Don't Leave NMTC Borrowers Behind: How a Support System Prevents Recapture Risk

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The author of this article explains how the New Markets Tax Credits federal incentive program can stimulate lasting growth and progress in low-income communities.

The New Markets Tax Credits ("NMTC") federal incentive program can stimulate lasting growth and progress in low-income communities ("LICs"). Yet, these tax credits also come with stringent and complicated reporting requirements that can burden or even exclude potential borrowers, particularly understaffed smaller organizations such as nonprofits. NMTCs incentivize investors to fund projects in LICs with long-term investments that can have a real impact on the community. But borrowers do not always receive the support they need to navigate the complexities of NMTC regulations and reporting requirements. This confusion can lead to recapture risk for Community Development Entities ("CDEs") and investors or prevent promising projects from ever coming to fruition.

Many NMTC borrowers receive some support—up until closing day. As soon as closing occurs, they find themselves surrounded by empty chairs with no advisers to guide them through the next seven years of compliance requirements, data tracking, and reporting. To save time, staffing and headaches for borrowers, investors, and CDEs, a consultant can serve as a support system entering the negotiations as the borrower's advocate and financial adviser. That consultant then remains with the borrower from the start of the transaction, through closing and until the compliance period is over and the deal is unwound. A smart investment in this type of consultancy can offer peace of mind to all parties, keep a deal on track for the full seven years and avoid recapture risk.

NMTC Program Overview

Congress passed the NMTC bill in 2000 to incentivize investors to provide long-term investments in LICs to help lift those neighborhoods out of poverty. The NMTC program is part of the U.S. Department of Treasury's Community Development Financial Institutions ("CDFI") Fund, which empowers economically

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distressed communities nationwide. To apply for and receive allocations of NMTCs, an entity can apply to be a CDE in one of two ways. The entity can apply to be a CDE directly, or if it is a CDFI already, the entity can apply for CDE certification without having to go through the official certification application process.

NMTCs encourage sustained investments over a seven-year period. The investor receives a 39 percent tax credit throughout the seven years: five percent for the first three years, then six percent for the remaining four years. Investors make their full investment on day one when the transaction closes and receive the tax credits over the seven-year period. Once they invest, they cannot pull out that investment until at least that seven-year period is over.

Investors are motivated to ensure borrowers have what they need to be successful in their ventures to prevent any risk of recapture. Even though the investors typically pass on the recapture risk to the borrower, a borrower is not always in a financial position to bear that risk—leaving the investor exposed. This risk of recapture incentivizes both the investor and the borrower to ensure the borrower remains successful and compliant. Investors are also incentivized by the return on their investment, not only from the tax credits taken against income, but also by not having to pay dollar for dollar for the credit over the seven-year period. For example, on a $10 million investment, investors receive a credit of $3.9 million, but they may only pay $3.2 million for that credit depending on the market at that time.

So far, the program has seen success. Since money began flowing into the program in 2003, CDFIs have proven to be a resilient and reliable capital resource for LICs, borrowers and their investors. As of the end of fiscal year 2015, the NMTC program has generated $8 of private investment for every $1 of federal funding. NMTCs have helped create 164 million square feet of manufacturing, office and retail space in these communities, having financed more than 4,800 businesses.[1] NMTCs have also funded a wide range of projects to provide for many vital community needs, from housing and health care facilities to grocery stores and child care centers.[2]

NMTC's Advantages and Disadvantages

For the investor, the key advantage of the NMTC is the 39 percent tax credit doled out incrementally over the seven-year period. Institutional investors may also qualify for a Community Reinvestment Act ("CRA") credit for certain types of investments—a double bang for their buck. Borrowers can benefit from being able to structure their investment to achieve a more affordable rate on their loans compared to what they might otherwise receive on the market. Sometimes borrowers will be able to qualify for loans they previously couldn't qualify for at all because of the particular areas in which they aimed to invest, or the less flexible loan offerings available without NMTC subsidy.

The primary advantage for LICs is the physical and economic revitalization of struggling areas in their community. This may occur through the creation of new jobs and businesses, social and commercial services, affordable housing, health care, transit systems, charter schools, grocery stores and other vital forms of infrastructure the LIC may lack prior to the investment.

Disadvantages are limited but primarily entail the typical suite of regulations that surround federal programs. In this case, complex regulations deliver a "double whammy" of both tax regulations and regulations set by the CDFI program itself. Those complex regulations can act as a barrier to nonprofits and other smaller community organizations that might be understaffed or under-resourced to handle the necessary data tracking, paperwork and accounting. That complexity often requires assistance from a team of experts, such as attorneys, accountants and consultants, the costs for which can add up to an unsustainable amount for smaller organizations. In short, the costs and complexities involved can impede, if not prevent, nonprofits and smaller organizations from participating in the NMTC program.

For investors, the primary disadvantages are avoiding a recapture and tying up funds in one investment for a minimum of seven years. Investors require the borrower to guarantee the NMTC recapture risk, which includes the tax credit amount plus interest and penalties.

Complex Reporting Requirements

NMTCs involve advanced, atypical accounting requirements that are specific to this program and its regulations. If a borrower's accountants are not familiar with NMTCs, this can cause confusion and additional time and expense. Instead, borrowers need someone who can guide their auditors through the NMTC requirements and explain why it is important to characterize or handle certain elements in a specified way. Any mischaracterized or mishandled element of financial reporting could potentially lead to a recapture risk.

CDEs must file an annual report on every one of their NMTC funded projects with the CDFI Fund. This report covers all projects the CDE has funded throughout its existence, and information on each project must be updated annually throughout the seven-year compliance period. The CDFI collects this data and information to analyze the effectiveness of the program.[3]

To obtain that data and information, the CDE must down-stream questions to the borrower(s) on each project. Because these questions can be highly detailed, community developers/borrowers on that project may not track or have processes in place to track the data sought. Examples of this data include the numbers and types of jobs created and retained at a facility; the number of construction jobs created; whether the jobs pay a living wage; the income levels of the people the facility serves on a regular basis, etc. Developing methods to track these details for the seven years of compliance could be cumbersome and often require specialized systems to capture this data.

Additionally, CDEs often require the borrower to provide a compliance certificate on either a quarterly or semiannual basis. The document quotes various regulations, asking whether the borrower complies with each. Many borrowers, especially first-time NMTC borrowers, do not understand what the CDE is asking or whether they are in compliance. Having outside advisers is critical because they can explain what all of the regulations mean and how they work, which helps ensure that the borrower has complied with all requirements.

Similarly, the CDE may require the borrower to submit quarterly or semiannual financial statements. But if the borrower has not had someone knowledgeable about NMTCs review those financial statements to ensure accuracy and compliance with NMTC requirements, borrowers could run into a problem with the CDE and investor.

Where Borrowers Need Help

Consider this real-world example: One client, a NMTC borrower, described how he was impressed with the assistance and shepherding that several individuals had provided him as they were preparing for the closing of his deal. But the day after closing, the client said it was like "falling into a black hole," as that entire support system had disappeared. He had no one to help him understand the ongoing reporting requirements going forward, and was seeking guidance.

This unfortunately is an all-too-common problem. NMTC borrowers' consultants are involved only up until the closing, or the consultants are the CDE's consultants involved on the backend to assist the CDE with accounting and reporting, not the borrower. This is true even though the borrower pays for those services.

Instead, borrowers can better benefit from having consultants who will begin working directly with them at the beginning of the transaction and continue providing assistance beyond the closing. These consultants should be experts in NMTC regulations, accounting, compliance and reporting requirements. The best scenario is for the consultant to stay onboard through the end of the seven-year compliance period and the wind-up of the transaction.

While it may be in a CDE's best interest to ensure borrowers have this type of support system available, many do not have a large enough staff or bandwidth to provide that assistance themselves. They may step in at times, but usually only when a borrower is struggling and there is risk of default or other recapture event. If they do not hear any complaints from the borrower, the CDE may not even realize there is an issue.

By being in constant communication with the borrower throughout this process, the consultants can identify potential problems and help the borrower work through them to find a resolution and avoid any potential recapture event. This support system works to ensure financials are accurate and NMTC-compliant, and consultants can complete any compliance questionnaires or other necessary documentation so the borrower need only review and sign it.

Conceptual Impact of NMTC Support Systems

Providing this support and assistance to borrowers may be an innovative approach that could mitigate the risk of recapture, especially for smaller organizations like nonprofits. That in turn provides comfort to the investor and CDE and frees up their time to devote to what they do best: investments, due diligence, etc.

If borrowers have this type of NMTC back office on their side, they can also save significant time, effort and regulatory headaches by relying on their support team of consultants. This type of support system also makes NMTC funding available to more borrowers. Otherwise, for many borrowers, the complexities of the regulations and reporting requirements involved may outweigh any potential benefit due to the burden on their staff.

Good consultants will take time from the outset to sit down with borrowers, their staff and their board of directors to explain what it means to be part of the NMTC program and how that might impact their books and operations for the seven-year period. This gives the borrowers the opportunity to evaluate the program's benefits and burdens realistically.

Best Practices to Support Borrowers

Borrowers can work with a consultant to ensure they have processes in place to track and report any impact factors or data they need to provide to their CDE for financial or compliance reports. The investor or CDE may also consider hiring such a consultant for the borrower.

From the beginning, borrowers can review the loan documents with their consultants before closing to ensure that any operational process requirements contained in the loan documents align with the processes the borrower already has in place. The borrower may become aware of and make any changes necessary to comply. Obtaining a recapture risk guarantee is also key for the borrower, investor and CDE alike. A consultant who provides that guarantee brings tremendous value to the transaction and project.

Because nonprofits can have a great deal of staff turnover, they may see the best results by not only having their consultants educate them and their board before the transaction closes, but also having the consultants available throughout the compliance period so that new staff and board members can be educated as needed. This is especially important if the new employee or board member will be involved in the NMTC accounting or reporting duties.

Don't Leave NMTC Borrowers Behind

Bottom line: when hiring a consultant for the borrower it is critical that either the borrower or its investor or CDE select a consultant who thoroughly understands complex NMTC regulations and reporting requirements. That might range from providing education and reviewing loan documents to ensuring the borrower is aware of any regulatory impacts on operations and financials.

Investors provided about $38 billion in direct NMTC investments to fund businesses between 2003 and 2014, and those NMTC investments resulted in nearly $75 billion in total capital to LIC businesses and revitalization projects. From 2003 to 2012, NMTC investments also created about 750,000 jobs, each of which cost the federal government less than $20,000.[4] These kinds of numbers can and will continue to increase if borrowers have the right support team of consultants advocating for them from beginning to the end of the NMTC transaction. Investors and CDEs may be hesitant to provide or finance these support systems for their borrowers. But the return on investment and relief that their tax credits are safe from recapture may be sufficient motivation going forward.

NOTES:

[1]NMTC Overview on CDFI Fund Website: https://www.cdfifund.gov/programs-training/Programs/new-markets-tax-credit/Pages/default.aspx.

[2]New Markets Tax Credit Progress Report 2015: http://nmtccoalition.org/wp-content/uploads/NMTC-Progress-Report-2015-Final.pdf.

[3]Fairchild, Gregory, B., et al. "Risk and Efficiency among CDFIs: A Statistical Evaluation using Multiple Methods." Office of Financial Strategies and Research, Community Development Financial Institutions Fund, U.S. Department of Treasury. August 2014.

[4]New Markets Tax Credit Coalition Website and Fact Sheet: http://nmtccoalition.org/fact-sheet/.