Alternative Financing for Commercial Real Estate

A Primer on Adding EB-5 Capital and Tax Credits to the Capital Stack

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Locating cost-efficient sources of mezzanine financing remains a key to structuring commercial real estate acquisitions and development successfully. As traditional mortgage lenders seldom finance projects at loan-to-value ratios greater than 65%, and often draw the line as low as 55%, funding gaps in capital stacks persist; and the gaps may grow as lending practices become increasingly conservative.

The mezzanine-financing environment has invited innovative, low-cost sources that match a specific real estate project. The challenge is to plan ahead to line up the source of capital whose pricing, timing, and risk profile complement the project. This article focuses on the U.S. Immigrant Investor Program, established under the federal Immigration and Nationality Act, better known as the "EB-5 Program." 8 U.S.C. § 1153(b)(5). The EB-5 Program provides financing at a cost much less than traditional private equity funding. The article intends to familiarize the reader with the use of EB-5 capital as a source of mezzanine funding and review the use of EB-5 capital in combination with federal tax credit programs such as new market tax credits (NMTCs), rehabilitation tax credits (RTCs), and low-income housing tax credits (LIHTCs).

What Is the EB-5 Program?

Congress created the EB-5 Program through the Immigration Act of 1990 to stimulate the U.S. economy through job creation and capital investment. See Immigration Act of 1990, Pub. L. No. 101-649, 104 Stat. 4978. The EB-5 Program allows immigrant investors the benefit of permanent residency in the United States following their investment of at least $1 million in a new commercial enterprise employing at least 10 full-time U.S. workers. For a "targeted employment area" (TEA), the minimum investment is $500,000. 8 C.F.R. §§ 204.6(3), (f). EB-5 investments can take the form of cash, inventory, equipment, secured indebtedness, tangible property or cash equivalents, and are valuated based on a U.S. dollar fair-market value. Id. §§ 204.6(j), (e).

Immigrant investors can invest directly in a company (a "Direct Investment") or in a regional center (a "Regional Center") designated and approved by the U.S. Citizenship and Immigration Services (USCIS). Each investor must demonstrate creation of 10 direct or indirect jobs within two years of an approved I-526, Immigrant Petition by Alien Entrepreneur application. Id. § 204.6(j). At that time, all conditions on the investors' green cards are removed and they may remain here and apply for U.S. citizenship.

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The program has grown in popularity, as each year the number of EB-5 applicants has increased. In 2008, USCIS issued 1,360 EB-5 visas. Four years later, this number increased to more than 4,000 EB-5 visa applications; 80% of these came directly from China, caused in part by the unprecedented economic growth of independently wealthy individuals in that country. In 2013, the United States issued 8,567 EB-5 visas; in 2014, China mainland-born investors constituted 9,128 or 85.4% of the 10,692 grand total in the EB-5 category. The United States is expected to issue a total of 9,005 visas to Chinese investors in 2015. See http://travel.state.gov/content/dam/visas/Statistics/AnnualReports/FY2014AnnualReport/FY14Annual Report-TableV-PartIII.pdf.

When first created by Congress, the EB-5 Program allowed only Direct Investment. Three years later, Congress created the Regional Center program as a five-year pilot to encourage more investors to apply for EB-5 permanent residency (the "Immigrant Investor Pilot Program"). Between 1992 and 2004, 6,024 EB-5 visas were issued, which averaged approximately 500 per year. See U.S. Gov't Accountability Office, GAO-05-256, Immigrant Investors: Small Number of Participants Attributed to Pending Regulations and Other Factors 2 (2005). The U.S. House and Senate passed the fiscal year 2016 omnibus appropriations bill on December 18, 2015, to extend the EB-5 Program to September 30, 2016, with no changes. See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, 161 Cong. Rec. S8844 (daily ed. Dec. 18, 2015), available at www.congress.gov/bill/114th-congress/house-bill/2029.

What Is a Regional Center and How Is One Created?

A Regional Center is typically a limited liability company, limited partnership, or C-corporation that has applied for Regional Center designation from USCIS by filing a Form I-924, Application for Regional Center. The I-924 requires submission of numerous documents including (1) a business plan for an actual, exemplar, or hypothetical project; (2) a business plan for the Regional Center; (3) a project report from an experienced EB-5 economist; (4) a private placement memorandum; (5) a subscription agreement and investor questionnaire; (6) an operating agreement (or partnership agreement, as applicable); and (7) related corporate, loan, securities, and transactional documents prepared by corporate, real estate, and securities counsel.

The time needed to prepare the application ranges from a few weeks to two months, depending on the advance preparedness of the principals and the complexity of the project. The USCIS processing time to review and adjudicate the I-924 can vary from four to 14 months or longer, depending on the quality and complexity of the submission and USCIS backlog.

There are three types of project applications. Each requires the same documentation, but the degree of disclosure, effort, and outcome will differ, as described in further detail below.

Hypothetical Applications

The simplest of the three is the hypothetical project application. A hypothetical project is the only type that would not include a "shovel-ready" project. The USCIS will review the project aspects of the I-924 cursorily without deciding on the project merits. An I-924 application with a hypothetical project can be based on a prior project in the developer's past or a probable future project that is not yet definite. The predictions about job creation, the economic model, the business plan, and offering documents can be

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based on loose assumptions, because the USCIS will not scrutinize the project particulars as with an actual or exemplar application. The hypothetical application makes sense for developers and entrepreneurs who want a Regional Center in a certain geographic area for future projects but do not have any projects shovel-ready. These applications are often approved most quickly, in as little as four to five months.

Actual Applications

The actual application, the most common, is based on an actual shovel-ready project; thus, the business plan and economic analysis describe the actual project, actual capital-investment structures (the offering and corporate documents), sources and uses, and capital stack, evidence of other funding, feasibility studies, permits, licenses, and other supporting documents. An "actual" project means one that is moving forward once the Regional Center can accept EB-5 funds and investors can file their Form I-526, Immigrant Petition by Alien Entrepreneur, to demonstrate that they are in the process of investing or have already invested the required amount of capital in a suitable EB-5 project. The USCIS "pre-approves" the business plan and the economist report, and small changes can be made to those documents and the offering documents as needed before investors file I-526 petitions.

Exemplar Applications

An exemplar application happens when the I-924 application includes a sample I-526 petition for an individual or an I-526 petition for an unnamed investor. It otherwise resembles an actual application but requires the most complete documentation. With an exemplar application, the USCIS "pre-approves" the project materials. Theoretically, once the USCIS approves an I-924 application, the only further documentation it requires for the investor's I-526 is the source of funds. This does not always happen, however, as the USCIS has the authority to re-review the project materials. Still, pre-approval of project materials in an exemplar application gives the Regional Center a distinct marketing advantage, as it can tell investors that the USCIS has "pre-approved" the project.

The Business Plan

Regarding the content of the I-924 or the I-526 petition, each must have a business plan to provide a basis for the USCIS to draw reasonable inferences about the project's viability. The more detailed the business plan, the easier the USCIS can assess the likelihood of success, which will translate to a higher likelihood of approval. The business plan must meet the requirements set forth in *Matter of Ho*, 22 I. & N. Dec. 206 (AAO 1998). The business plan should provide the USCIS with independent evidence to support reasonableness for the construction timeline and construction budget for the size, scope, and location of the project.

All real estate project business plans should include a third-party feasibility report to confirm the project's viability for the applicable geographic market and type of project such as hospitality, commercial, office, apartment, or condominium occupancy. To discourage wastefulness, the USCIS avoids approving projects that create redundancies. Thus, a comprehensive discussion of comparable properties is vital, as is a discussion of the assumptions relied on in calculating pro forma revenue and expenses.

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What Is the Appeal for Foreign Investors?

The EB-5 Program offers a reliable and proven immigration solution for those who have the financial resources to qualify and the fortitude for an at-risk investment; the number of applicants contending for the annual allotment of visas has doubled nearly every year since 2009. EB-5 does not require an employment offer from a U.S. employer, as other employment-based immigration categories do. Nor does it require a labor certificate or any particular business experience, just money to invest. The law does not limit eligibility to certain countries, although immigration authorities are more wary of applicants from countries that have exhibited a pattern of fraudulent applications.

The EB-5 Program investor's spouse and unmarried children under the age of 21 also can receive green cards, as accompanying relatives. EB-5 visas do not include limitations on work or investing as student visas do.

Which Real Estate Projects Are Best for EB-5 Capital?

Real estate developers seeking EB-5 capital are principally motivated by the relatively low interest rates from a pool of investors previously unavailable to them, and no personal guarantees, making it a compelling source of mezzanine capital. In the author's practice at Ballard Spahr, attorneys see rates on EB-5 capital as low as 1% and up to 6%, and occasionally as high as 7%. All real estate projects satisfy EB-5 Program requirements, but some are a much better fit than others, as discussed further throughout this article.

Targeted Employment Area

The first question to ask a real estate developer considering the utility of EB-5 capital for its project is whether the project is located in a TEA. The minimum EB-5 visa program investment can be decreased from $1 million to $500,000 if made in a commercial entity located in a TEA. 8 U.S.C. § 1153(b)(5)(C)(ii); 8 C.F.R. § 204.6(f)(2). The EB-5 project must be either in a rural area or in an area with high unemployment, which means at least 150% of the national average; the U.S. jobless rate decreased by 1.2 percentage points to 6.2% in 2014. Bureau of Labor Statistics U.S. Dep't of Labor, *Regional and State Unemployment—2014 Annual Averages* (Mar. 4, 2015), www.bls.gov/news.release/pdf/srgune.pdf. Thus, the census tract containing the project (plus census tracts surrounding the project if justified by demographics and commuting patterns) must meet or exceed 9.3% in 2015 to qualify for TEA designation.

Although there is no legal impediment to funding projects outside a TEA, very few such projects occur. This is understandable given the higher minimum investment. Investors risk their capital for at least five years. Investors typically do not share in the upside; once their preferred return and capital is returned, their investment is completed.

For these key reasons, investors seek to invest the lowest possible amount in a given project, so most Regional Center projects are found in TEAs. Non-TEA projects occur when the Regional Center or the project can entice investors because of unique appeal, a higher return, or relationships.

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EB-5 Job Creation Requirements

The USCIS requires that EB-5 investments result in creation of 10 full-time jobs for U.S. workers within the two-year period of an investor's receipt of his conditional permanent residency. 8 C.F.R. § 204.6(j)(4)(i)(B). Real estate projects funded through Direct Investments may count only direct jobs; in contrast, real estate projects sponsored through a Regional Center may count indirect jobs and induced jobs (each as defined below) as well, substantially increasing the job numbers. Construction jobs may be counted only if the construction period lasts 24 months or more. Id. § 204.6(e). When it does, job numbers benefit tremendously.

1. 1. Dir*ect Jobs. Di*rect jobs relate to employees who work directly within the commercial entity that received the investment, which requires a permanent 35-hour per week position. Id. Direct construction jobs are included only if the real estate construction period lasts 24 months or more. Construction jobs are easy to prove through a routine construction audit. The construction timeline for this purpose commences when shovels "hit the ground" and continues until the receipt of the temporary certificate of occupancy.
2. 2. Ind*irect Jobs. In*direct jobs are those created in businesses that supply goods or services to the EB-5 project, such as the architects, engineers, real estate brokers, suppliers, sellers of goods needed in the project, and so on. If the project's construction timeline is less than 24 months, only indirect construction jobs can be counted (that is, the amount expended on construction). Id. § 204.6(m).
3. 3. Ind*uced Jobs. In*duced jobs are jobs created within the greater community as a result of income being spent by EB-5 project employees.

USCIS requires the EB-5 petitioner to show that jobs will be created within two and a half years of I-526 approval. If the construction period is nearly 30 months or more, or construction is not slated to start until the EB-5 money is received, these direct operations jobs may not be created within the required time frame, so it is best not to include them in the job creation count when determining how much EB-5 capital to raise.

Preliminary Job Estimate

To assist clients with determining a preliminary estimate of job creation, the following are requested: (1) the type of project; (2) the projected direct job creation; (3) the number of months of construction projected; and (4) the developer's hard and soft construction cost projections. A job estimate can then be provided to assist in determining whether to proceed with EB-5 financing given the amount of capital eligibility and the gap in the project's capital stack.

The Regional Center Structure

Rarely do real estate projects occur by Direct Investment, because such structures make sense only when the capital expenditures are low (as in cases of real estate acquisitions or pre-existing ownership coupled with only minor renovations) but with significant new operational jobs on-site to support the amount of capital sought. In the author's practice, the Direct Investment model works with grocery stores, charter schools, fast food restaurants, and similarly structured projects. The clear appeal of a Regional Center, therefore, is the potential to receive job creation credit for the qualifying hard and soft

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costs undertaken by the project. Thus, although a Direct Investment is a simpler structure for the developer, the project will lose the benefit of the creation of indirect and induced jobs, which is typically a substantial majority of the jobs created by a real estate project.

When sponsored by a Regional Center, the Regional Center typically sets up a special purpose entity (SPE) per real estate transaction. The SPE is considered the new commercial enterprise (NCE), which is required as part of the EB-5 Program. The entity that owns the real estate project is the job creating entity (JCE). The NCE must be a lawful for-profit entity; any privately or publicly owned business structure established after November 29, 1990, will do. Id. § 204.6(e). Older commercial enterprises may qualify, however, if the investment leads to a 40% increase in the number of employees or net worth or if an older business is restructured to such a degree that a new commercial enterprise results. The NCE serves as the "issuer" from a securities standpoint; the EB-5 investors make their capital contribution into the NCE in exchange for an equity interest. In all cases, the capital contribution is an equity "at risk" investment under the private offering memorandum issued by the NCE to the EB-5 investors. Id. § 204.6(j)(2).

How Best to "Use" a Regional Center

Once a developer has cleared the preliminary hurdles of determining that the project is in a TEA and if estimates indicate sufficient job creation, the next significant structuring decision is whether the developer should (1) form its own Regional Center, (2) rent a Regional Center already formed in the geographic area in which the project is located, or (3) seek an arm's length investment from an existing Regional Center in the relevant geographic area. Following is a brief summary of the pros, cons, and costs for each choice.

Forming a Regional Center

The advantages to forming a Regional Center are significant, ranging from economic to strategic, including (1) it eliminates the middleman from receiving a spread between the amount the developer pays on the EB-5 funds for the project and the amount owed to the EB-5 investors and the marketing agents; (2) it provides a valuable asset to the owner of the Regional Center, which can be used to sponsor as many projects as it wishes; (3) only a Regional Center project can count both direct and indirect jobs; (4) the Regional Center format allows for the use of the "loan model" in which the NCE loans money to the developer, as well as the equity model; (5) the developer can set the terms of the loan or equity investment in the project and enjoy maximum structuring flexibility (as long as the terms are still marketable); (6) it offers the ability to sponsor third-party projects for attractive fees; (7) it avoids origination fees and loan closing fees; and (8) it facilitates the ability to control the timing and costs of EB-5 investment.

The downsides to forming a Regional Center are few and include the time and effort required for approval and management of the Regional Center. Costs associated with forming a Regional Center at present are (1) an application fee (currently $6,230) payable to the Department of Homeland Security, (2) fees for a third-party economist report (approximately $12,000–$20,000), (3) legal fees for the offering and loan documents and business plan preparation (approximately $40,000–$100,000), and (4) 2%–3.5% annually on the cost of funds to compensate the migration agents and marketing agents.

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Rent a Regional Center

The advantages of renting a Regional Center are very similar to forming a Regional Center except that the developer does not form a permanent asset; thus advantages subsections (2) and (6) above are not applicable. The distinct advantage is time savings, but an additional downside is the layer of fees to compensate the Regional Center principals and the legal fees to negotiate and document the rental arrangement.

Seek an Investment from an Existing Regional Center

The advantages to receiving an arm's length investment from a Regional Center include (1) avoiding use of the developer's time and personnel to form the Regional Center; and (2) the ability to rely on the Regional Center's time and experience to raise the funds for the EB-5 investment. The downsides relate chiefly to cost: typically 2%–3% more annually to compensate the Regional Center principals, an origination fee of 1.5%–2%, and higher legal fees.

The EB-5 Loan Model

EB-5 capital can take the form of debt or equity from the Regional Center into the project. As equity, the economic terms can appear as a traditional limited partnership investment. As debt, it can be senior or subordinated debt inclusive of terms typical for that capital source, subject to subordination, standstill, and subrogation agreements at the direction of the senior lender. The market average maturity term for an EB-5 investment is five years, with two one-year options to extend by the developer.

Fundraising Do's and Don'ts

As the popularity of EB-5 financing has grown among U.S. real estate developers, especially since the economic downturn in 2008, many "finders" have entered the arena, willing to solicit investments from foreign investors. With an ocean between investors and project, many such finders found a lucrative business. Under the SEC's broker-dealer rules, however, developers and Regional Centers may not pay commissions or finders' fees to people in the United States for helping to sell these securities. See 15 U.S.C. § 78a et seq. Using a person or entity that could be deemed an unregistered broker-dealer to assist with a sale of securities could create a rescission right in favor of the investors under federal securities laws and the securities laws of most states. If investors succeed in exercising their rescission rights, the NCE, as the issuer, would be required to return the money it received from the investors for the purchase of its shares. This is perhaps the most often-violated rule in EB-5 transactions because "finders" by definition do not have a license to sell securities.

A finder is an individual or entity that is not a registered broker-dealer that assists with the fundraising through the offer and sale of securities. A finder crosses the line if

• the finder participates in important parts of the offering, including soliciting, negotiating, or executing the sale of securities,

• the finder's compensation depends on the results or amount of securities sold,

• the finder has a history of executing these offerings, or

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• the finder is involved in offerings for others.

Although the presence of any one of the foregoing is an indicium of broker-dealer activity, the SEC has regularly considered transaction-based compensation as the hallmark of broker-dealer activity. The receipt of transaction-based compensation, coupled with the types of activities listed here, triggers the requirement to register with the SEC as broker-dealers. Entities organized offshore can conduct activities in foreign countries that would otherwise be U.S. broker-dealer activities if their activities comply with the laws of the countries in which they conduct their activities.

Combining EB-5 with Tax Credits

Developers can close a funding gap or reduce the need for other capital by taking advantage of one or more tax credits in addition to EB-5 capital. Tax credit financing can enhance returns significantly or facilitate a transaction that might not otherwise receive sufficient funding or make economic sense. Some federal tax credit programs the author has used in tandem with EB-5 capital include (1) LIHTCs for renovation or construction of affordable housing, (2) Historic Tax Credits for renovation of historic buildings, and (3) NMTC for development in urban and rural low-income census tracts.

Each of these three tax-credit programs is highly compatible with the EB-5 Program because the objectives of each are to rejuvenate and revitalize communities and to stimulate job growth. Developers can use a combination of these and other tax relief programs along with EB-5 for a single project. Tax credits require substantial amounts of advance legal structuring, however, and such structures often require certain holding periods, restrictions on refinancing, and on property sales. The following summarizes these credits.

Low-Income Housing Tax Credit

The LIHTC is a federal program used to finance development of low-income housing by encouraging private capital to invest in federal tax incentives for economic development and development of affordable rental housing. See IRC § 42. Each state's allocation agency issues tax credit allocations to applicant developers who sell the tax credits to private investors. The LIHTC allows taxpayers, either third-party investors or partners of the project, to subsidize either 30% (with the "4% credit") or 70% (with the "9% credit") of eligible costs for development of low-income units in a rental housing project. Id. § 42(b). The 9% credit is limited annually (allocated to each state based on population), thus making it a competitive, interstate allocation process. The 4% credit is not limited annually but rests on the obtainability of a determined volume cap for private activity bonds that must finance at least 50% of the total development cost. The LIHTC is claimed by the taxpayer pro rata over 10 years and can be used in connection with both new construction and renovation of residential rental units. Id. § 42(b)(1)(B).

Historic Tax Credits

If a certified historic building constructed before 1936 is being renovated, the project may receive rehabilitation tax credits from the federal government for up to 20% of qualified rehabilitation expenditures. Id. § 47. Most owners syndicate the tax credits to a third-party corporate investor. Structuring the historic tax credit requires the use of the EB-5 funds as permanent financing.

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New Market Tax Credits
Comparable to the EB-5, the NMTC program finances community development projects, stimulates economic growth, and creates jobs in underserved communities. Id. § 45D(d)(1). Providing evidence of job creation and other community benefits is crucial to receiving this competitive tax credit. The NMTC was designed to give private investors the financial incentive to invest in low-income communities. Id. § 45(D)(e). The federal government awards NMTCs based on the size and equity commitments of qualified investor groups. Projects that have typically received NMTC allocations include renovations or construction of office buildings, commercial and retail buildings, shopping centers, hotels, art centers, charter schools, hospitals, college campuses, high-tech and biotech facilities, homeless shelters, transitional housing, facilities to assist educating the homeless, and homeownership assistance. In general, the NMTC benefit ranges from 15% to 25% of total project costs, assuming that the deal is structured efficiently and enough NMTC credit allocation can be identified. Id. § 45D(a)(2)(A)-(B).

In addition, many municipalities provide tax-increment financing (TIF) and tax abatements to stimulate economic development and growth, which can be readily combined with EB-5 capital, as can bonds and other public financing. Further, the author completed a financing that combined an EB-5 loan with a senior loan guaranteed by the Department of Housing and Urban Development.

Conclusion
The availability of EB-5 capital and tax credits can bridge the gaps in the capital stack and allow a project to have an achievable return on investment and be fully funded. The investment from EB-5 sources can take various forms, including an equity investment in the form of a Direct Investment from the foreign investors or a Regional Center, or a loan from a Regional Center that the developer owns, rents, or receives on an arm's length basis. Incorporating EB-5 financing facilitates LIHTC housing rental projects while providing an incentive for private developers to make affordable rental housing available. As more states and cities realize the benefits of EB-5 to supplement their traditional funding efforts, the author anticipates an increase in the number of housing authorities and other public entities creating a Regional Center or partnering with an existing center to provide EB-5 financing to leverage these sources of foreign dollars. n

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