

NMTC REPORT

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Using the New Markets Tax Credit to Finance Affordable Housing - It Is Doable

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There has been a general impression that the new markets tax credit (NMTC) may not be used to finance housing development. However, while the credit is not available for loans for, or investments in, projects that involve solely residential rental housing, the credit is available for investments in and loans for certain mixed-use projects and certain other types of housing development. This article will review some of the ways in which the NMTC may be used to finance affordable housing in low-income communities.

New Markets Tax Credit

Generally, the NMTC is available to a taxpayer who holds a qualified equity investment (QEI) during the applicable credit period. Section 45D(a). (Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended, as in effect as of the date hereof.) In relevant part, a QEI means an equity investment in a qualified community development entity (CDE) if substantially all of the cash invested by the taxpayer is used by the CDE to make qualified low-income community investments (QLICI). Section 45D(b). QLICIs include equity investments in and loans to qualified active low-income community businesses (QALICB) located in low-income communities. Section 45D(d).

Generally, a QALICB does not include residential rental property if 80 percent or more of the gross rental income from the building for the taxable year is rental income from dwelling units. Section 45D(d)(3); Section 1397C(d); Section 168(e)(2). Furthermore, the rental real property is not considered a qualified business unless there are substantial improvements located on the property.

The test for whether a project involving housing qualifies as a QALICB is made on a building-by-building basis.

Thus, while a loan or investment in an apartment building comprised entirely of rental apartment units would not qualify for the NMTC, a mixed-use building could qualify for the credit.

Options for Using the New Markets Tax Credit to Finance Housing Development.

Mixed-Use Development.

Generally, the credit is available for investments in mixed-use projects where more than 20 percent of the gross rental income from the building is from non-residential rentals.

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Division of Building into Residential and Commercial Condominium Units.

In the case of the federal low-income housing tax credit (LIHTC), the Internal Revenue Service (IRS) treats a condominium unit as a separate building. There is currently no guidance on whether the IRS will follow a similar rule with respect to the NMTC. However, if a similar rule is followed, it would be possible to divide a building into one residential condominium unit composed of multiple residential apartments and a separate commercial/retail unit. Each condominium unit could be owned by a different entity and have separate investors. The housing condominium unit could be financed in part with the federal LIHTC. The commercial portion of the building could be financed with the NMTC.

Historic Rehabilitation Tax Credits.

A tax credit is available for the rehabilitation of certain historic structures. Section 47. Generally, in the case of a qualified rehabilitation of a certified historic structure, the credit is equal to 20 percent of the qualified rehabilitation expenditures incurred with respect to the rehabilitation of the building. The credit is generally 10 percent of qualified rehabilitation expenditures with respect to a qualified rehabilitated building other than a certified historic structure. Section 47(a). The credit is generally claimed in the year in which the rehabilitated building is placed in service. Section 47(b).

In Notice 2002-64, 2002-41 I.R.B. 690, the IRS stated that the rehabilitation tax credit may be combined with the NMTC so that both credits may be claimed with respect to the same investment. This Notice may be relied upon until the IRS issues further guidance.

Tax-Exempt Bond Financing.

Generally, tax-exempt bonds may be used to finance certain facilities that are owned by private for-profit entities. Section 142. The types of facilities that may be financed with tax-exempt bonds include qualified residential rental projects. Section 142. For tax-exempt bond purposes, a qualified residential rental project is generally a project in which either 20 percent or more of the residential units in the project are occupied by individuals whose income is 50 percent or less of the area median gross income, or 40 percent or more of the residential units in a project are occupied by individuals whose income is 60 percent or less of the area median gross income. Section 142(d).

Generally, at least 95 percent of the bond proceeds must be used for the housing portion of the project. Section 142(a).

Section 45D(i)(1) directs the IRS to prescribe regulations to implement the NMTC, including regulations to limit the availability of the credit for investments

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that are directly or indirectly subsidized by other federal tax benefits, including tax-exempt bond financing. To date, the IRS has not issued any direct guidance regarding the availability of the NMTC for projects that are in part tax-exempt bond financed. However, Notice 2002-64 provides that the availability of federal tax credits "other than Section 42" does not limit the availability of the NMTC. Based on this Notice and informal discussions with the IRS, it appears that a mixed-use project may be financed with both tax-exempt bonds and the NMTC.

Low-Income Housing Tax Credit.

In Notice 2002-64, the IRS specifically withheld guidance on the availability of NMTC in projects that are financed in part by the Section 42 LIHTC. The Notice stated that the Treasury Department and the IRS are studying how Section 42 may limit the availability of the NMTC.

Until such guidance is issued, it is not recommended that developers plan on being able to use both credits to finance the same building. (See discussion above regarding the definition of building and the potential option of dividing the building into a housing condominium unit and a retail/commercial unit, each of which might be considered a separate building for this purpose.)

However, because the LIHTC would be available only on the housing portion of a mixed-use building, and because state housing agencies are already required to limit the amount of federal LIHTCs available for a building to the amount required for the building to be financially feasible, it may be strongly argued that permitting the use of both the NMTC and the federal LIHTC for the same building would not result in duplicative tax benefits, but rather that the use of both credits would be to permit the development of a project in a low-income area that would otherwise not be financially feasible if only one of the credits were used. See Section 42(m)(2).

Single Family Home Ownership Development.

The restrictions with respect to the development of residential property under Section 45D apply only to rental property. Therefore, loans to housing developers that otherwise qualify as active low-income community businesses should qualify for the credit. Financing products to provide loans to qualified single-family home ownership developers are already being marketed. There are, however, substantial restrictions on investments in businesses that hold debt or other financial instruments (such as mortgages). Section 45(d)(2)(A)(v). ❖

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