New Markets Tax Credit Program

Development in low-income communities is a challenge because rents typically do not cover operating costs, debt service, and a return to the developer. To address this problem, Congress created the new markets tax credit (NMTC) program to encourage private investment in low-income communities. This tool, established through the Community Renewal Tax Relief Act of 2000, gives individual and corporate taxpayers credit against federal income taxes for making qualified equity investments (QEIs) in community development entities (CDEs). The program is administered by the Treasury’s Community Development Financial Institutions (CDFI) Fund.

To offer tax credits to investors, an organization must be certified as a CDE by the CDFI Fund and must be selected to receive an NMTC allocation during a competitive allocation round. A CDE then obtains a QEI from an investor. After making the QEI, the investor is able to claim a tax credit of 39 percent of the QEI over seven years according to a schedule established by the CDFI Fund. For the investor to claim the tax credit, a CDE must use “substantially all” — generally 85 percent — of the QEI proceeds to make qualified low-income community investments (QLICIs).

A QEI must be composed entirely of equity. In a “leveraged” financial structure, a QEI can be provided by a pass-through entity (i.e., an investor partnership) that has combined both debt and equity to finance the QEI. In this case, the lender and investor can be the same entity or different entities. There can also be more than one lender or investor. This structure has advantages for both the investor and lender. The investor is able to claim tax credits for the total amount of the QEI, not just the equity portion; thus, the equity is leveraged. The loan-to-value ratio is more favorable for the lender than if equity had not been included with the loan.

The four eligible types of QLICIs are: (1) loans to or investments in qualified active low-income community businesses (QALICBs); (2) qualified loans purchased from other CDEs; (3) certain loans to or investments in other CDEs; or (4) financial counseling or other services. To date, the vast majority — over 95 percent — of QLICIs have been in the form of loans to or investments in QALICBs. QALICBs may use the loans to develop real estate, purchase fixed assets, or serve as working capital. CDEs have also developed revolving loan funds to make eligible loans to several QALICBs simultaneously, often at below-market interest rates.

NMTC projects have ranged from small business loans under $100,000 to multi-million dollar real estate investments. NMTCs are most frequently used for real estate projects, such as charter schools, grocery stores, health-care facilities, shopping centers, and office buildings. NMTCs may be used to develop for-sale housing. Certain mixed-use projects that include rental units are permitted, as long as no more than 80 percent of the property revenue is from the rental units.

Other government programs and incentives, including historic rehabilitation tax credits, brownfields tax incentives, Empowerment Zone and Renewal Community incentives, and state and local tax abatements have been used in conjunction with NMTCs.

The CDFI Fund is authorized to allocate $19.5 billion in tax credit authority through 2008, which includes $1 billion specifically allocated to CDEs with a significant mission of redevelopment in the Hurricane Katrina Gulf Opportunity Zone.

The application process for NMTCs is highly competitive. During the first four rounds, the CDFI Fund received 1,078 applications requesting over $108 billion in allocation authority. During this time, the CDFI Fund made 233 awards totaling $12.1 billion in tax credit authority.

This program has proven successful in attracting new investment dollars to low-income communities. The CDFI Fund reported that as of May 2007, the program had generated $7.7 billion of investments for CDEs serving these communities. Also, through fiscal year 2005, the program had generated financing for the construction or rehabilitation of over 43 million square feet of real estate and had helped to create or retain 72,000 construction jobs and 20,000 full-time equivalent jobs in businesses in low-income communities.

The CDFI Fund will allocate the remaining $7.4 billion of tax credit allocation authority in 2007 and 2008. In April 2007, bills were introduced in the U.S. Senate and House of Representatives to extend the NMTC program from 2009 through 2013, with $3.5 billion in allocation authority per year.
Purpose
To encourage private investment in low-income communities by providing individual and corporate taxpayers with a credit against federal income taxes for making qualified equity investments (QEIs) in community development entities (CDEs).

CDE Eligibility
An organization must meet the following requirements to be certified as a CDE by the CDFI Fund:
- Be a domestic corporation or partnership at the time of the application;
- Have a primary mission of serving or providing investment capital for low-income communities or low-income persons; and
- 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.

A CDFI certified by the CDFI Fund or a specialized small business investment company (SSBIC) designated by the U.S. Small Business Administration automatically qualifies as a CDE.

Low-Income Communities
Generally includes any census tract in which:
- The poverty rate for the tract is at least 20 percent; or
- The median family income for the tract does not exceed 80 percent of the statewide median family income. (Note: Within a metropolitan area, the criteria vary slightly. The median family income must not exceed 80 percent of the greater of the statewide median family income or the metropolitan area median family income.)

Targeted populations, as defined by the IRS, are also eligible for NMTC investments.

Qualified Equity Investments (QEIs)
Investors make QEIs into CDEs by purchasing stock or capital interest in the CDE.

Tax Credit
By making QEIs, investors receive a tax credit. Investors can claim 39 percent of the original investment over seven years as follows:
- Years One to Three: 5 percent/year
- Years Four to Seven: 6 percent/year

Tax credits are nonrefundable. If the amount of the credit exceeds the investor’s tax liability, the investor will not be able to claim the credit that year. The credit, however, may be carried forward for up to 20 years.

Qualified Low-Income Community Investments (QLICIs)
A CDE must use substantially all — generally 85 percent — of the QEI proceeds to make investments in low-income communities as defined by the IRS, including:
- An investment in or loan to a qualified active low-income community business (QALICB), as defined by the IRS;
- A loan purchased from another CDE (this loan must be a qualified low-income community investment);
- Financial counseling and other services to businesses in and residents of low-income communities; or
- Certain investments in or loans to another CDE.

Investment/Compliance Period
By statute, CDEs have up to five years to issue QEIs to investors. CDEs must invest substantially all of the QEI proceeds as QLICIs within one year of receiving them. If a CDE receives a return on principal within the seven years, it must generally reinvest the amount within 12 months so that the QEI remains invested for the seven-year compliance period.

Recapture
During the seven-year period, recapture events would be triggered if the CDE were to:
- Cease to qualify as a CDE;
- Fail to use substantially all of the QEI proceeds to make qualified low-income community investments; or
- Redeem the investor’s equity investment.

A recapture event would require the investor to repay (with interest and penalties) any benefits received from the credits.

Transfer
For-profit and nonprofit CDEs may both be awarded NMTC allocations, but only for-profit CDEs may offer tax credits to investors. Nonprofit CDEs must first transfer the tax credit allocation authority to for-profit subsidiaries, which have also been approved as CDEs.

An investor may not redeem its QEI before the end of the seven-year compliance period. The investor may sell the investment to another investor, who would be entitled to claim any remaining credits.

CRA Test
For more specific information on CRA eligibility, lenders should contact their regulatory agencies. An interagency letter that discusses NMTCs is available at: www.ffiec.gov/cra/pdf/newmarketstaxcredit.pdf.

Program Information
Matthew Josephs, Program Manager, NMTC Program, CDFI Fund, 601 Thirteenth Street, N.W., Suite 200 South, Washington D.C. 20005; (202) 622-9254; josephsm@cdfi.treas.gov
www.cdfifund.gov/what_we_do/programs_id.asp?programID=5

Note: Recent IRS regulations regarding the NMTC program are available from the “IRS Materials” section of the CDFI Fund’s website.

For more information, please contact Erin Mierzwa, Community Development Specialist, Federal Reserve Bank of Philadelphia, Ten Independence Mall, Philadelphia, PA 19106; (215) 574-6641; erin.mierzwa@phil.frb.org; website: www.philadelphiafed.org/cca/index.html.