Topics of Discussion

Section I  –  New Markets Tax Credit (NMTC) Program Overview

Section II  –  Phases of NMTC Projects

Section III  –  MHIC’s Required NMTC Compliance & Reporting

Section IV  –  MHIC’s Audit and Tax Return Preparation Guide

Section V  –  Preparation of Historic Tax Credit (HTC) Cost Certification

Section VI  –  NMTC Unwind/Exit Process
Section I – New Markets Tax Credit (NMTC) Program Overview

1. New Market Tax Credits (NMTC)

2. Terms and Definitions

3. Deal Structures

4. Twining New Market Tax Credits with Historic Tax Credits

5. MHIC Suggested Audit and Tax Schedule
1. **New Market Tax Credits (NMTC)**

   - New Market Tax Credits were established in 2000 as part of the *Community Renewal Tax Relief Act of 2000*

   - Program was designed to spur revitalization in low-income communities (referred to as “Targeted Census Tracks”)

   - NMTC Program provides tax credit incentives to investors who invest in certified Community Development Entities (CDE)

   - The Tax Credit equals 39% of the investment paid out and is earned over a seven (7) year period (5% in years 1-3 and 6% in years 4-7)

   - NMTC Program is administered by the Community Development Financial Institutions (CDFI) Fund, a division of the Treasury Department, and governed by Internal Revenue Code 45D

   - New Market Tax Credits (NMTC) are allocated annually by the Community Development Financial Institutions (CDFI) (referred as “Allocation Rounds”)

   - Community Development Entity (CDE) must have a mission of investing in low-income communities
1. **New Market Tax Credits (NMTC) (continued)**

   - Community Development Entity (CDE) must be a For-Profit entity
   - Community Development Entities (CDE) apply to the CDFI for an allocation
   - Investors, through Investment Funds, make Qualified Equity Investments (QEI’s) in CDEs
   - Substantially all (85%) of the QEI’s must be used to make Qualified Low-Income Community Investments (QLICI)
   - Qualified Equity Investments (QEI’s) are made from combining investor equity and debt at the fund level
   - Community Development Entity (CDE) Investments into projects may be in the form of Debt, Equity or Both
   - The NMTC Program as well as the LITHC Program are at risk from possible tax reform. The NMTC and LITHC Programs are contained in the code as expenditures and will each have to demonstrate they provide for an activity that otherwise would not occur in the market place.
2. Terms and Definitions

NMTC – New Market Tax Credit
HTC – Historic Tax Credit
CDFI – Community Development Financial Institutions
CDE – Community Development Entities
QEI – Qualified Equity Investment
QLICI – Qualified Low-Income Community Investment
QALICB – Qualified Active Low-Income Community Business
QCT – Qualified Census Tract
QRE – Qualified Rehabilitation Expenditures
Put/Call Options – Put Option is the right for the Investor to sell its interest to the Developer. Call Option is the right for the developer to purchase the interest of the Investor.
Upper Tier – Upper Tier refers to entities such as CDE, Investment Fund, and other direct investment entities
Lower Tier – Lower Tier refers to Landlord (QALICB), Master Tenant and other developer controlled entities
Placed in Service – The date at which the building/equipment is ready for its intended use
Basis Reduction – Basis of depreciable QREs which must be reduced HTC claimed (20% reduction)
Substantial Rehabilitation – IRS test to determine whether project qualifies to claim Historic Tax Credits
3. **Deal Structures**

- Single Tier Structure
- Master Tenant Structure
- Loan only Deals
- Loan and Equity Deals
- MHIC/Investor and Fund’s Accountant administer “Upper Tier” Entities
- Sponsor and Sponsor’s Accountant administer “Lower Tier” Entities
- Some deals may have multiple CDE Investors/Lenders. This may require other compliance and financial reporting beyond those imposed by MHIC
- Entity types (Limited Liability Company, Corporation, Partnership, Tax-exempt) varies based on deal
- Accountant’s need to review project closing documents to ensure proper entity identification; such as IRS tax ID notices, State organizational documents, tax opinions, etc.
- Master Tenant entities are generally limited liability companies or corporations
- Accountant’s should carefully examine final Project Forecast/Projections
Single Tier Structure

Investor(s) in NMTC Fund
$3,200,000

Hard Debt
$1,000,000

Soft Debt
$5,900,000

New Markets Fund
$10,100,000

New Markets CDE
$10,000,000

Cash Reserves
$500,000

Fund Reserves
$100,000

Fees & 3rd Party Costs
$600,000

Qualified Equity Investment (QEI)
($10,000,000)

Qualified Low-Income Community Investment (QLICI)

Project Level LLC
$8,900,000

CDE 1st Mortgage Loan ($1,000,000) – market interest rate
CDE 2nd Mortgage ($5,900,000) – below market interest rate
NMTC Equity or Subordinate Debt ($2,000,000) – 1% ROE\int. rate

Qualified Active Low-Income Community Business (QALICB)

Interest, NMTC & ROE:
Investors earn credit of $0.30 per $1.00 of QEI over 7 year period ($0.05 per year, years 1-3; $0.06 per year, years 4-7), plus return on equity (in this example, 1%)
MHIC New Market Tax Credit Audit & Tax Workshop
December 16, 2015

Master Tenant Structure

Investors
$3,100,232

100% Members

Subordinate Loans:
Sponsor $2,740,000

PCI Senior Loan
$1,150,000

Perfected Pledge of Fund’s Interest in CDE Granted to Senior Lenders to Fund

MHIC New Markets Fund III LLC
$6,990,232

100% Member

MHIC New Markets CDE XXX LLC, Series X
$6,990,232

State Tax Credit Purchasers
Cash $1,044,000
State Tax Credits $1,044,000

Special Limited Member .01% (Sponsor)

Project Level LLC - $7,650,232
CDE 1st Mortgage Loan - $1,150,000
CDE 2nd Mortgage Loan - $1,932,496
Fourth Mortgage Loan - $2,740,000
Master Tenant Third Mortgage Loan - $917,736
Master Tenant Equity - $250,000
Sponsor Deferred Capital - $660,000

Loan $917,736
Equity $250,000
Member 20%
Rent
Managing Member 79.99%

QLICI (CDE Loans)
$5,822,496

QLICI (Equity Investment)
$1,167,736

100% Investor Member

Master Tenant LLC
CDE Equity - $1,167,736

Project Manager LLC

PCI Senior Loan
$1,150,000

Certified Public Accountants

Massachusetts Housing Investment Corporation
4. **Twining New Market Tax Credits with Historic Tax Credits**

- This happens when project qualifies for both New Market Tax Credits (NMTC) and Historic Tax Credits (HTC)
- Deals are generally structured with a Master Tenant entity
- Historic Tax Credit (HTC) is claimed in the tax year the project is Placed-in-Service
- Historic Tax Credit (HTC) is claimed on Form 3468 of the Master Tenant’s tax return, not the Landlord’s (QALICB) tax return
- §50(d)(5) Election must be completed and attached to tax returns
  - Election treats Master Tenant as owner of the asset for purposes of claiming the Historic Tax Credits
  - Election is attached to Master Tenant and Landlord (QALICB) Tax Returns
  - Sample Election may be found in the Master Tenant Operating Agreement
- §168(h)(6)(F)(ii) Election must be completed and attached to tax returns
  - Election treats Manager entity (of a whole owned tax exempt entity (Blocker Entity)) as a taxable entity
  - Election is attached to Manager’s first year Tax Returns
  - Sample Election may be found in the Manager Operating Agreement
4. **Twining New Market Tax Credits with Historic Tax Credits (continued)**

- **Tax purpose only** – Must report 100% of basis reduction on Master Tenant tax return
  - Basis reduction is equal to the HTC claimed (20% of QREs)
  - Accomplished by reporting imputed income on the Master Tenant tax return
  - Income is accreted based on the applicable portion of the basis reduction corresponding to the depreciable life of the asset
  - This is a book to tax adjustment (not GAAP)
5. **MHIC Suggested Audit and Tax Schedule**

- **December 1\(^{st}\)**: Audit and Tax Engagement Letter Signed
- **December 15\(^{th}\)**: Preliminary audit work completed. Loan and Equity balances should be reconciled with MHIC Finance Department
- **January 15\(^{th}\)**: Start Audit Fieldwork
- **January 31\(^{st}\)**: Completion of Audit Fieldwork
- **February 15\(^{th}\)**: Draft Audit and Tax Returns are to be reviewed by Project Management
- **March 1\(^{st}\)**: Deadline for Submission of Drafts to MHIC
- **March 15\(^{th}\)**: Deadline for Submission of Finals to MHIC (must receive a “Go Final” notification prior to submission)

**NOTE** – Consult MHIC’s *NMTC Project Audit & Tax Requirements* located in the “**NMTC Audit and Tax Return Preparation Guide**” as **some projects have fiscal year ends and/or different due dates**. Project Audit and Tax Schedule dates shown above are to be modified accordingly.
5. **MHIC Project Audit and Tax Schedule – Calendar Year End (continued)**

Example of MHIC’s *NMTC Project Audit & Tax Requirements*

<table>
<thead>
<tr>
<th>Projects</th>
<th>Asset Manager</th>
<th>Project Year End</th>
<th>QALICB Tax Form 1065</th>
<th>Master Tenant Tax Form 1065</th>
<th>QALICB Tax Form 990</th>
<th>Master Tenant Tax Form 990</th>
<th>Draft Due Dates</th>
<th>Final Due Dates</th>
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<td>x</td>
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<td>x</td>
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<tr>
<td>Central Sq. Theater (Loan only)</td>
<td>MJS</td>
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<td>x</td>
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<td>x</td>
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<tr>
<td>Cmty. Svgs-Niby Terrace LLC <strong>FINAL</strong></td>
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<tr>
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**NMTC FUND II**

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<th>Projects</th>
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<th>Project Year End</th>
<th>QALICB Tax Form 1065</th>
<th>Master Tenant Tax Form 1065</th>
<th>QALICB Tax Form 990</th>
<th>Master Tenant Tax Form 990</th>
<th>Draft Due Dates</th>
<th>Final Due Dates</th>
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<td>470 Main Street</td>
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<td></td>
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<td>3/15</td>
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<tr>
<td>Dudley Village North</td>
<td>SDB</td>
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<td>3/15</td>
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<tr>
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<tr>
<td>Girls, Inc.</td>
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Section II – Phases of NMTC Projects

1. Summary Phases of a NMTC Project

2. Common and Important Documents

3. Important Considerations
1. **Phases of a NMTC Project**

**Preliminary Project Development**
- Project is identified
- Permanent financing is obtained
- Preliminary financial forecast/projections prepared
- Determine NMTC Eligibility

**Project/Deal Closing**
- All legal documents are prepared and executed
- Final financial forecast/projections prepared
- Flow of funds is executed
- Identify entity issues
- Review flow of funds
- Identify project requirements
- Identify timing of lease payments
- Identify cash flow distribution schedule
- Identify commencement of debt repayment schedule
- Commencement of Asset Management fees (may be either annual or monthly based on CDE)
1. **Phases of a NMTC Project (continued)**

*Project Construction Phase*
- All effort is spent on Landlord (QALICB)
- Tracking of development costs
- Expenditures are treated as capitalized costs
- Important to correctly record construction requisitions timely
- Important to ensure all bank accounts are reconciled timely
- Continued correspondence with outside accountants throughout the development stage to ensure smooth and quick reporting
- Proper allocation of land and building acquisition
- Allocation of debt and reconcile to lender records
- Review commencement of cash flow distributions

*Placed in Service (PIS) Date*
- Date in which building may be used for its intended use
- Date which triggers year of Historic Tax Credits
- Placed in Service (PIS) date should be closely monitored to ensure Historic Tax Credits (HTC) are delivered as provided for in the financial forecast and HTC Pass-Through Agreement
1. Phases of a NMTC Project (continued)

Project Operations
- Additional emphasis is shifted from Landlord (QALICB) to Master Tenant entity
- Commencement of Landlord (QALICB) and Master Tenant financial reporting
- Quarterly compliance reporting
- All new leases must be submitted to MHIC for review and approval
- Execute monthly cash flow distributions

Exit of Investor
- Expected to occur after end of compliance period
- 7 years after last Qualified Low-Income Community Investment (QLICI) funding to project
2. Common and Important Documents

Deal Summary
- Description of overall deal structure
- Property and Sponsor information
- Project level and Fund level financing arrangements
- Lease structures
- Reserve structure
- Project guarantees
- Construction information
- Summary of exit strategy

Financial Forecast/Projections
- Provides entity structure outline
- Provides sources and uses of funds by entity
- Provides multi-year forecast of Income (Loss)
- Provides multi-year forecast of cash flows
- Provides information on all debt obligations
- Provides information on capital contributions
- Provides information on required reserves
2. **Common and Important Documents (continued)**

**Flow of Funds Closing Document**
- Provides flow of cash between entities
- Identifies cash accounts

**Operating Agreements** – QALICB (Landlord) and Master Tenant
- Timing and amount of capital contributions
- Allocation of profits, losses, depreciation, credits, distributions
- Entity compliance requirements
- Creation of reserves and compliance of reserves
- Accounting requirements
- Submission due dates of financial documents
- Operating covenants
- Special tax elections
- Outlines special distributions

**Investment Fund Operating Agreements**
- Outlines benchmarks for capital contributions
- Outlines provisions for credit adjustment on Historic Tax Credits
- Designates any required allocation of capital contributions for repayment of leverage loans, etc.
2. **Common and Important Documents (continued)**

*Loan Agreements*
- Loan repayment schedules
- Terms of the loans
- Debt covenants
- Requirements for financial, compliance, and impact reporting

*Master Lease & Sublease Agreements*
- Rent schedules – fixed and additional
- Operating cost obligations
- Tenant improvement obligations
- Assignment and subletting
- Pass-through Tax Elections
- Very important – could have timing implications. Must look at lease initiation dates.
- Lease payments may commence prior to project completion
2. Common and Important Documents (continued)

Project Tax Opinion
- Outlines how deal is structured
- Outlines the entities interact within the NMTC structure
- Describes each entity’s obligation within the NMTC program
- Details the structure of all debt obligations
- Outlines necessary tax elections

3. Important Considerations

- Establishing the project Year End
- Identifying/understanding all filling requirements for your entities (QALICB, Master Tenant, others)
- Required quarterly reporting (financial, compliance and impact reporting)
- Annual budget reporting
- Identifying required cash flow distributions
- Responsibility for fee payments
- Establishing proper accounting books/records and controls
- Informing MHIC of major deviations from closing financial forecast
- Inform MHIC of new or changed leasing arrangements (MHIC must approve all leases)
- Ensure Project meets all filing requirements
Section III – MHIC’s Required NMTC Compliance & Reporting
Section III – MHIC’s Required NMTC Compliance & Reporting

Quarterly MHIC Monitoring and Reporting (Pre-Operating and Operating Phases)
- MHIC’s Financial Quarterly Reporting Document (Landlord (QALICB) and Master Tenant entities)
- Copies of management generated financial reporting (balance sheet, income statement, cash flow statement, rent roll, etc.)
- NMTC Management Certifications of Landlord (QALICB)
- Other reporting requirements may be imposed by other CDE’s during pre-operating and operating phases
- Consult project documents for guidance

Annual Audit Requirements
- Consolidated/Combined Financial Statements (Landlord (QALICB) & Master Tenant)
- Must have detailed consolidating schedules
- Must be prepared on GAAP basis
- Financial statements are to be comparative (this may create difficulties between year in construction vs. first year in service)
- Full footnote disclosures
- Related party disclosures
- Profit and Loss must be fully disclosed either on the face of statement or in a supplemental schedule
- Cash flow statement
- Change in equity statement
Section III – MHIC’s Required NMTC Compliance & Reporting (continued)

- Must provide book to tax footnote disclosures
- Reserve account footnote disclosure reconciling reserve account activities
- Must prepare all supporting workpaper documents for financial statement accounts
  - Depending on “Upper Tier” accountants these workpapers may be required to be submitted to MHIC
- Disclosure of all debt obligations and compliance with covenants
- Consult and refer to MHIC’s “Audit and Tax Return Preparation Guide”

Annual Tax Return Requirements
- Review and understand original tax opinion
- Prepare Landlord (QALICB) tax returns (Form 1120, 1120S, 1065 or 990)
- Prepare Master Tenant tax returns (Generally Form 1065)
  - Required regardless if single member LLC (Disregarded Entity)
  - If single member LLC, tax return must be prepared on a “pro-forma basis” and submitted to MHIC for review
  - Federal single member LLC “pro-forma” tax return is NOT to be filed with IRS
  - State taxing authority may require a tax return along with franchise tax payment
- Prepare other Sponsor controlled entity tax returns
- All tax returns should include Schedule M-3
Section III – MHIC’s Required NMTC Compliance & Reporting (continued)

- All rental real estate activity must be reported on Form 8825 Rental Real Estate Income and Expenses of a Partnership or an S Corporation
- Those claiming HTC must complete Form 3468 Investment Credit (completed in year credits are claimed)
- Completion of special tax elections (50(d)5 election, 168(h) election, etc.)
- Complete applicable State tax returns
  o Some states require franchise tax
  o Some states require quarterly tax payments for non-resident members. This tends to be an issue at the Master Tenant level when Master Tenant member is a non-resident in the State of the project.
- No special tax reporting for claiming of NMTC’s. These credits are claimed at the CDE level and will be administered by the Upper Tier accountants.
- Allocation of partnership liabilities
  o Recourse – When partner bears economic risk of loss
    ▪ Applicable to CDE project loans which must be allocated to CDE Partner
    ▪ Sponsor developer debt obligations are allocated to Sponsor
  o Nonrecourse – When partner bears no economic risk of loss
- Guaranteed payments (applies only to Partnership prepared returns)
  o Allocate to CDE partner on Schedule K-1
  o Not subject to self-employment
Section III – MHIC’s Required NMTC Compliance & Reporting (continued)

Annual New Market Tax Credit Compliance Document

- Annual letter prepared by CPA documenting the Landlord’s (QALICB) compliance with NMTC Program
- Compliance letter must document project’s compliance in six (6) areas
  1. Gross Income Test: A QALICB must earn at least 50% of its total gross income within the low-income community.
  2. Services Performed Test: At least 40% of services performed for the QALICB by its employees are performed within the low-income community.
  3. Tangible Property Test: The QALICB must use at least 40% of the tangible property within the low-income community (this threshold is increased to 50% if the QALICB intends to satisfy the Gross Income Test above through a higher percentage of tangible property in a low-income community).
  4. Non-Qualified Financial Property Test: Collectibles other than those held for the ordinary course of business shall not exceed 5% of the basis of the associated property.
  5. Qualified Lessee Test: A QALICB may rent the associated property to others provided that the property is neither a residential rental property nor any of the unqualified businesses listed above.
  6. Substantial Improvement Test: Should a QALICB rent out the associated property to others, substantial improvements must be made to the property. While the IRC has no formal definition for substantial improvements, a compliance document released by the CDFI Fund defines the substantial improvement threshold as follows:

   A CDE must show cost basis (as defined in 26 USC § 1012) of any improvements incurred during the 24-month period following the [Qualified Low-Income Community Investment (QLICI)] equals or exceeds 25 percent of the adjusted basis (as defined in 26 USC § 1011(a)) of the building upon which the improvements are located. This ratio will be assessed as of the first day of the 24-month period. In the case of a QLICI being used to provide—take-out financing (as permitted under Section 3.3(h) of the allocation agreement), improvements equaling or exceeding 25 percent of the adjusted basis of the building upon which the improvements are located must have occurred within the 24 months prior to the QLICI being made. Additionally, there are other requirements within the IRC that a business must satisfy in order to be considered a QALICB. In general, a QALICB may not be a farm, golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, gambling facility or any operation where the primary business is the sale of alcoholic beverages for use off-site (i.e., liquor stores).
Section III – MHIC’s Required NMTC Compliance & Reporting (continued)

Other Documents
- Auditor Independent Letter
- Audit and Tax Workpaper Documentation
- Book to Tax Reconciliations
- First Year Tax Return Elections
  50(d)(5) Election
  168(h)(6)(F)(ii) Election
- Audited Cost Certification
Section IV – MHIC’s Audit and Tax Return Preparation Guide

1. Summary of Guide

2. Key Accounting and Tax Considerations
1. **Summary of Guide**

*Introduction and Summary of Requirements*
- MHIC Asset Management Staff Contact List
- NMTC Project Audit and Tax Requirements
- NMTC Fund Tax ID and MHIC Fund Contact

*Financial Statement Audits*
- Illustrative Independent Auditor’s Report
- Illustrative Financial Statements
- Illustrative Notes to the Financial Statements
- Common Financial Statement Reporting/Accounting Issues
- Illustrative Audit Management Letter

*Information for Lower Tier Auditor*
- Illustrative Independence Letter
- Audit and Tax Workpaper Requirements

*Tax Return Information*
- General First Year Tax Elections
- Federal Historic Rehabilitation Tax Credit
2. **Key Accounting and Tax Considerations**

*Phase I – Initial Development Stage through Placed-in-Service (PIS)*
- Understand entity structure and Sponsors responsibilities (bookkeeping, audit and tax requirements)
- Obtain and review all key deal documents
- Project Sponsor should consult MHIC prior to any change of accounting firm other than specified in the project documents
- CPA should review financial projections and provide guidance. CPA should be familiar with NMTC’s and HTC’s.
- Review and understand the Flow of Funds
  - Establish the entity chart of accounts
  - Distinguish between loan and equity investments
  - Record the purchase/transfer of the property
- Establish internal controls for tracking development cost of the project (capital vs. amortized vs. expense)
- Determine whether a Cost Certification is required
- Determine when the property is to be Placed-in-Service
- Understand the Sponsors responsibility for development cost overruns and guarantees
- Accounting for property acquisition
  - Allocating cost between land and building – fair value basis
  - Conveyance of property from Sponsor or related entity
2. **Key Accounting and Tax Considerations (continued)**

- Capitalizing construction period interest and taxes
- Track personal property separately (equipment, appliances, furniture, etc.)
- Segregate non-qualifying cost (non-QREs) from Qualified Rehabilitation Expenses (QREs)
- Establish procedures for accounting for non-cash activities (conveyance, deferred interest on loans, etc.)

**Phase II – Project Operations**

- Commencing of project leases
  - Lease commencement dates and payments
  - Additional rent provisions (operating costs & sublease)
  - Master Tenant leases
  - GAAP lease reporting vs. income tax (cash) lease reporting (GAAP requires straight line)
- Ensuring lease and debt payments are processed timely and from the correct entity
- Communicating project status to MHIC Asset Manager
  - Accomplished during quarterly report or as necessary
  - Cash flow difficulties
  - Change in tenants
  - Casualties and other losses
2. **Key Accounting and Tax Considerations (continued)**

- Completing annual reporting requirements
  - MHIC monitoring reports
  - Annual financial statement audits and tax returns
    - Consolidated or combined
    - Supplemental balance sheet and income statements showing consolidation activity
    - Supplemental schedule of profit and loss accounts if not detailed
  - Other CDE compliance and monitoring reports
  - GAAP only financial statements (Income tax basis financial statements not acceptable)
- Funding of various reserve accounts
- Fixed asset useful lives (Tax basis vs. GAAP)
- Accounts receivables should be examined for collectability and an allowance for doubtful accounts established as necessary
- All debt obligations must be reconciled with lenders (MHIC and others)
- All capital accounts must be reconciled with investors (MHIC and others)
- Payment of any related entity fees
2. **Key Accounting and Tax Considerations (continued)**

- **Completion of necessary and required footnotes**
  - Detailed Summary of Significant Accounting Policies
  - Shareholder/Member/Partner capital contributions and distributions
  - Restricted cash accounts
  - Reserve cash accounts (compliance, deposits, withdraws, etc.)
  - Fixed asset activity
  - Loan and debt footnote
  - Related party transactions including developer fee disclosure
  - Master lease and sublease agreement disclosure (consider GAAP to Tax Basis departures)
  - Book to Tax disclosures and reconciliation
  - Obligations of Sponsor disclosures
  - Debt covenant disclosures
  - Other disclosures deemed significant to the deal

- **Completion of required Landlord (QALICB) compliance documents**
  - Gross income test – 50%
  - Service provide test – 40%
  - Tangible property test – 40%
  - Nonqualified financial property test – 5%
  - Substantial improvement test – 50%
  - Qualified lease test – 20% rule/exclude businesses
2. **Key Accounting and Tax Considerations (continued)**

**Phase III – Unwinding/Exit Phase (7 Years)**
- Review and understand Sponsors obligations
- Communicate with MHIC Asset Manager
- Understand Put and Call Options
  - Unwinding of entity structure is the responsibility of Sponsor
- Consider preparing an exit financial model
  - Are there taxable entities?
  - What are the potential tax implications?
  - Will project be conveyed from Landlord (QALICB)?
  - Consult with CPA and Attorney regarding capital transactions
- Prepare for potential exit
  - Understand timing of CDE loan commitments
  - Plan for continuation or refinancing of hard debts
  - Understand issues associated with leverage lenders (Sponsor vs. CDE)
  - Understand CDE NMTC equity loans
  - Understand and plan for potential one time taxable income impact
    - Cancelation of debt (COD) amount and impact
    - 50(d) income amount and impact
Section V – Preparation of Historic Tax Credit (HTC) Cost Certification
Historic Rehabilitation Tax Credit is considered a General Business Credit under IRC Section 38

There are two types of Historic Rehabilitation Tax Credits
- A Certified Historic Structure which is a building listed on the National Park Service (NPS) National Register – **20% Credit**
- Other qualified building located in a registered historic district and certified by the Secretary of the Interior as having “historic significance to the district”. Property was originally placed-in-service pre 1936 – **10% Credit**

National Park Service (NPS) has a 3 part application process
- Part I – Evaluation of Significance of the Property
- Part II – Description of Rehabilitation Work
- Part III – Request for Certification of Completed Work
- NPS application is administered by the State Historic Preservation Office (SHPO)
  - See website – [www.nps.gov/nr/shpolist.htm](http://www.nps.gov/nr/shpolist.htm)

Internal Revenue Service (IRS)
- Project must meet “Substantial Rehabilitation” test
- Substantial Rehabilitation is considered met if the Qualified Rehabilitation Expenditures (QREs) exceed $5,000 or the adjusted basis of the building before the rehabilitation, and these expenditures (QREs) must be incurred within a 24-month period (referred as “measuring period”).
Internal Revenue Service (IRS) (continued)

- There is an Alternative 60-month measuring period for “Phased” rehabilitation. Taxpayer must:
  - Elect to use the 60-month measurement period
  - Rehabilitation “may be reasonably expected to be completed in phases set forth in architectural plans and specifications completed before the rehabilitation begins”

- HTC is claimed on Form 3468 Investment Credit, Part III Rehabilitation Credit and Energy Credit

  Required Information
  - Measurement period dates (start and end)
  - Adjusted basis
  - Total Qualified Rehabilitation Expenditures
  - NPS Project Number

- QREs are all costs allowed to be capitalized and considered depreciable costs under IRC §168 as incurred in the connection with the substantial rehabilitation

- Cost segregations are not permitted

- QREs exclude land, building acquisition, enlargements, equipment (FF&E), site work and certain organizational costs

- QREs also exclude “tax exempt use” property

- Tax credit is claimed in year project is Placed-in-Service

- Depreciable basis of property must be reduced by credit amount

- Part III must be approved by NPS within 30 months of claiming credit

- Risk of recapture for 5 years
Historic Tax Credit Audited Cost Certification Report
- Audited Cost Certification is completed and submitted after project has been considered Placed-in-Service
- Audited Cost Certification must include a CPA Audit Opinion
- Cost Certification must include “Schedule of Development Costs and Calculation of Federal Historic Tax Credit Basis”
   - Included on Schedule:
     o Total Development costs
     o Non-Depreciable Costs
     o Total Depreciable Costs
     o Depreciable Ineligible Costs
     o Rehabilitation QRE Basis
- Must Include Notes to Schedule of Development Costs and Calculation of Federal Historic Tax Credit Basis
- Include note on Substantial Rehabilitation Test
- Include note on related party transactions
- Review QREs incurred to ensure eligible costs and agree back to paid invoices
- **Note** — Some State’s require a separate Audited Cost Certification. CPA and Sponsor should be aware of their State requirements
Section VI – NMTC Unwind/Exit Process

1. NMTC Unwind/Exit Considerations


3. Refinancing/Assignment of Hard Debt

4. Assignment/Assumption of Subordinate Loans

5. Assignment/Cancellation of Financing Source from NMTC Equity

6. Mitigating COD Income
1. **NMTC Unwind/Exit Considerations**

- NMTC Unwind/Exit Process requires tax and legal expertise and should be thoroughly examined fully to understand the process

- The exit provisions provided for in the Project Documents must be fully examined

- The Fair Market Value of the project at the end of the compliance period must be assessed relative to the project’s total debt

- There are significant tax implications which could have an adverse impact on the Sponsor

- There may be strategic documents initiated during the Project/Deal Closing phase which may minimize adverse tax implications on the Sponsor

- Major adverse tax implications to the Sponsor generally occur from the potential Cancelation of Debt (COD) income required to be recognized by the Sponsor

- Cancelation of Debt (COD) income occurs from forgiveness of certain CDE loans

- Is the value of the property impaired and is the impairment greater than the investor sourced financing
2. **Put/Call Provisions**

- The Put and Call Agreement gives the Investor a “Put Option” to require the Sponsor to purchase the Investor’s interest in the Investment Fund (CDE).

- Value of “Put Option” is defined in Investment Fund Operating Agreement. Current MHIC deals have place the “Put Option” at $1,000.

- The “Put Option” typically begins at the end of the Tax Credit Investment Period (defined in Investment Fund Operating Agreement).

- The “Put Option” typically ends six months after the Investor receives notice from the Sponsor that the Investor may exercise its option.

- The Put and Call Agreement gives the Sponsor a “Call Option” to purchase the Investor’s interest in the Investment Fund for an amount equal to the fair market value of such interest.

- A Call generally must be exercised within a six (6) month period following the end of the “Put Option” period.
2. **Put/Call Provisions (continued)**

- Fair market value is determined by a mutual agreement among the parties or, by a qualified independent appraiser if no such agreement exists.

- Sponsor may NOT exercise call if:
  - There is a material default by the Landlord (QALICB) or under the QLICI loan documents.
  - Sponsor has a liability to the Investor under the Landlord (QALICB) Recapture and Environmental Indemnity executed in connection with closing.
3. **Refinancing/Assignment of Hard Debt**

- Determine whether the property needs to refinance or whether there will be an assignment of the 1st mortgage QLICI loan to the Leverage Lender to satisfy the Leverage Lender’s loan to the New Markets Fund
  - Evaluate the stability of the Project’s NOI to support refinance of 1st mortgage loan
  - If Sponsor made leverage loan to the New Market Fund then 1st mortgage QLICI loan would typically be assigned to the Sponsor
  - If a third party lender made the leverage loan to the New Market Fund then 1st mortgage QLICI loan would either be refinanced or assigned to the third party lender
- Assess the ability of the property to refinance its hard debt
- Does the property need to be financially repositioned in order to refinance
- In certain cases, to mitigate interest rate risk, the New Market Fund may refinance the leverage loan prior to the end of the NMTC compliance period and transfer such benefit to the Project
4. **Assignment/Assumption of Subordinate Loans**

- During the unwind/exit process consideration must be given to subordinate loans at the CDE and New Market Fund level

- What are the subordinate lender requirements for assignment of loans up through the New Markets Tax Credit structure

- Typically subordinate loans from the CDE to the Project will be assigned to the subordinate lenders of the New Market Fund

- After the subordinate loans have been assigned this will allow the CDE and the New Market Fund to exit their obligation concerning these loans

- In some cases, the Sponsor may want to re-negotiate the terms of the subordinate note or purchase the subordinate note for a discount. It is the Sponsor’s responsibility to negotiate with the lender. The note restructuring or purchase typically occurs after the assignment.
5. **Assignment/Cancellation of Financing Source from NMTC Equity**

- Develop a tax strategy to deal with potential Cancellation of Debt (COD) income required to be recognized by the Sponsor

- Cancellation of Debt (COD) income occurs when certain CDE loans are forgiven

- Cancellation of Debt (COD) relates to certain CDE loans that were originally sourced from NMTC equity

- Cancellation of Debt (COD) can also occur when leverage loans are amortizing at the investment fund and corresponding CDE loans are interest only

- Analyze the strategy for dealing with loans originally sourced from NMTC Equity

- Determine how such loans can be forgiven or assigned to mitigate tax impact to the members of the QALICB

- Consider the impact of net operating losses to offset potential Cancellation of Debt (COD) income
5. Assignment/Cancellation of Financing Source from NMTC Equity (continued)

- If a Master Tenant is part of the project structure, then the CDE’s interest in the Master Tenant is generally conveyed to a Sponsor related entity.

- After the hard debt, subordinate debt, NMTC equity sourced loans and Master Tenant interest have been assigned, allocated, refinanced, forgiven and/or conveyed, the CDE and New Market Fund exits the project structure.
6. **Mitigating COD Income**

- “Qualified real property business indebtedness” exclusion
  - Only available if QLICI debt was used to acquire or improve real property used in a trade or business and is secured by such real property
  - Limited to lesser of:
    - Excess of qualified debt over net FMV of such real property (FMV of such real property reduced by other qualified debt)
    - Prior adjusted basis in all of Taxpayer’s depreciable real property
- Basis write-down by amount of COD Income required
- Not available to C corporations; measured at the partner level for a partnerships

- Insolvency exclusion
  - If the debtor is insolvent, then COD Income exclusion to the extent of the insolvency
  - Insolvency is measured at the partner level of partnerships
6. **Mitigating COD Income (continued)**

- There is no deemed COD income if the “Put” is to an **Unrelated Party**
  - Who is a related party:
    - Individual related to parents, spouse, children and spouses, grandchildren and spouses
    - Corporations related if more than 50% common ownership
    - Partnerships related if same persons own more than 50% of capital or profits
    - Detailed rules under 267(b) and 707(b), constructive ownership rules apply
  - Recommendation – If possible, set up an **unrelated put obligor** from the beginning

- There is no COD income if original loan was from a Related Party
  - Reasonable expectations again an issue

- In some instances, it may make sense to keep the CDE loan sourced from NMTC equity in place to avoid COD income. In this case, the loan would be assigned to a non-profit entity.
Questions and Comments?

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