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**New Markets Tax Credit**

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Background

In the last days of 2000, Congress passed the Community Renewal Tax Relief Act of 2000, creating the New Markets Tax Credit program to encourage investments in low-income communities. These tax credits are intended 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 tax credit. In addition, since the amount of available credit each year is capped by Congress, CDFI Fund holds a competition each year to determine which applicants can accept investments that will earn New Markets Tax Credits.

To date, three competitive allocation rounds have been completed. In the first allocation round, concluded in 2003, 66 organizations were awarded allocations totaling \$2.5 billion in investment authority. Awards ranged in size from \$500,000 to \$170 million with an average award size of \$37.8 million.

In the second allocation round, \$3.5 billion in investment authority was awarded in May 2004. Second round awards were ultimately made to 63 organizations, including several first round allocatees. The average allocation increased from \$37.8 million in round one to \$56.45 million in round two and the median jumped to \$47 million. In all, 32 of the allocatees (or 52%) were described as "mission-driven" organizations (i.e., CDFIs; non-profit organizations; or governmentally controlled entities) or subsidiaries of mission driven organizations. These organizations received allocations totaling \$1.7 billion, with the balance going to applicants associated with public bodies or for-profits. Real estate investing was the clear favorite among financing activities.

The third round awards were announced in May 2005. Only \$2.0 billion in investment authority was available in this round and all of this was allocated among 41 organizations, with an average award of about \$50 million. The maximum award in NMTC authority to any single 2005 applicant was \$100 million. There were key differences between this and prior rounds. According to the CDFI Fund, in scoring the third round, additional weight was placed on

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innovative business strategies and the achievement of more challenging impacts in low-income communities.

The fourth round of allocation awards were recently announced in June of 2006. This round included \$3.5 billion in investment authority for investments nationwide and also included a special allocation of \$600 million for investments in the Gulf Opportunity Zone. Similar to the second round, 63 organizations were awarded allocations in the fourth round, 13 of which will be required to invest only in the Gulf Opportunity Zone. Awards ranged from \$2 million to \$143 million with a median of \$60 million.

The authorizing legislation also provides for an additional \$3.9 billion to be allocated in 2007, and a last round of competition is expected later this year for this amount.

In many respects the new markets tax credit is similar to the low-income housing tax credit, on which it was based. It was designed to bring private investment capital to commercial enterprises in low-income communities, as the housing credit does for housing. However, the credit is based on the amount invested in these communities, either as loans or equity – not on the cost of particular assets or buildings. The credit is also a “shallow” subsidy compared with the housing credit. As a result, investors will generally have to obtain some cash return on their investment in addition to the tax credits, and, as a result, be more subject to the economic risks of the investment.

#### Low Income Communities

In order to qualify for tax credits, 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. At the CDFI Fund’s website ([cdfifund.gov](http://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 qualifying 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.

#### Community Development Entities

In order for these investments in low-income communities to qualify for tax credits, they must be made by specially created entities which are certified by the CDFI Fund. These entities are called Community Development Entities. A CDE may be formed as a domestic corporation, a partnership, or a limited liability company (LLC) and must meet three requirements:

- 1) its primary mission is providing investment capital for qualified active business in low-income communities;
- 2) it has a governing board or advisory board that maintains accountability to residents of such communities; and

- 3) it is certified by the CDFI Fund.

Sponsors will have to form a CDE, or use an existing entity, which meets these tests and apply for certification by the CDFI Fund. As of August of 2006 there are now more than 2290 organizations that have been certified by the CDFI Fund as CDEs. In addition, small business investment companies and community development financial institutions will automatically be eligible to be certified as CDEs.

#### 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 directly serving 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 subsidiaries 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 an LLC, residents of low-income communities may be represented on a governing board or advisory board of the CDE's managing member. 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 be making investments in many areas, it may be necessary to have advisors who have experience with national organizations.

#### Qualifying Investments

Substantially all of the invested dollars must be used by the CDE to make qualifying investments. These qualifying investments 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 a 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, as defined above; 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 are not qualified active 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 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. The IRS has recently published Notice 2006-60 which provides an alternative to the tangible property, employee and services tests described above. 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.

#### How the Tax Credits Work

Once an entity has requested certification as a CDE, it can apply for an allocation of tax credits 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 (corporation, LLC, or partnership). However, if the CDE is a nonprofit corporation and is awarded an allocation of tax credits, it must form at least one subsidiary for-profit entity and get this entity certified as a CDE. It then must transfer its allocation to such entity, in order for investors to invest in the entity and qualify for the tax credits. This is because only for-profit entities can pass through the credits which they have to investors.

If a CDE is selected for an allocation of tax credits, it must enter into an Allocation Agreement with the CDFI Fund for the period during which it is obtaining tax credits (7 years) and also comply with certain annual reporting requirements. The attached Chart shows the allocation of credits to the CDE and the types of qualifying investments by the CDE.

Alternatively, a nonprofit or for-profit entity can become qualified as a CDE and never apply directly for an allocation of tax credits. If it makes loans to Qualified Businesses, these loans can be purchased by other CDEs which have an allocation of tax credits. Moreover, a CDE which has an allocation of credits can 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 CDE.

The CDE has 5 years after it receives an allocation to issue equity investments which qualify for tax credits. If the CDE fails to issue equity investments for all or part of its allocation within 5 years, the unused portion of the allocation will terminate. The cash invested in the CDE must be invested in a Qualifying Investment within 12 months of the date the cash is paid to the CDE.

Unlike the low-income housing credit, the new markets credit is not based on the cost of the asset or business which is receiving the loan or equity. The new markets credit is based solely

on the amount of the investment by the taxpayer who will use the credit. The amount of the credit to the investor will total 39 percent of the invested amount over a 7 year period. In the year in which the equity is invested in the CDE, the investor receives a tax credit of 5 percent of the invested amount. For the next two years thereafter the investor receives 5 percent of the invested amount each year. For the next four years thereafter the investor receives 6 percent of the invested amount each year. For example, for every million dollars which an investor invests in a CDE, the investor will receive a tax credit of \$50,000 per year for three years and \$60,000 per year for the next four years, or a total of \$390,000 in tax credits over a 7 year period.

As noted above, only equity investments in a CDE will qualify for tax credits. Because the amount of tax credits are 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.

#### Recapture Rules

The Final Regulations provide that the recapture rules will track the 7 year period of the credit. If during this period the CDE ceases to be qualified as a CDE, then any credits previously claimed are recaptured. In addition, the tax credits will be recaptured if the CDE redeems the original investor's equity during the 7 year period of the tax credits. Finally, if the CDE ceases to meet the test that "substantially all" (typically 85%) of the proceeds are invested in Qualifying Businesses, the tax credits are recaptured. A CDE has 6 months to cure a failure of the substantially all requirement, and such cure period is allowed only once per QEI during the 7 year period.

#### Investors Eligible for the New Markets Tax Credits

Any taxable investor that makes an equity investment in a qualified CDE is eligible for the tax credits. This includes, for example, individuals, corporations, partnerships, and investment funds. However, the tax credits, like the credits for low-income housing or historic rehabilitation, will not offset alternative minimum tax liability.

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For additional information, contact Herb Stevens, David Schon, Andrew Potts, Greg Doran, Michael Goldman or Merrill Hoopengardner in Washington (202) 585-8000 or Dave Kavanaugh in Boston (617) 345-1000.

**CHART**  
**NEW MARKETS TAX CREDIT**  
**OPTIONS FOR INVESTMENTS**

