



This article brought to you by **Commercial Investment Real Estate**, the magazine of the **CCIM Institute**.

To read the entire issue or find out more about the Institute, go to **www.ciremagazine.com**.



Equity Injection

Tax credit programs boost funding for qualified properties.

by John W. Waldeck Jr.



The dominos continue to fall in the commercial real estate market, leaving lenders exceptionally conservative in making loans for new projects. Loan-to-value ratios in the 50 percent range are not uncommon. In fact, some would say that outright rejections are the norm.

But not all news is bad. Opportunities exist in segments that can take advantage of existing and evolving federal and state tax credit programs, such as historic tax credits and new markets tax credits. Qualifying projects have the advantage of significant equity creation, which bridges the difficult loan-to-equity gap in today's market.

There is a catch, however: Not all projects will qualify. For federal and state historic tax credits, as the name implies, an existing, qualifying property's restoration must conform to standards issued by the U.S. Department of the Interior. For new markets tax credits, projects must be located in a low-income census tract (many urban centers qualify). Renewable and green energy credit programs also may generate credits at the state and federal level.

Historic Tax Credits

Developers may use federal historic tax credits to raise equity equal to either 10 percent or 20 percent of the project's rehabilita-

Steve Allen/Getty Images



The number of renewable energy and green tax credits continues to grow.

tion expenditures. Land and purchase costs do not count, and rehab expenditures must exceed the developer's basis in the project.

The majority of projects use the 20 percent credit, which is available for certified historic structures or qualifying structures that are in certified historic districts. Additionally, such funding requests require a three-part application, which is approved by the state historic preservation office and the National Park Service. The federal credit is automatic. If developers follow the proper guidelines and application, the 20 percent credit may be taken in the year in which the project is placed in service. State programs may be automatic or based on competition.

HTC equity comes into the project in the form of a capital contribution made by an investor in the project, usually C corporations with taxable income — many still are very active in the market. These investors contribute at the rate of 75 cents to 95 cents for each dollar of credit passed through to the investor. The investor remains in the project for the five-year tax-credit-recapture period, during which time there can be no sale or disposition of the property.

Numerous HTC projects would never have been completed, let alone realized, without this program. For example, in Cleveland much of the nationally publicized East Fourth Street District (which includes the House of Blues in a former Woolworth building and Iron Chef Michael Symon's Lola Restaurant) was restored and converted to an urban mixed-use retail and residential development, employing a combination of federal and state HTC.

New Markets Tax Credits

While new markets tax credits also may fill equity gaps, they differ from historic tax credits

in a number of respects. As contrasted with HTC, NMTC are available to the taxpayer over a seven-year period in an amount equal to 39 percent of the qualified investment (5 percent per year for three years; 6 percent per year for the next four years).

Also, NMTC are allocated annually on a competitive basis, requiring the developer to approach a successful allocatee with the project request. These allocatees may include banks, community development corporations, port and development authorities, and the National Trust for Historic Preservation.

Investment may be direct or through a leveraged structure. Due to the structure's complexity, fees and expenses can be significant; the project's size needs to be large enough to justify the costs incurred.

The beauty of NMTC in a real estate project is that these credits can be combined with HTC in an appropriate project (residential components are significantly

limited) to further boost the equity component to the point that the equity gap is nearly filled. A developer's typical equity contribution would not be sufficient. But with the push given by the tax credit equity pieces, the project will greenlight, notwithstanding a conservative loan-to-value ratio.

A recent example is a Cleveland hotel financing that closed in early fall 2009. The project, the conversion of the 1930s-era Tudor Arms into a Doubletree Hotel, featured HTC, NMTC, a conventional construction loan at approximately a 50 percent loan-to-value ratio, and some

additional layers of financing from community development sources. Getting a hotel deal done in the current environment is virtually impossible, yet with the twin engines of HTC/NMTC bolstering the financing it became a reality.

Other Credit-Based Financing

The number of renewable energy and green tax credits continues to grow. Developers on the cutting edge of affordable housing tax credits have successfully used solar panel technology to qualify for tax credits or outright grants to reduce

Where to Go Next

- www.nps.gov/history/hps/tps/tax/index.htm
- www.cdfifund.gov
- www.dsireusa.org

energy costs to tenants and pay for otherwise cost-prohibitive installations, giving hope that commercial real estate projects could also be suitable candidates for such installations.

For commercial and industrial projects that generate jobs, the more-traditional enterprise zone tax abatements and jobs creation tax credits often are available at the state or local levels. The tax-burden reduction changes the pro formas of such projects for the better, increasing appraisal numbers in a time when every dollar is critical.

Prospects are dim for near- or even mid-term restoration of more customary loan-to-value ratios. This means only those projects with significant equity to plug the gap will be built. Because such development doldrums often translate into developer demise, it's time to take a look at tax credit programs and qualifying development to generate some lifeblood in the commercial marketplace.

John W. Waldeck Jr. is a partner and practice head of the real estate section at Walter & Haverfield LLP in Cleveland. Contact him at jwaldeck@walterhav.com.

Tudor Arms Financing



\$3.3 million
in federal HTC

\$4.4 million
in state HTC

\$4 million
NMTC

\$8.9 million
mortgage

Source: Cleveland.com