MMCDC

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and affiliate leverage sources. In MMCDC's 11th small loan fund, MMCDC provided the NMTC allocation, with Wells Fargo Community Investment Holdings LLC as the tax credit equity investor. The QLICIs include below-market rate loans to White Earth Tribal and Community College to develop its facilities, financing of for sale housing, financing of a tribal networking company to connect homes, schools and business on a reservation to high speed internet, among others. The QLICIs are structured to provide potential forgiveness of indebtedness, described below.

- **Intermediary CDEs, debt and equity QLICIs**: Tiered CDE structures can be used to provide experience to an intermediary CDE or to take advantage of the intermediary CDE's relationships in the applicable low-income communities. Ariel Economic Development Fund, LLC (AEDF), as intermediary CDE, manages a $4 million revolving fund consisting of small debt and equity QLICIs, capitalizing on AEDF's knowledge of the applicable low-income communities. US Bancorp Community Development Corporation is the tax credit equity investor, and its affiliate USBCDE LLC provided the NMTC allocation. Ariel Ventures LLC is the leverage lender sourced from investments made by PNC Community Development Company, LLC.

The following is an overview of certain key structuring issues and tax implications to consider in planning a loan fund transaction.

Delivery of benefits of the NMTC financing to qualified active low-income community businesses (QALICBs)

The intended benefits to be delivered to QALICBs drive the loan fund structure.

- **Reduced interest rates**: The most common approach is to provide the benefits through reduced interest rates and other flexible terms. Since the total principal amount of the QLICI is required to be repaid, the portion attributable to tax credit equity provides a cushion for underwriting credit risks. This approach simplifies documentation and for the borrower will appear the same as a standard commercial loan.
- **Potential debt forgiveness**: Potential forgiveness of indebtedness may be offered by providing the CDE an option to put the QLICI to the borrower or a right to accelerate the QLICI for a discounted principal amount. Generally, the borrower cannot be provided a fair market value call option to purchase the loan. A call option is usually deemed exercised at closing under the Treasury regulations and the full principal amount of the loan is not respected as debt for tax purposes. The put or acceleration option structure (without a call option) may not be acceptable to borrowers who are not familiar with the NMTC program.
- **Additional flexible terms**:
  - ◇ Prepayment may be permitted: Depending on the allocatee's business model, prepayment of QLICIs may be permitted without penalty. Principal payments would be redeployed in new QLICIs if required to comply with NMTC reinvestment requirements. The prepayment right takes into consideration that the needs of the borrower may change during the term of the loan.
  - ◇ Shorter term QLICIs with amortization: The QLICIs may have a term of less than seven years consistent with the business needs of the borrower and the loans may amortize during the term to facilitate repayment. In analyzing redeployment requirements with amortizing or prepaid QLICIs, principal payments held in a loan loss reserve by the CDE up to 5 percent of the applicable qualified equity investment (QEI) may be treated by the CDE as invested in a QLICI

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if the use of such funds is restricted to loan losses or for additional investments in existing QLICIs.

- ◇ Collateral: As a result of multiple QLICIs with lower principal amounts, there may be greater flexibility in the collateral required to secure the loan. This flexibility may also reduce transaction costs for each borrower. Certain due diligence and recording costs will not be incurred if real estate collateral is not required.
- ◇ Equity QLICIs: CDEs are incentivized by the Opportunity Zone incentive to structure QLICIs as equity investments. The complexity of combining the two incentives may be worth the additional benefits provided to the low-income community. Guidance has been requested from the CDFI Fund regarding the ability of a CDE to make equity QLICIs if equity investments were not included as a financial product in the CDE's allocation application. The proposed equity QLICIs should otherwise be generally consistent with the strategies described in the allocatee's allocation application. With respect to equity QLICIs generally, there are additional risks related to compliance with the operating income safe harbor and the availability of the reasonable expectations safe harbor. Subject to certain exceptions, the reasonable expectations safe harbor is not available during any period the CDE controls the QALICB, defined generally as ownership or control of more than 50 percent of the QALICB. The degree of risk with respect to QALICB status depends on the nature of the borrower's business. Investors may be willing to waive reliance on the reasonable expectations safe harbor, depending on the types of investments and the CDE's management capacity.

Allocation agreement compliance

The following are a few of the compliance issues that may arise in loan fund transactions.

- **Refinance restrictions**: Community Development Financial Institutions Fund (CDFI Fund), Certification, Compliance Monitoring and Evaluation, Frequently Asked Questions ##44-46: Beginning with the 2015-2016 NMTC allocation, CDFI Fund guidance provides generally that QLICI proceeds can only be applied to reimburse or refinance project costs previously incurred by any person whose capital was used, directly or indirectly to fund the QEI if such costs were incurred within 24 months of closing the QLICI or do not exceed 5 percent of the total amount of the QLICI proceeds. These restrictions are less likely to apply in the loan fund structure. Affiliate leverage loans are less common. The requirements should still be analyzed to confirm compliance based on the financing sources for the QEIs. In addition, the CDE and investor may in their discretion apply a 24-month reimbursement restriction, although not technically required.
- **Better rates and terms**: The borrower is not necessarily the party that provides market comparables in loan fund transactions. The allocatee or the leverage lender may be more appropriate. The applicable favorable terms may differ from larger stand-alone transactions. In addition, loan funds are typically structured to minimize the borrower's involvement in NMTC documentation.
- **Allocatee control**: Loan funds may include a committee that approves QLICIs. It is important to assure that the allocatee has the authority to propose QLICIs and is required to approve all QLICIs to maintain "investment control" as defined in the allocation agreement.

Exit/liquidation strategies

The unwind structure of loan funds depends on the structure of the QLICIs and leverage loans. The following are a few of the potential strategies. There are many other approaches depending on the desired allocation of the economics of the loan fund.

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- **Investor**: There may be put and call options of the investor's interest in the investment fund between the investor and the loan fund manager or the allocatee. In addition, the loan fund may simply liquidate after the last compliance period. The loan fund structure will also be vetted by tax counsel to assure that the investor will be respected as a partner of the investment fund for tax purposes if the investment fund is a partnership, or of the CDE, if the investment fund is disregarded for federal income tax purposes. The analysis may differ from the standard stand-alone transaction, depending on the structure of the loan fund.
- **Leverage lenders**: QLICIs that remain outstanding may be assigned to leverage lenders after the compliance period if the leverage loans have not been satisfied. Alternatively, the CDE and/or investment fund may stay in place until the QLICIs have been satisfied to facilitate the allocation of the economics of the transaction.
- **Unwinding QEIs**: Loan funds may be structured to provide for the unwind to occur at the end of the last compliance period or for separate unwinds for each QEI, provided that the approach is carefully documented and is acceptable to the applicable investor and tax counsel.

Conclusion

There are additional issues and opportunities that arise in structuring loan funds–for example, related to the nature of the financing sources. The exciting aspect of loan funds is the potential for additional flexible terms, facilitating QLICIs that are not otherwise feasible in the NMTC program, and providing access to capital not otherwise available to businesses in low-income communities. ❖

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