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Tax Credits and Incentives Manual

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Executive Summary

In connection with its efforts to preserve the Ford Highland Park Plant, Woodward Avenue Action Association is interested in purchasing the Administrative Building and Executive Garage to be redeveloped into a mixed use facility that will serve as a catalyst for the ultimate redevelopment of the entire site in a manner that is harmonious with the historic significance of the property. Several federal and State tax incentive programs are available to assist developers and sponsoring organizations in financing the development and/or redevelopment of properties that face significant development challenges, including historic structures, environmentally contaminated sites, functionally obsolete facilities, blighted property, and property located in low income census tracts. This manual provides an overview of the tax credits and incentives that are most commonly utilized in Michigan to develop or redevelop disadvantaged properties. For each incentive, the manual answers the following key questions:

1. What are the benefits?
2. What are the eligibility requirements?
3. What is the process for obtaining the credits or incentive?
4. What is the catch? (drawbacks, limitations, etc.,)

Although the redevelopment of the Ford Highland Park Administrative Building and Executive Garage could take advantage of each of the incentives discussed in this manual, the incentives that are most likely to become part of the financing structure are the federal and Michigan historic tax credits, New Markets Tax Credits, Michigan Brownfield Tax Credits and Obsolete Property Rehabilitation Act (OPRA) property tax abatement.

The manual discusses the process required to “syndicate” each of these incentives. In short, syndication is the process of admitting an investor into the ownership structure of the building so that the investor can claim the tax credits and provide equity to the project. The manual discusses organization structures that are typically used to accomplish such a syndication and the manual provides contact information for the most active federal tax credit investors. In addition, the manual provides contact information for several Community Development Entities (CDEs) that could provide the project with an allocation of New Markets Tax Credits, which are a scarce resource. The manual also provides contact information for brokers that can assist Woodward Avenue Action Association in identifying state tax credit investors. Finally, the manual provides tips in negotiating term sheets and commitment letters with potential tax credit investors and CDEs and discusses the important role that financial projections play in the syndication process.

If Woodward Avenue Action Association is able to purchase the Administration Building and Executive Garage, the building will most likely need to be transferred into a for-profit subsidiary which will undertake the rehabilitation and admit one or more tax credit investors into the ownership structure, so that such investors can claim the tax credits and contribute permanent equity to finance the rehabilitation project. While the cost of implementing and maintaining such an organization structure can be significant, the benefits of the incentives are often very substantial. By layering multiple tax incentives into the financing structure, it may be possible to fund as much as 50% of the cost of the project from tax incentives.

Federal Historic Tax Credits (FHTC)

The Federal historic tax credit was enacted in substantially its current form as part of the Tax Reform Act of 1986. The credit was instituted to incentivize taxpayers to rehabilitate old and historic buildings. The applicable statute is Section 47 of the Internal Revenue Code.

What are the benefits?

1. Federal tax credit
 - a. Credit = 10% or 20% of Qualified Rehabilitation Expenditures (QRE)
 - b. Claimed in year QRE are placed in service (i.e. certificate of occupancy)
 - c. Tax credit investors will contribute equity to finance the project ranging from \$.85 to \$1.30 per \$1 of credit
2. QRE
 - a. Must be capitalizable as part of the cost of the building
 - b. Includes capitalized interest and property taxes
 - c. Includes reasonable construction management fees and developer fees paid to related parties
 - d. Excludes acquisition costs, land improvements, personal property and building expansion

What are the eligibility requirements?

1. Must be a building
2. Eligibility of building – Eligibility requirement differs between 20% and 10% credit
 - a. 20% credit – Building must be on the National Register of Historic Places
 - i. Individually listed or
 - ii. Contributing to a Historic District that is listed on the National Register
 - b. 10% credit – Building must have been originally “placed in service” prior to 1936. A building is generally deemed to be “placed in service” when it receives a certificate of occupancy.
3. Eligibility of rehabilitation
 - a. Rehabilitation must be “substantial” (Substantial rehabilitation test)
 - i. Taxpayer selects a date during the tax year that historic credits will be claimed.
 - ii. Taxpayer goes back either 24 months or 60 months from that date
 - iii. Taxpayer is required to use a 24 month period unless evidence existed before physical work began on the rehabilitation that the project was expected to be completed in phases
 - iv. Qualified rehabilitation expenditures during such 24 or 60 month period must exceed the building’s adjusted basis at beginning of such period

- b. 75% of the building's external walls must be retained
- 4. Restrictions on building use
 - a. Must be income producing – Use restrictions differ between 20% and 10% credit
 - i. 20% credit – Building must either be rental property (nonresidential or residential) or owner occupied depreciable property
 - ii. 10% credit
 - a. Building must either be nonresidential rental property or owner occupied depreciable property.
 - b. Residential rental property is not eligible for the 10% credit
 - b. Tax-exempt use property restrictions – Credits are reduced to the extent that:
 - i. More than 50% of the building is leased to tax exempt entities under lease terms of 20 years or more (i.e., disqualified leases).
 - ii. The owner of the building is a tax-exempt entity
 - iii. The owner of the building is a partnership with one or more tax exempt partners
 - iv. Tax exempt ownership restriction can be avoided if tax exempt entity owns the building in a for profit subsidiary that makes an election under the Section 168(h)

What is the process for obtaining the credits?

- 1. 20% Credit
 - a. National Park Service must approve three part application
 - i. Part 1 – Evaluation of historical significance of building
 - ii. Part 2 – Description of rehabilitation – Focus on compliance of proposed design with the Secretary of Interior's Standards for Rehabilitation
 - iii. Part 3 – Request for certification of completed work – Focus on compliance of completed construction with the Secretary of Interior's Standards for Rehabilitation
 - iv. Each part of the application is initially filed through the State Historic Preservation Office (SHPO) which forwards the application to the National Park Service with a recommendation to either approve or deny the application
 - b. National Park Service Fee = \$500 to \$2,500
- 2. 10% credit - No formal design review process
- 3. File IRS Form 3468 with your annual tax return to claim either the 10% or 20% credit

What are the drawbacks/limitations?

- 1. Construction costs to comply with rehab standards
- 2. Reduced depreciation - Must reduce basis of building by amount of credit
- 3. Recapture

- a. 5 year compliance period
 - b. Prorata vesting – 20% per year
 - c. Events that trigger recapture include:
 - i. Transfer of ownership of building
 - ii. Revocation of National Park Service Part 3 approval
 - iii. Destruction of building (e.g., fire, etc.,)
4. Limitations on use of credits – prevent many developers from utilizing historic credits
- a. Credits that exceed the developer's tax liability are not refunded, but rather are carried forward to future tax years
 - b. Basis limitation
 - i. An LLC member can only claim credits generated by a business to the extent of the LLC member's tax basis in the LLC
 - ii. Any credits in excess of the LLC member's tax basis will be suspended and carried forward until the member's tax basis in the LLC increases
 - c. Passive activity limitation
 - i. Passive activities are activities in which the taxpayer does not materially participate.
 - ii. The Internal Revenue Code prescribes that all rental real estate activities are passive activities by default
 - iii. Credits from passive activities can only be used to offset tax on income generated by passive activities.
 - d. Alternative Minimum Tax (AMT) limitation
 - i. Historic tax credits cannot reduce tax below a taxpayer's alternative minimum tax liability
 - ii. The AMT limitation only applies to credits attributable to QRE's placed in service before December 31, 2007
5. Transaction structuring costs can be high, particularly if the more complex "master lease" structure is utilized to syndicate the credits (see "Syndicating Tax Credits" section of manual for additional details)
6. Non-profit entities must transfer the building to a for-profit subsidiary, which could trigger federal and state income taxes and subject the property to real estate taxes.

Michigan Historic Tax Credits (MHTC)

The Michigan Historic Tax Credit was enacted to compliment the federal historic tax credit and provide additional incentive to rehabilitate historic buildings. The credit is available to reduce either Michigan Business Tax or Michigan Income Tax. The applicable statutes are Section 208.1435 of Michigan Compiled Laws ([MCL 208.1435](#)) which applies to Michigan Business Tax, and [MCL 206.266](#) which applies to Michigan Income Tax.

What are the benefits?

1. State tax credit
 - a. Credit = 25% of Qualified Rehabilitation Expenditures (QREs)
 - b. State credit must be reduced by available Federal credit
 - c. Example: If a taxpayer is eligible for the 25% Michigan credit and the 20% federal credit, then the taxpayer can only claim a 5% Michigan credit (25% Michigan credit less available federal credit of 20%)
2. Can be used to offset Michigan Business Tax (MBT) or Michigan Income Tax
3. Claimed in year completed rehabilitation certificate is issued (State Part 3)
4. May be assigned (but not re-assigned):
 - a. To owners of pass-through entities
 - b. Can assign pro-rata or 100% to a single owner
 - c. Tax credit investors will contribute equity to finance the project ranging from \$.50 to \$.75 per \$1 of credit

What are the eligibility requirements?

1. Eligible property
 - a. Includes buildings, structures, sites, objects, features and open spaces
 - i. Individually listed on National or State Register of Historic Places, or
 - ii. Located in National, State or local historic district
 - b. Can be non-income-producing (i.e., owner occupied residence)
 - c. Tax-exempt use property
 - i. Can be owned by tax exempt entity if leased to unrelated taxpayer
 - ii. Can be leased to tax-exempt entity on long-term lease
2. Eligibility of rehabilitation
 - a. QRE = same definition as Federal credit
 - b. QRE must exceed
 - i. 10% of State Equalized Value (SEV) of property, or
 - ii. 5% of appraised value, if no SEV

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- c. Certificate of completed rehabilitation must be issued not more than 5 years after the rehabilitation is certified by State
- d. QRE must be paid within 5 years of certification of rehab plan for historic resource not eligible for Federal credits

What is the process for obtaining the credits?

1. Must claim federal 20% historic credit (if eligible) in order to claim 5% state credit
2. Must comply with Secretary of Interior's Standard for Rehabilitation
3. State Historic Preservation Office (SHPO) reviews federal Historic Preservation Certification Application
4. SHPO issues Verification of Eligibility after Federal Part III approval
5. Fee = \$0 to \$2,500
6. Credit claimed on Michigan Form 3581
7. Credit is assigned by submitting Michigan Tax Credit Assignment Form 3614 to Michigan Department of Treasury and securing approval

What are the drawbacks/limitations?

1. Credit reduces Federal deduction for state taxes
2. Potential taxability of proceeds from "sale" of credits
3. Construction costs to comply with rehabilitation standards
4. Recapture
 - a. 5 year compliance period
 - b. Prorata vesting – 20% per year
 - c. Events that trigger recapture include:
 - i. Transfer of ownership of building
 - ii. Revocation of Part 3 approval
 - iii. Destruction of building (e.g., fire, etc.,)

New Markets Tax Credits (NMTC)

The New Markets Tax Credit is a federal tax credit that was enacted in 2000 as Section 45D of the Internal Revenue Code. The credit is intended to encourage investment in low income communities by subsidizing the economic return of lenders and investors, enabling them to pass the subsidy along to businesses that are located in and/or serve low income communities.

What are the benefits?

1. Goal = Provide incentive to invest in low income communities
2. Federal government provides subsidy to taxpayers who make such investments
3. Form of subsidy = Federal tax credit
 - a. Federal credit = 39% of investments made
 - b. Credit is taken over a 7 year period
 - c. Credit is subject to 100% recapture (non-vested)
4. Since New Markets Tax Credits are awarded directly to the investor, the developer must negotiate with the investor regarding the nature and extent of the subsidy to be provided to the project

Examples of Benefits of NMTC to Developer

1. Enhance loans to project
 - a. New Markets enhanced debt may be up to 400 basis points below market rates of interest or
 - b. Portion (up to 30%) of debt may be forgivable (i.e., permanent equity) and have very low interest rate
2. Enhance historic tax credit equity contribution
 - a. Value of New Markets Tax Credit subsidy to a developer = \$.35 to \$.55 per \$1 of historic tax credit

What are the eligibility requirements?

1. Determine eligibility based upon census tract data
2. Excluded businesses
 - a. Residential rental (>80% of total rent)
 - b. Leasing unimproved real property
3. NMTCs are a scarce resource
4. Importance of community impact in attracting an allocation of New Markets Tax Credits to a project
5. "But for" test – Must demonstrate that the project would not have occurred "but for" the availability of the credits
6. Complicated organization structures may be necessary to integrate New Markets Tax Credits into a transaction, which results in significant transaction costs and ongoing compliance costs

Brownfield Michigan Business Tax (MBT) Credits

The Brownfield Michigan Business Tax Credit was enacted to encourage the redevelopment of environmentally contaminated, blighted and functionally obsolete properties throughout Michigan in an effort to make such properties competitive with "greenfield" sites. The mechanism for encouraging such redevelopment is a state tax credit equal to a percentage of the total eligible investment incurred to redevelop the eligible property. The applicable statute is [MCL 208.1437](#). The statute has been revised numerous times since it was first enacted to improve the efficiencies of the program by facilitating the assignment of the credit, redefining the definition of eligible investment, etc.,

What are the benefits?

1. MBT credit = a percentage of "eligible investment"
 - a. 10% for projects with pre-approval letters before April 8, 2008
 - b. 12 ½% base rate for projects approved on or after April 8, 2008
 - c. 15% for Urban Development Area projects approved on or after April 8, 2008
 - d. 20% special rate for Urban Development Area project approved on or after April 8, 2008 and expended before December 31, 2010. "Urban Development Area" means the downtown, central business district or commercial corridor of county seat or certain governmental units
2. Claimed in year Certificate of Completion is issued by Michigan Economic Growth Authority (MEGA)
3. May be assigned without restriction (in year Certificate of Completion is issued). Assignment may be:
 - a. To owners of pass-through entities (payment may be considered investment and not currently taxable to taxpayer)
 - b. To tenants (with minimum 10 year leases)
 - c. To any other taxpayer
 - d. Can assign 100% to a single owner or tenant
4. New Law – Refundable at \$.85 per \$1 of credit
5. Eligible Investment
 - a. Includes:
 - i. Building demolition, construction and improvement
 - ii. Site improvements
 - iii. Addition of machinery, equipment and fixtures to eligible property
 - b. Excludes environmental remediation costs, infrastructure costs and land acquisition to extent reimbursed by Tax Increment Financing (TIF) (see next section of manual for explanation of TIF)
 - c. Incurred within 5 years after pre-approval letter issued (or 10 years for multi-phase projects)

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- d. Cannot exceed amount specified in pre-approval letter (i.e., no increase in credit if actual costs exceed projected costs)
- e. The eligible investment must be described in an approved Brownfield Plan (see below for details of approval process)
- f. New law excludes all soft costs other than architectural and engineering (e.g. developer fees, legal, appraisals). Applies to projects with pre-approval letter after April 8, 2008.

What are the eligibility requirements?

1. Eligible property

- a. Property can be either commercial, industrial or residential
- b. Criteria for determining the eligibility of the property depends upon whether or not the property is located in a Core Community.
 - i. 103 Cities, Townships and Villages in Michigan are designated as Core Communities
 - ii. Examples of Core Communities include Detroit, Grand Rapids, Lansing, Saginaw, Port Huron, Battle Creek, Traverse City, Warren, Muskegon
 - iii. Core Community map is available at the following website:
<http://www.michigan.org/cm/attach/8E4BFBA6-1AF9-4567-94B5-84B7DDE7DCC2/CoreComunitiesMap.pdf>
- c. Property must be either:
 - i. Environmentally contaminated - Defined as a “facility” – a property with hazardous substances exceeding that allowed for unrestricted residential use
 - ii. Blighted
 - 1. Criteria is available to projects in Core Communities only
 - 2. See definition below
 - iii. Functionally Obsolete
 - 1. Criteria is available to projects in Core Communities only
 - 2. See definition below
- d. Definition of “Blighted” = Local determination that property presents:
 - i. Public nuisance with local code
 - ii. Attractive nuisance to children
 - iii. Fire hazard or otherwise dangerous
 - iv. Utilities, plumbing, heating or sewage permanently disconnected, destroyed, removed, or rendered ineffective
 - v. Tax reverted property and owned by a qualified local unit of government (i.e., Core Community)
- e. Definition of “Functionally Obsolete”

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- i. The property is unable to be used to perform the function for which it was originally intended (poor electrical, inadequate plumbing, roofing, low ceiling height)
 - ii. A Level 3 or 4 assessor must make the determination that the property is functionally obsolete
2. Project Eligibility Criteria
- a. Projects with less than \$10 million of eligible investment
 - i. \$40 million of credits available per calendar year (\$63 million in 2008)
 - ii. 45 days to approve project
 - iii. Fewer criteria for projects up to \$2 million
 - iv. Available statewide
 - b. Projects with more than \$10 million of eligible investment
 - i. Must meet "but for" test (i.e., the project would not occur "but for" the availability of the credits)
 - ii. Only 20 projects can be approved in each calendar year
 - iii. 1 of the 20 projects can be for credits of \$10 to \$30 million. The credits for such project must be spread over 10 years vs. in the year that the Certificate of Completion is issued
 - iv. 3 of the 20 projects can be outside of a "Core Community." 2 of the 3 projects that are outside of a "Core Community" must be a facility (i.e., contaminated)
 - v. 65 days to approve
 - c. Michigan Economic Growth Authority (MEGA) Statutory Criteria When Considering Approval
 - i. Overall benefit to the public
 - ii. Extent of reuse of vacant buildings and blighted property
 - iii. Job creation
 - iv. Property in area of high unemployment
 - v. Private sector contribution
 - vi. Level and extent of contamination alleviated
 - vii. Cost gap between the site and a similar greenfield site
 - viii. Is the taxpayer moving from another location in the state, and will the move create a brownfield
 - ix. Financial statements of taxpayer indicate it is financially and economically sound
 - d. Policy Criteria When Considering Approval
 - i. Local community contributing to project through programs like TIF, property tax abatements, etc.

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- ii. Project improves the condition that qualifies the property as a brownfield.
- iii. Projects located in areas that are experiencing increasing market demand and property values, and do not substantially improve property conditions or do not stimulate other non-subsidized growth in the community, will generally not be considered
- iv. Located in core community or "cool city" and downtown areas.
- v. Rehabilitation of historic buildings is favored
- vi. Mixed-use preferred, retail only or primarily housing not favored
- vii. Manufacturing projects - priority

What is the process for obtaining the credits?

1. Contact Michigan Economic Development (MEDC) Community Assistance Team (CAT Team) member
2. Submit Application Part I to MEGA
3. Prepare Brownfield Plan and receive local government approval
4. Receive Application Invitation Letter
5. Submit Application Part II to MEGA
6. Receive Preapproval Letter
7. Submit Form 3694 to request Certificate of Completion
8. Receive Certificate of Completion
9. Submit Form 3693 if credit will be assigned

What are the drawbacks/limitations?

1. Costs to remediate environmental contamination
2. Potential immediate taxability of proceeds from "sale" of credits
3. Credit reduces Federal deduction for state taxes
4. Recapture
 - a. Only applies to personal property
 - b. Recapture = credit % (e.g., 10%) x adjusted basis of personal property upon sale, disposal or transfer to another location
 - c. No recapture for eligible investment in real property
 - d. Recapture risk stays with developer and is not transferred to assignee
5. Project delays while obtaining credit pre-approval

Brownfield Tax Increment Financing (TIF)

Brownfield Tax Increment Financing was enacted to encourage the redevelopment of environmentally contaminated, blighted and functionally obsolete properties throughout Michigan in an effort to make such properties competitive with “greenfield” sites. This is done by allowing municipalities to enter into reimbursement agreements with developers whereby the community can “capture” incremental property taxes generated from the development to reimburse the developer for certain eligible costs. The applicable statute is [MCL 125.2651 to 125.2672](#).

What are the benefits?

1. Allows local Brownfield Redevelopment Authorities to:
 - a. Capture the incremental increase in property taxes resulting from a development, and
 - b. Use the captured taxes to reimburse developers for qualified expenditures.

How does it work?

1. Developer is reimbursed for “eligible activities” on “eligible property”
2. Source of reimbursements = captured property taxes
 - a. Increase over base year property value is subject to capture
 - b. Most non-debt property taxes are eligible for capture (average of 50 mills statewide)
3. Funding alternatives:
 - a. Municipality issues bonds to reimburse developer and then uses captured taxes to pay debt service on bonds
 - b. Municipality reimburses developer as taxes are captured. Developer may negotiate for interest on unpaid balance

What are the eligibility requirements?

1. Eligible activities in Core Communities (e.g. Detroit)
 - a. Environmental remediation
 - b. Offsite infrastructure improvements
 - c. Demolition
 - d. Site preparation
 - e. Lead and asbestos abatement
2. Eligible property
 - a. Contaminated
 - b. Blighted
 - c. Functionally obsolete

What is the process for obtaining the incentive?

1. Local Government Unit establishes a Brownfield Redevelopment Financing Authority and a Brownfield financing plan
2. Brownfield financing plan must be approved by:
 - a. Local Brownfield Redevelopment Financing Authority
 - b. Community Advisory Board
 - c. Local Board/Council
 - d. Blighted or obsolete property requires assessor's affidavit and MEGA approval
3. Workplan is reviewed by MEGA and/or Michigan Department of Environmental Quality (MDEQ)

What are the drawbacks/limitations?

1. Approximately 4 months to get approval
2. Reimbursement is usually contingent upon property tax capture
3. Monetizing the TIF value to pay for cost incurred
4. Deferral of reimbursements of property is subject to OPRA abatement or is located in Renaissance Zone

Obsolete Property Rehabilitation Act (OPRA)

The Obsolete Property Rehabilitation Act was enacted to encourage the redevelopment of obsolete properties in Michigan's Core Communities by enabling such communities to abate property taxes for up to 12 years on the incremental increase in the value of property resulting from such redevelopment. The applicable statute is [MCL 125.2790](#)

What are the benefits?

1. Allows local governmental units to abate real property taxes on the value of renovations to blighted or obsolete structures in eligible communities

How does it work?

1. Up to 12 year exemption from Ad Valorem property taxes on increased value of buildings and improvements
2. Exemption does not apply to:
 - a. School operating mileage and State Education Tax
 - b. Personal property
3. Freezes value of building shell
4. Land remains subject to regular taxes
5. State Treasurer may exempt up to ½ of school taxes for up to 6 years (limit = 25 exemptions per year)
6. Exemption may be transferred with approval

What are the eligibility requirements?

1. Property must be Blighted or Functionally Obsolete
2. Property must be either:
 - a. Commercial property
 - b. Residential rental property
3. Must meet "but for" test (project wouldn't occur but for exemption)
4. Rehab must exceed 10% of fair market value of property before rehabilitation

What is the process for obtaining the incentive?

1. Qualified local governmental unit must establish an Obsolete Property Rehabilitation District
2. Owner of obsolete property files application for exemption with local unit's clerk (Form 3674)
3. Local unit approves application
4. State Tax Commission approves application and issues exemption certificate

What are the drawbacks/limitations

1. Must have district established before physical construction begins
2. TIF reimbursements are deferred since taxes that otherwise would have been captured are abated

Neighborhood Enterprise Zone (NEZ)

Neighborhood Enterprise Zones were enacted to promote revitalization of certain neighborhoods designated by the local community by reducing property taxes on residences in those neighborhoods. The applicable statute is [MCL 207.773](#)

What are the benefits?

1. Allows local governmental units to reduce property taxes in designated areas to promote revitalization of those neighborhoods

How does it work?

1. Exempts two different types of projects from ad valorem taxes
2. Exempt properties are subject to a Neighborhood Enterprise Zone Tax equal to approximately one-half (1/2) the ad valorem homestead property tax rate
3. Regular ad valorem property tax rates continue to apply to value of land and existing structures
4. Two types of eligible projects:
 - a. "Rehabilitated Facility" – an existing structure (or portion of a structure) that has or will have as primary purpose residential housing of 1 to 8 units
 - i. Current true cash value must be \$80,000 or less
 - ii. Rehabilitation cost requirements:
 - 1) If completed by a licensed contractor, improvements must exceed the lesser of 50% of true cash value; or \$5,000 per unit if owner-occupied, and \$7,500 per unit if not owner-occupied
 - 2) If completed by owner, \$3,000 per owner-occupied unit or \$4,500 per non-owner occupied unit (excluding any labor charges)
 - b. "New Facility" – a new structure or portion of a new structure that has as its primary purpose residential housing consisting of one or two units, one of which will be owner occupied.
 - i. Includes condominium units
 - ii. Excludes apartments
5. NEZ Certificate effective December 31 of the year the facility is substantially completed and has qualified occupancy
6. Certificate effective for up to 12 years
7. Certificate can be transferred to succeeding property owners.

What are the eligibility requirements?

1. Property must be in a designated Neighborhood Enterprise Zone
2. Owner must apply for NEZ prior to obtaining any building permits or starting any construction

3. New properties must be “primary residences”
4. Rehabilitated properties must be:
 - a. Primary residences or rental properties with eight units or less
 - b. Current true cash value must be \$80,000 or less
 - c. Renovation expenditures must exceed the lesser of
 - i. 50% of true cash value or
 - ii. \$5,000 if renovation is completed by a contractor or \$3,000 of materials if renovation is completed by the owner

What is the process for obtaining the incentive?

1. Qualified local governmental unit (“core community”) must establish a Neighborhood Enterprise Zone (limited to 15% of the governmental unit)
 - a. Government must determine proposed NEZ consistent with the master plan and preservation and economic goals of governmental unit
2. Owner must apply for NEZ Certificate after NEZ established with local government before a building permit is issued for work
3. Local government approves the application
4. State Tax Commission approves the NEZ application after approval by local governmental unit
5. After completion, owner submits to local government either a certificate of occupancy and affidavit building is owner occupied (new facility), or an affidavit by owner that facility is primary residence, and work completed in accordance with code (rehabilitated facility)
6. Local government approves and forwards to State Tax Commission for issuance of final certificate

Conservation Easements Donations

The conservation easement charitable contribution deduction was enacted by the U.S. Congress in Section 170(h) of the Internal Revenue Code to provide an incentive to taxpayers to preserve historic properties by placing a permanent restriction on the property to ensure that the architectural integrity of the historic property's exterior is maintained.

What are the benefits?

1. Easement protects the historic resource in perpetuity
2. Tax incentive = Federal charitable contribution deduction = Value of easement = decline in property value resulting from granting easement

How does it work?

1. Obtain designation as certified historic structure
 - a. Individually listed in National Register of Historic Places
 - b. Contributing to district listed in the National Register of Historic Places
2. Enter into easement agreement with qualified charitable organization (e.g. Michigan Historic Preservation Network)
3. Subordinate mortgages – All other liens on the property must be subordinated to the easement since the easement must be permanent to qualify for a conservation easement donation deduction
4. Obtain appraisal from qualified appraiser
5. Record easement on property deed
6. File IRS Form 8283 with tax return

What else do you have to consider?

1. Owner retains possession and use of property
2. Easement must be perpetual
3. Fees for monitoring and defending easement
4. Types of historic easements
 - a. Façade easement
 - b. Air rights/lost development rights easement
5. Impact of local ordinances on value of façade – The value of the easement will be lower if the property is subject to a restrictive local historic ordinance
6. Syndicating historic easement deductions

What are the drawbacks/limitations?

1. Donor must have 1 year holding period to obtain fair market value deduction
2. Impact of easement on historic tax credits
 - a. Easements granted during the 5 year period that historic tax credits are subject to recapture will trigger recapture since granting an easement is considered a partial disposition of the property
 - b. Easements granted prior to completion of the rehabilitation could prevent the taxpayer from claiming historic tax credits on qualified rehabilitation costs attributable to the façade of the building since the IRS considers granting of a façade easement to be equivalent to a disposition of the façade. If the taxpayer is deemed to have disposed of the façade, they will not be eligible to claim historic tax credits on cost incurred to rehabilitate the façade since the taxpayer must be the owner of the façade to claim historic credits for rehabilitating the façade.
3. IRS scrutiny of historic easement deductions
4. Tax deduction vs. tax credit
5. Limitations on use of deduction
 - a. Income limitation
 - b. Itemized deduction limitations

Low Income Housing Tax Credits (LIHTC)

The Low Income Housing Tax Credit was enacted as Section 42 of the Internal Revenue Code to encourage the development of affordable housing by providing a tax credit to developers of residential rental property who commit to restrict their rental rates and to rent a certain percentage of the units to low income individuals.

What are the benefits?

1. Federal tax credit
 - a. 4% Credit = present value of 30% of the basis of an existing building or federally subsidized new building, or
 - b. 9% credit = present value of 70% of the basis of a new building that is not federally subsidized.
 - c. Note - a higher credit is allowed in certain high cost areas.
 - d. Total credit is claimed over a ten year period after building is placed in service
 - e. Tax credit investors will contribute equity to finance the project ranging from \$.70 to \$.90 per \$1 of credit

What are the eligibility requirements?

1. Either 20% of the units must be occupied by individuals with incomes of 50% or less of area median income, or at least 40% of the units must be occupied by individuals with income of 60% or less of area median income
2. Rent charged to tenants may not exceed 30% of the imputed income limitation applicable to that unit
3. Must be subject to a minimum long-term commitment to low-income housing

What is the process for obtaining the credits?

1. Application Process
 - a. There is a limitation on the amount of credit available to projects in each state that are not financed with tax-exempt bonds
 - b. Credits are awarded through a competitive application process
 - c. In Michigan, applications are scored by the State Housing Development Authority based on specified criteria, and those projects meeting a threshold score are placed into a lottery process to determine the order in which the applications will be evaluated for credit reservations
 - d. 30% of Michigan's credits are awarded to projects dedicated to preservation of existing low income housing
 - e. 10% are reserved for small projects containing 24 units or less
 - f. 15% are reserved for projects serving tenants with special needs who receive substantial services

- g. Fee = \$35-\$50 per unit, with max of \$1,500-\$2,000

What are the drawbacks/limitations?

1. Application process is very competitive, and time-consuming
2. Recapture
 - a. 15-year compliance period
3. Limitations on use of credits
 - a. Credits that exceed the developer's tax liability are not refunded, but rather are carried forward to future tax years
 - b. Basis limitation
 - iii. An LLC member can only claim credits generated by a business to the extent of the LLC member's tax basis in the LLC
 - iv. Any credits in excess of the LLC member's tax basis will be suspended and carried forward until the member's tax basis in the LLC increases
 - c. Passive activity limitation
 - iv. Passive activities are activities in which the taxpayer does not materially participate.
 - v. The Internal Revenue Code prescribes that all rental real estate activities are passive activities by default
 - vi. Credits from passive activities can only be used to offset tax on income generated by passive activities.
 - d. Alternative Minimum Tax (AMT) limitation
 - iii. LIHTCs cannot reduce tax below a taxpayer's alternative minimum tax liability
 - iv. The AMT limitation only applies to credits attributable to building's placed in service before December 31, 2007

Explanation of the Need for Syndication

What is syndication?

- 1) Syndication is the process by which the owner of a building brings an investor into the ownership structure of the building so that the investor can claim the credits, typically in exchange for providing equity to the project
- 2) Federal Historic Tax Credits and low income housing tax credits are not “sold” directly to an investor
- 3) Investors become “owners” of the property as limited partners in a limited partnership or as non-managing members in a limited liability company
- 4) Some State Tax Credits can be “certificated” and sold to investors

What are some factors to consider?

- 1) Limitations on developer claiming the credits for itself
 - a) Tax exempt entity – Cannot claim credits since tax exempt entities generally do not have any tax liability
 - b) Insufficient taxable income - Credits that exceed the developer’s tax liability are not refunded, but rather are carried forward to future tax years
 - c) Basis limitation
 - i. An LLC member can only claim credits generated by a business to the extent of the LLC member's tax basis in the LLC
 - ii. Any credits in excess of the LLC member’s tax basis will be suspended and carried forward until the member’s tax basis in the LLC increases
 - d) Passive activity limitation
 - i. Passive activities are activities in which the taxpayer does not materially participate.
 - ii. The Internal Revenue Code prescribes that all rental real estate activities are passive activities by default
 - iii. Credits from passive activities can only be used to offset tax on income generated by passive activities.
 - e) Alternative Minimum Tax (AMT) limitation
 - i. Historic tax credits and Low Income Housing Tax Credits cannot reduce tax below a taxpayer’s alternative minimum tax liability
 - ii. The AMT limitation only applies to credits attributable to QRE’s and low income housing units placed in service before December 31, 2007
- 2) Net Economic Benefits
 - a) Equity raise versus cash flow to the tax credit investor (e.g. preferred return, put option, etc.) and (sometimes) lost depreciation

- b) Transaction Costs (both closing and on-going)
- 3) Possible additional equity needed to finance construction
- 4) Control - Willingness to have a partner
 - a) Loss of control issues – Must seek approval from tax credit investor for certain major decisions
 - b) Disclosure and Reporting – Must provide tax credit investor with periodic financial reports
 - c) Unwind concerns – Uncertainty regarding whether or not the tax credit investor will exercise its “put” option and sell its investment back to the developer at a nominal price shortly after the tax credit recapture period expires

Structuring Alternatives

What are the different alternatives?

1. Federal historic tax credit structuring
 - a. Single entity structure
 - i. Developer forms an LLC or Limited Partnership
 - ii. Developer admits the tax credit investor as a large majority Limited Partner or Investor Member for the five-year compliance period, e.g. 99.99%
 - iii. Developer retains a nominal General Partner or Managing Member ownership interest, e.g. .01%
 - iv. Historic tax credits earned and depreciation are allocated according to ownership interests
 - v. Advantages (vs. master lease structure)
 - a) Simplicity
 - b) Cost (transaction and ongoing)
 - vi. Disadvantages
 - a) Difficulty managing cash flow
 - b) Difficulty separating depreciation deductions from credits
 - c) Exit taxes for tax credit investors
 - d) Reduction of eligible basis for low income housing tax credit
 - e) Violates new markets tax credit related party restrictions
 - b. Master lease structure
 - i. Landlord LLC owns fee simple title, undertakes rehab, enters into development agreement, and earns the Historic Tax Credits
 - ii. Master Tenant LLC leases the entire project from the Landlord LLC for a fixed annual rental payment
 - iii. Master Tenant LLC operates the property, subleases to end users and enters into the Property Management Contract
 - iv. Landlord LLC makes a special tax election to pass the Historic Tax Credit through to the Master Tenant LLC
 - v. The Managing Member of the Landlord LLC keeps most of the depreciation through a significant ownership interest, e.g. 90%
 - vi. Challenge in structuring transaction to get tax credit investors money to Landlord, LLC to pay for construction costs
 - vii. Advantages
 - a) Increase in pricing of credits (up to 25% more)
 - b) Additional flexibility in managing cash flows
 - c) Developer keeps most of depreciation deductions
 - d) Additional tax benefits to tax credit investor upon exit

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- e) Makes twinning new markets tax credits possible
 - f) Avoids reduction of low income housing tax credits
- viii. Disadvantages
- a) Cost (transaction and ongoing)
 - b) Complexity
- c. New Markets Tax Credit structuring
- i. Historic tax credit equity enhancements
 - 1) Utilize historic tax credit master lease structure
 - 2) Tax credit investor equity must be contributed into community development entity (CDE) before it is contributed/loaned to the property owner
 - 3) Tax credit investor typically owns 99.99% of CDE which owns 100% of master tenant
 - 4) Twinning NMTC's with historic tax credits can increase the pricing of the historic tax credits by \$.35 to \$.55 per \$1 of historic tax credit
 - ii. Loan enhancement (leveraged structure)
 - 1) Loan proceeds are pooled with the tax credit investor's equity to increase the amount contributed to the CDE which increases the amount of NMTC's
 - 2) Funds are typically pooled in an Investment Fund LLC
 - a) Debt proceeds generally approximate 70% of the pool
 - b) Tax credit investor equity generally approximates 30% of the pool
 - c) Tax credit investor typically owns 99.99% or 100% of the Investment Fund LLC which entitles them to substantially all of the NMTC's
 - d) Loan terms are typically interest only for 7 years due to restrictions on repayment of principal within the NMTC program
 - e) Lenders to the Investment Fund, LLC (i.e., leveraged lenders) are not allowed to have a mortgage on the property. However, the CDE is allowed to have a mortgage on the property
 - 3) CDE loans to the project can be up to 400 basis points below market rates of interest
 - 4) Portion (up to 30%) of CDE loans to the project may be forgivable (i.e., permanent equity) and have very low interest rate
 - 5) Since the tax credit investors return on investment is subsidized with NMTC's the CDE is about to pass along a portion of the benefits of the NMTC's to the project, as follows:
- d. Low income housing tax credit structuring
- i. Limited partnership structure

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- 1) General partner owns just 0.01%, but controls and operates the project
 - 2) Passive limited partner invests equity in return for 99.99% ownership
- ii. Allocation to Investor Limited Partner of most of the tax credits and tax losses maximizes investor equity
 - iii. More investor equity reduces other financing needs and helps project development
 - iv. Investor Limited Partner is a passive investor and gets its return almost exclusively from the tax credits and losses
- e. Structuring to avoid tax exempt use restrictions
- i. Minimize tax exempt entity's direct ownership after the rehabilitation is complete
 - ii. Tax exempt entity owns its share of the project through a wholly-owned taxable subsidiary
 - iii. Tax exempt entity also a tenant
 - 1) "Disqualified lease" would cause property to be classified as tax exempt
 - 2) Term of lease (including extensions) of 20 years or more should be reviewed
- f. State tax credit structuring
- i. Credit transferred via sale of certificate
 - 1) Ordinary income upon receipt for assignor
 - 2) Ordinary deduction when credit is used to pay state tax for assignee
 - ii. Credit transferred via partnership allocation
 - 1) Capital gain upon disposal of LLC interest for assignor
 - 2) Mandatory basis reduction upon investor exit could accelerate income and convert income to ordinary for assignor
 - 3) Capital loss upon put/call exercise for assignee
 - iii. Risk that State could disallow assignment
- g. Easement contributions
- i. Value determined by a qualified appraisal
 - 1) Federal charitable deduction equal to fair market value of easement
 - 2) Value of easement equal to decline in property value resulting from granting easement
 - ii. Special allocation of contribution deduction to investor

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- 1) Amend operating agreement to reflect admission of investor member and special allocation of easement deductions
 - 2) Must have substantial economic effect – allocation of easement deduction to investor member must impair investor members right to receive cash distributions from the LLC
 - 3) Transaction must have economic substance – need to demonstrate that investor member anticipates making money from its investment regardless of tax benefits it expects to receive
- iii. Limitation on charitable deduction for investor
- 1) Basis in partnership interest
 - 2) Effect of appreciated property
 - 3) Percentage limitations
- iv. Investor capital account must be considered
- 1) Reduced by adjusted basis of property, but not below zero
 - 2) In-kind distribution

Potential Federal Tax Credit Investors

1. National Trust for Historic Preservation*
 - Al Shehadi at 203.531.5999 or al_shehadi@ntcicfunds.com
2. CityScape Capital Group*
 - Paul Hoffman at 310.335.2040 or paul@cityscapecapital.com
3. National City Community Development*
 - Dick Buss at 313.230.1615 or Richard.Buss@nationalcity.com
4. Fifth Third Bank (Eastern MI)*
 - Annette Williams at 248.603.0707 or annette.williams@53.com
5. Bank of America*
 - Richard Hosey at 313.234.8755 or richard.hosey@bankofamerica.com
6. US Bank*
 - Mark Hirshman at 314.335.2622 or marc.hirshman@usbank.com
7. Key Bank*
 - Donna Kelce at 216.689.3787 or donna_kelce@keybank.com
8. Consortium Structured Investments*
 - Jacob Norris at 704.554.8000 or jacobnorris@consortiumsi.com
9. Chevron*
 - Nadine Barroca at 415.733.4588 or nbarroca@chevron.com
10. Sherwin Williams*
 - Robert Olson at 216.566.2587 or rkolson@sherwin.com
11. Dudley Ventures*
 - Jim Howard at 602.468.9400 or jhoward@dudleyventures.com

* Also have functioned as CDE's to provide NMTC allocations and equity to projects.

Potential NMTC Community Development Entities (CDE's)

1. See list of potential Federal tax credit investors (potential CDE's are designated with *)
2. Wayne County Economic Development
 - Nancy Cappola at 313.224.4111 or ncappola@co.wayne.mi.us
3. Michigan Magnet Fund
 - Al Bogdan at 313.445.1843 or bogdanaa@aabds.com
4. Enterprise Community Investment
 - John Ducey at 410.772.6129 or jducey@enterprisecommunity.com
5. LISC
 - Bob Poznanski at 269.343.5472 or rpoznanski@lisc.org
6. NCB Capital Impact
 - Scott Spote at 510.496.2233 or sspote@ncbcapitalimpact.com
7. Port Huron CDE
 - Scott Willmott at 810.985.0463 or swillmott@cfsbank.com

State Tax Credit Brokers

1. Strength Capital Partners
 - Rob Dworz at 248-220-1167 or rdworz@strengthcapital.com
2. Stonehenge Capital
 - Michael Craven at 225.408.3265 or mkcraven@stonehengecapital.com
3. Foss & Company
 - Jeff Jacobson at 978.823.0200 or jeff@fossandco.com

Negotiating term sheets and commitment letters with Federal Tax credit investors and CDE's

What are the key factors?

1. Federal Historic Tax credit pricing
 - a. Can range from \$.80 to \$1.30+
 - b. Factors impacting federal historic tax credit pricing:
 - i. Syndication structure
 1. Master lease structure generates higher pricing due to tax benefits available to investor upon disposition of their investment
 2. Single entity structure generates lower pricing due to taxes triggered upon the investor's disposition of its investment
 - ii. Timing of pay in – Accelerated pay in results in lower pricing due to increased construction risk to investor
 - iii. Size of deal – Larger credits generate higher pricing due to economies of scale for investor
 - iv. Strength of guarantor – Stronger guarantor increases pricing due to decreased risk to investor
 - c. Investor's capital contributions are generally subject to "adjusters"
 - i. Upward and Downward Adjusters – Capital contributions are increased or decreased by the differences between projected and actual credits multiplied by the price per dollar of credit
 - ii. Timing Adjuster - Delay in delivery of credits results in reduction in capital contributions
2. NMTC pricing
 - a. Typically ranges from \$.70 to \$.80
3. Preferred return
 - a. Can range anywhere from 0 to 3% of historic tax credit equity
4. Historic tax credit equity pay-in
 - a. Nominal amount at closing
 - i. 0 to 25% paid in
 - b. Certificate of occupancy
 - i. 85 to 90% paid in (cumulatively)
 - c. Final payment at Part 3 and cost certification

- d. Review prerequisites carefully
- 5. Asset management fees to investor
 - a. Can range from \$0 to \$7,500 per year
 - b. Covers investor's internal costs of monitoring investment
- 6. CDE fees
 - a. Closing (origination fee)
 - i. 1 to 10% of NMTC allocation (rarely over 5%)
 - b. Annual fee
 - c. Exit fee
 - i. Rare, 0% mostly
 - ii. Occasionally can be high
 - d. Average total fees approximate 10% of NMTC allocation
- 7. Exit fees
 - a. Put price
 - b. Some percentage of equity investment
 - i. Range from 0% to 15% of historic tax credit equity
 - ii. Range from 0% to 5% of NMTC equity
- 8. Compliance requirements
 - a. Tax returns
 - i. Property owner and master tenant
 - ii. Master tenant may be proforma return of tax reporting form if master tenant is a single member LLC
 - b. Audited financial statement may be required
 - i. Almost always required form NMTC transactions
 - ii. Property owner and master tenant
 - iii. Investor may waive audit requirement during construction period
 - c. Cost certifications

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- i. Generally always required
 - ii. Attempt to defer timing so that cost certification will not delay an investor capital contribution (e.g., include as prerequisite to investors last installment)
- d. Timing
- i. Typically February 28th through March 31st
 - ii. Attempt to negotiate for later deadline
- e. Guarantees
- i. Construction completion – typical
 - ii. Operating deficit – typical
 - iii. Tax credit recapture – typical, excludes events within control of the investor

The Role of Financial Projections in Syndication

What is included in a comprehensive set of financial projections?

1. Flowchart detailing organizational structure of transaction
2. Assumptions
 - a. Financing terms (e.g., interest rates, maturity, payment terms, etc.)
 - b. Operations (e.g., rental rates, absorption, inflation, etc.)
 - c. Tax credit assignment terms (e.g., pricing, pay in schedule, preferred return, put price, etc.)
3. Project budget
4. Sources and uses of funds
5. Tax credit and tax credit equity calculations
6. Loan amortization schedules
7. Depreciation lapse schedules
8. Financial schedules for each applicable entity included in the organization structure (property owner, master tenant, CDE, investment fund)
 - a. Sources and use of funds
 - b. Operating cash flow analysis
 - c. Taxable income/loss analysis
 - d. Capital account analysis
9. Cash on cash IRR calculation
10. Investor benefit analysis, including exit tax analysis

Who are the users?

1. Developer
 - a. Used to attract an investor
 - i. Better projection = better pricing
2. Investor
 - i. Calculate investor benefits
 - ii. Monitor project during compliance period
3. Lender
 - i. Analyze operating cash flow
 - ii. Project ability to meet repayment terms of financing
4. Attorney
 - i. Support tax opinion
 - ii. Draft legal documents

5. Accountant
 - i. Refer to when preparing tax returns

Why are the projections important?

1. Demonstrate that deal is solid economically
2. Illustrates investor benefits
 - a. Tax credits
 - b. Cash flow
 - c. Tax benefits
3. Demonstrate profit motive
 - a. Cash on cash return to investor
4. Demonstrate development fee can be paid within reasonable time
5. Manage the economies of the deal with the investor
 - a. Limit cash flow to investor during compliance period
6. Identify and resolve structuring issues
7. Integrate with legal documents