

# NIXON PEABODY<sub>LLP</sub>

## New Markets Tax Credits Overview

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### Background

In December 2000, Congress passed the Community Renewal Tax Relief Act of 2000, creating the New Markets Tax Credit (“NMTC”) program to encourage investments in low-income communities – to provide a tax incentive for community development lenders and the capital markets to invest in those communities that historically have had poor access to capital. The Community Development Financial Institutions Fund (“CDFI Fund”), a branch of the Department of the Treasury, administers the program and prescribes the rules for qualifying for the NMTC. Initially, the CDFI Fund was authorized to allocate NMTCs on \$15 billion of equity investments through 2007. In December 2005, Congress passed the Gulf Opportunity Zone Act of 2005 and authorized an additional \$1 billion of allocation authority to be used for the recovery and redevelopment of the Gulf Opportunity Zone (“GO Zone”). Most recently, in December 2006, Congress passed the Tax Relief and Health Care Act of 2006 and extended the NMTC program through 2008 and provided for an additional \$3.5 billion of allocation authority to be awarded in 2008.

To date, through five competitive general allocation rounds and one GO Zone allocation round, the CDFI Fund has made awards totaling \$16 billion in allocation authority to 294 organizations.

Each of the allocation rounds have been very competitive. The CDFI Fund has selected CDEs who promise to deliver the maximum subsidy to people and areas of deepest economic need. In 2007, for example most applicants committed to make investments in areas characterized by more severe economic distress (i.e., areas that have significantly higher poverty rates and lower median family incomes than those minimally required under the NMTC Program; areas that have unemployment rates at least 1.5 times the national average; and/or areas that have been designated for economic development through other governmental programs such as Brownfields, Empowerment Zones and Renewal Communities).

The application period for the fifth allocation round (2007) concluded in early March 2007. There were 258 applications received by the CDFI Fund for the \$3.9 billion of allocation authority available (including \$400 million that will be awarded specifically GO Zone applicants). The aggregate NMTC allocation authority requested was \$27.9 billion (of which \$5.8 billion was requested by 42 of the 258 applicants for GO Zone allocations). The awards of NMTC allocation authority for the fifth allocation round were announced on October 5, 2007.

Beginning in the sixth allocation round (2008), Congress has increased the level of competition by requiring that rural areas receive a proportional amount of investment under the NMTC program. The CDFI Fund will now ensure that the pool of allocatees will, in the aggregate, make at least 20% of their qualified investments in Non-Metropolitan Counties (counties not contained within a “Metropolitan Statistical Area”). In addition, the CDFI Fund will ensure that the pool of allocatees includes a significant number of “Rural CDEs” (discussed below).

### New Markets Tax Credit

The NMTC is a 39 percent tax credit that is claimed over six years and one day with respect to investments in qualified community development entities (“CDEs”). In the year in which equity is invested in a CDE the investor receives a tax credit equal to 5 percent of the invested amount. In each of the next two years, the investor receives a tax credit equal to 5 percent of the invested amount. In each of the subsequent four years, the investor receives a tax credit equal to 6 percent of the invested amount.

### Community Development Entities

In order for investments to qualify for NMTCs, they must be made in specially created entities that are certified by the CDFI Fund as CDEs. A CDE may be formed as a corporation, a partnership, or a limited liability company classified as either an association or a partnership for federal tax purposes. An entity must meet three requirements to become a CDE:

1. its primary mission must be to serve, or provide investment capital for Low-Income Communities (as defined below) or low-income persons;
2. it must have a governing board or advisory board that maintains accountability to residents of such communities; and
3. it must be certified as a CDE by the CDFI Fund.

In order to apply for NMTC allocation authority, sponsors must either form a CDE or use an existing entity which meets these tests and apply for certification by the CDFI Fund. An organization is able to be certified solely on its own behalf or it may apply on behalf of itself and one or more subsidiary entities. In total there currently are more than 2,500 organizations that have been certified by the CDFI Fund as CDEs. In addition, Community Development Financial Institutions automatically qualify as CDEs, though their subsidiaries are required to apply for certification.

Beginning in the sixth allocation round (2008), the CDFI Fund will ensure that “Rural CDEs” are represented among the pool of NMTC allocatees. A Rural CDE is a CDE that has dedicated at least 50 percent of its activity for the preceding five years to Non-Metropolitan Counties and has committed to conducting at least 50 percent of its future NMTC activities in such areas.

### Certification as a CDE

Each applicant must provide specific information regarding its primary mission, which must be stated in its governing documents. The CDE must be able to demonstrate that at least 60 percent

of its activities are dedicated to serving directly low-income communities or low-income persons. If a CDE has subsidiaries, a CDE may submit to the CDFI Fund a single certification application for itself and its subsidiaries, though each subsidiary must separately meet the standards for qualifying as a CDE.

In addition, a CDE must demonstrate that it maintains accountability to residents of low income communities through their representation on a governing board or an advisory board for the CDE. At least 20 percent of the governing board or advisory board members must be representative of a low-income community (but not necessarily a resident in the community). In cases where a CDE is intended to serve a number of low-income communities, the persons on the board must be representative of those areas. For a national CDE, which will intends to make investments in many areas, it may be necessary to have advisors who have experience with national organizations.

### Qualified Low-Income Community Investments

Substantially all of the dollars invested in a CDE that are designated as qualified equity investments for NMTC allocation authority must be used by the CDE to make qualified low-income community investments (“QLICs”). These QLICs must meet one of four criteria:

1. a loan or equity investment in a qualified active low-income community business (“Qualified Business”);
2. equity investments in or loans to another CDE;
3. the purchase from another CDE of its loan to a Qualified Business; or
4. providing financial counseling or other services to businesses or residents of a Low-Income Community.

A Qualified Business can be a corporation (including a nonprofit corporation), a partnership, or a sole proprietorship and must generally meet the following two eligibility requirements: (1) it must be located in a Low-Income Community; and (2) it must have a substantial connection to that Low-Income Community.

A business will have a substantial connection to the Low-Income Community if at least 50% of the business’s tangible property is located in the community; and the employees of the business perform at least 50% of their services in the community. A Qualified Business includes, among other things, the rental of improved commercial real estate located in a low-income community (e.g., retail centers, manufacturing facilities, commercial facilities, health care facilities). However, rental of residential property or unimproved land do not qualify as Qualified Businesses. Rental of property which is mixed residential and commercial may be a Qualified Business if the gross income from the residential units is less than 80% of the total gross rental income of the property.

Investments in Qualified Businesses whose activities involve certain “targeted populations” who are either low-income persons or individuals who otherwise lack adequate access to capital may also qualify for tax credits. In June 2006, the IRS published Notice 2006-60, which provides an alternative to the tangible property, employee and services tests described above for targeted

populations. Under the targeted populations rule, Qualified Businesses may either have (1) 50% of their gross income from transactions involving low-income persons, (2) 40% of their employees be low-income persons; or (3) 50% of the entity be owned by low-income persons. A similar rule applies for all individuals, regardless of income level, who lost their principal source of employment or were displaced from their principal residence as a result of Hurricane Katrina.

### Low Income Communities

In order to qualify for NMTCs, an investment must be made to a business in a Low Income Community. This is defined, in general, as a census tract where there is a poverty rate of at least 20% or a census tract with a median income that does not exceed 80% of the comparable area median income. If the census tract is not in a metropolitan area, it must have a median income of no more than 80% of the statewide median income. If the census tract is within a metropolitan area, it must have a median income of not more than 80% of the metropolitan area median income or, if greater, the statewide median income. On the CDFI Fund's website ([www.cdfifund.gov](http://www.cdfifund.gov)), the entire United States has been mapped to show all qualifying census tracts. It is expected that if an investment is made in a Qualified Business and the census tract in which it is located loses its low income status during the period of the investment, the investment will remain qualified.

### How the NMTC Program Works

Once an entity has requested certification as a CDE, it can apply for an allocation of NMTCs from the CDFI Fund. A CDE which is applying for an allocation may be formed as either a nonprofit corporation or a for-profit entity. However, if the CDE is a nonprofit corporation and is awarded an allocation of NMTCs, it must form at least one subsidiary for-profit entity that gets certified as a CDE, transfer its allocation to such entity such that investors invest in the subsidiary entity in exchange for allocations of NMTCs (since the NMTCs are linked to the equity investment). If a CDE is selected for an allocation of NMTCs, it must enter into an Allocation Agreement with the CDFI Fund before it can offer NMTCs to investors. The Allocation Agreement will generally include the amount of the NMTC allocation, the permitted uses for the invested amounts, the approved service area(s) in which the QLICIs may be used, the CDE's schedule for obtaining equity investments from investors, certain reporting requirements, as well as a listing of any subsidiary CDEs to which the NMTC allocation authority may be transferred.

It should also be noted that an entity that is qualified as a CDE may participate in the NMTC program through lending activity to Qualified Businesses without ever applying for an allocation of NMTCs. If the CDE makes loans to Qualified Businesses, these loans can be purchased by other CDEs which have received an allocation of NMTCs. In addition, a CDE which has an allocation of NMTCs may make a direct equity investment in another CDE which does not have an allocation, and this will also qualify as a qualified investment by the NMTC allocate and permit the non-applying CDE to participate in the program.

Following the receipt of an award of allocation authority, a CDE is given 5 years to obtain equity investments in exchange for its NMTCs. If the CDE fails to obtain equity investments for all or

part of its allocation within 5 years, the unused portion of the allocation will terminate. In addition, the cash invested in the CDE must be used by the CDE in a QLICI within 12 months of the date the CDE receives the cash investment.

As noted above, only equity investments in a CDE will qualify for NMTCs. Because the amount of tax credit is based on the size of the equity investment in the CDE (and because they will return less than half of the amount of the investment), an investor who expects to receive a market rate return will either need to obtain an additional cash return on its investment, or leverage its investment with borrowed funds.

### Leveraging Equity Investments

In a 2003 Revenue Ruling, the IRS confirmed that equity investments in a CDE could be funded with a combination of tax credit investor equity and debt. It is expected that the use of this leveraged structure will result in more equity, especially for larger investment pools. One advantage of this structure is that those investors who are able to price the tax credits as the sole return on their investment can generally do so with only the tax recapture as a risk, and those investors who need to receive a cash return can focus more on the economic risks of the investments in the qualifying businesses.

This leveraged structure works as follows, as shown on the attached chart. Under the NMTC Program, \$39 of tax credits are earned over a 7 year period on every \$100 invested in a CDE. Under present conditions, the capital markets may price the equity which can be raised solely from these credits at between \$25 and \$30. This would leave the CDE to raise the rest of the \$100 in debt, at a market rate. For example, the CDE forms an Investment Fund and raises \$30 in tax credit equity and \$70 in debt. The Fund then invests all \$100 of proceeds in a CDE that makes loans to the desired projects. The Fund, which is composed of a Managing Member with a 0.01% interest and a Tax Credit Investor with a 99.99% interest, allocates 99.99% of the credits to the Investor. All of the cash that the Fund receives from the CDE in return of the Fund's equity in the CDE will first be used to first repay the \$70 loan to the Fund. The CDE lender has made between \$90 and \$100 in loans to a qualifying project or business, so the interest rate on the CDE's loans can be lower than the lender to the Fund.

### Recapture Rules

The recapture rules track the 7 year period of the credit ("Compliance Period"). If during this period the CDE ceases to be qualified as a CDE, then any NMTCs previously claimed are recaptured. In addition, the NMTCs will be recaptured if the CDE redeems the investor's equity during the Compliance Period. Finally, if the CDE ceases to meet the test that "substantially all" (typically 85%) of the proceeds are invested in Qualifying Businesses within 12 months of their receipt, the NMTCs are recaptured, though a CDE is permitted 6 months to cure a failure of the substantially all requirement.

### Investors Eligible for the New Markets Tax Credits

Any taxable investor that makes an equity investment in a qualified CDE is eligible for the NMTCs. This includes, for example, individuals, corporations, partnerships, and investment funds. However, the NMTCs, (similar to the credits for low-income housing or historic rehabilitation), will not offset alternative minimum tax liability, and may be subject to limitations by, among other things, the passive activity or at-risk limitations.

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**CHART 1**

**NEW MARKETS TAX CREDIT**

**LEVERAGED STRUCTURE**

