

The New Markets Tax Credit

A Promising New Tool for Community Revitalization

By Stockton Williams, The Enterprise Foundation



During their six years sharing power in Washington, one of the few things President Clinton and Republicans in Congress agreed on was the need to expand economic opportunity to distressed communities. In the final days of the 106th Congress last December, President Clinton and Congress reached consensus on a bipartisan bill designed to spur increased investment in urban and rural areas that have not fully benefited from the nation's recent historic economic expansion. The "Community Renewal Tax Relief Act of 2000" provides nearly \$26 billion in targeted tax incentives and regulatory relief that is expected to leverage several multiples of that amount in additional community development investment.

The key elements of the Community Renewal Act are:

- an increase and expansion of the Empowerment Zone program;
- a new initiative similar to Empowerment Zones called "Renewal Communities";
- dramatic increases in states' authority to allocate Low Income Housing Tax Credits for affordable apartment production and issue tax-exempt "private activity" bonds for housing, infrastructure and industrial development;
- a tax incentive, entitled the "New Markets Tax Credit,"

to encourage new investment in businesses, economic development and community facilities in low-income neighborhoods.

This article will look at the fourth element of this landmark legislation—the New Markets Tax Credit (NMTC). The NMTC is one of the most promising federal community revitalization initiatives in decades. The credit

enables lending institutions and community development groups to finance or assist a wider variety of projects and activities—from small businesses to retail centers, from manufacturing to high-tech, from charter schools to day care centers—where they are needed most. For lenders, the credit offers new opportunities to gain Community Reinvestment Act consideration, reduce their tax burden, tap new business markets and strengthen the communities in which they do business. For community developers, the credit provides a tool for raising desperately needed equity investment, stabilizing their capital base and attracting additional private investment to their neighborhoods.

While the NMTC is a new program, financial institutions and community groups should find it somewhat straightforward to work with, because it combines aspects of two familiar federal incentives for generating private investment in distressed neighborhoods: the Community Development Financial Institutions (CDFI) Fund and the Low Income

Housing Tax Credit (LIHTC). Like the CDFI Fund, the NMTC will be administered by the Department of Treasury and funneled through a variety of community development entities with expertise providing capital to distressed communities. Like the LIHTC, the New Markets Tax Credit will provide tax relief to individuals and institutions in exchange for their equity investment, provided those investments meet the strict, targeted requirements of the law.

In many important respects however, the NMTC is different from any incentive for community development ever created. Financial institutions and community groups interested in accessing the credit should read the law carefully. To do so go to: <http://thomas.loc.gov/home/c106query.html> and search for "Community Renewal Tax Relief Act." Please note that while the statute tells us much about how the credit will work, many questions, especially regarding when and how credits will be awarded, must await publication of the program's implementing regulations for answers. Those regulations are tentatively scheduled for release in mid-April. Treasury expects to allocate credits later this year.

The NMTC is intended to fill a glaring gap in the otherwise generally well functioning community development financing system—the need for equity capital for business and economic development investment. Because larger venture capital firms typically do business with established clients in established markets, smaller entities committed to investing in tougher areas cannot attract capital investments as readily. This inability handicaps their capacity to identify and cultivate potential projects, raise additional resources and build organizational strength.

This problem represents a real market failure, because, as readers of this

magazine well know, many urban and rural communities have a desperate need for businesses, jobs and services, *as well as the purchasing power and labor force to support them.* These communities in many ways are the most promising new markets for business investment in the country. According to the Boston Consulting Group and the Initiative for a Competitive Inner City, while inner-city consumers constitute \$100 billion in annual retail buying power, unmet demand exceeds 25 percent in many inner-city neighborhoods.

Despite this extraordinary, largely untapped market opportunity, inadequate information and higher risks—both real and imagined—have made many financial institutions, investors and businesses reluctant to commit capital in distressed communities. Those that do invest demand higher rates of return than most investments will yield. The New Markets Tax Credit is designed to bridge that gap. By increasing the after-tax return to investors that provide equity capital, the NMTC will lower risk for investors and businesses, while cutting the cost of capital for community development groups trying to bring business investment to their neighborhoods.

THE MECHANICS OF THE NEW MARKETS TAX CREDIT

The Treasury Department will allocate tax credits to certified "Community Development Entities" (CDEs). CDEs will be able to issue equity interests to investors for which investors may claim the credits, worth approximately 30 percent in present value terms. CDEs must place the tax credits within five years or the credits will be returned to Treasury for reallocation to other CDEs. This year, a total of \$1 billion of investment is eligible for NMTCs. That amount increases to \$1.5 billion in 2002 and 2003; \$2 billion in 2004 and 2005; and \$3.5 billion in 2006 and 2007.

Investors will be able to claim credits based on the amount of their equity investment in the CDE—rather than the cost of the CDE's project(s), as under the Low Income Housing Tax Credit, or the amount of the CDE or investors' investment in the project(s). The investor's equity investment in a CDE must be cash in exchange for stock (if the CDE is a corporation) or partnership interest (if the CDE is a partnership or limited liability company). The equity investment must be paid in cash, not as a bridge loan or commitment to pay. The equity investor's basis in the CDE is reduced by the amount of credit the investor claims, another difference with the LIHTC.

The tax credit is available over seven years—five percent for the first three years and six percent for the next four years, for a present value of approximately 30 percent. This is a relatively modest, although far from insignificant, subsidy. Thus, unlike the Low Income Housing Tax Credit, which generally provides a 70 percent to 91 percent tax credit, the NMTC alone will not be enough to attract investors. Projects financed with NMTC proceeds generally will have to generate economic benefits, such as cash flow, capital recovery and/or appreciation.

A CDE must be a corporation, partnership or limited liability company with a mission of serving or providing capital to low-income people or communities. It is also required to maintain accountability to the residents of those communities by providing for their representation on a governing or advisory board. A newly formed entity could meet the mission and community accountability requirements by referring to a parent organization. A CDE could be a for-profit subsidiary of a community development corporation (CDC) (including a bank CDC), for-profit community development financial institution (CDFI), community development venture capital fund, small business investment company

approved specialized SBICs automatically qualify as CDEs. In allocating credits, priority will be given to any CDE with a track record in community development, which could be the track record of a controlling organization, or to a CDE proposing to invest in businesses unrelated to the CDE itself.

A CDE must use “substantially all” (to be defined in regulations) of credit proceeds to provide financial assistance (grants, loans, equity, services) to “active low-income community businesses” in “low-income communities.”¹ Proceeds can assist virtually any business or enterprise, including other CDEs and nonprofit enterprises, with the following exceptions: golf courses, country clubs, liquor stores, massage parlors, hot tub and suntan facilities, racetracks and other gaming facilities and enterprises principally consisting of farming. Neighborhood retail centers, small businesses, manufacturing facilities, office space, childcare centers, charter schools, health care facilities and mixed-use projects that combine these uses are examples of projects that could be eligible for New Markets Tax Credit investment.

Also, housing generally is not intended as an eligible investment; the forthcoming regulations will provide more clarity on this. A CDE may provide investments to a business it owns in whole or in part. Qualified businesses must derive at least half their gross income from business in a low-income community. In addition, a “substantial portion” (to be defined in regulations) of their tangible property, as well as a substantial portion of services performed by their employees must be

¹ *Low-income communities are census tracts with a poverty rate of at least 20 percent or with median income not exceeding the greater of 80 percent of area median or statewide median income and, for a non-metro census tract, 80 percent of statewide median income.*

in a low-income community. A trade or business can be owned by or a branch of a larger corporation, provided that it is separately incorporated.

The credit may also be used in “targeted areas” within census tracts that do not meet the poverty or median income standards. Targeted areas must have pre-existing boundaries, such as established neighborhood, political or geographic boundaries, meet the poverty rate or median income standard as if they were census tracts and have an inadequate access to investment capital. A CDE may invest in one or more low-income communities or targeted areas. A CDE that falls out of compliance with requirements of the NMTC, such as by failing to maintain community accountability or invest substantially all of its credit proceeds in active low-income community businesses, risks recapture of its credits by the Treasury Department. Regulations will clarify how recapture will work and what flexibility a CDE will have to correct noncompliance before recapture occurs.

Any institution or organization committed to community revitalization should be enthusiastic about the New Markets Tax Credit, which has the potential to transform the financing of business and economic development in distressed areas. It is a particularly promising tool for encouraging profitable partnerships between lending institutions and community-based organizations. Lenders could invest in community group-established CDEs, provide financing to CDE projects and help CDEs raise additional resources. All such activities could benefit a lender’s bottom line, help it qualify for CRA credit and develop new customers, business lines and markets. Community groups and the neighborhoods they serve stand to benefit mightily from this increased private investment and economic opportunity.

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