EDWARDS ANGELL PALMER & DODGE LLP

One North Clematis Street / Suite 400 West Palm Beach, FL 33401 561.833.7700 *fax* 561.655.8719 eapdlaw.com

TO: Dick Barker, Finance Director
William "Rusty" Wells, City Attorney
City of Pensacola

FROM: Richard J. Miller
Steven L. Paul
Joe E. Forrester

DATE: September 17, 2009

RE: Use of New Market Tax Credits

You have raised a number of questions regarding the use of new market tax credits ("NMTCs") in conjunction with issuance of tax-exempt bonds or taxable Build America Bonds ("BABs") for the Community Maritime Park Project (the "Project") to be undertaken by the Community Maritime Park Associates LLP ("CMPA"), a 501(c)(3) entity, on behalf of the City of Pensacola ("City") and its Community Redevelopment Agency ("CRA"). We have reviewed the Community Redevelopment Act, Chapter 166, Florida Statutes, the Internal Revenue Code of 1986, as amended and related regulations (the "Code"), along with a draft Official Statement for a proposed City bond financing of the Project as well as organizational documents for CMPA and Capital Trust Agency ("CTA"), and the Master Lease and Master Development Agreement between the City and CMPA, among other things. See out attached memorandum to Rusty Wells dated August 17, 2007 for specific background information on NMTCs. Your questions and our responses follow.

Any tax advice contained herein was not intended or written to be used, and cannot be used, for the purpose of avoiding federal tax-related penalties or promoting, marketing or recommending to another party any transaction or matter addressed herein.

1. Can tax-exempt bonds be used in conjunction with NMTCs to fund the Project?

Tax-exempt bonds may be used in conjunction with NMTCs under the Code. In our view, the tax-exempt status of the bonds is determined by ultimate use of the bonds proceeds, in this case by CMPA as described below, rather than their use by the NMTC investor though which these proceeds pass.

As you know, tax-exempt bonds can be either governmental bonds or tax-exempt private activity

bonds, such as tax-exempt 501(c)(3) bonds. In the usual case, City bonds paid from tax increment revenues would be classified as governmental bonds because of characterization of the tax increment revenues as "generally applicable taxes" and the absence of, or limited nature of, private sector involvement. Unlike the usual case, the NMTCs structure as explained below requires that proceeds of the City's bonds and moneys used to pay debt service on the bonds both flow through CMPA. If CMPA is restructured to be an instrumentality or alter ego of the City, the City's bonds should qualify as tax-exempt governmental bonds. If CMPA is not an instrumentality of the City, the City's bonds should still qualify as tax-exempt, but could be classified as tax-exempt 501(c)(3) private activity bonds. Although in either case the City's bonds would be tax-exempt, a structure which results in the City's bonds being classified as private activity bonds precludes issuance of the bonds as taxable BABs as more fully described below.

Moreover, it is also important that other private users or beneficiaries of the Project or Project facilities, such as the museum or the stadium, do not collectively contribute directly or indirectly more than five percent (5%) of the overall debt service on the bonds to be issued in order to qualify for tax-exempt bonds (taking into account for-profit corporations only) or BABs (taking into account both for-profit and not-for-profit corporations). This is a matter that the Bond Counsel will address in the structuring of new leases and contracts for the Project.

2. Can BABs be issued in conjunction with NMTCs?

The answer turns on whether the proposed BABs can be characterized as "governmental" under the Code rather than a "private activity bond" or a private loan bond. Normally, bonds issued for 501(c)(3) corporations are considered private activity bonds under the Code where the corporation directly or indirectly repays the debt and uses the project or the facilities. The NMTCs structure requires that bond proceeds received by the City be loaned to the NMTC investor partnership (the "Investor") and used by the Investor, together with its own equity investment, to make an equity investment (referred to as a "qualified equity investment" or QEI") in the community development entity ("CDE") established by CTA, the recipient of the NMTC allocation, in exchange for the NMTCs. The CDE in turn makes a loan to the qualified low income community business, in this case CMPA, to finance the Project. See the attached diagram showing the structure and flow of funds that would be required to accomplish the bond financing with NMTCs.

CMPA will repay the loan related to the bond financing (the equity loan is treated separately). The source of CMPA repayment will begin with CRA tax increment moneys that pass through the chain of repayments starting with the CRA payment of tax increments up through CMPA (the qualified business), the CDE, the Investor and finally to the paying agent for the bonds. The additional security provided by the City's covenant to budget and appropriate non-ad valorem revenue may run through this chain back up to bondholders or sidestep the chain.,i.e., be paid by

the City at the paying agency level if tax increment revenues are not sufficient to repay the bonds in any year. Federal direct payments which subsidize the taxable BABs can also take either route in our view or flow directly to the City's general fund.

The BAB rules require, among other things, that bonds treated as BABs must satisfy virtually all of the rules applicable to tax-exempt bonds, but may not be private activity bonds. Classification of the City's bonds as private activity bonds would thus spoil the use of BABs. If the payments in the payment stream do not retain their characterization as "generally applicable taxes," as they move up the chain, the repayment and use by CMPA would meet the two-pronged private activity bond test and, thus, preclude issuance of the bonds as BABs. There is no certainty found in the Code or Treasury rulings that the stream of payments up the chain shown in the diagram would retain their character as generally applicable taxes, as they pass from CMPA through the CDE and the Investor to pay the bonds. However, this conclusion would not follow were CMPA to be controlled by the City and treated as an instrumentality of the City. In that event, the bonds would be deemed to have been issued by the City and repaid by the City, regardless of the intermediate steps, since CMPA would be an alter ego of the City for tax purposes.

It is our view that were the structure of CMPA such that it was controlled by the City, it would, in effect, be an instrumentality of the City and its bonds issued for the Project would be classified as governmental bonds. Further, it is our view that the status of CMPA as an instrumentality of the City will not preclude the qualification of CMPA as a 501(c)(3) corporation under the Code or the capacity to use NMTCs in conjunction with tax-exempt bonds or BABs under this structure.

In order to constitute an instrumentality of the City, a majority of the members of the Board of CMPA, by virtue of the terms of the charter and by-laws, must be appointed by the City and may be removed by the City without cause. Moreover, at the end of the day were the 501(c)(3) to dissolve , the assets of CMPA must be distributed to the City. Accordingly, the charter and by-laws of CMPA would require amendment and the membership in the Board adjusted in order to accomplish BAB financing in conjunction with NMTCs, as only 1/3 of the CMPA board members are now appointed by the City.

3. What is the required coincidence of the timing of the two funding sources? Must they be simultaneous?

NMTC's equal 39% of the Investor's QEI and are not directly tied to project costs. All the money invested should be placed in and through the Investor at the same time so that the Investor can combine the bond or loan proceeds with its own equity in determining the amount of its QEI. Thus, the Investor must be in place in time to receive the bond proceeds and invest them in the CDE.

4. Under the Code, when must the Project be completed to afford the benefits of NMTCs?

The Code provides a 12-month period for the CDE to disburse 85% of the QEI to CMPA, though as a regulatory matter most allocations agreements increase the required disbursement percentage to 95%. In order to be a qualified active low-income business ("QALICB"), CMPA, in turn, is prohibited from holding "nonqualified financial assets, including cash in excess of 5% of the adjusted basis of all its assets. There is an exception permitting CMPA to hold "reasonable working capital" and a safe harbor under this exception for up to 12 months of construction expenditures. The cumulative impact of all these rules permits expenditures to be spread over 24 months. The following is an example of how this can work: if total Project costs were $24 million to be expended at the rate of $1 million per month, all $24 million would be paid to the CDE at closing (so that the Investor can claim NMTCs immediately on the total investment), $1 million could be disbursed to the qualified business in each of the next 12 months, and on the final day of the 12 month period, an additional $12 million could be disbursed, and the qualified business would then have 12 months to expend the final $12 million.

It is contemplated, although not necessarily within the safe harbor, that it is reasonable to retain working capital for purposes of contracts that have been let and are reasonably expected to have been completed within the 24-month permissible period, but are not. Accordingly, the reasonably expected contractual period for expending 95% of the proceeds received from the CDE could be outside of 24 months. This outcome will depend upon the approval of the investors.

5. Can the park and the museum be combined as a single project for purposes of calculation of new market tax credits benefits?

Yes, if the project is put together in such a way as the museum and the other Maritime Park improvements are funded together as a single project within the low income community.

6. What is the risk to the City if the tax credits for some reason are not realized by Investors?

Under the Code, the Investor is at risk for "recapture " of NMTCs for an equity investment in a CDE where, (1) the CDE ceases to be a CDE ; (2) the CDE ceases to use substantially all of the proceeds of the equity investment for qualified low-income community investments; or (3) the CDE redeems the Investor's equity investment. . Since redemption of the investment is entirely within the Investor's control, that event of recapture does not place any liability on the CMPA or the City, even indirectly. Under clause (2), however, loss of NMTC will result from the failure of CMPA to maintain its status as a QALICB, the principal risks of which are that it will retain more than the permitted amounts of nonqualified financial assets or collectibles. The question

remains whether the close nexus between CMPA and the City could cause liability to the City were Investors' required to rebate their NMTCs.

We would recommend that the City take steps to alleviate the risks attendant to the NMTC obligations of CMPA by resisting any guarantees concerning CMPA's QALICB and through safeguards built into contracts with contractors and builders requiring on-time completion, completion bonds and penalties, not to mention substantial prior planning of the Project by CMPA , the museum and other participants. In addition, Project beneficiaries of the NMTCs may be requested to indemnify CMPA and the City from liability to the extent they benefit from the use of NMTCs.

The primary party responsible for the sale of the new market tax would be Capital Trust and its CDE. The primary parties responsible for disbursal of the bond and NMTC moneys received would be the CDE and CMPA. Presumably Capital Trust would bear any risk concerning the loss of status of the CDE.

7. This question relates to the substantial cost of the transaction and particularly, the substantial commission to CTA in connection with this transaction. Is this large commission in the permissible range?

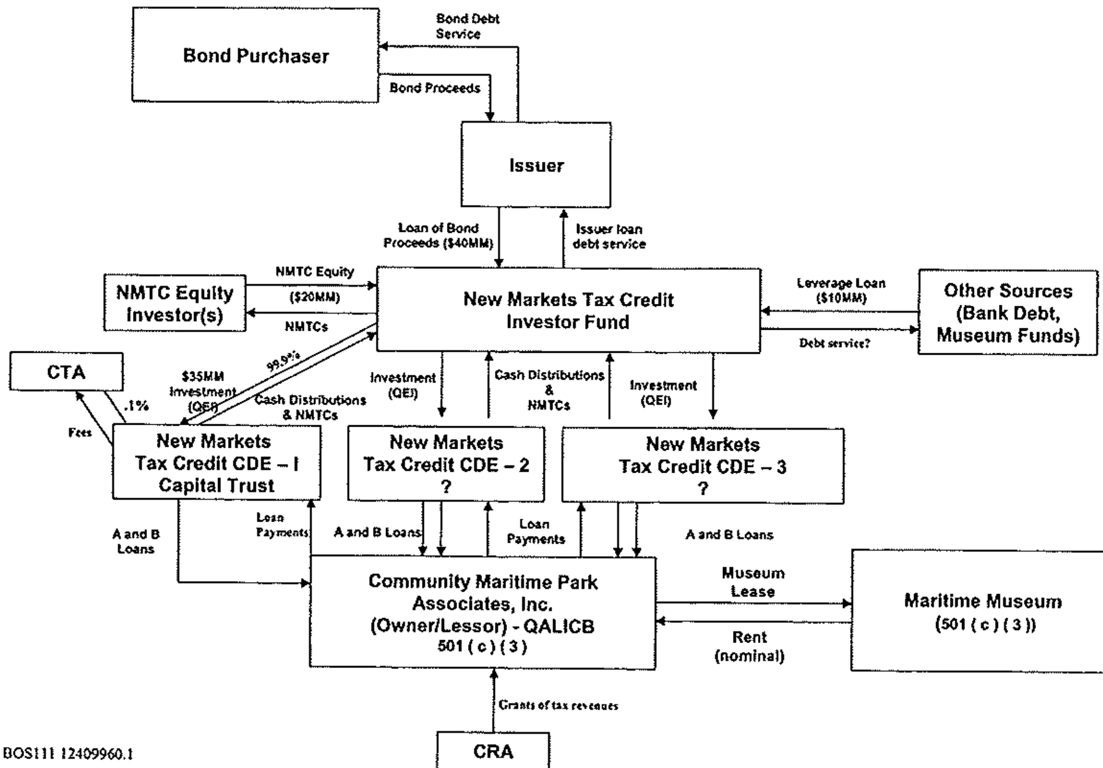
NMTC transaction costs are VERY high. They were nearly $3 million for a recent transaction in which the gross NMTC equity was about $8.5 million and the allocation was $30 million. Thus the net to the project was about $5.5 million.

8. What is the but/for test and does it present an issue here?

It appears that part of the Project and particularly the museum would not be funded without the use of tax increment monies in any timely fashion--the museum may take years to raise required amounts. However, the but/for test may be a regulatory matter because it's not part of the Code relating to new market tax credits, but rather, possibly, a policy of the oversight agency, CDFI.

9. Can the City act as trustee or disbursement agent in connection with the funds in the hands of CMPA.

Yes. An agency agreement would be permissible. The City may act similar to the way a lender would in overseeing its loan proceeds. Funds would need to flow to CMPA as outlined but could be deposited by CMPA in a project account administered by the City.



BOS111 12409960.1

PMB 383718.7

EDWARDS ANGELL PALMER & DODGE LLP

One North Clematis Street / Suite 400 West Palm Beach, FL 33401 561.833.7700 fax 561.655.8719 eapdlaw.com

To : William ("Rusty") Wells, Esq., City Attorney, City of Pensacola, Florida

From : Richard J. Miller

Date : August 17, 2009

Re : General Information on New Markets Tax Credit Program

NEW MARKETS TAX CREDITS

New Markets Tax Credits (or "Tax Credits") are federal tax credits used to raise investment capital for qualified businesses in low-income communities.[1] They are governed by Internal Revenue Code section 45D and Treasury Regulations section 1.45D-1. The Community Development Financial Institutions Fund ("CDFI Fund"), a part of the U.S. Department of Treasury, administers the New Markets Tax Credit Program.

Community Development Entities are the vehicles through which New Market Tax Credit investments are made. They must apply for certification by the CDFI Fund in order to receive tax credit allocations. Qualifying Community Development Entities must show that their primary mission is to serve the needs of, or provide investment capital via equity or loans to, low-income communities or individuals. They must also show that they maintain accountability "to residents of low-income communities through their representation on any governing board of the entity or on any advisory board to the entity." Internal Revenue Code § 45D(c)(1)(B). Community Development Entities must be either partnerships or corporations for tax purposes.

Once an entity has been certified as a community development entity, it can apply to the CDFI Fund for an allocation of New Market Tax Credit investment authority. Allocations are subject to an aggregate annual dollar limit, currently $3.5 billion, and are made once a year. Allocatees have included banks and other for-profit entities, nonprofits and state agencies.

Community Development Entities sell Tax Credits for cash to investors in exchange for investors' equity investment in the community development entity referred to as qualified equity investments. Community Development Entities have five years to use or sell all of their Tax

[1] A "low-income community" for purposes of the New Markets Tax Credit Program is any census tract with a poverty rate of 20% or more.

Credits, after which time the CDFI Fund may transfer the unused or unsold Tax Credits to another Community Development Entity. Investors receive Tax Credits over a seven-year period, and the Tax Credits amount to 39% of the equity investment in the Community Development Entity. For example, if an investor invests $1,000,000 in a Community Development Entity, the investor receives Tax Credits totaling $390,000 over seven years.[2]

Upon receiving cash from investors in exchange for Tax Credits, a Community Development Entity has twelve (12) months to place at least 85% of the investor's cash in qualified low-income community investments. Such investments must be maintained for seven years or the Tax Credits will be subject to recapture. Consequently, the Community Development Entity cannot make distributions to its members or shareholders in excess of its operating income from the qualified low-income community investments.

Qualified low-income community investments include any capital investment or equity investment in, or loan to, a "qualified active low-income community business" ("Qualified Business"), the purchase of certain loans made by other Community Development Entities to Qualified Businesses, an equity investment in, or loan to, a Community Development Entity, and financial counseling or other services to businesses located in, or residents of, low-income communities. (*See* Community Development Financial Institutions Fund: Guidance, New Markets Tax Credit Program, 66 Fed. Reg. 21,846 (May 1, 2001); Treasury Regulations § 1.45D-1(d)(1)(iv)). Because of the requirement that the investment be outstanding for seven years, loans frequently provide for interest-only payments during this seven-year period.

Qualified Businesses are, generally, businesses that, in any given tax year, generate at least 50% of their annual gross income by conducting business in a low-income community, use at least 40% of their tangible property within a low-income community and perform at least 40% of their services in a low-income community. Internal Revenue Code § 45D(2)(A). Thus, for example, a business would have to form a separate legal entity that constitutes a Qualified Business in order to receive money from a Community Development Entity. If a business has no employees, it is not required to perform 40% of its services in a low-income community but may be a qualified active low-income community business if 85% of its assets are located in such a community. Rental real estate may constitute a Qualified Business, provided that a) less than 80% of the rental income is from dwelling units and b) no low-income housing tax credits are allowable with respect to the property. In addition, not more than 5% of the assets of a Qualified Business can consist of "nonqualified financial property," which includes cash and cash equivalents (other than reasonable working capital and accounts receivable), securities and similar property.

Many Community Development Entities leverage investor's investments in order to maximize the tax credits and make the New Markets Tax Credit Program more attractive to investors. Note that the loan made in order to leverage the investment is made to the investor,

[2] Investors may take their tax credits on the date their equity investment in the community development entity and on each of the first six anniversaries thereof.

rather than the Qualified Business, and is typically secured by the investor's equity interest in the Community Development Entity, not by any security interest in the Qualified Business. Leveraging can be explained as follows:

> In a simple, straightforward [Tax Credit] transaction, an investor only receives [Tax Credits] based on the amount of cash that it pays for its investment in a [Community Development Entity]. By contrast, as an example of a leveraged transaction, an investment partnership could be formed in which the investor puts its money into the partnership and a bank makes a loan to the partnership and not the [Community Development Entity]. The investor would then receive [Tax Credits] based on the total amount of the partnership's investment and not just its own funds. In this case, the rate of return to an investor could rise dramatically.

Ted M. Handel, *The New Markets Tax Credit Program*, 25 L.A. LAW. 13, 20 (Jan. 2003).