NEW MARKETS TAX CREDIT BASICS

The new markets tax credit ("NMTC") is provided for under Section 45D of the Internal Revenue Code (the "Code"). The purpose of the credit is to encourage investment in low-income community businesses, while also effectively reducing the borrowing or financing costs to the businesses.

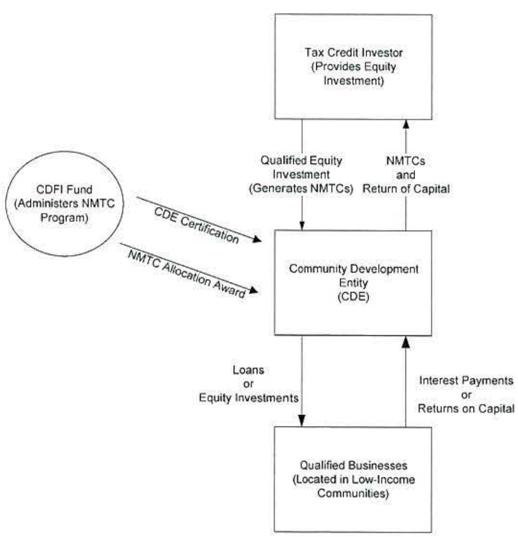
As discussed in more detail below, the NMTC is generated when a "qualified equity investment" is made into a "community development entity" that, in turn, uses the proceeds of such investment to make loans or equity investments in "qualified active low-income community businesses" located in "low-income communities". Each of these concepts is discussed in greater detail below, and attached to this memorandum is a glossary of NMTC terms.

NMTC loan transactions can be structured to look almost identical to a traditional commercial or real estate loan, with the NMTC benefit being used to reduce financing costs to the borrower while providing the lender with additional return through the tax credit, or additional equity cushion where the tax credits are syndicated to third-party tax credit investors.

HOW DOES THE NMTC WORK?

The NMTC (unlike many other credits) is generated at the moment a "qualified equity investment" or "QEI" is made into a "community development entity" or "CDE" (as opposed to the low-income housing tax credit that is earned only after the placement in service of a qualifying building). The NMTC equals 39% of the QEI, and is spread out over 7 years – 5% in the first three years and 6% in the final four years. Because the NMTC is based upon the QEI made to the CDE (which then must invest the proceeds in the manner discussed below), the tax credit investor in a NMTC transaction does not own an interest in the project and the costs associated with the project have no bearing on the amount of the credit. This is in sharp contrast to other tax credit programs such as the low-income housing tax credit or historic rehabilitation tax credit.

The structure chart below illustrates the basics of a NMTC transaction:



A QEI must be an equity investment (not a loan) into a CDE that has been certified by the CDFI Fund, a government entity entrusted with the administration of the NMTC, and the CDE must have received an allocation of NMTC authority from the CDFI Fund (more on CDEs below). The CDE is an intermediary that receives the QEI and uses those proceeds to make loans or investments in one or more "qualified active low-income community businesses" or "QALICBs".

The CDE has twelve months to invest the proceeds of the QEI, either in the form of loans, equity investments, or the provision of financial consulting services. The recipients of any of these investments must be located in a low-income community (generally speaking a low-income community is any census tract where the residents have family incomes less than 80% of the area median family income).

Any business that receives a NMTC-enhanced loan or equity investment must also meet the statutory requirements of a QALICB. These requirements are intended to ensure that the business is truly located within a low-income community and to preclude certain activities (such as gambling facilities or liquor stores). One very important limitation of the NMTC program is that the operation of residential rental property does not constitute a qualifying business. Mixed-use projects can qualify, but careful attention must be given to the NMTC requirements.

Examples of QALICBs in NMTC transactions include large high-end shopping malls, upscale condominiums, apartment buildings, student housing, large mixed-use facilities, hotels, restaurants, community facilities, biotech research facilities, charter schools, and nonprofit theatres.

WHAT IS A CDE?

CDEs are domestic partnerships or corporations that act as intermediaries in NMTC transactions. CDEs are often either community minded entities that intend to seek out investors or financial institutions that wish to self-fund the CDE to generate tax credits for their own account.

The CDE is the entity that receives the QEI and that must make investments in or loans to the QALICBs. Because of its important community focused role, the CDE must be accountable to low-income communities in the areas it intends to serve through a board that either advises the governing board of the CDE or a board that acts as the governing board of the CDE. In order to become certified as a CDE, an entity must apply to the CDFI Fund and demonstrate that it has the purpose of servicing low-income communities and that it will be accountable to those communities.

The most challenging aspect of participating in the NMTC program as a CDE is the credit allocation process. A very detailed application must be prepared by a CDE to receive an allocation in each annual round administered by the CDFI Fund. This process is extremely competitive – only about 25% of applicants get an allocation. Once an allocation is received, the CDE has five years to use the allocation. The allocation agreements that evidence allocations of NMTCs typically trail the allocation announcements by several months.

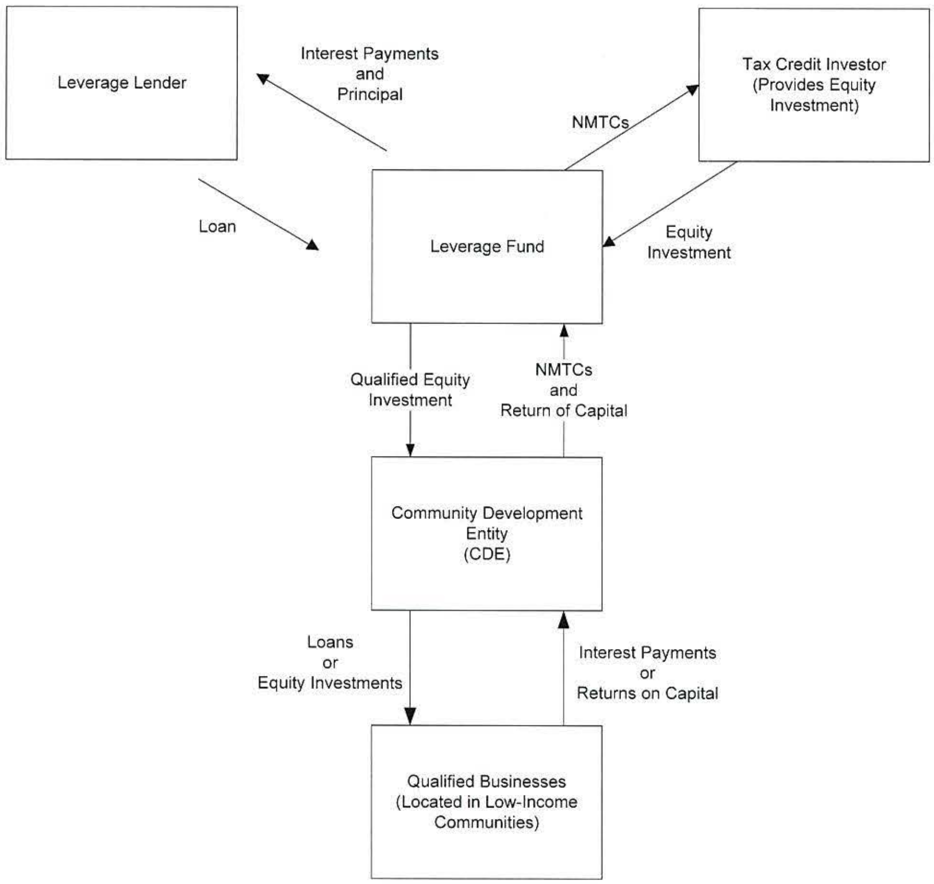
WHO MAKES MONEY ON THE NMTC?

The economics of a NMTC investment will vary depending upon the facts and circumstances of the deal. However, the credit benefits all players in the deal. The entity making the QEI will receive tax credits and a return of some or all of its equity investment (see below for how this return can be split among a tax credit investor and a leverage lender). The CDE, if not affiliated with the tax credit investor, will earn fees from the use of its allocation and management of the selected investments. The QALICB who ultimately receives the proceeds of the QEI in the form of loans or equity from the CDE will receive favorable terms (such as below market interest rates or equity features) on such proceeds.

NMTCs have proven to be a very useful tool in bridging financing gaps and reducing financing risks by introducing additional equity from the syndication of the credits. NMTCs can be paired with other federal tax incentives, most notably the historic rehabilitation tax credit, but cannot be paired with the low-income housing tax credit.

WHAT IS THE "LEVERAGED MODEL"?

In Revenue Ruling 2003-20, the IRS authorized a form of NMTC investment in which a tax credit investor makes an equity investment into a leverage fund and a lender makes a loan to the leverage fund (see the chart below). The combined proceeds of the equity investment and the loan are then used by the leverage fund to make the QEI in the CDE, as described above.



The main benefit of the leveraged model is to overcome the shallowness of the NMTC subsidy. The credit is only equal to 39% of the equity investment made into the CDE – no investor would be satisfied with an investment of $1 that results in a return of only $0.39. Because NMTC investments must be targeted at low-income community businesses, most NMTC investments do not generate significant economic return. The leverage model combines equity from a tax credit investor with the leverage loan proceeds, thereby increasing the size of the QEI and the NMTCs generated. The transaction is structured so that the leverage lender gets a return similar to its normal commercial lending activities – interest and principal and the tax credit investor gets what it is usually seeking – tax credits and some amount of cash return. The Revenue Ruling precludes the leverage lender from directly looking to the QALICB to secure the leverage loan which effectively prevents the leverage lender from taking a direct mortgage on the property. However, the leverage lender, through a pledge of the leverage fund's interest in the CDE and other administrative rights, can receive security indirectly that is commensurate with conventional financing.

SOME KEY NMTC CONCEPTS, DEFINITIONS AND TERMS

NMTC – The New Markets Tax Credit – a 39% credit taken in installments over 7 years; (5% for the first 3 years and 6% for the last 4 years adds up to 39%). 39% of what is explained below.

CDFI Fund – The Community Development Financial Institutions Fund – a division of Treasury tasked with, among other things, overseeing NMTC.

CDE – A "Qualified Community Development Entity" certified as such by the CDFI Fund. Basically has to be formed to help poor people or communities, "accountable" to low income people in that community, and certified by CDFI Fund. Can be a C-corp, S-corp, or partnership.

Allocation Agreement – The Agreement pursuant to which the CDFI Fund grants the CDE the authority to "designate" (to be distinguished from allocate) NMTC to an investor. Competitive allocation process.

Allocatee – A CDE which has received an allocation of NMTC from CDFI Fund.

QEI – "Qualified Equity Investment" – $ paid to the CDE to acquire equity in the CDE. The CDE designates the investment as a QEI, and the investor is then able to take a NMTC in an amount equal to 39% of the QEI.

QALICB ("Kwaw-lick-bee") – a "Qualified active low-income community business." Basically any trade or business which is carried on in a low income community. "Sin" businesses (golf course, country club, massage parlor, hot tub facility, suntan facility, gambling, liquor store) excluded. Nonprofits included.

QLICI ("Q-lick-ee" or "Kwi-lick-ee") – a "Qualified low income community investment." Generally a loan or investment by the CDE to/in a QALICB.

Sub-CDE – a "subsidiary" of the CDE, which itself also qualifies as a "Qualified Community Development Entity," also known as a "subsidiary allocatee."

Redemption – Idea here is that the QEI must "stay out" for 7 years. So if a QEI is made, the CDE makes a 3 year QLICI loan (lets say three year term, interest only with a balloon at maturity) to a QALICB, at the end of the 3 years the CDE can't just give the principal it receives (the balloon) at the end of the 3 years back to the investor. It has to find another QLICI for the balance of the 7 year term (i.e. 4 more years). If it does give the principal back, a "redemption" will occur, which is the first of 4 possible recapture events.

"Substantially All" Test – Requirement imposed on CDE that 85% of each QEI be in one or more QLICIs at any one time. The CDE (basically) gets a year long grace period to pass this test both after receiving a QEI from the investor and after receiving principal. Failure to meet this will cause the second of 4 possible recapture events.