



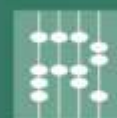
## **Investing in Distressed Communities: The New Markets Tax Credit Program**

WHITE PAPER

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# Investing in Distressed Communities: The New Markets Tax Credit Program

## Background

The New Markets Tax Credit (NMTC) program was enacted by Congress through the Community Renewal Tax Relief Act of 2000 and has been renewed every year since its inception. Like the low-income housing tax credit program, the overarching mission of the NMTC is to revitalize low-income and otherwise distressed communities by providing investors with tax credit incentives to make capital investments into low-income communities. As with any other tax credit program, the NMTC allows investors to directly reduce their tax liability. This differs from tax deductions, like charitable contributions, which only allow a reduction of taxable income.

## How the NMTC Program Works

The NMTC program is governed by two authoritative bodies: The Internal Revenue Service (IRS) and the Community Development Financial Institutions Fund (CDFI Fund) - a branch of the U.S. Department of Treasury. The IRS oversees the application of the NMTC within tax returns through § 45D of the Internal Revenue Code (IRC) and monitors such returns for tax credit recapture events. The CDFI Fund awards NMTC authority—called “allocation”—on an annual basis to Community Development Entities (CDEs) selected from a competitive application process.

In its most recent round of applications and awards, roughly 40% of applicants received allocation, with awards totaling about 22% of the amount requested by applicants. The amount of NMTC allocations awarded in each round is highly dependent on the general economic climate and the needs of specific geographic areas. For example, \$1.5 Billion in NMTC awards during the Seventh Round of Allocations were made possible by the Obama Administration’s American Recovery and Reinvestment Act.

In addition to granting allocation to CDEs, the CDFI Fund ensures that CDEs maintain compliance with an extensive list of requirements found within each awardee’s Allocation Agreement with the CDFI Fund. To date, the CDFI Fund has awarded over \$26 billion in NMTCs through eight rounds of allocations, including a special round of allocations in March 2009 as part of the American Recovery and Reinvestment Act.

## The Application Process

The application process for potential NMTC awardees is highly competitive. Each NMTC candidate must complete a 60+ page application which requires a candidate to detail how it would use the NMTC allocation, if awarded. While the CDFI Fund’s scoring method for these applications is not publically available, it is generally understood that NMTC allocations are awarded to those CDEs which the CDFI Fund believes will provide the most positive impact on distressed communities across the nation. When granted an allocation, an awardee is required to sign its Allocation Agreement with the CDFI Fund. This agreement dictates the terms of the NMTC award including, but not limited to, the involvement of low-income representatives on a

CDE's advisory board, the amount of qualified equity investment (QEI) made to "highly distressed" communities (as defined by U.S. census data) and the geographic area in which the allocatee must use its NMTC award.

Throughout the seven-year tax credit compliance period, a CDE allocatee is required to report its NMTC transactions to the CDFI Fund on an annual basis. These reports, titled the Institutional Level Report and Transactional Level Report, are required to be filed with the CDFI Fund no later than 180 days following the CDE allocatee's fiscal year-end.

### **NMTC Investment Qualifications**

Once a NMTC award is granted and the associated Allocation Agreement is executed, a CDE will typically search for an investor to provide capital in exchange for NMTCs. From the date an investor contributes QEI, the CDE has one year to invest substantially all of the QEI into Qualified Active Low-Income Community Businesses (QALICB). While § 45D of the IRC defines "substantially all" as 85% of the QEI, the Allocation Agreement between the CDE and the CDFI Fund may increase this percentage. The CDE must maintain this investment level throughout the seven-year tax credit compliance period.

Typically, these investments take the form of loans to the QALICBs which must be located in an approved low-income community, as defined by U.S. Census data. In order to ensure that the NMTCs and associated investments are used for the maximum benefit of a distressed community, a QALICB must satisfy the following tests:

- Gross Income Test: A QALICB must earn at least 50% of its total gross income within the low-income community.
- Services Performed Test: At least 40% of services performed for the QALICB by its employees are performed within the low-income community.
- Tangible Property Test: The QALICB must use at least 40% of the tangible property within the low-income community (this threshold is increased to 50% if the QALICB intends to satisfy the Gross Income Test above through a higher percentage of tangible property in a low-income community).
- Non-Qualified Financial Property Test: Collectibles other than those held for the ordinary course of business shall not exceed 5% of the basis of the associated property.
- Qualified Lessee Test: A QALICB may rent the associated property to others provided that the property is neither a residential rental property nor any of the unqualified businesses listed above.
- Substantial Improvement Test: Should a QALICB rent out the associated property to others, **substantial improvements** must be made to the property.

While the IRC has no formal definition for “substantial improvements,” a compliance document released by the CDFI Fund defines the “substantial improvement” threshold as follows:

A CDE must show that the cost basis (as defined in 26 USC § 1012) of any improvements incurred during the 24-month period following the [Qualified Low-Income Community Investment (QLICI)] equals or exceeds 25 percent of the adjusted basis (as defined in 26 USC § 1011(a)) of the building upon which the improvements are located. This ratio will be assessed as of the first day of the 24-month period. In the case of a QLICI being used to provide “take-out” financing (as permitted under Section 3.3(h) of the allocation agreement), improvements equaling or exceeding 25 percent of the adjusted basis of the building upon which the improvements are located must have occurred within the 24 months prior to the QLICI being made.<sup>1</sup>

Additionally, there are other requirements within the IRC that a business must satisfy in order to be considered a QALICB. In general, a QALICB may not be a farm, golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, gambling facility or any operation where the primary business is the sale of alcoholic beverages for use off-site (i.e., liquor stores).

### **Maintaining Compliance**

As with any other tax credit, failure to maintain compliance with the IRS regulations, and specifically § 45D of the IRC, will result in the recapture of the NMTC. Such an event is usually accompanied with penalties and fines. Since the burden of NMTC compliance usually rests with the CDE, recapture could also result in the investor taking action against the CDE (usually through a compliance agreement signed prior to the QEI being made). There are a variety of triggering events within the IRS regulations that could result in a recapture of NMTCs.

- The CDE fails to invest substantially all (85% or more) of the QEI in a QALICB.
- The CDE redeems the investment: It is especially important that the CDE does not distribute to its investor any funds in excess of its taxable operating income during any particular year throughout the seven-year compliance period. Such an excess, dubbed being outside the “safe harbor,” presents the risk that the IRS would deem such distributions as a redemption or return of capital.
- The entity initiating the NMTC ceases to be a CDE.

### **The Future of the NMTC Program**

Because it is not yet a permanent fixture of the United States’ budget, such as the low-income housing tax credit, widespread lobbying is conducted by a variety of groups each year to extend the NMTC program. Strengthened by the increased presence of national banks as investors, lobbyists are currently vying for a five-year extension to the NMTC.

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<sup>1</sup> Source: “New Markets Tax Credit Compliance and Monitoring Frequently Asked Questions: May 2009.” 30 April 2009  
<<http://www.cdfifund.gov/docs/nmtc/2009/NMTC%20Compliance%20Monitoring%20FAQ.pdf>>.

Concurrently, changes continue to be made to the NMTC program and its regulations. For example, the IRS has proposed new regulations which would allow CDEs to test their taxable operating income against distributions over a two-year period.

While it is a relatively young program, the NMTC provides exceptional benefits for distressed communities and investors alike. The CDFI Fund expects that, in the aggregate, the NMTC capital is available to be invested in nearly every state, and in urban and rural communities. Furthermore, the NMTC was named one of the Top 50 Government Innovations during 2009 by the Ash Institute at the Harvard Kennedy School.<sup>2</sup>

Given the NMTC's widespread usage through a variety of communities, it is clear that the program's mission to revitalize distressed communities through private investment continues to be a success – even during these uncertain economic times.

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<sup>2</sup> Source: "Harvard Kennedy School's Ash Institute Announces Top 50 Innovations in Government." 31 March 2009< [http://ashinstitute.harvard.edu/ash/03.31.09\\_Top50.pdf](http://ashinstitute.harvard.edu/ash/03.31.09_Top50.pdf)>.