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Twinning NMTCs with SBA 7a Loans: Legal and Practical Considerations

By Eric Usinger, Emmet, Marvin & Martin LLP

The new markets tax credit (NMTC) industry has been abuzz in recent months over recent proposals by the Treasury Department to ease restrictions on investments in non-real estate qualified active low-income community businesses (QALICBs). The proposed regulation defines a non-real estate QALICB as any business whose predominant business activity does not include the development, management or leasing of real property.

While the proposed regulations may make investments in non-real estate businesses more common, NMTC professionals are not waiting for regulatory relief and are forging ahead with innovative structures to increase small business investments. One such structure, which Emmet, Marvin & Martin LLP has been proud to help pioneer, is the twinning of the Small Business Administration's (SBA's) 7a loan guaranty program with NMTCs.

Under the 7a program, SBA-approved lenders can make loans guaranteed by the SBA. Depending on the type of loan (which currently can be as much as $5 million), the SBA may guaranty between 75 and 90 percent of the loan's principal amount. These benefits generally translate into reduced interest rates for borrowers, reduced risked for lenders, and more lending overall.

Once a 7a loan is made, a 7a borrower may use the proceeds for a variety of business purposes, including the establishment of a new business or the acquisition, operation or expansion of an existing business. To this end, 7a loans are often used to purchase real property, to finance the construction or expansion of existing facilities, or to purchase fixtures, furniture, equipment or inventory.

In a twinned NMTC/7a program transaction, a CDE that is also an SBA lender uses NMTC equity and financing through the traditional "leveraged loan" model to make loans to various 7a-qualified small businesses. This has the added benefit of aggregating structuring costs and increasing tax credit efficiency. Alternatively, a CDE with an available allocation of NMTCs may utilize its qualified equity investment (QEI) to make a loan to another CDE that is an SBA-approved lender. This model is reflected in the illustration on page 52, and serves to utilize investor equity to increase the total dollar amount of small business loans deployed.

As is always the case when twinning NMTCs with other federal or state programs, it is important to understand the various requirements of each program. Accordingly, the following outlines several legal and practical considerations for structuring these types of transactions.

CDE and 7a Certification

Any lender originating a 7a loan must be SBA approved. A CDE making a loan to an SBA lender need not have SBA approval; however the SBA lender originating the 7a loans will need to be a CDE. The reason for the latter requirement is that under the NMTC's "nonqualified financial property test" investments in entities that hold substantial debt instruments do not constitute qualified low-income community investments (QLICIs). However, loans by CDEs to other CDEs are permitted QLICIs. This may seem academic, but situations abound in which multiple CDEs will be needed to make a transaction work.

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Long Term Loans

Loans under the 7a program often have terms of up to 25 years. If a leverage lender has entered the deal to finance the credit relationship with particular 7a borrowers, then it may not mind remaining in the deal beyond the NMTC's seven-year compliance period. If, however, the leverage lender's sole interest is to leverage tax credit equity, then it will likely expect full repayment in seven years. In such cases, the leverage lender's credit risk will be determined by the SBA lender's ability to generate sufficient cash flow to allow the leverage loan to be repaid in seven years. Thankfully, owing to strength of the SBA's guaranty, there is a healthy secondary market for 7a loans. Nevertheless, it may be necessary to educate the leverage lender on these issues.

7a Loans are Fully Amortizing

All 7a loans must fully amortize and, in most cases, prepayment penalties are prohibited in all but the first three years. These requirements will inevitably conflict with the requirement that substantially all of an investor's QEI remain invested in a QLICI for seven years. In this regard, the proposed regulatory changes may provide some relief as the Treasury is considering alternative ways in which QLICIs in non-real estate QALICBs may be reinvested. In the meantime, a practical solution is to require the establishment of a sinking fund to capture principal payments as they are made, to be reinvested once a certain threshold is met. This may be as simple as moving the investment into the next project if the SBA lender has a healthy loan pipeline (focused on low-income communities). Alternatively, under the safe harbor method for calculating the substantially all test, it is possible for a CDE to create built-in "buffer" protection by making one or more extra qualifying loans to QALICBs, in excess of the amount needed to satisfy the substantially all test, and to count those additional loans toward the total QLICI.

SBA Limitations on Loan Assignments

The SBA generally allows collateral assignments of its guarantees, provided the SBA-approved lender retains an unguaranteed interest of not less than 10 percent of the loan and the SBA retains the right to deal solely with the SBA-approved lender. This may cause complications in deals in which the CDE has made a loan to a third-party SBA lender. Notwithstanding a default by the SBA lender in its obligations to the CDE, the CDE may nevertheless be required to continue working with the SBA lender as a minority participant and servicer for the 7a loans. Therefore, both the CDE and leverage lender may need to get comfortable with the SBA lender's industry track record, financial plan, lending standards and business model.

Cost Savings Limited by Investor Requirements

Although there will be great cost savings in structuring a multi-

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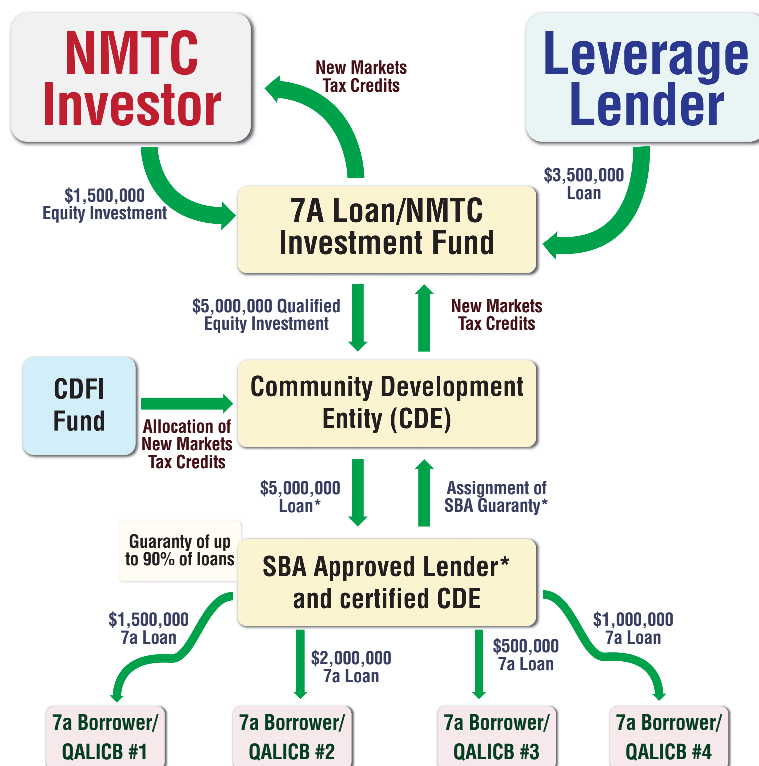
loan facility, the tax credit investor will still want a minimum level of NMTC due diligence in connection with each 7a loan originated. This may include an accountant's agreed upon procedures report with respect to each 7a loan, a QLICI opinion letter for each 7a loan, and a QALICB certification from each 7a borrower.

Borrower Qualifications

Each 7a borrower must satisfy the SBA's requirements and, during the entire NMTC compliance period, be a QALICB. Although several of the requirements for 7a loan eligibility overlap with NMTC program requirements, the 7a program has additional criteria. Notably: all 7a businesses must satisfy the SBA's definition of a "small" business, only for-profit businesses constitute eligible borrowers (non-profits cannot obtain a 7a loan), the leasing of real property does not constitute a qualified 7a business, certain businesses promoting religious activities are ineligible, and consumer and marketing cooperatives are generally ineligible.



Source: Eric Usinger; Novogradac & Company LLP

At the end of the day, the success of an NMTC transaction twinned with 7a loan guaranty benefits will be wholly dependent on the strength of the SBA lender's ability to locate, secure and deploy small business loans to low-income community businesses. Nevertheless, a well-structured and underwritten transaction can be successful in furthering the NMTC program's goal of creating jobs and stimulating investment in low-income communities.

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