

NEW MARKETS TAX CREDITS

Lewis Horowitz, Esq.¹
Karen Williams, Esq.²

I. Introduction

New Markets Tax Credits are available through a program established by Congress in 2000³. The authors have placed extensive information about New Markets Tax Credits on a website, "nmtcprogram.com."

The legislation authorized tax credits equal to 39 percent of a total of \$15,000,000,000 in equity investments in qualified Community Development Entities. The program is administered by the Community Development Financial Institution Fund, within the U. S. Treasury Department (the "CDFI Fund").

The purpose of the program is to encourage private equity investment in qualified low-income community development projects, through federal income tax credits. While this rough concept is similar to Federal Low-Income Housing Tax Credits ("LIHTC"), the actual structure of the New Markets Tax Credits program is quite different from the housing program. Participants should not assume that successful LIHTC business plans will be transferable to New Markets Tax Credit activity.

New Markets Tax Credits are allocated by an award of a qualified dollar amount of equity investment, for which investors receive tax credits over a seven-year period in an amount equal to 39% of the equity investment. The equity is placed in a Community Development Entity, not in an individual project or activity. This is only one of many areas in which these tax credits are significantly different from LIHTCs. In the LIHTC program, the tax credits are determined by the cost of the project, they are realized over a longer period of time, and the effect on the investor's basis is handled differently. Thus, the value

¹ Lewis M. Horowitz is chair of the Tax section of the Portland, Oregon office of Lane Powell PC. His practice focuses on planning and controversy resolution relating to federal income tax matters.

² Karen M. Williams is a partner in the Portland, Oregon office of Lane Powell PC. Her practice focuses on public / private financing, redevelopment and community development, and urban renewal.

³ The New Markets Tax Credit provision was added to the Internal Revenue Code under section 45D by section 121(a) of the Community Renewal Tax Relief Act of 2000 (Pub. L. 106-554).

calculation for New Markets Tax Credits is not the same as the methodology used for LIHTCs.

The Community Development Entity avoids recapture by investing substantially all of its assets into eligible projects and activities, during the seven-year compliance period. For these purposes, there is a safe harbor of 85% of gross assets, to meet the "substantially all" test.⁴

There are several alternative approaches to utilizing New Markets Tax Credits. Some sponsors may elect to form and qualify a Community Development Entity, and propose a single project or undertaking for a credit allocation. Sponsors already qualified as Community Development Financial Institutions may qualify as Community Development Entities easily, and could apply for an allocation that would generate equity investments in support of their community development programs.

Another approach is to develop a broad community development strategy that utilizes combined sources of funding in order to accomplish a blend of small business lending, marquee projects, venture capital participation, and related community development activities. This strategy enables the sponsor to leverage equity investments with conventional loan capital, and manage the total proceeds with a fund approach. This method allows the sponsor to blend market rate and higher-risk subsidized transactions in order to diversify the types of projects and activities that may be funded with New Markets Tax Credits.

II. The Community Development Entity

New Markets Tax Credits ("NMTCs") are awarded to qualified Community Development Entities ("CDEs"). An entity must meet certain criteria to be eligible to receive an award:

- *Legal Structure:* Non-profit and for-profit domestic corporations or partnerships that are duly organized and validly existing under the laws of the jurisdiction in which they are incorporated or established to apply for CDE status, may apply for an allocation of tax credits⁵. Only one application may be filed for an allocation to a parent and its subsidiary entities. Since non-profits cannot utilize tax credits, their application for an allocation must include their plan for reallocating any award they receive to for-profit subsidiaries. The subsidiaries must be approved CDEs, though they are not required to be created entities or to have CDE status at the time the allocation

⁴ 66 Fed. Reg. 66311 (December 26, 2001).

⁵ 67 Fed. Reg. 40116 (June 11, 2002).

application is made.⁶ The fact that entities may be treated as separate for purposes of allocation and transfer of allocation does not necessarily mean they will be treated as separate for federal income tax purposes. This is an important issue that applicants should discuss in detail with their tax counsel before an application is made. The CDFI Fund is not obligated to approve a transfer of credits to a subsidiary. Transfers must be incorporated into the allocation agreement between the applicant and the CDFI Fund, and approval of a transfer is in the sole discretion of the CDFI Fund.

- *Primary Mission:* An applicant entity must demonstrate that it has a primary mission of serving, or providing investment capital for, low-income communities or low-income persons, and that at least 60% of its activities are targeted to low-income persons or low-income communities.
- *Accountability:* The applicant must identify a qualifying geographic service area and demonstrate that it maintains accountability to the residents of the low-income communities in that area. To demonstrate accountability, the CDE must establish a board (governing or advisory, depending on CDE structure) in which at least 20% of its members represent the low-income communities within the service area. Board members can represent the community either by being a resident of a low-income community in the service area, or representing the interests of the residents of such communities. Representation for these purposes includes owning a business in the community, or serving as an employee or board member of an organization that serves the community. CDEs are encouraged to appoint some board members who are low-income persons from low-income communities. If a CDE establishes an advisory board, accountability is also achieved in the way the advisory board operates: how often it meets, how it solicits community feedback, and how the governing board uses the advisory board's recommendations to inform its actions.

Community Development Financial Institutions ("CDFI") or Specialized Small Business Investment Companies ("SSBIC") will be deemed to be CDEs and may request certification as a CDE via the Internet.⁷ An entity that is not an SSBIC or a CDFI must complete an application form and demonstrate satisfaction of the criteria.

III. Application Process and Timelines

After an entity receives status as a CDE, it must make a competitive application for an allocation of NMTCs. Applications may be submitted in hard

⁶ *Id.*

⁷ 66 Fed. Reg. 21847(May 1, 2001).

copy if the CDFI Fund approves a request to do so, but generally the application process is all on-line.⁸ Since reporting and other activities must be done electronically, paper applications are strongly discouraged. The online process limits space for most replies and does not allow attachments or exhibits, except for those that are required to be submitted by mail.

Entities that are not certified as CDEs have to apply for that status before the NMTC application deadline in order to be recognized and still have time to make an allocation application, though CDE certification is rolling. Entities wishing to participate in future allocations may apply for CDE certification at any time. Also, entities desiring to receive investments of NMTC proceeds from CDEs, or to sell loans to them, may find this easier to do if the recipient is a CDE. There are good reasons for entities who do not intend to apply for an allocation to nonetheless pursue CDE status, which is relatively simple to do.

The application form includes applicant instructions, requirements for assurances and certifications, general information, and a glossary. The substantive material is divided into four parts:

I. Business Strategy, which includes: Products, Services, and Investment Criteria; Prior Performance; Prior Performance in Disadvantaged Communities or with Disadvantaged Businesses; Projected Business Activities; and Investments in Unrelated Entities.

II. Capitalization Strategy, which includes: Investor Commitments; Investor Strategy; Sources of Capital; and Flow of Allocations

III. Management Capacity, which includes: Management Team; Experience Deploying Capital or Services; Experience Raising Capital; Asset Management and Risk Management Experience; and Program Compliance.

IV. Community Impact, which includes: Targeting the Use of QEI Proceeds within Low-Income Communities; Community Accountability; and Economic Impacts.

The application form provides a series of exhibit tables to be completed by the applicant, and the following glossary of key terms⁹:

⁸ The contact information is: (by mail) CDFI Fund, 601 13th Street, NW, Suite 200 South, Washington, DC 20005; (by e-mail) cdfihelp@cdfi.treas.gov; (by telephone) (202) 622-7373; (by facsimile) (202) 622-8911.

⁹ See: 66 Fed. Reg. 65806 (December 20, 2001); 66 Fed. Reg. 66311 (December 26, 2001).

"Affiliate Any legal entity that Controls, is Controlled by, or is under common Control with, the Applicant.

Allocatee An Applicant that receives a NMTC Allocation.

Allocation Agreement An agreement to be entered into by the Fund and a CDE, relating to the NMTC Allocation, pursuant to IRC §45D(f)(2).

Applicant Any legal entity that is applying to the Fund for the receipt of a NMTC Allocation. This term includes any Subsidiary of the Applicant which may receive a transfer of all or part of a NMTC Allocation from the Applicant.

Allocation Application The application form, issued by the Fund pursuant to a Notice of Allocation Availability (NOAA), to be completed and submitted by an Applicant in order to be considered for a NMTC Allocation.

Authorized Representative An officer, or other individual, who has the actual authority to sign for and make representations on behalf of the Applicant.

CDE Certification Application The application form, issued by the Fund, to be completed and submitted by an entity in order to be certified as a CDE.

Community Development Entity (CDE) Under IRC §45D(c)(1), any domestic corporation or partnership if:

(1) The primary mission of the entity is serving, or providing investment capital for, Low-Income Communities or Low-Income Persons;

(2) The entity maintains 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; and

(3) The entity is certified by the Fund as a CDE. Specialized Small Business Investment Companies (SSBICs) and Community Development Financial Institutions (CDFIs) are deemed to be CDEs in the manner set forth in Guidance published by the Fund (66 Federal Register 65806, December 20, 2001).

Community Development Financial Institution (CDFI) An entity that has been certified by the Fund as meeting the criteria set forth in section 103 of the Community Development Banking and Financial Institutions Act of 1994 (12 U.S.C.4702). For further details, refer to the CDFI Program regulations set forth at 12 CFR 1805.201.

Control is defined as:

(1) Ownership, control, or power to vote more than 50 percent of the outstanding shares of any class of voting securities of any entity, directly or indirectly or acting through one or more other persons;

(2) Control in any manner over the election of a majority of the directors, trustees, or general partners (or individuals exercising similar functions) of any other entity; or

(3) Power to exercise, directly or indirectly, a controlling influence over the management policies or investment decisions of another entity, as determined by the Fund.

Controlling Entity An entity that Controls an Applicant.

Disadvantaged Business A business that is (a) located in a Low-Income Community; or (b) is owned by a Low-Income Person; or (c) a business that has inadequate access to investment capital.

Disadvantaged Community This term has the same meaning as a Low-Income Community.

Equity Investment Under IRC §45D(b)(6) and the Temporary and Proposed Income Tax Regulations, equity investment means any stock (other than nonqualified preferred stock as defined in IRC §351(g)(2)) in an entity that is a corporation and any capital interest in an entity that is a partnership.

Financial Counseling and Other Services Advice provided by a CDE relating to the organization or operation of a trade or business. See 26 CFR 1.45D-1T(d)(7).

Low-Income Community Under IRC §45D(e)(1), any population census tract if:

(1) The poverty rate for such tract is at least 20 percent, or

(2) (a) In the case of a tract not located within a Metropolitan Area, the median family income for such tract does not exceed 80 percent of statewide median family income, or (b) in the case of a tract located within a Metropolitan Area, the median family income for such tract does not exceed 80 percent of the greater of statewide median family income or the Metropolitan Area median family income.

With respect to IRC §45D(e)(1)(B), possession wide median family income shall be used (in lieu of statewide income) in assessing the status of census tracts located within a possession of the United States. Upon an entity's application for certification as a CDE, the Fund may designate under IRC §45D(e)(2) an area within a census tract as a Low-Income Community if:

(1) The boundary of the area is continuous;

(2) The area would otherwise meet the definition of a Low-Income Community under IRC §45D(e)(1) if it were a census tract; and

(3) There is inadequate access to investment capital in the area (as demonstrated by studies, surveys, or other analysis provided by the Applicant).

Under IRC §45D(e)(3), in the case of an area that is not tracted for population census tracts, the equivalent county divisions (as defined by the Bureau of the Census for purposes of determining poverty areas) shall be used for purposes of defining poverty rates and median family incomes.

Low-Income Person Any individual having an income of not more than:

(1) For non- Metropolitan Areas, 80 percent of the statewide median family income; and

(2) For Metropolitan Areas, the greater of (a) 80 percent of the statewide median family income or (b) 80 percent of the Metropolitan Area median family income.

Metropolitan Area An area designated as such by the Office of Management and Budget pursuant to 44 U.S.C. §3504(e) and 31 U.S.C. §1104(d) and Executive Order 10253 (3 CFR 1949-1953 Comp., p. 758), as amended.

New Markets Venture Capital Company (NMVCC) An entity designated as a NMVCC by the Small Business Administration under the New Markets Venture Capital Company Program. See 13 CFR 108.10 for more information.

Notice of Allocation Availability (NOAA) A document published by the Fund in the Federal Register that provides specific guidance on how a CDE may apply for a NMTC Allocation, the competitive procedure through which such allocations will be made, and the actions that will be taken by the Fund to ensure that proper allocations are made to appropriate entities. The NOAA published in conjunction with the 2002 Allocation will only apply to the 2002 allocation year.

NMTC Allocation An allocation of tax credit authority pursuant to the New Markets Tax Credit Program.

Qualified Active Low-Income Community Business (QALICB) Under IRC §45D(d)(2), any corporation (including a non-profit corporation) or partnership if for such taxable year:

(1) At least 50 percent of total gross income of such entity is derived from the active conduct of a qualified business within any Low-Income Community;

(2) A substantial portion of the use of the tangible property of such entity (whether owned or leased) is within any Low-Income Community;

(3) A substantial portion of the services performed for such entity by its employees are performed in any Low-Income Community;

(4) Less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles (as defined in IRC §408(m)(2)) other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and

(5) Less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property (as defined in IRC §1397C(e)).

Please refer to the Temporary and Proposed Income Tax Regulations at 26 CFR 1.45-1T(d)(4) for more information.

Qualified Equity Investment (QEI) Under IRC §45D(b)(1), any Equity Investment in a CDE if:

(1) Such investment is acquired by the investor at its original issue (directly or through an underwriter) solely in exchange for cash;

(2) Substantially all of such cash is used by the CDE to make QLICIs; and

(3) The investment is designated for purposes of IRC §45D by the CDE as a QEI. QEI also includes an Equity Investment purchased from a prior holder, to the extent provided in IRC §45D(b)(4). QEI does not include any Equity Investment issued by a CDE more than five years after the date the CDE receives a NMTC Allocation.

Please refer to the Temporary Proposed Income Tax Regulations at 26 CFR 1.45-1T(c) for more information.

Qualified Low-Income Community Investment (QLICI) Under IRC §45D(d)(1), a QLICI is:

(1) Any capital or Equity Investment in, or loan to, any QALICB(as defined in IRC§45D(d)(2));

(2) The purchase from a CDE of any loan made by such entity that is a QLICI;

(3) Financial Counseling and Other Services to businesses located in, and residents of, Low-Income Communities; and

(4) Any Equity Investment in, or loan to, any CDE.

Please refer to the Temporary and Proposed Income Tax Regulations at 26 CFR 1.45D-1T(d)(1) for more information.

Specialized Small Business Investment Company (SSBIC) An entity defined in IRC §1044(c)(3).

Subsidiary Any legal entity that is owned or Controlled directly or indirectly by an Applicant. This term includes series funds, which are separate investment funds Controlled by an Applicant.

Temporary and Proposed Income Tax Regulations The temporary and proposed regulations promulgated by the Internal Revenue Service which provide guidance for taxpayers claiming the New Markets Tax Credit under IRC §45D.

See 26 CFR 1.45D-1T for more information.

Unrelated Persons who are not related within the meaning of IRC §267(b) or IRC §707(b)(1)."¹⁰

IV. Utility and Utilization

The proceeds of NMTC equity investments may be used in qualified Low-Income Communities.

After receipt of the allocation, the CDE will have five years to issue equity investments or the unused portion of the allocation will terminate. The CDE must ensure that substantially all of its assets are invested in qualifying investments (QLICIs), a requirement which may be met by meeting the safe harbor of assuring that 85% of its aggregate gross assets are invested in qualified activities. The CDFI Fund may recapture the tax credit if the CDE fails to meet the program requirements for investment and reinvestment of returned capital. Returned capital must be reinvested within twelve months of receipt, as long as the twelve months will terminate within the 7-year compliance period (capital returned to the CDE in the 73rd month or later, probably need not be reinvested).

Investments of funds raised through NMTCs must be made in qualified Low-Income Communities. Those investments may consist of:

- any loan or equity investment in any qualified Low-Income Business;
- the purchase from another CDE of any loan made by such entity that is a qualified Low-Income Community investment;
- technical assistance to help in the organization or operation of a business in Low-Income Communities;

¹⁰ *New Markets Tax Credit Application Form*, cdfifund.gov

- investments in other CDEs that are making investments or providing technical assistance in Low-Income Communities to Low-Income Businesses and Low-Income Persons.

A qualified Low-Income Business:

- derives at least 50% of its income from doing business in the Low-Income Community, or
- 40% of the low-income business is located in the Low-Income Community, or
- 40% of the services provided by the company's employees are provided in the Low-Income Community.

V. Additional Resources

Our New Markets website is nmtcprogram.com, where you will find copies of the statutes and regulations, information and application materials for forming CDEs, information and application materials for allocations, and comments and updates regarding new regulations and other actions by the CDFI Fund or the IRS. The CDFI Fund's website is cdfifund.gov.