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HISTORY AND THE HILL

If at First You Don't Succeed...

By John Leith-Tetrault, National Trust Community Investment Corporation

There is something to be said for getting it right the first time. Sometimes it takes so long to do something once, you hate to have to go back and do it again. And there is no guarantee of a second chance. But in the tax credit world, change comes slowly and seems to require focused, repetitive efforts before advocates get what they are after.

Illustrative of this pattern are two long-term campaigns to improve the effectiveness of federal and state historic tax credits (HTCs) and new markets tax credits (NMTCs): one where the industry tried very hard, still got it wrong, and must regroup for a second try; and one where it took 11 years of failed attempts before ultimate victory was achieved. These otherwise unrelated stories from the field involve efforts to fix the Community Development Financial Institutions (CDFI) Fund's original related party test that made it nearly impossible to contribute HTC proceeds as equity to qualified real estate businesses, and a host of related problems. The second story recounts the recent unexpected legislative win by Minnesota preservation advocates to put in place what may be the nation's most usable state historic tax credit statute.

A Second Try is Needed to Fix the Related Party Test

Alas, despite the work of the industry's best thinkers, the effort to reinvent the related party test has hit a snag. As discussed in last month's History on the Hill, in 2009 the CDFI Fund finally invited community development entities (CDEs), investors and qualified active low-income community businesses (QALICBs) to amend the related party test to help eliminate its unintended effect of discouraging equity qualified low-income community investments (QLICIs) by CDEs. The unanimous industry response was to test for "relatedness" after the QEI and before the QLICI. The mantra seemed to make sense– if you aren't related before the transaction, you shouldn't be related after the transaction. But solving one problem in the tax credit business can sometimes create another, and no one noticed the collateral damage until after the industry solution had been codified into new CDFI Fund guidance effective April 15, 2010.
As it turns out, under the Internal Revenue Service (IRS) NMTC regulations, a CDE that "controls" the QALICB at any time during the seven-year compliance period loses the safe harbor of the "reasonable expectations" test. This safe harbor means that a CDE that had a reasonable expectation that the QALICB would remain a QALICB through the seven-year transaction would not suffer a recapture of the NMTCs if events proved it wrong. As important, if a CDE had a reasonable expectation that a mixed-use project would not fail to maintain at least an 80-20 split of residential and commercial revenues respectively, it would also be protected from recapture if the unexpected happened.

The problem is that IRS defines control as either control by virtue of the value of the CDE's equity interests in the QALICB or by its voting rights in or management control of the business. Because CDEs are passive investors that normally own less than 50 percent of the LLC's interests, the first definition of control is not problematic. But there is no IRS guidance on how to determine control based on the value of the CDE's equity interest. But contributing more than 50 percent of the equity starts to sound like it. Apparently none of the industry's leading law firms will go out on a limb in the form of a tax opinion, and based on feedback from investors, even a CDE that provides an indemnity for a deal that lacks the

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reasonable expectation protections, will have a tough time placing its HTC/NMTC investment.

At the June 10-11 Novogradac NMTC conference, the consensus seemed to be that the CDFI Fund and NMTC industry should ask the IRS to consider, for the purposes of the NMTC program, guidance that it will look to voting or management rights rather than the value of the CDE's equity to determine whether the CDE has the kind of control that could have an impact on QALICB compliance.

Getting it Right After Many, Many Tries in Minnesota

The campaign started as far back as 2000 when only a handful of states had some form of state HTC to leverage the federal program (now there are 31 states with state HTCs). Surely the progressive state of Minnesota that produced Hubert Humphrey and Walter Mondale should be among the first to embrace the idea of spending state treasure to save its architectural heritage. But due to the opposition of key committee leaders during a 10-year period, every legislative proposal stalled in committee or failed to emerge from the annual House-Senate Tax Conference Committee. As this year's legislation made its way through committee, a proposed statewide cap of $5 million looked likely to stymie its usefulness to the development community.

Then the unexpected happened. An 11th hour agreement uncapped the HTC as legislators recognized that the move would maximize the bill's job growth potential. "To say that we were surprised is an understatement," said Bonnie McDonald, executive director of the Preservation Alliance of Minnesota, who has led the advocacy charge in recent years. "The fact that our legislators passed an uncapped, certificated, refundable credit during the worst budget deficit in our history speaks volumes for their recognition of the incentive's potential."

It may have taken multiple tries to get something enacted and signed by the governor. But Minnesota's advocacy coalition of historic preservationists, architects, construction companies, labor unions, and community development professionals got the legislation's technical provisions more than right the first time—they hit a homerun. All of the elements of a strong state HTC were considered and thoughtfully addressed in what has to be described as a model state HTC legislation for the nation.

New Minnesota Chapter 216 has flexibility above all. It can be deployed four ways: as an allocated credit through a partnership, as a certificate sold outside the partnership or through a tax refund. Reflecting the current scarcity of corporate tax credit buyers, the law even allows for a "grant-in-lieu of credit" option at 90 cents on the dollar similar to stimulus features now offered for the federal low-income housing and renewable energy tax credits. No other state HTC offers this feature. Special allocations among partners

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are also allowed and there is no recapture provision. Unusual for these recessionary times, the bill does not cap the amount of credits that can be earned per transaction and there is no annual statewide expenditure cap. Avoiding New York's mistake, the credit can defray state corporate, franchise and premiums taxes so that banks and insurance companies, the usual market for state HTCs, can participate fully.

Minnesota's state HTC has other useful features. Credits expire if not used after three years, avoiding the glut of unused credits that revenue departments worry will eventually be used. Another strong feature is the legislation's generous five-year sunset provision that will give proponents and users plenty of time to get projects under way and completed to build a case for the statute's positive economic impact and to fix any early regulatory mistakes.

Norm Jones of Winthrop and Weinstine PA, who participated on the legal team that drafted the bill, attributed the bill's technical soundness to "practical historic tax credit industry experience from other states about what features would make the credit most desirable for investors and efficient for developers."

Bitter experiences like the state of Maryland's have taught preservationists that well-drafted state tax credits can be their own worst enemy. The first large historic rehabilitation project that earns a $15 million Minnesota state HTC could become the poster child for per project caps. A concentration of the tax credit's use in big cities like Minneapolis, St. Paul and Duluth at the expense of rural communities may set the stage for per region caps as happened in Ohio and Maryland.

State-by-state experience advises that Minnesota credit advocates should depend less on future economic impact studies and more on marketing the program around the state to spread out the benefits. Making sure that legislators across the state know when the credit is used in their communities, and that real people have been put back to work, will help assure that this "best in the nation" state HTC stays that way. ❖

John Leith-Tetrault has 32 years of experience in community development financing, banking, community organizing, historic preservation, training and organizational development. He has held senior management positions with Neighborworks, Enterprise Community Partners, Bank of America and the National Trust for Historic Preservation. Mr. Leith-Tetrault is the founding president of the National Trust Community Investment Corporation and serves as the Chairman of the Historic Tax Credit Coalition. He can be reached at (202) 588-6064 or jleith@ntcicfunds.com.

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