



The Community Development Bulletin is a timely discussion of community development, affordable housing and tax credit issues sent to clients and friends of the Community Development Team of Womble Carlyle Sandridge & Rice, PLLC. For further information in regard to any matter herein, please contact Todd C. Brockmann, Esq. (704) 331-4964, tbrockmann@wcsr.com, Andrew H. Foster, Esq. (919) 484-2383, afoster@wcsr.com or Peter J. Duffley, Esq. (919) 755-2108, pduffley@wcsr.com.

Peter J. Duffley Joins the Community Development Team

We are very pleased to announce the addition of Peter J. Duffley to the Community Development Team. Peter will be located in our office in downtown Raleigh. Peter regularly advises banks and other corporate investors on a variety of issues relative to the syndication of federal and state low-income housing and historic rehabilitation tax credits and has extensive experience in structuring, organizing and capitalizing investment funds deployed to affordable housing, historic and mixed-use developments in North Carolina, South Carolina and throughout the Southeast. Peter has also developed a broad range of experience advising banks on Community Reinvestment Act compliance and eligibility issues and on other regulatory matters relating to community development activities. In addition, Peter and his wife Kim were recently blessed with the birth of their second child on August 12th at 3:25 p.m.. Emily Paige Duffley weighed in at 7 lbs., 2 oz. and was 20 ½ inches tall. Aside from a lack of sleep, Mom, Dad, Emily Paige and her big brother John are all doing well.

Proposed Amendments to the Section 42 Regulations

Last month, the IRS issued proposed amendments to the regulations under Section 42 of the Internal Revenue Code, which changes are in response to the modifications to Section 42 contained in the Community Renewal Tax Relief Act of 2000. The proposed amendments modify §1.42-6 (carryover allocation date for 10% test), §1.42-8 (election of appropriate percentage month), §1.42-12 (effective dates, transitional rules and electronic filing simplification changes) and §1.42-14 (credit ceiling allocation rules). The implementation of the change in Section 42(h)(1)(E)(ii) of the Internal Revenue Code related to the carryover allocation date has been a subject of some confusion, especially in the Southeast. Some of the confusion deals with the semantics of “award” vs. “allocation,” and some of the confusion has been generated by various requirements contained in qualified allocations plans. For example, the 2001 QAP in South Carolina required that the 10% test be met “no later than six months after the tax credit allocation date.” Even though South Carolina made “awards” in the late summer of 2001, the effective date of the “allocation” was considered to be December 31, 2001. Therefore, the 10% test did not need to be met until June 30, 2002, which was six (6) months subsequent to the “allocation” date used by the State of South Carolina. Currently, South Carolina does use the “award” date as the “allocation” date, so the 10% test must be met within six (6) months of the award. In 2002, the awards were made on September 5, 2002, so the 10% test was required to be met on March 5, 2003. North Carolina is even more confusing because the 2003 QAP requires that the 10% test be met on or before November 14, 2003, regardless of when the award is received by the taxpayer. This requirement completely ignores the test set forth in Section 42(h)(1)(E)(ii) of the Internal Revenue Code and essentially requires the taxpayer to meet the 10% test in a window of approximately three (3) months – the exact problem the revised statute was intended to solve. Anecdotal evidence from the 2002 cycle in North Carolina (the 10% test was similarly required to be made on or before November 15, 2002) indicates that this requirement created an additional expense to many 2002 projects that were required to quickly close on the land prior to having all of the debt and equity financing in place. This requirement has led to additional closing costs and carrying costs that likely could have been avoided if the six (6) month test had been used.

Update: Progress on the New Markets Tax Credit

In recent editions of our bulletin, we have outlined the mechanics of the newest federal community development tax credit, the New Markets Tax Credit (“NMTC”), as well as the opportunities this new program offers to investors, developers and businesses interested in revitalizing low-income communities. Unfortunately, this program’s promise has not yet been realized because of slow implementation. It appears, however, that the pace is picking up on at least two fronts:

2002 Allocations Are Close to Completion: At the end of July, the CDFI Fund released the final draft of the form Allocation Agreement. This document will serve as the basic contract between the CDFI Fund and the community development entities (“CDEs”) that were awarded NMTC allocations through the allocation process that ended in August, 2002. The expectation is that the CDFI Fund will begin negotiating the individual Allocation Agreements with each of these CDEs shortly. Once the agreements are executed, the CDEs will then be able to issue their NMTC allocations to investors in exchange for equity. At that point, the market should begin to see a number of NMTC deals begin to be funded. As a result, if you have a project or a business that you think can be financed under the NMTC program, now is the time to begin sharing the opportunity with CDEs that have NMTC allocations.

Application for 2003 and 2004 Allocations Due Soon: The CDFI Fund announced that applications for the NMTC allocations reserved for 2003 and 2004 will be jointly allocated through a competitive allocation process that will conclude on September 30, 2003. Through this process, the CDFI Fund will allocate enough tax credits to raise \$3.5 billion in equity for investing in eligible activities in low-income census tracts. In order to be eligible to apply in this round, interested applicants must have applied for certification of their CDEs with the CDFI Fund no later than August 29, 2003. In addition, CDEs that received an allocation in the 2002 round are eligible to apply for a second allocation if they meet certain conditions, including a requirement that such CDEs have issued at least fifty percent (50%) of their qualified equity investments prior to February 17, 2004. Copies of the current Allocation Application may be downloaded from the CDFI Fund’s website at www.cdfifund.gov.

Senate Bill 119 – NC Historic Tax Credit Amendment

On August 14, 2003, Governor Easley signed into law Senate Bill 119 (SB 119) which effected certain changes to North Carolina’s historic rehabilitation tax credit. The provisions of SB 119 modify (a) the basis requirement for bifurcation of the credit and (b) the sunset period for the bifurcation provisions.

Basis Reduction for Special Allocations: SB 119 reduces the basis requirement for special allocations made among the owners of pass-through entities that qualify for the historic credit (i.e. the bifurcation of the state credit from the federal credit), and, therefore, should make the state historic credit more attractive to investors. Prior to SB 119, N.C.G.S. § 105-129.35(b) provided that a pass-through entity such as limited partnership or LLC could specially allocate the state historic credit among any of its owners in its discretion provided that the total amount of the credits so allocated did not exceed an owner’s adjusted basis in the pass-through at the end of the tax year in which the historic property was placed in service. In other words, a state-only investor was required to invest \$1 into the project for each \$1 of state credit received. Because an investor naturally will invest at a discount relative to the size, timing and federal tax consequences of any state tax credit, the dollar-for-dollar requirement in the prior version of the statute eliminated any economic incentive to invest in the state credit unless one investor was willing and able to invest in both the state and federal credit. Under the modified statute, an investor is now only required to invest at least \$0.40 for each \$1 of state credit received. If this issue sounds familiar, you may recall that North Carolina’s low-income housing tax credit statute was plagued by the same dollar-for-dollar basis requirement before the statute was amended in 2002 to reduce the basis requirement for pass-through owners with respect to projects that received credit allocations in 2000, 2001 and 2002. As

applied to both low-income and historic projects, this basis hurdle has undoubtedly hindered the ability of developers to effectively market the credits to state-only investors. After all, the opportunity to invest money in today's dollars in exchange for the right to claim, in equal annual installments over the following 5 years (i.e., the credit period), the identical amount in the form of a tax credit is not, by any investment performance standards, a sensible investment. The marketability issue was noted in the Legislative Fiscal Note prepared in connection with the introduction of SB 119. Specifically, the Fiscal Note indicated that the basis amendment was intended to increase the likelihood that the credit will be fully utilized by taxpayers. While this was the stated intent of the legislation, the Fiscal Note also acknowledged that for technical reasons the North Carolina Department of Revenue was unable to report on the actual percentage of state historic credits taken by taxpayers in 2000 and 2001 relative to the total state historic credits that were available during those years. Given the lack of historical data regarding the utilization of the credit under the old basis rule, the actual impact of the amendment may be largely uncertain. However, it seems logical that the new lower basis requirement (a) will make the credit easier to bifurcate, (b) should generate more competition among investors and (c) generate higher credit prices in the market. Even though SB 119 was signed into law on August 14, 2003, the new basis rule became effective for taxable years beginning on or after January 1, 2003. As a result of its retroactive effective date, SB 119 imposes the following timelines with regard to the bifurcation of the state historic credit:

<u>Placed in Service Date</u>	<u>Basis Requirement for Bifurcation</u>
Jan. 1, 2003 – Dec. 31, 2007*	At least 40% of the credit allocated to taxpayer
Jan. 1, 1999 – Dec. 31, 2002	100% of the credit allocated to taxpayer
Pre-Jan. 1, 1999	Bifurcation not allowed
* scheduled repeal date for bifurcation provisions under N.C.G.S. § 105-129.35(b)	

Extension of Sunset Period. As indicated above, SB 119 extends the repeal date for the statute's special allocation provisions such that bifurcation of the credit will be permitted for income-producing historic properties placed in service on or before December 31, 2007. The prior law permitted special allocations only for properties placed in service on or before December 31, 2003. The sunset period, as extended by SB 119, could be further extended by future legislation.

Duke Law Community Economic Development Clinic Begins Second Year

The Duke Law CED Clinic recently began its second year of operations under the direction of Community Development Team member, Andrew Foster. The clinic represents a wide variety of non-profit organizations and low-wealth entrepreneurs on community development transactions in North Carolina and throughout the Southeast. Currently, the clinic represents clients in low-income housing tax credit transactions and other affordable housing projects; assists clients on economic development projects, including many that will utilize the New Markets Tax Credit; and generally works to strengthen the non-profit community development sector through a variety of community education, public policy and training initiatives. All legal services provided by the clinic are performed on a pro bono basis by second and third year Duke Law students working under Andrew's supervision. In its first year, the clinic had an immediate and substantial impact by providing more than 2,500 hours of pro bono legal services to clients (an estimated value of \$360,000). These services enabled clients to significantly increase their capacity in the areas of housing, commercial real estate development and job creation. The clinic will enroll up to twenty-five (25) students in 2003-2004, and they look forward to this year being even more productive. If you know of a non-profit organization or a small business that might need the clinic's services, please contact Andrew at the clinic (919-680-2964 or foster@law.duke.edu).